Half Year Report – July 2018

This is the first update that we have provided with our new branding and we will be following this format moving forwards – red is our everyday documents, green for valuation and blue when we want to send you more generic information or updates.

Since the start of the year we have written to you on two occasions to provide you with an insight into market conditions and why we feel risk is so high. In fact, by April our concerns reached a level where we thought it would be prudent to recommend an increase to cash balances to above average levels.

Nothing has changed here; the risks that we see and indicators that we trust continue to lead us to follow a defensive approach with the aim of protecting your capital whilst ensuring a reasonable rate of return on investments.

One thing that has changed however is our process and how we would hope to identify investment opportunities in the future; in the post Financial Crisis World of 2009-2011 we could certainly have adopted a more aggressive approach (easy to say looking in hindsight's rear view mirror) and we are now confident that similar opportunities will occur when the chances come around again.

Successful investment strategies are built on consistency and a good knowledge of history; but they also need to evolve and improve and this is what we hope we have done over the last few years.

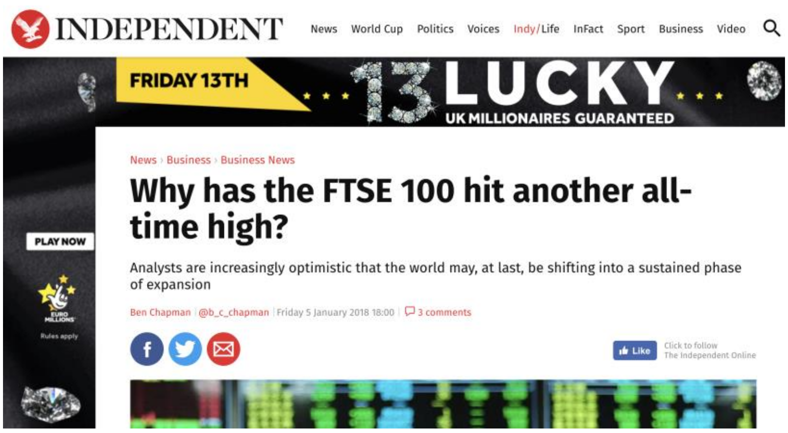
No scenario is the same as the last - but they do have similar traits – and whilst we cannot predict with certainty how events will unfold, we can ensure our systems help us make appropriate investment policy decisions when reacting to conditions.

The rest of this report focuses on two key areas that we hope you will be interested in; this first "Investor Preferences" explores the approach that we take when building our strategies and hopefully encourages you to consider what you as the investor wants. The second looks at the investment policy decisions we think are appropriate to deal with the conditions we have described to you this year.

Investor Preferences

Availability of information and the news flow from a multitude of sources covers every aspect of investment; this can not only be confusing and difficult to understand but also create worry or concern that for you. Think of some of the headlines that we see :

January 2018 The Independent – article on increasing optimism and a new high with predictions of sustained expansion.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Why has the FTSE 100 hit another all-time high?

Analysts are increasingly optimistic that the world may, at last, be shifting into a sustained phase of expansion

Ben Chapman | @b_c_chapman | Friday 5 January 2018 18:00 | 3 comments

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Fast forward a month to February 2018 and The Independent runs an article on massive sell off and inflation fears.


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FTSE 100 tumbles after worst day for US stocks in more than six years

LIVE BLOG **As it happened**: global markets suffer massive sell-off on inflation fears

Josie Cox Business Editor | @JosieCox_London | Tuesday 6 February 2018 09:22 | 3 comments

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Key Points

- FTSE 100 falls sharply
- Nikkei closes down 4.7 per cent
- Strategists and analysts from across the City react
- 'Fear index' spikes
- Dow Jones takes biggest hit since 2011

In January you could have been wondering whether to be “bullish” and invest heavily in the FTSE-100; the next month should you be “bearish” and hide out in cash?

News flow has a big effect on sentiment and how individuals feel about investment; we would wager that if we sent a reader of the Independent an attitude to risk questionnaire in January to complete after reading the first article they would probably be in a higher risk classification than if they had completed it after reading February's article!

Human nature means we can spend too much time dwelling on the thought that we have missed out and think about what could have been! If we act and it goes wrong, we reprimand ourselves for making a hasty investment decision and losing capital!

But is there a better way?

To our minds yes there is; the route is not easy but investors like you should try to train themselves to focus on what is important to them; what do you want to achieve? How long that I wait for it to happen? How much risk can I take?

