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INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

October 2016

A Different Class

September proved to be something of a mixed-bag across the financial markets, with most indices edging lower as the month progressed only to rally in the final week as relief spread on news that US interest rates were to be kept on hold. The UK's largest 100 companies closed just off a 12-month high and in headline terms are slightly ahead of their counterparts in the S&P-500 and Dow Jones. However, in sterling terms, due to the dollar's strength, any US-based assets will have enjoyed an additional 13% return through the currency. European equities have been notably weaker than the UK in euro terms, but for UK investors, after allowing for the pound's weakness, returns have been astonishingly similar. Elsewhere, as the quarter drew to a close, oil edged up, closer to the $50/barrel level for the first time since June, whilst German bund yields challenged new lows and gold continued its move sideways.

We hope that you have found the new-look valuations easier to read and any feedback is gratefully received. One key area that has changed is the classification of securities within each asset class. Having felt for a long time that many of the existing industry standards were confusing and out of date, we have made our own amendments and as we enter Q4 it seems like an opportune time to explain the changes and comment on our positioning across the asset classes.

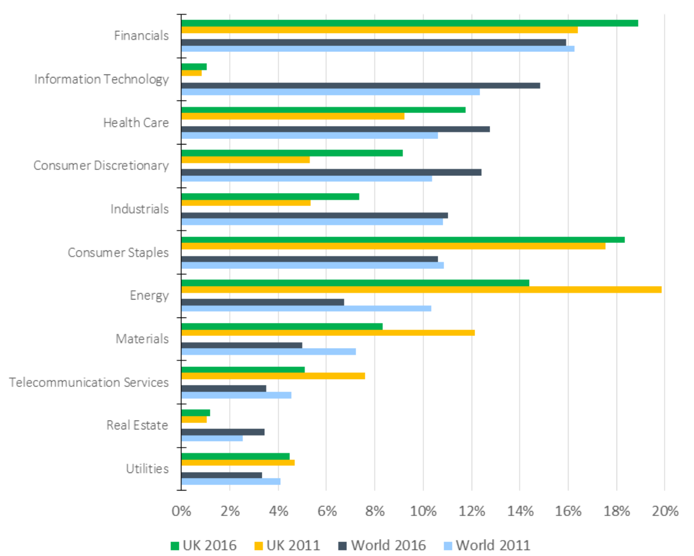
UK Equities

In this category, collective vehicles, regardless of whether they are an investment trust, unit trust or other structure are now split two broad styles: ***Large-cap Funds*** and ***Mid & Small-cap Funds***. The line of thought here is that it is easier to spot where the risk lies in a portfolio, assuming that mid and small-cap tend to be more volatile with greater downside potential. So far this year, large-cap has enjoyed a much better run, up 15%, compared to the mid-caps +10% and the small-caps +5%. The recovery in gold and oil prices has been a major factor, helping push the likes of Anglo American and Shell an incredible 340% and 60% higher respectively from the lows in January.

In addition, many of the large-cap stocks are benefitting from a strong dollar, given their international exposure. In the mid and small-cap arena, which tend to be more focused on the domestic market, some companies are missing out on the tailwinds of the weak pound whilst importers are facing a headwind because of it. As the performance numbers suggest, investor inflows, especially from overseas, have been directed towards the more liquid, FTSE-100 heavyweights. The result is that the small and mid-caps have seen their relative valuations slip and, in time, we expect to see some catch up amongst the group. In more general terms, we remain positive on UK equities and expect to see a resurgence of M&A activity as Brexit fears recede and overseas companies take advantage of their newly found purchasing power.

For individual stocks, companies are separated according the relevant GICS (General Industry Classification Standard) sectors. The table below shows all eleven, including the new Real Estate category, that was separated from Financials in August. Part of the reason to keep an eye on the weightings is for risk control purposes. For example, a portfolio heavy on utilities but light on financials is likely to perform in a very different manner from the main index.

EQUITY INDEX SECTOR WEIGHTS 2016 VS 2011 1



Source: Bloomberg ®

International Equities

It also matters which country is being analysed and as the table also shows, a global equity portfolio will have very different weightings from to that purely in the UK, especially in technology. Indeed, over time the landscape changes, as illustrated by the fall of energy and the rise of healthcare.

In short, adopting the GICS framework helps identify risks and this is relevant whether it is for portfolios of direct equities or portfolios that contain funds.

On a regional basis, the ***US*** remains one of our favourite regions, with earnings growth set to grow at a heathy clip in 2017. The Presidential race may raise concerns, but this isn't being reflected by the market. Indeed, a Trump administration would be very pro-business which should be good for Wall Street. As in the UK, the mid and small-cap stocks seem overlooked too and we advise keeping plenty of exposure here.

