Notes from Meetings with Fund Managers: 9 November 2015

Hosted by Baillie Gifford

Manager	Attending
Marathon	Graeme Neuff Simon Todd
Franklin Templeton	Chris Orr Stuart Lingard
UBS	Digby Armstrong Steve Magill Guy Walker
Baillie Gifford	Anthony Dickson David McIntyre

Marathon

Performance	Return	Benchmark	Relative
	%	%	%
Quarter	-3.2	-6.0	2.8
1 year	3.5	-0.1	3.6
3 years*	12.3	9.3	3.0
5 years*	9.8	7.3	2.5
10 years*	9.4	6.1	3.3
Since inception*	10.8	7.5	3.3

**Annualised*

1. Met with Graeme Neuff and Simon Todd.

2. Some reservations expressed about the emerging market ‘speed bumps’ and the interpretations that can be generated.

3. Marathon’s long standing scepticism about China was helpful as investor concerns about the pace of slowdown took hold over the summer. Also, the China infrastructure boom funded by long term debt.

4. The portfolio has a large overweight to safe consumer staples and is very underweight in mining, energy, construction and industrials. This benefitted both security selection and market allocation, with low exposure to emerging markets.

5. Valuation swings have been prominent, so there are increasing opportunities in emerging markets, albeit selectively. An example is the Chinese snacks business Want Want that has fallen from a Price Earnings ratio of 30x to around 17x.

6. Marathon thinks it is still too early to make a decisive move into industrials. Valuations, while lower, are not in ‘revulsion’ territory and there is scope for further disappointment on China. Once a low point is reached, there is an opportunity for a bounce back. Chinese subsidiaries of western consumer businesses are reporting flat or subject to falling demand, which is not consistent with the consensus view that economic growth is still around 6%. Despite this negative stance, Marathon thinks there are still good businesses in China.

7. Marathon is concerned about US companies using debt to finance share buy backs. Capex in US is low at around 6% of sales and debt levels are high. While corporate cash balances are high, this is largely focused on a small number of large companies, for example, Apple and Coca Cola.

8. Marathon managers are wary of companies with high debt because they are vulnerable to any loss of confidence in central bankers. Having said this, the consumer staples holdings are now much more expensive – Reckitts is an example on 26x PE with margins of 24%. Marathon is concerned about the US and UK delay in increasing interest rates and the market uncertainty that is generated being damaging to expectations. The adage that low interest rates beget low interest rates with too much debt built on that low permanence was mentioned. A consumer melt down on event the slightest increase is considered a possibility.

9. Discussions took place on VW (cars purchased with PPI payouts and consumers now on the verge of more compensation). VW is a stock that is in the European sleeve but not in the global sleeve of the portfolio. While the share price has fallen a long way, Simon is not sure that it is possible to assess the potential scale of liabilities – he believes fines in such high profile cases are levied according to ability to pay rather than damage done, so there is further downside possible in the share price. VW also has a significant exposure to Chinese markets, representing a double whammy in their current fortunes.

10. A couple of housekeeping issues were also discussed, including fee aggregation, the timing of the move to a more tax efficient fund structure and the possibility of using P-notes in India, given the holding limits for the pooled fund. Graeme was asked to provide more details about the counterparty risk aspects of P-notes and to what extent we could address the India issue within the pooled fund constraints.

    Advisor view: another very strong period of performance supported by clear and insightful investment thinking. Marathon remains a core investment capability.

Franklin Templeton

Performance	Return	Benchmark	Relative
	%	%	%
Quarter	-6.9	0.5	-7.4
1 year	-8.8	-3.6	-5.2
Since inception*	-1.8	-1	-0.8
Capability:			
*3 years**	*1.5*	*-1.5*	*3.0*
*5 years**	*4.2*	*1*	*3.2*

**Annualised*

1. Met with Chris Orr and Stuart Lingard.

2. Franklin Templeton has suffered large outflows from its retail products and there has also been some loss of investment professionals. The team confirmed that the institutional client base for the Global Macro fund has seen minimal net outflows in 2015 to the end of September 2015 (10 new clients and 14 losses with net outflow of less than $20m) and that the asset base is close to $100bn. There have been no changes in the investment team in 2014 or 2015.

