Telford Mann
Pensions & Investments

Market Outlook

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Financial Planners
Chartered

"When one door closes another door opens; but we so often look so long and so regretfully upon the closed door, that we do not see the ones which open for us."

Alexander Graham Bell

UK equities are currently unloved, undervalued and high yielding, and in our opinion an opportunity is waiting to unfold.

With Brexit still waiting to be resolved, investors around the world have put the UK stock market in the "too difficult" basket.

The global nature of markets means that international developments have often set the tone for UK equities, and following the slump after the global financial crisis of 2007/08, UK shares enjoyed a good run, as have equities generally around the world. However, for the last 3 years, Brexit has loomed large and has been a drag on returns.

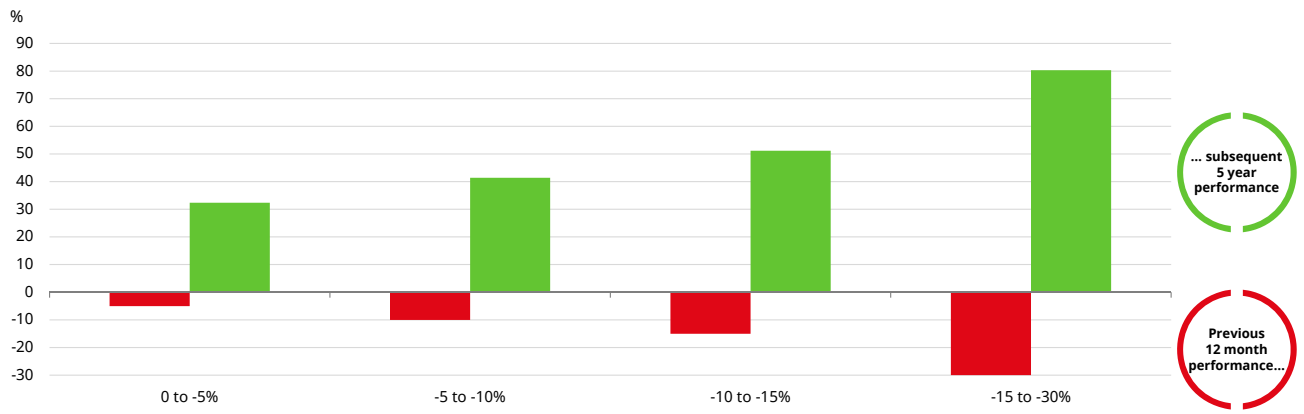
UK equities have underperformed global equities since the EU referendum. As a consequence, relative to global equities they are now the most lowly valued for decades.

The negativity of international investors towards UK equities is entrenched and global fund managers have been "underweight" the UK for three years. This lack of demand for UK equities is driven by Brexit uncertainty and since demand has been low, prices have fallen.

UK equities are trading at a 30% valuation discount to global peers, close to their 30-year lows. While it is likely to persist until there is some form of clarity over the

Fixed Income	▲
Property	▬
Absolute Return	▼
UK Equity	▬
US Equity	▬
European Equity	▬
Asian Equity	▲
Emerging Market Equity	▲
Commodities	▬
Global Equity	▼

Recovery Fund performance vs/ FTSE All-Share index



Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, returns are shown net of fees for Schroder Recovery Fund A Inc.
Based on rolling 12 month performance from date that the Global Value Team's investment approach was adopted (30 September 1995 to 31 December 2018).

terms of any Brexit deal, the bad news and uncertainty is already priced into markets. This chart from Schroders shows how their Recovery fund has recovered from periods of UK underperformance. The red bars show a 12 month period of underperformance, with the green bar showing how the fund then recovered over a subsequent 5 year period. The message being that if we are in a period of UK market underperformance and undervaluation, the rewards for remaining invested far outweigh any short term negative returns.

Over the past 30 years the dividend yield of the UK equity market, relative to the rest of the world has only been higher during the 1991 recession and at the peak of the technology media and telecoms bubble. If you bought every share in the UK stock market (including the good and the bad) and collected your dividends at the end of the year, you would earn a 4.5% return, quite apart from any change in the capital value of the shares.

We believe in long term investing and whilst Brexit may not get resolved quickly, it will ultimately get resolved, one way or another and that could be the catalyst for a bounce back in valuations.

