TRAILS

January 2020

Rationale for recommendations

& Frequently Asked Questions

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TRAILS™ 2020 Portfolio Review

Foreword:

The market landscape is ever changing. We have BREXIT on the near horizon, the possibility of an interest rate reduction in the UK (due to lower than planned inflation), tensions in the US (as always it seems) with various other countries, political wrangling (globally), virus fears, global warming tensions – and more. There is always something going on! But as we always say at Tandem, ignore the news if you can because most news is bad news.

We constantly review our TRAILS™ funds and all of our model portfolios, to make sure we have what we consider to be the 'best' funds. This means sourcing and selecting funds that give us exposure to the asset class we require, the right sector, geographical region, style and investment type, all at the lowest cost, with the greatest efficiency.

We have had more than 10 years of (generally) positive returns. We do not know when the next correction might occur, but we all know at some point this will occur. There is no pattern as such and you know we do *not* advocate the idea of timing markets, knee jerk reactions, predicting what might happen etc. At Tandem, we believe in diversification, asset allocation and using low-cost, risk-based investment portfolios. This strategy works. One's mindset should focus on the long term which means a minimum of 7-10 years plus.

We as investors / advisers cannot control the markets but we can control the asset allocation we choose; we can control how diversified our portfolio is and above all we can control costs! It has never been so important to lower investment fund fees and the proposed fund changes below help achieve this. We are also conscious of protecting against UK inflation, which is currently lower than the 2% government target, but could rise after BREXIT in the coming years. We always want our model portfolios to give you the investor, the best chance of achieving a risk-adjusted return.

The whole point of investing is to achieve a better return than cash and inflation. But it does mean taking on some risk and making sure one's mindset is focused on the long term, rather than dwelling on current events, short term volatility or irrational predictions.

Therefore, we propose the following changes to TRAILS:

Change 1: Global Inflation:

Proposed Action:

- Sell L&G Global Inflation-Linked Bond Index Acc
- Buy Vanguard UK Government Bond Index Acc

Reasons:

The L&G Global Inflation-Linked Bond Index Fund is currently included in in 6 of our 7 TRAILS™ models. It does very little to protect UK investors against the backdrop of BREXIT and the increased inflation risks to the UK market. We originally chose to include it in early 2017 because we were concerned about global inflation, but this risk has since subsided. Inflation has not been an issue in western economies in the last 3 years.

In its place, we are advising to buy the Vanguard UK Government Bond Index Fund. It holds nominal gilts which provide protection against implied UK inflation but not a direct hedge against an unexpected increase in RPI. This can be achieved through equities within a diversified portfolio.

We therefore believe the Vanguard UK Government Bond fund will improve the defensive profile of the fixed income elements of our TRAILS™ portfolios and this change also reduces annual fees on this fund from 0.27% p.a. to 0.12% p.a. which is significant.

Change 2: Global Small Companies

Proposed Action:

- Sell Dimensional Global Small Companies Acc
- Buy Vanguard Global Small-Cap Index Acc

Reasons:

1. **Cost** – Cost saving of 0.21% per annum. Vanguard Global Small Cap Index fund has an OCF (ongoing charges figure of) 0.29% p.a. vs Dimensional Global Small Companies fund which is 0.50% p.a.)
2. **Performance:** Since a common inception point, the Vanguard fund has achieved approximately 1% more per annum in additionally returns. The difference in fees is largely responsible for the difference in performance and slight tilts to value stocks.
3. **Like for like replacement** – Both the Dimensional Global Small Cap Index fund and Vanguard Global Small Cap Index fund have tracked the index extremely closely, and the correlations between them are 0.99 – the exposures are very similar to the index. We still believe in having equity tilts to small cap equities and value stocks. If we can get the same exposure for a cheaper price it makes sense to switch to the Vanguard offering.

Change 3: Re-order and re-weighting of bond funds

Proposed Action:

We have re-weighted the percentage allocations to our bond funds based on risk and volatility. All four of the TRAILS™ selected bond funds are investment grade (BBB and above) and are largely short to medium term duration. Bonds are used to protect against volatility and downside risk.

