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INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

July 2018

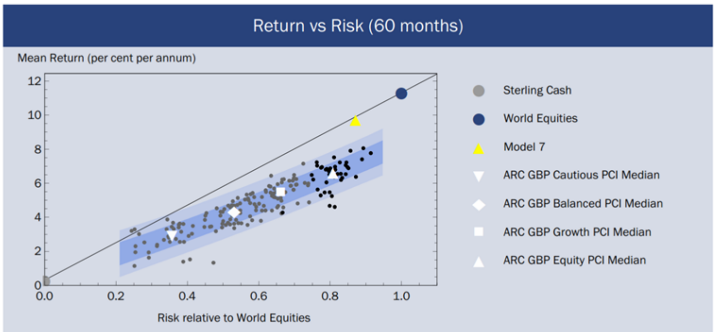
Prices Down, Value Up

Despite all the rhetoric about tariffs and trade wars, June proved to be a fairly uneventful month for most equity markets in the developed world. The UK and Europe closed marginally lower and the US and Japan marginally higher. It was a different story in China, however, where the Shanghai Composite Index fell 8% and below the psychologically important 3,000 level. With the yuan weakening an unusually large 4% over the month against the dollar, currencies across the Pacific Rim moved in sympathy and it seems clear that investors in the region are far more concerned about the fallout of any trade war than counterparts in the West. Despite supposedly acting as a defensive asset gold slipped a further 3.5%. Oil rallied another 10% and at $70 a barrel, is now back to levels last seen in November 2014.

As we enter the second half of the year and take stock, the various economic data points show real GDP growth positively synchronised around the world, unemployment levels hitting record lows and solid US fundamentals building in momentum. Despite these positives, the 'wall of worry' is still firmly in place, but its composition has changed. Not so long ago we were concerned about the unknown consequences of Brexit, secular stagnation, negative interest rates, military conflict and the scale of Chinese debt. To be fair these problems have hardly gone away, but the foundations of the new wall are built on President Trump, trade wars and quantitative tightening.

Speculating on the near-term direction of the global economy, based on assumptions around variables such as Brexit, Trump's intentions, or the price of oil, is a futile exercise. Investors should be very wary of 'experts' who make noisy, confident predictions about macro-economic outcomes and outline how they will profit from the situation. We know our limits, but we also know that by breaking asset classes down, interviewing fund managers, looking at valuations with a logical, disciplined, consistent approach, the probability of enhancing returns are improved.

As we flagged last month, the performance of our model portfolios has steadily improved over the last few quarters. Over five years, our Model 7 portfolio (as shown by the yellow triangle in chart below) is now top amongst a peer group of more than thirty contributors. Our Model 5 and Model 6 also enjoy number one positions in their respective categories.

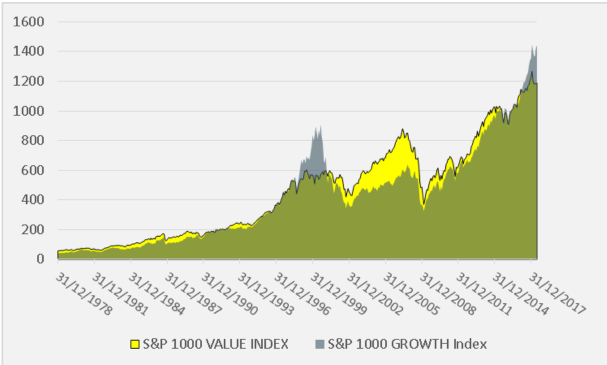


Source: Asset Risk Consultants, 31 March 2018

The reason why our portfolios have performed so well against the competition is due to a growth bias in equities, evidenced by:

- Explicit **exposure to technology** (Polar Capital Technology Investment Trust +200%) over five years.
- **Small-cap exposure** (Henderson Smaller Companies Investment Trust +75%, Artemis US Smaller Companies +60%) over two years.
- **Overweight US** equities, **underweight UK** equities (S&P-500 +115% in sterling terms vs FTSE All Share +44%) over five years.

This was all based on an opinion that the various underlying sub-asset classes looked relatively attractive and it just so happened that they had *growth* characteristics. This approach will not work forever and *value* (which we have been light on) will come back into favour. A full debate on the difference between the value and growth investing is best saved for another time - this youtube video explains it all rather well. Very crudely, growth stocks tend to have high valuations as measured by P/E and price to book ratios and value stocks have correspondingly low valuations. The performance of the two categories have diverged sharply in recent years and many casual observers will have forgotten that value has outperformed growth consistently over the long-run. The chart below bears this out, highlighted by the pure yellow areas. More to the point, the grey areas where growth wins, are few and far between.



