TRUSTNET magazine

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THE ADVICE AGE COMETH
The Pensions Advice Allowance explained

TAKING BACK CONTROL
Managing your retirement income

ON THE RIGHT TRACK?
Can you rely on passives in your pension?

DRAWING A BLANK

Why the industry has missed a trick with drawdown

ISSUE 34

CREDITS

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EDITOR'S LETTER

THIS ISSUE OF TRUSTNET MAGAZINE focuses on the impact of pension freedoms, which were introduced two-and-a-half years ago now. According to Pádraig Floyd, writing in this month's cover story, it has been something of a missed opportunity for the industry – not only have pension providers failed to offer new products to plug the gap left by plummeting annuity sales, but there has also been a worrying trend of savers pulling their money out at retirement without having the faintest idea of what to do with it. This latter problem was one that the Pensions Advice Allowance was supposed to address, but as Maggie Williams finds out, stringent rules surrounding its withdrawal have prevented take-up.

John Blowers also highlights some of the major considerations for investors who want to take full responsibility for their retirement income when they enter drawdown, while in this month's final story on pensions, I look at whether passives are a suitable product for this type of investing.

In our regular columns, Adam Lewis finds out whether all the easy gains in Japan have already been made, Evenlode Income's Hugh Yarrow names three stocks that streamline their customers' businesses and Aviva Investors' Thomas Wells reveals why he is using Baillie Gifford Japan to complement an existing holding in GLG Japan Core Alpha.

Enjoy reading,

Anthony Luzio
Editor
Trustnet Magazine

IN THIS ISSUE

22


DRAWING
A BLANK

Pádraig Floyd says the industry and end consumer alike are still struggling to make sense of pension freedoms, more than two years after they were introduced

SINCE THE PENSION FREEDOMS WERE INTRODUCED IN APRIL 2015, there has been an enormous amount of activity in the retirement income market. Data from the Financial Conduct Authority (FCA) shows that almost three-quarters (72 per cent) of those pension pots accessed are held by policyholders under the age of 65 and 90 per cent of these funds contain less than £30,000.

The freedom to either take cash or access income drawdown has had a damaging effect upon the annuity market. Last year, the number of annuities sold was down by 75 per cent from the pre-freedoms level. On average, there have been three times as many income-drawdown sales over the past two years.

People don't want to buy annuities because the yields on UK government bonds – which their valuation is based on – are at historically low levels. This makes them appear overly expensive and as a result, more consumers are entering into drawdown contracts. But is this really the best decision?

MORE CHOICE OR LESS?

Drawdown has replaced annuity purchase as the default solution for releasing pension income, but despite increased demand for this service, there has been anything but an increase of freedom and choice in this arena.

"Looking back to 2015, there was a high expectation that pension freedoms would enhance this market," says Tom McPhail, head of pensions research at Hargreaves Lansdown. "We expected a Cambrian explosion of new products and ideas, but what we have seen is near extinction."

Many providers have withdrawn from the market or dropped products – particularly those with a guarantee – leaving a relatively homogenous range.

The FCA recently called upon the industry to innovate in this product area, particularly for older investors who could run out of money. But the reduced demand for annuities offers little encouragement for providers to develop new products in this area and this isn't really necessary, says Billy Burrows, director of Retirement IQ.

"The more you add bells and whistles to annuities, the more you lose any advantage," he says. "Likewise, adding things to drawdown does not work, as people are simply prepared to pay for the guarantee. You can make good use of the existing plans."

ON THE REGULATOR'S RADAR

However, the regulator remains concerned that investors may be making sub-optimal decisions. The FCA is to conduct a review of the unadvised income drawdown market to see if the lack of proper advice has caused consumers to make poor decisions.

After all, drawdown was never intended as a mass market instrument, but a workaround under the old regime for those who didn't want to be forced in to buying an annuity once they reached the age of 75.

It was always something of a stopgap and restricted to those with sizeable funds or assets besides their pension. This remains true in the advised market, where 26 per cent of IFAs insist their clients have more than £100,000 of assets and 27 per cent insist they have more than £200,000, according to Never Mind the Quality, Feel the Width 3, a recent report from independent financial services consultancy The Lang Cat.

There is little by way of shopping around for the best deal, either, with 94 per cent of consumers who enter non-advised drawdown doing so with their existing provider.

"They simply want tax-free cash and not to think about the rest for now," adds McPhail. "In fact, many don't even think of themselves as 'in drawdown'," which, he says, can present its own problems.

WHEN CASH AIN'T KING

This is because drawdown isn't an insurance policy, but an ongoing investment strategy. If you intend to stay invested and decide not to take an income, the existing accumulation strategy may suffice for some years. If it is your sole source of retirement income, you may want to consider whether you can live with the present levels of volatility.

Income drawdown does not operate like your general investment account. As an income product, there is likely to be a requirement to hold more cash than you may wish.

It is common for the drawdown product to hold in excess of a year's income in cash so it can pay out a regular amount, meet any fees and avoid becoming a forced seller if liquidity dries up. Data from The Lang Cat even shows 23 and 32 per cent of advisers holding a minimum of 12 and 24 months' cash in their drawdown products, respectively.

Cash may not be as volatile as some other asset classes, but it is guaranteed to provide a negative return as there are no savings accounts capable of beating current rates of inflation without tying up your money for at least three years.

Principal at The Lang Cat Mark Polson says that where reviews are undertaken, they tend to be backward-looking and there is little management of volatility.

"This means that investors with significant assets should be managing their drawdown very closely," he adds.

CHARGES

Cash is not the only potential drag on drawdown. Just as many investors fail to differentiate between saving for a pension and starting drawdown, advisers largely fail to differentiate between charges in the accumulation and drawdown phases of a pension.

"The same fee model is often applied, meaning the cost is typically 1.8 per cent to 2 per cent and anything up to 2.5 per cent including other charges," says Polson. "The industry is very good at creating incentivised accumulation products, but not for those who want to take the money back out again."

In this "lower for longer" investment environment, if you generate 5 per cent net of fees a year and are withdrawing 4 per cent as income – a typical amount many advisers would be satisfied with if you have sufficient funds – your pension pot will still lose money as inflation is running at more than 3 per cent.

Burrows' view is that if you want an annuity, you should look for the purest one you can get to maximise the income. However, drawdown is an investment proposition and you need to invest where you feel it is appropriate.

NON-ADVISED IS NOT NECESSARILY CHEAP

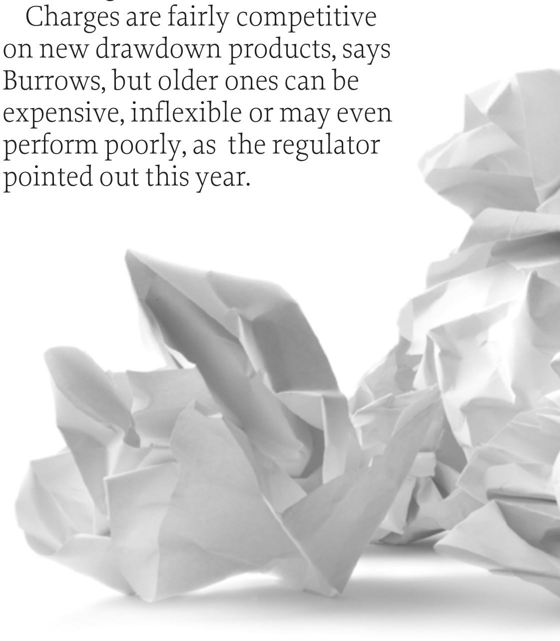
Although many consumers distrust advisers, Burrows cautions against rejecting the advised route on the basis of cost: "In the eye of the customer, a non-advised sale is free, but it couldn't be further from the truth," he says.

