Investment Insight

Taking profits and staying diversified

Morningstar Wealth
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For Financial Advisers to use with their clients

Key points

- Taking profits on Global Financials, Germany
- China still attractive even after recent gains
- Low inflation means lower interest rates

September was another momentous month with interest rate cuts, escalating conflict and Chinese government stimulus. But instead of macro-driven views, we have found it more profitable to rely on "bottom up" research to identify opportunities and risks.

The changes recently made to portfolios lock in gains from Global Financials and German equities. Both opportunities arose from market over-reaction to bad news and required patience and active management to generate gains.

With Global Financials, the buy trigger was the collapse of Silicon Valley Bank, evoking memories of the 2008 Global Financial Crisis. In this case, SVB's demise strengthened the hand of tightly regulated and well capitalised dominant banks, as flagged by our colleagues in Morningstar Equity Research (1). The subsequent rally, helped by rising interest rates and hence rising profit margins, benefited portfolio returns this year.

With German equities, the catalyst was the Russian invasion of Ukraine, impacting supply lines and removing cheap energy. Weaker Chinese economic growth also played a role. The fall in share prices vs broader Europe offered enough extra return for the risks of an automotive industry in transition, given the balance sheet strength and established positioning of many major listed companies.

One market where we continue to see value, is China. Over the past 4 years, it has journeyed from "market darling" to "un-investible", stock market indices falling by over 50% along the way. China's path is a textbook case of exaggerated price moves that tell you more about sentiment swings and current fundamentals, than they do about the future.

Over time international investors have cut back exposure or even fully exited China, giving rise to the launch of EM ex China strategies. Within EM and Asia funds, exposures have also fallen in absolute terms and versus benchmark weights. Taken with the huge de-rating in share prices, it's clear that investors formed a bleak view on the outlook and the risks. Recent moves have not unwound this.

Portfolio positioning in Morningstar multi asset portfolios and funds has been contrarian and capped, to manage China specific risks and have the staying power needed to benefit from rebounds.

So is it time to cash in after the bounce?

Despite large gains, the market is still priced to generate attractive risk-adjusted returns vs other markets, because prices are coming off a very low base. So, we are retaining exposure, noting that China has many high quality, rapidly evolving franchises with preferential access to the second largest economy in the world.

The other headline grabber this month has been the 0.5% reduction in US interest rates. Our base case is that more interest rate cuts are on the way, in most developed economies. Central banks can see the "whites of the eyes" of lower inflation, hence high real interest rates are no longer justified and may pose a threat to economic growth. This backdrop is supportive for high-quality bonds, which also continue to offer diversification benefits.

Overall we see a stronger case for a more balanced approach to portfolios than a bold approach, given current market valuation levels, economic conditions and investor sentiment.

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