TRUSTNET magazine

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WEIRD AND WONDERFUL
The obscure parts of the market you can access with ETFs

INCOME TRACKS
Can you build an income-paying portfolio out of passives?

FROM LITTLE ACORNS
Small steps that can have a big impact on your pension

MONEY FOR NOTHING
Is active management worth paying for?

ISSUE 18

CREDITS

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EDITOR'S LETTER

About 99 per cent of the copy we publish in this magazine and on the main FE Trustnet website is focused on actively managed funds. The reason for this is not, as the more cynical readers may suggest, because a similar proportion of our advertising revenue comes from groups promoting active funds, but because there is a view among journalists that there is little of interest to write about passive funds after the subjects of cost and tracking error have been covered.

However, Robin Powell, who blogs at The Evidence Based Investor, has blown that argument out of the water with a lengthy and detailed piece on the actives vs passives debate. He makes a number of arguments that make even a committed actives advocate such as myself sit up and re-consider why I have always preferred the more expensive products. Has it made me sell out of the beloved star managers in my portfolio in favour of index trackers? Not quite, but it has certainly made me think twice about using them in future.

This edition also features articles from Adam Lewis about whether you should build an entire income portfolio out of passives, and Pádraig Floyd, on the weird and wonderful parts of the market that ETFs can give you exposure to. For investors who are looking for even more diversification, Phil Scott reviews the investment trust sectors given the "Specialist" prefix by the AIC.

In our regular columns, John Blowers advises on how small changes to your saving habits can have a big impact on your pension pot, Schroders' Kevin Murphy tips three banking stocks to rebound and Thesis Asset Management's Gaurav Gupta reveals which fund he is using to navigate the bond market volatility.

Enjoy reading,

Anthony Luzio
Editor
Trustnet Magazine

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MONEY FOR NOTHING

Robin Powell, who blogs as The Evidence-Based Investor, says simple arithmetic shows why active management isn't worth paying for

For me, it's not so much a question of "why choose passively managed funds?" It's more "why avoid the high-fee actively managed funds the investment industry overwhelmingly wants to sell us?"

Ultimately, it all comes down to arithmetic, as explained by Nobel Prize-winning economist William Sharpe in his paper The Arithmetic of Active Management. It's short and I urge people to read it, but in a nutshell this is what it says.

The investing community is divided into active and passive types. Before costs, the return on the average actively managed pound equals the return on its passive equivalent. After costs, the return on the average actively managed pound will be less than the return on its passive equivalent. It's that simple.

The investment industry doesn't like to talk about cost. As we heard in Prime Minister's Questions in April, fund managers will go to great lengths to hide the true cost of investing. In the end, though, cost is the most important thing.

Most people – and I'd include investment journalists and finance professionals in this – cannot grasp the staggering costs involved in financial intermediation.

Last year, for a video for Sensible Investing TV, I added up all the costs associated with investing in actively managed funds in the UK – the cost of advice, the annual management charge, platform charges, custody and administration costs, plus transaction costs. Based on average percentages, the total cost came to 2.74 per cent a year.

I then looked at how fees of 2.74 per cent, compounded over 40 years, would affect an investment of £100,000. I assumed annualised returns of 8 per cent before fees which, after charges of 2.74 per cent, nets down to 5.26 per cent.

Forty years on, that £100,000 you invested would, before charges, be worth £2,172,452, and after charges £777,203. So your actual gain would be just £677,203. The effect of total charges reduced your potential return by a colossal £1,395,249. In other words, more than two-thirds of your potential gains have been lost.

It's crazy. You as the investor provide all the capital and take all the risk, yet active managers and other financial intermediaries take a huge chunk of your returns.

I'm not against active management in principle and take no delight in the data undermining it. I would even consider using an active fund if I could identify a manager who was going to outperform after costs for the next 15 years. But I can't, and I haven't met anyone else who can either.

Both S&P Dow Jones Indices and Morningstar provide regular data on how active funds perform relative to their benchmark. You rarely read about this data in the press. But it clearly shows that active funds fail to outperform over any meaningful period of time.

There are thousands of funds. By the law of averages, you would expect some to outperform over three, five or 10 years. Only a tiny proportion do. Research suggests the proportion of long-term outperformers is around 1 per cent.

But people invest over much longer time periods than those the industry and the media prefer to dwell on. Graduates today will be saving for retirement for the next 40 to 50 years. Hardly any active funds will still be around then and I'd be surprised if a single one will have beaten the index.

People often say active managers in the UK are an exception. It's true •••

they have fared better than their peers in the US, or the Netherlands, where 100 per cent of active managers have underperformed over five years.

But it's all relative: over all timeframes, the record of UK active managers is poor. The survivorship rate is particularly shocking. SPIVA data shows 55 per cent of funds available to UK investors 10 years ago have since closed down or merged with others because they performed so poorly.

The most comprehensive study in recent years was conducted by a team of academics led by David Blake from the Pensions Institute at Cass Business School.

The paper, titled New Evidence on Mutual Fund Performance: A Comparison of Alternative Bootstrap Methods, is based on a study of 561 UK equity funds between 1998 and 2008.

The study concluded: "The average equity fund manager in the UK is unable to deliver outperformance from either stock selection or market timing, once allowance is made for fund manager fees and for the set of common risk factors known to influence returns. The results provide powerful evidence the vast majority of fund managers in our dataset were not simply unlucky, they were genuinely unskilled."

Some people say: "That doesn't worry me because I can identify star managers with genuine skill." In reality it's almost impossible to identify future winners in advance.

Blake and his colleagues calculated it takes "eight years of performance data for a test of a fund manager's skill to have 50 per cent power and 22 years of data for the test to have 90 per cent power".

Even if the managers you choose go on to be stars, there may be no advantage in using them. The study said: "Though a small group of managers appear to have sufficient skills to generate superior gross performance, they extract the whole of this via fees, leaving nothing for investors."

Of course, a small number of actively managed funds outperform with some consistency. But is this really due to skill?

You can't blame fund managers for taking the credit for outperformance. It's natural, as well, that most financial advisers ascribe strong returns to managers' expertise. After all, their business model is based on their ability to pick the best funds. Journalists too are predisposed to emphasise skill; star managers make great copy, quite apart from the advertising revenue that they generate.

> **The record of UK active managers is poor. The survivorship rate is particularly shocking**

In reality, though, much of what passes as skill in fund management actually isn't. With around 200,000 active managers in the world, you'd expect there to be winners by the law of averages. In fact, rather fewer funds outperform consistently than you'd expect by chance. Luck undoubtedly plays a part in outperformance, though precisely how much is difficult to calculate.

But there is another explanation for outperformance that's often overlooked: many managers who have beaten the market over the long term have done so by tilting their fund towards risk factors known to deliver higher returns.

As Eugene Fama and Kenneth French demonstrated in 1992, small cap and value stocks have historically outperformed large and growth stocks, albeit with greater volatility. So, by increasing their exposure to small cap and value, managers can deliver higher returns over time in exchange for a bumpier ride along the way.

In the UK, for example, the average five-year returns of active managers are slightly better than their peers' in the US, France and Germany. This is because the FTSE 100 is dominated by a few large stocks, so UK managers naturally tilt towards smaller companies.

Of course, active managers are entitled to move up or down the cap scale, or invest in other asset classes; typically the small print allows them to invest up to 30 per cent of the fund in something completely different. But a large cap fund with a 25 per cent holding in small and mid caps should not be compared against a large cap index.

Of course, none of this means there are no skilled managers. There are, but they're low in number, almost impossible to identify in advance and, even if you pick one before they outperform, their fees are likely to cancel out much of any value they add.

The easiest, cheapest and most efficient way to invest is via a diversified portfolio of index funds. This should include tilting towards the different factors proved to generate higher returns. That's nothing to do with skill; it's just evidence-based investing. ●

***Robin Powell** blogs as The Evidence-Based Investor*

THE COUNTER-ARGUMENT

UNSURPRISINGLY, IT WAS NOT TOO DIFFICULT TO FIND PEOPLE in the industry who take the opposite point of view.