Quite often a non-advised annuity or drawdown sale may attract fees of 2 to 3.5 per cent (your author discovered one example of 4 per cent being charged for a drawdown before the tax-free lump sum of £60,000 was withdrawn). Meanwhile, defined benefit (DB) transfers are being undertaken for around 3 per cent.

"Non-advised drawdown platforms have their own expenses, but customers have to realise they're on their own," adds Burrows. "They may feel it is better to pay a fee to keep someone with a watching brief over it, as if anything should go wrong, the detriment is likely to make the fee look insignificant."

Charges are fairly competitive on new drawdown products, says Burrows, but older ones can be expensive, inflexible or may even perform poorly, as the regulator pointed out this year.

> **As an income product, there is likely to be a requirement to hold a lot more cash than you may consider sensible**



However, just because a product is with profits and has a higher annual management charge, this doesn't necessarily mean you should dismiss it out of hand, as it may offer smoothing – taking those nasty peaks and troughs out of the investment returns – or even valuable guarantees which no-one draws attention to any more as they cost the life company a lot of money to provide.

TOO MUCH, TOO SOON

One of the greatest dangers is drawing down too much income from a fund that isn't big enough, says McPhail. Typically, the smaller the pot, the higher the level of withdrawal – up to 8 per cent in some cases – which, he says, is simply unsustainable.

The longer you preserve capital at the start of drawdown, the more likely it is to offer an opportunity for annuity purchase later on when you favour security over growth potential – and once annuities become better value, usually around the age of 80.

There may yet be a revision of the pension freedoms. When introduced, the government failed to consider the lack of existing infrastructure for a mass market that did not buy an annuity or the deficiencies in the drawdown model.

Frank Field MP – a champion of the freedoms – suggested a minimum income to prevent savers from spending all their pension. A default structure has been mooted that providers would impose on all drawdown policies where investments have not been selected.

While a price cap for drawdown has been considered, it is not likely to be imposed. In any case, like any investment, there are some simple rules.

Strategies should be reviewed regularly to ensure they are appropriate. Where you can, pay a fixed fee – this is becoming a common option – rather than a percentage.

Don't pay too much for the strategy employed and don't take out more than your pension pot can afford. Finally, make sure any commission paid for a non-advised sale is money well spent – it may seem poor value when a similar amount may offer the protection of advice from a regulated adviser.●

WOULD YOU LIKE THAT IN A SMALL, MEDIUM OR LARGE, SIR?

Janus Henderson's **Neil Hermon** offers three "pretty compelling reasons" why it can be more lucrative to invest in smaller firms than their larger counterparts

UK-BASED INVESTORS HAVE TENDED TO FILL THEIR PORTFOLIOS with funds investing in the large, liquid firms of the FTSE 100. They are easy to buy in large amounts, generally well established in their sectors, and tend to have strong governance and long histories of creating shareholder value.

But history lends us evidence of investments with even stronger returns: the UK's smaller companies. These are firms in the bottom 30% of the UK stock market by market capitalisation – so the FTSE 250 and smaller, or less than around £4bn.

The volatility for investors likely contributes greatly to small-cap reluctance – their share prices tend to swing more wildly, setting nerves affray, and they've been known to disappear from time-to-time on account of poor management.

But the long-term numbers – where investors should be focused – speak for themselves: if you'd put £100 in the FTSE All-Share in 1955, by 2016 you would have received £96,792; for the FTSE-Small-Cap it would have been £597,433. The latter is quite remarkable at six times the former.

WHY IS SMALL MIGHTY?

Professors Elroy Dimson and Paul Marsh of London Business School developed the theory behind why small-cap firms outperform larger ones.

1) Organic growth – The growth potential tends to be greater because it's much easier for small, more ambitious companies, with profits in the millions rather than billions of pounds to double their business. It's partly a law of numbers: a firm earning £1 million one year could feasibly double that over the course of the following year, but one that earned £1 billion would have to generate an additional billion pounds over that time to achieve the same growth rate.

Small companies also have more options for increasing business. They are inherently more nimble, dynamic and innovative, and so are more able to expand into new parts of the country, launch new products or services, or venture overseas – and make a huge difference to the bottom line. In contrast, new initiatives for giant multinationals are likely to affect only one of their many subsidiaries or product lines. And it's a self-fulfilling prophecy – a company that repeatedly delivers on its earnings increasingly satisfies investors who then place a higher value on the business. This is known as momentum.

2) Lack of research – The stock market is a pricing mechanism that takes into account all of the

DISCRETE PERFORMANCE

Performance	Jun 2016 - Jun 2017	Jun 2015 - Jun 2016	Jun 2014 - Jun 2015	Jun 2013 - Jun 2014	Jun 2012 - Jun 2013
Nav	14.50%	3.10%	6.40%	14.80%	23.90%
Price	16.60%	0.30%	7.20%	15.10%	21.50%

Source: © Morningstar 2017. Annual Return to 30/06/2017

publicly available information there is regarding a firm's finances and its operations. The price is informed by the work of analysts. Big companies tend to be followed by lots of analysts: it averages 24 per firm for those over £10bn. Because their operations are so extensively scrutinised it's very unlikely any great corporate initiatives or managerial shake-ups will pass under the radar, so the share price tends to reflect the business realities fairly accurately, making it harder for fund managers to find pricing anomalies.
In contrast, smaller firms have fewer analysts following them, with those under £500m averaging only two. It means there's more opportunity to spot mispricing. Academics call this the 'neglected effect'.

3) Mergers & acquisitions – One of the big attractions of investing in smaller companies is the likelihood of a corporate action, usually when a larger firm snaps them up. For large, slow-growing companies, taking over an attractive small firm is probably the easiest way to expand the business in a lucrative new direction. M&A deals are viewed as good news for shareholders in the acquired company because as owners of the business they will receive payment, usually in the form of cash or shares in the acquiring company, or a mixture.

Many companies had built up a war-chest of cash in the years following the financial crisis, having been reluctant to commit to major investments in such an uncertain environment – but as economic confidence has recovered, they've been spending. According to Dealogic, records were broken in 2015, with $4.7trn of deals. 2016 still proved high at $3.8trn.

A RICH HISTORY

The Henderson Smaller Companies Investment Trust has not always been in the business of smaller companies. It was founded in 1887 as the Trustees Executors and Securities Insurance Corporation, aiming to beat UK government bonds. Its original Chairman branched out into accountancy services and eventually formed Touche Ross, now a key part of Deloitte – one of the biggest accountancy firms in the world.

It was not until 1992 that it started investing in smaller companies and in 2000 only in those from the UK. This makes it one of the oldest investment trusts there is: surviving, adapting and evolving over many years.

In 2002, in the wake if the dotcom crash, I became the Trust's fund manager. Much has happened since: four prime ministers, various polarising US presidents, oil prices bucking between $30 and $140 a barrel, Harry Potter and his famous scar, a Middle Eastern melt-down, a searing global financial crisis, and the explosion of social media, smartphones and apps.

Throughout these twists and turns markets have gyrated, yet we have delivered an average annual return of 17.9%, outperforming the benchmark in 13 of the last 14 years. We know the past doesn't predict the future, but this would have transformed £1,000 of your cash into over £12,000.

> **"Small companies are inherently more nimble, dynamic and innovative, and so are more able to expand"**

We've done it through consistency, consistency... you get the idea – the method has never changed. Now supported by Indriatti van Hien, our focus is on finding exceptional management teams and good-quality businesses, buying them at prices we think are value for money (other small-cap managers care less about firms priced expensively against history or otherwise, but we think this is a key mistake). With Brexit-this and interest rate-that, the UK market seems on a more cautious footing: now has probably never been a better time for stock picking.●

THE ADVICE AGE COMETH

You can now use money from your pension pot to pay for financial advice, but **Maggie Williams** says stringent rules around its withdrawal appear to be hampering take-up

A LUXURY WATCH. AN ENTRY-LEVEL SEASON TICKET for Brighton and Hove Albion Football Club. Fifty months' worth of Netflix access; 50,000 penny chews. The ways of spending £500 are many and varied.

