MANAGED PORTFOLIO SERVICE (MPS) MPS INDEX (IDX) STRATEGIES 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 IDX 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 IDX strategies for the 3 month, 1, 3 and 5 year periods to 30 June 2018.

Strategy/Benchmark/IA Sector	Q2 2018 (%)	1 Year (%)	3 Year (%)	5 Year (%)
IDX Growth	**6.56**	**7.51**	**33.76**	**57.03**
Strategy Benchmark[1]	6.54	7.87	35.55	59.00
IA Flexible Investment	4.38	5.04	25.38	44.66
IDX Balanced	**5.42**	**6.54**	**29.26**	**50.61**
Strategy Benchmark[2]	5.42	6.73	31.04	52.71
IA Mixed Investment 40-85% Shares	4.89	4.85	24.08	43.36
IDX Income	**4.55**	**5.72**	**24.62**	**41.40**
Strategy Benchmark[3]	4.78	5.95	26.73	46.03
IA Mixed Investment 20-60% Shares	2.82	2.44	16.73	30.87
IDX Conservative	**2.79**	**4.24**	**19.83**	**34.24**
Strategy Benchmark[4]	3.22	4.46	22.16	39.19
IA Mixed Investment 20-60% Shares	2.82	2.44	16.73	30.87

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.**

MARKET COMMENTARY

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TACTICAL POSITIONING OVERVIEW – 30 JUNE 2018

Within the context of their individual risk profiles, the IDX 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 adjacent summary indicates, the strategies typically have a bias towards overseas equities at the expense of the domestic market, a position we are happy to maintain.

IDX BALANCED STRATEGY TACTICAL POSITIONING – 30 JUNE 2018

	Underweight	Neutral	Overweight
UK Equities	■		
International Equities			■
North America Equities			■
Europe ex UK Equities			■
Japan Equities			■
Asia Pacific ex Japan Equities			■
Emerging Markets Equities			■
Sovereign Debt			■
Corporate Bonds	■		
Cash			■
Property	■		
Hedge / Absolute Return	■		

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 across the strategies' 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 bonds 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 IDX 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 broadly flat. As mentioned above, we implemented several changes to the composition of the strategies' bond allocations, 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 allocation posted strong gains over the quarter, albeit finishing marginally behind the broader market, due principally to underperformance from the **HSBC FTSE 250 Index** and **Vanguard FTSE UK Equity Income Index** funds. During the period we further reduced the strategies' exposure to UK equities, resulting in a more pronounced 'underweight' allocation to the domestic market from a tactical perspective.

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.

The strategies remain 'overweight' the region from a tactical asset allocation perspective.

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 remain 'overweight' the region from a tactical asset allocation perspective.

Equities – Japan: In keeping with other developed markets, the FTSE Japan index finished in positive territory over the quarter, returning 3.2%.

The strategies remain 'overweight' this market from a tactical asset allocation perspective.

Equities – Asia Pacific ex Japan: The FTSE Developed Asia Pacific ex Japan index returned 4.4% over the period. During the quarter we increased the strategies' exposure to Asia Pacific ex Japan equities, increasing the 'overweight' allocation to this region from a tactical perspective

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.

During the quarter we added to the strategies' exposure to emerging markets equities, increasing the 'overweight' allocation to this region from a tactical perspective

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 aggregate during 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 remain comfortable with the role these holdings play within the strategies.

Finally, the performance of the strategies' Commercial Property holdings was positive over the period. The **Aberdeen UK Property Feeder Unit Trust** fund produced a pleasing gain of 1.3%, while the smaller holding in the **iShares Global Property Securities Equity Index** fund recouped last quarter's losses and more with a stellar return of 12.4%, albeit one driven partly by currency appreciation against the pound.

IDX STRATEGIES – Q2 PORTFOLIO CHANGES

Please note that the activity detailed below may not apply to each 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 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, raising the 'overweight' allocation to this region from a tactical perspective

- We selectively increased the strategies' exposure to **emerging markets** equities, raising the 'overweight' allocation to this asset class from a tactical perspective

As previously highlighted, the most significant changes implemented at the **fund selection** level during the quarter were across the strategies' fixed interest allocations. The existing conventional gilt holdings were reduced, while the exposure to sterling credit was increased by adding to the existing holdings in the **Vanguard UK Investment Grade Bond Index** and **Legal & General Short Dated Sterling Corporate Bond Index** funds. The **Legal & General All Stocks Index Linked Gilt Index** fund was also added to the allocation; providing low-cost exposure to the index-linked gilt market, we believe this holding provides additional protection within portfolios should heightened political risk result in another sharp fall in the pound. Lastly, the allocation to the **Legal & General Global Inflation Linked Bond Index** fund was sold across the relevant strategies to help fund this purchase.

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 Growth Index to 3 April 2018 and then 100% MSCI WMA Private Investor Growth Index thereafter.

(2) 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.

(3) 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.

(4) 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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