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Keeping you informed matters

Annual Investment Review

January 2018

Outlook

Economic growth in the US and emerging economies is leading the way, with global growth falling in line. This is creating a favourable environment for asset prices over the coming year. A decade of falling interest rates has produced historic lows, but the current tightening of monetary policy could see volatility increase.

Ben Bernanke, Chairman of the Federal Reserve from 2006-2014 – and throughout the financial crisis of our generation – referenced the work of Milton Friedman and Anna Schwartz to support his view that the Federal Reserve would never make the mistakes of the late 20s and early 30s again. In their 1963 book, "A Monetary History of the United States," Friedman and Schwartz blamed the move from recession to depression on the aggressive monetary policy of the Fed. That policy raised the expectation of a fall in prices, leading to a sharp rise in "real" interest rates – the rate paid by consumers and businesses after allowing for inflation.

Going into 2018, world growth is set to accelerate and average 3.7% per annum out to 2022 according to the recent World Economic Outlook published by the IMF.

There are, therefore, plenty of investment opportunities. However, the United Kingdom is the exception, lagging behind in this otherwise predominantly benign economic outlook.

Real growth in the UK economy has slowed noticeably post referendum from 0.5% per quarter in 2016 to 0.3% per quarter in 2017. This is a notable contrast to the other G8 economies where growth has been accelerating throughout 2017.

After the Brexit vote, the sharp depreciation of the Pound raised inflation and lowered real incomes at a time when wage growth is very low. At the same time UK productivity continues to lag badly. The Office for Budgetary Responsibility notes that UK productivity will be 27% below the pre-crisis trend level by 2023. That translates into very weak wage growth, weak spending, higher borrowing and/or additional austerity.

Equally, the British consumer has not lost the taste for foreign goods. Therefore, with imports exceeding exports, the UK deficit in traded goods stands at 6% of GDP.

This combination of weaker growth, higher inflation and large current account deficit may not bode well for the Pound. Ironically the lower Pound helps export competitiveness and the value of British profits secured by firms with significant overseas investments. These firms make up much of the listed sector in the UK. Weak economic news in the domestic economy can lead to rising profits and dividends for UK listed companies and does not necessarily lead to weak stock market performance.

Globally many key economic variables are beginning to even out. Low inflation rates in the developed economies are, at last, gently rising and the high inflation rates associated with the emerging economies are gently declining. The global inflation rate is forecast to be stable at around 3% for the foreseeable future.

Employment rates around the world are also rising.

In some economies, notably the US, unemployment rates are already below the level considered consistent with stable inflation. Historically this would have been a precursor to inflation sparked by higher wage demands.

So far, these demands are largely absent, and the low wage growth coupled with weak productivity is probably the real key economic problem of our time.

Nonetheless, we do expect to see wage growth increasing - certainly in the US and followed by the UK. However, not so fast as to threaten the inflation outlook or trajectory of interest rate rises. As far as interest rates are concerned we are almost certainly going to see rising rates this year, but at a much slower and lower pace than we have seen previously.

As the UK is the outlier in terms of growth; the outlier in terms of capacity is Europe. Europe is the major economic area where employment trends have not improved as much or as quickly as elsewhere in the global economy.

At 4%, German unemployment is low, but rates of 23%, 20%, 12% and 11% in Greece, Spain, Italy and Portugal respectively point to large pools of unused labour. This will depress European wages until employment rates are significantly higher. Europe still has extensive spare capacity.

The other important area where we see global convergence is in trade. Trade flows measured by current account surpluses or deficits are reducing in size and trade is becoming much more balanced which is good news for sustainable trade growth.

China has adopted a trade policy which is much more open to foreign goods, and is as likely these days to be a net importer as a net exporter.

The key global imbalance lies closer to home. We have already mentioned the UK trade deficit but the counterpart to this is the German trade surplus which is around 8% of GDP.

If there is one lesson from the financial crisis, it is surely that unchecked financial imbalances are self-defeating. Nonetheless, Germany simply ploughs on sucking demand from countries within and without the Eurozone.