By considering these questions at outset, at regular intervals or as life changes the outcome for you as a client the investment experience and hopefully result will be much more satisfying. These questions can often be easily answered and are probably much more relevant than the various attitude to risk questionnaires that we see based on varying different psychological models.

Using an appropriate benchmark is crucial as short term price swings can have a big effect e.g. the FTSE-100 lost almost 40% in the Financial Crisis and has had years when it has gained almost the same yet the long term annualised return is 4.7% without dividends and around 8.7% including dividends – surely then we should be using the long run returns as a benchmark? The need to follow irrelevant news or benchmarks can be removed; as is the need to worry or feel regret.

Here is an example of how and investor preferences can be defined and a solution created for them that is specific and relevant to their objectives and needs, which is also benchmarked appropriately.

The Defensive Investor

The objective is to maintain the real value of your wealth above a measure of inflation over the next 20 years whilst avoiding losses of more than 10% which would make you feel uncomfortable then a Defensive Portfolio is suitable.

When we put together our long term portfolios we test them using statistics to see how they have historically performed across a variety of economic and market conditions.

Using statistics, we can establish over the investors chosen time horizon the range of returns the portfolio has achieved; probability allows us to seen how these returns are distributed – for example if we use a 95% confidence level and the return was 3.9% this means that 95% of outcomes have been 3.9% per annum or greater.

We can then test other confidence levels and compare them to the long run returns from the appropriate benchmark, in this case the Retail Price Index (RPI).

The table below provides a selection of some of the key information for our Defensive Model Portfolio over 20 years.

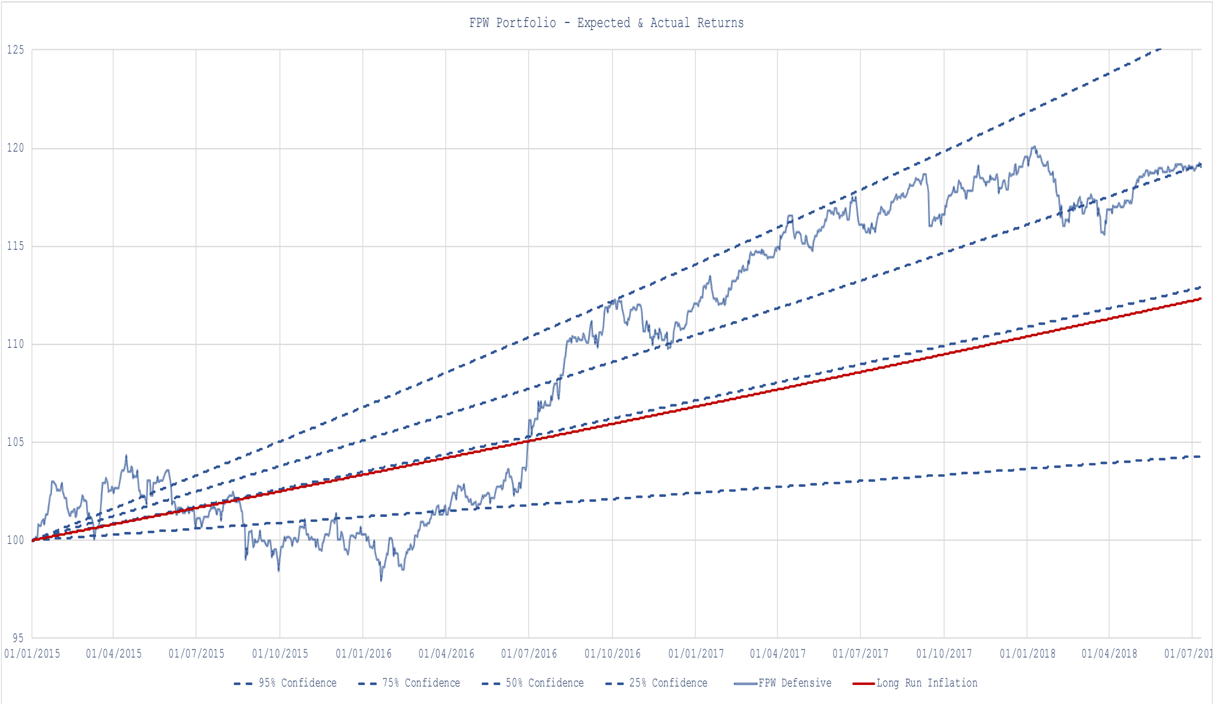
	FPW Defensive Portfolio
RPI Long Run Annual Return	3.35%
Average Return	5.92%
Median Return	5.36%
Maximum Annual Return	21.44%
Minimum Annual Return	-9.95%
Expected Returns 95% Confidence	1.20%
Expected Returns 75% Confidence	3.50%
Expected Returns 50% Confidence	5.10%
Expected Returns 25% Confidence	6.80%
Maximum loss over a 3 Year Period	-6.06%

This tells us that we can expect this portfolio to outperform inflation 75% of the time; the average return is above the long run rate of inflation and the historic maximum annual loss is less than -10%. All this means the portfolio is appropriate for the clients described risk profile.