With the newspaper headlines continuing to be dominated by the problems at the Woodford Equity Income fund, let's start by confirming that there are no consequences for our client portfolios. We do not own any funds run by Neil Woodford. We owned some of his funds 10 years ago, when he was at Invesco Perpetual, but we sold out of those funds well before he left there to set up Woodford Investment Management and we have not invested in any funds managed by him since.

We are loath to jump on the Woodford bashing bandwagon here, as one never knows what is around the corner and without all the facts, it can be dangerous to take the high ground, but our decision to not invest with him is one which we think is important to explain. Neil Woodford has long been seen as the bellwether of UK fund managers. Comment on his strategies has filled weekend newspapers and undoubtedly he has called many scenarios correctly over the years, such as his avoidance of banks and other financials in the run up to and during the crisis of 2008. Our reticence to continue investing with him post his departure from Invesco Perpetual, was due to us having greater conviction in alternative UK fund strategies and concerns over some of the risk management applying to the unlisted, illiquid

stocks which have caused him so many problems of late. We also don't subscribe to some of his current conviction ideas, such as his belief that China will implode causing the rest of the world to spiral downwards. Highlighting the Woodford predicament is not to say that the funds we choose in his place will always outperform his funds, but sometimes we do need to look at those funds we choose not to invest in and explain how that decision has affected our performance.

Liquidity is always one of the main factors we consider when selecting funds. At a headline level, the size of the fund typically provides a gauge on the liquidity available within the fund. For example, a fund with assets of £900 million is likely to be far more liquid than a fund with assets of £50 million. We have to look at the size of the investment we are likely to be making and work out whether or not the fund could cope with that scale of the investment and if so, what the impact on potentially exiting the fund may be should we no longer wish to stay invested. Being able to exit any fund, under any circumstances is as important a decision as investing in the first place.

Once we have established the headline fund size, we then need to consider what assets the fund is investing into. We have written at length over the years about the property sector and the inherent illiquidity that can exist in property funds. We try to manage this by being very particular about the funds we invest into, but we are always aware that the property sector is the least liquid sector one can invest into. Perhaps, less well publicised are the liquidity risks associated with investing into funds that have a focus on small or micro-cap stocks and those investing in niche regions around the world. Small and micro-cap stocks exist globally not just in the UK and the size of the fund manager's exposure to each holding and their ability to fully liquidate the portfolio in a worst-case scenario are factors we look at when selecting funds.

Niche regions around the world may include parts of Africa or the Middle East where their domestic trading days are different to the rest of the world. The Woodford situation has highlighted the risks of unlisted, illiquid assets, but they in themselves are not the problem, the problem is knowing what you are buying and ensuring that it is suitable for the people you are buying it for.

Unexpected events either on a global, geopolitical or even stock specific level can happen no matter how much research is done, but we spend a large amount of our time trying to understand where all of our managers are investing, discounting those we don't think are suitable for our investors and shortlisting those where we think there is scope to consider investing, before deciding how much is suitable to invest. We try to meet the managers of all funds in our portfolios. A face to face meeting at which we can scrutinise the details of how a manager works, what they invest in and why, is a vital part of our research process. All of the managers of the UK equity funds we own and invest into have visited us in our offices and they have made themselves available for questioning on all aspects of their portfolios. Sid Chand Lall of Marlborough and Clive Beagles of JO Hambro were here a couple of months ago, Nick Kirrage of Schroders is due here this week and Richard Colwell, Head of UK Equity at Threadneedle is here next month. Visits don't guarantee good returns, but they do breed accountability. This is not the case with all managers and needless to say that the bigger the name, the less accessible they are. Interestingly, Neil Woodford never visited us, not even in his Invesco Perpetual days when we did hold his fund.

A good example of a fund where we would have liked to invest more since it launched in 2010 is the BMO UK Property fund, but the reason we have gently topped up the holding over time rather than make substantial increases to our exposure is due to the fund size. It does neither our investors nor the fund manager any good to pile into the fund even though we believe in the strategy and so we have managed our exposure accordingly over the years.