Lee Robertson, chief executive officer of Investment Quorum, says that while he has some sympathy with Powell's argument and does use some passive funds in his clients' portfolios, it is always worth paying a little extra for the best managers.

"Active managers often come into their own in bear and sideways markets as it is not always beneficial to own the whole market or index, but much better to own specific stocks, or indeed, certain sectors within that market."

"This means active managers can, and often do, perform very adequately against a passive approach," he said.

Robertson adds that some areas of the market are a lot more suited to active rather than passive management.

"These include property funds, where they buy commercial property and pay returns based upon rental income and capital value growth, or specific asset classes and sectors, such as smaller companies, emerging markets, technology and healthcare, where expert knowledge is imperative to help seek out value."

He finished by pointing out that it is worth keeping an eye on some of the older passive funds as these can charge almost as much as their active rivals.

In a recent article on FE Trustnet, Yves Choueifaty, president and founder of TOBAM, described many of the arguments in favour of passives as "toxic" and even said the death of active management would spell the end of capitalism.

"Active managers are here to arbitrate what is expensive versus what is cheap and contribute to the reality of prices. If nobody is doing that, prices will mean less and less. Then you will have bubbles that will last longer before ultimately bursting," he explained.

"It's important to have active managers to make pricing efficient and so that the economy prospers. It's important to understand that in order for the economy to prosper, we need a reality of prices and this is the role of active managers – to make sure markets are still efficient."

Click here to read the full article.

INCOME TRACKS

Investors have traditionally looked to actively managed funds for income, but **Adam Lewis** says a smart beta approach could deliver similar results at a much lower price

When it comes to hunting for income from equities, there is a natural perception that the best way to obtain it is from a portfolio of actively managed funds. This would traditionally mean the IA UK Equity Income sector, or going further-a-field and investing in more globally orientated portfolios, such as those with significant exposure to Europe, the US or Asia.

One avenue investors may not have thought of going down is the passive route. While index tracking funds are generally considered cheaper alternatives for gaining access to the market, they are not widely known for their income-producing prowess.

Hargreaves Lansdown's head of passives Adam Laird says the perception that tracker funds aren't suitable for income investors is based on two myths: that these products do not yield anything and that only active managers can build income indices.

"Both of these perceptions are false," said Laird. "When we quote the FTSE 100 as standing at 6,000, this does not factor in dividends, but index tracker funds do receive income. Also, investors now have a number of options available to them as the index investing space has evolved over the past decade."

For anyone considering the passive route, Laird says there are two options: using plain vanilla index trackers or ETFs, or taking more of a hybrid approach and using smart beta products.

> "There is a risk there will be dividend cuts, but on the other hand the active managers do not always get it right"

Taking the more traditional route, he says investing in a FTSE 100 tracker does have income appeal. "The FTSE 100 index holds the biggest companies in the market and many of these are high dividend producers," Laird explained. "The index has a track record of being consistent with its yields, coming in at around 3.5 per cent for most of the last decade and currently standing higher at 3.9 per cent."

He highlighted two funds to use for this purpose: the L&G UK 100 Index Trust and, for ETF exposure, the iShares Core FTSE 100. "The L&G fund takes a simple approach of holding all the stocks in the index and carries a low charge of under 0.1 per cent," he said.

"The iShares ETF, meanwhile, is the oldest on the London Stock Exchange and is again a simple product and has a fee of just 0.07 per cent."

When investing in a tracker fund for income purposes over a more actively run fund, Laird concedes it is important to remember you are investing in the whole market. This means you are getting exposure to those companies that are cutting their dividends, of which there have been several over the last couple of years.

"You can look at it in two ways," he said. "There is a risk there will be dividend cuts that you will suffer from, but on the other hand the active managers do not always get it right."

"This year the best growth has been from the mining and oil stocks and the managers who made the call to get rid of these have missed out on a lot of the subsequent rebound."

Of course, the UK is not the only region in which to go looking for dividends and over the last 10 years, active investors have had much greater choice in terms of where to seek income. Just like the UK, Laird says tracker funds provide a cheaper alternative in these markets.

•••

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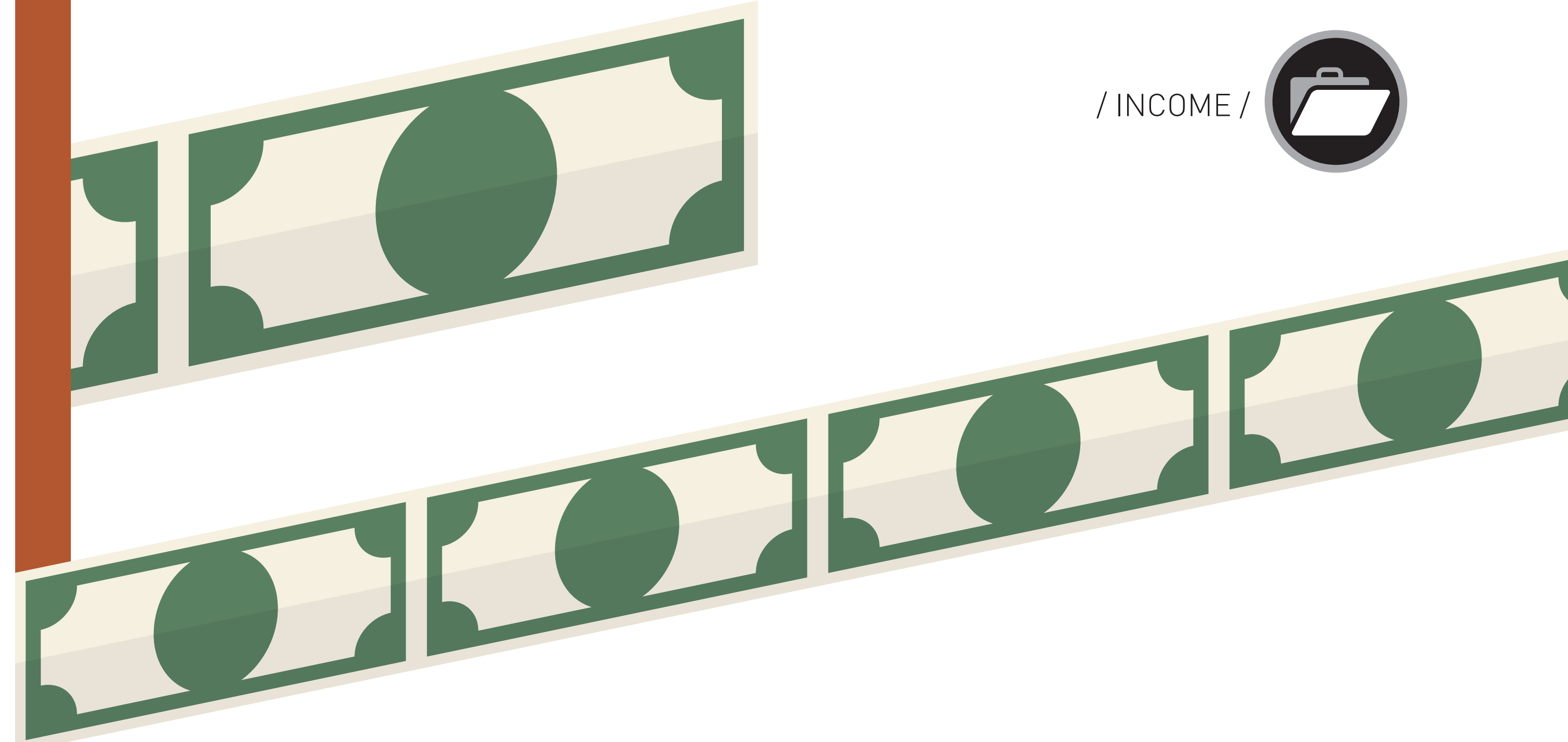


"Asia is one market which is not only a high dividend region, but also looks attractive from a valuation standpoint," he explained. The tracker he recommends to gain access to this theme is BlackRock Pacific ex Japan.