You could also make a single tax-free withdrawal from your pension scheme to fund advice, using the new Pensions Advice Allowance. Introduced in April 2017, the allowance enables pension-scheme members to withdraw up to three tranches of £500 from their pension pot tax-free to pay for professional guidance. Each of the withdrawals must be made in a separate tax year, and the money can only be used for advice about pensions.

The introduction of "freedom and choice" reforms in April 2015 has heightened the need for affordable advice for pension savers. Anyone over the age of 55 can now take their money out of a workplace defined contribution pension whenever they like. It can be taken as cash, to buy a flexible drawdown product, purchase an annuity – or a mixture of all three.

With that flexibility comes the need for greater understanding of the choices on offer. There are questions of tax efficiency, and ensuring that the approach savers choose for their pension savings will sustain them for the rest of their life.

But scheme members are often unwilling to take advice. The Financial Conduct Authority's (FCA) July 2017 Retirement Outcomes Review found 30 per cent of drawdown products are now being bought without advice – compared with 5 per cent before freedom and choice was introduced. The Association of British Insurers (ABI) found that 94 per cent of individuals who did not take advice simply invested in products from their incumbent pension provider.

Is the Pensions Advice Allowance the solution? "In theory, it is useful," says Simon Harrington, senior public policy adviser at the Personal Investment Management & Financial Advice Association. "People coming up to retirement are thrust into a market they don't understand and the fact the allowance is tax-free is beneficial."

While £500 may buy a lot of penny chews, it won't fund much in the way of advice. "It could cover basics such as 'am I paying enough into my pension?', or 'am I in the right risk profile?', or perhaps help with finding an annuity," says Debbie Falvey, DC proposition leader at Aon. "But

beyond that, it only really works as a contribution towards more comprehensive advice."

"It's better than nothing, but limiting it to pensions advice is a challenge," she adds. "Good advice should encompass all of your finances and the current arrangement could make life difficult from a financial adviser's perspective."

The pensions-only focus of the advice that the allowance can fund is an issue, but an even bigger problem may be getting £500 out of a member's pension pot in the first place.

"Schemes and providers are not required to implement access to pension savings for the allowance, so it's unlikely all of them will," says Falvey. Payment has to be made directly from a pension fund to the adviser – it is not paid to the individual.

Pension providers are already under pressure to improve support for freedom and choice reforms, tighten up governance and reinvent default funds for a new way of retiring. It is unlikely reconfiguring administration to support the allowance will be at the top of many to-do lists.

> **"If someone has complex financial affairs, it's unlikely that you will get to the root of their needs in the adviser time covered by £500"**

"Access will be driven by consumer demand," says Tim Gosling, policy lead: DC for the Pensions and Lifetime Savings Association. That has been low so far, but the allowance has only been available for six months.

"It is too early to tell what the demand and response will be – in 18 months, it might be time to realistically review this," Gosling adds. But that risks creating a vicious circle: providers don't offer it because there's no demand, but consumers don't use it because their provider hasn't enabled it.

Given the restricted size of the withdrawals, muted enthusiasm from providers and narrow focus of the advice it can fund, does the Pensions Advice Allowance have a future?

Harrington believes that, with some adjustments, it could deliver greater benefits. "We would like to see a relaxation in how you can access it. It would be better if it could be accessed as a single lump sum rather than over three separate tax years. If someone has complex financial affairs, it's unlikely that you'll get to the root of their needs in the adviser time covered by £500." Clearer signposting in pre-retirement wake-up packs and scheme documentation would also help to raise awareness, he says.

In its present form, the Pensions Advice Allowance is a work in progress. However, if it can offer confused workplace pension savers a taste of advice that helps them see the benefit in buying more, then it will have achieved a valuable goal. For more knowledgeable savers familiar with the advice market, the advantages may be less pronounced – but "tax free" is never a bad thing and the allowance could still make a positive contribution towards more inclusive advice. The initiative may be far from perfect, but it's a step in the right direction. ●

DEPENDABLE DIVIDENDS

SAINTS' co-managers **James Dow** and **Toby Ross** believe they have identified the characteristics of businesses best placed to offer a consistent payout to shareholders

THE GOAL OF THE SCOTTISH AMERICAN INVESTMENT COMPANY, also referred to as SAINTS, is one that may be attractive to pension investors. It aims to deliver a high and dependable income stream, together with real capital growth over the long term.

The trust invests mainly in global equities, but it also holds assets including property and fixed income.

"SAINTS is designed to provide both a dependable income and growth," says SAINTS co-manager Toby Ross. "The focus is therefore on identifying companies that generate real growth in cash flow as well as dependable dividends."

Income investors look for more than total returns. They also expect dividends that will grow over time and remain robust even during periods of economic stress. The trust aims to meet those expectations by investing the bulk of the equity portfolio in companies seen as most likely to meet those demands.

The trust's goal to provide investors with dependable dividends is underpinned by a number of factors. Among them is the way in which the assets are invested.

Taking a 'bottom-up' investment approach to portfolio construction, the trust selects companies on their ability to grow their cash flows and their future dividends.

Co-managers James Dow and Toby Ross look for companies that will be able to grow dividends in real terms but which can also be relied upon to continue providing them during times of stress.

By studying dividend performance over the long term the managers have identified the characteristics of businesses that are best placed to offer dependability of dividends.

Their research picked out several predictors of dependability, including the pay-out ratio (the percentage of earnings paid out as dividends to shareholders); balance sheet strength (if needed to support the dividend); the margin of the business; and whether it's structurally growing or shrinking.

Companies that produce consistently high scores across the different criteria are those that can be most depended upon to provide sustainable dividends.

In judging whether a company can be relied upon for sustainable dividends the team also takes a close interest in the attitude towards dividends of the board of directors at each company SAINTS invests in. It's this board that makes dividend decisions, so gauging their commitment to maintaining payments even during turbulent periods is a priority.

The Baillie Gifford philosophy of long-term ownership plays an important role here, and not just because it enables the trust to engage with and influence boards about dividend policy. Company boards also recognise that if they can continue paying dividends even in difficult periods, the better their chances of getting investment support when they need to recapitalise.

Of fundamental importance to dependability is the resilience of the cash flow generated by a business. Among the questions asked during the stock research stage is whether it will deliver real cash flow growth over the next five years. If a company has strong cash flow growth potential there can be greater confidence that it is capable of growing its dividend over time. The view is that sustainable real dividend growth cannot be achieved without real growth in profits and cash flows.

The emphasis on cash flow is an example of how the trust is run in accordance with the established Baillie Gifford approach. Typical Baillie Gifford businesses, says James Dow, are those with strong balance sheets, which are cash generative long-term growth companies with attractive valuations and good management.

"Of fundamental importance to dependability is the resilience of the cash flow generated by a business"

It's a combination that could deliver strong total returns over time. Many UK income products invest in companies that may have high yields but which are not investing in the future. The promise of attractive income over the short-term has less appeal in retirement, when investors need their portfolio to protect against inflation and provide an income for as long as they need it.

The way in which an investment trust is structured means that sustaining a regular income is likely. That's because their rules allow them to set aside up to 15% of annual earnings in reserve to ensure they can cover dividend pay-outs during leaner times.

