MANAGED PORTFOLIO SERVICE
MARKET & REBALANCE COMMENTARY - Q2 2018

QUILTER CHEVIOT
INVESTMENT MANAGEMENT

EXECUTIVE SUMMARY

- Global equities posted a positive return over the second quarter of 2018, rallying strongly from their March lows
- The UK and North America led the way for a sterling-based investor as developed markets made gains; in contrast, emerging markets struggled amidst trade tariff concerns, heightened political uncertainty and a strengthening US dollar
- Conventional gilts delivered a modest return over the quarter, rallying off the back of worries surrounding Italian politics and benefiting from the Bank of England's decision to hold interest rates at their current levels following a run of poor growth data
- The MPS strategies delivered positive returns to investors over the quarter, with the more equity-orientated strategies outperforming those with more significant fixed interest exposure
- During the quarter we selectively reduced the strategies' UK equity exposure in favour of an increased weighting to international markets, and implemented a number of changes to the strategies' underlying fund holdings, most notably within fixed interest allocations

The table shows the performance of the MPS strategies for the 3 month, 1, 3 and 5 year periods to 30 June 2018.

Strategy/Benchmark/IA Sector	Q2 2018 (%)	1 Year (%)	3 Years (%)	5 Years (%)
MPS Global Growth	**6.63**	**8.28**	**45.22**	**65.50**
Strategy Benchmark(1)	7.25	9.86	53.98	83.14
IA Global	7.86	9.12	43.99	70.09
MPS Growth	**6.33**	**6.43**	**27.94**	**47.70**
Strategy Benchmark(2)	6.54	7.87	35.55	59.00
IA Flexible Investment	4.38	5.04	25.38	44.66
MPS Balanced	**5.18**	**5.70**	**24.59**	**43.45**
Strategy Benchmark(3)	5.42	6.73	31.04	52.71
IA Mixed Investment 40-85% Shares	4.89	4.85	24.08	43.36
MPS Global Income	**3.75**	**4.40**	**27.19**	**44.32**
MPS Global Income Composite Index	4.36	6.37	38.39	64.65
IA Mixed Investment 40-85% Shares	4.89	4.85	24.08	43.36
MPS Income	**4.43**	**4.95**	**21.12**	**37.13**
Strategy Benchmark(4)	4.78	5.95	26.73	46.03
IA Mixed Investment 20-60% Shares	2.82	2.44	16.73	30.87
MPS Conservative	**4.43**	**3.70**	**17.00**	**29.91**
Strategy Benchmark(5)	4.78	4.46	22.16	39.19
IA Mixed Investment 20-60% Shares	2.82	2.44	16.73	30.87
MPS Cautious	**1.93**	**2.26**	**12.92**	**23.75**
MPS Cautious Composite Index	2.24	1.85	11.92	33.37
IA UK Gilt	0.28	2.39	15.56	27.91

Source: Quilter Cheviot Limited, Financial Express, 13 July 2018. All figures to 30 June 2018. Strategy performance is shown gross of management fees with all income reinvested, real returns may vary. IA Sector returns are net of the underlying fund manager charges while benchmarks will not include any charges. **Past performance is not a guarantee of future results.**

INVESTMENT INSIGHTS

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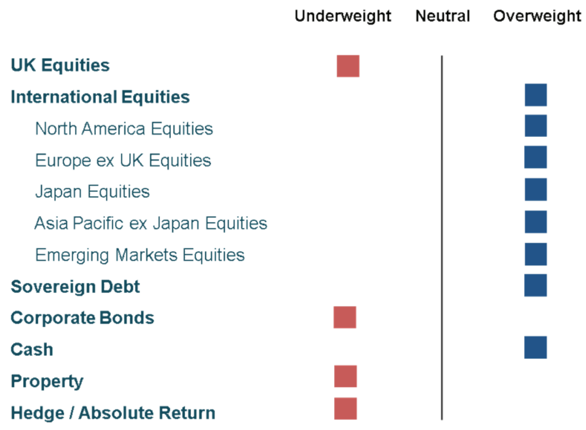
For private clients: https://www.quiltercheviot.com/uk/private-client/insights/

TACTICAL POSITIONING OVERVIEW – 30 JUNE 2018

Within the context of their individual risk profiles, the MPS strategies remain tilted in favour of equities, a position founded upon the continued strength of the global economic backdrop, a positive corporate earnings picture and healthy corporate cash positions that could mean increased returns to shareholders in the form of bumper dividends and share buybacks. Nevertheless, we remain mindful of the risks that continue to dominate global headlines, most notably the threat of protectionism, monitoring these closely for signs that could impact our current outlook.

