PORTFOLIO REVIEW

FLYING COLOURS LIFE
Investment Management

Review date: 12/01/2021

PORTFOLIO REVIEW 2020

2020 has been a year marked by a viral pandemic, the UK's departure from the European Union, a tightly contested election in the United States and the worst global recession since WWII. Lockdowns have transformed the way we work and do business; restrictions on movement have decimated hospitality, retail and travel industries.

Yet many equity markets have ended the year near record highs and all Flying Colours portfolios have made investors money in 2020.

The table below shows the annual returns relative to Morningstar category averages, which have broadly similar equity levels to our own portfolios.

It is only when you dig beneath the bonnet and look at regional and sector returns that the true picture of 2020 becomes clear. Global technology stocks are up 39%, global energy down 33%; Asian equities up 19%, UK stocks down 11%; and long-dated UK government bonds up 14%, emerging market bonds down 0.5%.

The 70% spread in equity sector returns in a single calendar year is the most obvious evidence of volatility that has hit the markets this year. The fact that our longer risk portfolios have outperformed the higher risk profiles is another hint of the year it has been.

HOLDINGS

Fund Name	Return Date (Month End)	Total Return 1Yr (Month End) GBP	Total Return Annlzd 3Yr (Month End) GBP	Total Return Annlzd 5Yr (Month End) GBP
Flying Colours: Dynamic Defensive	31/12/2020	7.95	4.69	6.38
Flying Colours: Core Defensive	31/12/2020	8.06	5.04	6.93
EEA Fund GBP Cautious Allocation	31/12/2020	3.80	2.93	4.46
Flying Colours: Dynamic Conservative	31/12/2020	6.56	4.54	7.02
Flying Colours: Core Conservative	31/12/2020	7.04	4.98	7.84
EEA Fund GBP Moderately Cautious Allocation	31/12/2020	3.83	2.91	4.43
Flying Colours: Dynamic Balanced	31/12/2020	5.88	4.50	7.43
Flying Colours: Core Balanced	31/12/2020	5.91	4.77	8.46
EEA Fund GBP Moderate Allocation	31/12/2020	4.10	3.37	5.51
Flying Colours: Dynamic Growth	31/12/2020	5.64	4.59	8.12
Flying Colours: Core Growth	31/12/2020	4.38	4.45	8.96
EEA Fund GBP Moderately Adventurous Allocation	31/12/2020	3.80	2.93	4.46
Flying Colours: Dynamic Aggressive	31/12/2020	4.51	4.47	8.70
Flying Colours: Core Aggressive	31/12/2020	2.37	3.94	9.20
EEA Fund GBP Adventurous Allocation	31/12/2020	6.97	5.59	9.06

IMPORTANT INFORMATION

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SO, WHAT HAS WORKED FOR OUR PORTFOLIOS AND WHAT HASN'T IN 2020?

The key contributor to returns in our lower risk portfolios has been the allocation to government bonds. This positioning has been a mainstay of the Flying Colours portfolios since launch and continues to generate excellent returns in times of market stress.
We own a blend of government bonds issued by the United Kingdom, United States and Japan. All three markets enjoy excellent credit ratings, de minimis default risk and robust demand from pension funds, insurance firms, sovereign wealth funds and more recently from governments (via QE programmes).

Yields are now near record lows and future returns are likely to be lower as a result, but the asset class should continue to provide diversification benefits when the next downturn comes, given their safe-haven status. You need to have some very good reasons to explain why a 40-year bull market in government bonds is going to go into sharp reverse.

The second factor behind the portfolios' success has been prudent exposure to debt issued by corporates rather than governments. Going into the pandemic, our corporate bond positions were at lower weights and of significantly higher quality than peers (when measured by the credit rating agencies) and as a result, protected capital far better than most peers.

In March and again in May, we increased the exposure to credit assets, thus capturing some of the gains in the recovery, but not owning any high yield or emerging market debt in the downturn was a real boon.

The outperformance of the Defensive, Conservative and Balanced portfolios was excellent in 2020, however the returns of Growth portfolios were in line with peers and Aggressive lagged.

EQUITIES

The story for the latter two portfolios has been the equity positioning – in particular, the allocation to UK equities; in other words, the size of the home bias. The underperformance of the UK equity market, and outperformance of the US equity market, has been defining feature of the equity landscape for British investors this year.

Brexit uncertainty has clearly been a driver of the poor UK equity market returns. Investment flows into UK equity funds have been negative since the Brexit referendum vote, M&A activity lacklustre and sterling, weak.

However, the underperformance has not only been a Brexit story; it has also been wrapped up in commodity price weakness and Value vs Growth.

The UK equity market has a sizable weight to energy (8%) and mining companies (10%) and as commodity prices fell, so too did the stock prices of index heavyweights like BP, Shell, and Rio Tinto. In addition, value sectors make up more than a third of the index and the UK has very little weight in technology, especially in the large caps.

Our view is the valuation gap between Value and Growth stocks has become too extended and that this, combined with an expectation of economic improvement in 2021, will catalyse a shift into more value and cyclical sectors. UK equities should benefit from this trend.
In February, we updated the strategic asset allocation which underpins our portfolio positioning. At this time, we increased the exposure to US equities and reduced our UK equity weight. However, when compared to peers, the move was moderate.

What stayed our hand in shifting more to the US?
The UK market remains comparatively cheap – both versus other asset classes and relative to other equity markets.

The dividend yield is roughly 3.5% above the UK 20-year Gilt yield, high even relative to the history of recent years. And the UK market is on a 35% P/E discount to the US.

It should also be noted the UK has not always been an underperformer; from 1970 to 2009 the FTSE All-Share was up 7.6% per annum, slightly above MSCI World at 6.3% per annum. But since 2010, the UK market has lost roughly half of its value versus the World index.

As well as holding UK equities at a reasonable size, we have also bought a low-cost global value fund, managed by Dimensional Fund Advisors.

This fund follows a rules-based process seeking to buy firms with higher-than-average profitability trading on lower-than-average valuations. This position has already enhanced returns for our portfolios since its purchase in May 2020.

OUTLOOK

As we enter 2021, vaccines bring hopes of reopening and a return to normal, but the reality is that markets and the world are constantly evolving.
At Flying Colours, we do not build our portfolios around a single macro-economic view or forecast, and many of our positions are similar in size to when we launched in 2015. However, given the volatility, we have been shifting our portfolios in 2020 to take advantage of some of the dislocations in the market.

Economic activity remains deeply depressed throughout most of the world and unlike most other business cycles throughout history, the world economy today is being held back by a public health crisis caused by a contagious virus. As a result, the economic and market outlook largely depend on the prospects for controlling the virus.

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As vaccines programmes take hold, we believe there is room for a cyclical recovery to take place and for both value stocks, and small- and mid-cap firms to outperform. Both are trading on lower than average multiples and we have initiated positions in both these themes, at what we believe are excellent entry points for investors.

Another theme that is prevalent in our portfolios is the consequences of proactive fiscal policy. Government spending has been a pillar of the recovery – for example, the UK Government's budget deficit is reaching levels last seen in WWII - and we expect structurally higher spending going forward. The outcome of this spending is unclear but there's a possibility that higher spending means higher rates and higher inflation.
As a result, we introduced global inflation linked bonds – which are structured to provide protection against inflation - and gold-mining shares – which should perform well in rising inflation environments - to our portfolios in 2020 as a hedge against this possibility.

As ever, we remain true to our core beliefs – that simple, low cost, low turnover and well diversified portfolios will deliver the best returns for investors. This belief has been borne out with excellent returns over the past five years and we are confident we can continue this success over the next five.

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