Market Perspective

Ten years gone | Aggressive passive?

Issue 95 | September 2017

Rothschild
Private Wealth

Foreword

Investors returning from the beach may find that little has changed.

The US and Europe have been growing healthily, and still without any serious outbreak of inflationary pressure. Corporate profitability is improving alongside only modest interest rate risk. Hurricane Harvey is a humanitarian crisis, but not an economic one.

Market dynamics themselves offer more cause for concern – if today's low-volatility markets can be said to have any, that is. Alleged investor hubris, the absence of a significant setback for more than a year now, lumpy US stock returns (which are also fuelling the debate about passive investing – see the second essay on page 5), frothy credit markets, and echoes from the 10-year anniversary of the start of the Global Financial Crisis (GFC), are unsettling. But we still meet few complacent investors, and stock valuations are not yet alarming. Earnings are rising faster than stock prices.

Geopolitical risk has mutated again these last few weeks. But North Korea's aggression has achieved the rare feat of unifying much of the rest of the world. Meanwhile, the much-feared protectionist policies (or indeed, any big policies at all) of the US administration have yet to materialise, France is toying with liberal reforms that were not even on the radar six months ago, and Chancellor Merkel seems poised to retain office. UK politics continues to undershoot low expectations – but we still think the impact on investments is manageable.

There are plenty of profits to be taken if nervous, benchmark-chasing institutional investors want to, and many possible triggers for that long-overdue setback. But we are not yet convinced that growth-related assets have run out of longer-term, inflation-beating headroom, and continue to advise that investors respond constructively to higher volatility.

Kevin Gardiner
Global Investment Strategist
Rothschild Wealth Management

Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

Publication date: September 2017.
Values: all data as at 31st August 2017.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

Ten years gone

Risks centre on market dynamics and geopolitics rather than economics

"Then as it was, then again it will be..."
Page/Plant

Growth, but still no inflation
We know this is a long cycle, but there were always good grounds for thinking it might be. The retrenchment after the GFC was massive. With the average US household even now acting as a net source of liquidity, rather than as a reckless borrower, there are still few signs of the excesses that often herald renewed retrenchment.

Similarly, there are few signs of the sort of inflation risk that might push the Federal Reserve into normalising interest rates and its balance sheet more dramatically. Even in the UK, where import prices surged after sterling's slide, and real wages are being squeezed again, the pressures have been smaller than we'd have guessed.

We are not ready to relax completely on this score. Even if inflation stays put, real interest rates are still very likely to rise over the months and years ahead. But a dramatic acceleration in costs and prices, and a more sudden normalisation of policy and of bond yields, feels even less likely than it did. Meanwhile, low inflation does not seem to have hurt profitability or employment.

Are markets themselves the danger?
If the economic news remains healthy, the workings of markets themselves have moved up the wall of worry. Concerns might perhaps be grouped under three related headings – investor sentiment; valuations; and echoes, as its 10th anniversary approaches, from the GFC.

Investor sentiment The price of portfolio insurance, measured by the VIX index of implied volatility, the so-called "fear index", recently dipped to a quarter-century low, even as the S&P500 was hitting new highs. A big chunk of recent market gains can be traced to just a handful of stocks. Is complacency fuelling another bandwagon?

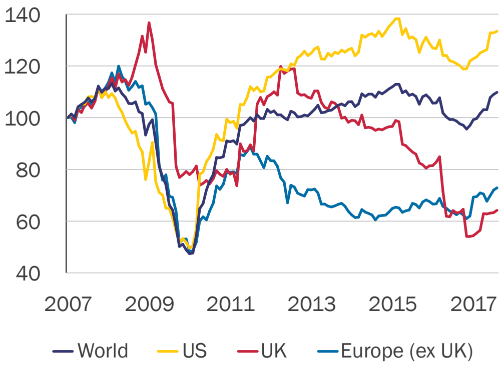
We think not. The bear market in implied volatility since the GFC does not reflect a newly perceived lack of danger. The big central banks have remained in firefighting mode, and this very public commitment can itself be seen as a form of free portfolio insurance, mitigating the need to pay for it directly. Those low interest rates may also have encouraged yield-seeking investors themselves to sell insurance (writing options can generate premium income).

The contribution made by the "FANMAG" stocks – Research Affiliates' acronym for Facebook, Apple, Netflix, Microsoft, Amazon and Google (as was) – to total market gains this year, while disproportionate, is not outlandish. Roughly one-third of the US market's total return in 2017 has come from these six stocks – a lot, but not unprecedented (in 2015, this group contributed 3 percentage points to a market return of just 1).

