TRUSTNET magazine

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KEEP ON RUNNING

CAN THE BULL MARKET LAST?

THROWING IN THE TOWEL
How to protect your profits

BIT BY BITCOIN
A beginner's guide to cryptocurrencies

TIMING CRISIS
Why you shouldn't call the market peak

ISSUE 36

CREDITS

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EDITOR'S LETTER

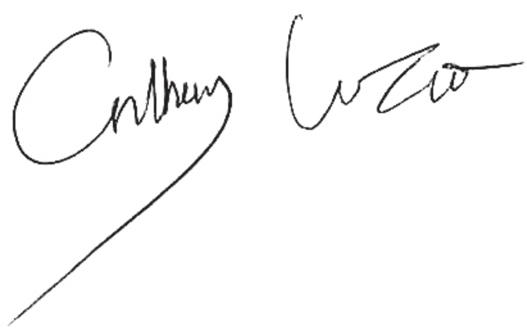
FOR THE FIRST TIME IN MY CAREER AS A FINANCIAL JOURNALIST, we are starting the year with virtually everyone in agreement that markets are in a bull run and will end this 12-month period higher than where they started. As you can imagine, this naturally gives me cause for concern, and not just because a sharp correction makes for an eye-catching and effort-free headline.

My first experience of a market rally came back in 2011 when I started at FE and it convinced me to invest a significant chunk of my life savings into equities – just in time for my first experience of a market crash, as the sovereign debt crisis hit. What struck me back then – and every time a correction has struck ever since – is how few, if any, people saw it coming. As a result, this month's cover story examines three of the biggest threats to the bull market to see whether it really is too good to be true.

If you are erring on the side of caution, Daniel Lanyon offers advice on throwing in the towel and protecting any profits you have already made, but you should bear in mind that taking on too little risk can be just as harmful to your wealth as taking on too much – Adam Lewis finds out this is a fate that has befallen investors who have made IA Targeted Absolute Return the top-selling sector in two of the past three years. Meanwhile, John Blowers notes that trying to time the market can be the most damaging tactic of the lot.

In our final article on the bull run, Rebecca Jones presents a beginner's guide to cryptocurrencies – explaining why they may mark a shift in the global monetary system, even if Bitcoin's bubble has already begun to deflate. Finally, in our regular columns, Unicorn UK Growth's Fraser Mackersie names three stocks that provide the "picks and shovels" of the online retail boom, while River and Mercantile's Tamsin Evans reveals why she has bought the iShares Edge MSCI World Quality Factor UCITS ETF.

Enjoy reading,



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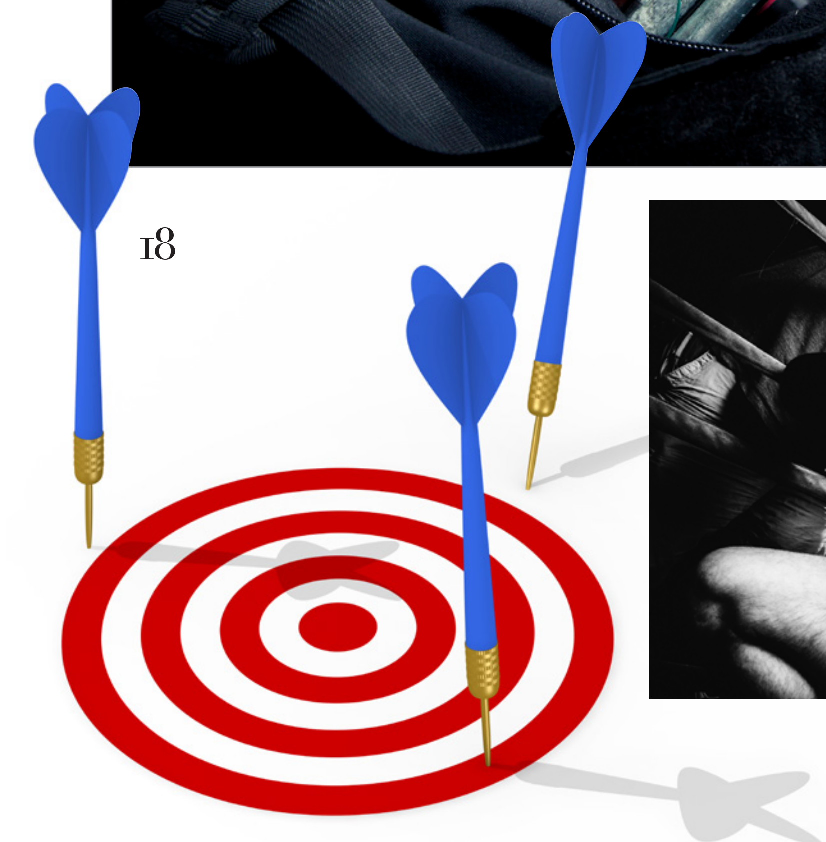


KEEP ON RUNNING

Anthony Luzio examines what have been cited as three of the biggest threats to the bull run

LOOKING AT THE REASONS WHY THE CURRENT MULTI-YEAR BULL MARKET can keep on running, it is difficult to say anything you might not have heard already.

