The Pulse June 2024

EQUILIBRIUM

# Protecting portfolios

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## Executive summary


- **Investors appear to be drawn to rising markets. In particular, the main US stock market (S&P 500 index), has exceeded analysts' predictions.**
- **This has helped portfolio returns as (for example) we have over 10% US equity exposure in our Balanced fund and more than 35% US exposure in Global Equity. However, as stated previously, this strong performance raises the possibility of a correction at some point.**
- **We have somewhat reduced equity exposure in our core portfolios following the kick out of a few defined returns products, and some of these proceeds have been used to top up bonds. However we don't want to reduce exposure too much in case markets continue rising.**
- **We believe it is likely that there will be a correction at some point, albeit short-lived, as opposed to a full bear market (a fall of 20% or more).**
- **A correction provides us with a buying opportunity where we can top up equities at a relative low and then benefit from any uptick.**
- **Even in the worst-case scenario, markets have always recovered from bear markets eventually.**
- **Another way to protect our portfolios against a downturn is to take out some insurance.**


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- **By this, we mean a "put option" which, like any other insurance policy, comes with an "excess".**
- **It doesn't cover the first 10% of any fall, which can be managed through rebalancing our portfolios.**
- **For a sharper downturn of 10% or more, our insurance policy (based on the S&P 500) will pay out, enabling us to maintain greater market exposure than we might otherwise be comfortable with.**
- **We may have to bear the cost of the insurance premium if the market does go up, but it's a small price to pay for the peace of mind it gives.**
- **It is difficult to foresee what impact the upcoming UK and US elections will have on markets, which is another reason why we want to add some "insurance" to portfolios right now.**

We've been making the point recently that it's been quite a while since we've had a stock market correction.

As we explained in last month's **The Pulse – Corrections and opportunities**, equities tend to see frequent corrections, and it's rare that we go through a 12-month period without a 10% decline, for example.

Equities have been doing well since last autumn, especially in the US, where we haven't even seen a 5% pullback in that time.

Volatility is very low, and sentiment is buoyant. This sounds positive, but as Warren Buffett pointed out, it often pays to: "be fearful when others are greedy, and greedy when others are fearful". Right now, investors seem to be mainly focusing on the upside, not the downside. They are getting greedy.

This is despite the fact that the main US stock market (the S&P 500 Index) has already gone up much further than most Wall Street analysts were predicting earlier this year.

**Chart one** shows what the various investment banks thought the market would reach by the end of 2024. The forecasts were all made in December 2023. The yellow bar is the average forecast, the blue bar is where we are today!

Given the above, we have been reducing equity exposure in our core portfolios as markets rise. This is primarily because some defined returns products have kicked out. We have used some of the proceeds to top up bonds, which we think have attractive yields at present, rather than reinvesting back into defined returns or directly into equities.

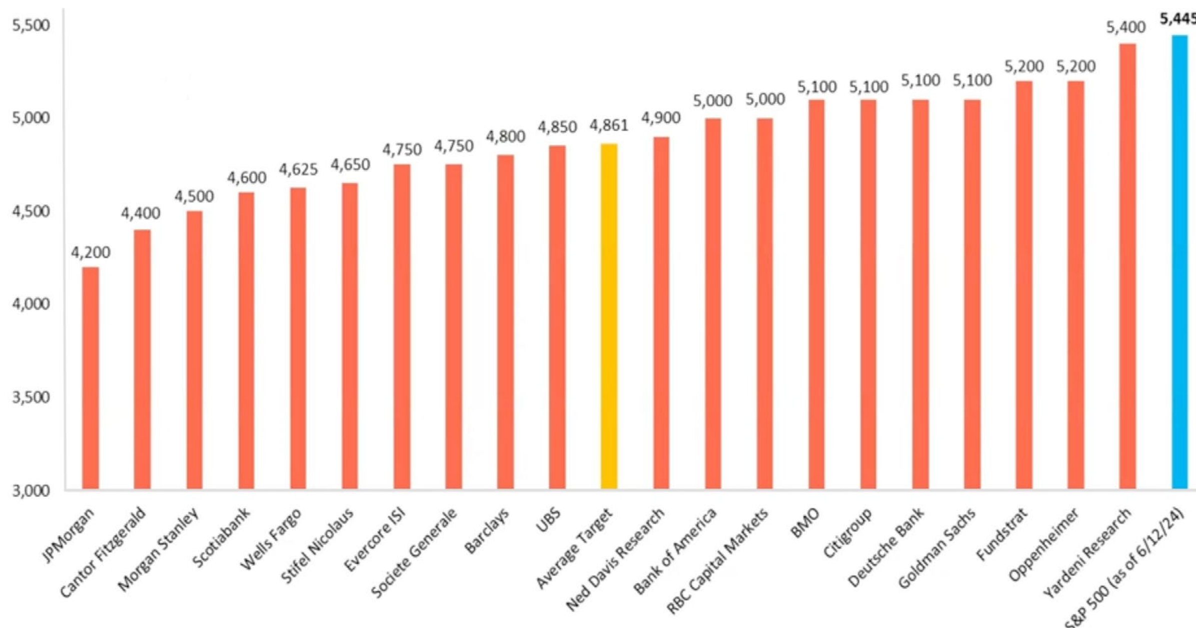
However, we won't make big shifts out of equities for one simple reason - we could be wrong.In fact, we hope we are wrong! Hopefully, markets will continue to go up for a long time without even a blip.