"At investment trust level, investors benefit from the next level of defence," says Ross. "Revenue reserves give the SAINTS' dividend an additional tool for sustainability – nearly a year of reserves can be called upon to support the dividend should the underlying investments suffer a temporary wobble."

Perhaps the quality that drawdown investors seek more than any other is reliability of income. SAINTS' record here speaks for itself. The trust has officially increased the dividend for 37 successive years, while the company records show that the last actual reduction in the SAINTS net dividend per share was in 1938. Past performance is of course no guarantee of future performance.

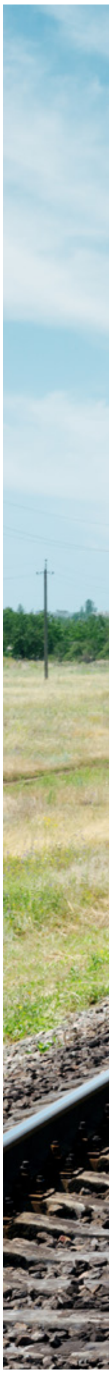
Maintaining that record means investing in companies that can grow dividends in real terms and continue to pay them when others struggle to do so. For drawdown investors craving a reliable and growing income in an ever-changing and uncertain world, SAINTS could be worth considering. ●

DIVIDEND RATES

SAINTS	2012	2013	2014	2015	2016
Total dividend per ordinary share (net) - pence per share	9.8	10.2	10.5	10.7	10.825

Source: Baillie Gifford & Co, data as at 31 December 2016

ON THE RIGHT TRACK?



Passive funds are booming in popularity – but is it wise for pension investors to entrust their retirement fund to a computer for periods of 30 years or more? **Anthony Luzio** finds out

ON THE FACE OF IT, THE CASE FOR USING PASSIVELY MANAGED FUNDS when investing for the long term looks overwhelming. From a pure mathematical point of view, the return on the average actively managed pound before costs 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.

And, while regular readers of this magazine may fancy their chances picking an active manager capable of beating the market over the long term, you don't know which ones are capable of doing this until they have demonstrated at least five years of strong performance – by which time they are likely to have received significant inflows, which often reduces their flexibility and prevents them from performing in the way that attracted the excess assets in the first place.

Investors certainly seem to be warming to this argument. Exchange traded funds (ETFs) now account for 30 per cent of all US trading by value and Moody's estimates that index-tracking funds will account for more than half of assets in the investment management business by 2024 at the latest.

PROBLEM SOLVING

Howie Li, chief executive officer of Canvas at ETF Securities, says the use of passives such as ETFs is also on the rise in pensions, adding: "Institutional investors are beginning to see asset allocation via ETFs as a means of problem solving. Due to an industry-wide need for almost immediate [environmental, social and governance] compliance and a burgeoning interest in smart beta tracking, ETFs' popularity in the pensions industry is growing."

While the rising use of passive funds suggests investors are becoming more astute when it comes to seeking value for money, industry experts have expressed a sense of unease about where this could be leading – especially when it comes to pensions.

For example, Chris Wagstaff, head of pensions and investment education at Columbia Threadneedle, says: "Passives tend to do very well in rising markets but they are susceptible to momentum risk and concentration risk. They become forced buyers of market favourites which leads to concentrated portfolios. For example, the FTSE All Share has 50 per cent in its top-10 holdings."

"Passive funds can't avoid the downturn in markets – when a bear market turns into a bull market, you find that they have bought a lot of the stocks that have become overvalued and are now leading the market down."

This is a well-worn argument in favour of active management, but is it one that stands up for someone in the accumulation stage of their pension? If you are a decade or more away from retirement, any crash just means that you will be buying into the market at a lower level over the next few years. If you are any closer, postponing the de-risking stage – when you reduce your exposure to equities in exchange for other income-producing assets – for a couple of years should in theory help to lessen the impact of a sudden shock to the system.

However, this is assuming that the market conditions remain the same – and the problem for Wagstaff is that the take-up of passives is growing so quickly, it is threatening the very environment that they are seeking to take advantage of.

"A STRANGE PARADOX"

"There is a strange paradox where passives can't survive without active funds and actives do better when passives dominate," he says. "The efficient market hypothesis assumes analysts are looking at every company in the universe and know all the information. If you don't have an active community, there won't be an efficient market."

"Once one-third of the market is in passives, it becomes less efficient because companies are not as well researched and there are more opportunities for active managers. The US is approaching one-third in passives, so it is close to a tipping point."

This is a view echoed by Eric Syz, chief executive of Syz Group. "If passives dominate the investment world, there will be no more discrimination. In other words, companies' prices will no longer go up or down as a result of how well they are doing. Passives will simply invest according to what the market cap is."

Carlos Hardenberg, manager of the Templeton Emerging Markets Investment Trust, says another problem with the trend towards passive funds relates to the responsibility that active managers have in holding company directors to account.

"Maybe I am 'old school' here, but when it comes to addressing ...

… shareholder concerns in companies that are immature, it is an important relationship that cannot be done by an automated system," he explains.

"We have seen throughout history many of the performance drivers came because we had that shareholder activism. On the flipside, this has allowed us to avoid disasters like Satyam in India where we sold before it went bust."

Hardenberg adds that while some passive funds do engage with holdings on a shareholder level, others that claim to do so don't appear to understand what it actually means.

"When they say they vote, they outsource their vote to the shareholder proxy services," he continues. "I have been doing this for 17 years; every year I deal with proxy services and that is not what I would call looking after shareholder interests. They are going through box-ticking activities. They don't do enough and they would never call an extraordinary annual meeting, they would never try to force agenda points on to the meeting schedule."

A CHANGING ENVIRONMENT

The impact of a changing market environment on pensions can already be seen in the way rock-bottom gilt yields have created poor value in annuities. Fortunately, the pension freedoms mean you are no longer obliged to buy these products and as a result, many people are choosing to go into drawdown instead. However, Wagstaff says he can see problems arising if people think they can rely on passives at this stage of their retirement.

"If you want to enjoy rather than endure your retirement, you must have a standard income in mind," he continues. "This doesn't mean simply buying an annuity, but most people don't want to be looking at their portfolio every month thinking 'do I need to sell some assets now the market is up? Should I go without because the market is down?'"

"You need to have a sustainable income withdrawal rate that you can take each month without worrying and you need to have a strategy to support that, with a portfolio that delivers strong and smooth returns."

"A truly talented active manager will be better than a passive fund for this purpose as they will be able to anticipate and react to changing conditions and make their fund less susceptible to drawdowns."

Wagstaff also recommends taking a multi-asset approach in retirement to give diversification and reduce volatility, something that he says is possible with returns that won't be too far behind those of equities – however, he says a passive product has yet to be launched that can compete with the active funds that already do this.

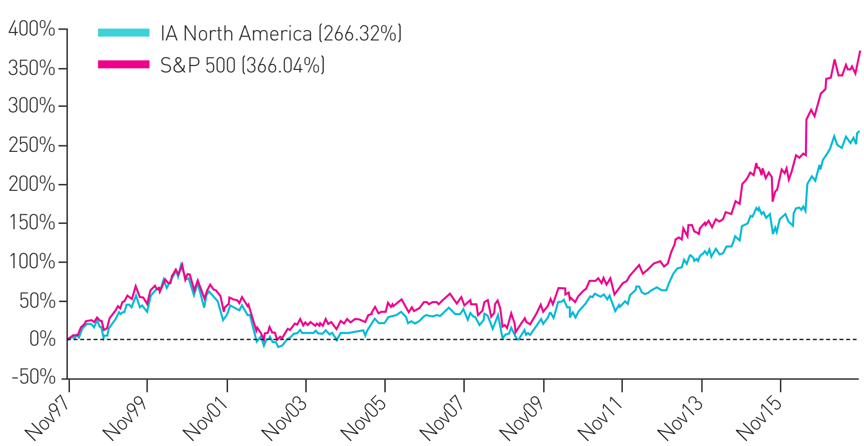
> **"If you want to enjoy rather than endure your retirement, you must have a standard income in mind"**

IMPORTANT QUESTIONS

There are many good reasons, then, to hold passive funds in the accumulation stage of your pension, provided you are diversified by sectors and regions and regularly review your portfolio, especially as you draw closer to retirement.