Similarly, we have made the decision in our latest review to sell out of the Jupiter UK Smaller Companies fund. This fund has excelled since we invested. It is an example of a fund where there was a core existing allocation, but where we felt the manager was growing assets and we had the opportunity to enter at a point where it was small enough to really maximise the positions it took, but not so small that we couldn't exit if need be. James Zimmerman, the fund manager recently announced he was leaving his post and returning to work in the USA. A new fund manager has been appointed, however, his track record at his previous employer, M&G, is not stellar and his approach historically hasn't mirrored James Zimmerman's and so we are not confident that future performance will be so strong, or that it will be managed with such conviction.

We wish to maintain our UK fund exposure, for the reasons set out at the start of this update and we need to maintain a breadth of exposure to small, medium and large companies whilst the Brexit outcome remains so uncertain. There are currently no funds that have outperformed the Jupiter fund performance in the smaller companies sector, but the nearest competitors are funds with a micro-cap/nano-cap/AIM focus. These funds have performed really well over time, but their overall fund sizes are small, the risk of being solely focused on the most illiquid end of the UK equity market should be higher than other UK equity funds. However, the managers' have dealt with this issue well historically so in reality that hasn't been the case. Unfortunately our worry is that the managers' may not be able to cope with a sudden inflow of around £15 million of assets from us in one go, given the size of company they are then investing into.

We have therefore decided to reallocate the proceeds of the Jupiter UK Smaller Companies fund across our existing UK equity funds with JO Hambro UK Equity Income and Marlborough Multi Cap Income being the biggest benefactors from this decision, as they both have a reasonable exposure to smaller cap stocks within their strategies, which allows us to maintain our broad exposure to UK equities.

On the theme of Jupiter, we have also sold our exposure to their Absolute Return fund. This had not been in the portfolios long and was brought in to provide a complete lack of correlation to the other funds in the portfolios. The diversification aspect remains true, however, the fund should be rising when other markets fall and remain relatively flat whilst other markets rise. Unfortunately, the fund called some of its investment decisions incorrectly and ended up falling more than we had hoped. It has recovered over the past couple of months as global markets have struggled, but it needs to significantly outperform from here to recoup its losses. We need something more consistent in our strategies to act as a diversifier and so we have included the Blackrock Ishares Overseas Government Bond Index fund in Jupiter's place.

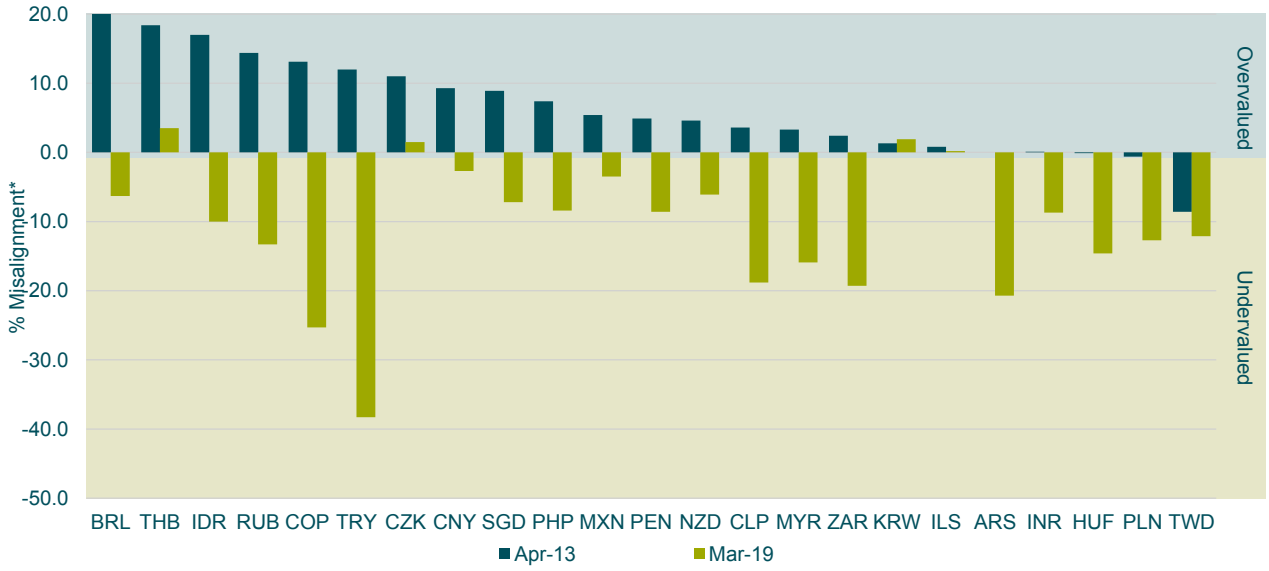
The Janus Henderson Fixed Interest Monthly Income fund has been one of our best performing funds over the last 12 months and this has been boosted by allocating at the right time to Treasury and Gilt holdings. We feel that with increased global uncertainty surrounding markets at the moment, a fund which can hold predominantly more Gilts and Treasuries as well as other major market Government bonds may provide a better counterweight to our portfolios than Absolute Return. These types of assets have traditionally held up well in times of increased market volatility. The yield on both the 10 year Treasury and 10 Year UK Gilt have both fallen markedly over the past month and so we do need to be careful about timing investment into the sector, but we feel that these assets warrant a place in our portfolios as part of our lower risk allocation.

