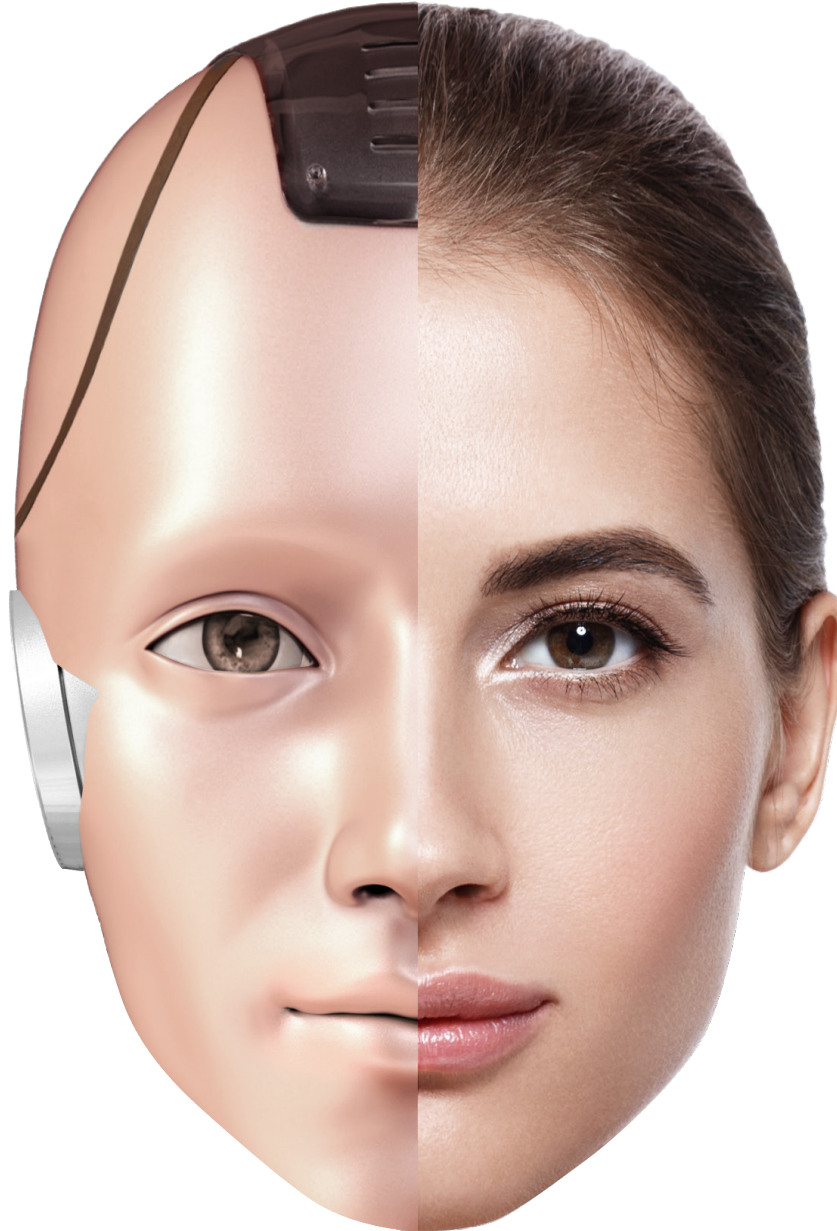


Investing on the verge of the AI revolution

Annual Report **2023**



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Much went right in 2023, but the benefits are yet to come



Nathan Glaister
Director & Chartered
Financial Planner

The past year has been one which in some ways has been better than many expected. Economic growth has proved more resilient than many feared and whilst interest rate rises have been painful the inflation which caused them has begun to fall sharply. Yet, the turbulence associated with these things has proved more than unsettling enough to make for a year where investors have experienced only muted returns.

We can see this as a year where we took our medicine, accepting that in order to curb inflation and restore economic stability we would have to have higher interest rates, lower returns and weaker economic growth. We can see the coming year as one where we hope to enjoy the benefits of that process.

As we look to the world in 2024, we see opportunities across a wide range of asset classes that can support portfolios. As interest rates fall it is our job to harness those opportunities for you and look in particular at those areas which are now very cheap following two difficult years. We also see a world on the verge of the artificial intelligence (AI) revolution. This promises to deliver the most rapid period of productivity growth we have seen in our lifetimes. Productivity growth is ultimately what drives stock market returns and gives us much cause for optimism about the decade ahead.

We can reflect over this holiday and New Year period upon a difficult series of years for the world; marked by pandemic, war and inflation. But we can also remind ourselves that ultimately, we invest in a dynamic world which has the capacity to rebuild itself after every crisis. It is this creative, destructive and then creative again process that enables portfolios to thrive in the long-term.

I hope you find this Annual Review useful and I would like to take this opportunity to thank you for your continued support and wish you a happy New Year from all of us at Dodd Wealthcare.

Annual Review 2023: A good amount went well, but few people noticed

In 2023 the global economy proved more resilient, and inflation fell faster than many feared. Yet the turbulence felt along the way proved more than enough to prevent the market seeing the big picture throughout the year.

A wise man once pointed out that the stock market is not formed by thousands of clever men and women independently arriving at their own views.

It is much more like a school exam hall where two bright kids at the front – one an optimistic bull, and one a pessimistic bear – pass back the answers to the rest of the class. Ultimately each investment has a buyer and a seller and so views form into two basic groups, even though the world itself is far more nuanced than this suggests.

This was never truer than in 2023. At the start of the year, inflation enthusiasts argued for a generational shift in inflation expectations – forecasting a return to the malaise of the 1970s, as growth proved stubbornly high.

