Quarterly Report
Model Portfolio Service and Volare Funds, October 2018

Q3 market review

Summary

The summer months have been unpredictably volatile for investors, particularly for those with allocations to Asia and Emerging Markets. A combination of disruptive actions by Trump in stepping up the trade wars rhetoric and following through with tariff action, the sustained rise of the value of the US dollar, a bounce back in the oil price and some isolated political crises in Turkey and Argentina amounted to a difficult period. Outside of these regions, the US continues to benefit from the clear momentum that has carried technology sector valuations higher, but we have also seen earnings come through to justify them. Investors who have been under allocated to the US, and specifically to technology, have suffered in relative performance terms as the majority of other developed markets regions have experienced a fairly benign few months in markets. As inflation continues to come through and the economy continues to chug on, we anticipate the Federal Reserve to continue on this path to 'normalise' the interest rate cycle. Despite a volatile political landscape, our view of equity markets has not changed a huge amount as we continue to focus on the evidence of strong macro fundamentals and try not to put too much weight on the background political noise.

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The story at home

The start of the quarter was eventful for UK politics, as Theresa May's Chequers deal and white paper on Brexit appeared to show a compromise way forward. This envisaged a continued close relationship with the EU and a free trade area with a "Facilitated Customs Agreement" that would eliminate the need for custom checks. More recent news from the EU's chief negotiator, Michel Barnier, and others have suggested an unprecedented deal may be done by November. However, detailed examinations of these comments reveal that many of the sticking points remain unresolved, particularly on the Irish border. Over the quarter sterling remained sensitive to the Brexit headlines. Positive UK economic data and suggestions of progress towards a deal by mid-November pushed up the pound. This weighed on the UK equity market, given its significant exposure to overseas revenues. Brexit aside, the economic data in the UK has modestly improved, with manufacturing and services survey data considerably above their average over the first half of the year. Unemployment remains low, wages are ticking up and GDP numbers have been stronger than expected.

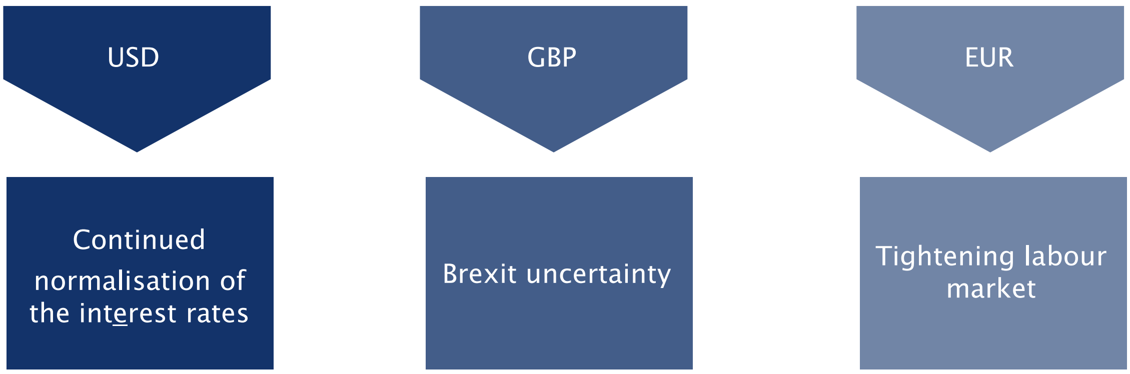
The Bank of England raised rates in the August meeting by 0.25% to 0.75%; the highest since 2009. The vote was unanimous, which was deemed slightly more aggressive than expectations, but the overall tone of the press conference comments seemed to be more dovish. Following the rate hike in August, no further rate rises in the UK are expected before the middle of the next year. The fall in sterling that we have seen over the course of the quarter resumed its path south. This supported the equity market; however a number of events since have resulted in the opposite effect. Swings in the Brexit negotiations, the Turkish crisis and trade war concerns weighed on the market.