Another area of fixed interest which we have increased exposure to is the M&G Emerging Market Bond fund. We have purchased this in lieu of the Artemis Monthly Distribution fund. The Artemis fund has been one of our most consistent performers, however, it has struggled over the last 18 months. We do already have a significant weighting to the manager of the equity portion of the Monthly Distribution fund, Jacob de Tusch-Lec via his Global Income fund and the fixed interest allocation within the fund has been focused at the high yield, corporate bond market rather than government bonds. The managers are now looking to shift some of their fixed interest allocation towards government bonds, but we feel we can better allocate to both fixed interest and global equity via specific funds rather than this hybrid for current market conditions.

Emerging Market Bonds have traditionally been a core holding for us, however, we have been out of the sector for a while now amidst concerns about global volatility, currency movements and potential default risk. We feel that now represents a good entry point back into the sector. Emerging Market Bonds are highly correlated to movements in the Dollar. Many funds only offer exposure to emerging market debt hedged back into US Dollars. At times this can smooth returns, but if there are concerns over the strength of the US Dollar it can also lead to extreme valuation movements, which we have experienced before. There are currently two quite polarised schools of thought on US Dollar strength, but overall we feel that the US Dollar will weaken over time. How quickly and with what impact may largely depend on the forthcoming US election season, but there is scope for emerging market bonds valued in local currencies to bounce back, some analysts predict by as much as around 8%, should we see pressure build on the US Dollar.

The chart below demonstrates how undervalued some of the main local emerging market currencies are today when compared to six years ago.

Valuation of EM currencies today vs. April 2013



The M&G Emerging Market Bond fund is a flexible strategy which allows the manager to move between US Dollar and local currency denominated bonds as the market develops. Presently the fund is split around 70% US Dollar and 30% local currency. In addition, the fund offers a yield in excess of 6% which rewards the perceived risk in owning emerging market bonds over developed world government debt. To counter the default risk concern, US high yield defaults are currently higher than emerging market default rates, which in turn are also lower than current global high yield default rates. Undoubtedly emerging market bonds are higher risk than US Treasuries, but at a time when we are concerned about corporate bonds more generally, emerging market debt does seem to offer an alternative way of diversifying our portfolios.

Our ethically biased fixed interest funds have bucked the trend of broader UK corporate bond concerns. The Rathbone and Royal London Ethical Bond funds in particular have excelled over the past year and we have increased allocation to these. It is important to recognise this, as whilst we hear reports over default and liquidity concerns affecting corporate bonds, the more select nature of ethical bond funds provides some resistance against the wider market. Royal London have taken advantage of new issuance in the social housing sector, which is a sector that the fund is strategically trying to add to, by purchasing Clarion Housing Group, MORhomes, Hastoe Capital and Futures Housing Group. Away from social housing, the fund also increased allocation to Income Contingent Student Loans, which is the Government's second securitisation of student loan debt.