Sector returns were much more concentrated in 1999, ahead of the eventual bursting of the "TMT" (tech, media and technology) bubble in 2000. Then, technology alone delivered two-

Figure 1: Corporate earnings are rebounding

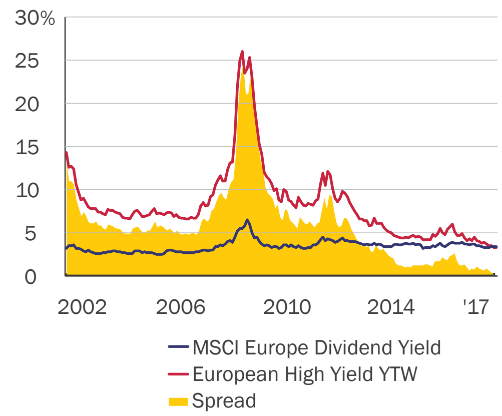
Trailing local currency earnings per share, indexed



Source: MSCI, Datastream, Rothschild & Co

Figure 2: Speculative grade credit is now "high yield" in name only

European speculative grade credit yields and equity dividend yields, %



Source: MSCI, Datastream, Rothschild & Co thirds of the 21 percentage point index total return. In 2017 to date, and in the last five years as a whole, it has contributed one-quarter of the market's 11 (in 2017) and 95 (last five years) percentage point returns.

Valuations As stock prices have risen further, concern over valuations has grown. But behind the scenes, corporate profits have recently been rebounding (figure 1), and trailing PE ratios are falling back from the levels to which they rose as oil profits fell in 2015/2016. Valuations are still higher than usual, but not prohibitive. Compared to the 2000 bubble, most valuations are materially lower – for example, forward PE ratios in the US are around 19 (20 in technology), compared to a peak of 27 (54) in 2000.

Relative to money and bond markets, equity markets do look cheap. But we should not rely on these comparisons: we expect interest rates and bond yields to rise gradually from their historic lows.

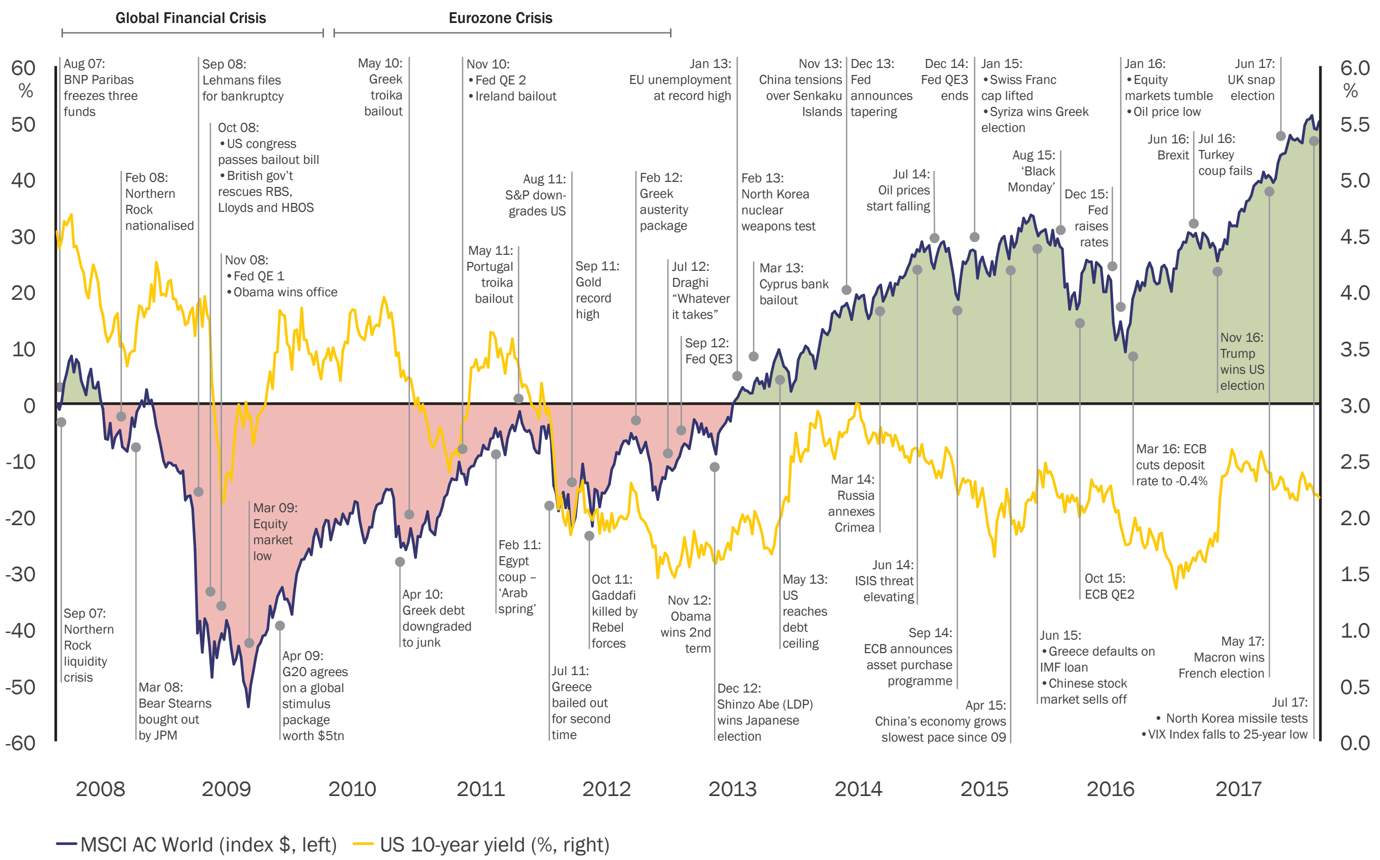
That said, when allowance is made for low inflation, interest rates and bond yields look less unusual now. There are perhaps more signs of froth in credit markets. Investment grade credit, like the government bond market, is also being boosted by the ECB's ongoing purchases. Yields would be lower still were it not for recent issuance. Speculative grade credit may be most fully valued: in Europe, yields have dipped to match those on stocks for the first time (figure 2).