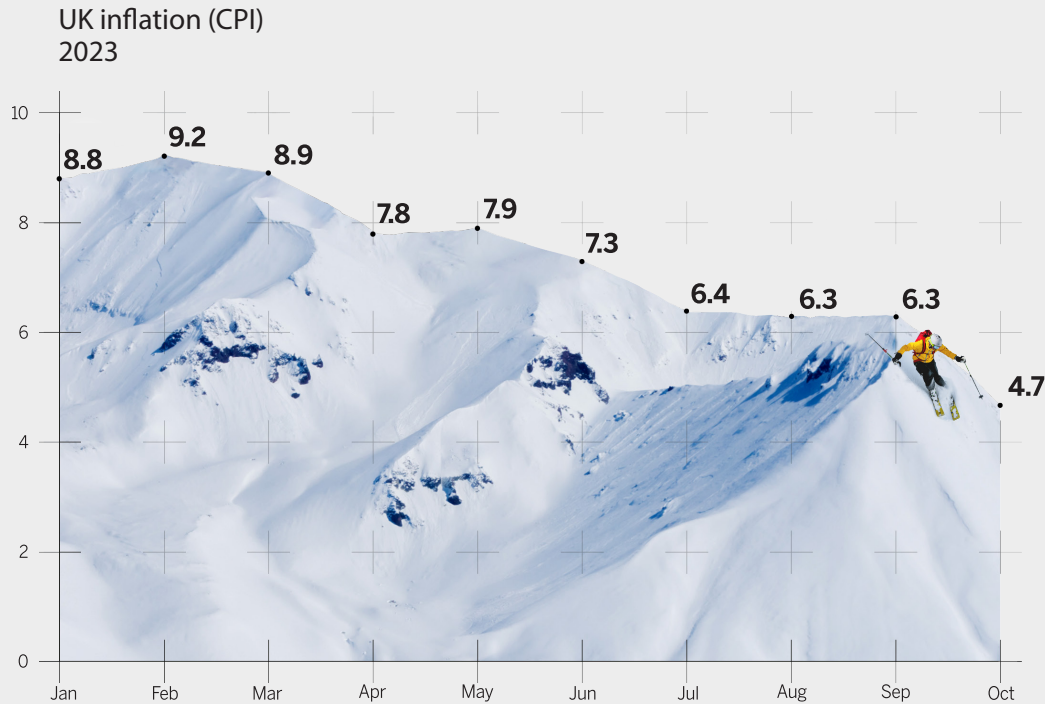
Meanwhile economic pessimists foresaw an avalanche of consumer and business failures resulting from the higher interest costs.

Thankfully, neither outcome came to pass, and inflation slowed meaningfully even as the world economy continued to grow at close to 3%. This year is a reminder that the volume of the debate is often a poor indicator of the likelihood of outcomes.

Financial markets price in uncertainty, which dampens valuations and helps enhance the long-term returns for patient investors. At Albemarle Street Partners we aim to deliver consistent returns for clients by focusing on a broad assortment of data, rigorous diversification, and pragmatic alignment of portfolios based on the balance of risks.

As we entered 2023, we recognised a shift in this balance due to a decline in global energy prices. Natural gas prices fell rapidly as alternative supply and lower demand helped meet Europe's needs.

Interest rate rises quickly delivered price stability as consumer demand started to slow. Today US and European headline inflation is near 3% and even core measures, which respond with a lag, have declined. Even the UK, a laggard in the inflation fight, has made some notable progress in recent months. On the downside, economic growth in the UK and Europe has ground to a halt and market participants expect interest rate cuts as early as the second quarter of 2024.



Source:
Office for National
Statistics (ONS).

The US economy has surprised the sceptics by delivering 2.5% growth in 2023. Buoyed by a resilient labour market consumers dipped into pandemic era savings. US companies have started to grow their earnings, delivering 4% earnings growth in the most recent quarter. This has helped support a more positive economic narrative.

Portfolios have outperformed peer benchmarks year to date, delivering low to high single digit returns across a variety of growth mandates. Past performance is not a guide to future performance. Recognising the prevailing gloom in markets, the heightened expected returns on offer, and the need for safety, we sought diversification seasoned with a healthy dose of downside protection.

We favoured larger companies, neutral duration investment grade bonds and a lower-than-normal allocation to emerging markets and smaller companies. During the year, the higher sensitivity of our bond holdings helped protect portfolios when there was risk of a banking crisis. The large-cap passive funds we used in the US, Europe, and Japan not only helped lift portfolios during market rallies but did so with greater reliability than active equivalents. We increased high yield bond allocations at the start of the year, which proved to be an apt decision.

Investment decisions over 2023



— World equity market

- Tactical decision**
- Strategic decision**

Source:
 Bloomberg, world equity market returns, \$, at 30th November 2023.

Past performance is not a guide to future performance.

In terms of equity performance, US and Japanese shares generated the strongest returns driven by their technology and consumer discretionary exposure. Smaller UK Mid Cap companies significantly lagged the broader UK equity market. Across fixed income, riskier high yield debt strongly outperformed top-rated government bonds year-to-date. Meanwhile inflation-linked UK debt produced poor returns.

As we think about the coming year, we are excited by elevated expected returns across a range of assets. While the debate on the depth of the upcoming recession is likely to rage for some time, we have pragmatically positioned portfolios for declining inflation and a slowdown in economic growth.

Neutral duration bond holdings and our equity exposures to large cap quality equities will help portfolios participate in market rallies as we gradually increase allocations to beaten down areas such as smaller companies, emerging markets, and higher yielding debt. A mild US recession, which is now the base case for many investors, could still prove challenging for earnings from cyclical sectors. We anticipate earnings growth in these sectors to bottom in the first half of next year. As we think about the opportunity set for 2024, we will start allocating to a variety of cyclical sectors in a controlled and gradual fashion with a keen eye on the direction of data.