More helpfully for Eurozone growth, this surplus should be recycled through German wages into higher domestic consumption expanding German demand. In aggregate, excess German saving is a tax on the rest of the world, and like productivity is a key economic issue that should be tackled sooner not later.

In terms of markets one of our key worries is that stronger growth and a bias to accepting higher inflation by Central Banks could lead to falling prices and increased selling – a 'bear' market – in bonds and fixed interest. However, Gilt yields and more importantly US Treasury yields are well off their lows trading at 1.24% and 2.47% respectively. Gilt yields traded below 1.00% in 2017 and Treasuries below 1.40% at the end of 2016.

We see this gradual rise in yields as signalling a return to pre-crisis normality. Yields have been suppressed as noted above to secure economic recovery. Nevertheless, City traders have not seen a bear market in bonds since 1994. This is a real risk.

In contrast, while the outlook, short of return to recession, is negative for bond markets, the growth outlook for businesses and in turn company shares is fundamentally positive.

The key question for investors, wherever we think we are in the economic cycle, should always be the valuation of assets. Paying the wrong price in good times is not an effective strategy. Interestingly corporate cashflows are robust and 2017 will be noted as a record year for dividends. In this respect equity yields still offer a significant premium to both UK Gilts and US Treasuries.

The price you pay for a company's earnings today varies with market sentiment. When times are good, investors are willing to pay more for earnings up front and when times are bad they want to pay less. Over time markets find a mean valuation that they revert to and this is where investors ultimately anchor their views.

At present it is hard to describe markets as cheap when looked at in a historical context. In our view however, if corporate earnings continue to grow, and central bankers keep "real interest rates" low, then equities continue to look like a more attractive asset class than bonds. The role of central bankers is therefore as important as the earnings themselves.

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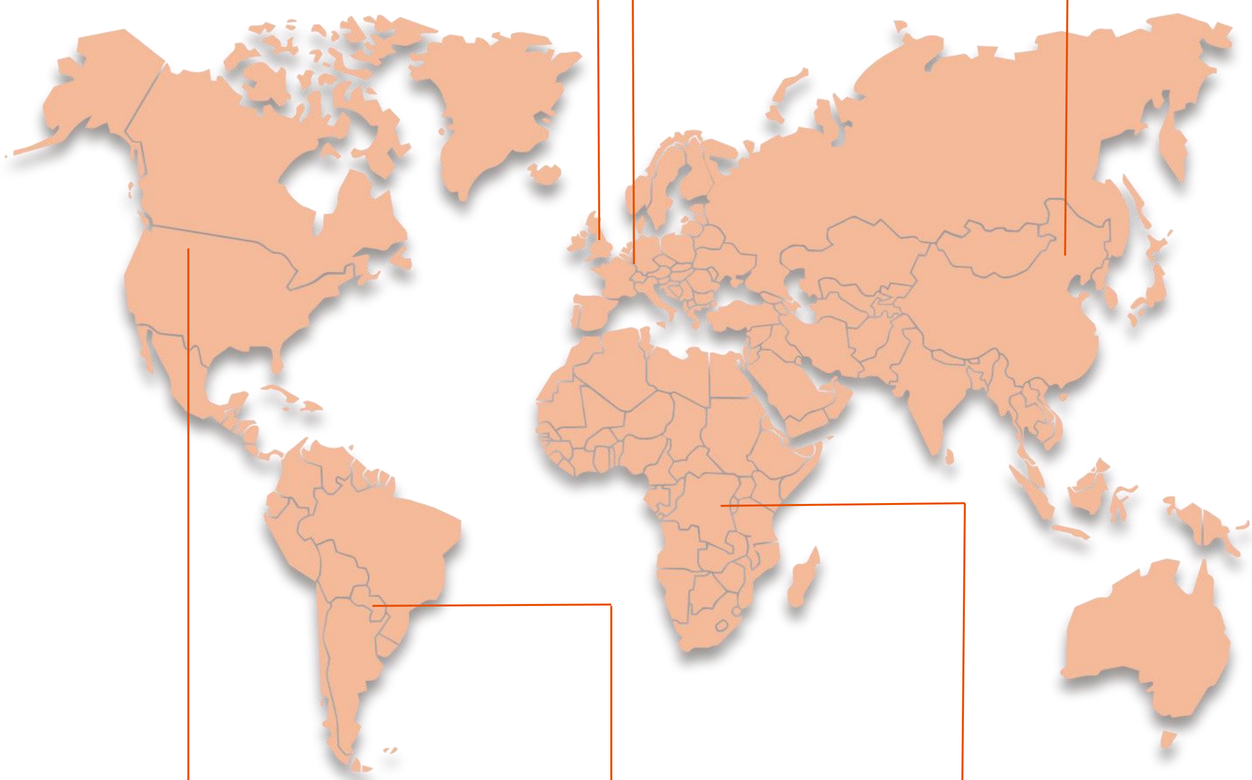
Key facts about the world