The story over the pond

In the US, economic data continues to come in at lofty levels and suggests a robust economic environment. For example, a recent weighted average of manufacturing and non-manufacturing survey data is consistent with the US economy growing at a rate of around 5% annualised. Average wage growth remains a touch subdued, unchanged at 2.7%, but the labour market looks broadly robust and expectations are for two more Federal Reserve hikes in 2018. The economic environment in the US continues to be solid, despite the ongoing trade war with China. Consumer confidence has risen to an 18-year high and inflation is now at the Federal Reserve's target level. Some positive policy news came from Trump during the quarter as the US formally announced a new NAFTA agreement with Mexico. The S&P 500 Index was up 8.9% over the quarter in Sterling terms, with a noteworthy 22% three month return for Apple making it the world's first $1 trillion company, swiftly followed by Amazon. Amazon's share price has risen over 68% since the start of 2018.

Currencies

Highlights



After a period of strength, the US dollar has strengthened slightly over the quarter. While the interest rate differential between the US and other major economies is widening, Trump's unpredictability and the fact that interest rate rises are already priced in means we retain a neutral stance on the US dollar. With regards to sterling, we also hold our neutral position since we feel the currency will be a function of the Brexit negotiations for some time to come. There is potential for a bounce should progress be made, but also potential for further declines if unfavourable exit terms arise or a 'no deal' scenario becomes more likely. On the euro, political uncertainty poses a concern and the recent economic data has exhibited a slight weakening in the region. However, the Eurozone's labour market is tightening and inflation is starting to come through; we feel the outlook for the currency is balanced. Across all major currencies, we expect that there might still be significant volatility throughout 2018.

On balance, our market view is generally unchanged over the quarter. The already heightened levels of volatility, due to political tensions and the escalating trade war, are here to stay. However, the economic environment remains broadly constructive for equity markets over the medium term. Although there are some signs of slowing, we feel that the global economy is still in a relatively good place and equity markets continue to look attractive, particularly relative to bonds.

Asset class look through

- **Fixed Interest**
  - we continue to be selective in this area as bonds remain a challenging asset class
- **Equities**
  - a marked dispersion in the returns from different equity geographies
- **Alternatives**
  - in our view, this is a core component of multi-asset investing

Fixed Income review

Government Bonds

During the quarter, as an investment house we reversed our neutral stance on UK government gilts back to negative. We had moved from negative to neutral in mid-May to reflect the more challenging macro-economic data and the move higher in gilt yields from the start of the year. Gilt yields have now moved back to levels seen at the start of year where valuations are no longer compelling, thus warranting a negative stance. Given strong commodity prices, weak exchange rates and better valuations, the inflation-linked exposure used in the model portfolios and Volare funds, retains a neutral stance. We maintain our negative stance on gilts even after the recent Bank of England (BoE) rate hike. Even though the forecasted BoE end target for base rates is much lower than historic averages, current gilt levels imply that they won't be able to raise rates anywhere near these levels. We acknowledge that Brexit may distort these levels for the near term but current employment trends gave the BoE little room to hold rates where they were.

Investment Grade Bonds

The recent earnings season was strong, resulting in better metrics across the investment grade fixed income universe. Valuations have cheapened in recent months but this mostly reflects the expectations that central banks will seek to support the market less actively in the future. Given that the AT&T and Time Warner merger was given the go-ahead in a historical ruling, we expect that M&A risk will become a bigger consideration over the coming months. Therefore, we advocate only selective exposure in this market to capture the yield advantage whilst avoiding the event risk, and hence in the model portfolios and Volare funds used strategic bond managers who are able to flex the duration and credit risk of their portfolios to take advantage of opportunities in the fixed income markets.

Emerging Market Debt

Broader valuations in Emerging Market Debt markets look attractive following the significant volatility in these geographies. However, the recent strengthening of the dollar has put pressure on both local and hard currency debt. Turkey was particularly vulnerable to these factors given its twin deficits and subsiding confidence in its central bank independence, resulting in the currency falling in excess of 20% since the end of Q2. Whilst there might be some contagion in terms of asset flows, the majority of Turkey's problems are of its own doing and therefore are not an indicator of wider issues across emerging markets. The rise in oil prices this year will benefit some countries but weigh on others and therefore if we added specific exposure to Emerging Market Debt in portfolios it would only be via an experienced active manager. We are watching markets carefully for a potentially attractive entry point into EMD for the higher risk portfolios.