Reasons:

We felt it made more sense to re-order our bond funds (meaning the lowest risk at the top) and re-weight them based on past performance, assumed risk and volatility. The new bond weightings show in your Portfolio Breakdown, available to view when you login to TRAILS™ Online. This will all be resolved with the annual re-balance in February, which includes the proposed bond fund switch. The result is a bond allocation that includes UK and Global government bonds as well as UK and Global corporate bonds. We do not advocate the use of High Yield (Junk Bonds) or Emerging Market Debt Bonds.

Change 4: Reducing Emerging Market funds to one fund

Proposed Action:

We currently have two emerging markets (EM) funds within TRAILS™. We feel it sensible to only have one fund that gives exposure to all Emerging Markets at a low cost.

Reasons:

We currently have a core equity EM fund and a targeted value EM fund, which has recently underperformed. This has led us to conclude that we should sell the Dimensional Emerging Markets Targeted Value fund and merge the proceeds into the Dimensional Emerging Markets Core Equity fund which we still like after examination. The re-balance will also re-weight exposure to global EM, which has reduced from c. 15% to c. 12% of the World Market Cap.

Frequently Asked Questions:

Q: Is there is a cost/fee to action (agree to) these changes?

A: The answer is hardly any! Tandem do not charge to make fund changes or re-balance. There are no fees or costs to sell a fund. There are negligible costs to buy (max 0.05%) via platform costs, stamp duty and dilution levies. See the Re-balancing guide also for more details.

Q: Can I change risk profiles?

A: Yes, just let us know which you prefer. Please speak to us, should you wish to discuss this. You can increase or reduce risk profile and the best time to do this is at the point that we are suggesting some fund changes and a re-balance of your portfolio. One should not generally chop and change their risk profile as a result of topical news events. More logically it could be due to age, health, attitude and feeling towards volatility, or whether you 'need' to take more risk, or whether you do 'not' really need to take risk.

Q: Do I have to agree to the suggested fund changes?

A: No, but this means you won't be in the latest 2020 TRAILS™ models and your charges will remain the same.

Q: Why do you only use OEICs and Unit trusts?

A: OEICs (open-ended investment companies) and Unit Trusts are both types of open-ended collectives, 'pooled investments' or 'funds.' 'Open-ended' means they can create new units as the fund grows.

The OEICs and Unit Trusts within TRAILS™ can be divided into a 10,000th of a unit (unlike ETFs (Exchange Traded Funds) or direct shares, for which you have to buy at least one unit or share. This is far better for regular premium investing as you can pay just £20 per month and still have the contribution spread between all 10 funds as per the asset allocation of the TRAILS™ portfolio you select.

Unlike OEICs and Unit Trusts, Investment Trusts are closed-ended funds. This means they cannot create new units. Investment trusts can also trade at a premium or discount which means they can utilise gearing, which can incur risk and volatility. ETFs can have dealing fees/ brokerages fees and 'spreads,' which is the difference between the offer and the bid price.

All of the above collectives have their pros and cons, but we prefer to use OEICs and Unit Trusts within all 7 x TRAILS™ portfolios. All of our TRAILS™ funds have a 0% initial charge to the fund house, nor do they have an exit fee. They are incredibly transparent, low-cost index and passive funds with extremely strong companies like Vanguard, iShares (Blackrock) and Dimensional. All of our selected funds can be used inside all the tax wrappers (ISAs, GIA, Pension, Onshore and Offshore bond) and they are suitable for lump sum investing and regular premiums.

Q: Why do you only use ACC (Accumulation) funds?

A: With accumulation units the income generated by the assets within the fund (e.g. dividends distributed by company shares and interest generated from bonds) is reinvested automatically back into the fund. The effect of this is either an increase to the price of the fund represented by the 'unit price' or by buying more units within the fund. It is almost always the former these days. Holding accumulation units gives the investor discipline because it eradicates the need to manually buy more units in the fund, which can prove to be hugely uplifting in the long-term, since reinvesting dividends and income from bonds, is a major factor in generating long term returns.

Q: Why do you use Institutional funds?

