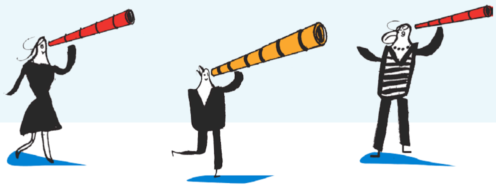
fund focus

Quarter 2, 2017



clarity

Market commentary

The US, Europe and much of the global economy has continued to make progress over the last quarter, with the overall outlook looking promising. However, as we start negotiations to leave the EU, growth in the UK economy appears to be flagging.

UK economic fundamentals weaken

Whilst the UK economy has been relatively robust following the result of the EU referendum, the ensuing weakness of sterling has contributed to a rise in inflation. Initially, retailers took the brunt of higher prices. However, more recent figures suggest that, as currency hedges end, they have become less willing and able to absorb higher import costs, and more likely to pass these on to the end consumer. Those companies with mainly UK costs in terms of inputs and staff have fared better than the majority who import stocks and/or raw materials and therefore suffer the full effects of the weaker currency.

Looking at the fundamentals, real wage growth continues to fall and is now negative against higher inflation. This has coincided with declining consumer confidence as prices rise. Real earnings are beginning to feel the squeeze as the pound has weakened, and inflation is likely to hit the 3% mark by the end of the year. The weakness of this recent data suggests that the likelihood of a rate increase this year remains relatively low, despite a more hawkish tone amongst Bank of England Monetary Policy Committee members.

The momentum of UK economic growth has been fading as we move through 2017. Retail sales growth, house prices and inflation-adjusted incomes are all weakening, as is the savings rate, in what remains a very consumption-driven economy. Future growth will depend on whether higher export numbers can counterbalance this consumer weakness.

The Trump effect

Following the US election, markets rose on the belief that President Trump would implement an array of policy initiatives, including infrastructure spending and tax cuts, to reflate the global economy. To date we have seen little action or any cohesive plan to implement these policies, which has prompted investors to tread cautiously.

President Trump also took a controversial decision to pull out of the Paris climate accord. In doing so, Trump claimed he was fulfilling his America First policy, stating that the agreement was detrimental to American workers and needed to be revised. Trump's actions have thrown the accord's targeted reductions into doubt, prompting criticism from senior officials in China and the European Union.

In June 2017, the US Federal Reserve raised interest rates for the third time since the credit crisis, adding a further vote of confidence to an already improving US economy. Currently, the US has a strong labour market and wage inflation continues to move ahead, providing policymakers with the ammunition to raise rates further this year. More important was their narrative on reducing the size of the $4.5trillion balance sheet through phasing out the proceeds of maturing investments. This will need to be handled smoothly, as the risk of policy error by the Central Bank remains one of the biggest threats to stability.

Global instability

Oil prices fell over the quarter, as traders remained concerned that a deal between OPEC and Russia to cut production was being counteracted by increased output from other producers such as Libya, Nigeria and, most significantly, the US. Oil prices are now languishing at the cheapest levels in more than seven months, whilst non-OPEC production is set to grow by 1.5 million barrels per day in 2018, slightly more than the expected increase in global demand.

China's markets suffered after ratings agency Moody's downgraded the country's debt on concerns surrounding the future of its economy. The downgrade reflects Moody's expectation that China's financial strength will erode somewhat over the coming years, with economy-wide debt continuing to rise as potential growth slows. The downgrade is yet another sign of the challenges faced by China, which is juggling rising debt, declining growth rates and ongoing structural reforms.

Europe makes progress, but concerns remain

The French elections concluded with centrist candidate, Emmanuel Macron, defeating right-wing candidate, Marine Le Pen, by some margin, providing relief for market participants. In the medium term, one would expect this victory to be reflected in a strengthening of the Euro and further equity gains. However, we still have the German and Italian elections to come. In Italy, the anti-establishment party has gained significant strength, which could create some volatility ahead.