While there is nothing wrong with this, it raises two important questions: are you really in a better position than the professionals to make calls on asset allocation and, by saving a few basis points a year in charges, is this really giving you value for money? ●

PERFORMANCE OF SECTOR VS INDEX OVER 20YRS



Source: FE Analytics

Fund

TROJAN GLOBAL EQUITY

Gabrielle Boyle's fund has underperformed over the past five years, but should come into its own when the bull run ends

IN A WORLD OF GEOPOLITICAL UNCERTAINTY AND CONCERNS that the end of the bull run is nigh, investors could be forgiven for exercising a little more caution when positioning their portfolios.

For anyone who finds themselves with this diminishing appetite for risk but is unwilling to pull their money out of the market, Trojan Global Equity, which has been managed by Gabrielle Boyle since November 2011, is one option. The fund offers exposure to developed market equities and has a strong track record of protecting investors' capital when markets fall.

Stocks must tick a number of boxes to merit inclusion in the portfolio, including high barriers to entry, pricing power, a dominant position in their industry and strong corporate governance.

The portfolio currently contains 31 stocks, with its top-10 accounting for 45 per cent of the overall fund. Some of its largest holdings include American Express, Alphabet (Google), eBay and PayPal.

It has a 60 per cent weighting to stocks domiciled in the US, although investors should note this is the result of bottom-up stock selection as opposed to an active play on the country.

"People always question our US weighting and say it's expensive," Boyle recently told FE Trustnet.

"My argument has always been that it's too simplistic to look at it like that on a pure top-down basis, because there's all the difference in the world between a Google or a Visa and a smaller industrial business which is purely exposed to the US."

In terms of sectors, Boyle has found a number of opportunities in healthcare, which she said has been the victim of an irrational sell-off by investors considering the fact many stocks in this area boast stable long-term performance records.

She is also positive on stocks driven by technological advancement as they tend to need less capital and are more immune to e-commerce as a disrupter.

Trojan Global Equity has returned 94.38 per cent in the past five years compared with 108.97 per cent from its MSCI World index benchmark.

While this represents a significant underperformance, the fund's focus on downside protection meant it was always likely to lag during bull markets. That said, it has still outperformed its IA Global sector average by 4.72 percentage points over this time.

In terms of its risk metrics over five years, the fund's maximum drawdown – which measures the most money investors would have lost if they bought and sold at the worst possible moments – is 6.63 per cent, almost half that of its sector average. It has an annualised volatility of 10.18 per cent.●

FILE

MANAGER: **Gabrielle Boyle**

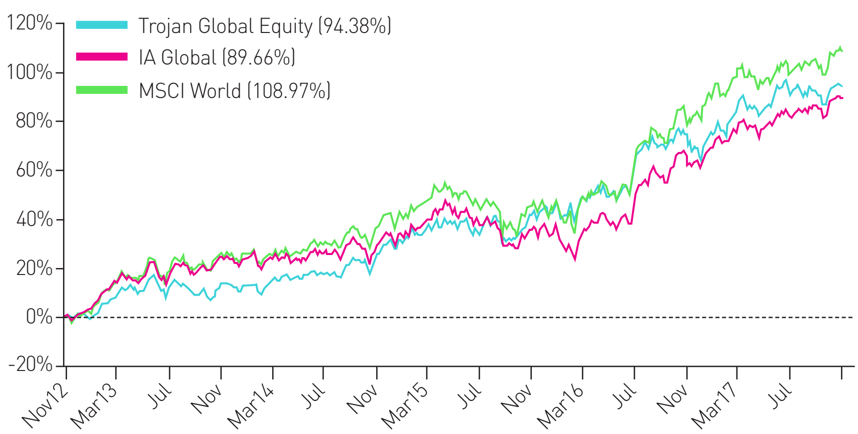
LAUNCHED: **06/03/2006**

FUND SIZE: **£238m**

OCF: **0.97%**

FE CROWN RATING:

PERFORMANCE OF FUND VS SECTOR AND INDEX OVER 5YRS



Source: FE Analytics

Pension

BLACKROCK SMALLER COMPANIES IT

Mike Prentis's trust has more than doubled the gains of its IT UK Smaller Companies sector since he took charge 15 years ago

INVESTORS LOOKING TO INCREASE THE VALUE OF THEIR PENSION pot over the long term will often explore strategies and managers specialising further down the market capitalisation scale.

It is not difficult to see why, as the opportunity to participate in the growth of smaller companies has led to spectacular gains in the past.

One manager who has excelled in this area over several market cycles is Mike Prentis, whose BlackRock Smaller Companies Investment Trust has more than doubled the gains of its sector since he took charge 15 years ago.

However Prentis, who also manages the Throgmorton Trust, said that while smaller companies are certainly capable of outperforming their larger peers, particularly during periods of cyclical recovery, he warned this is not something that investors should take for granted.

"If you're a good stockpicker you can do very well, but if you get it wrong you can lose money quite quickly," he explained.

FILE

MANAGER: **Mike Prentis**
LAUNCHED: **01/05/1906**
DISCOUNT/PREMIUM: **-13.6%**
OCF: **0.69%**
FE CROWN RATING:

The trust's investment approach is straightforward and effective, aiming to invest in growth companies with the potential to become much larger.

Its core holdings stick to stringent criteria, including: a proven management team, strong market position, clear record of earnings growth, good conversion of earnings into cash, and sound balance sheet. As a result, they have fared well across a range of differing economic conditions.

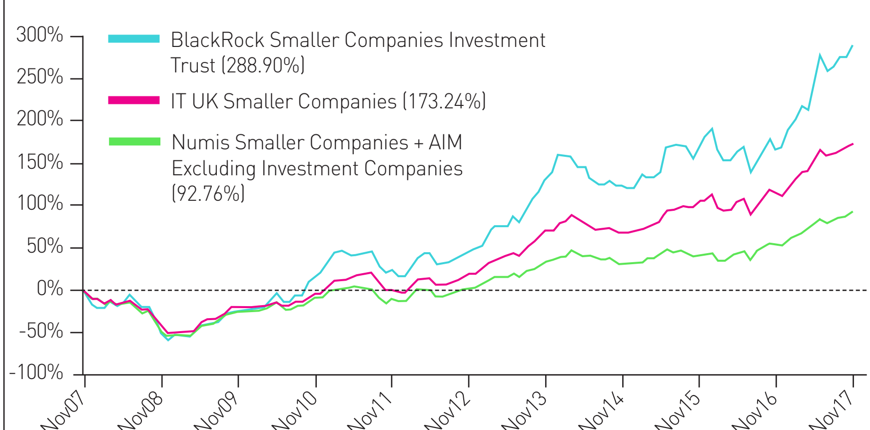
Prentis takes a disciplined approach, only selling out of stocks if fundamentals or investor perceptions change or when recovery stocks have rebounded. The manager said he rarely sells out based on valuations.

Some investors have recently begun to shy away from the UK small- and mid-cap space due to its perceived correlation to the domestic economy and fears relating to Brexit. However, Prentis has positioned his portfolio so that half of its revenues are generated overseas, which will benefit if economic woes translate into further sterling weakness.