In an environment where all major economies are putting in a sustained period of consistent growth for the first time since the financial crisis, strong earnings figures have made equities look cheaper on a P/E ratio than they were a year ago, despite markets regularly breaching new highs over this time – the S&P 500 alone closed at record levels more than 60 times in 2017, for example.

However, pride comes before a fall, or so the saying goes, and the final stage of the bull run before the inevitable crash is said to be a state of euphoria.

So, have levels of optimism reached such levels that things have started to look too good to be true?

INFLECTION POINT

Chris Godding, chief investment officer at Tilney, shares the consensus view on the bull run, which he admits is a "dangerous place to be" – but only if markets are at an inflection point. According to Gary Potter, co-head of multi-manager at BMO Asset Management, the obvious inflection point at this moment in time is a reversal in the liquidity provided by central banks.

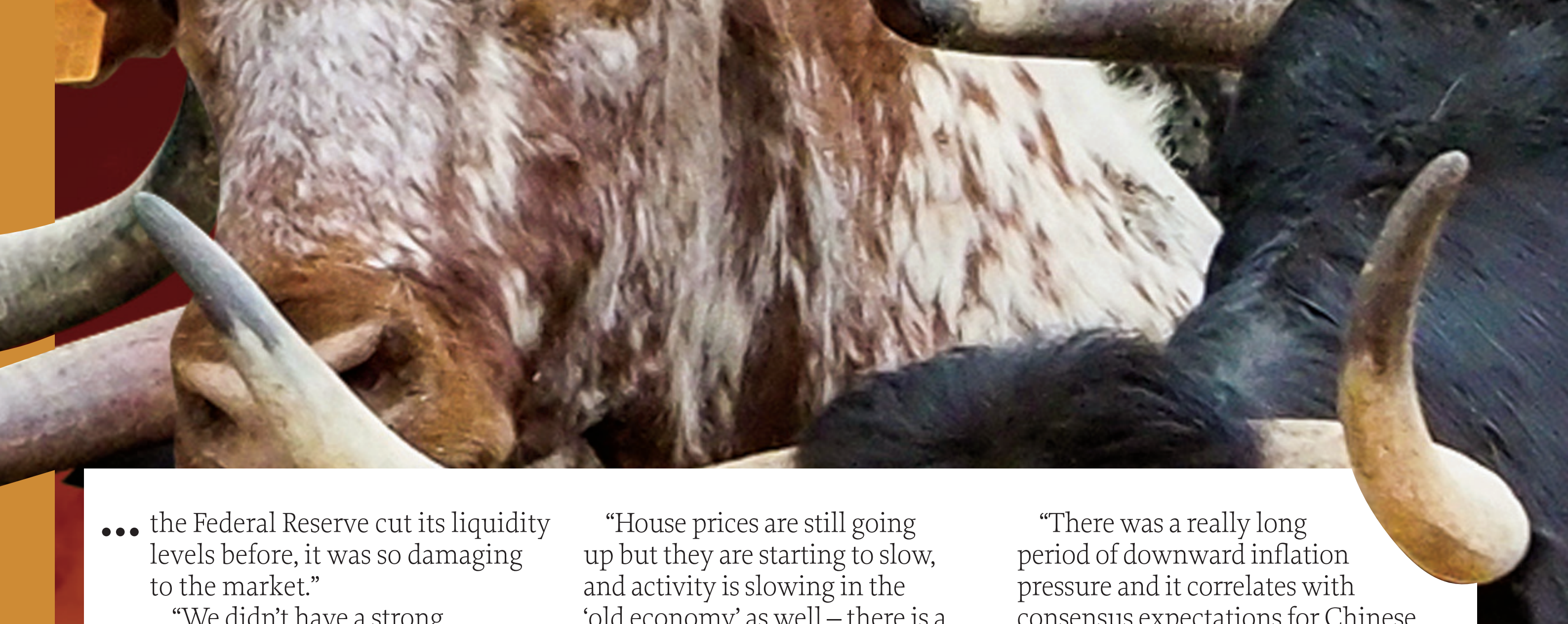
"It is inconceivable to think that – with all the QE that has gone on in the past seven years and with the way asset prices have risen – if they put that into reverse, nothing will happen," he adds.

However, Godding says the first thing to note is that with the European Central Bank and the Bank of Japan continuing to expand their balance sheets, there is going to be more liquidity added to the system this year than there was in the last.

He adds that what is even more important is while the Federal Reserve's decision to reduce its balance sheet in 2014/2015 correlated closely with a fall in the MSCI World index, there are a number of factors supporting equity markets today that weren't in place back then.

Godding points to the economical equation MV = PQ, in which monetary supply, M, multiplied by the velocity of money, V, is equivalent to P, the price of goods and services, multiplied by Q, the quantity of goods and services.

"What we know as a fact is that M, the monetary supply, is declining," he says. "We therefore have to think about what is happening to the velocity of money in that system and this depends on other factors that didn't exist before, which is why when ...