Source: Bloomberg ©, Albert E Sharp

Value investing involves a belief that there is a structural inefficiency in the financial markets whereby low valuations today predict superior returns in the future. This sometimes involves taking a stubborn, contrarian view to the consensus and to a large extent explains why the reputations of star fund managers like Neil Woodford have been so badly dented over the last three years or so. The market has had a very choosy appetite for growth and generously rewarded companies such as Amazon and Facebook who have shown the ability to grow their earnings much faster than the wider market.

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Companies such as ITV or Lloyds Bank have, on the face of it looked cheap, but not materially improved their profitability and subsequently seen their share prices drift.

Value investors are relying on mean-reversion and assume that conditions will eventually go back in their favour and we have some sympathy with this. To use an extreme example, Amazon has seen its forward P/E ratio go from 60x at the beginning of 2016 to 86x today. Because profits have in the meantime grown six fold, the market has compensated Amazon by allowing its share price to grow three-fold. The gap between a valuation that was clearly too low then and, for argument's sake today's what is 'fair' now, has been narrowed by the share price rising. We are not saying that share prices will stop rising (in fact we think there is further to go) it is just that a lot of the heavy lifting may already been done.

Besides, choosing a fund is not a binary decision between value or growth. Many investment managers adopt a blended approach, consciously or not, and many prefer to avoid making such a distinction in the first place. Furthermore it should not be concluded that all value managers have done badly and all growth managers have done well. Nevertheless, as we go through the recent model portfolios changes, a value theme starts to emerge.

Model Portfolios: Equities Rejigged

There is no denying that UK equities have been out of favour of late, particularly with international investors, as Brexit and the frailty of the Conservative government undermine an otherwise relatively strong investment case. Large-cap funds have carried the brunt of this and after undertaking a thorough review we have made several changes in this area. Out go **Investec UK Alpha**, **Standard Life UK Equity Income Unconstrained**, in come the **Liontrust Special Situations**, **Franklin Templeton UK Equity Income** and **Livingbridge UK Microcap** funds. This is the result of analysis looking at how the combination works, rather than like-for-like fund switching. **Henderson Smaller Companies** and **CFL UK Buffettology** stay firmly in place having been excellent performers, up 80% and 58% respectively over the last two years.

In Europe we stay with **Artemis European Opportunities** and introduce **European Assets Trust** and the open end equivalent **F&C European Smaller Companies** fund. Manager Sam Cosh has in place a disciplined process that has delivered stellar returns over the years and it is fair to characterize his philosophy as value-driven. Performance has undeniably lagged of late but we believe this provides an entry-point for patient investors, especially with the investment trust trading at a 5% discount to NAV.

In the US we have introduced the **Dodge & Cox US Stock Fund** for our large cap active exposure. Largely unheard of in the UK, Dodge & Cox is a big name in the US, well known for its almost evangelical approach to staff development and adherence to investment philosophy. There is a clear value bias as demonstrated by the fund's P/E ratio of 14x compared to the S&P-500 index on 17x.

We have mitigated some of the dollar risk through using hedged fund classes. Remember that for UK investors, a strong dollar is good for portfolio returns, whereas a strong sterling has the reverse effect. It is important to point out that the decision to hedge is not based upon a strong currency view, rather that the sizeable dollar exposure presents risks.

In Japan we have sold the **Neptune Japan Opportunities** position taking the view that a tracker combined with the sterling-hedged **Legg Mason Japan Equity** fund keeps the strategy intact, but the new mix produces a more optimal outcome.

Our Asian exposure remains unchanged with **Schroder Asia Alpha Plus** and **Schroder AsiaPacific** investment trust representing our large cap exposure. The **Scottish Oriental** investment trust and **Schroder Small Cap Discovery** cover the small caps. In this area there are numerous out-and-out growth stocks, such as **Tencent Holdings** and **Alibaba**, who stand to cash in on the growth of the emerging young middle class.