The manager is also aware of other risks associated with the sector and so ensures he considers the size of new holdings, maximum position size, percentage of equity held and diversification. As such, the portfolio has around 170 holdings. It also has significant underweights to sectors with greater consumer exposure which are at threat from rising inflation and low wage growth, squeezing incomes.

The trust has made 288.9 per cent in the past 10 years, compared with 173.24 per cent from the IT UK Smaller Companies sector and 92.76 per cent from the Numis Smaller Companies + AIM ex Investment Companies index. ●

PERFORMANCE OF TRUST VS SECTOR AND INDEX OVER 10YRS



Source: FE Analytics

Trust

EDINBURGH INVESTMENT TRUST

Mark Barnett's trust is trading at a wider discount than its sector average, even though it is a top-quartile performer since he took charge

TRYING TO TIME THE MARKET IS WIDELY ACCEPTED as something of a fool's errand, but when a trust with a respected manager and excellent long-term track record is trading on one of the widest discounts in its sector, it is a different matter.

This is the case with FE Alpha Manager Mark Barnett's Edinburgh Investment Trust, which has slipped on to a wide discount following a period of underperformance.

The four crown-rated trust invests primarily in UK securities (with up to 20 per cent overseas) and aims to increase NAV in excess of the FTSE All Share and dividends in excess of inflation over the long-term.

Barnett is cautiously positioned even though corporate earnings growth has been strong across a number of sectors in 2017. This is because he is concerned the market has priced in the benefits of a weak pound while overlooking the numerous macro risks.

In a recent note, research house Killik said: "The manager is sceptical of the need to raise rates aggressively in the short term, principally due to the absence of a strong backdrop of sustainably higher levels of inflation."

"The aim is therefore to invest, with sensible diversification, in companies with the prospect of making money in absolute terms, either driven by growing dividends or from companies that can improve or transform their financial prospects regardless of the shifting economic weather."

Edinburgh Investment Trust has struggled over the past year, making just 11.91 per cent compared with 18.4 per cent from its IT UK Equity Income sector and 15.92 per cent from its FTSE All Share benchmark.

It has done even worse over the past six months, losing 2.66 per cent – this means it has made just 3.65 per cent year-to-date, one of the lowest returns in the sector.

However, the trust has made 42.22 per cent since Barnett took over from Neil Woodford back in 2014 – a top quartile return.

For investors worried that this track record is not long enough from which to draw any conclusions, they should take note that the Perpetual Income and Growth Investment Trust, which Barnett has managed since 1999, is a top quartile performer in the sector over the past decade.

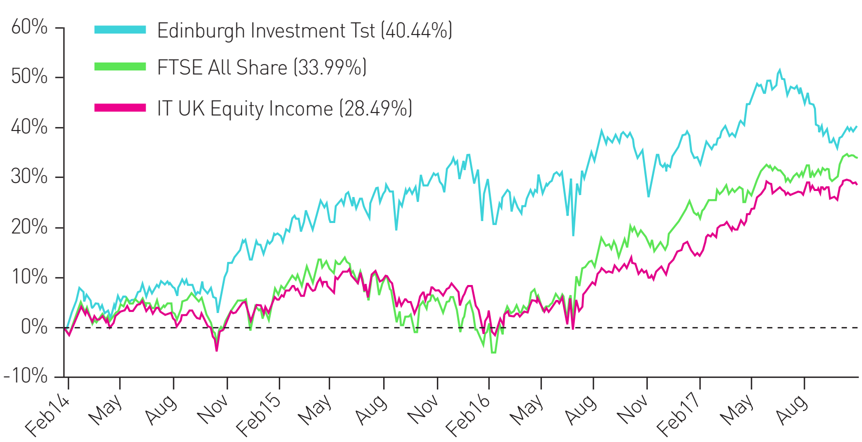
Edinburgh Investment Trust is currently on a discount of 7.5 per cent, according to the latest data from the Association of Investment Companies (AIC), compared with 5.15 and 2.6 per cent from its one- and three-year averages. The sector average currently stands at 4 per cent.

The trust is currently yielding 3.6 per cent, which was 1.1 times covered by earnings last year. ●

FILE

MANAGER: **Mark Barnett**
LAUNCHED: **08/02/1952**
DISCOUNT/PREMIUM: **-7.5%**
TER: **0.6%**
FE CROWN RATING:

PERFORMANCE OF TRUST VS SECTOR AND INDEX OVER MANAGER TENURE



Source: FE Analytics

ON THE RISE

The Japanese market is rallying after years in the doldrums, but have long-term investors missed out on the easy gains? **Adam Lewis** finds out

AS A COUNTRY IN WHICH TO SAVE FOR YOUR RETIREMENT, Japan may not top the wish-lists of many investors.

With an ageing population, years of moribund economic growth, deflation and question marks over the effectiveness of government reform, it has become all too easy to dismiss the case for investing in the east Asian nation. So often it has promised to deliver, and so often investors have been left disappointed.

ABENOMICS

However, there are signs that things are genuinely beginning to change and that allocating a significant proportion of your retirement pot to Japan may not be as crazy as it sounds.

The strength of Prime Minister Shinzo Abe's victory in October's snap election exceeded expectations, with the Liberal Democratic Party (LDP) securing half the number of lower house seats. This win was greeted as good news for Japanese equities, although some commentators were quick to point out that Abe's third straight election win owed more to the feeble opposition than it did to his own strength.

While sagging approval ratings for Abe's administration suggest the Japanese electorate is still far from convinced by his "Three Arrows" economic policy, or "Abenomics" as it is more commonly known, markets are still racing ahead, with the Nikkei 225 index trading at a two-decade high. Meanwhile, corporate earnings have recovered strongly from the second half of last year and the latest quarter produced a near 30 per cent increase in net profits.

ONE DIRECTION

Japan's economy also continued to expand in the second quarter of 2017, which Russ Mould, investment director at AJ Bell, notes is the sixth straight period of growth. This is the longest run in a decade, the best sequential rate of improvement for more than two years and the third longest rate of economic expansion in the post-war period.

"In addition, the Tankan, the major quarterly corporate sentiment survey, offered a 10-year high reading in early October for both large and smaller manufacturers, while the number of firms citing labour shortages reached levels not seen since 1992," he says.

"The Nikkei seems to track the Tankan (or vice-versa) so any sustained upturn in corporate confidence could mean that huge piles of corporate cash will start to finally circulate, potentially benefiting the economy and stocks alike."

So has this translated into fund returns? Over the last 12 months the IA Japan and Japanese Smaller Companies sectors have delivered 11.24 per cent and 14.37 per cent respectively, while over five years – encompassing the period Abe has been in office – these returns have surged to 120.98 and 172.19 per cent.

SURPRISE TO THE UPSIDE

But what about over longer periods? What about the sort of time lengths those in the accumulation stage of their pension would be committing their money for? Well for Japanese

PERFORMANCE OF SECTORS

Sector	1yr (%)	3yr (%)	5yr (%)	10yr (%)	20yr (%)
IA Japan	11.24	65.69	120.98	104.48	155.92
IA Japanese Smaller Companies	14.37	87.02	172.19	187.26	428.48

Source: FE Analytics

Smaller Companies, the numbers make the most compelling reading, with the sector up 187.26 per cent over 10 years and 428.48 per cent over 20. The numbers aren't quite as dramatic for the wider Japan sector, although gains of 104.48 per cent and 155.98 per cent aren't as terrible as many people might have thought, especially after all those false dawns.

traditionally has not paid much in terms of income, but that is all changing. Companies are more focused on shareholder returns and are running companies for the interests of investors. This is demonstrated by the fact that the capital returned to shareholders through dividends and share buybacks has reached record levels over the past three years, with 2017 expected to continue the trend."

Lowcock adds the region is also slowly reforming, with Abenomics beginning to have an impact in terms of workplace reforms and corporate governance improvements.