Laird argues: "In my view, the current low interest rates make it more important than ever for investors to minimise charges. With yields around a couple of per cent, why pay a third of your profit to an active manager?"

When it comes to picking passive products, LGIM's multi asset fund manager Justin Onuekwusi warns investors against "blindly chasing" high yielding companies and recommends instead that they give proper thought to genuine active asset allocation.

"If you go down the index route, we tend to favour smarter beta income strategies that use some form of active screen, in order to filter out those companies that are high yielding simply because they are effectively about to go bust," he explained.

As a result, Onuekwusi says that if you are going to manage a sustainable income portfolio of index products on an ongoing basis, you have to do it in an active way. This is because at times you will have to decrease your exposure to certain regions and sectors when the income opportunities look more stretched.

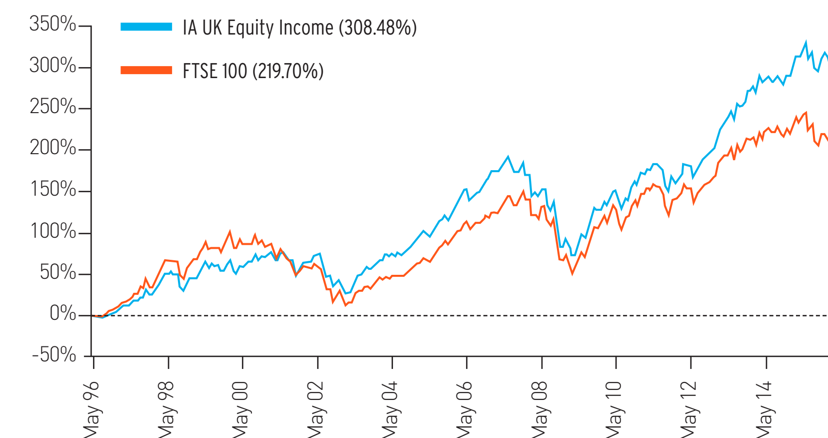
> "With yields around a couple of per cent, why pay a third of your profit to an active manager?"

"Using smart beta, blended with index building blocks, also helps you address the fee issue," he added. "Fees are important because people are living longer and so need to sustain their pension pot over a longer time horizon. But the building blocks do have to be actively managed to receive the sustainable income over time."

Onuekwusi says just sticking to one asset class, such as UK equity income, will not provide a diversified income stream. This is because if there is a specific issue on the horizon with the potential to affect that asset, such as the EU referendum vote in June or the bulging fiscal deficit in the UK, your performance will be affected.

"There are plenty of other asset classes such as emerging market debt, property and infrastructure, that allow you to spread your risk more globally," he continued. "As such, using a multi asset approach is the next stage in the evolution of income investing."●

PERFORMANCE OF SECTOR VS INDEX OVER 20YRS



Source: FE Analytics

WEIRD AND WONDERFUL

ETFs allow retail investors to access obscure and exotic strategies – but **Pádraig Floyd** says they may be better off keeping it simple

While people usually turn to exchange traded funds (ETFs) to keep a lid on costs in their portfolio, these products also offer another important benefit that is often overlooked – providing significant exposure to parts of the market that open-ended funds simply can't access.

Unlocking enormous new areas of the investable universe has become particularly important at a time when returns from the typical equity/bond allocation are expected to be poor for the foreseeable future – and Chris Mellor, executive director of equities product management at Source ETF, says investors who are new to this part of the market may find themselves spoilt for choice.

"There are ETFs available that offer exposure to markets such as China A shares – companies listed on the mainland China stock markets – sectors such as US biotech, European media or thematic ideas like companies with the greatest exposure to foreign revenues or high yield bonds," he said.

More esoteric instruments are available, such as leveraged products or short exposure ETFs, but many people will find these a little racy. As with any investment, the most important thing is to ensure you fully understand what you are investing in and if you don't, you probably shouldn't do it.

KNOWLEDGE IS POWER

Thankfully, information is abundant in the ETF market, but some areas on the fringes may include instruments less suitable for long term investors. As a result, Mellor says you should ask yourself three questions of every holding.

- Does it offer the exposure to the market, sector or theme you want?
- How easily can you get in or out?
- What are the true costs of investing?

Although ETFs are considered low cost, they occasionally feature charges that are not immediately apparent, so it is important to look beyond the headline figure.

"Check how well the ETF has tracked its index, as any performance drag will undo the benefit of a lower ongoing charge," said Lynn Hutchinson, assistant director at Charles Stanley.

If the ETF doesn't hold physical assets but uses derivatives, this can have implications for performance. "Fees applied on synthetic ETFs may not be shown in the total expense ratio/ongoing charges, as not all providers publish this," Hutchinson added.

Size matters, too, making it important to check how concentrated or well-resourced the fund is

Even some physically replicated ETFs don't hold all the underlying stocks, due to illiquidity or availability, and performance will therefore deviate from that of the index.

Hutchinson says size matters, too, making it important to check how concentrated or well-resourced the fund is. Does it have a number of authorised participants, are there sufficient assets under management and how liquid are assets? Although ETFs trade throughout the day, if one you hold experiences high redemptions, will you end up getting trapped?

FINDING OPPORTUNITIES

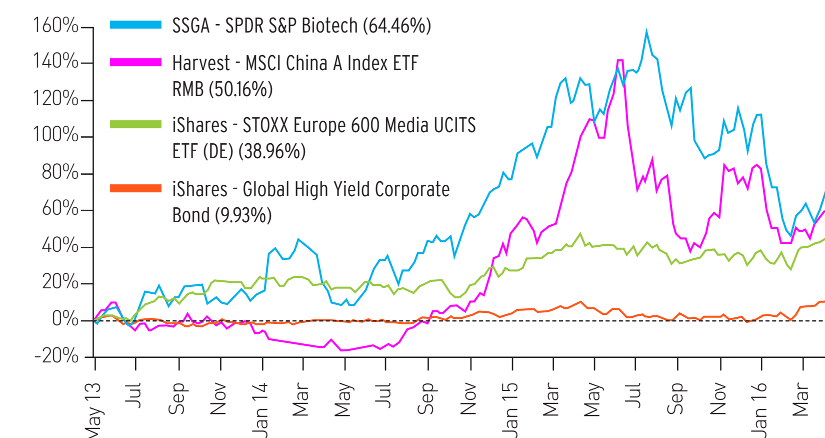
One of the major benefits of ETFs is that they have allowed individual investors to replicate the kind of strategies only available to their institutional counterparts in the past, says Allan Lane, managing partner of Twenty20 Investments.

There are numerous opportunities available in emerging market equities – Indonesia has been one of Lane's favourites for some time, with the Philippines, Thailand, Taiwan and South Korea also performing strongly.

Brazil has had a tough time and still has political problems to work through, but appears to be bouncing back if you're looking for single-country equity exposure.

Lane adds that quantitative easing has changed the fixed income arena, leaving bonds •••

PERFORMANCE OF ETFs OVER 3YRS



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••• "broken" in the West, although retail investors may find dollar-denominated local markets a step too far – products are available, but local currency emerging market debt is likely to scare the horses.

BIG STRATEGIES FOR LITTLE MONEY

Lane adds that these products are based on the same strategies used by institutional investors: "The old institutional framework is being democratised for affordable management fees."

Nowhere is this more apparent than with smart beta products. Smart beta is still relatively new for many institutional investors, but offers a little more comfort to the index investor.

These products – also referred to as smart trackers because they are designed to track an index – offer managers some discretion about how they can change – be smart about – asset allocation.