3. Performance was very poor in the quarter to end September 2015, but has improved since then, with a return of 3.9% in October (versus a benchmark of 0.4%) and further gains in the first few days in November. The since inception performance for Surrey to end October 2015 would be about 0.5% per annum, ahead of the benchmark.

4. The portfolio is positioned for rising US interest rates and is to be very different from the benchmark, with a negative correlation to US Treasuries and large exposures to EM bonds. These were both significant detractors in the latest quarter to September 2015.

5. Credit views were positive (+0.8%), but offset by country (-2.7%) and especially by currency (-5.6%). Within emerging markets, the biggest hits were from currencies exposed to China (South Korea, Malaysia) or oil (Mexico, Brazil). The main positives were a short position in Australian dollars (a hedge on China) and the refinancing of Ukrainian bonds. The Ukrainian holdings are now trading above cost despite the haircut on refinancing.

6. Franklin's core views remain the same – that US interest rates will rise in December 2015 as wage pressures increase and the strength of the US economy and the US consumer continue apace; China will experience a soft landing (with consumer/service sectors offsetting weak industrial sectors) and world economic growth will be about 3% pa. FT regards the Chinese devaluation as having made sense and a sensible move, despite the poor communications and poor implementation. The Chinese stock correction was marked but should be taken in the context of previous growth.

7. On this basis, they believe US Treasuries are highly overvalued. FT regards the Federal Reserve as remaining very aware of global events. Could EM economies could be a disaster area when the US raises its rates? Possibly, but places like Mexico will continue to supply export markets. They regard it as being hard to argue against the future strength of the US dollar.

8. The Franklin portfolio has virtually no duration (0.1 years) and a very short profile to maturity (average 2.8 years). This is regarded as a defensive stance. They hold very little in US or Euro bonds and no Japanese government bonds. The currency positions are also hugely short in terms of Euro (-48%) and Yen (-30%), with long positions in Mexico (+19%) and the Korean Won (+18%). Ukraine debt is still holding a profitable position.

9. With regard to Brazil, reforms will worsen the recession in the short term, but things look favourable over the long term.

Advisor view: FT takes huge views relative to the index so relative returns will often be very different each quarter or year. While the latest quarter is clearly disappointing, it is still too early to judge the manager properly. The encouraging aspects are that they are sticking to their views and that the team is stable. Nonetheless, we should remember that this fund will not behave like any of our other bond mandates. It would suffer hugely if a collapse in China prompted a global deflation crisis, but should deliver good returns if the world economy continues to muddle through. As a result it is a diversifying growth asset not a defensive matching asset.

UBS

Performance	**Return**	**Benchmark**	**Relative**
	%	%	%
Quarter	-8.4	-5.7	-2.7
1 year	-4.8	-2.3	-2.5
3 years*	**9.7**	**7.2**	**2.5**
5 years*	8.2	6.7	1.5
Since inception*	6.7	5.5	1.2

**Annualised*

1. Met with Digby Armstrong, Steve Magill and Guy Walker.

2. The retirement of Richard West and the new arrival of Guy Walker have not resulted in any changes to the client base for the UK Value product. Indeed, it has been upgraded to 'buy' by Mercer, although there is little demand for new UK equity mandates. The UBS team regard Guy as having made a good start since Richard's departure.

3. Different value indices all show substantial headwinds for the style since early 2014, with a large fall over the summer. Value indices are overweight in mining, oil and banks, so they were heavily hit by weaker commodity prices and concerns about China. The portfolio was also affected by the mining section downturn.

4. The performance shortfall of 2.7% in the quarter is large, but not unprecedented for this product. Roughly half of the shortfall came from strong performance from stocks not held, such as SAB Miller that was the subject of a takeover bid. Active risk is regarded as having risen over the year with a medium risk stance now being taken.

5. Historically, M&A activity tends to benefit the value style, but this is not the case at present because most M&A is in 'safe' sectors that are already expensive.

6. Valuation remains the key focus for stock selection. The Value Team does not interact with the wider analyst team at UBS.

7. During the quarter the fund added to mining stocks, which now trade at a low price relative to tangible assets or sustainable return on capital. The fund introduced Glencore during the quarter as its price fell from 250p to a low of 70p. The average purchase price was 114p with many small purchases undertaken during the quarter. The market perception of risk and low price has allowed aggressive buying to take place. Industrial stocks contributed significantly over the quarter and consumer stocks detracted from performance.

