Market Commentary (cont)

Market Outlook (cont):

Considering that we are now in the summer months, investors should be cautious.

Once this period of uneasiness is out of the way however, we remain constructive on equities. It is true that equity markets are expensive on almost any metric, but valuation is a terrible short-term indicator.

Today's levels suggest lower long-term returns, but even those returns generally stack up well vs other asset classes. We continue to see limited risk of recession, given strong underlying fundamentals in the economy such as relatively full employment and rising wages, which are increasing consumer buying power.

In our view, the biggest upside risk to the market is driven by capitulation-like inflows into stocks in euphoria. Euphoria typically ends a bull market, and has been glaringly absent during this eight-year bull market.

Recommended Investment:

City Merchants High Yield 199p, 5.0% yield, 1% TER

City Merchants High Yield Trust Limited ("CMHY") is a Jersey-incorporated investment trust listed on the London Stock Exchange. Its investment objective is to obtain both high income (a high level of dividend income relative to prevailing interest rates) and capital growth from investment in high-yielding fixed-interest securities and also in equity-like investments such as preference shares.

Management

The fund is managed by Paul Read, Paul Causer and Rhys Davies of Invesco Perpetual. They form part of Invesco's well-resourced fixed interest team of 19 investment professionals, which is responsible for AUM of over £28bn. The team's investment universe comprises all Euro and Sterling high yield securities and each analyst has sector coverage responsibilities. The team therefore has top-down sector views as well as individual company credit views. The managers take a pragmatic approach to valuation and are not particularly model driven. In essence, they seek to avoid investments where they feel the yield is not sufficient for the level of risk being taken.

Track record

CMHY has an excellent track record, with the NAV having risen 65% over the last five years, comfortably outperforming its benchmark.

Investment Style

The portfolio holds a range of high yield bonds along with an allocation to investment grade corporate bonds. It is actively managed and typically consists of around 100 individual positions to ensure that the portfolio is diversified (individual positions are limited to 15% of the portfolio), having regard to the nature and type of securities (duration, credit rating and liquidity) and the geographic and industry sector composition of the portfolio. The managers pay little regard to any benchmark weights and security selection is focused on well-seasoned issuers that Invesco believes provide a good balance of risk and return. In addition, they have significant exposure to other areas of the market that they believe still offer relatively attractive yields such as corporate hybrid bonds.

Market Commentary (cont)

Recommended Investment (cont):

Summary

The fund's fully covered dividend yield of 5%, paid in quarterly instalments, is very attractive in today's low interest environment. While the fund's shares continue to trade at a premium to net asset value, we take comfort from the fact that they have traded at close to NAV for a number of years. Furthermore, given investor's continued demand for yield, we would expect the shares to be well supported. **Buy.**

Tweet of the Month:

"There is good evidence to suggest that we should use rules rather than unaided judgment when investing in stocks"

Simple rules work. It has been proven that buying 'defensives' or 'momentum' stocks or following the '10-month average' and 'sell in May' rules beat the market on average over the long term.

This is not a recent finding, nor even one confined to investing. In 1954, psychologist Paul Meehl discovered that medical statistical models often outperformed doctors' subjective judgments. And in 1979 Robyn Dawes found that even very rough statistical models were often better than expert opinion: models don't even have to be 'optimal' to be useful.

We have, therefore, good evidence to suggest that we should use rules - algorithms - rather than our unaided judgment. Which poses the question: why don't we do so more often?

Some recent experiments by Jennifer Logg of Harvard Business School shed light on this question. She found that people are not intrinsically averse to using algorithms, indeed quite the opposite. When given the same advice from an algorithm and a human, people preferred the algorithm even when told that the human was an expert. Why then, the reluctance to use algorithmic rules more in investing?

One reason is path-dependency. We believe things today because we believed them in the past: this tendency to under-react to new evidence is one reason why momentum investing works. Because we relied on judgment in the past, we continue to do so today.

Another reason is that we love stories. And humans tell us these, whereas algorithms do not.

But there's something else. Dr Logg's work found that experts rejected algorithms in favour of their own judgment even when the algorithms were good. *"Algorithmic advice falls on deaf expert ears,"* she says. Perhaps this shouldn't surprise us. Algorithms are a threat to experts' jobs and as Upton Sinclair said, *"it is difficult to get a man to understand something when his salary depends on his not understanding it"*.

And herein lies a good reason why retail investors should distrust some algorithms. 'Experts' can exploit our trust in science to rip us off. A team of Swiss economists has shown that this is what happens with structured products - high-charging but opaque assets that promise to protect us from downside risk.

We must, therefore, always ask: what's behind the algorithm. For good ones, such as momentum or defensive-based investing, we have abundant published scientific backing. Bad ones, however, are more like black boxes. When these come with high fees, we should be very wary of them.