... the Federal Reserve cut its liquidity levels before, it was so damaging to the market."

"We didn't have a strong economic growth scenario, high consumer confidence, high business confidence. We didn't have low unemployment and the European area was struggling."

Godding adds that the velocity of money reflects confidence in business conditions and that as the amount of money in the system declines, the critical issue is whether its velocity continues to rise.

"Given what we have seen so far, it's very difficult for us to assume that that velocity, that confidence level, will not continue to be quite buoyant," he says. "It will compensate for the lack of growth in liquidity in the system in 2018."

MADE IN CHINA

Ever since China's ascension to the position of global economic superpower, there have been worries that any "hard landing" could have a similar impact on markets to what was seen in 2008. It may give cause for concern then when Trevor Greetham, head of multi-asset at Royal London Asset Management, says there are signs of tightening in the world's second-largest economy.

"Although official interest rates haven't been hiked in China, the market bond yield has been rising," he explains.

"House prices are still going up but they are starting to slow, and activity is slowing in the 'old economy' as well – there is a tightening in the pipeline."

"This is something that is more likely to become a problem later in the year than now, but it is a potential risk and if this happens, then people will panic."

However, rather than acting as a threat to the bull run, Greetham says this could actually prolong it.

In the past when unemployment in the US has reached the low levels that it currently occupies, he says this has resulted in wage inflation and subsequently an uplift in interest rates – which is when recessions happen.

> **"If there is a tightening in China, the market could pull back a long way. But that would be a good correction to buy"**

However, wage inflation currently stands at about the 2 per cent mark, which is where it has been for the past five years.

Greetham says this is because wage inflation is more a function of cost-push dynamics rather than demand-pull ones.

"And what's been really notable over the past decade or so is commodity prices have been on the floor the whole time," he adds.

"You've had this long period of weak commodity price inflation, that's meant it's been hard to get that wage inflation going because you haven't had that cost-push."

The manager adds the reason for that weakness in commodity prices is the economic picture in China.

"There was a really long period of downward inflation pressure and it correlates with consensus expectations for Chinese growth. So China's slowdown over the past eight or nine years has helped wages to stay low."

"If there is a tightening in China, it won't be nice, the market could pull back a long way. But that would be a good correction to buy."

OUT ON ITS OWN

One of the reasons given for why markets are not excessively valued is that on a cyclically adjusted price to earnings (CAPE) ratio, global equities are only slightly more expensive than their long-term average. Jason Hollands, managing director at Tilney, notes there is one anomaly here, however – the US, which trades on a CAPE ratio of 28.37x compared with 20.59x from its long-term average.

"US equities are particularly stretched compared with longer term trends, in large part due to the high representation of technology and new media companies in the S&P 500 index. This is particularly relevant for the great many investors who chose to access the US market through low-cost S&P 500 index tracker funds and there is a case for shifting at least some exposure from these into funds or ETFs that tilt towards more conservatively valued and cyclical businesses," he says.

However, while tech stocks such as the FAANGs [Facebook, Apple, Amazon, Netflix and Google] have pushed up valuations across the US index, there are other managers who say the market has failed to grasp their enormous potential.

In a recent article on FE Trustnet, Tom Slater, co-manager of the Scottish Mortgage Investment

Trust, said: "The dramatic changes set into motion by the giant tech companies on the west coast of the US and the east coast of China are still largely underappreciated, despite the size and the scale they have reached already."

John Bilton, global head of multi-strategy at JP Morgan Asset Management, agrees with him, saying technological advances could help to prop up the bull run for a sustained period from here and that investors could miss out on significant gains if they try to apply outdated views on valuations to markets over the long term.

"This is the first year where we have had cause to call out potential upside risks and technology is one area we have focused on a great deal," Bilton explains. "There has been a lot of focus on technology and many commentators have been trying to understand what it may or may not do to the industry, to the workplace, to society in general."

"Productivity has been remarkably low since the financial crisis," he continues. "It is not unprecedented, but it is very low. And technology is often associated with improvements in productivity. We predict the large number of technological innovations that will become mainstream in the coming decade will accrue positively, improving productivity over the longer run."

THE OTHER SIDE OF THE COIN

Not everyone is convinced by these arguments, however. FE Alpha Manager Neil Woodford says the most dangerous words in the world of investment are "it's different this time" and is convinced we are firmly in bubble territory.

"Whether it's Bitcoin going through $10,000, European junk bonds yielding less than US treasuries, historic low levels of volatility or smart beta ETFs attracting gigantic inflows – there are so many lights flashing red that I am losing count," he says.