Echoes of the GFC The anniversary is prompting some soul-searching, and markets are being scrutinised for signs of history repeating or rhyming.

There have been some eye catching developments recently. Negative government bond yields and money rates; tight credit spreads amidst surging corporate bond issuance; Argentina, a serial defaulter, issuing an oversubscribed 100-year bond; Greece raising new bond finance while still in a bailout programme; financial innovation in sub-prime territory, this time in auto finance; resumed sub-prime lending in the US housing market; the return of covenant-lite security, and complex securitisation; and perhaps the absence of comprehensive deleveraging (consumer and government balance sheets are bigger than ever).

Figure 3: A decade in markets

Charting the financial impact of major economic and geopolitical events over the past 10 years



Source: Rothschild & Co, Bloomberg, Financial Times
Note: MSCI AC World data shows cumulative total returns from 31st August 2007 to 31st August 2017. Green shading denotes outperformance and red shading denotes underperformance relative to start date.

Meanwhile, as noted, most assets seem to be either fully valued or expensive, just as the interest rate cycle is slowly turning a corner.

Some comparisons are more favourable, however. Banks are less geared than in 2007 (figure 4), and fewer expensive and complicated investments are owned with borrowed money. Banks are also less dependent on wholesale deposits, and interbank spreads are docile. Housing loan-to-value ratios are lower.

A wholesale deleveraging was never likely, because the GFC was not about aggregate solvency. Steve Eisman, a prominent and successful bear in 2007, said recently, “for the first time in my working life, which is more than 30 years, I would regard the financial system as safe.”

We are not saying “it is different this time” – these are the most dangerous words in investing. But those historical rhymes can be overstated: while crises and recessions recur, it is a *bit* different *every* time.

Geopolitical tension: the focal points shift

How concerned should we be that the US administration has delivered little to date? Not very. US government is often dysfunctional, and brinksmanship over the debt ceiling (next deadline in December) is common.

The “reflation trade” was always overstated: US growth was already set to continue, and earnings were going to rebound once oil prices stopped falling. Substantial tax cuts would have been icing on the cake. Protectionism seemed more central to the likely agenda, so the failure of the administration (so far) to deliver is an absence of bad news. A case of “bad food – and such small portions”, perhaps.

President Macron may also be unpopular but he is pressing ahead with attempted reform of the French labour market. That he is even in a position to do so is a better investment outcome than feared at the start of the year. The big unions are (again, so far) less hostile than they could have been.

Policies that seek to protect something often end up harming it – whether that be US manufacturing or French employment. Conversely, making it easier to negotiate pay and more flexible working practices will eventually help boost jobs.

Barring a UK-style surprise, German elections later this month seem likely to give Chancellor Merkel another solid mandate. Migration remains an understandably contentious issue in Germany as elsewhere, but anti-EU populism may not be making much headway. A revitalised Franco–German leadership of the European project is possible.

Ironically, the things we worried about at the start of the year (US idiosyncracies, anti-EU populism) we shouldn’t have, while some things we didn’t worry about, we should have – such as UK political instability. Britain will get little credit for helping inspire any EU relaunch. The interminable discussion and debate around the UK’s leaving the EU feels more costly than any likely net economic boost or burden from secession itself. Our view has been (1) that leaving will be bad news for UK business, but not a game-changer, while (2) the UK government’s negotiating position is weak, whoever is in power, and anything other than a “hard” Brexit will reflect goodwill on the part of the EU partners.

The most pressing development these last few weeks has been the escalation of risk around North Korea and its nuclear weapons programme. As yet, markets have been little moved – another indication, some might argue, of investor complacency.