United Kingdom
- Sterling actually rose against the US$ in 2017
- UK equities remain attractively priced relative to the rest of the developed world
- The Brexit outcome will continue to drive the political environment

Europe
- The ECB has continued its purchase of government debt to stimulate growth
- The German election has resulted in a hung parliament which could alter the balance across the Eurozone in 2018

Asia
- China's nominal GDP is set to grow at about 6% from 2017 - 2021
- The Chinese economy has become highly leveraged which could pose risks to the global economy in 2018
- North Korean tensions continue



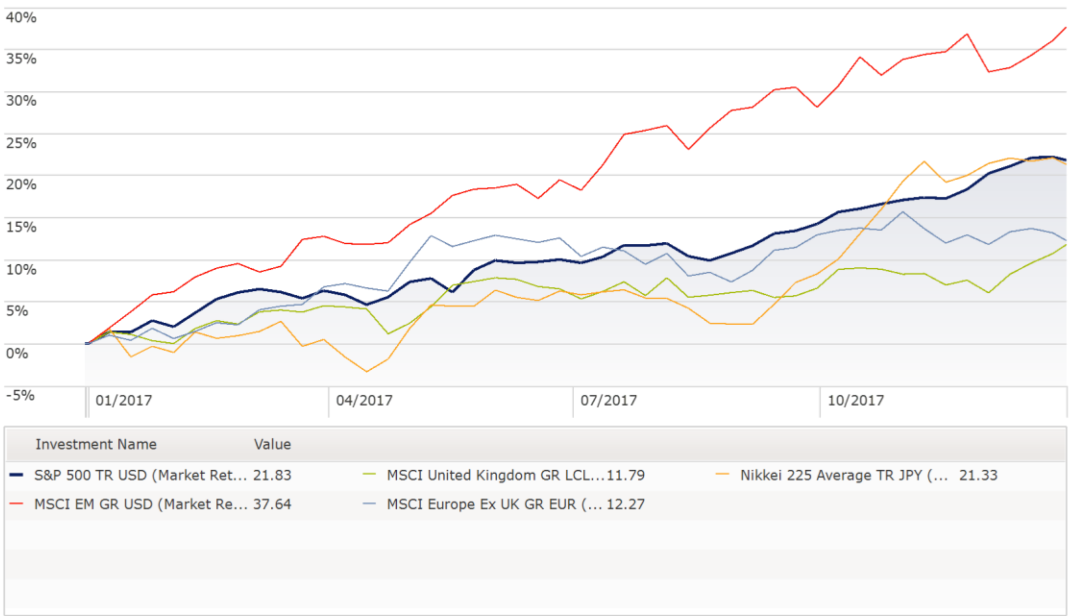
North America
- Interest rates will rise in the US during 2018
- Major equity indices are at all-time highs
- President Trump passed a bill to cut corporate tax from 35% to 21%

South America
- Brazilian equities rallied in 2017 after the country clamped down on corruption
- Argentina – a country that has defaulted on its debts 8 times since its independence - issued a 100-year bond