While Lane points out they don't guarantee returns, he says they do offer a degree of potential for intervention at the discretion of the asset manager.

Lane also likes certain commodity funds such as gold, but tends to keep away from oil and gas. Another theme he likes the look of is cyber security.

Smart beta is still relatively new for many institutional investors, but offers a little more comfort to the index investor

"It invests at the company level and may look like a good bet, as each day cyber security becomes one of the biggest threats facing the West."

KEEP IT SIMPLE, STUPID

Not everyone agrees, however. Alan Miller, founding partner and chief investment officer at SCM Direct, says "one of the most ridiculous" ETFs he has seen specialises in internet security stocks.

"That's the classic launching of something highly specialist, very concentrated, fashionable and prone to high levels of disappointment," he explained.

Miller says an investor's overarching general principle should be to keep things simple and that looking beyond plain vanilla ETFs may carry more risks. While this isn't a reason to reject these products, he says you should ensure you are aware of the risks.

"Often these products are built on completely illusory back-testing, which is done before the charges have been deducted," said Miller.

This is problematic when an ETF uses high quality bonds, for example, which yield little if anything and skew the potential performance.

Miller is also cautious about some smart beta indices where historic performance is driven by the increasing valuation and so the end performance is determined by the price you pay on the day you invest rather than the performance of the stock.

"The best thing to do is to keep things simple," he continued, "invest and don't worry about micromanagement".

This doesn't mean you can't invest outside of the UK or Europe, but you may be better off holding well-spread, low-cost market cap weighted ETFs that are not concentrated in one sector to deliver the returns you are seeking without keeping you awake at night.●

Fund

HERMES GLOBAL EMERGING MARKETS

FE Alpha Manager Gary Greenberg's five crown-rated fund has managed to grind out a positive return in a woeful period for emerging markets

Emerging markets funds have found themselves under the spotlight recently, given their strong performance year-to-date.

While the sector is renowned for its volatility, having suffered from a slowdown in China over the past few years and the resulting collapse in commodity prices, it is looked upon favourably for its growth potential.

What is something of a rarity, though, is an emerging markets fund that can benefit from this growth potential while also protecting capital on the downside. Hermes Global Emerging Markets has, however, managed to do exactly that.

The fund has been headed up by FE Alpha Manager Gary Greenberg since July 2011, over which time it has made 11.97 per cent compared with hefty losses from its peer group composite and MSCI Emerging Markets index benchmark. What makes this even more impressive is that Greenberg has achieved this with a below-average annualised volatility and maximum drawdown (the most investors would have lost if they bought and sold at the worst possible moments).

The fund has a fairly concentrated portfolio of 56 holdings – its top-10 account for just over one-third of assets under management. These stocks include the likes of Chinese investment holding company Tencent, e-commerce giant Alibaba and web services firm Baidu.

The fund is 8.11 percentage points overweight China versus its benchmark, meaning it accounts for just shy of one-third of total assets. Other less drastic regional overweights include Taiwan, Indonesia and Hungary, while the manager is underweight Korea, South Africa, Brazil and Mexico.

When speaking to FE Trustnet earlier this year, the manager said he uses a bottom-up process to pick stocks, which he couples with broader macroeconomic views.

"I'm not sure how many people in long-only emerging markets integrate bottom-up and top-down," Greenberg said. "I think a lot of people are bottom-up and I don't understand how you can just be bottom-up in the world we live in."

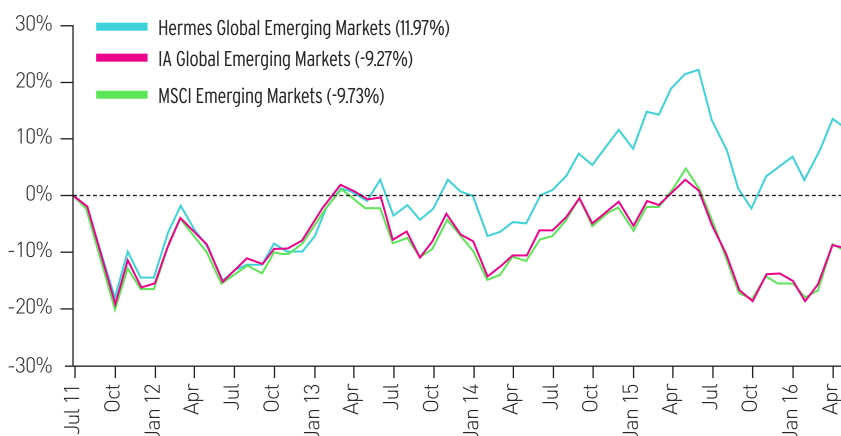
"It strikes me as being an incomplete process. Since we took over the fund four-and-a-half years ago, we have added alpha. Most of this is bottom-up, but a good third has been from top-down. It's not impossible to do, and it seems to me that [the issue of bottom-up-only investing in emerging markets] is an elephant in the room."

The manager also uses Hermes' in-house ethical research group EOS to assess environmental and social factors before buying into a stock, which he believes indicates strength in the management team while also showing support for firms that prioritise ethical practices.●

FILE

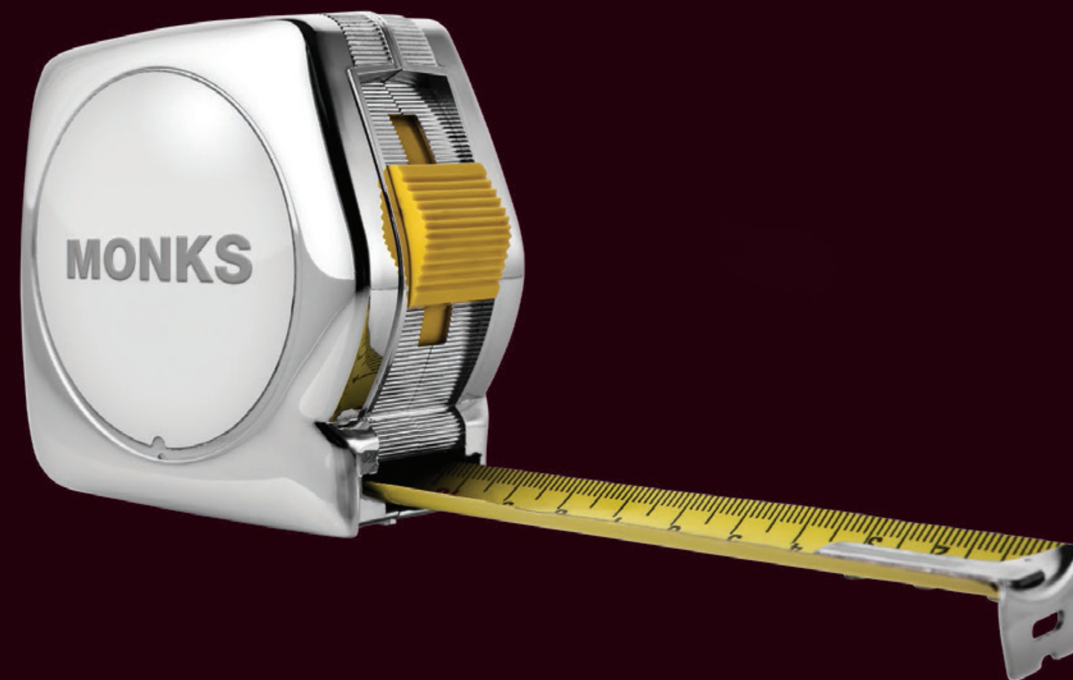
MANAGER: **Gary Greenberg**
FUND SIZE: **£593.4m**
LAUNCHED: **09/12/2008**
OCF: **1.14%**

PERFORMANCE OF FUND VS SECTOR AND INDEX UNDER GREENBERG



Source: FE Analytics

MONKS INVESTMENT TRUST



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Pension

GUINNESS GLOBAL EQUITY INCOME

This fund has managed to increase its dividend payout in every year since launch and has beaten its sector and benchmark over this time, too

Taking a globally diversified equity income approach when building a pension pot makes a lot of sense.