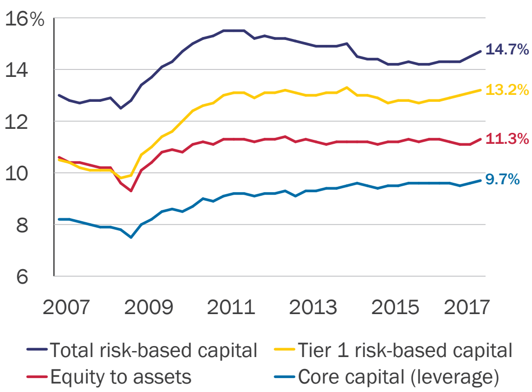
We would not pretend any geopolitical expertise, and we can imagine a safer pair of hands at the White House (though probably not before 2021). But we can understand that market response.

We noted in February how even some stark political risks – such as the Cuban Missile Crisis – can be shrugged off by markets, which focus callously on the narrow bottom lines of interest rates and profitability.

Actual conflict would be unthinkably grim, but you need to be pretty sure it’s going to happen before stepping off the forward-moving investment train. North Korean aggression may be born of defensiveness: the regime is in a tight corner. Tougher sanctions are still available, and China in particular is likely very active behind the scenes.

Figure 4: Bank balance sheets are less leveraged now

US capital ratios (Q2 2007 to Q2 2017)



Source: Rothschild & Co, FDIC

Investment conclusions

Stocks still remain our preferred asset. We have lost track of the number of times we have noted that a significant setback feels overdue, and that the cyclical clock is ticking. Nonetheless, we think that the investment climate – growth with relatively modest inflation risk – remains temperate, and geopolitical risk manageable.

- Stocks still do not look to us to be troublingly expensive, and remain the most likely asset to deliver inflation-beating returns. Restructuring portfolios in an attempt to avoid a short-term setback could leave us stranded if markets rally.
- Most government bonds do look expensive: yields remain below likely (modest) inflation rates. We still prefer high-quality corporate bonds (credit), but they are also unlikely to deliver positive real returns. We view bonds and cash as portfolio insurance.
- We continue to favour relatively low-duration bonds in Europe. In US dollar portfolios we see some attraction in inflation-indexed bonds. Speculative grade credit looks to be running out of cyclical headroom in the US, and now valuation headroom in Europe.
- Our top-down regional conviction on stocks remains low, though we prefer them to bonds in most places, even the UK (where the large-cap indices are driven by global trends). We still prefer a mix of cyclical and secular growth to more defensive bond-like sectors – a preference that has, if anything, strengthened slightly in the last month.
- It is not possible systematically to add value by trading currencies. Our exchange rate conviction, rarely high to begin with, has faded further. The dollar has most cyclical support, but is expensive, and the biggest positive surprises have been coming this year from the eurozone, where political rejuvenation is still not priced in. The Swiss franc remains the most expensive big currency, and this (alongside a more stable euro) seems to be mattering again. We still think the pound overreacted to the EU referendum, but our conviction there fell on the election result, and the Bank of England is dragging its feet on interest rates. Similarly, we still believe the yuan will falter again, but for the time being China's growth and slowed liberalisation is underpinning it. On a one-year view we rank sterling highest, the yuan lowest, and other big currencies somewhere in between.

Aggressive passive?

A needlessly polarised debate

Active and passive investing revisited

The big contribution made recently by a small group of stocks to US market returns has raised eyebrows. We suggest earlier that it is not yet a troubling indication of a new mania. Nonetheless, it is fuelling the long-standing debate about whether investment portfolios are best managed actively or passively.

A "passive" investment, remember, is one that mimics a particular market index (hence they are also known as "index trackers"). A passive investment in the FTSE 100 index, for example, might hold each of the 100 stocks in the proportions in which they are represented in that index.

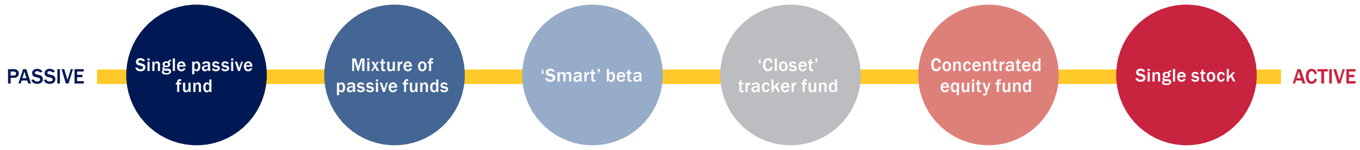
In practice, small divergences occur, depending on the technical method chosen to track the index. Otherwise, as its label suggests, a passive fund is largely inert, its positions dictated solely by the index it tracks. Because it follows a predetermined formula, it needs little research and marketing support. As trading has become more automated, costs have fallen further, in some cases (usually in the largest and most liquid markets) to less than 0.1% per annum (before adding any platform charges).

In contrast, an "actively managed" investment is free to hold pretty much any stock or bond, and in any amount, subject to the broad constraints and risk controls specified by the prospectus (which might label it as, say, a "UK large cap fund"). The fund can thus perform quite differently to the market indices associated with its chosen universe.