8. The advisor asked about stocks where the team had changed its view. An example is Standard Chartered where the initial expectation for a management turnaround was undermined by deteriorating trading conditions in Asia. The position was sold at a loss when the fund bought HSBC. The team is currently debating whether or not to switch back into Standard Chartered following a substantial share price fall. There is a compelling case to return but a clear out at the bank and further price fall could still happen.

9. The team took positions in Serco Group with a new management team in place. The shares were lowly valued with the company looking good with prospects for major improvement.

10. The portfolio will remain overweight with oil/gas, industrials and financials. The portfolio still has a very strong value bias and the team are very happy with the new working arrangements.

Advisor view: Value is a cyclical style that has a good long-term track record but with a lot of bumps along the way. When investors change from being relaxed to being worried, as they have this year, it is usual for value stocks to suffer. As those fears recede, value stocks should tend to do well.

Western Asset Management

1. Met with Anthony Dickson and David McIntyre.

Performance	Return	Benchmark	Relative
	%	%	%
Quarter	-2.1	0.1	-2.2
1 year	1.6	0.5	1.1
3 years*	**4.5**	**0.5**	**4.0**
Since inception*	5.8	0.5	5.3

**Annualised*

2. Following Mike Brooks's departure, the Diversified Growth team has added a new analyst (Scott Lothian) and Felix Amoako has been appointed a Fund Manager.

3. Performance is regarding as having fallen away over the last quarter.

4. The long term capital market assumptions have been reduced to reflect lower expected 'normal' interest rates at 2.25% nominal over the next 10 years. This, in turn, reflects lower structural productivity growth, demographic headwinds in developed economies and the high starting debt burden. The implication is that equities will probably trend to 6% per annum rather than 8% per annum.

5. The last 12 months have been disappointing, with emerging market exposure undermining positive contributions from currency, absolute return and property. EM markets are weak as the market reassessed future growth prospects under the threat of increased US interest rates. However, EM markets are still favoured in the long term, given the advantages of demographic profile and the potential growth from infrastructure improvements. Also, whilst the level of EM debt is lower, growth prospects are higher than developed markets.

6. However, some emerging economies will fail despite having the right ingredients, largely because the political structures are inefficient. Brazil is an example. Mexico, by contrast, is progressing well, although it has been hit just as hard in the recent sell off. In part, this is due to liquidity factors. Mexico has a more liquid bond market, so it tends to suffer when investors want to reduce EM exposure across the board. Mexico's structural reforms provide a clear sense that things are starting to get better.

7. While positive on EM generally, BG are wary of China. The transition of such a large economy from industrial to consumer/services driven seems implausible without a financial crisis along the way, but the economic/investment data is too opaque to be sure what is actually happening. While such an outcome would be damaging, they would expect some offsets through short positions in Australian and NZ dollars. They would also expect the trend following absolute return funds to perform well.

8. Recent valuation swings make listed equities and high yield more attractive relative to senior secured assets. Similarly, the reduced expectations for cash returns make real assets with low nominal returns (property and infrastructure) more interesting.

9. Insurance linked continues to be wound down, with the exposure likely to fall from 4% to below 2% early next year following renewals. Capital flows into this market have forced renewal rates too low. In particular, they highlighted US retail demand, with one firm apparently now accounting for over 10% of the ILS market and needing to bid aggressively for every new issue to satisfy fund flows.

10. The new Diversified Growth fund is still in the pipeline, but will launch soon. It is designed for the DC market, so has a lower fee charge and makes less use of external or illiquid capabilities.

11. The advisor asked if there were any regrets in the quarter. With hindsight, BG would have chosen to hedge EM currencies. The portfolio suffered for this.

12. With regard to the worst future scenarios, deflation and a China collapse remain high on the possible damage radar. If such a collapse took place, high rated sovereign gilts would be a safe haven to turn to. Currently, Brazilian bonds are very cheap but BG are unsure if they might go cheaper still.

Advisor view: it has been a difficult year for Diversified Growth funds generally and Baillie Gifford has performed broadly in line with others. The fund continues to provide exposure to a range of interesting asset classes and an attractive mix of consistent, risk adjusted returns in the long term.

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