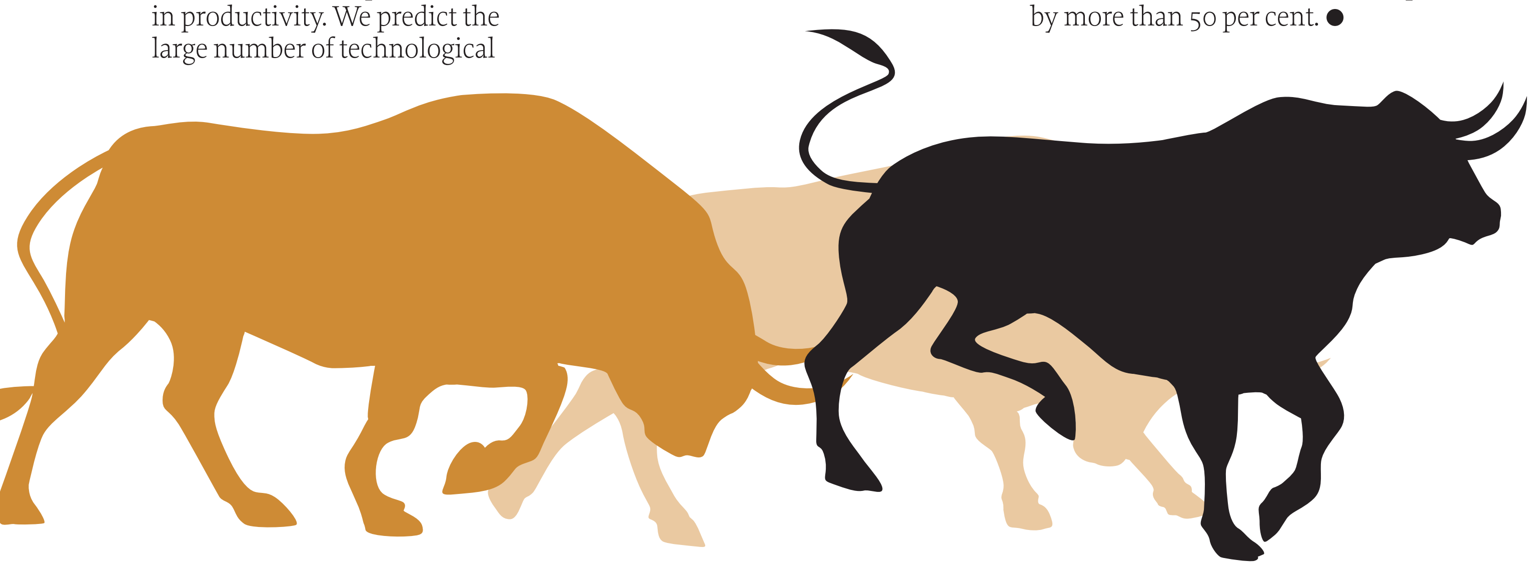
While Woodford's short-term performance has been poor, he has a habit of being on the right side of history in previous crises – he avoided tech stocks in the dotcom bubble in 2000 and banking stocks in the financial crisis in 2008.

Jason Hollands, managing director of Tilney, says that while every time a market index tests new highs it provides a cue for perma-bears to warn of an impending crash, in reality corrections are extremely difficult to predict with any accuracy.

"Long-term investors should try not to get too distracted by such attempts at tea-leaf reading and instead focus on well diversified strategies that balance risk and opportunities," he adds. "Bull markets don't die of old age, they are typically stifled by either a deterioration in economic fundamentals, policy errors by central banks (either tightening too aggressively or allowing asset price bubbles to get out of control) or triggered by unforeseen shock events."

It is also worth considering the words of Andrew Roberts, RBS's research chief for European economics and rates, who said: "Sell everything except high quality bonds. China has set off a major correction and is going to snowball. Equities and credit have become dangerous, and we have hardly begun to retrace the 'Goldilocks love-in' of the last two years."

This recommendation was made almost exactly two years ago, since when the MSCI Global index is up by more than 50 per cent. ●



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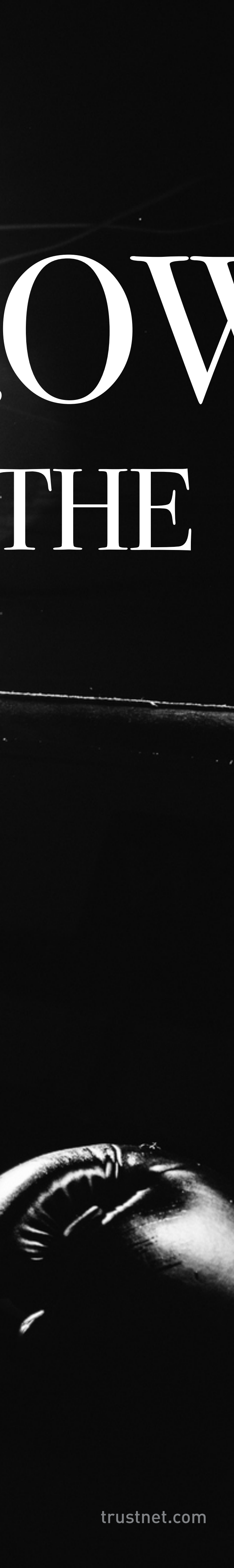


OWING *in* THE TOWEL

Daniel Lanyon finds out how investors should go about protecting the profits they have made from the "most hated bull run in history"

BOXING LEGEND MIKE TYSON IS NOT WIDELY KNOWN FOR HIS INVESTING PROWESS – he went bankrupt after losing a $300m fortune – but knows a thing or too about unpleasant surprises and how they can knock you off course. His most famous quote – "everyone has a plan until they are punched in the face" – is just as relevant to market crashes as it is to going 12 rounds with a heavyweight champion.

