Q1 market review

Many investors went into 2018 with an air of trepidation. Macroeconomic data across the world looked strong, forward looking indicators such as purchasing managers index (PMIs) were projecting continued strength for the year ahead and the growth of corporate earnings, particularly in the US, looked very encouraging. However, as money managers, we are coming up to a decade of stunning equity and bond market returns, and with the pain of the Global Financial Crisis still very fresh, nervousness by investors is entirely understandable. But since the end of last year, in the main, the background macroeconomic environment has not changed. Reflecting this, across the portfolios our overweight exposure to risk assets, such as equities, has remained static throughout the first quarter of 2018.

Investors' anxiety about markets has been compounded by the existence of known risks, and the inference therefore about what the unknown risks might consist of. The wage growth data that came out of the US at the end of January and sent equity markets into a bit of a tailspin was one of the key risks almost unanimously highlighted by market commentators at the end of 2017. Despite the wage inflation being a very well documented likelihood, equity markets reacted dramatically reversing gains of almost 10% across some developed markets.

This sell off over a very short time horizon was a great opportunity to measure the effectiveness of the absolute return strategies we employ within the portfolios. We have long believed that these funds are a key counterbalance to the lack of diversification of returns between bonds and equities in the age of quantitative easing. They are not without complexity so we have to be extremely diligent throughout the fund selection and portfolio construction process. Each of the absolute return funds in a portfolio are selected from a different sub-strategy of absolute return funds (such as momentum, macro, long/short), and are designed to behave in different ways to ensure diversification and add an element of downside protection into the portfolios. It was pleasing therefore to see that all of the funds in the portfolios behaved as we expected.

To highlight a couple of funds, the Old Mutual GEARS (Global Equity Absolute Return) is a classic momentum strategy. In a sell off as immediate and concentrated as the one we saw in January and February the fund isn't designed to provide a huge amount of protection. However in a continued equity market downturn, this type of momentum strategy will be able to provide protection from falling equity prices. The second fund that is worth highlighting is the JP Morgan Global Macro Opportunities fund, held across all of the risk rating portfolios and funds. Throughout 2017, the Global Macro Opps fund had a directional equity trade on Chinese banks and technology companies. A couple of days before the wage growth data was released in January of this year, that position was pared right back, and the equity exposure was reduced to c.35% (from c.75% in 2017). The Macro Opportunities fund is run within an unconstrained mandate, allowing the fund managers to make these major changes. The changes to portfolio's exposure has led to the fund being one of the top performing funds in the portfolios not only for 2017, but also for 2018.

One of the most difficult things is marrying together the knowledge that markets have shrugged off significant political events over the last 18 months (Brexit, Trump, North Korean nuclear threat) and the widely held assumption that volatility is creeping back in. Certainly, the first quarter has seen volatility return to asset markets with a wide dispersion of returns seen across asset classes, geographies and sectors. We anticipate these higher levels of volatility will remain and if so, strategies that benefit from stock dispersion, such as the recently added Artemis US Absolute Return fund, should outperform. This fund has the capability to buy and short both the US and international equity markets and in the portfolios has replaced the Invesco Perpetual Global Targeted Returns fund.

Now that the market has seen the first glimpse of evidence that central banks may have to raise interest rates to control wage growth generated inflation, certain sectors have been marked out as unattractive. Global infrastructure has been caught up in this trade, despite the fact that the US infrastructure market is really the only geography that is likely to experience an increase in cost of debt, at least in the short term. For this reason we have held onto our Lazard Infrastructure fund as we anticipate it will recover from the indiscriminate selling of European infrastructure. However we do plan to reduce or sell the position in the months to come, and will most likely replace the holding with an additional absolute return fund.

Over the first three months of 2018, we have witnessed some clear mid-late cycle signals, such as divergence of performance between sectors within similar regions or indices. This highlights the importance of using active fund managers who are able to select companies, sectors and where there is value and opportunity. A clear example of this is the Baillie Gifford Japanese Smaller Companies fund, the best performing fund within the portfolios for Q1, by quite some margin. The fund has outperformed its large cap cousin by 10% over the past three months.

The Jupiter India fund has been one of the laggards in the portfolio year to date. We still have conviction in the fund manager, primarily because of the strength of his investment process of identifying and investing in companies that offer growth at a reasonable price (GARP). The fund manager is very interlinked both with the political world of India (and over the past year has been personally involved with negotiating India's trade policy) and the corporate tech world, and has spent time visiting company headquarters on the west coast of America. The recent underperformance of the fund versus the index comes primarily from stocks that the fund manager has held in the portfolio since 2016. The fund manager still sees value in these companies, and believes the market doesn't appreciate the long term growth potential, and his investment rationale has therefore strengthened as prices have fallen. Since we have added the fund to the portfolios there hasn't been any style drift or market cap drift and the esoteric nature by which this fund is managed is, in our view, the element that adds the value.

Towards the end of the quarter, market and media attention turned to trade wars. Initiated by Trump citing dubious national security concerns, tariffs were imposed on $50 billion worth of Chinese imports. As expected, China retaliated with reciprocal action, imposing tariffs on the US. This impacted markets, affecting sentiment as the action will increase costs for US and Chinese corporates. There is a risk that sentiment continues to deteriorate and the damage from a further escalation of the trade conflict with China could be much greater. We will continue to monitor the situation as it develops and actively manage the portfolios in line with our thinking.

Model Portfolio Performance as at 31 March 2018

	3 months	6 months	1 year	3 year	5 year	Since inception
Defensive	-1.15	0.83	3.25	13.13	25.98	48.65
Cautious	-1.58	0.69	3.13	15.63	30.90	58.05
Balanced	-3.04	0.22	2.96	19.64	42.95	77.80
Growth	-3.35	0.58	4.49	24.75	49.35	91.06
Adventurous	-4.06	0.58	5.00	27.92	56.16	101.68
Strategic Income	-2.33	-0.14	2.17	16.71	32.00	51.60

Portfolio positioning during Q1 2018

Changes to the portfolios were made in January, ahead of the volatility experienced throughout the rest of the quarter. Despite the distractions of Brexit, we remain positive on the UK market and increased exposure to UK small and mid-cap companies in January in the Balanced portfolio to reflect this. In the lower risk portfolios we sold the exposure to the Liontrust Special Situations fund and reallocated it to the L&G FTSE 100 Index Fund which has a higher exposure to financial and energy, two sectors we are positive on in the UK. We also noted that China is increasingly important and the growing consumer sector may be a positive driver of returns in the long run. In response to this we switched out of the Stewart Investors Asia Pacific Leaders fund and into the Blackrock Asia Special Situations fund which has a higher exposure to Chinese equity and gives the portfolios more exposure to the Asian growth story.

As already mentioned, we also sold the Invesco Perpetual Global Targeted Returns fund during the quarter. We believe that the Invesco Perpetual Global Targeted Returns fund has grown to a size which reduces its ability to generate returns as well as when it was a smaller fund. We have replaced the fund with two other absolute return funds both with better risk/return profiles than the IP GTR, the Old Mutual GEARs fund and the Artemis US Absolute Return.

No changes were made to the portfolios for the rest of the quarter, reflecting our confidence in both fund selection and asset allocation positioning across the portfolios. We will continue to manage these portfolios in a truly dynamic way; actively asset allocating in response to changes in market conditions or taking advantage of compelling opportunities presenting themselves across the market cycle.

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