Although political challenges remain, growth within the Eurozone accelerated in the first quarter. Current fundamentals paint a picture of a reassuringly solid-looking economic upturn. Unemployment is at its lowest level for seven years, while recent indicators of business and consumer confidence have hit multi-year highs. The European Central Bank (ECB), has even acknowledged improving growth figures but maintained interest rates at their current level as inflation has fallen back once again.

The global recovery

Despite the recent increase in political uncertainty, the global economy is growing at a healthy pace and this seems set to continue during the second half of 2017. Supported by both developed and emerging markets, global macroeconomic data has recently improved, if somewhat slowly and with increasing divergences at the country level. While macro data for the US and the UK has weakened recently, it remains strong in the Eurozone, Japan, and several emerging markets.

Economic growth in the UK has been more resilient than many expected following the referendum, but headwinds are building, with inflation growing ahead of wages and the consumer showing signs of flagging. The economic environment is weakening and, as negotiations with the rest of the EU have only just begun, the outlook is becoming increasingly complex and uncertain.

Fundamentally, global growth continues to improve, supported by central bank action. During 2017, geo-political events will continue to overshadow these steady improvements, creating pockets of volatility. Ultimately, positive change is occurring across the globe and growth is likely to improve from here, even as we enter the summer lull.

Summary of quarterly buylist review

highest 3 scores	lowest 3 scores
Henderson UK Absolute Return	JPM Natural Resources
Rathbone Income	Invesco Perpetual Latin American
Liontrust Special Situations	Standard Life Invesments Global REIT
biggest mover up	**biggest mover down**
Jupiter Ecology	M&G Index-Linked Bond

The clarity fund scoring system is a quant-based process designed as the first phase of selection for our new buylist funds and to monitor existing buylist funds relative to their peer groups. Peer groups are the sectors as defined by the Investment Association (IA). Source for all figures: FE Analytics, July 2017.

Fund comments

In contrast to last quarter's fund focus, we have seen a lot more change in the rankings in Q2 2017. There has again been little change at the bottom though.

High scores:

Henderson UK Absolute Return

This fund aims to provide a positive return over the long term, whether markets go up or down, by investing primarily in UK company shares. Derivatives are used to help the fund achieve its objective. The fund's strategy is relatively straightforward, avoiding the more complex types of derivatives used by the majority of funds in the sector.

discrete annual performance to last quarter end (GBX)					
	0-12m	12-24m	24-36m	36-48m	48-60m
Fund	4.64%	3.56%	7.20%	9.76%	14.28%
Sector	4.16%	-0.54%	3.72%	3.40%	6.39%
Relative to sector	0.46%	4.11%	3.35%	6.15%	7.41%
Rank within sector	32/71	11/68	13/57	8/53	11/49
Quartile	2	1	1	1	1

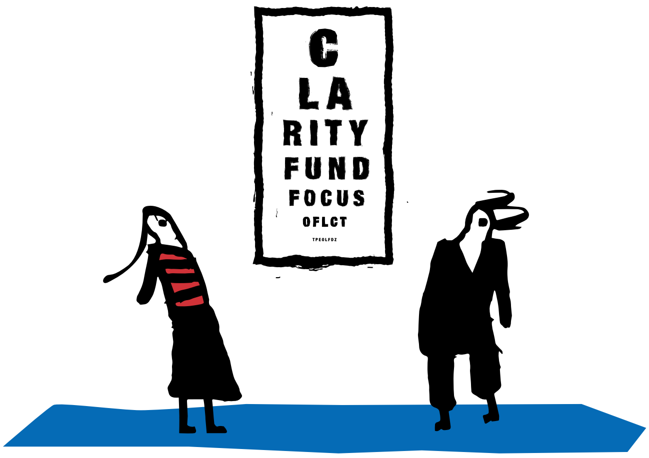
clarity verdict: The managers' experience with this flexible UK equity long/short strategy has worked well in outperforming the targeted absolute return sector average, with relatively low volatility. This fund is relatively new on the clarity buy list and features in our more cautious portfolios.