Source: Investment Week.
Matthew Dobbs heads up the Asia team at Schroders

The emerging markets category has always been an area that overlaps with Asia presenting something of a doubling-up risk. After some detailed analysis, this issue has been attenuated with the inclusion of **Guinness Emerging Markets Equity Income**. We have increasingly warmed to the Guinness approach and despite having a track record of less than two years, we see no reason in waiting to jump on board.

Finally, the 'global equities' category in our model portfolios has been singly represented by technology for more than five years now. This direct exposure to the sector has been an important factor explaining our outperformance. **Polar Capital Technology** has been one of the mainstays, up more than 200% over the period, compared to 50% for the FTSE All Share. Whether it is the **Allianz Technology** or the **AXA Framlington Tech** fund we still see the potential for this sector to outperform the wider market, but remian watchful for signs of over-exuberence. Also, for the first time in portfolios at the higher end of the risk spectrum, we have added worldwide small cap exposure through the exciting **Baillie Gifford Global Discovery** fund.

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Property Still In Favour

This broad sector still has attractions in our opinion, yet remains overlooked by a lot of UK investors. Open-end vehicles have quietly retuned around 7% over the last 12 months and look set to deliver a similar amount over the next. We are sticking with the **Aviva Property** fund on the view that the management has positioned the portfolio well, but also in the knowledge that there is a 'call option' of a near 5% uplift once the fund returns to offer pricing. The investment trusts have generally performed better and **TR Property** which has featured in our models is up 25% over the last year and nearly 60% over three years. Now at a slight premium to NAV, the case is less compelling and we are taking profits and switching into **Schroder European Real Estate** that trades at an 11% discount, with a 5.5% yield.

Fixed Income and Absolute Return: GARS Goes

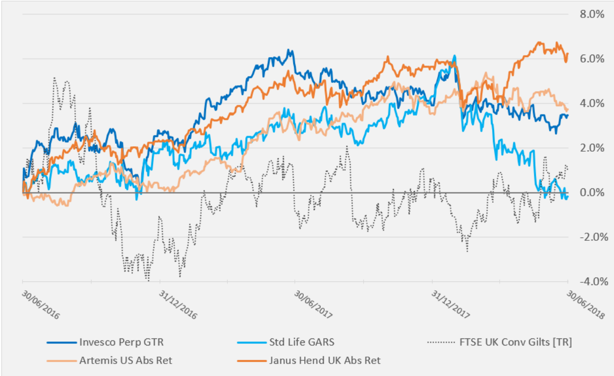
The objective of this combined section of the portfolios was, and continues to be, to achieve what might be considered 'normal' bond-like returns , in a framework of 'normal' bond-like risks. This may appear like a statement of the obvious, but in a post-QE world of rising interest rates, there is scope for bonds to behave in a far-from-normal manner, requiring more careful consideration.

In extremis, the fear was that interest rates moved up too quickly, sparking a global bond market crash. Although we thought an outright crash was unlikely, the headwind of higher rates made it very difficult to see why being long government bonds in the developed world would prove to be a profitable trade. As a result, we have had zero direct exposure to gilts and with the FTSE Actuaries Conventional Gilts Index showing a total return of just 0.8% over the entire last two years, this admittedly basic analysis proved accurate .

This created a new problem though in deciding where to put the money. After much debate, the multi-asset, multi-strategy solutions provided by funds such as **Standard Life Global Absolute Return Strategies (GARS)** and **Invesco Perpetual Global Target Returns** looked like a good option. On the face of it, the risk/reward profile was just what we were looking for and managed by impressive teams in terms of size and quality, the proposition was appealing.

These funds will have several concurrent trades in play at any time. For example, they might buy the Korean won and sell the Canadian dollar or buy US T-bills and sell German bunds. The countless permutation of these types of trade makes it difficult for the managers to run short of ideas. With a series of risk controls in place, the incremental contribution from getting one individual 'bet' right would never be so large as to make a materially positive impact on the fund. Crucially, one individual bad call would not noticeably dent the fund either. Consequently these types of fund have the ability to profit even when markets fall and with limited downside, the proposition is attractive.

Regrettably however, the managers have simply made too many wrong calls of late. This may be unfair but one gets a sense of managers spinning plates, rushing from one trade to another. This hasn't been a disaster but the contrast with the single-strategy, single-asset absolute return funds, like Janus Henderson's, has become stark, as seen above.