Few saw the financial crisis coming before they were sitting on huge losses amid rapidly falling markets, as evidenced by a quick look at national newspaper archives from a decade ago. Among the stocks tipped at the start of 2008 was HSBC, with one article referring to it as a top "buy", having fallen 20 per cent in 2007. It wasn't. It went on to fall a further 65 per cent and is yet to recover its 2008 opening price. In the same article, every expert polled predicted the FTSE 100 would hold its own through 2008 or rise from 6,457 points. In fact it recorded its biggest annual decline since its inception in 1984, ending the year down 31.3 per cent. If you fail to prepare, prepare to fail.

Now though, 10 years on from one of the worst financial crises in history, investors are facing their most difficult dilemma yet. Nobody knows for certain if a crisis is about to hit but many fear one could be on its way and rising inflation is leaching away spending power.

Simon Evan-Cook, multi-asset fund manager at Premier Asset Management, says that while investors should always have one eye on downside protection, there are occasions when it is more important than ever – and now is one of those times.

CASH IS STILL KING, JUST

Cash is the basic portfolio anchor to protect value, says Jason Hollands, managing director of Tilney, but low interest rates and higher inflation – currently 3 per cent – mean it is losing money in real terms. Ben Conway, a fund manager at Hawksmoor, says cash has lost its crown but it is worth taking the small hit in real terms to benefit from ...

> **Among the stocks tipped at the start of 2008 was HSBC, with one article referring to it as a top "buy", having fallen 20 per cent in 2007. It wasn't.**

the "optionality" it affords in a correction and especially a crash.

Adrian Lowcock, investment director at Architas, adds that diversification, while holding a small amount of cash on the sidelines, is the best strategy to protect against the downside.

"While many may predict a market correction, few will actually get the cause or the timing right. Being diversified across a large number of assets means you will be better protected in the event of a correction and your portfolio will fall less than a more concentrated one," he says.

So where can investors turn to for diversification? In 2008 to 2009, the best asset to own was fixed income. In 2008 for example, the average fund in every sector lost money, while gilt funds generated positive returns. But will fixed income prove as useful in the next equity sell-off?

Evan-Cook says gilts are still the default setting for most institutional investors in a crash, but currently offer terrible value and look vulnerable. Rob Morgan, pension and investment analyst at Charles Stanley Direct, says it depends on what causes the crash.

"If it's much higher-than-expected inflation, then no: fixed income will be at the centre of the fall-out. If it is a stagnating economy, high-quality bonds could do well, though valuations are not attractive, relatively speaking, so their beneficial impact will not be as great as in 2007 to 2009," he says.

"If we do get a reappraisal of risk at some point in the markets, we may well see a synchronised slide in both equity and bond markets," Hollands warns.

Conway says diversification therefore now means looking beyond equities and bonds to other assets, particularly those available via investment trusts.

"We remain as defensively positioned as we have ever been," he says, and is using strategies in which risk is "idiosyncratic in nature and not dependent on the vagaries of central bank speak or the direction of liquid risk assets".

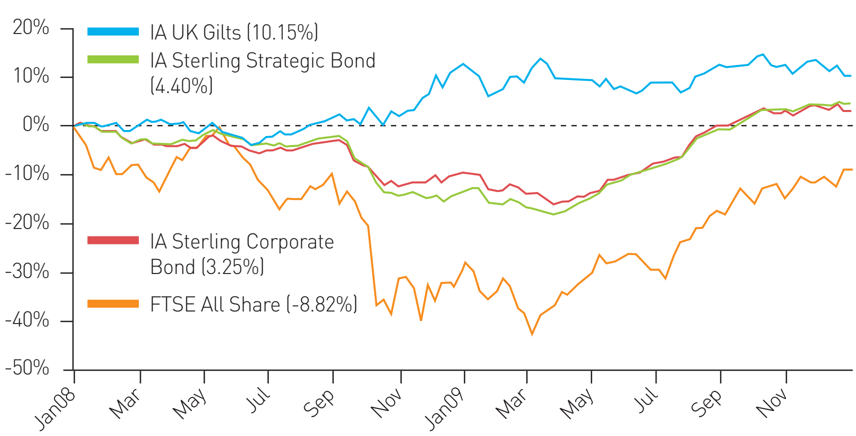
This has led Hollands to conclude low-volatility absolute return funds may provide the answer. He favours Invesco Perpetual Global Targeted Returns, a multi-strategy fund, and Threadneedle UK Absolute Alpha, a long/short equity fund.

Morgan agrees absolute return funds could provide some protection in an environment where most assets are falling, favouring Personal Assets IT and Newton Real Return as well as infrastructure and property funds.

"Gold – which I sense is rather unfashionable right now – could reassert itself as a dependable store of value," he adds.