Rathbone Income

The objective of this fund is to achieve above average, maintainable income, without neglecting capital security and growth. The fund manager intends to achieve the objective primarily through the purchase of ordinary shares with an above average yield. Although the fund's remit allows him to invest globally, investments will always be predominantly in UK companies.

discrete annual performance to last quarter end (GBX)					
	0-12m	12-24m	24-36m	36-48m	48-60m
Fund	20.15%	1.41%	9.12%	13.46%	26.35%
Sector	19.33%	-3.19%	7.19%	14.08%	20.95%
Relative to sector	0.69%	4.75%	1.80%	-0.55%	4.46%
Rank within sector	36/95	20/88	28/85	45/83	19/80
Quartile	2	1	2	3	1

clarity verdict: Fund manager, Carl Stick, runs a relatively concentrated portfolio, with a focus on quality companies with a healthy dividend yield, aiming for progressive growth in both capital and income. He is supported by a fairly small, but well-resourced, team with a high level of analytical expertise.



Liontrust Special Situations

This fund invests in a portfolio of companies from throughout the UK stock market, aiming for capital growth in excess of the FTSE All Share Index over rolling three-year periods.

discrete annual performance to last quarter end (GBX)					
	0-12m	12-24m	24-36m	36-48m	48-60m
Fund	23.01%	6.85%	8.90%	12.02%	23.33%
Sector	22.50%	-4.77%	6.77%	13.83%	21.79%
Relative to sector	0.42%	12.20%	2.00%	-1.60%	1.27%
Rank within sector	98/273	8/267	87/258	177/252	114/245
Quartile	2	1	2	3	2

clarity verdict: This fund invests across the range of market cap sizes using a very clear investment process centring around intellectual property and barriers to entry with, for smaller companies, a requirement that directors together have a shareholding of at least 3%. The fund's long-term performance is excellent. After a somewhat weaker period, it is good to see the managers consolidate its return to form. In the clarity rankings, it has again dropped one place over the last quarter.

Low scores:

JPMorgan Natural Resources

This fund invests primarily in the shares of companies throughout the world that are engaged in the production and marketing of commodities. The fund aims to provide capital growth over the long term.

discrete annual performance to last quarter end (GBX)					
	0-12m	12-24m	24-36m	36-48m	48-60m
Fund	19.74%	2.49%	-28.31%	17.58%	-23.20%
Sector	12.93%	5.99%	-0.81%	6.81%	7.79%
Relative to sector	6.03%	-3.30%	-27.72%	10.09%	-28.75%
Rank within sector	32/106	58/104	96/100	13/94	79/84
Quartile	2	3	4	1	4

clarity verdict: Relative performance has suffered over the last few years from low commodity prices. Although performance improved in 2016, pushing the fund into the 1st quartile, there has been a pull-back over recent months. The risks inherent in the fund's small- and mid-cap bias tend to come to the fore in slow markets, but the manager benefits from a large and well-resourced global team.

This fund sits in the Specialist sector, which includes a wide range of funds with very different investment remits, hence relative performance in this context is not a reliable comparator. It is notable that over the last 12 months this fund has made good outperformance against the Specialist sector, but it is currently one of the worst-performing funds in the clarity buylist over three years.

Whilst this fund remains as a useful diversifier for some clients, the decision has been taken to move it to a Hold. This has the benefit of enabling clients who are longstanding investors to remain in the fund and participate in any upside, whilst we will continue to formally review it every quarter.