Fahad Hassan
 Chief Investment Officer, Albemarle Street Partners

Asset class returns over 10 years (%)

The overwhelming body of evidence suggests that it is almost impossible to time the stock market perfectly or pick the best performing asset class each year. Instead, we aim to use a wide variety of investments to ensure our portfolios stay on track and achieve their long-term goals, irrespective of economic conditions.



- US Equities
- UK Large Cap Equities
- UK Mid Cap Equities
- European Equities
- Japan Equities
- Asian Equities
- Global Infrastructure
- Global High Yield
- Corporate Bonds
- UK Gilts
- Global Government Bonds
- Cash

Past performance is not a guide to future performance. Capital at risk.

Source: Bloomberg at 30th November 2023.

What is AI and when is it useful?



AI-generated image of Taylor Swift, Donald Trump and Piers Morgan.

Artificial Intelligence (AI) refers to the simulation of human intelligence in machines programmed to think and mimic human actions. It encompasses a broad array of technologies, algorithms, and approaches that enable machines to perceive, reason, learn, and act intelligently. The goal is to create systems that can perform tasks that typically require human intelligence.

At its core, AI involves two key concepts: machine learning and deep learning. Machine learning allows computers to learn from data and make decisions without explicit programming. Deep learning, a subset

of machine learning, uses neural networks inspired by the human brain's structure to process data and make complex decisions.

AI is deployed across various domains, revolutionising industries and daily life. In healthcare, it aids in diagnostics, personalised medicine, and drug discovery, enhancing accuracy and efficiency. In finance, AI-driven algorithms optimise trading, risk assessment, and fraud detection. Moreover, in transportation, AI powers self-driving cars, optimising routes and enhancing safety.

Natural Language Processing (NLP) is another pivotal aspect of AI, enabling machines to understand, interpret, and generate human language. Voice assistants like Siri and Alexa rely on NLP to comprehend and respond to user queries. Additionally, sentiment analysis tools use NLP to gauge public opinions from social media and other text sources.

The ethical implications of AI are a significant concern. Issues such as bias in algorithms, data privacy, and job displacement due to automation require careful consideration and regulation. Ensuring transparency, fairness, and accountability in AI systems is crucial for their responsible deployment.

The future of AI holds immense potential. Advancements in AI continue to push boundaries, with ongoing research in areas like reinforcement learning, quantum computing, and AI ethics. AI's integration with other

technologies, such as the Internet of Things (IoT) and robotics, promises to reshape industries and create new possibilities.

As AI evolves, discussions around its societal impact, regulation, and governance intensify. Striking a balance between innovation and ethical considerations remains a critical challenge. Collaboration between researchers, policymakers, and industry leaders is crucial to harness AI's potential while addressing its ethical, societal, and economic implications.

In essence, AI represents a transformative force reshaping the world. Its ability to analyse vast amounts of data, automate tasks, and emulate human cognition fuels advancements across industries. However, ensuring its ethical and responsible use is paramount to harnessing its full potential for the benefit of society.

Credit for this article, including the celebrity contributions goes to the generative AI, ChatGPT.

ChatGPT



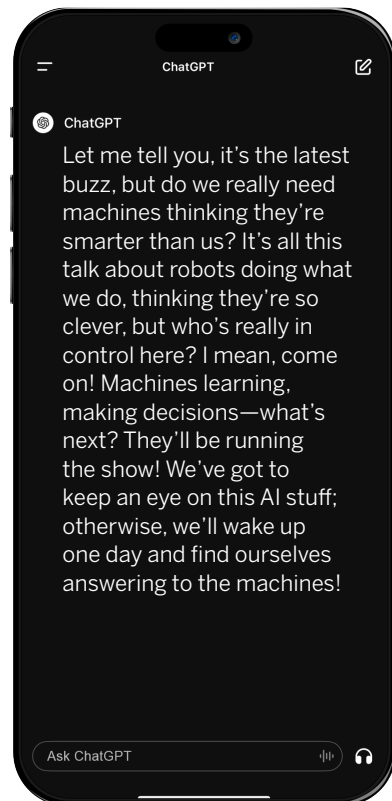
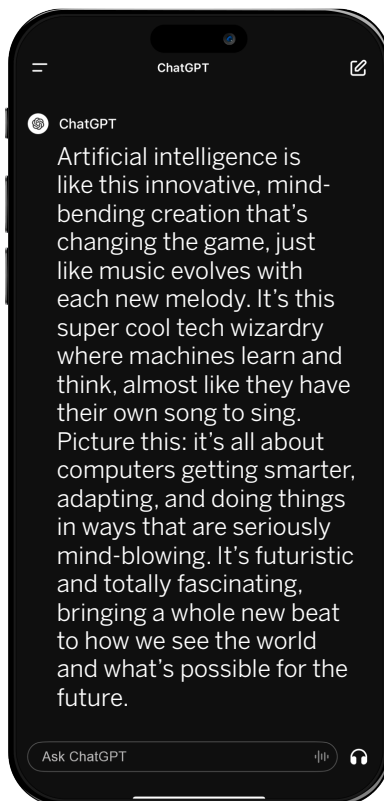
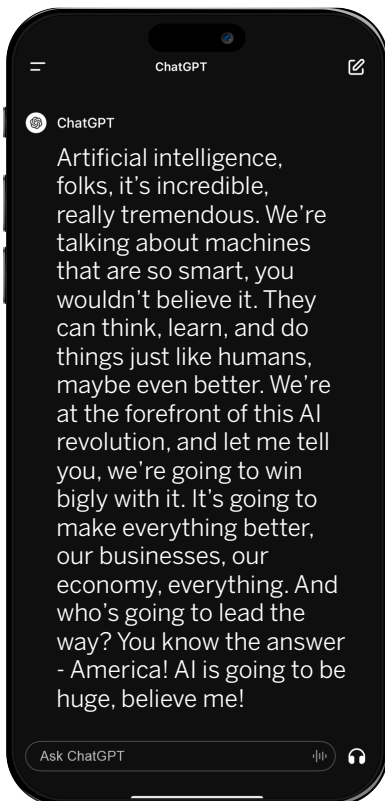
Donald Trump
is wowed by AI:



Taylor Swift
is inspired:



Piers Morgan
is concerned:



Generated by Chat GPT.