Africa
- The economy of Africa's largest nations – Nigeria and South Africa came out of a short-lived recession in 2017
- Currency volatility has increased due to political changes
- South Africa has experienced a significant downturn

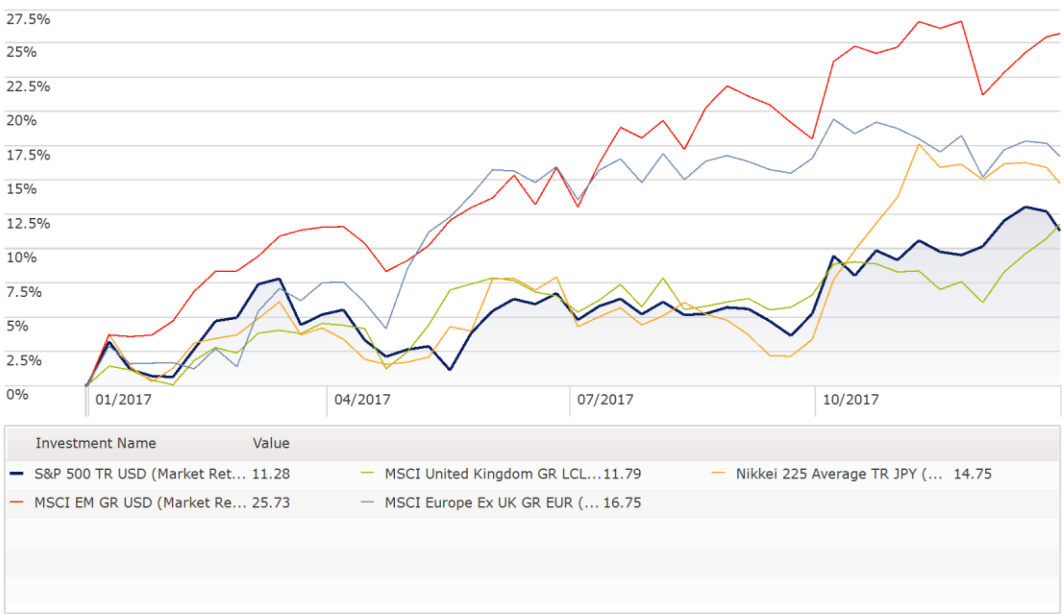
2017 in charts

Major market movements in local currency (1 year)



Source: Morningstar Advisor Workstation

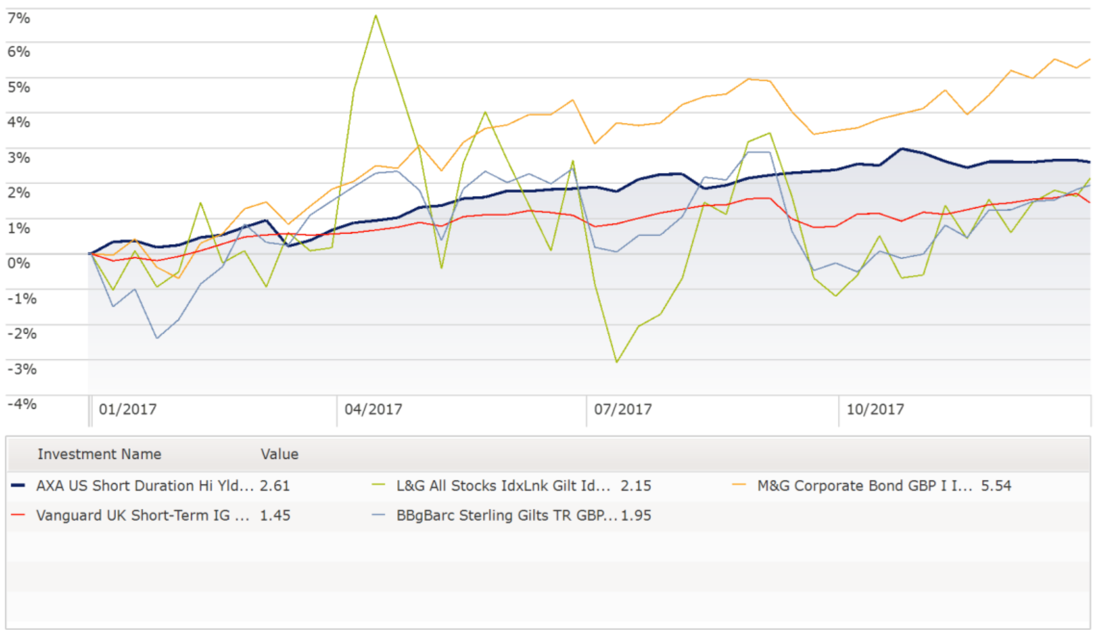
Major market movements for sterling investors (1 year)



