Manager Review meetings – 6th February 2017

Newton: Global Equities

Jeff Munroe (Head of Global Equities)
David Moylett (Client Relationship)

- Mandate size: £295m
- Target: MSCI AC World Index +2% pa (gross of fees) over rolling 3 years
- Performance: 1 year: 6.0% below index (+21.0% vs +28.7%)
  3 years: 0.4% pa ahead of index (+14.2% pa vs +13.7% pa)
  5 years: 1.3% pa ahead of index (+16.0% pa vs +14.5% pa)

Having outperformed by 7% in 2015, Newton has given up most of the gains in 2016 without significant changes to the key themes or sector positions. What has changed is the market perception of risk. In 2015, investors were fearful about slowing global trade growth, falling commodity prices and potential bad debts in the Chinese banking system. The bounce in oil prices, continued credit growth in China and the prospect of fiscal stimulus following the US Presidential Election have prompted a reversal in market leadership. The laggards of 2015 (financials, energy and materials) have been the leaders in 2016. The leaders in 2015 (healthcare, consumer staples and consumer discretionary) have been the laggards in 2016.

We challenged Newton as to why they had not closed the underweight positions in financials and energy stocks in late 2015, given the significant falls in share prices that had been seen. They did debate whether or not to move closer to the index to 'lock down' commercial risk, but decided that this would be counter to their investment views. They believe that aging populations and high debt burdens remain headwinds to global economic growth and that the balance sheets of many cyclical businesses are too highly geared. They therefore stuck to quality sectors and stocks, which has resulted in poor relative performance in a rampantly cyclical market.

Looking forward, they remain cautious and the portfolio has a defensive bias. The major overweights are IT, consumer staples and healthcare and the underweights are financials, materials and energy. European markets are valued at a 24-year low relative to US$ stocks, although a lot of the difference is due to different sector weightings rather than genuine valuation anomalies. The portfolio is overweight Europe and UK and underweight US and emerging, but the bias within Europe is to US earners rather than domestic businesses.

We asked if the big relative swings of the last two years indicated a change in risk profile within the portfolio. The active risk models suggest that 'theoretical' risk is similar but the outcomes have been wider. This may reflect the failure of risk models to capture the correlation of risk on/risk off trades.

Adviser view: *Newton's performance last year was clearly very disappointing, but should be seen in the context of the longer term results, which have been ahead of the index over the last three and five years. Their investment process is based on robust fundamental research, both in economic and company analysis. They do not try to second guess short term market behaviour and will experience erratic relative performance in markets that flip between fear (e.g. 2015) and greed (e.g. 2016). The critical issue is whether their long-term views are correct. I have a lot of sympathy with their caution about current market optimism. Our manager structure comprises two managers that have consistent philosophies (UBS for value and Newton for quality/growth) and two with a more flexible approach (Majedie and Marathon). This is a well-diversified structure that I would be reluctant to change at present.*

Ruffer: Diversified Growth/Absolute Return

Alex Lennard (Investment Director)
Trevor Bradley (Investment Director)

- Mandate size: £125m
- Inception: 20 September 2016
- Performance: +2.6% in period from inception to end 2016

Ruffer had performed well in the nine months prior to taking on our mandate during a period of falling bond yields, so were pleased that they had continued to deliver positive returns in Q4 given the sharp rises in bond yields. They successfully de-risked their bond exposures in summer 2016, prompted by seeing Swiss corporates issuing bonds on negative nominal yields. The portfolio retains a large exposure to long-dated index-linked gilts and gold, both of which were detractors, but this was more than made up from gains on equities, particularly in Japan.

They characterise the market behaviour of recent years as having an over reliance on central banks being able to "catch the vase before it hits the floor". However, with interest rates so low and the effectiveness of QE diminishing, central bankers are highlighting the need for fiscal policy to take over from monetary policy. President Trump's reflationary policies are consistent with this requirement, although the impact of growing protectionism is less clear.

The problem for assessing financial valuations is that everything has been distorted by excessively low and ultimately unsustainable interest rates – likened to "poisoning the river at source". Liquidity constraints may also be destabilising, particularly in corporate credit markets where overall issuance has expanded the market hugely while the trading depth has been shrinking – likened to "doubling the size of the stadium while narrowing the fire exits".