How would you explain AI in the words of Donald Trump, Taylor Swift and Piers Morgan?

AI will free up our time and energy, the question is how we then use it



Dr Fabian Braesemann
University of Oxford

We met Dr Fabian Braesemann, Departmental Research Lecturer in AI and Work at Oxford Internet Institute, University of Oxford. Dr Braesemann researches the Science of Success, including which technologies will thrive in the digital age and what the future of the workplace will look like. He answered our questions about what we should be expecting from AI in the near future.

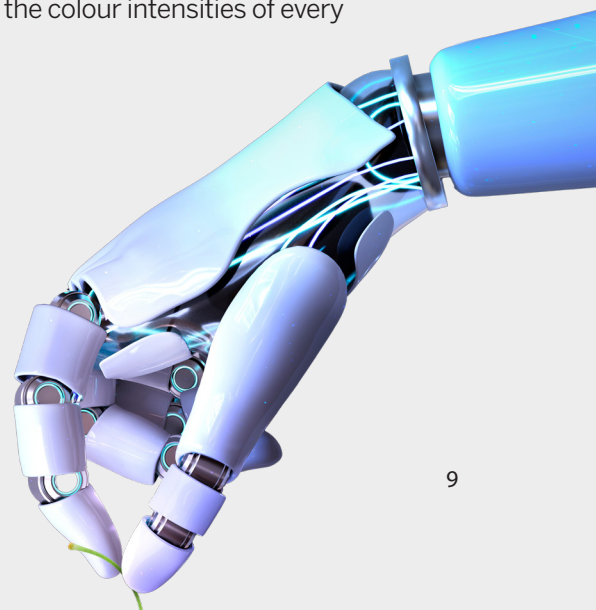
WHAT IMPACT IS AI HAVING ON OUR LIVES?

The most important effects can be seen in the labour market, how we work and where we work. There have been assessments of what the effects of AI might be in the future, one thing all these studies have in common is that they are ambiguous in terms of the time frame and the tangible effects. AI is a technology like other general-purpose technologies we are used to. In our lifetimes, new technologies have appeared, like the internet and smartphones and we have accepted them in our daily lives. Of course, there have been unanticipated effects: the internet and the smartphone led to fake news and everything else good and bad happening on the internet. As such, we cannot know for sure what will happen with AI technologies. No one has seen such a huge uptick of generative AI technologies such as ChatGPT. A likely result is that AI will have differing effects in the labour market, with some able to increase their productivity and others finding their work replaced.

HOW WILL THE TECHNOLOGY AFFECT OUR LIVES AND WORK?

We will become consumers of numerous AI services, with data being used to draw conclusions and make predictions to tailor these services; many will be useful and convenient.

We are already users now. Just think of the voice assistant Siri. Automatic facial recognition technology is also used on smartphones. We can search through our photos to find ones of specific people. The AI technology working here behind the curtain is called computer vision; it uses the colour intensities of every





pixel of an image as data points and learns shapes, contours, and eventually faces using the machine learning technology 'artificial neural networks'. Of course, this technology can also be used for controversial means like tracking populations and how they move in cities, and this is being done by autocratic regimes across the world.

CAN AI IMITATE HUMAN EMOTIONAL INTELLIGENCE?

This is a very difficult question because it draws on many different concepts. The worry is that AI will behave like AI in the movies, getting a life of its own. This is not going to happen. Of course, I cannot foresee the future, but this is very, very unlikely. What I expect, though, is that AI tools might be used incorrectly or abused by people, which can cause harm. Think of industrialisation in the 18th and 19th centuries, suddenly, there was a large-scale problem of machinery accidents with people working in factories. In the same way, we see accidents with self-driving cars, but also other unintended consequences that could be the stock market crashing because of automated trading algorithms accidentally trading as a reaction to fake news.

But will AI have human emotional intelligence? I don't think so; these machines might mimic behaviour we would expect in certain situations, but they are not emotionally intelligent themselves.

SHOULD WE WORRY ABOUT AI?

It's unavoidable with complex systems, such as the interaction between technology and society, that they will have unintended consequences. But we should not worry about the technology per se. Instead, think of it as a hammer; it could be used to construct and build, but it could also be used to smash a skull, so it can be used as a weapon. Technologies can be used in the same way. We are seeing the adverse use of AI technologies, for example, in warfare with the drones being applied by Ukrainian and Russian armies in the war in Ukraine. But I would like to emphasise that the technology itself is neutral.



It is neither good nor bad. More knowledge and education are needed, allowing people to make informed judgments about how it should and could be used.

WHAT NEW OPPORTUNITIES WILL AI BRING US?

These are vast across all fields. Most likely, it will be like the advent of industrial machinery technologies. Think about the steam engine, originally developed to pump water out of mines. Its impact on agriculture was something no one had foreseen; suddenly far fewer people were needed, which freed up a huge workforce that went into industrial manufacturing and ultimately led to an unprecedented growth of large cities. In the present day, many people work in services. We will again see people's energy being freed up, and this will be channelled into different types of activity.