The question then that follows, is that for those who have not invested and enjoyed the rally of the last five years, is now a good time to get involved?

"There is a temptation to think that you have missed the boat, but this is not necessarily the case," says Mould.

"After all, the Nikkei is still more than 40 per cent below its (admittedly overblown) all-time high of 1989, which is a marked contrast to say the UK or US which stand at, or just below, their highest ever marks."

Valuation therefore, adds Mould, is one thing that still stands in the Japanese market's favour. "At least a forward P/E multiple of around 14 times and a price-to-book multiple of 1.3 times, based on analysis from Société Générale, suggests there is maybe some select value to be had."

STILL CHEAP

Lowcock says Japan's 14.3 times P/E compares favourably to the 18.1 times of the US and an average of 16.6 times for developed markets. He notes Japan's average P/E ratio since 2004 is 15.4.

"The Nikkei is still more than 40 per cent below its all-time high of 1989, which is a marked contrast to the UK or US"

"One of the most important factors to consider in retirement is spreading your risk and diversifying your investments," says Adrian Lowcock, investment director at Architas. "If you have not done so beforehand, then as you approach retirement would be a good time to do it."

ALL CHANGE

Lowcock says there are two reasons to do this. The first is that any falls in your investments will be felt most keenly just before you stop working, as you will not have time to wait for the market to rebound. Second, he says investors need to ensure that growth continues so they do not run out of money later on.

"Japan is rarely spoken of in the context of retirement planning," he says, "It

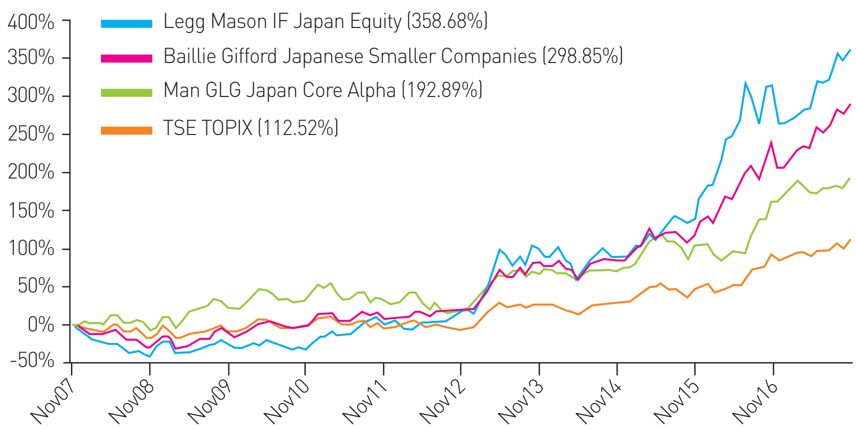
"Despite reaching a 21-week high recently, Japanese stocks remain cheap compared with the market's history as earnings growth has supported the market," he says. "Unemployment is now about 3 per cent and real wages, after inflation, are starting to rise for the first time since 2010, where they spiked following a big drop during the financial crisis."

HANDS ON

When it comes to Japan funds, investors have a number of choices, with 62 products in the IA Japan sector and seven in IA Japanese Smaller Companies. In terms of saving for retirement however, Lowcock says going active is key.

"Active management matters in Japan as the structural reform will have a big impact on different sectors at different times and the opportunities they create could drive performance over the short and medium term," he says. "Companies that are unable to reform themselves could be seen lagging behind."●

PERFORMANCE OF FUNDS VS INDEX OVER 10YRS



Source: FE Analytics

The alpha choice

MAN GLG JAPAN CORE ALPHA

LOWCOCK DESCRIBES MANAGER STEPHEN HARKER as a contrarian investor who uses valuation measures including price-to-book, dividend yield and P/E to identify out-of favour stocks. "He selects companies with strong fundamentals where he believes there is the opportunity for a turnaround," says Lowcock. "The portfolio is currently positioned to benefit from a stronger economy in Japan with exposure to cyclicals and financials." The £2.1bn fund is ranked second quartile over one and three years and first quartile over five.

The small cap option

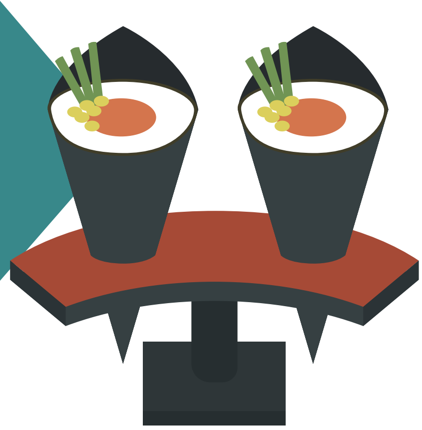
BAILLIE GIFFORD JAPANESE SMALLER COMPANIES

LOWCOCK SAYS THE £468M BAILLIE GIFFORD JAPANESE SMALLER COMPANIES FUND, managed by Praveen Kumar, benefits from the group's expertise in Japan. "The fund looks to invest in companies with above growth potential," he says. "Kumar invests on a three-to-five year horizon and investments include companies with innovative business models, disrupters, companies that challenge traditional Japanese practices or firms with growth from overseas." The fund tops the IA Japanese Smaller Companies sector over three and five years, with returns of 110.24 per cent and 227.65 per cent, respectively.

A roll of the pachinko ball

LEGG MASON IF JAPAN EQUITY

TOP OF THE IA JAPAN SECTOR OVER FIVE AND 10 YEARS, with returns of 287.20 and 358.68 per cent respectively, is Hideo Shiozumi's £746m Legg Mason IF Japan Equity fund. Based in Tokyo, Shiozumi is a bottom-up, growth-orientated stockpicker. He focuses on exploiting the investment potential created by the belief that Japan is in the process of two structural changes to its economy from regulated to deregulated and from manufacturing-orientated to service-orientated: the "New Japan". The fund has been extremely volatile, however, and with a maximum drawdown of 82.71 per cent since launch, it is not for the faint-hearted.



TAKING BACK CONTROL

John Blowers highlights some of the major considerations for investors who want to take full responsibility for their retirement income

AS RECENTLY AS 2014, MOST UK RETIREES found that the default – and least intimidating – method of deriving an income in retirement was to purchase an annuity. There are a number of different types of annuity but they all operate on the principle that they will pay you a defined income until you die.

The big advantage with an annuity is you know where you stand as it will last as long as you do. Yet the disadvantages are numerous and we have seen an 80 per cent decline in their popularity in the last three years. The key disadvantage is that as soon as you buy an annuity, you lose exposure to any market gains. An actuary will work out how long you are likely to live and divide up your pension pot to last over your predicted lifespan. Sometimes people live longer than these forecasts and sometimes for less, but actuaries are canny creatures and

will ensure they are unlikely to lose money on these products.

Consequently, the income you will be offered from an annuity is likely to be far less than you will receive if you leave your retirement fund invested and draw down cash from your pot when you need it.

The big life and pension companies – which previously offered annuities to customers at retirement – are now focusing on offering drawdown solutions. It would be wrong to make sweeping assumptions, but it is worth being aware that pension company charges can be higher than investing the money yourself. Most pension companies invest in third-party funds and consequently there is an extra layer of costs that inevitably gets passed on to the customer.

Robo advice can be very useful if you notice that you have started walking into a room, but aren't quite sure why

Additionally, just like in the bad old days of annuities, it can make a massive difference if you shop around when you approach retirement. Most retirees used to accept the annuity offer from their incumbent pension provider rather than looking at the entire market – often cheating themselves out of thousands of pounds.

The same principle applies when you enter drawdown. You should conduct thorough research into the charges that your pension provider levies and look around the market to see if you can obtain the same service for less.