We can also take this to the next level with graphical analysis of the actual portfolio against these expectations, comparing the actual returns from a client or model portfolio against the expected range of returns and the appropriate long run benchmark.

This means that at any given point we can establish if we are outperforming long run expectations and client objectives removing the need to focus on short term news.

The Defensive Model Portfolio was started in January 2015 and we have compared this to long run inflation and our expected range of returns if you had started investing at inception.



Initially the model out performed inflation but through the end of 2015 and into 2016 we underperformed (and can explain the reasons) before our strategies started to pay off and led to a bumper 2016-2017 that put us in the upper range of expected returns. At present we are still ahead of benchmark but recent declines in all markets have set us back slightly.

In our view this is a far more effective and relevant way for a client to look at their portfolio and assess whether it is meeting their objectives and needs - the latest soundbite and short term market fluctuation has become irrelevant, they are on target!

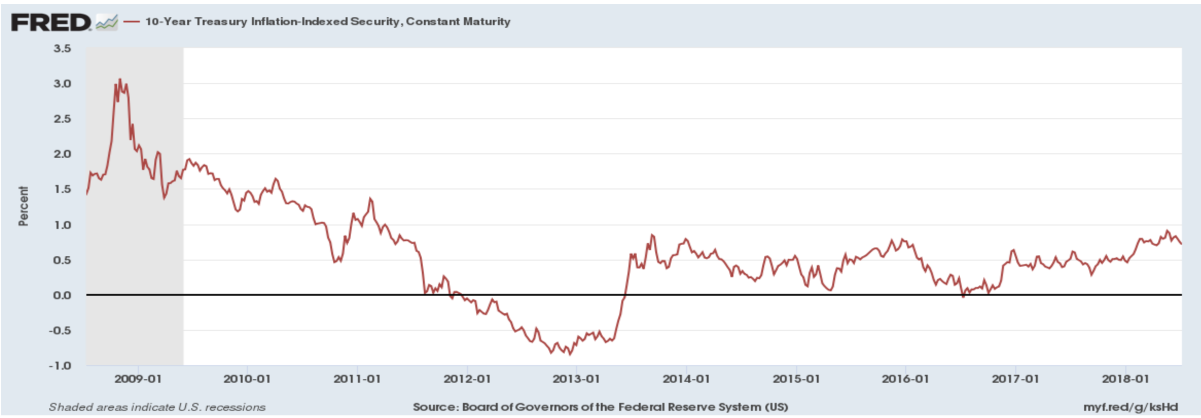
We would encourage you to consider carefully what your long term objective and preference is; that way we can provide a clear indication of the return profile you can expect from the selected portfolio.

Current Strategies

Cash remains our biggest problem at the moment; which whilst offering the protection that we require is a drag on performance in a rising market as interest rates remain at record lows – we continue to look for ways to recommend effectively deploying funds.