Source: Morningstar Advisor Workstation

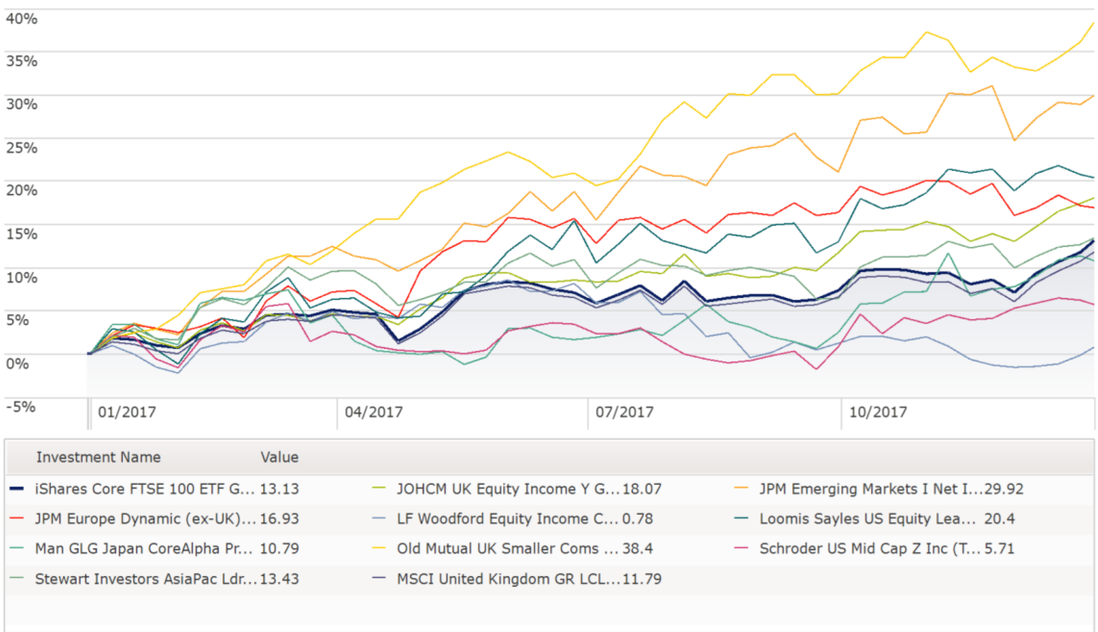
2017 in charts

Model Growth Returns Fixed Interest (1 year)