A further major asset allocation decision we have made is to sell out of our Japan focused funds entirely. We had previously been more positive on the Japanese market, but 2019 has raised more questions than it has answered. Japanese valuations are cheaper than Europe and other developed world markets, but the momentum of the market is downwards. Whilst political reforms and incentives to business to return capital to investors all remain reasons why Japan should be a profitable place to invest, Japan cannot shake off the effects of the global slowdown. They seem caught up in the US/China trade dispute. Global auto sales are declining and this represents much of Japanese exports so although the workforce demographics in Japan are much improved and unemployment is low, stimulus in wage growth and household spending is minimal. There is a disconnect between corporate profits and share prices. Corporate profits are over twice the level seen in 1989, but share prices are less than 60% of the peak level seen in the first year of the Heisei era (the reign of former Emperor Akihito) which commenced in 1989. The link between earnings growth and share price growth has been broken. Around half of Japanese companies

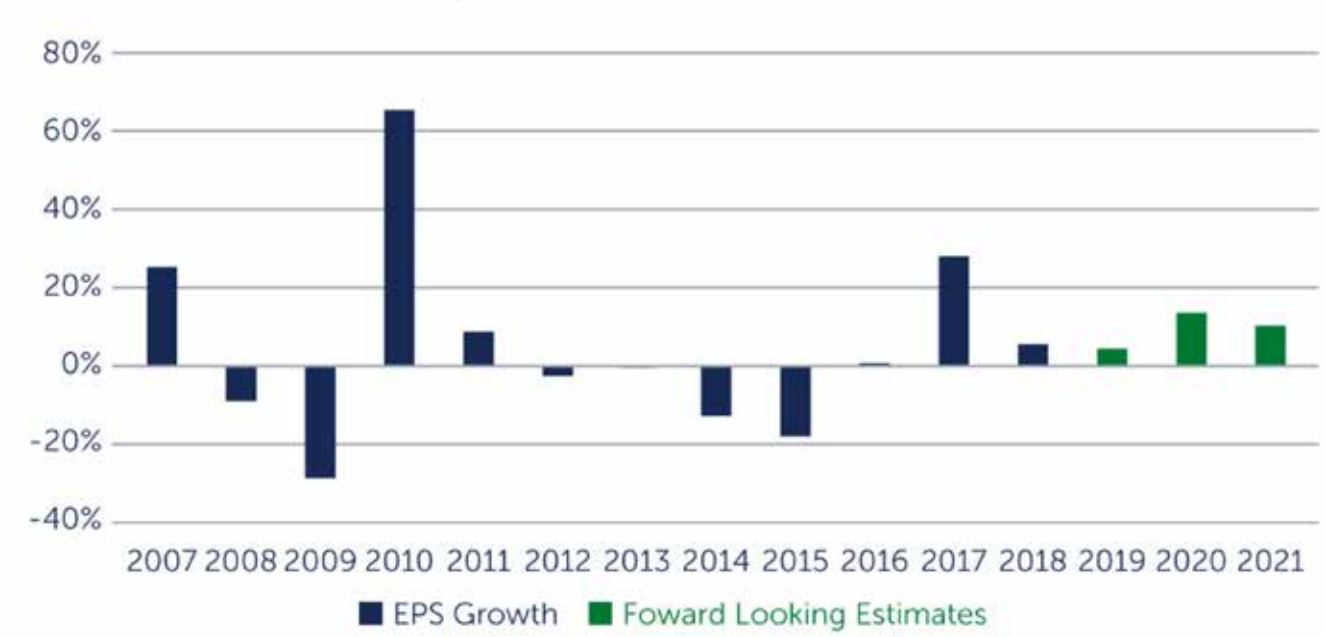
are trading below their tangible book value compared to around 20% in Europe and less than 10% in the US. Of all global economies, the earnings growth potential for value biased stocks in Japan is superior to that of growth biased stocks, but we have been here before with Japan. It remains a favourite sector of UK Multi Managed funds, but the catalyst to stop this decline is hard to find. On paper and anecdotally Japan should be leading the developed world markets in terms of a recovery, but in reality it is lagging.