Invesco Perpetual Latin American

This fund invests for capital growth throughout South and Central America, including the Caribbean, with an emphasis on Brazil. Dean Newman has managed the fund since launch in 1994. The fund is actively managed and, although notionally benchmarked against the MSCI Emerging Latin America Index, is unconstrained. As a fund investing in a small part of the emerging markets universe it is very high risk and should be considered only on a 5- to 10-year view.

discrete annual performance to last quarter end (GBX)					
	0-12m	12-24m	24-36m	36-48m	48-60m
Fund	13.97%	5.27%	-20.56%	-6.53%	10.68%
Sector	12.93%	5.99%	-0.81%	6.81%	7.79%
Relative to sector	0.92%	-0.68%	-19.91%	-12.49%	2.68%
Rank within sector	60/106	45/104	86/100	89/94	47/84
Quartile	3	2	4	4	3

clarity verdict: Latin American equities have responded well over the last year or so from a combination of currency effects, largely based on a weakening US dollar, and improved commodity prices, after performing poorly over the last few years. Political factors have also helped to improve sentiment towards the region.

Standard Life Investments Global REIT

The fund aims to provide long-term growth from a combination of income and capital growth, by investing predominantly in a globally diversified portfolio of listed real estate investment trusts (REITs) and quoted property companies. Non-sterling denominated assets in this fund are typically hedged back to sterling.

discrete annual performance to last quarter end (GBX)					
	0-12m	12-24m	24-36m	36-48m	48-60m
Fund	-2.59%	4.95%	5.40%	12.76%	17.64%
Sector	5.21%	6.29%	7.48%	7.00%	5.89%
Relative to sector	-7.41%	-1.26%	-1.94%	5.38%	11.10%
Rank within sector	53/53	28/52	43/51	12/44	6/40
Quartile	4	3	4	2	1

clarity verdict: Weaker sterling has caused much of the underperformance over the last year or more. For instance, over calendar year 2016, the unhedged return was a gain of 17.3%, with currency effects turning this into a decline of 9.61%. Svitlana Gubriy has managed the offshore version of this fund since 2007 and took on the onshore fund in 2016 following the resignation of her predecessor. As a fund investing in companies, rather than directly into property assets, it is relatively correlated with global equity markets. However, for more adventurous investors it offers indirect exposure to commercial property around the world, which often works on different cycles from the UK.

Biggest mover up:

Jupiter Ecology

The objective of this fund is to achieve long-term capital appreciation together with a growing income consistent with a policy of protecting the environment. The fund's investment policy is to invest worldwide in companies that demonstrate a positive commitment to the long-term protection of the environment.

discrete annual performance to last quarter end (GBX)					
	0-12m	12-24m	24-36m	36-48m	48-60m
Fund	23.21%	7.32%	5.58%	13.53%	23.57%
Sector	22.83%	5.62%	8.53%	8.56%	19.86%
Relative to sector	0.31%	1.61%	-2.71%	4.58%	3.09%
Rank within sector	129/242	109/231	180/221	26/211	67/197
Quartile	3	2	4	1	2

clarity verdict: This fund is found in the Global sector, where it has suffered in relative performance terms over recent months from being underweight US and overweight Europe compared with the sector average. It is now good to see the fund bouncing back. Manager Charlie Thomas is highly experienced in environmental investment and a perennial enthusiast for the fund's themes, which in general take longer to play out than more mainstream sectors. This fund is now over 25 years old and makes long-term investments in leading companies providing solutions to global environmental challenges. The key investment themes are resource efficiency, infrastructure and demographics. We consider this to be an ideal global fund for investors interested in 'green' themes.

Biggest mover down:

M&G Index-Linked Bond

This fund aims to protect the value of capital and income from the effects of rising prices over rolling periods of five years or longer, with a total return (the combination of income and growth of capital) consistent with investment in index-linked fixed income securities. The fund invests mainly in inflation-linked bonds issued by the UK government, but up to 20% of the portfolio may be invested in index-linked corporate bonds guaranteed by the government or foreign index-linked government bonds.

discrete annual performance to last quarter end (GBX)					
	0-12m	12-24m	24-36m	36-48m	48-60m
Fund	6.75%	14.91%	13.93%	3.08%	2.73%
Sector	6.58%	14.83%	12.58%	2.54%	2.61%
Relative to sector	0.17%	0.07%	1.20%	0.53%	0.12%
Rank within sector	12/17	11/17	6/16	8/16	11/15
Quartile	3	3	2	2	3

clarity verdict: This fund has a record of making small incremental gains ahead of the sector average, which amount to worthwhile outperformance of the peer group over the long term. With UK inflation expected to be more elevated over an indeterminate period than we have become accustomed to, the fund can help to combat erosion of returns in the fixed interest portion of a portfolio. Year to date, this fund has been relatively weak against the average of its small sector, but we remain confident in the managers and the M&G fixed interest team.

