ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

September 2017

Working Models

It is maybe a little surprising that stock markets in the developed world ended August flat to moderately higher given some of the developments during the month. An escalation of tensions in Korea, Hurricane Harvey and more chaos in the White House would have undoubtedly caused a bout of jitters some 18 months ago, but investors are now taking a much more sanguine view of world events. Indeed, the market seems to be concentrating on fundamentals at the moment, rather than being influenced by politics, supposition or rumours, and the fundamentals are undeniably positive. In the US, GDP data for Q2 was recently revised higher to 3%, its highest rate in more than two years due to better consumer spending and business investment. In addition, manufacturing activity hit a six year high and employment levels continued to improve. Talk of a hard-landing in China has all but disappeared following an increase in the GDP growth rate in the first half of 2017. That said, one shouldn't expect too much in the way of bad news coming out of Beijing ahead of the Communist Party Congress in mid-October. Closer to home, the Eurozone purchasing managers index (a measure of business activity) remained in expansionary territory; even Greece recorded its best numbers in nine years. The UK continues to progress steadily with some members of the MPC suggesting that the time has come for a rate rise. But whilst all this has been great news for equities, especially those in the emerging markets of late, bonds have been under pressure and investors in UK government bonds will have lost money over the last 12 months, despite a nice bounce in August.

Over the last few weeks, as part of the regular review process, we have been analysing the performance data for our model portfolios. The numbers don't lie and ultimately reveal what went right, what went wrong and enable us to assess what changes need to be made, if any. The model portfolios run from 1 to 10 based upon risk tolerance (with 10 being the riskiest) and contain varying proportions of our favoured funds. There are two versions of the models: one set is held in the legal custody of *platforms*, which are third party agents such as Transact, Standard Life Elevate or Nucleus, for example, and work in partnership with financial advisers. The other is where Albert E Sharp arranges custody, using a subsidiary of FIS one of the world's leading financial services support companies. The main difference is that the latter provides us with a larger investment universe and, importantly, makes access to investment trusts much easier. In practice, the difference can be found in three or four holdings and the correlation of returns between the two is high.

Technically, our lowest risk model starts at 1, which is purely cash but given that interest rates are so low, this strategy currently has no relevance. There is much more appetite for *Model 1-2* also colloquially known as the *Beat The Bank* model. The objective here is to create a portfolio that returns more than what would be achievable through a deposit account, but it is vital to understand that this can only be achieved by taking more risk. Nevertheless, we look to mitigate the hazards by selecting a series of funds that we believe have a high probability of positive returns. Equally, each holding must have a low probability of acute loss in the event of another crisis. Historically, portfolios such as this would have contained a high level of exposure to bonds, especially gilts, but given the fact that interest rates currently have the potential to rise quickly, and due to the inverse relationship between bond prices and interest rates, such naked exposure carries significant risks. Consequently we have a high number of absolute return funds, which effectively carry some form of insurance and the strategy is working nicely. For the year to the end of August, the FTSE Conventional Gilts Index was down 3.3% which compares to the **Premier Defensive Growth** fund, **Invesco Perpetual GTR** fund and **Muzinich Global Tactical Credit** which all returned over 2% over the same period. In fact every single holding in this model was in positive territory in the 12 months to the end of August.

A large part of our portfolio construction process involves stress-testing and scenario analysis and this is based on the last 20 years of data. In a worst-case scenario, the *Beat The Bank* portfolio would have lost around 7.9% over a 12 month period, which included two cataclysmic events (tech meltdown and credit crisis). In this context the 3% return to August 31st looks like a success. Although this is not a huge number, don't forget that the objective was to beat deposit rates which at best currently yield 1.25% p.a. You can't have your cake and eat it – if you want more return, you have to take on more risk.

So in order to do so and as we move through Model 2 and beyond, the equity exposure starts to grow. Decisions about how much to allocate to each region within each model is taken by the team at Albert E Sharp. We prefer to control allocation rather than leaving it to the fund manager of a global fund who may alter the balance quickly without us knowing. We generally prefer actively managed funds over passives, although we will buy trackers when we feel that it is appropriate.