While the compounding effect of dividends helps in the accumulation phase and the available income is useful for anyone who has already retired, investing your capital in different regions, sectors and economies helps from a diversification point of view as well.

However, you would be hard pressed to find a global equity income fund that has managed to outperform and deliver a growing source of dividends.

Odd as it seems given active IA Global Equity Income funds have the entire planet to choose from, the sector has underperformed the MSCI AC World index by 5 percentage points over the past five years and all but two funds have had to cut their dividend since 2011.

One fund that has managed to deliver the goods, however, is Guinness Global Equity Income – which also happens to be one of the smallest in the sector.

The fund, which is just £111m in size, has beaten both the index and the sector by some 16 percentage points since its launch in 2011. Although it has paid out less in total dividends than the sector average since opening for business, investors who bought £10,000 worth of units in the fund in January 2011 would have seen their annual income payments steadily increase from £349 in the first year to £409 by the end of 2015.

This dividend track record stems from managers Ian Mortimer and Matthew Page's innovative approach, which was built from scratch prior to the fund's launch. They start by screening for companies that have at least 10 years of consecutive cash-flow returns on investment (ROI) of 10 per cent. After removing companies with either a market cap below $1bn or high debt levels, this leaves them with an investment universe of roughly 500 companies. After that they use valuation metrics such as price/earnings before even looking at a stock's dividend.

"In terms of the philosophy, in the global income space you have different funds with different strategies," Page said.

"You've got M&G with its dividend growth, high dividend yield guys like Newton, though they have brought that down more recently, then you've got the more total return type strategies and more macro-led funds like Artemis."

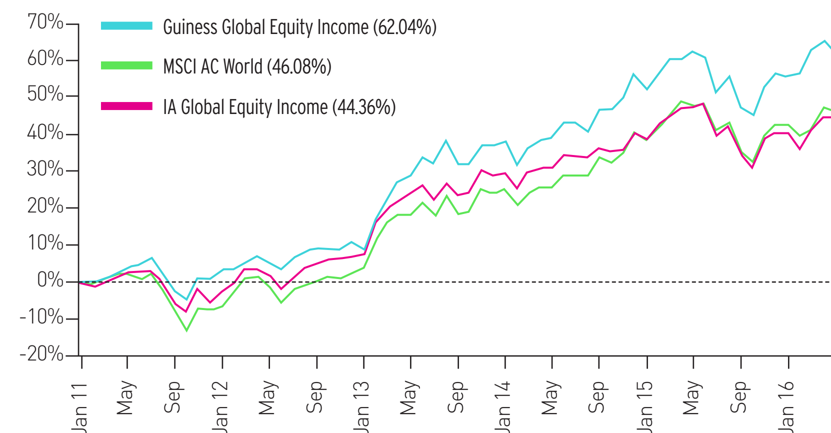
"Then you've got people like us with a more moderate yield, looking for dividend growth but not stretching ourselves for yield."

This methodical and conservative approach has worked in other ways as well, given Guinness Global Equity Income is top quartile for risk-adjusted returns and maximum drawdown since launch.●

FILE

MANAGERS: **Ian Mortimer & Matthew Page**
FUND SIZE: **£111m**
LAUNCHED: **18/01/2011**
OCF: **0.99%**

PERFORMANCE OF FUND VS SECTOR AND INDEX SINCE LAUNCH



Source: FE Analytics

Trust

SCOTTISH MORTGAGE INVESTMENT TRUST

Manager James Anderson believes growth tech stocks such as Amazon, Facebook and Google will outwit blue chip dividend stalwarts over the long term

Scottish Mortgage is one of the largest investment trusts listed on the London market, with a total capitalisation of £3.5bn. Launched in 1909, it has come a long way from its origins as a vehicle for lending to Malaysian rubber plantations.

Today it is a portfolio of high growth stocks at the cutting edge of technology, such as Amazon, Tesla, Alphabet (parent company of Google) and Baidu. Manager James Anderson believes these companies and others such as Facebook and Illumina will outwit blue chip dividend stalwarts over the long term.

His strategy of investing thematically in global trends has more than proved its worth over the medium term – Scottish Mortgage has made 83.5 per cent over the past five years compared with 37.01 per cent from the IT Global sector and 47.27 per cent from the FTSE World index. However, this strong performance has come at a price, with the trust proving to be more volatile than its peers and benchmark.

Anderson has recently started to favour unquoted firms and is seeking to increase permitted exposure to this area of the market to 25 per cent of total assets.

He thinks many companies are now delaying their IPO until later stages of their development, which means investors need exposure before they are listed to capture the strongest growth. However, Anderson refutes the claim this makes the trust more risky.

In a recent interview with FE Trustnet, he said: "I challenge anybody to come up with a view as to why most of the big companies today are not much more risky in the sense of permanent loss of capital than the unquoted companies that we own, even accepting that plenty of them could fail."

"It is that potential destruction of the vast bulk of the quoted major British companies that worries me, rather than the volatility of disclosure surrounding unquoteds."

"We think there is a terrible and dangerous confusion between risk and volatility in the financial markets. We think most share prices and most companies that are unvolatile are like most states and people who appear to be unvolatile and then change dramatically."

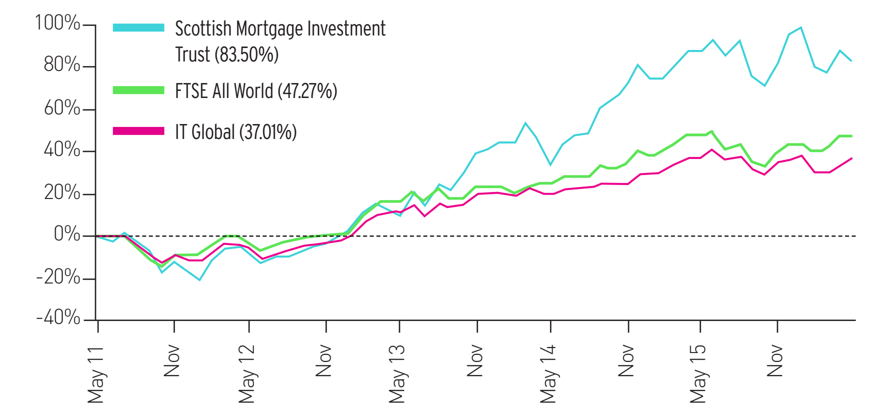
Stifel's head of research Iain Scouller says the manager is aiming to further differentiate the trust from the rest of the IT Global sector, but that investors should realise this comes with the potential for greater discount risk.

"They need to be careful not to put too much in unquoteds in case it scares investors and impacts the discount rating," he said.●

FILE

MANAGERS: **James Anderson & Tom Slater**
DISCOUNT/PREMIUM: **+2.4%**
GEARING: **14%**
OCF: **0.48%**

PERFORMANCE OF TRUST VS SECTOR AND INDEX OVER 5YRS



Source: FE Analytics

FOR NONE BUT THE BRAVE

While the sectors given the "Specialist" prefix by the AIC offer instant diversification, **Phil Scott** says they are not for the faint hearted

The eclectic fund category that is the Association of Investment Companies' Specialist sector has enjoyed something of a boom period over recent years.

More than half of the investment trusts rolled out since 2011 now inhabit this sector of sub-sectors.

Its rise began in earnest a decade ago, with 66 of the nigh-on 80 trusts inhabiting the group launched over the past 10 years.

The set's range makes it impossible to compare trusts across the board, given it houses everything from specialist leasing vehicles to liquidity funds and much more besides. One factor the sector's constituents do have in common, though, is that the closed-ended, listed nature of investment trusts tends to suit their objectives, given many deal in illiquid assets.