Japan has been in its own orbit over the last 12 months or so with the currency strengthening, somewhat counter-intuitively and the market remaining flat. The initial euphoria of Abenomics has waned, but it remains early days and we are unwilling to write off the project. The upside is significant if the stars align and we suggest keeping some exposure to the region.

Asia Pacific ex-Japan is a huge region including China, India and Australia and as a result will have individual bright spots and danger zones, but as a very broad generalisation we are optimistic that China will avoid a hard landing and that as the country shifts to a more consumer-orientated economy the wider region will benefit. The fact that assets are frequently measured in US dollars has helped of late and may continue to do so.

Emerging Markets covers South America, Russia and other developing nations and it seems glib to generalise, but as an asset class the correlation to the China-factor remains high, and as stated above, we are sanguine on the subject. The case is helped further by a stable US economy.

Europe is noticeably last in the list due to the fact that we are not convinced that the economic problems are in the past and also that as we head into 2017, several key election results could create political turmoil. As a result we simply have more confidence in other regions and believe that any exposure here should be undertaken very selectively.

Global is a catch-all category for funds with exposure to multiple regions. This also covers specialist international funds such as technology or natural resources, for example. Risk factors can vary in this area and often requires further analysis.

Property

In addition to the category of listed ***UK Real Estate*** companies, we have tried to simplify this category by splitting the group in to three: ***UK International Property Funds***, ***UK REITs***, and ***UK Unit Trusts***. International property is too general to call, but UK property still looks attractive. As long as the pound stays low, the incentive to overseas investors is high, especially given the paltry income potential across bond markets. According to real estate specialists CBRE, UK commercial property currently yields 5.4% and although UK gilt yields have increased to 1.1%, the 4.3% difference remains extremely wide by historical standards and we expect this to keep property prices well supported.

Fixed Income

This broad category is mainly split between ***UK Government*** (gilts) and other ***Non-UK Sovereign*** bonds and ***UK*** and ***International Corporate Bonds***. There also is a catch-all category of ***Strategic Bond Funds*** that contain a mixture of the above. Although the fixed income area is huge and varied, we find that it is actually possible to generalise. Partly due to quantitative easing, interest rates in most of the developed world are at extremely low or negative levels, and in time we see that this can only go one way – up. Due the inverse nature of bond prices and yields, this doesn't bode well and we worry that there is more risk here than first meets the eye. For that reason we prefer the safer, shorter-duration, domestic issues. That said, we acknowledge that opportunities will present themselves, possibly fleetingly, as markets adjust. This could be in emerging markets, high yield or floating-rate notes, for example, but we believe that the ability to be nimble will prove critical to performance. Consequently, we are drawn toward the broad ***Strategic Bonds*** category, where the manager has few constraints and can jump across geographies, maturities and investment grades providing upside potential and downside protection – so long as the right fund is selected.

Alternatives

This broad category covers what might be generally regarded as non-conventional assets classes. ***Commodities*** specifically relate to funds that track an underlying price, such as gold, steel or cotton. We have tended to avoid making calls in this area on the grounds that putting money in feels closer to speculating than investing. This area also covers ***Private Equity*** and ***Infrastructure***, which have several interesting specialist funds, often with attractive yields.