At the headline level the strategies' equity allocations remain unchanged from earlier in the year. At the regional level, we selectively reduced the weighting to UK equities over the quarter, increasing exposure to international markets and North America, the Asia Pacific ex Japan region and emerging markets in particular. As the summary below indicates, the strategies typically have a biased towards overseas equities at the expense of the domestic market, a position we are happy to maintain.

MPS BALANCED STRATEGY TACTICAL POSITIONING – 30 JUNE 2018



During the quarter, the most significant changes implemented to the strategies' underlying fund holdings were across the fixed interest allocations, where we have diversified the exposure to include a broader range of bond holdings. This has been funded by reducing the strategies' exposure to conventional gilts. To reiterate comments from previous updates, we remain cautious overall on bonds, remaining 'underweight' the asset class. In addition, the exposure remains focused predominantly toward the higher-quality, more liquid areas of the bond market, with the increased credit exposure arising from this quarter's changes obtained without chasing yield in some of those riskier areas. We have also introduced an allocation to index-linked gilts, which still look fully-valued but provide some protection should political risk lead to another sharp fall in the pound

There were no changes to the strategies' allocations to Absolute Return and Commercial Property funds, while broadly speaking cash positions remain modestly overweight.

Q2 2018 STRATEGY ATTRIBUTION ANALYSIS

All index and fund returns are quoted on a total return basis in sterling terms. Please note that not all strategies may hold the investments detailed below. Further information relating to a particular strategy and its current allocations can be obtained from your usual Quilter Cheviot representative.

Fixed Interest: Conventional gilts posted a small positive return in the second quarter. Their safe haven status proved beneficial given the backdrop of negative trade headlines and worries about Italian politics. Gilts were also helped by the Bank of England backing off from raising interest rates at the May meeting following a run of poor growth data

The performance of the UK economy remained lacklustre amid ongoing Brexit uncertainty, and anecdotal evidence suggests businesses are increasingly putting investment decisions on ice. On a positive note, the jobs market remained buoyant and inflation pressures continued to ease. At the end of June, 10-year UK government bond yields had fallen modestly to 1.28%. Index-linked gilts underperformed conventional gilts over the quarter as longer-term inflation expectations fell.

UK investment grade corporate bond underperformed conventional gilts by around 0.5% during the second quarter. The asset class was somewhat held back by the worries surrounding Italian political risks and global trade, both of which favoured UK government bonds. Elsewhere, US high yield bonds were boosted by the performance of the energy sector, while emerging market debt markets suffered a poor quarter in the wake of global trade fears, a strong US dollar and country-specific political problems.

The MPS strategies remain 'underweight' the asset class at the headline level, a position that assisted relative performance in a period where equity gains outstripped returns from bonds. From a headline return perspective, the allocation finished either broadly flat or in marginally negative territory across the strategies. As mentioned above, we also implemented several changes to the composition of this allocation across the strategies, further details of which can be found overleaf.

Equities – UK: After a torrid start to 2018, the FTSE All-Share index returned 9.2% in the three month period to the end of June, with the FTSE 100 index enjoying its best quarterly performance in over three years. International investors fell a little less out of love with the market, adding to 'underweight' equity allocations to the UK, while renewed sterling weakness also increased the attractiveness of large internationally-focused companies. The strength of the oil price also proved a big boost to FTSE 100 index heavyweights BP and Royal Dutch Shell, further increasing the outperformance of this index over the mid-cap, more domestically-orientated FTSE 250.

The strategies' UK equity exposure also posted solid gains, and it was pleasing to see that relative performance was also positive over the period. Central to this was the performance of the **Majedie UK Equity** (10.9%) and **Investec UK Alpha** (10.8%) funds, two core names that we added to earlier in the year. The Majedie team's significant overweight exposure to food retailing names such as Tesco (also a core holding of the Investec fund), Sainsbury's and WM Morrison was central to their outperformance over the period, while the underweight position in British American Tobacco (which struggled over the quarter) also contributed to relative returns for both funds.