Additionally, for the most part they tend not to be for the faint-hearted, and investors with a lower appetite for risk are probably better off sticking to more mainstream vehicles.

However, when it comes to looking for some extra portfolio diversification, it offers a smorgasbord of variety. Gavin Haynes, managing director of Whitechurch Securities, says: "It is a good place to trawl when looking to add niche areas to a portfolio; particularly for higher risk portfolios."

Here are some of the main sub-sectors and the vehicles within them the experts are backing.

INFRASTRUCTURE

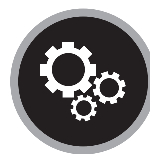
Income and alternative income assets have dominated launch activity recently. Infrastructure's rise to prominence comes in the wake of the income dearth, which has plagued investors since the financial crisis.

These vehicles derive the majority of their revenues from investments in government-backed projects and buildings, which can offer a secure income due to business models that operate with multi-year contracts, which means they can offer a secure income. Its appeal has, however, driven the sector to trade on a hefty average premium of 13.9 per cent – but for the added expense, investors are receiving a typical dividend of 4.8 per cent.

The Infrastructure – Renewable Energy sector is less expensive, but still carries a mean premium of 2.9 per cent, albeit with a higher average yield of 5.6 per cent. Commenting on the high price tags, Peter Hewitt, manager of the F&C MultiManager Trust, says: "These trusts offer a higher level of income, which is reasonably secure. I do not think these premiums are going anywhere. When interest rates rise, they will feel pressure, but I do not see that happening any time soon."

In terms of picks, Henderson multi-asset fund manager James de Bunsen highlights the HICL Infrastructure trust, which is trading on a significant premium of 15.8 per cent but yields 4.6 per cent. He says: "This is all about the likes of school, hospital and prison buildings. The revenues it earns essentially come from the government, which makes the income very solid and visible." From the renewable energy set, AXA Wealth's head of investing Adrian Lowcock tips Renewables Infrastructure Group, which is on a premium of 4.7 per cent and offers a 6 per cent yield. He says: "This fund offers a good source of income as well as diversification."

...



COMMODITIES & NATURAL RESOURCES

The commodities universe has taken a hammering recently, primarily as a result of China's slowing demand for natural resources. The difficulties it continues to face are evident given the sector's average discount of 20.2 per cent – with some trusts now trading at seriously stretched levels.

However, Haynes says this represents a recovery play for investors willing to take a long-term punt, noting in particular the City Natural Resources High Yield trust. While it boasts a dividend yield of 5.9 per cent, it trades at a discount of 22.9 per cent. Haynes says: "This is for the adventurous. The risk of dividend cuts in the sector is high, but the yield on this fund is attractive."

DEBT

Debt is the most dominant sub-category and provides exposure to unique areas of the bond market. Its inhabitants invest in the likes of property loans, which have been packaged together, other types of collateralised debt and even peer-to-peer lending. Its appeal is largely down to the yields on offer, which presently average

> **Debt is the most dominant sub-category and provides exposure to unique areas of bond markets**

6.6 per cent, while the typical trust is trading on a discount of 2.5 per cent. De Bunsen rates NB Global Floating Rate Income, which invests in floating-rate senior secured loans, a type of bond. Right now it is trading on a discount of 2.9 per cent and offers a yield of 4.1 per cent. De Bunsen says: "With floating-rate notes, your payments will go up if interest rates rise, as these are not fixed, unlike regular bonds. They are not duration sensitive."

BIOTECHNOLOGY & HEALTHCARE

Housing just four portfolios, this sector is on an average discount of 6.2 per cent. According to Mona Shah, senior research analyst at Rathbones, it is facing a number of headwinds, including "the US election, the future of Obamacare, rising interest rates and patent expiries, and most importantly, the noise around drug pricing". However, she believes this backdrop has opened up opportunities as valuations and discounts have widened.

Shah points out that US biotech majors are currently showing some value, trading on an average P/E of just 13x, compared with 20x in August. She adds: "This is cheaper than US pharmaceutical majors on 14x, despite the fact most analysts agree they have lower growth profiles and the same political headwinds."

She rates the Biotech Growth Trust, currently trading on a discount of 4.5 per cent, saying: "It is one of the most defensive biotech funds in the listed peer group. The manager only buys stocks that are already profitable and growing their earnings."

TECHNOLOGY

Tech Media & Telecomm (TMT) consists of just two funds – Allianz Technology and Polar Capital Technology – while its sister category Small Media, Comms & IT only houses one: Herald. While many investors were left nursing severe losses as a result of the implosion of the technology sector early into the new century, it is an industry that has evolved dramatically since then, especially as a result of the social media revolution.

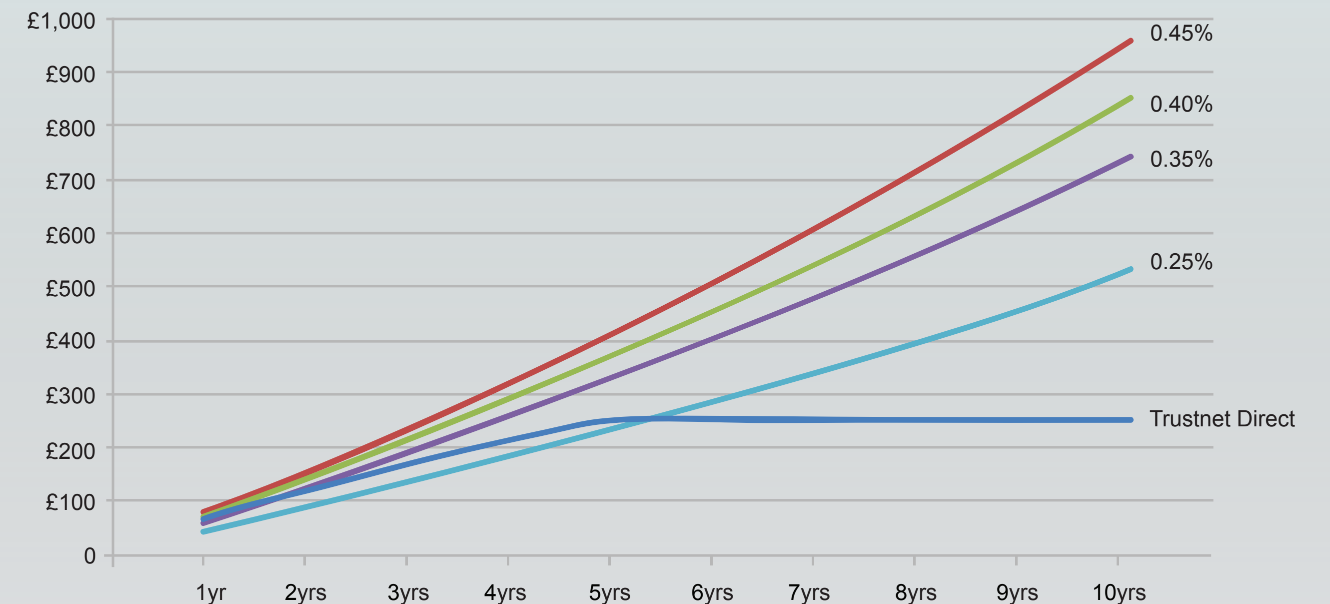
Hewitt highlights the Polar Capital trust, which is on a 5.2 per cent discount. He says: "Polar Capital is a great way to get exposure to big tech firms like Facebook and Amazon."

FORESTRY & TIMBER

Forestry & Timber also holds just two portfolios: Forest Company and Phaunos Timber. Nick Greenwood, manager of Miton Global Opportunities, is a fan of

These are the growth figures you don't want to see in your next ISA

Annual Platform Fees over 10 years*



*The graph displays platform fees plus the cost of 5 transactions per annum with Trustnet Direct compared with platforms charging 0.45%, 0.40%, 0.35% and 0.25% per annum in platform fees. Assumes £15,000 new ISA limit invested each year for 10 years and assumes 5% growth net of charges.

