

MANAGED PORTFOLIO SERVICE (MPS) MPS INDEX (IDX) STRATEGIES MARKET & REBALANCE COMMENTARY - Q4 2018



QUILTER CHEVIOT
INVESTMENT MANAGEMENT

EXECUTIVE SUMMARY

- 2018 was unexpectedly challenging for financial markets despite the supportive backdrop of above trend global economic growth and below target inflation
- Investor confidence was shaken at the beginning of the fourth quarter when the Chairman of the Federal Reserve said US interest rates were a 'long way' from neutral; with markets already worrying about growth, this ultimately proved to be the catalyst for the ensuing sell-off seen in the final months of the year
- Major equity markets fell more than 10% during the period, hitting their 2018 lows just before Christmas, as escalating Sino-American trade tensions, the looming spectre of a 'no deal' Brexit and budget proposals from the new 'populist' Italian government all added further fuel to the fire
- The IDX strategies posted falls over the period, most notably across the higher-risk models, while the positive returns delivered by sovereign bonds failed to offset the equity losses experienced by a multi-asset investor
- During the quarter we selectively trimmed the strategies' international equity exposure, initiated a US Treasuries holding as a diversifying position and deployed the strategies' cash weightings by introducing a new absolute return fund idea

The table shows the performance of the IDX strategies for the 3 month, 1, 3 and 5 year periods to 31 December 2018.

Strategy/Benchmark/IA Sector	Q4 2018 (%)	1 Year (%)	3 Year (%)	5 Year (%)
IDX Growth	-8.93	-5.36	24.28	36.18
Strategy Benchmark ⁽¹⁾	-8.96	-5.39	25.60	37.71
IA Flexible Investment	-8.27	-6.72	18.07	26.31
IDX Balanced	-7.31	-4.43	21.68	34.14
Strategy Benchmark ⁽²⁾	-7.44	-4.61	22.53	35.00
IA Mixed Investment 40-85% Shares	-7.89	-6.11	16.55	25.48
IDX Income	-6.15	-4.21	17.88	29.00
Strategy Benchmark ⁽³⁾	-6.55	-4.44	19.11	31.10
IA Mixed Investment 20-60% Shares	-5.40	-5.10	12.19	19.07
IDX Conservative	-3.97	-2.95	14.73	27.11
Strategy Benchmark ⁽⁴⁾	-4.60	-3.19	16.38	29.85
IA Mixed Investment 20-60% Shares	-5.40	-5.10	12.19	19.07

Source: Quilter Cheviot Limited, Financial Express, 28 January 2019. All figures to 31 December 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 – 31 DECEMBER 2018

Markets will undoubtedly be more volatile in 2019 than in recent years. There are a number of events on the horizon that have fairly unpredictable outcomes, and investor wariness has increased as a consequence. Cognisant of these concerns in the final months of 2018, we reduced several long-standing international equity allocations, while also diversifying the strategies through the introduction of several new alternative holdings.

However, despite the fears looming large in many investors’ minds, we still see opportunities across equity markets, particularly given how attractive valuations are in the wake of the recent sell-off. We believe equities could deliver reasonable returns for the year-ahead, and indeed have positioned the strategies accordingly, with a tactical tilt towards risk assets (and in particular international markets) remaining in place at the beginning of 2019.



Q4 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: Volatility impacted global bond markets over the fourth quarter, with UK and US yields falling sharply in the final weeks of the year as investors sought shelter in perceived ‘safe haven’ assets. The FTSE Actuaries UK Conventional Gilts All Stocks index delivered a return of 1.9% over the period, dragging total returns for 2018 as a whole back into positive territory – albeit very modestly – with a gain of 0.6% over the twelve months. Index-linked gilts also enjoyed a strong finish to the year with a total return of 2.0% over the quarter, while sterling credit, emerging market debt and high yield bonds all delivered a negative return to cap a mixed 2018 for diversified bond investors.

The fixed interest component of the IDX strategies delivered a positive return over the quarter, though failed to offset the severe falls experienced by equity markets during the period. The **iShares UK Gilts All Stocks Index** and **Legal & General All Stocks Index Linked Gilt Index** funds both delivered positive returns. Within the strategies’ credit exposure, modest losses were posted by the **Legal & General Short Dated Sterling Corporate Bond Index** (-0.1%) and **Vanguard UK Investment Grade Bond Index** (-0.6%) funds.

During the quarter we implemented a number of changes to the strategies’ fixed interest holdings, selectively trimming the conventional UK government bond exposure while adding to existing index-linked exposure. Existing sterling corporate bond fund holdings were also marginally reduced to incorporate a new global credit holding – the **Vanguard Global Corporate Bond Index** fund. Finally, we also introduced a new US Treasuries position – the **Vanguard US Government Bond Index** fund – which enjoyed a strong finish to the year. Further details of the rationale for these changes are outlined in the relevant section later in the commentary.