We will see new markets arising, new products and services in all kinds of fields. In finance, for example, automated trading has largely replaced manual brokerage via the phone. As a result, we saw a vast increase in the different financial products you could buy via trading apps and online.

The opportunities are incredibly vast and will outweigh the risks to some extent. We'll see a much more personalised experience in many fields and will definitely see more convenience as machines will be able to predict what we want and when. Overall, there will be a rise in productivity in the economy but also frictions in the time needed for the workforce and businesses to adapt to the 'new machine age'.

It's all in your head: Can a brain scan show you what sort of investor you are?

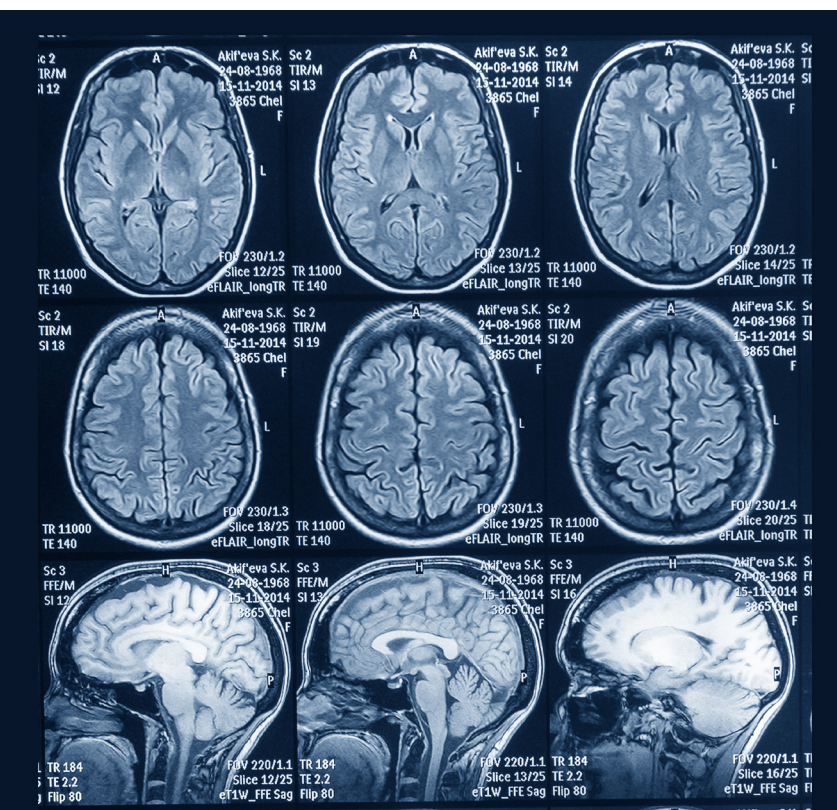
All investment managers work hard to portray themselves as cool, calm rational creatures.

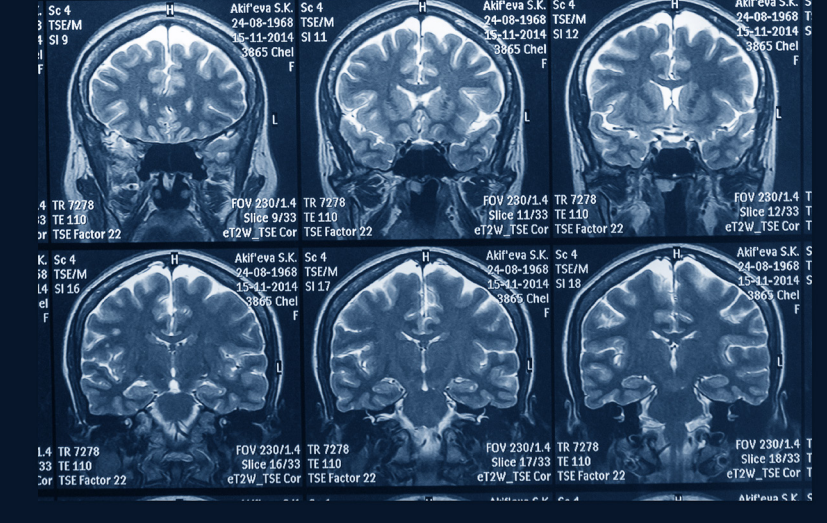
We would want our clients to see us as evidence-based decision makers and would surely not want to be seen as ever making a decision out of our emotions, or worse still simply because of the inherent biases contained in the brain we were born with.

Bad news then comes from Hannah Critchlow, a Cambridge neuroscientist and author of a range of neuroscience books including 'The Science of Fate: Why the future is more predictable than you think'. Her focus is to study how our brain's physiology affects our decision-making and how we can train ourselves to think longer-term, a vital heuristic tool for investors seeking to avoid being blown around by the winds of market sentiment.

A key conclusion she has reached is that much of who we are, how we think and the decisions we favour is based not on the data we receive into our brains but simply how they are built in the first place.

Her central thesis is that we underestimate how much of our behaviour is linked to the brain physiology we happen to have. For example, she argues the size of different portions of the brain can indicate our political preferences. She claims that around 30% of our ideology is attributable to our identifiable brain structure. Brain region volumes predict with 72% accuracy, she argues, whether people have liberal-minded or conservative viewpoints. The amygdala region of the brain – which drives our threat





response – is larger amongst those with a conservative worldview, it makes them hostile to big new ideas.