With the new year upon us, diversification and a certain amount of downside protection should be on all investors' minds – as should the contention that all the preparations in the world may not be enough to prevent your portfolio from receiving a right-hook. ●

PERFORMANCE OF SECTORS VS INDEX IN FINANCIAL CRISIS



Source: FE Analytics

BIT BY BITCOIN

Rebecca Jones presents a beginner's guide to cryptocurrencies such as Bitcoin – and explains why they could mark a major shift in the global monetary system

THE RISE OF BITCOIN IS A UNIQUE PHENOMENON in the annals of financial markets. Created by a mysterious online entrepreneur known only as Satoshi Nakamoto in the wake of the financial crisis, Bitcoin was envisioned as a global currency that would be entirely free of central bank control and – more importantly – market manipulation.

This would be enabled by the technology behind it, the blockchain, which is an incorruptible ledger that tracks the creation of every Bitcoin and every transaction – hence the moniker "cryptocurrency".

To create Bitcoins, all you need is a computer: so-called "miners" simply download software that processes mathematical equations through their hardware, for which they are rewarded with Bitcoins – or infinitesimal fractions of Bitcoins as is the case today.

The earliest fiat currency-to-Bitcoin exchange rate was published on 5 October 2009, when $1 bought 1,309.03 Bitcoins, or rather one Bitcoin was worth $0.00076. (The potential gains of first adopters are eye-watering: more than $330m for a $20 initial investment, for example). The first real-world transaction came just over six months later, when Florida resident Laszlo Hanyecz paid 10,000 Bitcoins – worth $150m as of December 2017 – for two pizzas from Papa Johns.

The evolution of the currency from these early days has been fraught. Bitcoin remains mired in scandal thanks to its use on now defunct online drugs marketplace Silk Road, while high-profile thefts including $375m swiped from the holding account of Mount Gox – formerly one of the biggest online exchanges – have led to concerns over legitimacy and security.

These events have, however, proved to be short-term setbacks: since surpassing the $1 parity barrier in February 2011, Bitcoin's value has been on a sure (if highly volatile) journey north.

Endorsements from mainstream institutions including former Chair of the Federal Reserve Ben Bernanke and HM Treasury (then Chancellor of the Exchequer George Osborne invested the princely sum of £20 at an innovative finance conference in 2014) have reassured traditional investors, while Microsoft's move to accept Bitcoins as payment for video games in 2015 gave its early adopters somewhere to spend their hard-mined coins.

"When people ask about Bitcoin, I say it's like someone in 2000 asking if the internet is going to be big. Cryptocurrencies will be massive in 10 years"

The past year, however, has been the most momentous for the cryptocurrency. Mainstream acceptance has continued apace, with the Bank of Japan legalising Bitcoin as a method of payment in April as Wall Street goliaths proclaimed large stakes. These included former Goldman Sachs partner and billionaire Michael Novogratz, who in the same month declared to a Harvard Business School forum: "Ten per cent of my net worth is in this space. [The] best investment of my life."

The major catalyst, though, came in August when the currency "forked", creating a second form: Bitcoin Cash. The move was a result of a disagreement over the evolution of Bitcoin among its mining and development community and was initially viewed with scepticism by backers and traders alike. Despite an initial tumble in value after the split, the success of the operation ultimately initiated the biggest market rally seen for decades.

The second major catalyst for the currency – which sent it within a hair's breadth of $20,000 a coin in mid-December – was the Chicago Mercantile Exchange's decision to launch futures contracts in Bitcoin. Analysts say this has been the single biggest endorsement to date and marks the true beginning of the online currency's acceptance among the mainstream financial community.

There remains, however, a significant number of detractors.

•••

$150m
December 2017
=
Value of Bitcoins used to buy two pizzas in 2010

Jamie Dimon, chief executive officer of JP Morgan Chase, declared Bitcoin "a fraud" and said he would fire any employee he found trading it

These include Jamie Dimon, chief executive officer of JP Morgan Chase who in September declared Bitcoin "a fraud" and said he would fire any employee he found trading it; and Morgan Stanley chairman and chief executive officer James Gorman, who in November said the cryptocurrency was "by definition a speculative investment".

Others have included the Queen's bank Coutts, which said it had no plans to invest in the purely "sentiment-driven" asset, alongside as many analysts, traders, business professors and financial columnists you care to Google – it is safe to say the cryptocurrency remains deeply unpopular with the financial establishment.

What many analysts do seem to agree on, however, is that Bitcoin marks the beginning of what is set to be a major shift in the global monetary system. "When people ask about Bitcoin, I say it's like someone in 2000 asking if the internet is going to be big. Cryptocurrencies will be massive in 10 years," says Nick Kirrage, co-manager of the £2.1bn Schroder Income and £1.2bn Schroder Recovery funds. "Are you going to make money buying cryptocurrencies? Yes," he adds.

Kirrage, like many other investors, has his eye on the action outside of the Bitcoin frenzy. The number of new cryptocurrencies available has been ballooning and now stands at more than 1,300. Ethereum, Litecoin and Ripple are among the next big contenders, each employing unique technology with equally unique applications. The potential of cryptocurrencies is so promising that Italy is considering creating its own – the Itcoin – to make it more competitive within the eurozone, while there are rumours the Bank of England could do the same within a year.