Overall, the portfolio has about 40% in index-linked bonds (23% in UK and the rest in US and Canada), about 40% in equities (of which Japan 16% and UK 11%) and 20% in cash/gold/options/illiquid strategies.

Adviser view: *it is very early days in our relationship, but it is already clear that Ruffer's portfolio will be very different from any of our other mandates. The quality of analysis and clarity of thought is impressive and they certainly back their views robustly.*

CBRE: Property

DJ Dhananjai (Portfolio Manager)
Nandika Sharma (Analyst)

- Mandate size: £225m
- Target: AREF/IPD UK All Balanced Property index +0.5% pa (gross of fees)
- Performance: 1 year 0.8% ahead of index (3.6% vs 2.8%)
  3 years 0.2% pa ahead of index (10.9% pa vs 10.7% pa)

The commitment to the Global Alpha fund is starting to be drawn, with £22m invested by end 2016 and a further £13m drawn in January 2017. There is a further £19.6m to invest, of which £2.6m is in cash already held by CBRE. The current weighting is 16% and the target is 25%.

CBRE became more cautious of the UK property environment in 2016 and 2017 following the UK Referendum, but expects yields to stabilise by 2018. Their current forecast is for a return below 2% in 2017, but above 5% pa thereafter, mostly from income. Within this they expect offices to perform less well than industrials and retail.

The key themes in the UK are to favour logistics/multi-let industrial, secure income and defensives, such as student accommodation and leisure. They are diversifying regionally away from the expensive London market. Similar themes apply overseas, but with the addition of cyclical office exposure in some US and Australian cities. The overall portfolio currently has 28 holdings, but this will fall to about 20 when planned disposals are executed in 2017. Leverage will rise from 18.5% to close to 20% given the extra investment in Global Alpha.

Performance was helped in 2016 by currency positions, which added 0.9% in Q4. There was a much above average activity in 2016, with well-timed disposals in Q2 and acquisitions at discounts in Q3. Lower activity is expected in 2017.

Adviser view: *CBRE's performance would have been lacklustre had it not been for the currency kicker in Q4. Having said that they have coped well with the transition of the fund post Brexit and the integration of the Global Alpha holding. The portfolio provides a well-diversified property exposure.*

Franklin Templeton: Absolute return bonds

Vivek Ahuja (Portfolio Manager) by phone
Chris Orr (Client Relationship)

- Mandate size: £70m
- Target: 5 – 7% pa
- Performance: 1 year 7.9% (bond index 2.8%)
  3 years 1.7% pa (bond index 0% pa)

What a difference a quarter makes. The +9.4% return in Q4 was achieved in a falling bond market, with the Barclays Multiverse index returning -6.7%. This is a dramatic reversal of fortunes after three successive quarters of negative returns.

Our concern ahead of the meeting was that currency positions had become too dominant making this more of a currency trading fund than a bond portfolio. Currency did have a big impact this quarter as well, with the 40% short Yen position, delivering +6.5% out of a total return in Q4 of +9.4%. Over the year as a whole, however, the attribution of returns shows that currency accounted for about a quarter of the total return, compared with three quarters from country yield curve or credit exposures.

FT's process identifies three potential sources of return: currency, curve and credit. Currency views can be based on relative valuation (e.g. Mexico in the wake of a 17% fall relative to the US$ in 2016) or on carry (e.g. high interest rates in Brazil, Indonesia and India). The higher interest rate markets may also merit duration views (e.g. Argentina).

The current portfolio has very little exposure to developed market sovereigns. FT believes the threats of protectionism and/or inflation are high and yields far too low. This includes holding no government bonds in US, Japan, Germany or UK. The overall duration is only 0.26 years (versus a bond index of 6.74 years), so there is very little interest rate sensitivity. The yield is over 9%, reflecting very high yields on emerging market bonds.

Adviser view: *FT is the opposite of a benchmark aware investor. The positions taken are punchy, both in the scale of positions in esoteric markets and in currency views. When many sovereign bonds yield nothing or less and the broader global bond market index yields less than 2%, a yield of over 9% on a well-diversified portfolio of lower rated bonds appears remarkably attractive. The extra yield more than compensates for the additional default risk on all but the most disastrous scenarios.*

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