So how does our brain physiology affect the way investment managers make decisions? Critchlow argues that because we have inherent biases which we are never likely to fully successfully isolate, the only viable way to improve our capacity to understand the world is to pool

our analysis of the world with others, hoping that this blurs away the damaging effect of bias.

This is not a thesis that supports the lone wolf star fund manager theory, committees reign supreme when we must work to limit the damage of our own physiological bias.

Consensus is more likely to be right than contrarian eccentrics. “We can see this in many different fields, that cognitive capacity increases when people work together rather than in isolation. Our genes create biases in our brains. When you bring different brains together those biases start to balance out and create a more accurate representation of the world - and

there are scientific studies that prove this – you can create a better decision-making profile.’

The key word used by Critchlow here is ‘capacity.’ It is not merely that larger groups make better decisions, but they actually are able to deploy more intellectual fire power by working together than the sum total of the cognitive ability of the individuals would suggest.

Her philosophy also argues for more diverse investment teams.

In particular, she is able to point to studies which show that the more women in any one team the better that team becomes at taking turns sharing ideas. This enables the collective biases to better blend out and for more accurate decision-making. “Taking turns is vital not just for our own intelligence but for the group’s intelligence.”

One simple measure of the power of diversity when making decisions comes from studies which examine the number of women in a team. Because women are, her studies show, in general better at listening to others’ opinions. She has found teams including larger numbers of women do a better job of tackling neurological biases.

Charlie Parker
Managing Director, Albemarle Street Partners

“Taking turns is vital not just for our own intelligence but for the group’s intelligence.”



In conversation with Ben Needham

Ben Needham, Portfolio Manager at Ninety One, a global asset manager with emerging markets roots and a commitment to developing specialist investment teams, spoke to us about the opportunities and threats facing UK businesses.

HOW HAS THE CURRENT ECONOMIC BACKDROP IMPACTED THE LARGEST COMPANIES IN THE UK?

The performance of the FTSE 100 index, representing the largest 100 companies in the UK, is broadly flat so far this year in sterling terms. That does, however, belie the significant variation in performance we have seen between individual stocks and sectors and the volatility in the index as a whole over that time. In 2023, we have had record rampant interest rate increases in the face of persistent inflation, conflict break out in the Middle East and developed world growth start to creak. A rising oil price in the third quarter helped UK energy stocks such as Shell outperform. Rising yields have benefited banks such as HSBC and larger cap stocks more broadly, relative to growthier mid-cap stocks with longer dated cash flows. They have, however, simultaneously provided a headwind to more defensive parts of the market perceived to be more bond-like such as healthcare and consumer staples. The latter sector has also been impacted by an increasingly uncertain consumer backdrop.

HOW IS AI DISRUPTING THESE BUSINESSES?

For many businesses, AI can act as both a disruptor and an enabler. Arguably one of the most exposed UK large cap businesses to developments in generative AI is the data and information company, RELX. Its legal information platform, LexisNexis, is a good example of how generative AI can actually have a significantly positive impact when the underlying content is proprietary in nature. LexisNexis provides a comprehensive collection of historical court rulings, laws and accompanying commentaries without which subscribing lawyers cannot do their job. Around 10 million legal documents worldwide are uploaded onto the platform every week and all of LexisNexis' proprietary



legal data is protected and ringfenced in the cloud. The company's new AI product, Lexis+AI applies Large Language Models to allow users to easily search their library of content and generate immediate, comprehensive and accurate responses to specific queries. There are also additional helpful functions such as "draft email to client" and "Brief Analysis", the latter of which allows lawyers to upload documents and use AI to highlight relevant legal arguments. Extensive testing of Lexis+AI found lawyers saved hours of time every week completing their usual tasks, enabling RELX to price the product at a premium and further enhance their competitive advantage.

WHAT ARE THE OPPORTUNITIES?

In my opinion, high quality businesses with strong competitive advantages will continue to generate steady levels of free cash flow, which creates more optionality in challenging times. In a world where money is no longer free and the economy is rockier, differentiation, pricing power, strong balance sheets and free cash flow generation will really matter and there remain significant opportunities in attractively valued companies with these attributes.

WHAT'S THE BIGGEST RISK TO THESE TYPES OF COMPANIES?

The biggest risk remains higher discount rates. This risk is somewhat mitigated for quality companies by three main factors: the first is pricing power, which enables quality companies to pass on higher costs to the end customer in an environment of persistent inflation; the second is balance sheet strength, where high-quality companies have lower debt levels and correspondingly lower refinancing risk; and the third is low capital intensity, where these businesses have less of a drain on their cash flow in an environment of capex inflation. Together with a reasonable starting valuation, these factors should help protect these types of companies should we continue to see higher discount rates.



WHAT TYPES OF COMPANIES ARE YOU MOST EXCITED ABOUT OVER THE NEXT 12 MONTHS?

Our quality universe is looking as interesting as it has for quite a while with a number of shares having de-rated on the back of concerns related to both higher discount rates and slowing economic growth. Around 90% of our portfolio holdings reside in companies with revenue persistence, i.e. consumer staple companies (Unilever and Reckitt Benckiser), medical device companies (Convatec and Smith+Nephew), companies with high subscription revenues (Sage, Kone and Partners Group) and companies with high retention ratios (AJ Bell and Compass Group). Revenue persistence has not been in favour in recent years but against an increasingly uncertain and challenging macro environment, we think it will be a characteristic that could well come back to the fore.

NEW YEAR'S RESOLUTION?

To bite the bullet and buy the family home despite believing property values are still woefully overvalued, particularly compared to the Ninety One UK Equity Income Fund!

Set for a decade of extraordinary innovation

Recent years have reminded us how unpredictable our world is. Unknown pandemics and unexpected wars have blown our best-laid plans asunder.