So this, perhaps, is where the smart money is going in this space. As seen with the early dotcom pioneers of the 1990s, it may not be the individual product or company that sticks – but the concept. If central banks, governments and financial heavyweights such as Novogratz and Kirrage are right, cryptocurrencies could be how we all use money by 2028. ●

Fund

MAN GLG INCOME

Henry Dixon's value-focused fund has a habit of outperforming even when his style is out of favour

IT IS NO SECRET THAT GROWTH HAS BEATEN VALUE OVER THE LAST DECADE. However, that is not to say that value-focused strategies have automatically underperformed over this time – for example, one fund that has bucked this trend is Man GLG Income, which is a top quartile performer over one, three and five years and a second-quartile performer over 10.

While the portfolio underperformed in 2016 – which may raise eyebrows given the return to favour of the value trade – the Bank of England's rate rise helped it come roaring back last year, with a return of 27.55 per cent – making it the top performer in the IA UK Equity Income sector.

The fund's FE Alpha Manager Henry Dixon said that while Brexit remains a risk there is a chance that the Bank of England will continue to raise rates if inflation remains high – an event that few investors are pricing in.

"What you will find is when bond yields fall there is an element of balance sheet forgiveness," Dixon recently told FE Trustnet.

"Because the cost of borrowing debt is so unbelievably low, people have been getting a little complacent with regards to ever increasing amounts of debt in certain businesses."

The manager added that when bond yields are not either falling or at ultra-low levels, investors tend to focus more on company fundamentals including the strength of balance sheets.

As such, the fund should be well positioned if interest rates rise as it is invested in companies that are in a strong financial position.

Another feature that sets the fund apart from its peers is its flexibility – it invests in companies across the market cap scale, with 26.69 per cent in smaller companies and 8.95 per cent in micro caps.

While Dixon predominantly invests in UK companies, he can also hold continental European companies that derive a substantial part of their revenues from the UK, and has the ability to invest up to 20 per cent of the fund's assets in corporate bonds.

Ben Gutteridge, head of fund research at Brewin Dolphin, recently named Man GLG UK Income as the UK equity fund he is backing for 2018.

"When we look at the underlying characteristics of the fund we see both growth and value features and within those value characteristics a premium dividend yield to the market," he said.

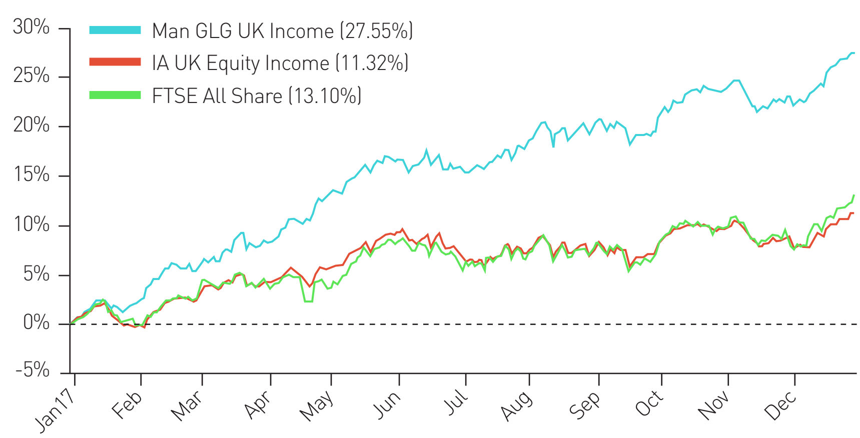
"The fund targets companies already uncovered by the team's Undervalued Assets process in addition to a focus on companies with materially stronger balance sheets where the potential for dividend growth is high."

The portfolio is yielding 4.16 per cent and has a clean ongoing charges figure of 0.9 per cent.●

FILE

MANAGER: **Henry Dixon**
LAUNCHED: **05/03/1999**
FUND SIZE: **£328.9m**
OCF: **0.9%**
FE CROWN RATING:

PERFORMANCE OF FUND VS SECTOR AND INDEX OVER 1YR



Source: FE Analytics

Pension

CHELVERTON SMALL COMPANIES DIVIDEND TRUST

This trust is the best performer in its IT UK Equity Income sector over three and five years

SMALLER COMPANIES-FOCUSED STRATEGIES ARE OFTEN ASSOCIATED WITH HIGHER RISK than their large-cap peers, due to concerns over liquidity and the higher rate of failure among firms further down the market cap scale.

As such, a small-cap focused trust may not immediately stick out as the safest option for pension investors. However, the five FE Crown-rated Chelverton Small Companies Dividend Trust offers an alternative strategy for investors who may have concerns about concentration risk among income products.

The £46.5m trust, managed by David Horner and David Taylor, targets a high income with the opportunity for capital growth.

Horner and Taylor invest principally in companies valued at up to £500m, but a maximum of 20 per cent of the portfolio may be invested without reference to the market capitalisation of a stock.