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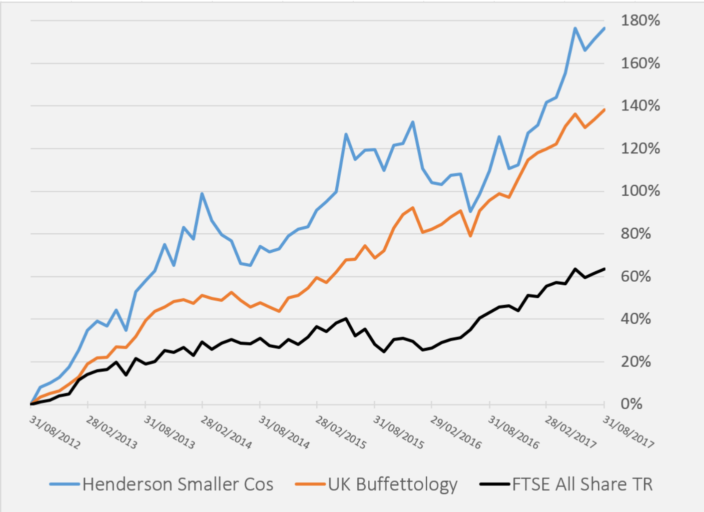
In our allocation to UK equities, the main contributors to return have been the **UK Buffettology Fund** and the **Henderson Smaller Companies Investment Trust.** As Chart 1 shows, both funds have beaten the FTSE All Share Index by a significant margin over the last five years, underlining the value of active management. Furthermore, our assessment of the fund managers, their process and philosophy, gives us confidence that this outperformance will continue.

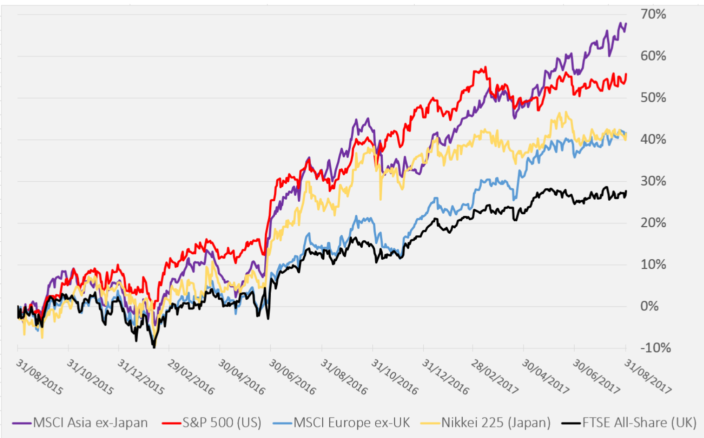
CHART 1: UK EQUITIES



Source: Albert E Sharp, Bloomberg®

For a number of years, our portfolios had zero exposure to continental Europe on the grounds that the region was becoming increasingly politically and financially unstable. Relatively, Asia and the US offered much more visibility and stability and therefore, we thought, scope for superior returns. Over the last two years, this has worked extremely well, as Chart 2 below shows. However, as valuation gaps narrowed and attractive opportunities emerged in France and Germany, our opinion changed. This coincided with a steadying political environment and improving economic data. Consequently, we allocated a small weighting, having identified the **Artemis European Opportunities** fund as an ideal vehicle with an unconstrained remit and an excellent track record of bottom-up, stock picking.

CHART 2: INTERNATIONAL EQUITIES



Having had a materially overweight position in the US for several years, we trimmed our exposure toward the end of 2016 and again earlier this year. The region has been hugely beneficial for our portfolios but it felt prudent to bank some profit. In so doing, we were able to buy into the punchy **Legg Mason Japan Equity Fund** that we had been monitoring closely. In the event, this worked extremely well, with the fund up 20% since the start of June.

Compared to our peer group, we have consistently had a high level of exposure to Asia and the emerging markets and although this has had its testing times, particularly in 2015, returns over the last 18 months have been phenomenal, with the **Templeton Emerging Markets Fund** almost doubling. Home bias is an understandable phenomenon whereby investors put an outsized proportion of their wealth in domestic stocks and shares. We try hard to avoid this behavioural trap and looking back, this has certainly paid off. Chart 2 shows that for a UK investor, plenty of overseas exposure has been a critical factor in achieving superior returns over the two years.