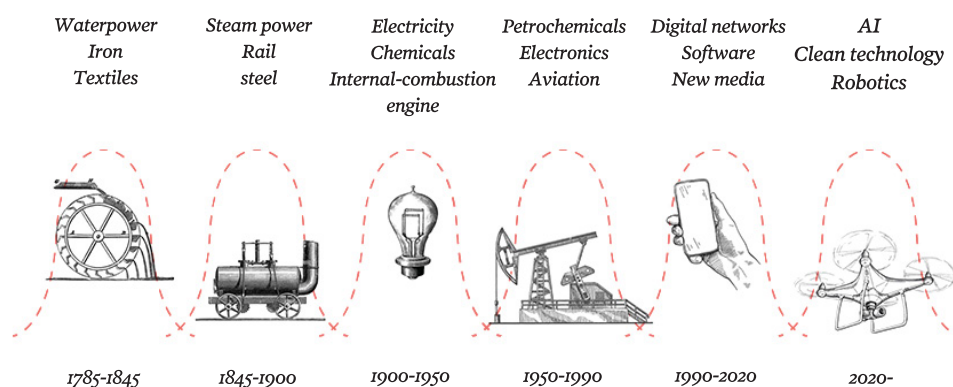
For investors the unknown perils and known perils of our world can often cause us to approach the future with scepticism, even fear.

As we enter 2024, we could choose to focus on high interest rates, instability in the Middle East and the war in Ukraine. We could focus on the impending uncertainty around coming elections in both the United States and the United Kingdom. Problems come and problems go.

Yet the extraordinary thing about investment is just how well stock

markets have done for the past 130 years despite everything the world has thrown at them.

In fact, had we chosen to ignore the bad news and just left a portfolio invested for a century we would have enjoyed returns on average of around 8% a year from shares.

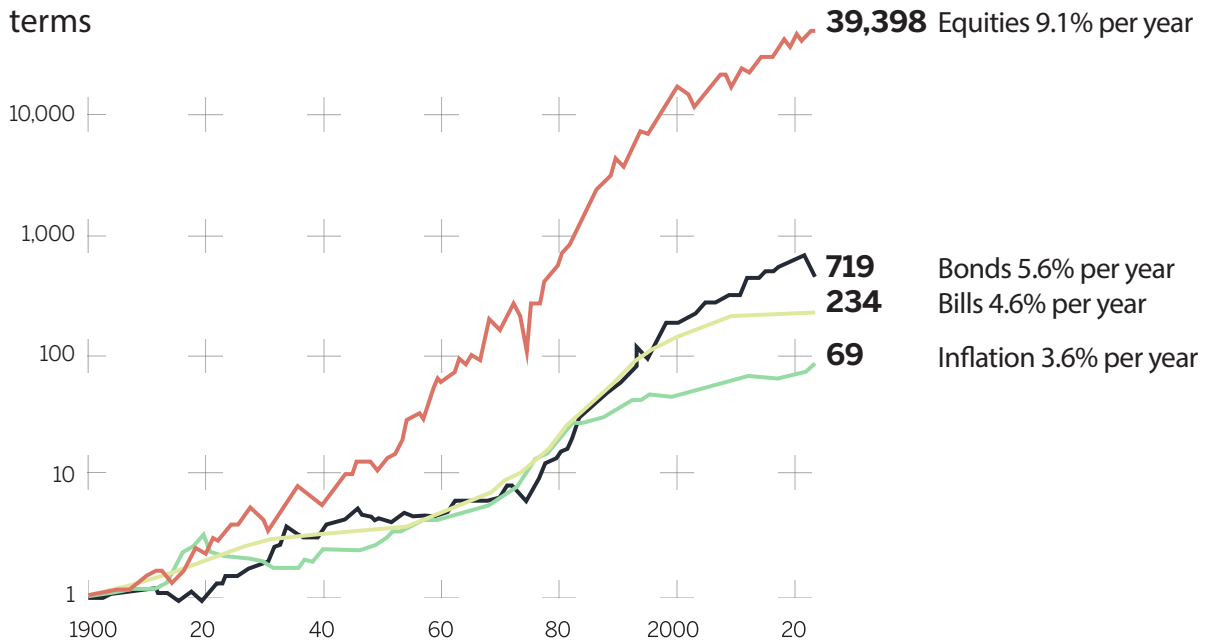


So, what is the magic ingredient that has enabled stock markets to rise through world wars and seismic global changes? What is the magic ingredient that could give us cause to be optimistic about the future even with the storm clouds that we can see for the year ahead?

One word holds the key here: productivity. The reality of human society is that whatever goes wrong in the world ordinary people have found ways to make themselves more productive day to day and it is this productivity growth that has fuelled economic growth since the Industrial Revolution.

There are moments in time though when the steady productivity growth that ordinary folks manage gets turbocharged. The charge comes from key breakthrough technologies – appearing suddenly to radically improve the productivity levels of society.

UK Nominal terms



Source:
Credit Suisse Global
Investment Returns
Yearbook 2021

**Past performance
is not a guide to future
performance.
Capital at risk.**

Today we stand on the threshold of the Artificial Intelligence revolution and the accelerated computing power behind it.

With financial institutions, academics and politicians optimistic about the potential of AI, on the face of it this creates a promising backdrop for any investor. Except of course that we know that these breakthrough technologies come with a catch for investors.

They have a capacity to create dangerous bubbles which are great all the way up until the moment they pop. Those who have been investing since the early 2000s will remember the collapse of internet technology stocks. They crashed not because people had overestimated the impact of the internet – if anything it has been underestimated. They collapsed because it took longer than people anticipated for the profits to come through and indeed was harder than they imagined to identify where the profits would occur.