Source: Bloomberg ©, Albert E Sharp

Our favourites in this category continue to be the **Janus Henderson UK Absolute Return** fund and the **Artemis US Absolute Return** fund. Both have a very focused strategy of simply buying stocks that they think will go up and selling stocks that they think will go down, or at least go up less than the others. In its simplest form, the Henderson fund might buy shares in Tesco and sell shares in Sainsbury. If the former goes up 10% and the latter goes up 8% then a 2% profit is made. Artemis might do something similar buying Pfizer and selling Merck. To be fair it is a little more complicated than this, but since each manager has a fixed universe, their expertise can be honed accordingly. By working within a limited opportunity set and adhering to a pre-defined and clear gameplan, these managers have produced remarkably consistent returns over an extended period.

Elsewhere, the addition of new funds has proven more straightforward. New entrants include the **Royal London Bond Opportunities** and **Baillie Gifford Strategic Bond** funds, where we have been impressed by two quite different but refreshingly simple fixed-income investment strategies.

Side Effect: Portfolio OCFs Fall

Each fund charges an annual management fee and with additional costs such as marketing and distribution, the total is referred to as the ongoing charges figure (OCF). In reality this is one of the last metrics that we examine, as performance is always the primary consideration.

A perfect example is the CFL Buffettology fund that according to Trustnet is currently the number one performer out of 255 UK equity funds over the last 12 months, up 27%. Over 3 years it is in third place, up 71%. Its OCF of 1.28% is also one of the highest, but it would be myopic in the extreme to conclude that it is expensive, given the vastly superior returns.

In contrast the **Fidelity UK Index** tracker is up 6.6% and 27% over the same period, but charges just 0.09% per annum. On a £100,000 portfolio invested three years ago, the annual 'saving' from using the tracker (£90 vs £1,280) would have resulted in a return that was £38,500 lower. So much for 'cheap' funds!

However, sometimes you can have your cake and eat it. One of the impacts of this reorganisation is that weighted portfolio OCFs have dropped. **In some models they were over 0.9%; now they are 0.7% or less across the board**. This has partly come about as a result of the multi-asset funds going, replaced by much more keenly-priced strategic bond funds. The Dodge & Cox fund charges noticeably less than most in its area and the Guinness Emerging Markets funds has an institutional class that also contributes to the savings.

Conclusion

Moving into the second half of the year, we remain optimistic in our outlook for equities, albeit doubtful that some of the recent phenomenal gains will be repeated. That said, there is an outside chance of a melt-up and if this occurs our portfolios will certainly benefit. Nevertheless, we have moderated our positioning, but it would be incorrect to characterise our stance as now being defensive. Instead we are less reliant on a growth narrative. In contrast, our fixed-income positioning is certainly defensive and is likely to remain that way for some time to come. Be assured that we will be constantly reviewing our assumptions, strategy and fund choices.

A huge amount of work was involved in getting to the top of the performance charts and we intend to stay there. Many thanks to the advisors and individuals that have supported us along the way.

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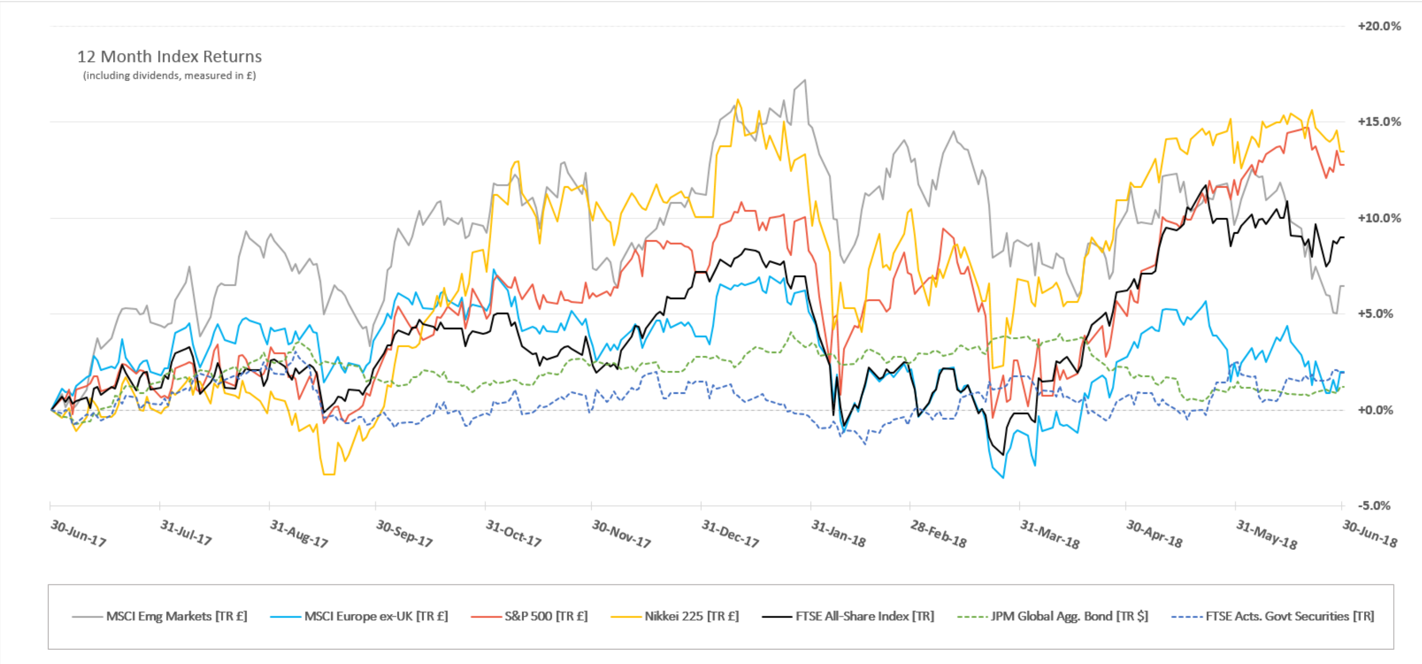
INDEX RETURNS