However, we think a more likely scenario is that we get a correction at some point but it will be relatively short-lived and not turn into a full bear market (a fall of 20% or more).

If this happens, we will plan to use this as a buying opportunity, potentially reducing bond exposure to top up equities at a relative low, and then benefit from any rebound.

Of course, we could be wrong in a different way, and the market could fall further than we expect, meaning topping up equities after a 10% fall could worsen short-term losses. But even in that scenario, history shows markets have always recovered from past bear markets eventually.

**Chart one:** S&P 500: Wall Street's 2024 year-end targets vs. current level (Target data via Bloomberg in December 2023).




Source: Creative Planning, 12 June 2024

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## Hope for the best, prepare for the worst

Another way we can guard against a downturn whilst still benefiting from any gains is through insurance.

Similar to home insurance, we pay a premium and hope the policy never pays out!

We can also buy insurance against the stock market falling. Again, if the market doesn't fall, we lose the insurance premium. We hope the policy never pays out, but if the market does fall sharply then we might be glad of the insurance.

Most insurance policies have an "excess", which means that we suffer the first bit of any loss. This keeps the cost of insurance lower. If there wasn't an excess on our house insurance, then we could claim for every little thing that breaks or goes wrong, which would be very expensive for the insurer (and ultimately lead to higher premiums).

Our stock market insurance (called a "put option") also comes with an "excess"; it doesn't cover the first 10% of any fall. The first 10% represents a normal correction which we would deal with through rebalancing the portfolio as mentioned above. However, a sharper downturn – whilst we don't expect it to happen - would have more of an impact.

Our insurance policy is based on the S&P 500 Index, and we pay around 3.4% of the amount we want to insure. So, to insure 10% of the portfolio (roughly the amount of US equity exposure in Balanced, for example), it will cost 0.34%. This is pretty cheap relative to history, given how unconcerned investors seem to be about a drop in markets.

The policy will pay out if the market drops 10% from the highest point over the next 12 months, reducing the losses.

Having this insurance allows us to keep market exposure higher than we might otherwise be comfortable with, offering protection against a (hopefully unlikely) sharp fall in markets.

It does mean that we make a slightly smaller gain if the market goes up due to the cost of the insurance premium, but we think this is a small price to pay that allows us to sleep better at night.

## Election fever

Since the last edition of The Pulse, there has, of course, been an election called.

In the March edition of **The Pulse**, we showed how, historically, the party in power hasn't significantly impacted UK markets.

Of course, if the polls are correct then we are likely to see a Labour government next month. Given the size of their lead, this is already to a large extent factored into market expectations.

The Labour Party has ruled out major tax increases including hikes to corporation tax, income tax, national insurance and VAT, although interestingly they have simply said they have "no plans" to change capital gains tax (which means they still might...).

Their manifesto puts economic growth at the heart of their plans. If they are successful at "kickstarting the economy" then, along with plans for infrastructure and renewable energy investment, this could be a net positive for UK investments. Whether or not they are successful is a different question!

More significant for markets is likely to be the US presidential election later in the year. If Trump is elected, it seems likely he will try to increase trade tariffs, cut taxes and potentially increase spending. This could have implications for growth in the short term, but also for US government debt and inflation. It could also mean higher interest rates for longer.

Without more detail on actual policies, it is difficult to assess the impact at this stage, but the uncertainty this brings is one more reason why we'd like to add some "insurance" to the portfolios right now.

*Past performance is for illustrative purposes only and cannot be guaranteed to apply in the future.*

*This newsletter is intended as an information piece and does not constitute a solicitation of investment advice.*

*If you have any further questions, please don't hesitate to get in touch with us on **0161 486 2250** or by reaching out to your usual Equilibrium contact.*

## Factsheet links

Take a look at our monthly fund factsheets to find our positioning on each.
To view the latest factsheets please visit:

**equilibrium.link/IFSL-Equilibrium-fund-factsheets**

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