Equities – UK: In keeping with other developed indices, the FTSE All-Share index fell sharply during the fourth quarter, returning -10.2% to cap a miserable year for the domestic equity market. The headline index ended with a total return of -9.5% for 2018. Interestingly, this figure masked a large disparity between the performance of large- and mid-sized companies, with the FTSE 100 returning -8.7% in 2018 and the FTSE 250 (ex IT) index faring significantly worse, with a total return of -15.2%.

The strategies’ UK equity allocation posted a negative return over the quarter, lagging the return posted by the broader market. The modest allocation to the **HSBC FTSE 250 Index** fund was the principle detractor to relative performance, returning -13.3% as mid-cap names underperformed.

The strategies remain ‘underweight’ the domestic market from a tactical asset allocation perspective.

Equities – North America: After peaking shortly before the end of September, the US stock market subsequently experienced a torrid final three months of 2018. The majority of these losses were seen in December with the market experiencing the biggest monthly fall since February 2009. It was also the worst December performance by US stocks since 1931, while the Christmas Eve trading window failed to deliver any festive cheer, finishing as the worst on record for that day. A rally in the final few sessions of the year meant that the FTSE North America index finished with a total return of -11.5% for the fourth quarter. However, and perhaps surprisingly for investors reeling from the severity of Q4’s sell-off, the index finished 2018 in positive territory from a sterling investor’s perspective, with the strength of the dollar versus the pound



resulting in a total return of 0.8% for the year. Technology, Healthcare and Consumer Discretionary stocks were the biggest contributors to the market's return in 2018, with Amazon and Microsoft finishing top of the pops. The Financial sector was the biggest sector detractor, while AT&T, Facebook, GE and Philip Morris had the largest impact from an individual stock perspective. Meanwhile, 'value' companies outperformed in the fourth quarter, although 'growth' names finished well ahead over the full twelve month period.

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

Equities – Europe ex UK: 2018 was a difficult year for European equities. The economy continued to grow during the first half of 2018, albeit at a slower pace than in 2017. However, the second half of 2018 was a trickier environment and less supportive of economic growth; consumer demand fell, the oil price rose eating into company profits, and production capacity issues and labour shortages became more pressing.

The FTSE Developed Europe ex UK index returned -11.1% in the fourth quarter, finishing with a total return of -9.8% for 2018. The Banks, Materials and Industrials sectors lagged over the year, while Utilities outperformed.

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

Equities – Japan: The Japanese stock market was caught in the same maelstrom of global investor concerns over the quarter, returning -12.4% to finish with a total return of -7.9% for the year as a whole.

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

Equities – Asia Pacific ex Japan: Asian equity markets recorded a negative return over the quarter, albeit outperforming other regions. The FTSE Developed Asia Pacific ex Japan index returned -7.6% during the quarter to post a total return of -8.7% for 2018. While countries with high current account deficits and / or a sizable amount of US dollar denominated debt generally suffered over the year, the ongoing trade dispute between the US and China had a more negative impact across Asia.

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

Equities – Emerging Markets: The FTSE Emerging Markets index was a notable outperformer during the fourth quarter when compared to other regions. That a fall of 'only' -3.9% should be highlighted as a relative positive demonstrates just how difficult a period the quarter proved to be. The index fell by 7.6% for the year as a whole, albeit these figures again mask what was a considerable disparity in returns across the underlying geographies that comprise the index. In Q4 Brazil performed strongly as investors took cheer from Jair Bolsonaro's election, with the market gaining ground after a period of weakness earlier in the year. Conversely, China and Taiwan fell.

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

Alternatives: Long-only equity managers were not alone in struggling to navigate 2018's market landscape, with many Absolute Return and Hedge Fund managers enduring an equally difficult year. Some of the reoccurring themes behind the underperformance seen across a range of differing strategies included the impact of investor deleveraging as crowded positions unwound; sharp sector and factor reversals; trend following funds being caught out by the quick reversal in market direction in October; and the speed and severity of equity market falls, which did not last long enough for some of the hedges or protective positions in multi-asset and macro portfolios to kick in. The IDX strategies' 'basket' of diversified holdings posted a negative return over the period, albeit less than that seen from equity markets, with the **Aspect Diversified Trends** holding – a smaller, more volatile position – the largest detractor with a return of -12.3% during the quarter. While this might seem outsized, Aspect is the only fund within the portfolios that can take a materially net short position, a characteristic that would serve it (and the allocation) well in a protracted bear market correction. However, during the course of 2018, the whipsaw nature of equity market sell-offs and the subsequent rallies prevented this holding from benefiting from a sustained trend. At the other end of the spectrum, the larger holding in the **LFIS Vision UCITS Premia** fund returned -1.1%, significantly better than many of its peers.