Equities – North America: The FTSE North America index delivered a total return of 10.1% for the second quarter of 2018. In a reversal of the trend seen in the first three months of the year, the dollar appreciated by over 6% against the pound, considerably boosting the gains enjoyed by a sterling investor. Returns were by no means solely down to currency movements, however, and the trends witnessed during the first quarter broadly continued into the second, albeit with more volatility. Large 'growth' stocks continued to outperform, with Technology names towards the fore once more, while the Energy sector also performed strongly. Against this backdrop the strategies' allocation to the region outperformed the market, with the **Sands US Growth** fund once again at the forefront of these returns across the strategies' active fund holdings. Names such as Netflix and Amazon, mentioned in last quarter's commentary, were joined by other holdings including Loxo Oncology and Align Technologies in contributing meaningfully to returns. Please note that we switched into a lower-cost version of this fund during the quarter – the **Sands Capital US Select Growth** fund – a beneficial change for investors.

The detractors to relative returns during the period were the holdings in the **Iridian US Equity** (5.3%) and **Vulcan Value US Equity** (8.7%) funds. In the case of the former, stock specific mistakes (notably Wyndham Destinations) impacted upon headline returns, while the fund's focus on mid-sized companies also detracted, with the key drivers of performance across the US market generally found in the large- and small-cap segments. In the case of the Vulcan holding, an absence of smaller 'value' names within the portfolio, coupled with an 'underweight' exposure to the large-cap, momentum-driven 'growth' segment of the market impacted upon relative returns. Despite this, the fund remains pleasingly ahead of the broader market year-to-date.

Equities – Europe ex UK: The FTSE Developed Europe ex UK index delivered a total return of 3.2% for the period, led principally by the Energy, Technology and Healthcare sectors. Heightened political risk drove volatility, with Financials a drag on performance (particularly Italian banks) in the wake of the political uncertainty seen over the period. Auto makers also struggled, as concerns grew that the looming spectre of US tariffs would develop an increasingly European focus.

The strategies' exposure finished ahead of the broader market over the period, with both the **Janus Henderson European Selected Opportunities** (3.8%) and **JOHCM Continental European** (4.0%) funds extending their outperformance year-to-date. In the case of the Janus Henderson fund, it is pleasing to see that performance has improved in recent times following a difficult period over the course of 2017. We have a forthcoming meeting with John Bennett and several new members of the team, where the catalysts for this change as well as the rationale behind recent activity will be discussed in more detail.

Equities – Japan: In keeping with other developed markets, the FTSE Japan index finished in positive territory over the quarter, returning 3.2%. Performance from the strategies' exposure finished marginally ahead of the market, with the **Baillie Gifford Japanese Income Growth** fund (6.8%) once again delivering strong outperformance, driven in part by strong stock selection in the Technology sector. In contrast, shipping firms and industrials were weaker, both areas that detracted from returns for the **Eastspring Japan Dynamic** fund (0.6%) over the period.

Equities – Asia Pacific ex Japan: The FTSE Developed Asia Pacific ex Japan index returned 4.4% over the period, with the strategies' underlying managers – which invest across a broader range of emerging Asian markets than this benchmark – underperforming in aggregate over the quarter. Fortunes were, however, contrasting across the strategies' two principal holdings. The **Veritas Asian** fund, introduced last quarter, delivered a pleasing return of 6.1% over the period, driven by names such as Aristocrat Leisure (the Australian gaming machine manufactures) as well as selected pharmaceutical and biotechnology holdings. The fund remains heavily focused on sectors focused upon the continued growth of the Asian consumer, a theme that the team overseeing the strategies' other core Asian holding – the **BlackRock Asian Growth Leaders** fund (0.0%) – have started selectively reducing in favour of increased exposure to more unfavoured areas of the market. We continue to discuss the rationale for this change with the BlackRock team, while remaining of the view that these two strategies complement each other well, thereby ensuring a well-positioned exposure to the region.