Those indices can be viewed as "benchmarks" for the active fund, and its manager might expect to be judged by how it performs relative to them. The FTSE 100 is a large-cap index, and a common benchmark for a UK large-cap fund, but other index providers exist, including MSCI, S&P, and so on.

Figure 5: A view of the passive–active spectrum

We believe choosing a suitable investment strategy should be determined by your objective



Source: Rothschild & Co

Rule-based funds, such as the fashionable "smart beta" funds, which use, say, earnings-based weightings for stocks, or follow a designated "style", sound passive, and can have lower charges than many active funds. But they can still diverge meaningfully – in both directions – from the mainstream indices.

The average investor cannot beat the market: performance is a zero-sum game. For each investor who has an overweight position in a stock, another one (or several others) has to have a corresponding underweight position. The question is whether divergences from the average are persistent – do some investment managers demonstrate consistently better returns? If not, and if returns are all that matter, then the lower-cost passive fund becomes more appealing.

Some active managers focus not on beating an index, but on preserving real wealth by delivering returns in excess of inflation. Others target an absolute return, sometimes a specific number mandated by their clients. But independent advisers are still likely to judge the effectiveness of the managers by referring to whether or not the specified objectives could have been achieved by using cheaper passive funds.

The portfolio managers here at Rothschild Private Wealth aim to preserve and grow real wealth, but take a markedly longer-term view than most. Our New Court Fund managers' main frame of reference is the company: they seek reasonably valued businesses with a sustainable competitive advantage, irrespective of region or sector. Their resultant "bottom-up" view pays little direct attention to average market returns.

Actively managed investment charges are bigger, and not simply because they trade more often and have higher research and marketing costs. In theory, active funds also charge for their ability to deliver better returns. In practice, however, their performance is often no better than passive funds. Collectively, it can't be – as noted.

This is a big difference between selling investment funds and other products.

If you are buying a car, for example, you can choose between a basic low-performance economy model, or a fancier, zippier luxury one. The price you pay will be linked closely to the driving experience you get.

Your investment experience, however, is not so closely linked to its cost. There are no high-cost, high-performance models clearly labelled as such in the investment showroom. There can't be, because investments are much more difficult to predict than motoring experience, and because of the law of averages (what if everybody wanted to own a high-cost, high-performance fund?).

Historical returns, in particular, are no guarantee of future performance – as regulators rightly insist on reminding us.

This doesn't mean that high-cost, high-performance funds don't exist: many do. But it takes careful due diligence and monitoring to identify those with the necessary horsepower, and even then there are no guarantees that it will be translated into on-the-road performance. For sure, you can spot the expensive suppliers – likely charges should be clear. But you don't know for sure whether they will actually deliver.

Many don't deliver. Lower-cost runabouts – those passive investments – often do better in practice than sportier investment vehicles. The most expensive group of active investments – hedge funds – appear to have collectively lagged both stock and bond markets over the last five years. The difference seems too large to be explained by their higher fees, or by their having non-traditional objectives (such as those absolute return mandates noted above). The average hedge fund may have been marketed as a Porsche, but it drove like a bus.

This does not mean the managers of hedge funds or active funds generally are not smart, hard-working or ethical. It does mean that intelligence, effort and good intentions are not always enough: investing is about the future, and the future is profoundly unpredictable. Similarly, some successful active managers may not have been any of those things, but just got lucky.

Some active managers effectively deliver average performance by holding large numbers of securities in a mix similar to that of the index. Again, this may not be deliberate – they may be inadvertently over-diversifying in an attempt to reduce risk. But such a fund is arguably a closet tracker, and should be priced accordingly.

Why passive is on a roll

Burton Malkiel's *A Random Walk Down Wall Street*, first published in 1973, popularised the idea that it is difficult to "beat the market", and did a lot to foster growth in passive investing. (He became a long-serving trustee of Vanguard, a pioneer index-tracking firm, and one of the three dominant firms in the sector today.)

Passive funds are intuitively attractive because, as Malkiel pointed out, financial markets are often pretty efficient.

This does not mean they necessarily deliver an optimal or rational outcome. Rather, an "efficient" market in the investment jargon is one that quickly prices in all relevant publicly available information.

It might move in mysterious and arbitrary ways, but the key thing is that it is difficult to outperform it by picking stocks or timing trades using data in the public domain – as opposed to private, "inside" information. (There is a "strong" version of the efficient market hypothesis which suggests that even private information does not give investors an edge, but we urge readers not to test this hypothesis themselves.)

Malkiel suggested that many professional investment selections had been no better than those produced (in a famous and provocative analogy) by a blindfolded monkey throwing darts at the financial pages.

If markets are efficient, then the usefulness of analysing the public accounts of companies, or trends in economic data, is reduced. The actions and intentions of thousands of investors and traders interested in the outcome might ensure that the value of such knowledge is immediately reflected in market prices as soon as it is known.