Equity review

UK Equity

The FTSE All-Share Index fell just under 1% over the quarter. We believe that the UK equity market looks increasingly appealing, with a prospective price to earnings ratio for the next year of 12.5x and an average dividend yield of 4.5%, at the time of writing, on the All-Share Index. This compares very favourably with a muted 1.48% yield on a 10 year gilt. The equity market has also been well supported by sterling's slide, given that a significant amount of revenues comes from overseas. However, with greater clarity needed with regards to Brexit and its potential impact on the currency and equity market, we have remained neutral at this time, and have 30% of the overall equity exposure in portfolios allocated to the UK.

Europe ex UK Equity
The Euro Stoxx 50 Index is up slightly over the quarter in Sterling terms, as the Eurozone continues to see a slight weakening in economic data. However, despite this, some indicators now suggest a moderate pickup in the region for the final quarter of 2018. Germany's economy accelerated in Q2, with robust consumer confidence, a further drop in the unemployment rate and rising income expectations. Solid economic data was also seen in France, suggesting that the rest of the euro area experienced a muted month in August as survey data for the Eurozone as a whole showed little change. In contrast, during the quarter, the ratings agency Fitch revised its outlook on Italy from 'stable' to 'negative', reflecting its fiscal and political woes.In response, markets have been concerned about the Italian government's efforts to put a budget together. This has pushed Italian bond yields to their highest level since 2014. European banks have been under pressure in recent months, principally due to concerns about their exposure to troubled emerging markets like Turkey. Global funds that we hold in portfolios such as Artemis Global Income have been reducing exposure to European banks, favouring instead American counterparts. Despite ongoing levels of uncertainty in the Eurozone, valuations in the region remain attractive and therefore we feel a neutral stance is appropriate.

US Equity
Economic data from the US continues to come in at robust levels, with survey data near multi-year highs. The first two corporate earnings seasons of 2018 have been impressive, buoyed by Trump's tax reforms and disregarding of trade war concerns. Economic data continues to impress with the consumer confidence and ISM surveys showing that growth is likely to remain robust. The US remains the market that we feel is home to the most high quality companies who can sustainably compound growth over the longer term. Whilst there is likely to be more volatility this year, this continues to be our preferred market and we maintain our positive stance.

Japan Equity
We have been positive on the equity market since the back end of last year given Abe's policies towards improving corporate governance, dividend pay-outs rising, earnings improving and sustained economic growth. We see particular appeal in the excess cash flow and dividend growth story. Extended terms for Prime Minister Abe and Bank of Japan Governor, Kuroda, have further reassured us on the long-term attractiveness of the Japanese market. Japan is less affected by trade wars than its global peers because many of its manufacturers already have factories in the US.