Source: Morningstar Advisor Workstation

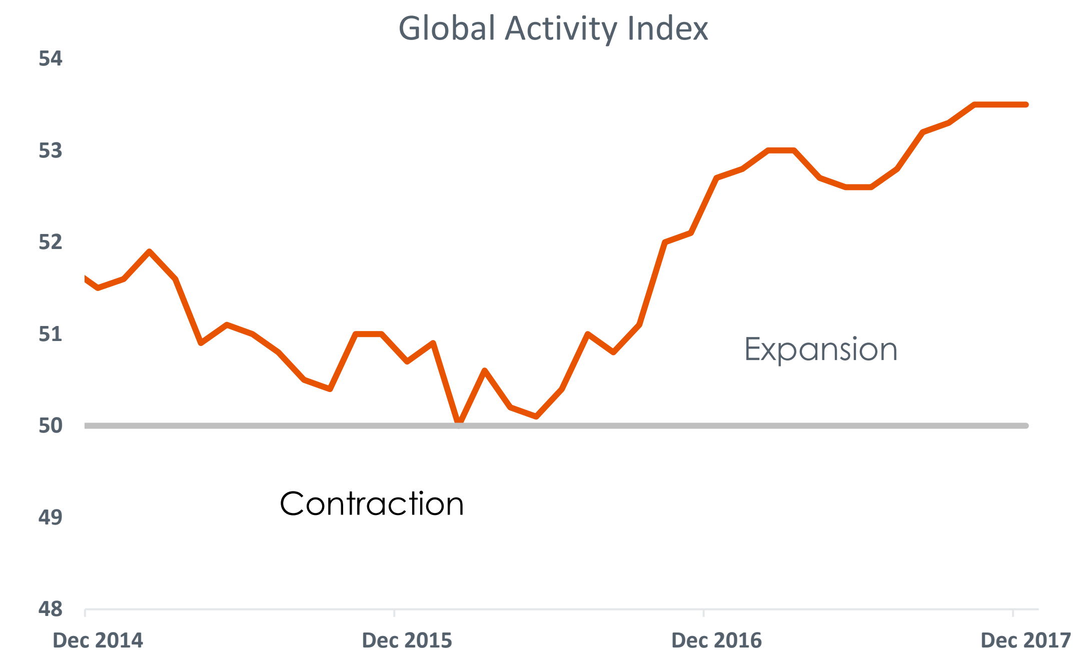
Model Growth Returns Equity (1 year)