This doesn't mean that (say) disappointing company results or a surprising surge in retail sales don't affect stock prices: such things clearly do, and sometimes for a long time. But the adjustment can be so quick as to make it impossible to take advantage of the news. Prices move quickly to their newly appropriate levels, and in some markets can do so without any transactions at all taking place.

An efficient market makes it difficult to pick the best stocks to own, and to identify the right times to own them – and both security selection and market timing are two of the tools traditionally relied on by active managers.

Passive investing has now been popular for some time, and was given an added boost by the even cheaper vehicles that have become available as trading technology has improved further, namely exchange traded funds (ETFs).

Intelligence, effort and good intentions are not always enough: investing is about the future, and the future is profoundly unpredictable.

Some commentators have taken against these. Some investors may mistakenly have assumed that ETFs somehow alter the liquidity of the underlying assets, which they don't. Others might be surprised if they were to look beneath the wrapper and see what securities they own or track (particularly in the case of innocuous-sounding "high yield" bond ETFs, perhaps). But most ETFs are simple, transparent and highly competitive ways of investing.

Just to confuse matters, ETFs can be popular tactical tools for active investors. Because tactical market timing is just as difficult as stock selection, their use in this way will in some cases ironically have contributed to poor returns – though that is hardly the fault of the ETFs.

Almost one third of the funds that invest in US stocks are passively managed, up from perhaps one tenth 15 years or so ago. Elsewhere, the proportion is likely smaller, though there are some high-profile exceptions. In Japan, the Government Pension Investment Fund – the largest in the world, with $1.4 trillion in assets – has most of its holdings of Japanese stocks in passive vehicles, and the Bank of Japan has used ETFs to acquire the equities it has bought as part of its unconventional monetary measures.

In reality, market efficiency varies across regions, assets and time. Not all markets are large or liquid enough to warrant continual scrutiny by a legion of investment analysts. Even those that are, can be prone to fads and fashions: momentum can persist and develop into bandwagons, booms and busts that drag passive investors along for the ride. This is one of the reasons – but not the only one – why we doubt it can or should sweep all before it.

Passive or active? Passive and active!

Many pundits assume that the passive bandwagon is – and should be – unstoppable. However, passive investing has not made inroads as dramatically as it was initially expected to, and we are a little more measured in our enthusiasm. We think the active–passive debate is needlessly polarised.

The case for some passive investing is strong, and it might be the default option for many. But imagine a world in which all investment is passive. What might happen to corporate and market governance? Who will hold badly performing managements to account, or capitalise on mispriced assets? How do capital markets signal the best use of capital if nobody is looking at profitability or valuations – are index compilers best trusted with that task?

Committed believers in efficient markets might say that such anomalies wouldn't arise under perfectly competitive, open markets. But our faith in free markets is not that strong – some real arbitrage is likely needed to make markets work in practice, not just the theoretical threat of it. Japan's Government Pension Fund is in fact reducing its strongly passive stance for exactly this reason: it is worried that wider, allocative efficiency is suffering.

Passive investing has not in fact made inroads as dramatically as it was initially expected to, and we are a little more measured in our enthusiasm.

There is plenty of room for both approaches, and we can and often do advise clients to have a foot in both camps. Our portfolio managers will use passive funds, but the mostly active wealth management we offer is, we think, the best way to achieve our clients' aims, which, as noted, are not easily framed in terms of market indices but in terms of wealth preservation.

Passive investing is not perfect – not all markets are equally or permanently efficient – and active investing can have distinct advantages.

For example, to return to the potential problem posed by a small group of stocks dominating market returns: passive investing is unlikely to be the cause of their ascendancy, but passive funds can do nothing to reduce it. They are obliged to match the constituent components of the index, however unbalanced those might be.

Passive bond funds can face a different concentration effect. As an issuer borrows more, and their creditworthiness deteriorates, passive funds are compelled to raise their holdings – a case of reward for failure, perhaps. Italian government bonds (BTPs) have a big weighting in European bond indices.

Investors in passive funds could go along with an overly concentrated or otherwise exuberant market and hope to sell their tracker at the right time. But market timing is one of the things that passive investors should not have to worry about. With passive investments, as noted, you're in for the market ride – however rough it gets. Many private clients in particular rebel against the idea of tracking a falling index.

The room for market indices to become unrepresentative is not limited to the roles played by dominant stocks, but extends to sectors and countries. Not all investors, for example, would be happy owning a passive emerging market fund dominated by China's A shares, which could become a distinct possibility. Currently, the second-largest market in the MSCI emerging index is South Korea, and a quarter of the Korean index is accounted for by one company, Samsung – not what many investors attracted by talk of the recently fashionable 'BRIC' (Brazil, Russia, India and China) quartet would expect.

Market timing is just as difficult as picking stocks. An active manager, however, can at least smooth the pot-holed roads travelled by individual markets by using diversifying investments. Wealth managers can extend this diversification not just across regions and sectors, but across asset classes, including the carefully chosen alternative assets and other forms of portfolio protection favoured recently by our portfolio managers.