For investors the next decade involves shrewdly exploiting this period of extraordinary productivity growth that can occur, whilst avoiding the many companies that will fall by the wayside on the journey and ultimately not being in a bubble when it pops.

Discipline, cold-headed valuation work and a long-term view will be vital to ensure the next decade is one of opportunity and not threat for investors.

2024: Investing on the verge of the AI revolution

After two years of muted investment returns the scene is set for a recovery powered by the most rapid technological revolution in history and cheap prices in unloved areas of the global market.



Fahad Hassan
Chief Investment
Officer, Albemarle
Street Partners

The world enters 2024 laden with the political and economic traumas of the past three years.

It has suffered a pandemic which produced the sharpest economic contraction in history, the first major European war for 70 years and a painful wave of inflation which has raised the cost of living across the world.

These problems have of course taken their toll on investors. As interest rates rose to combat inflation the price of both bonds and shares fell. The role of investment managers became to preserve wealth and diversify away the damage that could be done to portfolios.

Yet many of these problems, whilst painful, are resolving themselves – setting the scene for a period of stock market recovery turbocharged by an exponentially accelerating technological revolution.

This backdrop though, however exciting, cannot fully hide the anxiety that has dominated the market over the past year. An underlying fear about the economy means that on average US companies rose just 2% in 2023. Meanwhile a 15% return was made by the stock market index which gives the largest weighting to the very largest companies.

This shows us that a handful of very large stocks have accounted for most of the market's gains. These are principally those companies most exposed to technology, and particularly the growth of artificial intelligence.

It will be tempting for many investors to simply allocate more and more to these few companies. However, it is worth noting that periods of pessimism like the present often resolve themselves with a broadening of returns through a recovery in the laggards.

Empirical data suggests investors realise significant diversification and return benefits by introducing allocations to beaten-up asset classes

with higher perceived risk. As we experience amplified fears of a global slowdown, areas such as smaller companies and emerging market shares as well as high yield fixed income may warrant consideration.

THE COMING CASE FOR SMALLER COMPANIES

Extensive academic research show that over the long-term smaller companies generate excess annual returns of 3%* above large cap counterparts due to the higher long term revenue growth. Past performance is not a guide to future performance.

Additionally, the outperformance gap between small caps and large tends to prove most extreme in recessionary periods. As the economy slows, the perceived risk in smaller companies typically skyrockets - sending valuations plummeting far below intrinsic value. Smaller companies in the UK and Europe trade at a 20% to 35% discount to their larger peers, despite having higher longer-term earnings growth.

EXAMINING HIGH YIELD CORPORATE DEBT

Economic downturns also typically lead investors to overestimate the risks involved in lending money to lower-quality companies, who issue what are known as high yield bonds.

The risk of investing in this area is always that companies are unable to pay their debts as an economic slowdown bites. However, these risks typically emerge early into a slowdown. As they emerge the interest paid by these bonds peaks and then begins to fall. As the price of bonds moves in the opposite direction to the yield on the bonds, this creates an opportunity for investors.

Historically, some 6-12 months following the start of prior recessions, high yield bonds commenced sizeable rallies - dramatically outpacing lower risk bonds. Our expected return framework highlighted high yield assets in 2022. While the asset class has delivered high single digit returns this year, absolute yields remain attractive. The economic backdrop requires judicious debt selection as we expect default rates to rise in the coming months. We have identified suitable active funds to take advantage of the high expected returns on offer.

INCORPORATING EMERGING MARKET EQUITIES

The need to keep a diversified portfolio alone warrants some of your portfolio to be allocated to the developing world. However, at

the current time attractive valuations strengthens the investment case. Despite rapid growth trajectories, Chinese and other emerging market companies today trade a staggering 60% cheaper than US counterparts when examining price to earnings ratios. Many emerging markets began tightening monetary policy ahead of the US and have been able to reduce

* The Cross-Section of Expected Stock Returns" by Eugene Fama and Kenneth French (1992).





inflation to desirable levels. As the Federal Reserve calls time on its own tightening cycle, it allows emerging market central banks to start cutting interest rates to support domestic demand. This could create a powerful revaluation dynamic for regional equities markets as investors seek to diversify their equity exposures.

THE TECHNOLOGICAL BACKDROP

Alongside the market recovery, another force is affecting the world economy and this will find its way into a wide range of asset classes. The rapid acceleration of artificial intelligence creates a backdrop

which can lead productivity in the global economy to improve by 1.5% a year by 2030, according to analysis by Goldman Sachs. Ultimately it is productivity growth that drives the long-term return of stock markets. As the economist Paul Krugman once said: 'productivity isn't everything, but it's almost everything.' The productivity gains from artificial intelligence are akin to the peak gains made at key inflection points in the history of technology – such as the mass uptake of the personal computer, the advent of modern electronics and the internal combustion engine. A key goal for us is to make sure we harness this opportunity, whilst avoiding the inevitable bubbles it will create.

IMPLICATIONS FOR PORTFOLIO POSITIONING

During periods of economic weakness, investors broadly paint all risky assets with the same brush despite significantly varying long-run return prospects. However, having the discipline to allocate to fertile segments of the market requires taking a more hard-headed approach. Those able to acknowledge that pessimism sows the seeds for eventual upside, reap outsized rewards over full cycles.

Our approach will always be highly conscious of risk and our approach to this market recovery will be to turn gradually into the riskier areas of the market as our level of confidence progressively grows.

However, we must not forget that 2024 is a year abundant with huge opportunity found not just in the most obvious technology companies benefiting from artificial intelligence, but also from less loved areas of the market such as smaller companies, high yield bonds and emerging markets.



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