Across the strategies' Commercial Property allocation, the **Aberdeen UK Property Feeder Unit Trust** delivered a positive return of 0.4% to cap a pleasing year with a gain of 4.4%. The **iShares Global Property Securities Equity Index** fund, a smaller weighting within the allocation, fell 2.9% over the quarter to finish broadly flat for the year.

IDX STRATEGIES – Q4 2018 PORTFOLIO CHANGES

Please note that the activity detailed below many not apply to each IDX 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 North American equities, trimming the long-standing 'overweight' position to this market
- We selectively **reduced** the strategies' exposure to Japanese equities, trimming the long-standing 'overweight' position to this market



- We used the proceeds to **introduce** a 'tactical' unhedged exposure to US Treasuries
- We selectively **increased** the strategies' exposure to Hedge / Absolute Return funds, adding a new holding to the allocation
- We selectively **reduced** cash weightings across the strategies, investing the proceeds received from the ongoing liquidation of the GAM Star Absolute Return Bond fund

At the **fund selection** level, the strategies' conventional gilt weighting was reduced during the quarter, part of a decision to further diversify across a range of differentiated bond exposures. The proceeds from the reduction in the **iShares UK Gilts All Stocks Index** holding were partially used to add to the existing position in the **Legal & General All Stocks Index Linked Gilt Index** fund. Across the strategies' credit exposure, we selectively reduced the **Legal & General Short Dated Sterling Corporate Bond Index** and **Vanguard UK Investment Grade Bond Index** funds to incorporate a new global credit holding – the **Vanguard Global Corporate Bond Index** fund. This fund is extremely diversified in nature, comprising over 5,000 bonds across a broad spread of regional exposures, with the US constituting over half of the market allocation. The currency exposure is hedged back to sterling.

The introduction of the US Treasuries exposure – outlined above – was obtained through the purchase of the **Vanguard US Government Bond Index** fund. As well as providing an additional element of protection within the strategies, the purchase of this position also meant that we avoided repatriating the proceeds from the reduction of the US and Japanese equity positions to sterling, a move we felt prudent given continuing Brexit uncertainty

Finally, we introduced a new Alternatives allocation – the **Mygale Event Driven UCITS** fund – to sit alongside the strategies' existing absolute return holdings. This is a European-focused, global event driven fund that combines exposure to merger arbitrage opportunities, catalyst driven investments, relative value opportunities and more tactical special situations. Merger arbitrage will typically have the highest exposure in the portfolio and entails, for example, buying the shares of an acquiree company in a cash takeover in anticipation that the deal spread tightens and hence generates an investment profit. The fund has historically exhibited quite low volatility, and complements well the other Hedge / Absolute Return holdings within this allocation.

CONCLUSION

We may not face as strong a backdrop as we did in 2018, but things still look encouraging. We agree with the consensus view that global economic growth is likely to be around 3%, but stress that this is not recession territory. The main contributors to growth will, as usual, be the US consumer and China, with Japan and Europe likely to lag by a considerable margin. The lingering impact of US tax cuts will help support activity in the first half of 2019, as will fiscal stimulus measures (such as increased public spending or tax cuts) in China and to a lesser extent in Europe, where austerity is being eased in France, Italy and the UK. Central banks, including the European Central Bank, will aim to reduce net asset purchases and move towards neutral real interest rates, but there is no need for restrictive conditions at this time. Employment and wages have been increasing modestly, while lower oil prices will provide short-term relief for headline inflation. Recent comments suggest that the Fed will be more measured in its monetary stance, and will adjust policy in either direction as necessary during the course of the year.

The litmus test for markets over the next three months will be the financial results that companies report for the final quarter of 2018. Apple's recent sales warning rattled investor sentiment, and while there may be more disappointments to come, we still expect profits to rise across the majority of industrial sectors this year. Company analysts are currently estimating earnings per share growth of around 6-7% in every major investment region bar Japan, where estimates come in at a little over 2%. Couple this with the recent fall in share prices, and the valuations of most markets are looking attractive on a forward-looking basis.

March certainly has the potential to be one of the busiest months for news. By the end of the first quarter of 2019, we will have a better sense of the likely path for US interest rates, and should know whether the US and China have managed to come to a longer lasting truce over trade. We will also know if the UK is leaving the EU with a deal or not, or even postponing the whole event. However, if the Withdrawal Agreement passes, it could be a catalyst for more positive feeling amongst investors globally. UK assets would react strongly, with domestic sectors like banks and housebuilders most exposed to a potential 'Brexit bounce'.

In conclusion, markets will undoubtedly be more volatile in 2019 than in recent years. There are a number of events on the horizon that have fairly unpredictable outcomes, and investor wariness has increased as a consequence. However, we still see attractive opportunities in many markets, and believe equities could deliver reasonable returns. As such, we believe investors should take a more optimistic view of 2019.

Source: Quilter Cheviot, Financial Express, February 2019



- (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.

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