A completely and purely passive approach to such broader wealth management or asset allocation would require owning an accurate reflection of the entire investment universe, the multi-asset "market portfolio". Anything else is an "active" investment to some extent.

Such a portfolio is, however, difficult to construct. The appropriate categories of investments – the investable asset classes – are debateable, and their respective sizes are in many cases simply not known, and not just in the case of relatively exotic assets, such as emerging and frontier market stocks and bonds, speculative grade credit, commercial loans and so forth. What, for example, might determine the appropriate weightings for cash and real estate in a purely passive multi-asset portfolio?

The financial mathematics, which relies on estimated returns and volatility to generate portfolios that are "optimal" (focused on return), or offer "risk parity" (focused on risk), doesn't work. In the real world, there are no "risk premia", the standard deviation of historical returns is not a good guide to "risk" per se, and the leverage associated with the "risk parity" method introduces a new sort of danger and path-dependency to investing.

As a result, while some multi-asset passive funds are available, there are not yet any completely passive balanced funds which convincingly offer comprehensive wealth management, mixing volatile equity returns with more stable and ideally less correlated returns from other assets.

There are other practical considerations to consider. The prospective longer-term returns from stocks likely exceed those from most other assets. If all assets are issued in similar quantities, then in a purely passive mixed-asset portfolio, the equity weighting might gradually approach (though never quite reach) 100%. There is no avoiding the need to rebalance from time to time – which means some active decision-making at some stage.

What investing is not about

Marketing literature often presents investing as a ceaseless, winner-take-all hunt for short-term profit, in which confident and opinionated blokes in a hurry (it is usually a bloke) search tirelessly against a backdrop of imminent drama for the unique, precisely constructed optimal portfolios that will quickly make their sophisticated risk-taking investors rich.

Churning portfolios in a restless search for the next best thing, or a better entry or exit point, incurs transaction costs – small individually, but they add up.

Other active managers recognise that the reality is more prosaic. Drama is the exception, and responding to events can be more important than predicting them. No one can see the future, and as noted the optimal portfolio maths doesn't work. Investors are not necessarily rewarded for holding risky or illiquid assets. We see investment as being not about getting rich quickly, but about preserving and growing wealth over a long period of time.

It is possible for active managers to take a long-term view aimed at preserving real wealth – beating inflation – and to do so by focusing on businesses that seem to have a good chance of being around in a decade or two, and by avoiding needless portfolio churn and excessive risk in the meantime. In particular, active managers don't have to be market timers – our portfolio managers are anything but.

Such a long-term and multi-asset approach can't easily be appraised in the typical active versus passive assessment timeframe, which is shorter and focused on single-asset portfolios.

Deep value investors, for example, who buy out-of-fashion stocks believing that eventually the markets will recognise their overlooked worth, might underperform a market index for several years before their strategy comes good. Even Malkiel accepted that some active strategies – including some focused on valuation and long-term perspectives – are more attractive than others.

There is more to the investment experience than single-asset returns, important though they are.

Stewardship matters too

There is more to the investment experience than single-asset returns, important though they are. Volatility; diversification across asset classes; taking a long-term view; and beating inflation are all important too, as we have seen. So too is the provision of accountable stewardship and agency, and personalised client service.

Passive funds offer an obvious way of "doing it yourself" in the investment world – but money saved on fees needs to be considered alongside the time and engagement that even a determinedly passive investor will need to allocate to investing. Not all investors want to have to consider which assets and markets to track, and prefer to hand responsibility completely to an accountable adviser, effectively to do their worrying for them.

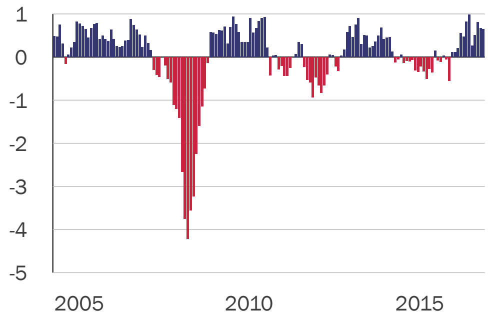
Conclusion

As we see things, the "either/or" approach to passive/active investing is overly constrictive. Passive investing will not, and arguably should not, sweep all before it, and there is room for both approaches in a balanced portfolio. Indeed, our own portfolio managers can and do use passive funds when they think they are the best way of achieving a particular objective.