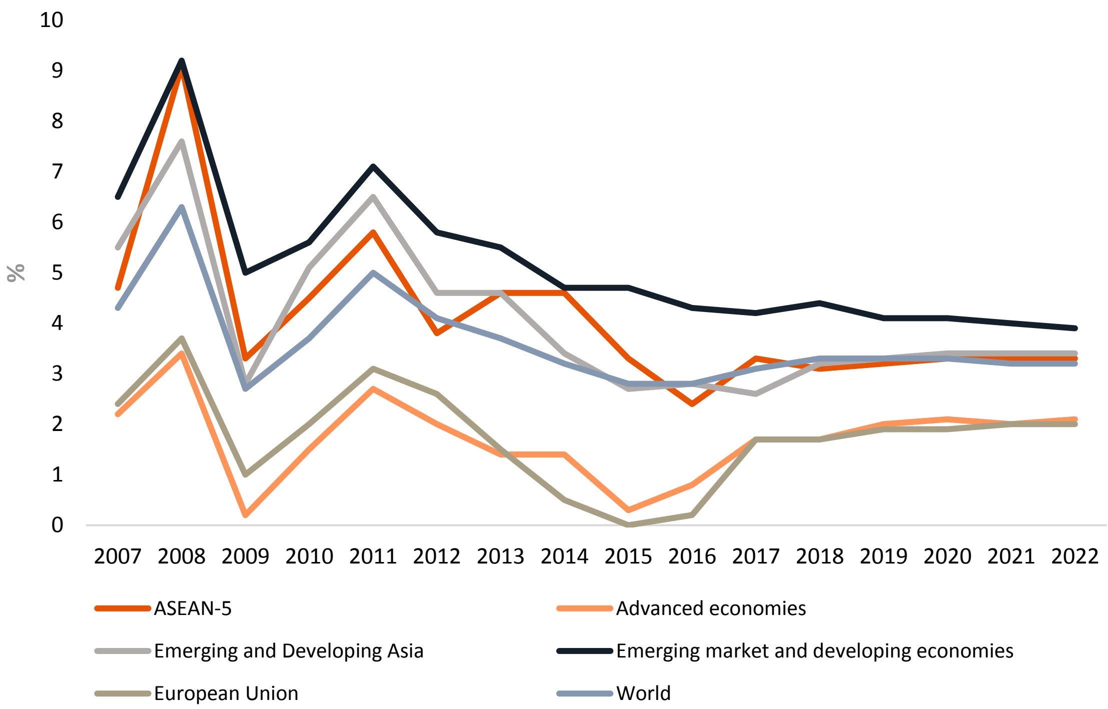
Source: Morningstar Advisor Workstation

2017 in charts

Strong Synchronised Global Growth



Coupled With Low Inflation Expectations



Source: Thomson Reuters, December 2017

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2017 performance review

UK Smaller Companies and Emerging Markets led returns

- UK equity exposure benefited from our bias towards smaller companies
- Emerging Markets exposure continued to lead returns
- Holders of European equities profited from a rising currency and improving economics
- Property exposure added returns whilst providing reduced volatility

Equities drove returns in 2017

Within UK equities, smaller companies performed best as the falls in the value of the Pound in 2016 provided a competitive advantage to this area of the market.

Despite the Brexit negativity, in a reversal of the 2016 trend, defensive stocks were derated and companies with a bias to improving economic growth profited. Within the UK equity component of our strategies, Old Mutual UK Smaller Companies and the JO Hambro UK Equity Income fund provided returns of 38.4% and 18.1% against a UK equity market return of 11.8%.

Within the UK equity area one fund that did not perform well was Woodford Equity Income. The fund's structural bias towards defensive companies and a lack of exposure to economically sensitive stocks detracted from returns. This fund has historically behaved in this manner during periods when markets are strong, however we continue to monitor the holding carefully.

Emerging Market equities provided the best return from the overseas exposure in strategies. The JPM Emerging Markets fund returned 29.9% during 2017. Our bias towards Continental European equities also helped returns as the Pound fell against the Euro and European equity markets adjusted to the improved economic outlook for the region. JPM Europe Dynamic returned 16.9%.

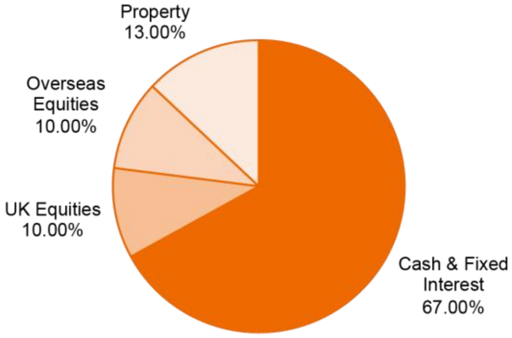
Property returns improved and significantly outperformed fixed interest markets as bond yields were volatile during the year. Having said this, all holdings within our strategies provided positive returns during the year driven by our positioning in corporate bonds. M&G Corporate Bond returned 5.5% in a year when Gilts provided no return to investors.

SECTOR	3 months	1 year to 31/12/17	1 year to 31/12/16	1 year to 31/12/15	1 year to 31/12/14	1 year to 31/12/13	5 years (annualised)
IA OE Japan	8.43	17.78	23.55	16.21	0.43	26.11	16.45
IA OE Asia Pacific Excluding	7.25	25.29	26.00	-2.80	9.73	1.89	11.40
IA OE Global Emerging Markets	5.84	24.49	31.62	-9.23	3.43	-3.76	8.16
IA OE North America	5.66	10.48	30.09	4.53	17.77	30.61	18.24
IA OE UK Smaller Companies	5.49	27.13	8.52	14.92	-1.58	37.59	16.51
IA OE UK Index Linked Gilts	3.77	2.21	25.13	-1.34	18.66	0.05	8.42
IA OE Property	3.47	7.08	8.59	5.58	13.08	5.64	7.96
IA OE UK Equity Income	3.04	11.50	9.05	6.62	3.62	25.79	11.06
IA OE £ Corporate Bond	1.84	5.24	9.69	0.22	10.63	1.34	5.34
IA OE Europe Excluding UK	1.03	17.45	17.06	9.38	-0.94	26.30	13.48

