CITYWIRE

David Stevenson: Building a defensive all-weather portfolio

13 July 2021

Last week I updated my exchange-traded fund (ETF) focused growth portfolios and ended with a promise to outline a model portfolio that might assist a more cautious investor looking to build a defensive strategy using listed funds.

Inflation protection would also be another plus.

I am not using ETFs for this exercise because in all honesty I think they aren't really up to the job for most defensive private investors. They are fantastic instruments if you have a thought through asset allocation strategy and know which ETFs within the equity and bonds space to pick for each asset class.

But even I would struggle to construct said portfolio which is why in the past I've favoured fund managers who put together these diversified, defensive portfolios of ETFs in one fund, with the Vanguard LifeStrategy topping my list. Even this excellent range of funds from Vanguard has its disadvantages though. It's an avowedly passive approach by which I mean their managers don't take big asset allocation calls and don't indulge in stock picking.

Now that has and might continue to make great sense but if some of the tectonic plates beneath us do move and say central bank intervention changes radically, that passive approach might underperform and ditto if we enter a more inflationary era.

Breaking down my defensive portfolio

Cue this defensive portfolio which is focused on actively managed investment trusts. The great advantage of these funds is that they allow managers to take wildly contrasting strategic approaches to allocating between different asset classes: bonds, equities and absolute returns strategies. That introduces real risk that the manager might pick the wrong ideas but most of the funds listed below have a great track record in making big calls about changing macro economic circumstances.

At least one of the funds listed is also an explicit bet on market volatility, meaning if markets do start yo-yoing up and down, its manager should hopefully benefit.

There are some fairly obvious criteria for fund selection, apart from a decent track record. I think even cautious investors should be more skewed towards equity holdings, but nevertheless have some exposure to bonds which provide useful diversification.

It's also crucial to have exposure to real assets that can increase cashflows in an inflationary environment, plus I think limited but valuable exposure to private businesses through private equity is a very useful alternative asset.

Lastly, as I mentioned, I would quite like some hedges against market volatility and if we're lucky we might also benefit from the promise of absolute returns.

One crucial point is that I have picked five funds and in my perfect world I'd allocate 20% to each. This equal weight strategy is based on ignorance. I have no idea how any of these funds will perform in the coming years and given that ignorance its best to place equal weighting on each fund.

My five fund picks

I've also tried to suggest a diversified range of strategies. In the first equities-skewed box I would put Ruffer Investment Company (RICA) and Capital Gearing Trust (CGT), which are in structural terms not dissimilar.

Both are weighted towards equity investments and in a very diversified way in the case of Capital Gearing, co-managed by Peter Spiller (pictured above), Alastair Laing and Chris Clothier, for instance which invests in myriad investment trusts. Both funds also have heavy bond weightings, with both holding government securities and index-linked ones as well.

Now that goes against my comments on index-linked gilts from a few weeks back, but I am not trying to build an explicit inflation-proofing portfolio here; my aim is simply to have all weather managers who can change tack where necessary in a defensive fashion. That focus on bonds is helpful as an insurance policy.

RIT Capital Partners (RCP) bears some similarities to both Ruffer and Capital Gearing but adds two extra elements. Sure, it's also 48% exposed to equities but it also has a huge weighting towards private equity funds, as well as absolute return managed funds, so diversified alternative assets. If markets do surprise us to the upside, as I think they will, then RIT should be in a strong position from that heavy equities and private equity weighting.

My last two suggestions are contrasting plays on market volatility, or should I say lack thereof. The first is BH Macro (BHMG), one of Brevan Howard's two listed hedge funds, which will shortly merge with its peer BH Global (BHGG). This is an explicit bet on firstly a great fund management team and secondly a play on market volatility using macro strategies.

I'm usually deeply suspicious of all absolute returns strategies and accompanying fund managers, but as a long-term investor in BH Global I think their track record, in listed funds at least, is second to none.

More to the point check out the last column in the table which shows the price change for the funds over the period of peak bearishness last year, from 21 February 2020 through to 23 March 2020. Most of the funds on my list experienced price falls, especially RIT, while a few, Ruffer and Capital Gearing, chalked up very modest falls. By contrast BH Macro recorded a 6% gain.

That might not happen in the future, but it's not a bad indicator that this fund might benefit from a surge in future market volatility.

The last suggestion is a deliberate play at picking a boring stock that generates a steady income and has assets that might prove useful in a future inflationary environment, UK-focused infrastructure trust International Public Partnerships (INPP), which currently yields 4.4%.

Some alternative defensive funds

One last point. In the table below I've also included some alternatives for each type of fund.

Instead of Capital Gearing and Ruffer, investors should also look at Personal Assets Trust (PNL) which I think is another excellent defensive vehicle. In my view Ruffer and CGT have produced better results in the last five years and have a slightly better track record, but I also think that Personal Assets has an impressive equity portfolio, which features top holding Microsoft.

As for BH Macro, it's also worth looking at its sister fund BH Global which follows roughly the same strategy and is slightly cheaper. That said both funds are due to merge into one entity fairly soon. The VT Gravis UK Infrastructure Income fund (a unit trust fund) could also swap out nicely for INPP, as could the SDCL Energy Efficiency Income Trust (SEIT).

Overall, this model portfolio is yielding 1.48%, which is a useful potential future income stream that could be reinvested in the underlying funds. On average my five funds would have fallen by just 11% in the period between 21 February and 23 March 2020, while over the last five years the five funds would have returned 38.5%, a compounded annual return of 6.73% per annum.

Defensive portfolio and alternative components

Name	Performance %			%chg between
	1 year	3 year	5 year	21/2/20 to 23/3/20
RIT Capital Partners	38.3	20	43.7	-30.5
Ruffer Investment Company	21.5	23.9	33.3	-2.31
Capital Gearing Trust	11.8	22.7	41.1	-11.8
BH Macro	2.27	61.9	74.3	6.06
International Public Partnership	-0.65%	17.50%	10.60%	-19.3
average	14.7727	25.735	38.5012	-11.57
VT Gravis UK Infrastructure Income fund	8.86	24.6	39.1	-23.6
SDCL Energy Efficiency Income Trust	8.1			-26.6
Alternatives for BH Macro				
BH Global	5.08	30.5	51.2	1.81
Alternatives for Capital Gearing/ Ruffer				
Personal Assets Trust	9.3	21.5	21.7	-11.5
Benchmark				
FTSE All-Share	19.8	-3.79	12	-34

Source: Morningstar