Economy and markets: background

Growth: major economies

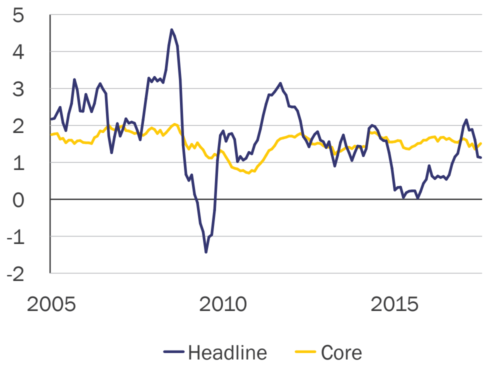
Business optimism: standard deviations from trend



Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

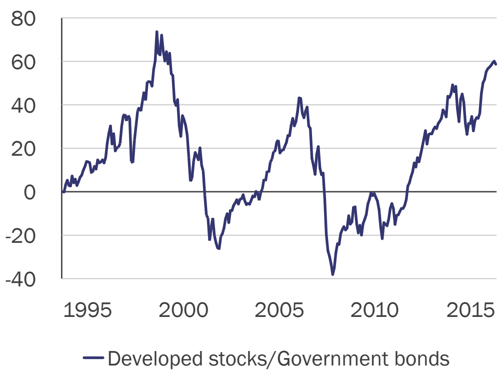
G7 inflation

%, year-on-year



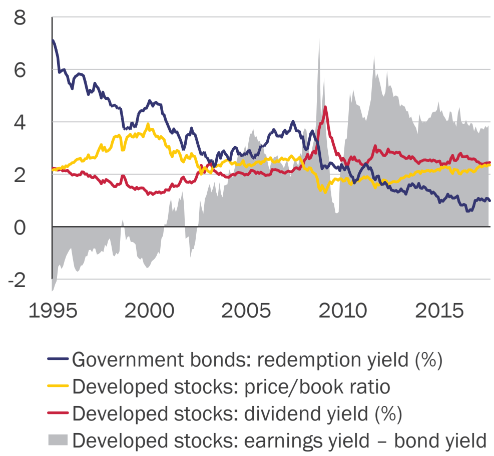
Source: OECD, Bloomberg, Rothschild & Co

Stocks/bonds – relative return index (%)



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Stocks/bonds – relative valuations



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Selected bonds

Current yields, recent local currency returns

	Yield (%)	1yr (%)	3yr (%)
10-yr US Treasury	2.1	-1.4	9.0
10-yr UK Gilt	1.0	-1.0	17.2
10-yr German bund	0.4	-2.0	8.3
10-yr Swiss Govt. bond	-0.1	-1.9	6.4
10-yr Japanese Govt. bond	0.0	-0.4	5.5
Global credit: investment grade (USD)	1.5	0.3	9.9
Global credit: high yield (USD)	5.2	8.7	18.7
Emerging (USD)	4.4	4.8	15.8

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.4	16.2	24.8
Developed	2.4	15.4	25.1
Emerging	2.4	21.8	21.8
US	2.0	15.5	28.4
Eurozone	3.1	17.1	25.0
UK	4.2	13.9	21.0
Switzerland	3.2	11.9	12.7
Japan	2.0	21.0	29.1

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (1980 = 100)

	Level	1yr (%)	3yr (%)
US dollar (USD)	321	-1.8	20.5
Euro (EUR)	282	4.5	6.2
Yen (JPY)	473	-7.8	4.8
Pound sterling (GBP)	96	-5.5	-12.7
Swiss franc (CHF)	305	-0.8	7.9
Chinese yuan (CNY)	36	0.5	6.5

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	181	0.4	-38.2
Brent crude oil ($/b)	52.4	11.4	-49.2
Gold ($/oz.)	1,321	0.9	2.6
Industrial metals (1991 = 100)	265	35.5	-6.8
Implied stock volatility (VIX, %)	10.6%	-21.1	-11.6
Implied bond volatility (MOVE, bp)	5.1%	-26.0	-15.5

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 31st August 2017.

Notes

At Rothschild Private Wealth we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

Brussels
Avenue Louise 166
1050 Brussels
Belgium
+32 2 627 77 30

Frankfurt
Börsenstraße 2 – 4
60313 – Frankfurt am Main
Germany
+49 69 299 8840

Geneva
Rue du Commerce 3
1204 Geneva
Switzerland
+41 22 818 59 00

Guernsey
St. Julian's Court, St Julian's Avenue
St. Peter Port
Guernsey GY1 3BP
Channel Islands
+44 1481 705191

Hong Kong
16/F Alexandra House
18 Chater Road
Central Hong Kong SAR
People's Republic of China
+852 2525 5333

London
New Court
St Swithin's Lane
London EC4N 8AL
United Kingdom
+44 20 7280 5000

Manchester
82 King Street
Manchester M2 4WQ
United Kingdom
+44 161 827 3800

Milan
Via Agnello 5
20121 Milano
Italy
+39 02 7244 31

Paris
29 avenue de Messine
75008 Paris
France
+33 1 40 74 40 74

Singapore
One Raffles Quay
North Tower
1 Raffles Quay #10-02
Singapore 048583
+65 6535 8311

Zurich
Zollikerstrasse 181
8034 Zurich
Switzerland
+41 44 384 7111

Important information