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Fund Managers Report 5th April 2016 to 5th October 2016

The Wild Ride and a Vintage Year

It has certainly been a summer to remember in the global capital markets. The good news is we are looking at a vintage year with regards to returns. The worrying part is that most of the gains are related to a collapse in Sterling after the Brexit vote. We have a US presidential election on the horizon with at the same time a US economy that is still growing. We still see no growth in Europe despite a negative interest rate, and a more stable but slower China. However the biggest issue remains much closer to home and it's the elephant that's still in the room, Brexit.

Brexit

The Brexit referendum threw up an unexpected result. The only certainty anyone could bank on from the result was a collapse in Sterling, which duly occurred. After that we are in unchartered territory where no one, on either side of the table, knows the outcome or how to get there. This is genuine and unprecedented uncertainty and one that requires the answering of very important questions not yet asked or resolved, such as the kind of relationship we have with Europe, the rest of World and how to unwind agreements dating back 40 years.

Even worse, in this long interim, we have to endure a never ending stream of clueless drivel from journalists, less important officials or politicians. Eye catching headlines and attention grabbing soundbites from clueless journalists and politicians are a long way from any reality or facts and even the more reliable business media have done nothing but produce all kinds of agenda driven stories. All we know is this process will certainly make lawyers and consultants rich, but leave the rest of the UK and EU economy anxiously waiting for an outcome that will take years.

Whilst uncertainty is never good, and Brexit will certainly be a drag on both economies, it does not have to be fatal. Markets will get used to it, price it in, and things will carry on and the extent of the price of risk will determine the size of the drag. Our own view is that the UK economy was reasonably strong going into the vote and that as the 5th largest economy in the world and a net importer from the EU, the UK is in a much stronger position than currently portrayed. The real issue is that neither the U.K. nor the E.U. actually knows what they really want. As always, those with the real power in the UK and the EU are far more tight- lipped. That said for the next year there will be a large amount of noisy "kite flying" by various lobby groups to make their voices heard. From our point of view as asset managers we need to navigate this mine field, seeing the opportunities and avoiding the pitfalls.

Below are our current thoughts on each major asset class.

Bonds

Conventional fixed income has had a good year with uncertainty and low cash returns driving investment. We have seen some eye watering low levels of interest (German bond yields were negative out to ten years at one point) as surplus cash and central bank bond buying forced investors into longer duration and higher risk or into negative returns.

We do not expect the Bank of England to either raise or lower rates for the next year, likewise we feel the ECB will keep European rates at negative levels for the foreseeable future, despite the fact it is causes stresses to European banks. The ECB simply cannot do anything else until there is fiscal reform in Europe. It is in the US that we do expect interest rates to rise and most likely by 0.25% in December, presidential elections could scupper that, but the US economy is still growing.

For a while we have felt the best days were behind conventional fixed income and in the summer after Brexit we reduced portfolio exposure to bonds. This was both in terms of asset allocation and in terms of quality and duration. Portfolios that had the Pennon bond saw these sold as this was a lower quality bond that we felt had peaked (we added shares in its place) and in social housing bonds we sold the long dated Circle Anglia and Places for People Bonds and replaced them with less of a lower coupon and shorter duration Places for People Bond.

The recent decline in fixed income levels has meant this move has already exceeded our expectations (for example the Places for People bond we sold has fallen 8 points and the bond we added has fallen just 4 points), but despite the fall in fixed income we prefer to wait and see before adding to this asset class.

We are more positive to the index linked bonds we hold as we expect the low level of Sterling to lead to some inflation next year. In fact at the time of writing this report headlines were made by Unilever and Tesco having a spat over prices. In our view its simple, a country cannot devalue its currency by nearly 20% and not get some inflation as a result, even if it may take a year to work into the system. Although they are expensive we still see good value in the index linked bonds we hold (Network Rail and Yorkshire Water).

We have been looking over some interesting higher risk and more socially directed bonds recently and some may be added to portfolios that permit these investments in the future.

Property

This asset class made the headlines after Brexit for the wrong reasons. Whilst the press certainly gave a sense of panic as some open ended property funds closed their gates, this was more of an arbitrage (where you buy something in one market and sell it for more in another) rather than panic selling. The closed end REITS and listed property funds (such as British Land) saw sharp price falls as they are priced by the supply and demand for their shares in the market, whilst the open ended funds, which are priced by their net asset value, did not really fall as sharply. Many of the closed end funds later bounced back and most of the funds that were closed have now been reopened.

As far as our portfolios are concerned the only investment impacted was British Land (where held) and we responded by adding to this investment in the immediate aftermath of the

Brexit vote and taking advantage of the recovery. We are less concerned about British Land than other property investment given the quality of their Central London properties (we do not foresee any Brexit job losses in the City).

The other core property and infrastructure investments were not impacted by the Brexit and all are all higher on the 5th October than they were prior to the vote.

We still like property and infrastructure as an asset class, in most cases these investments have sought to limit their interest rate risk, as this is the biggest risk to their valuation.

Equities

Without a doubt, UK equities in Sterling terms have had a vintage year. In Euro or US$ terms the story is different. The foreign direct equities and loan notes clearly gained from their currency moves as well as share price movements. This was also the case for some of the UK based thematic investment trusts we hold (in lieu of foreign equities) and these have made up a substantial part of a portfolios equity holdings.

As far as UK equities are concerned the reaction was positive for about three quarters of the holdings. Brexit benefited larger UK companies, including some of those we may hold that are truly global, Vodafone, Johnson Matthey, GlaxoSmithKline and Unilever are all obvious global giants. However even less obvious companies are more global, National Grid, Spectris and FirstGroup for example have more sales in the US than the UK. Also more defensive utilities benefited as interest rates fell and the chances of a rise in UK rates have moved well over the horizon.