Index	Region/Asset Class	30 Jun 2018	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,636.9	-0.5%	+4.4%	+17.4%
UK Mid Cap	UK	576.3	-1.0%	+5.5%	+19.7%
UK Small Cap	UK	5,876.8	-0.8%	+5.2%	+31.4%
Dow Jones Ind Avg	USA	24,271.4	-0.6%	+13.7%	+35.4%
S&P 500 Index	USA	2,718.4	+0.5%	+12.2%	+29.5%
NASDAQ Comp.	USA	7,510.3	+0.9%	+22.3%	+55.1%
Nikkei 225	Japan	22,304.5	+0.5%	+11.3%	+43.2%
Euro Stoxx 50	Europe	3,395.6	-0.3%	-1.3%	+18.5%
CAC 40 Index	France	5,323.5	-1.4%	+4.0%	+25.6%
DAX Index	Germany	12,306.0	-2.4%	-0.2%	+27.1%
Milan Index	Italy	21,626.3	-0.7%	+5.1%	+33.5%
MSCI Emg Mkts (£)	Emg Mkts	550.7	-3.4%	+6.5%	+35.6%
IBOVESPA Index	Brazil	72,762.5	-5.2%	+15.7%	+41.2%
IMOEX Index	Russia	2,296.0	-0.3%	+22.2%	+21.4%
S&P BSE SENSEX	India	35,423.5	+0.3%	+14.6%	+31.2%
Shanghai SE Comp.	China	2,847.4	-8.0%	-10.8%	-2.8%
Hang Seng	Hong Kong	28,955.1	-5.0%	+12.4%	+39.2%
UK All Property	UK Property	133.7	+0.3%	+6.9%	+10.9%
UK Conv Gilts	UK Gilts	3,604.1	-0.6%	+1.9%	+1.1%
UK Index linked Gilts	UK IL Gilts	4,864.5	-0.7%	+1.8%	+8.7%
JPM Glob Agg. Bond ($)	Global Bonds	561.2	-0.3%	+1.2%	-0.8%
iBoxx Non-Gilt	UK Corp Bonds	336.0	-0.5%	+0.6%	+5.9%
WTI Crude ($/barrel)	Oil	74.2	+10.6%	+61.1%	+53.4%
LMEX	Base Metals	3,203.9	-4.4%	+12.3%	+35.2%
Gold Spot ($/oz)	Commodities	1,253.16	-3.5%	+0.9%	-5.2%
S&P Agri & Livestock	Agriculture	725.64	-6.5%	-11.6%	-17.4%
£1 = US$	Currencies	1.32	-0.7%	+1.4%	-0.8%
£1 = €	Currencies	1.13	-0.6%	-0.8%	-5.7%
£1 = Yen	Currencies	146.24	+1.1%	-0.1%	+6.5%



Source: Albert E Sharp, Bloomberg ®

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