The good news is that if you invest the new ISA limit of £15,000 per annum over the next 10 years and it grows at 5% per annum net of charges, you'll have built a nest egg of over £198,000 tax-free.

The bad news is that platform fees can seriously damage your wealth, as the chart above shows.

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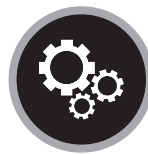


the latter vehicle, which invests in timberland and related sectors across New Zealand, North America, South America, Africa, and Asia. It trades on a deep discount of some 24.1 per cent. Greenwood says: "The timber sector has been perceived poorly in the past, primarily as a result of bad management. But a lot of work has been carried out in the industry. Phaunos has had new management come in and its outlook has improved – and overall the sector is gradually becoming more mainstream."

ENVIRONMENTAL

The focus on green and clean technology companies is a trend that continues to rise and the consensus view seems to be the sector is positioned for further growth. The Environmental sub-sector consists of four trusts – and between them the average discount is at 11.7 per cent.

A popular pick is Impax Environmental Markets, which is another trust backed by Haynes. "The fund focuses on companies that provide products or services in environmental markets, in particular looking at areas such as alternative energy, water treatment, energy efficiency, pollution control, and waste and resource management," he said. "The team has extensive specialist expertise and at a 10.1 per cent discount, this could prove to be a good entry point for long-term investors."

> **The focus on green and clean technology companies is a trend that continues to rise**

FINANCE / INSURANCE & REINSURANCE

Between them the Financials and Insurance & Reinsurance sub-sets house just three funds, with the former holding just one, Polar Capital Global Financials. Henderson's de Bunsen is not a great fan of the Insurance & Re-Insurance sector, where investors receive returns in exchange for being exposed to catastrophe risk. The holdings are widely regarded as very complicated and the returns on offer are getting lower, while the risk levels remain the same, according to the manager.

However, de Bunsen backs the Polar Capital trust, which is on a discount of 10.4 per cent. "We think banks in particular are cheap at the moment," he said. "There is a lot of negativity surrounding them, with interest rates in negative territory in Japan and Europe. But the bad news is in the price."●

PERFORMANCE (%) OF SECTORS IN DISCRETE CALENDAR YEARS

Sector	2016	2015	2014	2013	2012	2011
IT Biotechnology & Healthcare	-9.37	12.73	39.34	43.24	27.52	10.90
IT Commodities & Nat Resources	-19.73	-38.98	-21.51	-32.73	-8.43	-20.07
IT Debt	-2.73	-2.57	2.38	9.15	-4.23	-4.77
IT Environmental	0.27	-4.92	-3.30	24.04	5.26	-18.56
IT Financials	-7.68	7.10	-4.38	N/A	N/A	-52.10
IT Forestry & Timber	-21.42	-29.63	-25.86	-23.24	-18.87	-15.96
IT Infrastructure	11.25	6.66	14.59	12.16	7.60	-3.77
IT Infrastructure Renewable Energy	1.72	4.75	4.25	14.62	-1.15	-5.50
IT Insurance and Reinsurance Strategies	18.30	16.95	11.79	11.50	-16.49	N/A
IT Small Media Comms & IT Cos	-0.11	13.09	-3.83	33.77	12.75	-6.28
IT Tech Media & Telecomm	-4.96	11.32	12.96	49.08	10.41	-11.23

Source: FE Analytics

SCOTTISH MORTGAGE INVESTMENT TRUST

SCOTTISH MORTGAGE WAS ORIGINALLY LAUNCHED TO PROVIDE LOANS TO RUBBER GROWERS IN MALAYSIA IN THE EARLY 20TH CENTURY.

WHILE OTHERS STICK TO THE INDICES, WE ARE FREE TO CHOOSE.

Scottish Mortgage Investment Trust has its own way of doing things. So it's hardly surprising that the Trust's portfolio looks nothing like the index. After all, we are active rather than passive investors and we firmly believe that the index is an illustration of 'past glories' rather than future prospects. In fact, our abiding principle has always been to invest in tomorrow's companies today.

But don't just take our word for it. Over the last five years **Scottish Mortgage**, managed by Baillie Gifford, has delivered a total return of 91.1%* compared to 48.0%* for the index. And **Scottish Mortgage** is low-cost with an ongoing charges figure of just 0.48%.†

Standardised past performance to 31 March each year*:

	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016
Scottish Mortgage	-2.9%	18.5%	28.9%	29.6%	-0.7%
FTSE All-World Index	-0.2%	17.1%	6.8%	19.2%	-0.5%

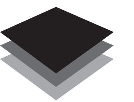
Past performance is not a guide to future returns.

Please remember that changing stock market conditions and currency exchange rates will affect the value of your investment in the fund and any income from it. You may not get back the amount invested.

For a free-thinking investment approach call **0800 917 2112** or visit **www.scottishmortgageit.com**

Long-term investment partners

*Source: Morningstar, share price, total return as at 31.03.16. †Ongoing charges as at 31.03.15. Your call may be recorded for training or monitoring purposes. Scottish Mortgage Investment Trust PLC is available through the Baillie Gifford Investment Trust Share Plan and the Investment Trust ISA, which are managed by Baillie Gifford Savings Management Limited (BGSM). BGSM is an affiliate of Baillie Gifford & Co Limited, which is the manager and secretary of Scottish Mortgage Investment Trust PLC.



FROM LITTLE ACORNS...

Making a few small changes to your saving habits can have a big impact on your pension pot, writes **John Blowers**

I may be teaching my grandmother to suck eggs, but there are a few simple steps to take that can either produce a larger income in retirement or allow the option of stopping work earlier on, without putting too much pressure on your finances earlier in life.

It's tough in Britain these days to put enough money into your retirement savings account, what with soaring property prices, expensive children, lacklustre growth – in fact a myriad of calls on your money in the here and now.

However, it is vital to ensure you have a retirement plan, as the state pension is not going to offer you the lifestyle you'll be hankering for when you hang up your boots.

TIP 1: START EARLY

Everyone says it and in your heart, you know it's true, but starting a pension early makes a massive difference to how wealthy you will be in retirement.

A recent Trustnet Direct client survey found the biggest single regret among older respondents was not starting to invest earlier. Yes, a deposit for a home will always seem more important, but if you think about it, there are always small savings to be made that can translate into big pots of money at retirement.

A beer and a coffee less a day could result in a £180,000 retirement pot. How? Investing the £8 a day you would have spent on the drinks means you are putting an extra £240 a month towards your pension. If you start at 30 and retire at 67, that will grow (at an average of 5 per cent growth per annum) into a pot of £179,828.21.

TIP 2: INCREASE CONTRIBUTIONS EVERY YEAR

The most obvious – but often overlooked – method of increasing your retirement pot is to raise the amount you invest every year. Let's look at two scenarios: the first is based on a 30 year old who starts by investing £240 per month and increases it by 2.5 per cent a year; in the second scenario, they increase it by 5 per cent each year.

In reality, you can't keep putting up your pension fund by 5 per cent each and every year, but any increase – whatever you can afford – makes a big difference.

Example 1: 30 year old, £240 per month (£2,880 a year), 2.5 per cent increase in contributions a year over 37 years.

We continue to use the £8 a day, £240 per month saved from not having a beer and a premium coffee every day for a 30 year old planning to retire at 67 years old.

By increasing contributions by 2.5 per cent each and every year, the forecast pension pot would grow from £179,828.21 to a whopping £466,744.53.

We assume that your investments grow on average by 5 per cent a year in this example.

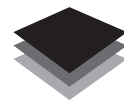
Example 2: 30 year old, £240 per month (£2,880 a year), 5 per cent increase in contributions a year over 37 years.

With an annual contribution increase of 5 per cent a year and using the same assumptions as above, the pension pot at retirement would rise to a staggering £690,902.43.