Equities – Emerging Markets: Ongoing fears around protectionism, trade war rhetoric and pronounced US dollar strength all proved headwinds for emerging markets over the second quarter of 2018, resulting in the FTSE Emerging index delivering a return of -2.4%. Argentina, Brazil, South African and Turkey were amongst those markets hit hardest, as investors focused more acutely upon current account deficits and political uncertainty. This impacted upon the performance of the **Lazard Emerging Markets** fund (-7.1%), where overweight allocations to these markets, coupled with challenging stock selection, combined to ensure a challenging quarter. The strategies' other core emerging markets holding – the **Janus Henderson**

Emerging Markets Opportunities fund – also struggled, returning -3.1%. The relative outperformance of the fund's Indian holdings was offset by the underweight exposure to the Chinese market, which generally held up better than other regions. At the same time, the fund's South African exposure also detracted from relative performance.

Alternatives: The period proved to be a disappointing one for the strategies' basket of Absolute Return / Hedge Fund holdings, with the allocation having a considerable impact upon the strategies' relative performance. After a strong start to the year, where the allocation delivered a positive return against a backdrop of volatile equity and fixed interest markets, the returns from the holdings were negative in the second quarter. The **Aspect Diversified Trends** (-5.6%) and **Old Mutual Global Equity Absolute Return** (-2.7%) funds proved to be the principal detractors, with exposure to Italian government bonds in the former and disappointing stock selection in the latter two of the themes contributing to these falls. As a reminder we trimmed exposure to the more volatile Aspect fund in Q1, and when reviewing these losses in the context of the broad blend of funds that make up the allocation, we are comfortable in the role these holdings play within the strategies.

Finally, returns were positive from the strategies' Commercial Property allocation, with both the **Aberdeen UK Property Feeder Unit Trust** (1.3%) and **F&C Property Growth & Income** (4.3%) gaining over the period.

Q2 2018 STRATEGY CHANGES

Please note that the activity detailed below may not apply to each MPS strategy. Further information relating to a particular strategy and its current allocations can be obtained from your usual Quilter Cheviot representative.

To summarise, the key changes made to the strategies' **asset allocations** during the quarter were as follows:

- We selectively reduced the strategies' exposure to **UK** equities, resulting in a more pronounced 'underweight' allocation to this market from a tactical perspective
- We selectively increased the strategies' exposure to **North America** equities, adding to existing fund holdings and raising the portfolios' 'overweight' allocation to this region from a tactical perspective
- We selectively increased the strategies' exposure to **Asia Pacific (ex Japan)** equities, increasing the 'overweight' allocation to this region from a tactical perspective
- We selectively increased the strategies' exposure to **emerging markets** equities, increasing the 'overweight' allocation to this asset class from a tactical perspective

At the **fund selection** level, there were relatively few changes to the strategies' underlying fund holdings. We exited the **HSBC FTSE 250 Index** holding, introducing in its place an attractive 'small-cap' investment idea identified by our analysts, the **Franklin UK Smaller Companies** fund. The selection of the fund is the culmination of a review of the UK Smaller Companies universe by our investment fund research team. Overseen by the Leeds-based Franklin Templeton UK Equity team, the fund demonstrates what can be best described as a 'common sense' approach to investing when considering candidate stocks. This process places significant importance on identifying quality businesses in which to invest, while also retaining a keen eye on the valuation multiples on which they are trading. This disciplined process typically results in a relatively concentrated portfolio, and is an approach that we believe lends itself to achieving compounded outperformance to investors over the longer term.

The only other actions of note across the strategies' equity allocations involved changes to ensure access to improved terms for several of the holdings. Firstly, we undertook a switch from the **PrivilEdge Sands US Growth** to the **Sands Capital US Select Growth** fund, a move that ensures access to a lower-cost version of this investment strategy. We also undertook a unit class conversion for the **Iridian US Equity** fund resulting in a lower headline fee, and continue to proactively engage with our fund partners to seek access to the best terms possible.

As previously highlighted, the most significant changes implemented during the quarter were across the strategies' fixed interest allocations. The existing conventional gilt holdings were reduced, while the exposure to sterling credit and global investment grade credit (currency-hedged) was increased. Several new holdings were introduced as part of this reallocation, while the **AXA US Short Duration High Yield and Legal & General Short Dated Sterling Corporate Bond Index** funds were selectively sold across the strategies.