Sector analysis

The table below summarises the performance of each sector in which we have buylist funds over the last five discrete years. The top performing sector for each time frame is highlighted in green and the lowest performing sector highlighted in red.

discrete annual performance (%) to last quarter end (GBX)					
	0-12m	12m-24m	24m-36m	36m-48m	48m-60m
Asia Pacific Excluding Japan	29.63	5.83	7.75	5.26	13.11
China/Greater China	35.84	-5.10	23.99	4.94	15.57
Europe Excluding UK	29.39	4.14	4.22	15.21	31.74
Flexible Investment	16.23	1.38	6.61	7.42	14.87
Global	22.83	5.62	8.53	8.56	19.86
Global Bonds	4.24	11.54	-0.97	-0.30	3.91
Global Emerging Markets	27.91	4.77	0.27	3.26	6.81
Japan	25.35	7.40	17.68	-1.42	25.35
Mixed Investment 20% -60% Shares	11.93	1.85	4.86	6.84	10.09
Mixed Investment 40% - 85% Shares	16.40	1.95	6.59	7.58	14.10
North America	23.72	14.43	15.01	10.04	24.56
North American Smaller Companies	28.21	7.43	13.80	9.77	31.59
Property	5.21	6.29	7.48	7.00	5.89
Specialist	12.93	5.99	-0.81	6.81	7.79
Sterling Corporate Bond	6.32	6.30	4.54	6.11	5.83
Sterling High Yield	10.74	0.91	-0.42	10.42	10.69
Sterling Strategic Bond	6.08	3.55	2.79	7.42	6.91
Targeted Absolute Return	4.16	-0.54	3.72	3.40	6.39
UK All Companies	22.50	-4.77	6.77	13.83	21.79
UK Equity Income	19.33	-3.19	7.19	14.08	20.95
UK Index-Linked Gilts	6.58	14.83	12.58	2.54	2.61
UK Smaller Companies	35.76	-6.63	9.32	22.30	26.73

Source for all figures: FE Analytics, July 2017.

Sector analysis - clarity verdict:

China took the top spot this quarter, returning +35.84% in the 0-12m period and +23.99% in 24-36m. Although it declined by -5.10% in the intervening period, it avoided coming last by a relatively small margin. Index-Linked Gilts was the top performer in 12-24m with +14.83%, which was a surprise to many; however, it was also the weakest sector in the 48-60m period with +2.61%.

Our old friend, UK Smaller Companies, performed best in 36-48m, returning +22.30%, but was also worst in 12-24m with -6.63%. This sector's volatile nature is illustrated by good gains of +26.73% in 48-60m and +35.76% in 0-12m, neither of which hit the top spot.

Targeted Absolute Return was again the worst-performing sector in 0-12m, although with a better return of +4.16% this time. In the five periods in the table, the average of this sector has only declined once, by -0.54% in 12-24m. Whilst the sector overall has provided an absolute (i.e. positive) return over the five years, as it is designed to do, individual funds in the sector will have performed better or worse. With this type of mandate, there is little margin for error and, in general, this is not a sector we recommend for most clients.

Unusually, all sectors rose over the last twelve months. Better global growth has been reflected by more optimism in markets, although corporate valuations remain relatively 'full'.

What can we learn from the table on page 7? Whilst individual sectors have been more or less volatile over the last five discrete years, depending on their nature, if we take the average of the Mixed Investment (40-85% Shares) sector as a proxy for a 'balanced' portfolio, this has increased cumulatively by 55.25% over the last 5 years. This shows the value of a well-diversified asset allocation in reducing volatility and producing growth.