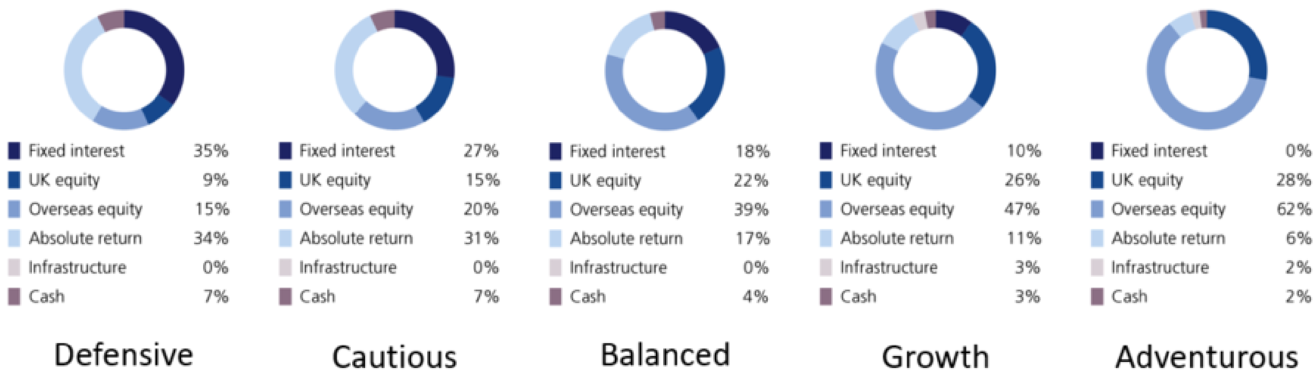
Asia ex Japan Equity
We have a positive stance on Asia ex Japan but believe that a selective approach is key. The region continues to benefit from the cyclical global upswing and earnings momentum within the region. Our particular preference within the market is India, where we see an attractive long-term growth story. Prime Minister Modi has unleashed India's potential with far-reaching reforms and we believe that the clock will not be turned back. GDP growth should be high and sustainable for many years to come because of population growth, rising incomes, reforms, infrastructure investments, and the rapid adoption of digital technologies. This supports our bias towards India within the region. Asian equities were weak over only up 2% in Sterling terms with China and Hong Kong as the weakest countries due to an escalation in US-China trade tensions. India has also been affected by the trade war, with its currency hitting its weakest level on record against the dollar. However, the surplus that India has with the US is roughly 1% of India's GDP, allaying concerns over this matter. We continue to believe that long-term prospects for the Indian market are good and that there is an attractive long-term growth story on the back of Prime Minister Modi's reforms.

Emerging Markets
Concerns over trade wars and a crisis in Turkey weighed on global equity markets through the quarter, with indices in the UK, Europe and Emerging Markets all down. Sharp declines in the Turkish lira pushed Turkey into an economic crisis at the start of August, threatening the country's banking system. President Erdogan has accused the West of waging economic war on Turkey and his rhetoric has inhibited the Turkish central bank from raising rates. To make matters worse, Trump imposed sanctions against Turkey after they refused to release a detained American pastor who was arrested after the failed 2016 coup. Looking to other emerging economies, Argentina has been hit hard and a 50% fall in the Argentinian peso this year has helped to push the economy into a deep recession. Austerity measures by the government weren't enough to regain confidence so it has asked the International Monetary Fund (IMF) for an emergency bailout of $50bn. Despite this and the world's highest interest rates of 60%, Argentina's crisis is getting worse as markets worry about potential for political backlash against the austerity programme. The Brazilian real has also been affected by