Since the Brexit result last summer, currency market swings have impacted returns significantly. A sterling denominated position in the US S&P 500 Index returned 38% between 23rd June 2016 and 31st August 2017 which compares to 20% in dollar terms. Thankfully, we have enjoyed nearly all of this additional currency gain. Predicting currency markets is notoriously difficult and we do not make asset allocation decisions based on a sterling forecast. Instead we will hedge if we believe there is a compelling threat to capital and there is a practical hedging method available. In early January we switched exposure from an unhedged S&P 500 index tracker into a sterling-hedged equivalent. As the dollar moved from £1:$1.25 to £1:$1.30, this gave us a 10.3% return, compared to the 5.4% we would have achieved in the unhedged version. In contrast to equity markets which seem to be reacting to fundamentals at the moment, the currency markets seem more prone to react to 'noise'. With this extra volatility, it helps to have contingency plans.

For a number of years there has been a bias towards technology running through most of the AES portfolios. The **Polar Capital Technology Trust** has tended to be our fund of choice in the sector and it has returned 160% over the last five years, which compares to 60% for the UK FTSE All Share Index. Despite the rise, we believe that our investment thesis is still intact and expect to retain a meaningful weighting in technology for the foreseeable future.

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If there is one area that has been disappointing it is in the 'bricks and mortar' property funds. These are direct owners of buildings across the UK, which tend to be large office blocks, shares of retail parks and distribution hubs. The funds also hold a cash pot in order to satisfy routine unit holder sales. In the run up to, and in the immediate aftermath of the Brexit decision, investors fled from the asset class on concerns that prices were set to slump. Although this didn't happen, the rush to the exit forced several funds to suspend trading while they sold properties to raise cash to pay redeeming unit holders. Over the last few months the sector has recovered somewhat and the **Aviva UK Property Fund** which had previously managed to lose 2% between the start of 2015 and the end of 2016 is now up almost 6% since January. The equivalent, albeit riskier real estate investment trusts (REITs) fared much better, and our favourite **TR Property** is up 25% for the year.

Not so long ago we said that with so much potential for change we were prepared to make wholesale changes to the portfolios if needed. The prospect of Brexit, Trump, sharp interest rate rises, economic turmoil in oil-producing countries, a Chinese hard landing etc created the need for flexibility. Amazingly, although many of these supposed worries have come to pass, we have made very few changes. In conclusion, the combination of an appropriate (top down) asset allocation framweork with a disciplined (bottom up) fund selection process has provided strong risk adjusted returns that we can be satisfied with.

That's easy for us to say, so in order to get some independent verification we turned to performance measurement specialists Asset Risk Consultants (ARC) who reviewed our strategies alongside similar portfolios at competing firms. We were delighted to discover that all of our models were in the top quartile of the peer group and several in the top decile. Pleasingly, as Chart 3 shows, we are the clear winner in our Model 7 group over 5 years and at the very top of the group over three years. (Our return is shown by the yellow triangle and the portfolio returns at competing firms is shown by the black dots.)

We regard these results as a validation of our investment process. It is the outcome of numerous hours analysing data, meeting managers and sticking to our principles and as a result we have comfortably beaten some of our much larger competitors. And for those who might want to suggest that that this is pure luck, we would agree that is difficult to know for sure, but there again they do say that *diligence is the mother of good fortune*.