We feel that there is greater scope for growth in China and the broader Asia/Emerging Markets than in Japan. The Chinese/US trade wars are ongoing, and so whilst our Chinese funds are both up over 10% for 2019 year to date, they were up well over 20% in May 2019 before the latest round of talks broke down. The tensions have escalated beyond trade into telecoms and arms, but ultimately neither the US nor China want a full-blown trade war, despite their reticence to admit this in public. The next round of talks between President Trump and President Xi Jinping are scheduled for the end of June 2019 at the G20 Summit in Japan. We may not see an immediate end to the prevarication at that Summit, but one would imagine plenty of rhetoric around it will emerge which may move markets. On the face of it, China is in a weaker position. China exported $560 billion of goods to the US in 2018, whilst the US exported $179 billion of its goods to China. In summary, China seems to need the US more than the US needs China and that is President Trump's bargaining chip. With another US election campaign already upon us, the US negotiating a deal with China that helps boost the US domestic economy at a time when it is starting to report negative numbers would be timely and for China, a global recession would be bad news at a time when they need a feelgood factor to offset some of the negativity surrounding Hong Kong and its governance. There are incentives on both sides and whilst we feel the US is closer to a recession than China, we don't anticipate a recession being allowed to happen ahead of the next US election and so we have maintained our US exposure and increased our Chinese exposure on the premise that any agreement should lead to improved returns from China.

With regard to broader Asia, Prime Minister Modi won the recent Indian elections. The Indian stock market rallied a little on the back of the election result and longer term the signs of continued recovery in India remain strong as Modi now has a mandate to implement land and labour reforms which should boost the creation of large-scale manufacturing plants and infrastructure spending. With India this week announcing retaliatory tariffs on US goods, one can expect a pausing in the Indian stock market. These tariffs were delayed from last June when the US refused to exempt India from higher tariffs on aluminium and steel imports. President Trump is also unhappy about India's talks with Russia over the supply of arms, but India is a predominantly domestically driven economy and so global tariff issues should not have a lasting detrimental effect on Modi's mandate to kickstart the Indian economy with fiscal and monetary stimulus expected to boost the business cycle. A further cut in interest rates in a low inflation environment, should provide the requisite pick me up to the Indian stock market in the months ahead.

Across broader emerging markets, sentiment has turned upwards in Brazil with President Bolsonaro enjoying unprecedented popularity polls and Emerging Europe enjoying a recovery as well with stocks such as Lukoil up more than 20% in the first quarter of the year and Rosneft increasing its dividend payout ratio to 50%. With the negative sentiment surrounding Russia, these stock level improvements and investor rewards have not been priced into markets. That said these markets are heavily linked to natural resources and the price of oil, which fell over 16% between the middle of April and early June 2019. With such sharp movements as we are experiencing in the Oil sector and the increase in tensions between Iran and the US over the recent oil tanker attacks, the natural resources sector is a hard one to call. If we see a complete breakdown in Iran/US relations then we can expect oil companies to deem the risks in the Middle East too great. These risks are already as high as they can reach in peacetime, thus causing supply chain concerns and a likely rise in the oil price. Emerging Europe and Latin America are not solely oil driven economies, but they are inherently linked. The Bolsonaro effect hasn't had a prolonged effect on the Brazilian stock market yet and Russia remains a global area of risk, but they both remain relatively cheap markets with evident ongoing reform and so we have allocated to the JPM Emerging Market and Emerging Market Income funds to gain exposure to the wider emerging market economies beyond Asia. If our prediction of a weaker US Dollar over time proves accurate, then this could be beneficial for emerging market economies who currently trade below their long-term average. Now could also represent a good re-entry point for emerging markets as investor expectations remain relatively depressed, but markets could surprise on the upside if the forecast growth figures are correct, as the chart from Baring Asset Management demonstrates on page 10.