It is worth highlighting how important the effects of annual charges are to your pension. At retirement, your pension pot should be at its zenith. I can't stress enough that every fraction of a percentage point you can save in charges will make a big difference to your ultimate returns.

•••

Every fraction of a percentage point you can save in charges will make a big difference to your ultimate returns

Some basic maths – over 20 years, £100,000 will grow to £265,330 assuming 5 per cent average growth per annum including charges. If your charges are just 0.20 per cent more (so your growth will be 4.8 per cent per annum), your investments after 20 years will be £255,403 – almost £10,000 less. If you're paying an extra 0.6 per cent in charges, the same portfolio will be worth £236,997 or nearly £29,000 less.

It's an industry mantra – performance can't be predicted, but charges can, so do whatever you can to keep these as low as possible.

When you are in retirement, you will be taking money out each month and additional charges will exacerbate the depletion of your pension pot, leaving less behind to keep on accumulating.

In terms of a checklist when it comes to entering drawdown, you need to consider the following:

- The overall cost of the funds in your pension pot (check the ongoing charges figure)
- Whether it is cheaper to make direct investments in your portfolio rather than leaving your money in a pension fund, which may charge more
- Additional costs, such as platform fees, discretionary management charges, or financial advisory fees
- Whether there are cheaper funds (for example ETFs) that can achieve the same results as the current products in your pension
- The administrative cost of your SIPP (if you are using one for drawdown)

What you may find is that, rather than using your original pension fund manager, you can achieve similar or better results by managing your own pension fund in drawdown. But use the checklist above to ensure that any initial savings aren't swallowed up by additional fees such as trading costs, administration or platform fees.

Another important consideration to think about is whether you will actually spend the time needed to manage your portfolio effectively and have the necessary knowledge to make informed decisions.

Although we have stressed the importance of cost, it is pretty irrelevant if you have picked some poorly performing investments.

The other thing to bear in mind is that – how shall we put this? – sometimes people begin to lose their "faculties" in old age, which may have a bearing on their portfolio.

Finally, there are some new kids on the block, alternately called discretionary fund managers or robo advisers. Discretionary fund managers have been around for decades, but historically, they have been pretty pricey, rather exclusive and have typically catered for the top end of the market.

More recently, robo advisers have sprung up with a technology-led approach to help investors into an appropriate portfolio to suit their needs. This typically means actively managed using exchange traded funds, which come with lower costs.

Although these offerings are broadly similar to managing your own investments, they benefit from expert ongoing management, which means you don't have to fret about rebalancing your own portfolio.

This can be very useful if you notice that you have started walking into a room, but aren't quite sure why.

Investing is definitely a case of horses for courses. There are opportunities to make a few mistakes while you are building your portfolio, but in retirement there is little margin for error.

Small mistakes, such as paying too much in charges, taking out too much cash early in retirement or poor fund selection can accelerate the depletion of your pension pot.

Remember you have a finite amount of money, an increased lifespan and few opportunities to top up your pension pot in retirement, so use it wisely.

Keep as much invested for as long as possible, don't overpay on charges and if you're nervous about managing your own portfolio, why not leave it to the experts? ●

STOCKPICKER

Evenlode Income's **Hugh Yarrow** names three stocks that streamline their customers' businesses, helping them cope with a changing world

THE THREE D'S – HIGH GLOBAL DEBT LEVELS, ageing demographics and technological disruption – have been signature motifs of our age. They are key drivers of the macroeconomic backdrop and present investors with opportunities and challenges.

These disinflationary trends provide a challenge for companies in all industries in terms of pricing power and overall growth rates. And, while no business is immune, those willing and able to invest in innovation can evolve with the market over time.

Those companies harnessing technological change enable their customers to cope with a changing world by offering products and services that increase efficiency and productivity. Software analytics and proprietary data are often key planks in this strategy and some of the best examples are in the business-to-business information and software sector.

RELX

RELX'S CHIEF EXECUTIVE ERIK ENGSTROM summed this theme up when he described his company's strategy. Its priority is the organic development of increasingly sophisticated information-based analytics and decision tools that drive higher value for its customers. As recent results for this group of companies demonstrate, delivering such services tends to command pricing power and good customer loyalty, with renewal rates on subscriptions often 80 to 90 per cent or more.

rotork

EVEN IN THE TRADITIONAL ENGINEERING SECTOR, a similar theme is emerging for companies such as Rotork, whose customers are becoming more aware of the benefits that data analytics and interconnectivity can bring to their operations. Rotork announced an increased focus on R&D with the aim of developing more products to address these needs. The ability to install smart feedback systems that enable predictive maintenance and ensure critical components don't fail is a powerful value proposition.

informa

INFORMA HAD BEEN UNDERINVESTING UNTIL the arrival of the new management team, which prioritised investment over margin expansion – a move that is paying off. The company owns a strong portfolio of business-to-business media brands (academic journals, digital analytics, trade exhibitions and so on) which enjoy high recurring cash-flow and attractive long-term growth potential. Informa's dividend is covered by cash flow and the latest increase was 4.2 per cent.

BAILLIE GIFFORD JAPAN

Aviva Investors' **Thomas Wells** is using this fund to complement an existing holding in GLG Japan Core Alpha

IT HAS BEEN NEARLY A YEAR SINCE WE BOUGHT BAILLIE GIFFORD JAPAN, the most recent addition to our multi-manager range.

And what an eventful year it has been! Early excitement surrounding the election of Donald Trump soon fizzled out as the reality of Washington politics began to bite. Ten-year US treasuries yo-yoed by 30 basis points, only to finish the year pretty much where they started – a performance that defied both the bond bull and bear pundits. Value sectors, having initially outperformed, have now fully reversed course. Japanese banks, for example, had at one point outperformed by 20 percentage points but are now flat with the Topix. Such significant market moves highlight the importance of blending different investment styles; this is something that we have learnt to do in Japan.

Last year, the deep-value contrarian fund GLG Japan Core Alpha represented our sole Japanese equity allocation. Although it outperformed the Topix index by 9 percentage points over the course of 2016, it was a rollercoaster ride with the fund at one point trailing the wider market by 12.5 percentage points.

We remain convinced that it is an exceptional fund, but this experience has taught us the benefits of blending GLG's value-orientated approach with that of a growth manager. Hence at the end of last year, we reduced our exposure to GLG Japan, taking some profits and reallocating the proceeds to Baillie Gifford Japan.

While GLG relies heavily on buying cheap out-of-favour stocks and patiently waiting for mean reversion, Baillie Gifford focuses on detailed and fundamental bottom-up research to unearth good-quality companies that offer high return on equity. Both funds have a strong performance track-record; however, as a consequence of their investment styles, their return profiles are uneven. So it is helpful that they both have parent organisations that are supportive when times are tough. Furthermore, both funds are run by experienced, well-resourced teams that have a patient, long-term approach.

The funds' differing investment strategies are highly complementary, creating a stable return profile for our investors. The Baillie Gifford fund has outperformed the Topix by 9 percentage points so far this year, more than offsetting GLG's 6 percentage points' underperformance and validating our decision to diversify our exposure in Japan.

We continue to favour Japan and with exposure to two excellent fund managers, we do not anticipate making any further changes in this market.●

Thomas Wells *is a fund manager on Aviva Investors' multi-asset range*

TRUSTNET magazine

DECEMBER PREVIEW

Where did it go?

The next issue of Trustnet Magazine will carry our traditional end-of-year review and, while 2017 has so far been a lot less eventful than the year that preceded it, it has still contained plenty for investors to sink their teeth into.

More important than looking back, however, is looking forward, as we give our outlook on every major sector and region in 2018 and find out where the experts will be putting their money.