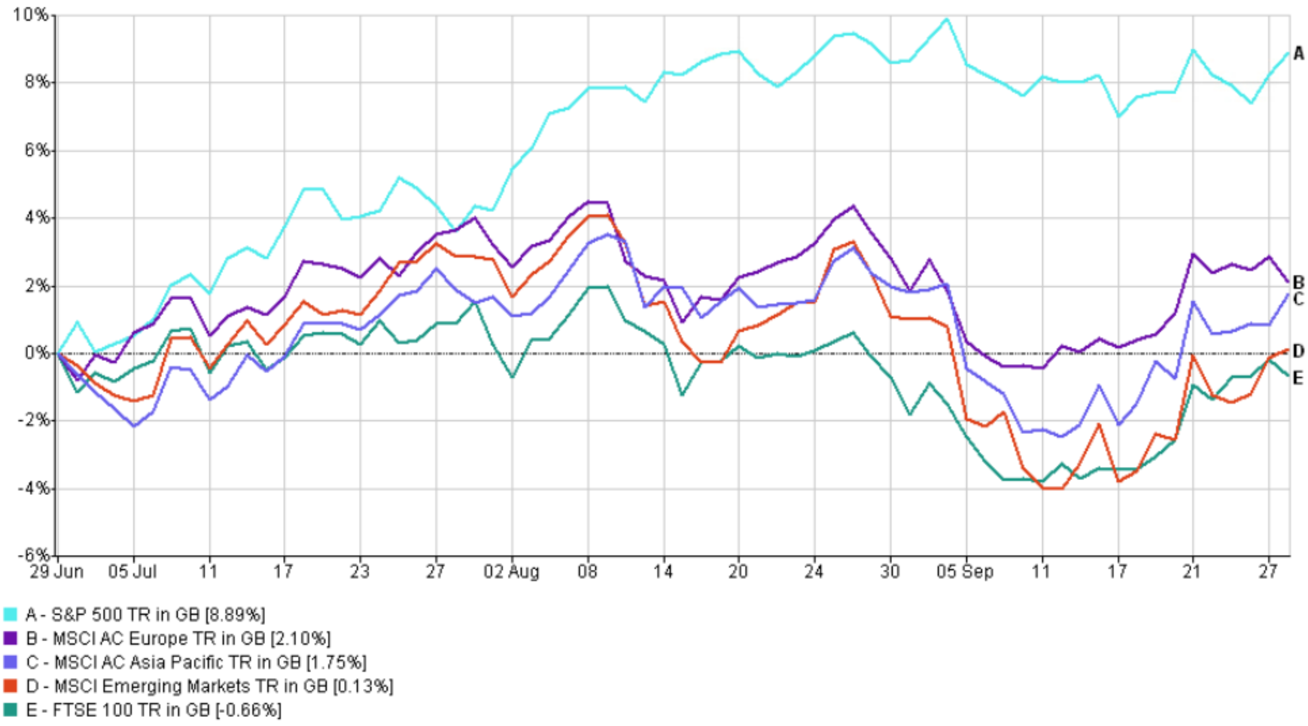
the rising US interest rates and by the upcoming election uncertainties, at a time when the country is facing a contraction. On the other hand, other countries within the Emerging Market space have focused on domestic reform agendas that could result in longer-term growth prospects. Given the size of the fall across these markets, we believe that selective opportunities are starting to appear and there is potential for us to turn more positive in the months to come.

Alternatives review

In the alternatives space, we maintain our preference for "Long/Short", "Systematic" and "Macro" strategies that can come into their own in an environment of increased volatility. From a portfolio construction standpoint, the diversification offered by these strategies is valuable when traditional asset classes (bonds and equities) are challenged. Trend-following strategies also have diversification benefits and have tended to do well when there is a sustained downturn in equity markets. We have held our positive stance as we believe that, going forward, the search for diversified sources of return within portfolios may become more pertinent than for some time. However, we stress the importance of manager selection in this space.



Performance review



Source: Financial Analytics

In terms of market returns over the quarter, the stock markets reflected what is happening at a macro level. The relative success of the US economy, which from the majority of indicators and measures looks extremely robust has played out in a strengthening currency and stock market. The stock market darlings have been dominated by the tech stocks we have seen double in value from this time last year. Over the past quarter, the funds that have done well have been those with US or tech exposure (or both). Funds such as the Morgan Stanley US Advantage, the L&G Global Technology tracker, Schroder US Mid Cap and Fundsmith have been top performers.

Conversely, the funds that have done badly are those with exposure to Emerging Markets as these geographies have had a challenging quarter. This has affected the returns of RWC Emerging Markets and BlackRock Asia Special Situations. Value also sold off over the summer, which affected the performance of R&M World Recovery and Schroder Income. Many of the funds have stuttered through the quarter as fund managers have battled to navigate through troubles relating to EM woes, trade wars, Brexit fears and concerns over the Italian political situation.

Looking forward, the gap we have seen between US and the rest of the world up to this point has the propensity to narrow. Whether or not this happens depends on US capacity and/or the actions of Jerome Powell and the Fed.