Absolute Return & Multi-Asset

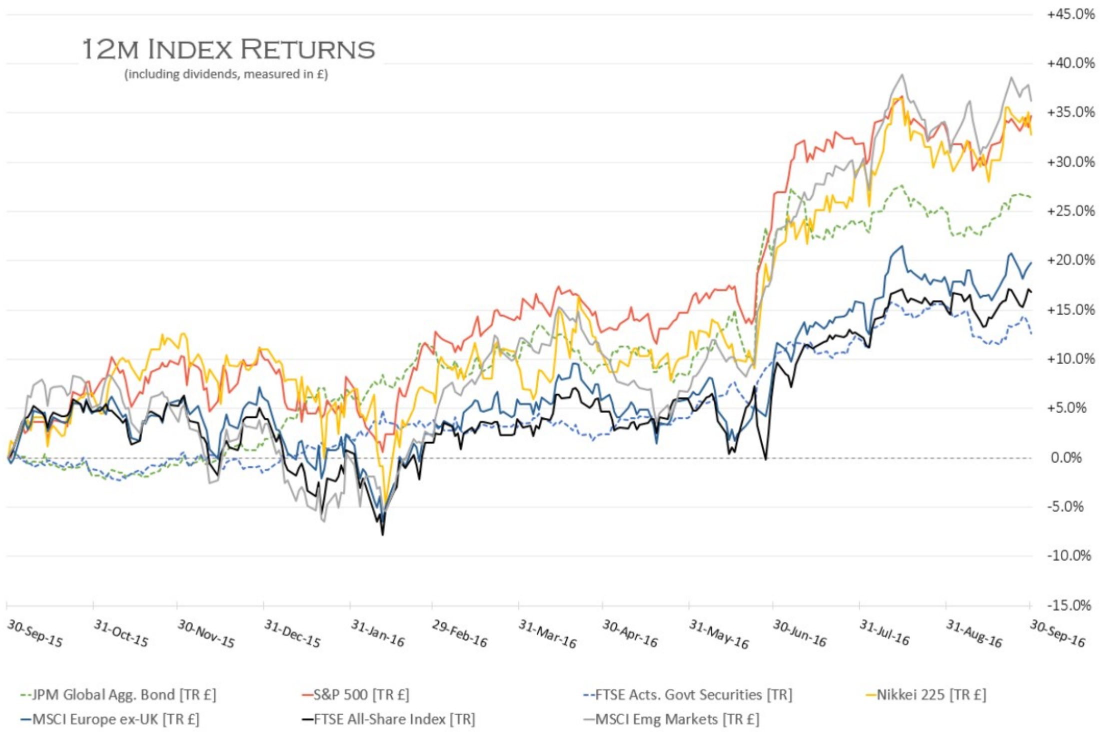
Due to our concerns over the bond market, we have a higher exposure to this category than ever before. In principle, some of these funds could be risky, but we have tended to select those that have a demonstrably conservative approach, with a proven history of low volatility and low drawdown (peak to trough declines). Indeed, we have tried to find funds that have 'bond-like' characteristics of old.

There are several varieties of absolute return fund, but we have categorised them into ***Multi-strategy*** (funds with several different trading approaches or tactical plays) and ***Equity Long/Short*** (in addition to buying and owning shares in a conventional manner, the manager also potentially benefits by selling short if the share price falls).

If you have any questions on this new way of reporting, please let us know and any feedback is very gratefully received.

Index Returns

Index	Region / Asset Class	30-Sep-16	Monthly Change	1 Yr Change	2 Yr Change
UK 100	UK	6,899.33	+1.7%	+13.8%	+4.2%
UK Mid Cap	UK	521.15	-0.4%	+7.1%	+16.2%
UK Small Cap	UK	4,974.86	+1.6%	+11.0%	+13.6%
Dow Jones Ind Avg	USA	18,308.15	-0.5%	+12.4%	+7.4%
S&P 500 Index	USA	2,168.27	-0.1%	+12.9%	+9.9%
NASDAQ Comp.	USA	5,312.00	+1.9%	+15.0%	+18.2%
Nikkei 225	Japan	16,449.84	-2.6%	-5.4%	+1.7%
Euro Stoxx 50	Europe	3,002.24	-0.7%	-3.2%	-6.9%
CAC 40 Index	France	4,448.26	+0.2%	-0.2%	+0.7%
DAX Index	Germany	10,511.02	-0.8%	+8.8%	+10.9%
Milan Index	Italy	16,401.00	-3.2%	-23.0%	-21.5%
MSCI Emg Mkts (£)	Emg Mkts	455.78	+2.1%	+36.2%	+17.6%
IBOVESPA Index	Brazil	58,367.05	+0.8%	+29.5%	+7.9%
MICEX Index	Russia	1,978.00	+0.3%	+20.4%	+40.2%
S&P BSE SENSEX	India	27,865.96	-2.1%	+6.5%	+4.6%
Shanghai SE Comp.	China	3,004.70	-2.6%	-1.6%	+27.1%
Hang Seng	Hong Kong	23,297.15	+1.4%	+11.8%	+1.6%
Conventional Gilts	UK Gilts	3,649.94	-2.3%	+12.6%	+21.9%
JPM Glob Agg. Bond (£)	Global Bonds	827.42	+1.3%	+26.4%	+32.1%
WTI Crude	Oil	48.24	+7.9%	+7.0%	-47.1%
Gold Spot $/Oz	Commodities	1,315.75	+0.5%	+18.0%	+8.9%
£1 = US$	Currencies	1.30	-1.3%	-14.3%	-20.0%
£1 = €	Currencies	1.15	-2.0%	-14.7%	-10.1%
£1 = Yen	Currencies	131.50	-3.2%	-27.5%	-26.0%



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