For the record, by increasing your pension contributions by 5 per cent a year over the 37-year period, you would be putting in £1,532.51 in the final month before retirement.

> It's tough these days to put enough money into your retirement savings account

•••



TIP 3: DON'T GIVE UP ON GROWTH

We'll tackle this in more detail next month, but in essence, the new pension freedoms require a different approach to your retirement planning.

In a drawdown world, there are still opportunities to increase the value of your pension pot when you are actually in retirement. The accepted investment wisdom used to be that you dialled down risk in the final few years before you stopped working, at which point you purchased an annuity or converted the focus of your portfolio from growth to income.

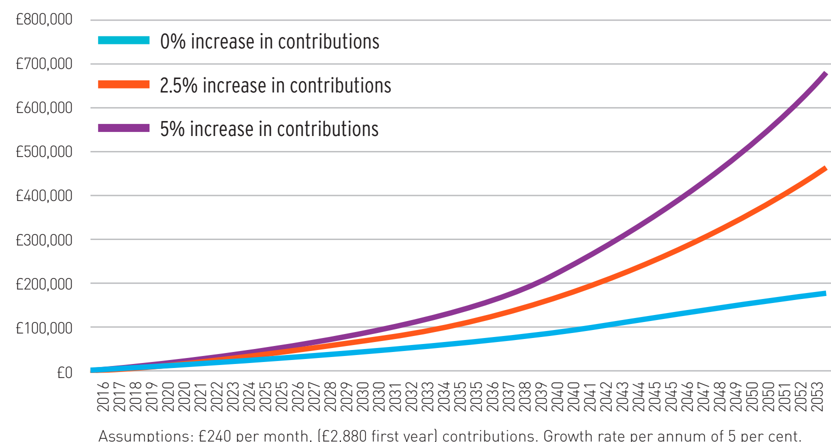
Now, as we live longer and can freely access our investment fund, we should take a fresh look.

If you retire at 67 and live until your late 80s, a further 20 years of potential growth are still to be had as you enter drawdown. There is the risk of your investments falling in value, which can mean you have to sell assets at a loss in periods of down markets, but you can mitigate these risks.

> A beer and a coffee less a day could result in a £180,000 retirement pot

By entering retirement with a high-risk portfolio and around three years of cash, you can sell funds that are in profit in positive markets and dip into your cash in negative ones, so you don't have to sell investments at a loss. They tend to recover as markets go through the cycle and you can top up your cash in the good times.●

EFFECT OF INCREASING RETIREMENT CONTRIBUTIONS



Source: Trustnet Direct

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WORTH BANKING ON

Schroders' **Kevin Murphy** says the ongoing improvement in the core business of UK banks will lead to significant share price increases and a return to sustainable dividends

The past decade encompasses the majority of the fallout from the worst lending, M&A and investment decisions ever made in banking history. Banks remain vilified by the press and are firmly "out of favour" – but much has changed in the eight years since Northern Rock went under, most importantly their resilience to future negative events. We believe domestic UK banks are not only cheap but also have the potential to increase and sustain dividends in the coming years.

UK banks' capital ratios are now among the highest in the world, with buffers 10 times their size in 2007. An irony of the credit bubble was that although banks made high returns, they were driven by taking on more balance sheet risk and not by profit margins. Today, new lending is highly profitable and better reflects the risks of the borrowers. Robust profit margins remain masked by losses on legacy assets and exceptional charges, but over the longer-term, the improvement in banks' core business will warrant significant share price increases.

BARCLAYS' RECENT FINANCIAL RESULTS were disappointing and included a dividend cut to preserve its balance sheet. Attractive income investments should come from the intersection of income and value. The challenge the market sets income investors is capturing the capital gains as profits improve and the dividend growth as profit is returned to shareholders. While this cut is a setback, historically Barclays has distributed 40 to 50 per cent of its profits as dividends. Several of the factors preventing Barclays from paying out more will ease in the next few years, allowing it to raise its payout well ahead of profits.

STANDARD CHARTERED HAD A DIFFICULT 2015, with $3.2bn of bad debt impairments (linked to falling commodity prices and a slowdown in India) and a $700m decline in income due to weakness in emerging market currencies. These issues stretched its balance sheet, which led to a rights issue. The UK banks taught us a recovery can take longer than expected but, for each extra year to full health, there is another year of pre-provision profits to ease the pain. There is potential for share price upside as impairments recede and income recovers. After the rights issue, we believe the risk has greatly reduced.

RBS FACES MULTIPLE HEADWINDS in the short-term from litigation to regulatory uncertainty, while low interest rates continue to hamper profitability. But the potential for long-term capital and dividend growth is significant. It is one of the best capitalised banks in Europe, yet currently trades at just 0.6x its tangible book value. The dramatic de-risking that it has undergone over the past eight years means that it is now almost solely a UK & Ireland retail business, government pressure will diminish as the taxpayers' stake is sold down and its dividend is likely to be restarted during 2017.

MUZINICH GLOBAL TACTICAL CREDIT

Thesis Asset Management's **Gaurav Gupta** is using this fund to navigate bond market volatility caused by uncertainty over US interest rate rises

The uncertainty surrounding the timing of the first rise in US interest rates for nearly a decade ended in December 2015 as the Federal Reserve announced a 0.25 per cent increase. Markets have been volatile since then and there is much debate over further rises during the coming months.

So far this year, fixed income markets have been volatile and the risk-off sentiment has made even seasoned investors nervous, which is best illustrated by the dispersion of first quarter performance in the IA Sterling Strategic Bond sector. The world is also awash in negative yielding paper, with approximately 25 per cent of the global government bond market currently guaranteeing a loss.

Thesis has a bias towards strategic bond funds that can navigate the tighter valuation differences between the various fixed interest asset classes and credit qualities, and react astutely to manage interest rate risk through duration management, while offering an attractive yield. Within this allocation, we aim to identify fund managers that have different (but to an extent, complementary) approaches.

We therefore increased our allocation to Muzinich Global Tactical Credit, a fund that has an absolute return objective and aims for average annual returns of Libor plus 5 to 7 per cent over the course of a credit cycle. Manager Michael McEachern employs a "go-anywhere" strategy that prioritises risk management. This is the lowest risk of our strategic bond funds, as the portfolio's allocation often changes to avoid short term volatility and, from analysing his past performance, McEachern is not afraid to sell positions in favour of cash or government bonds. He also uses Muzinich's in-house research when allocating to sectors and positions, resulting in a "best ideas" portfolio.

The process and focus on risk management have allowed the fund to mitigate losses in tough market periods, but capture returns when they improve. A good example of this was during the taper tantrum (spring 2013), when it lost a tiny amount but participated in the market upside in the following months. This style of management is optimal for a low-risk strategic bond fund as the manager can take a short-term view either to benefit from opportunities or avoid losses.

So far this year, performance has been strong and the 12-month yield is competitive. McEachern has a good track record, conviction in his ideas and dedication to the investment style, which we believe makes for a great low-risk strategic bond fund over the long term. Muzinich Global Tactical Credit offers our strategic funds enhanced diversification in positions and manager investment style. As we prepare for volatile markets and uncertainty over the timings of future interest rate rises, strategic managers offer a dynamic exposure to fixed income markets and having the right blend is important for protecting capital while still offering an attractive income and capital growth prospects.●

***Gaurav Gupta** is a fund and research analyst at Thesis Asset Management*

JUNE PREVIEW

Europe: The final countdown

The next issue will be published just days before the referendum takes place on Britain's membership of the EU. While it may be too late to make any meaningful changes to your portfolio by that point, we'll give you the latest expert opinion on what "Brexit" will mean for you.

Whatever the result of the referendum, England is likely to see one early exit from the continent next month if, as expected, our national football team is knocked out of the European Championship. We'll stick with the themes of Europe and football by putting together our own dream team of fund managers to complete your portfolio and taking a closer look at the IA Europe ex UK sector.