Model Portfolio Performance as at 30 September 2018

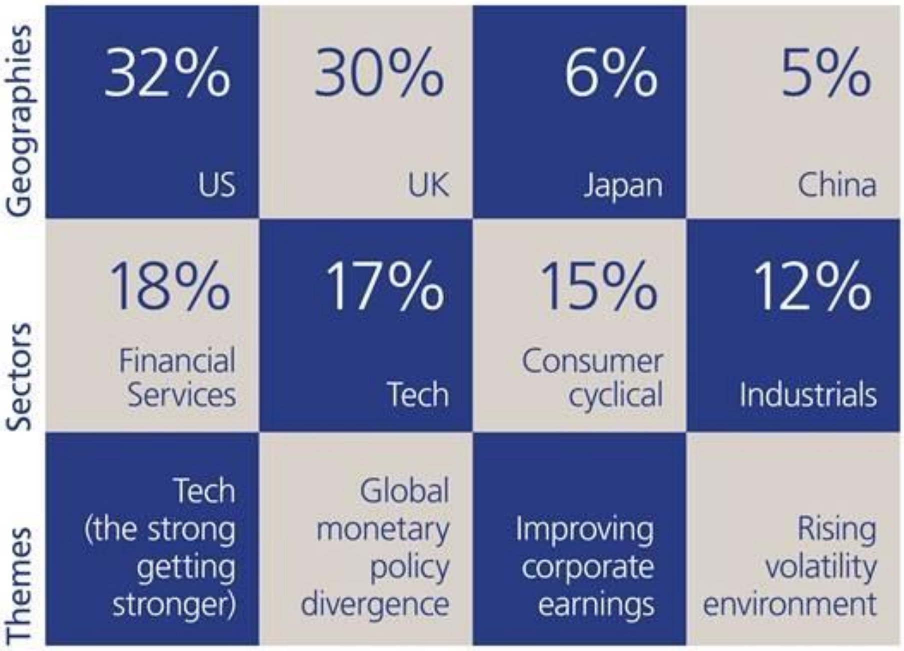
	3 months	6 months	1 year	3 year	5 year	Since inception
Defensive	0.89	2.78	3.63	19.60	30.86	52.78
Cautious	0.78	3.44	2.31	23.46	37.33	66.85
Balanced	0.71	4.81	3.36	29.68	48.36	89.60
Growth	0.85	5.93	6.54	37.13	56.68	105.30
Adventurous	1.42	7.79	8.42	42.90	63.48	117.39

Portfolio positioning

Despite the moves in the market and noise throughout the quarter we decided to sit tight and keep the portfolios largely unchanged, save for a few tweaks around the edges. In the Defensive portfolio, we sold our FTSE 100 Index tracker, utilising the cash to increase our holding in the active fund Lindsell Train UK Equity. Given the conservative nature of the Defensive MPS portfolio, we favour a holding that can actively profit from the market volatility and has exposure to large cap consumer staple stocks. The Fund has a fantastic long-term track record and we have belief in the managers' ability to find pockets of opportunity in this time of market weakness and uncertainty.

In the Balanced portfolio, we decided to top up our cash position and lock in some profits following the lows of the first quarter by reducing our European equity holding, the BlackRock European Dynamic fund run by Alister Hibbert. We felt the time was right to raise some cash owing to concerns over the geopolitical situation in Europe (specifically Italy), the ongoing trade wars and the potential for an Emerging Market weakness spill over into European equities (Turkey and Argentina). We still hold the fund in the Balanced, Growth and Adventurous portfolios.

Later in the quarter, the MPS Investment Committee decided to add a new holding, the Winton Absolute Return Fund, to the Defensive and Cautious portfolios. The Winton Fund is a multi-strategy systematic fund that uses trend analysis to provide uncorrelated returns. The Fund has the capability to utilise a number of different trading strategies such as trend following, CTA (commodities), long-short, carry and reversion. While we have other systematic strategies in our portfolio, none have the ability to take positions in commodities (other than gold). We raised the cash from our position in the Troy Trojan Fund, a fund with a higher Beta to equity markets that has suffered from share price weakness in the tobacco stocks and gold.



Source: LGT Vestra, Morningstar

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The market views herein are drawn from the minutes of the LGT Vestra LLP Investment Committee which meets on a monthly basis.