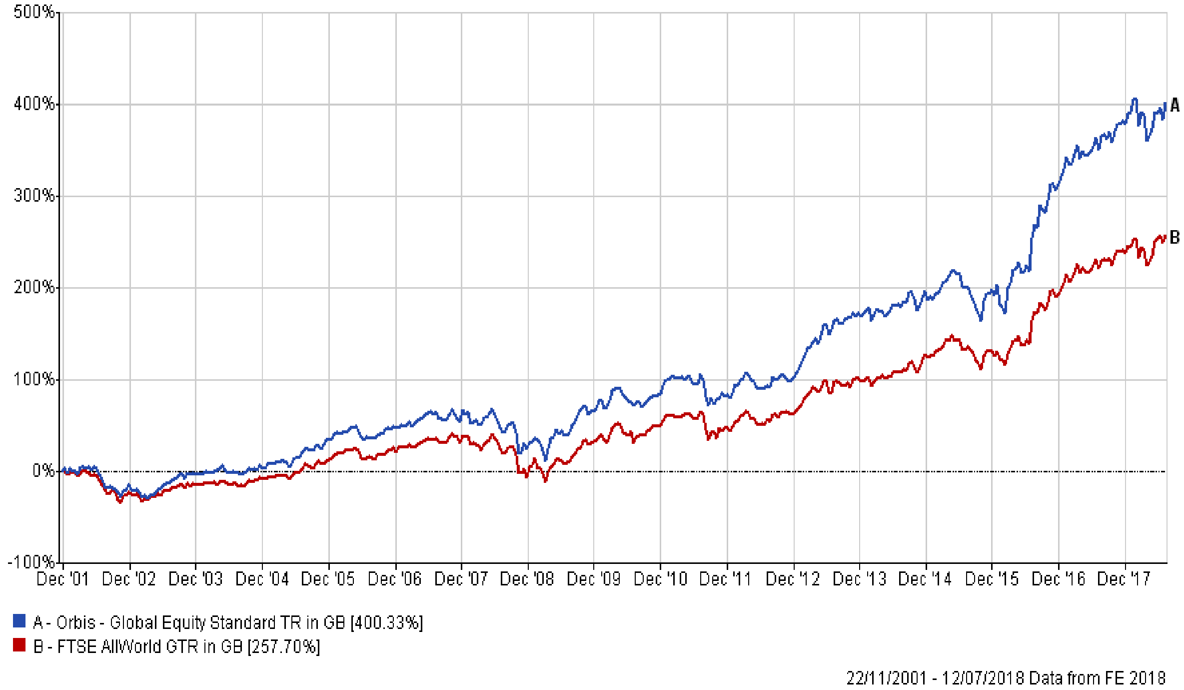
Fixed interest holdings – such as Gilts and Corporate Bonds – continue in our view to offer little value. The graph below shows how the yield of 10 year gilts remains at or near record lows (low yields = high prices, we need yields to fall to make gains).

One area that we became positive about in early 2018 was US Treasury Inflation Protected Securities (TIPS); like Index Linked Gilts in the UK these provide a return linked to inflation. The graph below shows how at the start of the year TIPS yields had increased to a level not seen for around two years suggesting some value – since then yields have fallen and we have seen reasonable returns of 5-7% on holdings in a TIPS low cost tracker holding.



When it comes to equities we remain cautious but one fund we really like is Orbis Global Equity Standard; they are a fairly small investment house but follow a "contrarian" strategy that over the years has provided significant outperformance of the FTSE-All World.

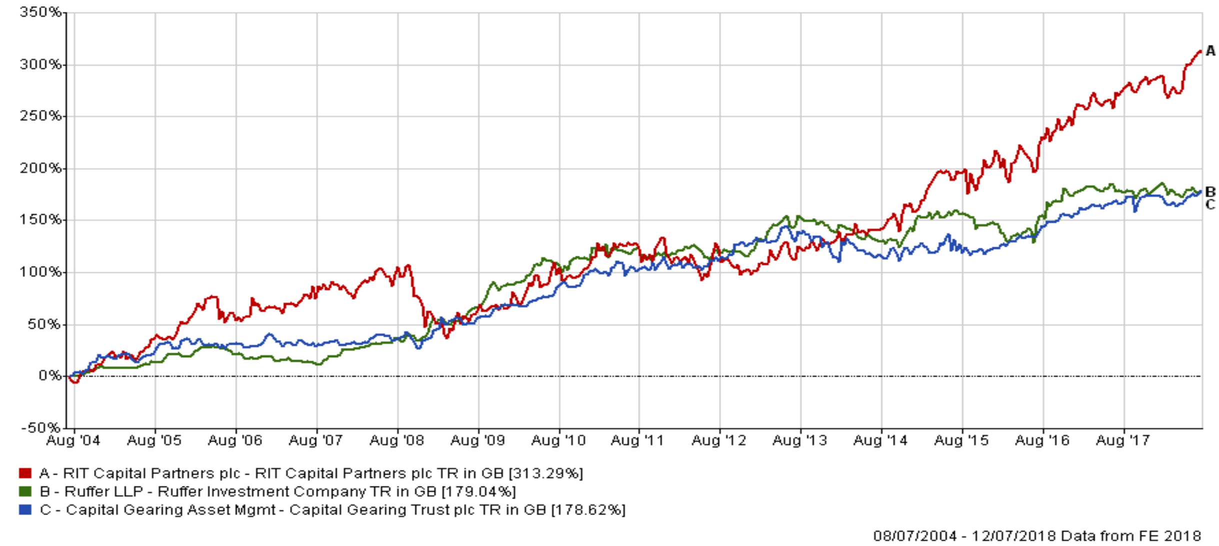
As well as offering great returns and a robust investment process this fund is unique in its charging structure in that no charges are levied unless it outperforms its benchmark.



