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What Keeps Us Up at Night?

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Despite all the doom-laden headlines and geopolitical uncertainties we have witnessed this year, risk assets have delivered remarkably strong returns. The MSCI World index is up nearly 13% year-to-date, with many markets trading near all-time highs. This resilience in the face of adversity demonstrates the market's ability to climb what we call the "wall of worries."

However, strong returns can sometimes be a double-edged sword for investor behaviour. There's a natural human tendency to extrapolate recent strong performance into the future, which we must guard against just as much as any investor would.

At our recent quarterly Investment Strategy Group meeting, a significant theme emerged amongst our experienced strategists, economists, and portfolio managers, concerning government debt levels and their potential impact on the financial system.

Government debt, particularly US government debt, sits at the very core of our global financial system. It provides the anchor for most financial asset prices and has underpinned the system since the 1970s. At Tacit, our core investment outlook does not envisage a breakdown in this global financial order. However, we cannot completely ignore the possibility that the US might attempt to renegotiate its debt obligations, perhaps by reducing interest rates paid or extending maturities. Such scenarios, whilst not probable in our view, could cause significant disruption to asset prices globally if they were to occur.

Interestingly, these concerns create challenges primarily within the stabiliser component of our strategies rather than the growth elements. Traditional "safe haven" assets like government bonds face particular risks in a scenario where governments might restructure their debt obligations. This does not mean we are departing from our established investment approach, but it does require us to think carefully about which stabiliser assets will provide genuine protection should such an environment arise.

Let's be clear about what investing in equities means: you're accepting short-term volatility, including periodic drawdowns of 10-20% or sometimes more. Markets don't move in straight lines upward. History shows us that equities periodically fall back – we simply can't forecast when this will happen.

However, the reason we maintain exposure to growth assets is straightforward: to generate real returns over time, you need to accept some level of risk. To grow your wealth in real terms, you need to take on more risk. The degree of risk you take should reflect your time horizon, capacity for loss, appetite for risk, and ultimate objectives.

We operate what we call a barbell structure, combining stabiliser and growth assets, we use similar investments across all our strategies but adjust the mix depending on each client's objectives. The growth assets serve as the engine that delivers real growth over a market cycle, whilst the stabiliser assets help manage volatility over the same period.

Looking at the current environment, several factors support continued market resilience:

- Earnings growth remains robust, with companies continuing to deliver double-digit earnings growth
- Central banks globally are cutting interest rates, providing support for risk assets

- Valuations, whilst elevated, aren't at bubble levels when considered alongside earnings growth
- Consumer and investor sentiment remains surprisingly subdued despite strong market performance, suggesting we are not in a euphoric phase

Markets have successfully navigated through what many feared would be more challenging conditions.

After a period of strong returns, our focus naturally turns to researching how our strategies would behave when markets do fall, rather than getting carried away with recent gains. This disciplined approach is crucial for long-term success.

The key point for investors is this: do not extrapolate recent strong returns into your longer-term planning. If you have taken risk and it has generated above-expected returns, now might be the time to review your need to take as much risk going forward with your adviser.

Markets will always be volatile, that is their nature. History consistently shows that owning equities generates the best returns over time, but this can be over longer periods than many investors can comfortably tolerate. Your personal objectives and capacity to tolerate any short-term loss in your asset base remain the most important considerations in determining your investment approach. Rather than fearing volatility, we should understand it as the price we pay for the opportunity to participate in long-term wealth creation. The current environment, whilst presenting challenges, also offers opportunities for those with the patience and discipline to stay invested through market cycles.