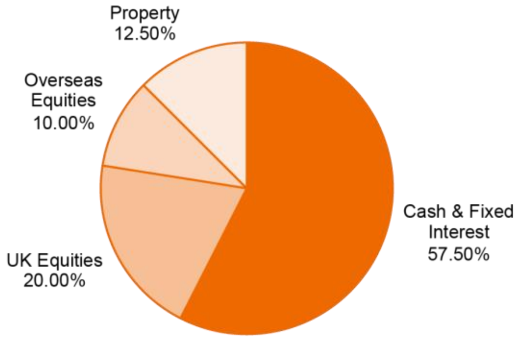
Source: Morningstar, bid-bid pricing, net income reinvested

The positioning of our strategies

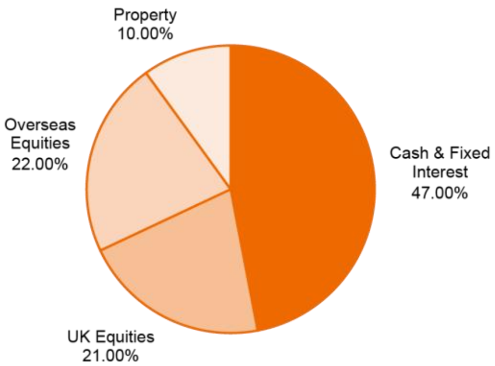
Very Conservative



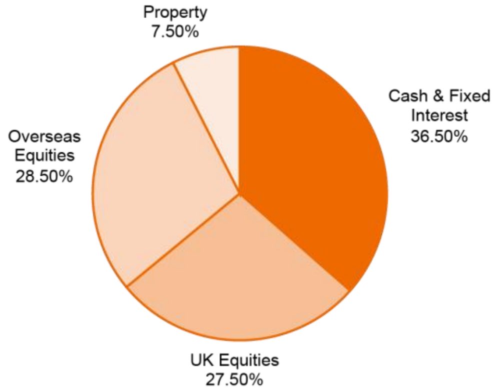
Conservative



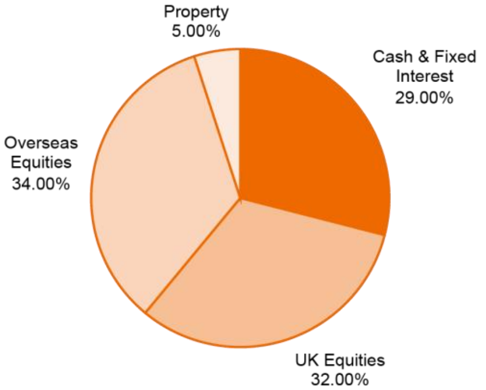
Cautious



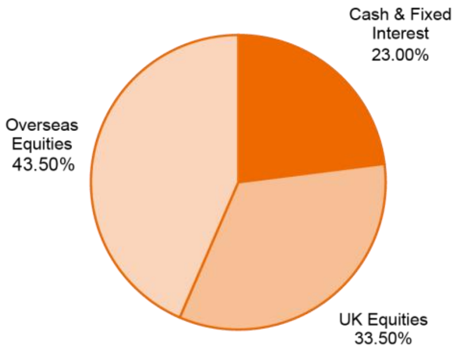
Balanced



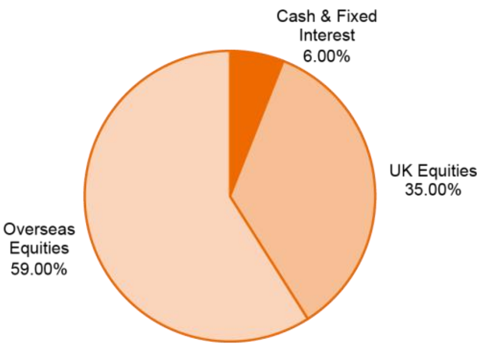
Growth



High Growth



Adventurous



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