One theme that we are really keen on in equities is Japan for a number of reasons: -

- Quantitative Easing is continuing and supportive of share prices
- Extremely stable Government
- Longest period of economic expansion since World War 2
- Labour shortage and move from temporary to permanent employment
- Change in Corporate culture as firms start to pay dividends
- De-regulation encouraging entrepreneurship
- Rising US interest rates positive for US Dollar and likely negative for Japanese Yen – increasing exporter's profits and justifying higher share prices

Within the alternatives sector we continue to support Multi-Asset Funds that have a high level of flexibility in where they can invest and can offer consistent and predictable long term returns. On the back of recent strong performance we plan to recommend adding to holdings in RIT Capital Partners

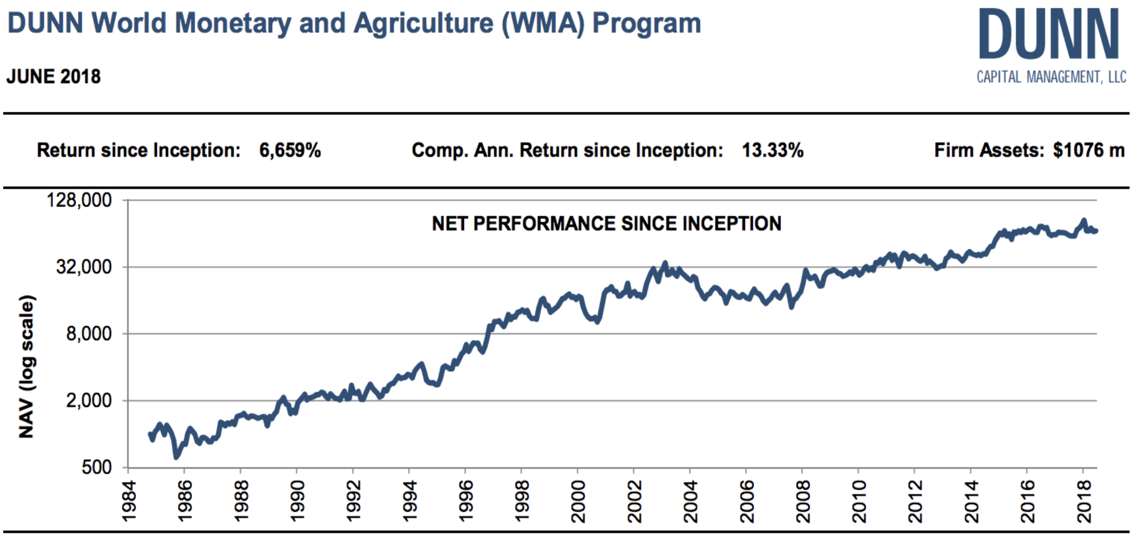


Whilst Capital Gearing (and Ruffer) can be a little boring at times they, and RIT represent ideal “core” portfolio holdings; a look back to 1995 should tell you why when compared to the FTSE-100 (including dividends).

One area of real interest in the Alternative Sector is Hedge Funds and in particular trend following strategies; we spent a long time looking for a fund that would produce profit if markets declined but at the same time wouldn't be a drag on returns if the up-trend continued.

There were a few candidates but few had a suitable track record that could demonstrate success in all conditions – ultimately luck played a part and I happened to pick up a magazine that mentioned Montlake Dunn WMA, here's some background

The DUNN WMA Institutional UCITS Fund, managed by DUNN Capital Management LLC, a Florida based CTA Manager with a long history of superior absolute performance. The firm was founded in 1974 by Dr. William A. Dunn, a pioneer in the managed futures industry. Today, based on Dr. Dunn's original revolutionary efforts to apply computer technology to portfolio management, DUNN is the managed futures industry's second-oldest firm and is managing over $1 billion in its strictly quantitative, 100% systematic, computer-based portfolios. In addition to organising, selling and managing over a dozen private futures funds, DUNN has traded for numerous other public and private funds and private accounts. Over the past thirty-six plus years, the firm's composite track record has achieved a net compounded annual rate of return of over 18% for DUNN's investors. No other futures manager has achieved such a high composite rate of return over such an extended period of time.



As you can see a track record back to 1984 and some terrific long run returns made us feel comfortable that moving forward this could be a great addition to our recommended portfolios.