Most of the pain was felt by investments closer to the UK consumer or housing market, and these shares were hit quite hard. Prior to the Brexit vote we were cautiously positioned with equities and higher in cash and we used the aftermath as an opportunity to buy more equities.

Whilst we do see many equity markets close to historic highs, the global economy is continuing to recover from the global financial crisis and actually handling political shocks quite well. Quietly confidence is building and we prefer it that way, if anything we see more risk in fixed income. We have a risky period ahead of us, notably the US election and Brexit discussions, both of which are well flagged and whilst we remain positive we also seek to remain nimble.

Specific Ethical Sectors

Each portfolio has distinct ethics and different risk profiles and objectives, therefore some of the companies and strategies listed below may not be relevant to your portfolio. We actively encourage you to review your ethical stance by completing and returning the Values Based Questionnaire when applicable, as this is an important part of our investment process. A copy can be downloaded from our website.

Renewable Energy

The Brexit effectively led to a change of government, and we frankly find that a big positive. Whilst the coalition government was good for renewable energy, an unfettered George Osborne and Amber Rudd were not. Then in April this year the UK energy achieved a milestone with the first coal free electricity production day, and since then we have seen a substantial shift from coal to gas and a more noticeable impact from solar energy over the summer.

Over the last six months (in most portfolios) we trimmed the holding in SSE to take some profit and reduce exposure to one of the big 6 and increased exposure to smaller renewable energy yield based investments. We used a placing in John Laing Environmental Assets to add this yield focused investment in UK and European wind, solar and water plants. This sits alongside other yield focused investments in solar and wind. We trimmed Siemens a little to keep the holding in line.

The growth of renewables and its increasing role in energy production and the increased adoption of electric cars have breathed new life into the energy storage sector. We have already added back an old high risk investment in the area, Ilika, a UK leader in battery technology and development.

Transport

We have made no changes to our core fixed income exposure and have been very pleased with the Network Rail Index linked bonds in particular which are naturally helped by inflation expectations. As these are some of the highest quality bonds we hold and either implicitly or explicitly guaranteed by governments we have left exposure as it was here.

In our last report we mentioned that we had sold Go-Ahead on valuation grounds. Over the summer this stock fell about 20% to some attractive levels. We therefore began adding this investment back into portfolios.

After disappointing results and outlook we took advantage of the post Brexit fall in Sterling and sold the holdings in INIT. We also sold Alstom sooner than we had planned to. We had seen a strong gain in the share price (in Euro and even more in sterling terms) but become very concerned about some aggressive political interference when they wanted to make changes to their Belfort plant. French elections next year are a serious political concern.

We added a small stake in Tesla to portfolios that permitted a car company. We have followed this global pioneer in electric cars for a long time and as we see the commercialisation process take place we decided to make a small initial investment as scalable production increases and sales become a reality. Although less risky than before we still considered this a higher risk investment as it remains a sector pioneer with a maverick founder at the helm. We were shocked by the decision to merge with Solar City and whilst this knocked the share price initially it has recovered and remains a profitable investment. We feel electric cars (with the field led by Tesla, Nissan, Toyota and Mitsubishi) are going to make significant headway in the next few years as consumer acceptance widens and it has certainly become a viable urban alternative.

Social Housing

We mentioned previously that we had reduced the bonds exposure for asset allocation reasons; we still like these bonds and having seen them fall in value we may look to add back at some stage in the future as levels become more realistic.

Construction and Property

We mentioned the Brexit effect on this sector earlier in the report and mentioned the addition to adding British Land. We also made some other changes in this sector. We sold the London based builder Berkeley Group as we were seeing weakness ahead of the Brexit votes, not wanting to reduce sector exposure we added exposure in the weakness to Kier Group and MJ Gleeson. Kier Group is a major infrastructure company (not road building) and we anticipate an increase and possible speeding up of infrastructure investment in the UK to mitigate some of the Brexit effect and to take advantage low long term interest rates, we will know more after the autumn statement in November. Gleeson builds houses for working class families in Northern England (we recently visited their Rotherham site) and we still see good growth potential in this area as their home prices compete with social housing rents.

Environment, Waste and Water

After the Brexit rally we trimmed some Johnson Matthey to take profit and to bring the investment back into line and to make some space for some new investments. This has been one sector we have added new investments to since the last report.

We also used the dip to add to investments in the UK water sector with adds to Pennon (a leading UK waste company) and adding a new investment in United Utilities, although this was just after the 5th October so it will appear in the next report. We also increased waste exposure after this report date by adding Biffa at their IPO, we used to hold them until they were taken private (which was a disaster) but the management and new owners have built into a leading UK recycling company.

Healthcare

Where held, GlaxoSmithKline benefited from the weakness in Sterling and we trimmed a little as part of risk management and to take profit. In the high risk area we added to Omega Diagnostic where mandated as they continue to make progress.

Retail

We added back to Sainsbury's as UK focused retailers were hit in the Brexit vote, their takeover of Argos, which pitches them against the rise of Amazon, shows some leadership in this sector.

Finance

Where banks were not an issue we added and subsequently took profit on Barclays, we have though for the time being kept HSBC. Otherwise we made no changes.

Food

Where we held Unilever and Cranswick we may have trimmed the holding a little. We made a new key investment in this sector where animal product ethics permitted by adding Leroy Seafood to the portfolio, where we added this we have enclosed an ethical profile of this investment.

Other

We increased Vodafone on the morning after the Brexit vote, using some of the cash we had kept in reserve.