A: Investopedia defines an institutional fund as, "A fund that targets high value investors with low management fees, but very high minimum investing requirements." Using the Transact and Nucleus wrap platforms, we have access to over 7000 funds comprising both retail and institutional funds. Both platforms can only be accessed directly through an intermediary (e.g. Tandem). Collectively, Tandem now manage more than £85 million of client monies and consequently, through economies of scale, we are able to negotiate the use of institutional funds which benefit all of our clients largely because they have lower costs.

Q: Why do we use Vanguard?

A: Vanguard makes up the majority of the 'index' funds within TRAILS™ giving you exposure to market equity returns in a very cost-effective way. For example, the Vanguard FTSE Developed World ex-UK Equity Index Fund gives you exposure to global equities at a cost of just 0.14% per annum.

We also use Vanguard to give exposure to both Government bonds and Corporate Bonds. Vanguard has massive financial strength and is extremely reputable. They are the second largest investment house in the world after Blackrock with over $6 trillion of funds under direction. They are a mutual firm (not a PLC), so their profits go back into the funds to reduce charges further. They are extremely transparent and low cost.

Q: Why do we use Dimensional?

A: At Tandem, we fundamentally agree with and endorse the core principles of Dimensional, regarding market efficiency, using factors like Market, Value, Small-Cap and Profitability and using scientific analysis to formulate an investment portfolio, rather than trying to time the market or predict what will happen.

We use Dimensional's passive funds to give exposure Global Short Dated Bonds, UK Core Equity, International Value and Emerging Markets. Dimensional don't forecast; they are not restrained by an index. Their investment strategy is about logic and decades of academic research. One of their founders (Eugene Fama) even won the noble prize in economics!

Dimensional represent a new model of investing: a model based not on speculation but on the science of capital markets. Decades of research guide the way. The mission of Dimensional Fund Advisors is to deliver the performance of capital markets and increase returns through state-of-the-art portfolio design and trading.

Q: Why do we use iShares (Blackrock)?

A: iShares is the biggest fund house in the world with over $7 trillion assets. They have a large array of funds, including the Global Property Securities Equity Tracker Fund, which tracks the 'FTSE EPRA/NAREIT Developed Index' giving you exposure to property at an efficient and low cost. iShares fit the principles of TRAILS™ by offering clarity and transparency. This fund does not invest in direct property i.e. actual buildings, it instead invests in equity securities. This means it does not suffer the same liquidity issues that the more traditional property fund can.

Q: What is 'Value Investing'?

A: Value stocks tend to trade at a lower price relative to their fundamentals (i.e. dividends, earnings, sales, etc.) and thus are considered to be undervalued by a value investor. Common characteristics of such stocks include a high dividend yield, low price-to-book ratio and/or low price-to-earnings ratio. 'Price to Book' is a key indicator for Dimensional when selecting stocks for one of their passive funds. The ratio is made up of the price of a share multiplied by all shares in circulation for that company, divided by the book value (essentially the balance sheet: all assets minus all liabilities).

Q: What does 'Small-Cap Equity' mean?

A: Refers to stocks with a relatively small market capitalisation. The definition of small-cap can vary among brokerages, but generally it is a company with a market capitalisation of between $300 million and $2 billion. In the UK as an example, if you were to list all stocks that trade on the FTSE All Share, small-cap would be the bottom 15% in terms of size. One of the biggest advantages of investing in small-cap stocks is the potential for outperformance (in all geographical regions), largely due to the ability of small companies to be more flexible in certain market conditions, albeit one must consider the potential risks and often higher volatility than large cap stocks.

Q: What does 'World Market Cap' (Capitalisation) mean?

A: Market capitalisation (or market cap) is the total value of the issued shares of a publicly traded company; it is equal to the share price times the number of shares outstanding. As outstanding stock is bought and sold in public markets, capitalisation could be used as a proxy for the public opinion of a company's net worth and is a determining factor in some forms of stock valuation. World Market Capitalisation is the value of all issued shares of all publicly traded companies in the world. The US comprises 46% of this number, the UK 7% and Japan 7%. See the chart here to show these percentages for each of the world's major countries as a map of the world. You may be surprised! This is exactly why it is important to have a large exposure to US Equity in all TRAILS™ portfolios, because it is where nearly half of the world's market shares are traded.

Should you have any further questions, please feel free to email info@tandemfinancial.co.uk or call 01582 635909.