The first of these new purchases – the **Royal London Sterling Credit** fund – is a core sterling credit portfolio managed by Paola Binns and the long-standing team at Royal London. The fund provides access to a well-diversified spread of bonds (approx. 360 at the current time), while retaining a focus on credit and sector selection, as opposed to duration calls, as the main drivers of outperformance. As a consequence, we see this as an attractive way to gain access to opportunities within the sterling credit market, while also enabling us to manage the overall duration of the strategies' fixed interest.

The second addition, the **M&G Optimal Income** fund, is a flexible Strategic Bond portfolio which invests in a combination of government bonds, investment grade corporate bonds and High Yield debt; it can also hold equities up to a maximum of 20% of the fund, although this exposure currently constitutes only a small part of the fund. The portfolio is backed by M&G's extremely experienced research team who enhance manager Richard Woolnough's macroeconomics views through bottom-up credit analysis. While the fund remains a relatively small component of the strategies' fixed interest exposure, we nonetheless believe this to be an attractive diversifier within the allocation.

The final addition to the strategies is the **Allianz Index-Linked Gilt** fund, a new product managed by Mike Riddell who also oversees the strategies' preferred conventional gilt holding – the **Allianz Gilt Yield** fund. Providing active, low-cost exposure to the index-linked gilt market, we believe this fund provides the opportunity for long-term outperformance within the asset class, as well as protection should heightened political risk result in another sharp fall in the pound.

CONCLUSION

There has been little change in global GDP estimates, and while financial markets appear to view trade tariffs as a negotiating tactic, with marginal impact on GDP, the uncertainty may already be damaging confidence and investment in the US. Indeed, this doubt could be offsetting some of the benefits from the recently passed tax cuts. It is impossible to quantify the impact, but with other measures including foreign investment, cloud services and semiconductors under consideration, and US mid-term elections in November, trade tensions are unlikely to disappear.

The threat of protectionism is likely to dominate headlines over the summer, and with institutional investors holding low cash balances, a meaningful market setback is possible. The 'normalisation' of interest rates together with modest inflation will continue to be challenging for bonds, but the rise in US yields means the near-3% yield on 10-year Treasuries offers some value for investors seeking income. Corporate bonds will at some stage face the additional challenges of a maturing credit cycle and deteriorating balance sheets. These conditions typically prove challenging for the asset class, although the gradual approach by central banks suggests the short-term risks are limited. Merger and acquisition activity is also likely to accelerate while credit remains readily available.

For equities, the economic backdrop and favourable financial conditions should mean another good year for global company earnings, with prospective valuations for most major markets towards the lower end of their 12 month range and in line with longer-term averages. This may partly reflect the de-rating of equities that takes place as interest rates and inflation rise in the maturing phase of an investment cycle, but could also be in anticipation of estimates being trimmed after the half-year reporting season – a result of the stronger dollar and management caution about trade tensions. Offsetting these risks are the significant cash levels held by many companies, which could mean returns to shareholders in the form of bumper dividends and share buybacks.

Source: Quilter Cheviot, Financial Express, July 2018

(1) The strategy benchmark was 100% FTSE UK Private Investor Global Growth Index to 3 April 2018 and then 100% MSCI WMA Private Investor Global Growth Index thereafter.

(2) The strategy benchmark was 100% FTSE UK Private Investor Growth Index to 3 April 2018 and then 100% MSCI WMA Private Investor Growth Index thereafter.

(3) The strategy benchmark was 100% FTSE UK Private Investor Balanced Index to 3 April 2018 and then 100% MSCI WMA Private Investor Balanced Index thereafter.

(4) The strategy benchmark was 100% FTSE UK Private Investor Income Index to 3 April 2018 and then 100% MSCI WMA Private Investor Income Index thereafter.

(5) The strategy benchmark was 100% FTSE UK Private Investor Conservative Index to 3 April 2018 and then 100% MSCI WMA Private Investor Conservative Index thereafter.

Performance data for the above benchmarks is therefore shown as a combination of both benchmarks over relevant time periods, and may differ from the performance calculated for one of these alone. Full details of the history of the strategy benchmarks are available upon request.

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