Emerging Markets Equities are Forecast to Continue Reporting Positive EPS Growth[1]

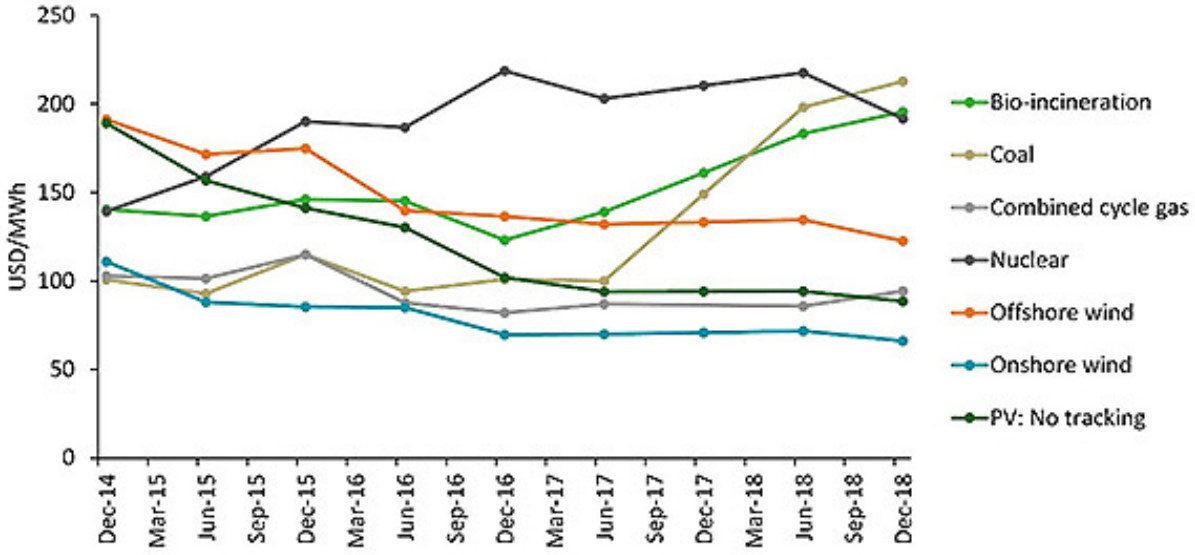


1. SOURCES: Barings, Factset, MSCI. As of April 30, 2019.

The performance of our ethically biased strategies has been pleasing over the last year. In line with the asset allocation moves we have explained in the previous pages, we have in turn increased our allocation to the Liontrust range of sustainable investment funds. Their range of funds have performed particularly well of late and one of the focuses for their funds is the movement towards a net zero emissions world. Climate change and the awareness of it can be seen in the shift to more businesses set to win from capitalising on the opportunities presented by combating climate change than those businesses for whom climate change is a threat. The UK Committee on Climate Change recently issued its latest report targeting the reduction to net zero of greenhouse gas emissions by 2050. This target is helped by the way renewable energy costs have fallen in recent times. Liontrust have already seen implications in the market for those companies who are carbon-intensive in either products or services and who fall on the wrong side of regulation to reduce emissions. Coal is a good example of a product which is structurally challenged in a world where clean energy and automotives are the future to meet tightening pollution targets.

As Liontrust's chart shows, solar and onshore wind are now the cheapest ways to generate electricity in many countries, including the UK. The chart shows how the costs of generating electricity from various sources over the last four years has evolved:

Levelised cost of electricity history in UK



Source: Bloomberg, NEF, April 2019

Both regulation and sentiment will make it harder for companies whose targets are not to provide renewable energy, energy efficiency, efficient transport, waste sorting and recycling to remain attractive investments, which will over time diminish their residual value.

To conclude, we have reviewed the merits of re-investment into European equities. We recently met with the Fidelity European Opportunities portfolio manager, a fund which is on our shortlist should we look to buy back into the region, but we continue to be unsure that now is the right time to reinvest. Much of the talk about Europe is that it remains cheaper than the US and has much of the bad news already priced into valuations. There are undoubtedly sectors such as autos and some of the banks that need avoiding, but if the US Dollar weakens then this could be good for Europe, for which 40% of its GDP derives from exports. President Draghi of the European Central Bank is due to leave his post later this year, but in the last few weeks has made further positive noises about taking action to stimulate the Eurozone. The problem Draghi has is that the Eurozone is already suffering from negative rates and so the tools he previously used to stimulate growth are less likely to work. Fiscal stimulus is needed across Europe, but this is out of Draghi's hands as it requires each individual state to agree to take action, which is unlikely to be supported when we assess the increasingly delicate political situation in Germany, Italy and France amongst the core nations. With the potential of a stronger Euro added to the mix, it would seem that finding a fund to invest into in Europe now would be more about which one will fall less, rather than which one will grow the most.

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