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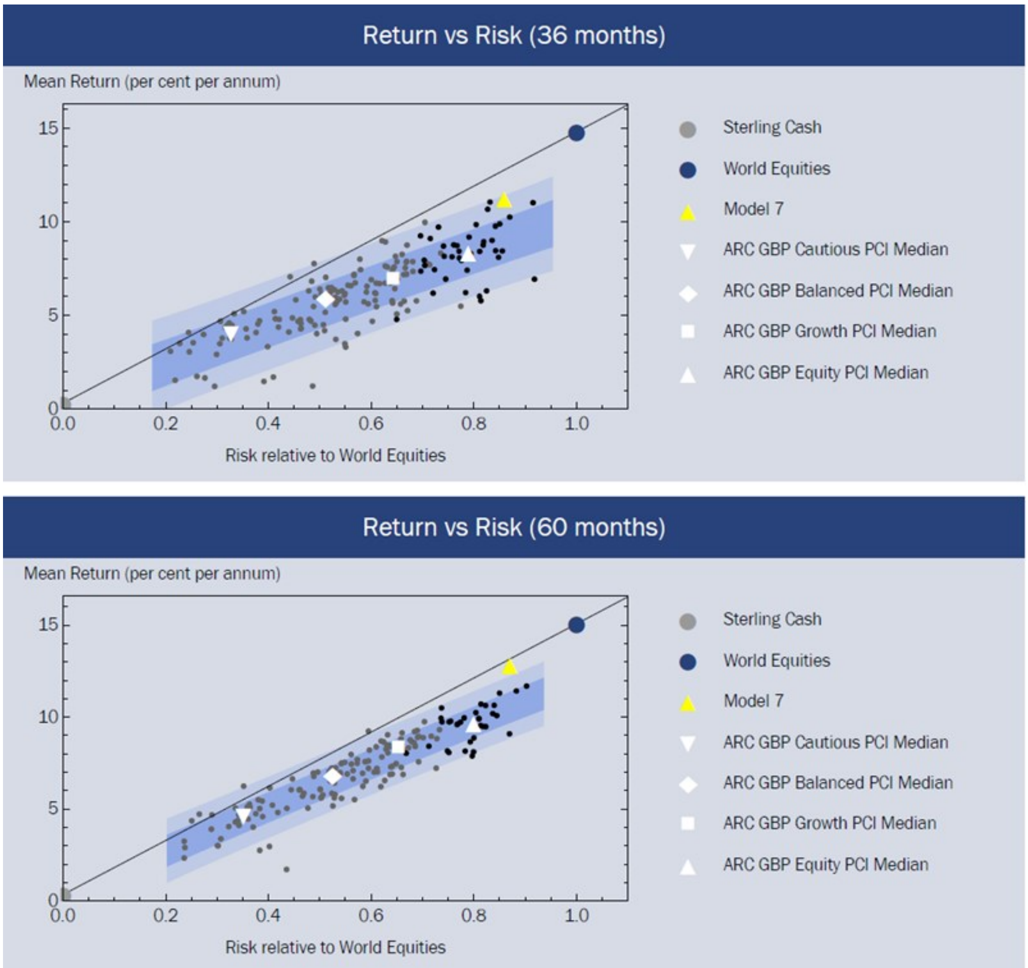
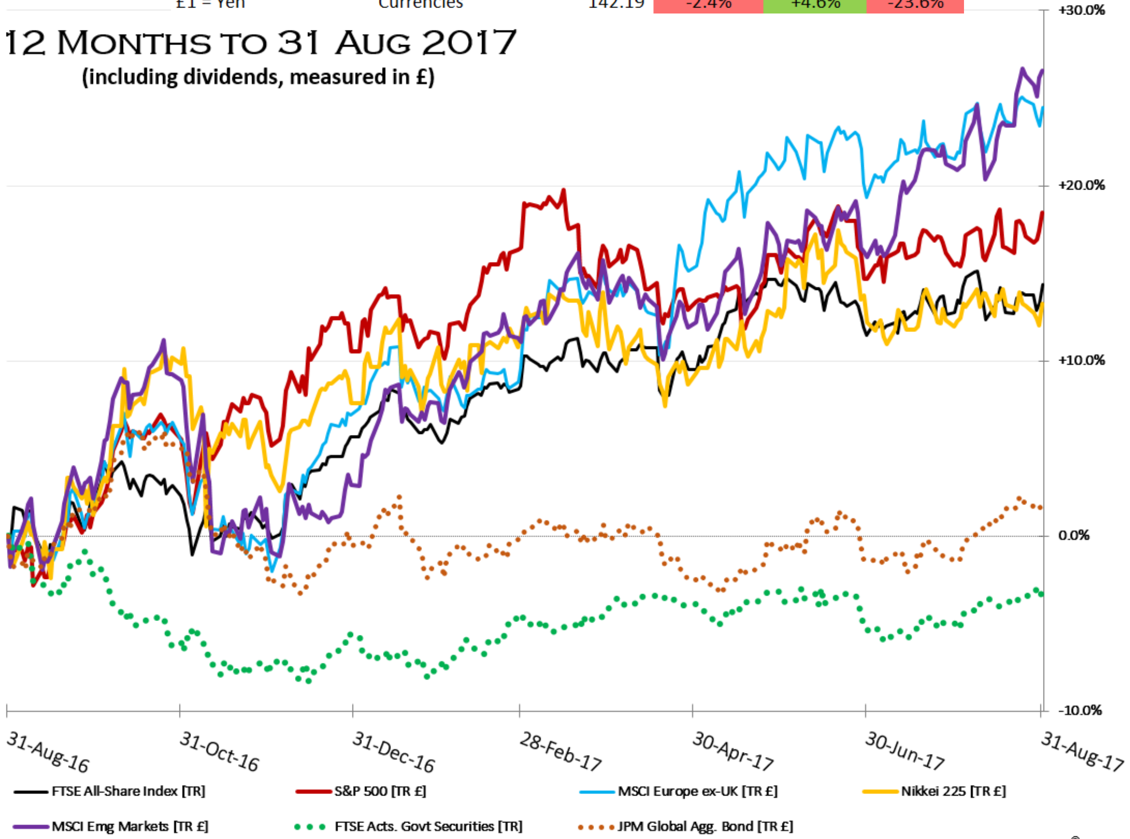
Chart 3: AES Model 7 vs Peer Group



INDEX RETURNS

Index	Region/Asset Class	31 Aug 2017	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,430.6	+0.8%	+9.6%	+18.9%
UK Mid Cap	UK	555.8	+0.4%	+6.2%	+11.6%
UK Small Cap	UK	5,715.2	+0.2%	+16.7%	+24.4%
Dow Jones Ind Avg	USA	21,948.1	+0.3%	+19.3%	+32.8%
S&P 500 Index	USA	2,471.7	+0.1%	+13.9%	+25.3%
NASDAQ Comp.	USA	6,428.7	+1.3%	+23.3%	+34.6%
Nikkei 225	Japan	19,646.2	-1.4%	+16.3%	+4.0%
Euro Stoxx 50	Europe	3,421.5	-0.8%	+13.2%	+4.6%
CAC 40 Index	France	5,085.6	-0.2%	+14.6%	+9.3%
DAX Index	Germany	12,055.8	-0.5%	+13.8%	+17.5%
Milan Index	Italy	21,670.0	+0.9%	+27.9%	-1.2%
MSCI Emg Mkts (£)	Emg Mkts	564.9	+4.6%	+26.6%	+66.2%
IBOVESPA Index	Brazil	70,835.1	+7.5%	+22.3%	+51.9%
MICEX Index	Russia	2,022.2	+5.3%	+2.6%	+16.7%
S&P BSE SENSEX	India	31,730.5	-2.4%	+11.5%	+20.7%
Shanghai SE Comp.	China	3,360.8	+2.7%	+8.9%	+4.8%
Hang Seng	Hong Kong	27,970.3	+2.4%	+21.7%	+29.1%
UK All Property	UK Property	6,962.6	+0.2%	+6.4%	+9.5%
UK Conv Gilts	UK Gilts	3,613.1	+1.9%	-3.3%	+12.9%
UK Index linked Gilts	UK IL Gilts	4,939.4	+4.7%	-0.5%	+24.2%
JPM Glob Agg. Bond	Global Bonds	832.6	+3.4%	+1.9%	+29.9%
iBoxx Non-Gilt	UK Corp Bonds	340.7	+1.3%	+0.3%	+16.2%
WTI Crude	Oil	47.2	-5.9%	+5.7%	-4.0%
LMEX	Base Metals	3,217.3	+8.0%	+37.0%	+35.3%
Gold Spot $/oz	Commodities	1,321.4	+4.1%	+0.9%	+16.4%
S&P Agri & Livestock	Agriculture	749.70	-6.8%	-4.5%	-14.5%
£1 = US$	Currencies	1.29	-2.2%	-1.6%	-15.7%
£1 = €	Currencies	1.09	-2.7%	-7.8%	-20.7%
£1 = Yen	Currencies	142.19	-2.4%	+4.6%	-23.6%

12 MONTHS TO 31 AUG 2017
(including dividends, measured in £)



Source: Albert E Sharp, Bloomberg®

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