The trust invests in stocks further down the market cap scale – including those in the AIM index – but will not hold unquoted companies or other trusts.

Horner and Taylor have a strict approach and will only invest in a company for the first time if it has yielded at least 4 per cent on a 12-month view, something they describe as a "cast-iron rule".

However, the pair will not invest just because a company has a high yield. "We are careful to avoid these value traps through rigorous due diligence," they said.

As part of the trust's screening process, the managers ensure companies do not carry too much debt on the balance sheet and that working capital requirements are not too onerous.

They also examine sales growth and margins as a measure of likely dividend growth, as the pair believe it is important to build a portfolio that will increase its underlying dividend over time.

At 3.98 per cent, the trust's yield in 2017 was below the sector average of 4.22 per cent. However, an investor who put £10,000 into the vehicle 10 years ago would still have received £5,295.68 in income over this time.

The trust is the best performer in the IT UK Equity Income sector over three and five years, and its return of 233.79 per cent over the past decade is the second highest figure – the average product made 86.5 per cent while the FTSE Small Cap (ex IT) index made 126.69 per cent. It also had a strong 2017, making 27.6 per cent compared with 15.61 per cent from the index.

As a split capital trust, investors can also access the vehicle without the income element through investment in its limited life, zero-dividend preference shares. These benefit from the capital gains – if there are any – when the shares expire.●

FILE

MANAGERS: **David Horner & David Taylor**

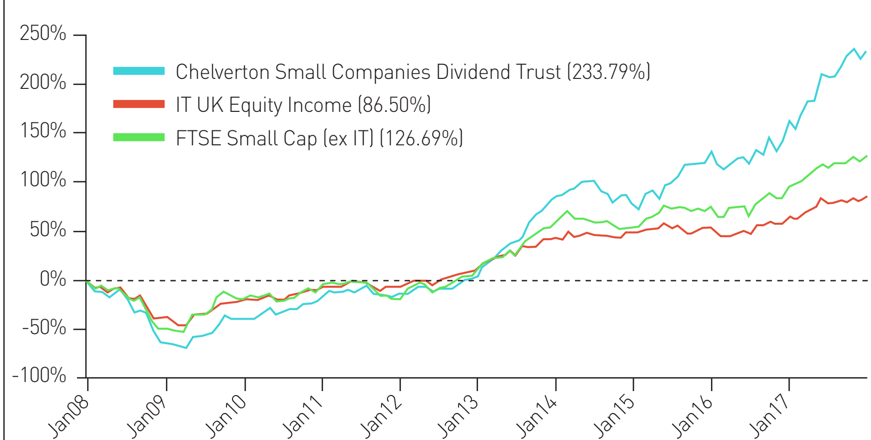
LAUNCHED: **1999**

DISCOUNT: **-1.69%**

OCF: **1.93%**

FE CROWN RATING:

PERFORMANCE OF TRUST VS SECTOR AND INDEX OVER 10YRS



Source: FE Analytics

Trust

FOREIGN & COLONIAL

The world's oldest investment trust has been given a new lease of life under the management of BMO's Paul Niven

FOREIGN & COLONIAL INVESTMENT TRUST IS THE OLDEST COLLECTIVE INVESTMENT VEHICLE in the world, having been set up in 1868, and the past three-and-a-half years under a new manager have seen it build on its reputation of delivering steady returns.

The £3.6bn trust has the aim of growing both capital and income over the long term. While FE Analytics data doesn't go back that far, it does show the trust has made 450 per cent over the past 20 years.

Foreign & Colonial's strong record has continued over more recent time frames, too – it has made 84 per cent since Paul Niven, head of multi-asset investments at BMO Global Asset Management, took charge in June 2014. This compares with a 69.05 per cent gain from its average IT Global peer and a 65.51 per cent return from its FTSE All World benchmark.

The trust is built around a number of focused sub-portfolios, run by external managers and teams from BMO. This means Niven does not select individual stocks and instead focuses on selecting underlying strategies, coordinating with the managers running the sub-portfolios and overseeing the trust's gearing levels.

Access to such a broad spread of investment expertise means Foreign & Colonial is a highly diversified trust, with more than 500 companies in its portfolio.

Unlike many of its peers, the portfolio offers true global exposure with a limited weighting to the UK market. Just 5.5 per cent of the portfolio is currently in UK equities, while North America accounts for the largest geographic exposure at 47.6 per cent. It also has 19.6 per cent of assets in Europe ex UK stocks, 12.7 per cent in emerging market equities and 10.5 per cent in Japan.

The outsourced management structure means the trust invests in different kinds of companies rather than being bound to a particular investment style. Although it owns many established names such as Microsoft and GlaxoSmithKline, the portfolio also owns rising stars such as Netflix and Tesla Motors, looks into emerging markets such as China and Latin America and has an allocation to private equity, with past positions here including Facebook and Twitter.

Looking ahead, Niven is optimistic in his outlook for global equities but said investors cannot expect market volatility to remain at the historic lows that have been experienced more recently.

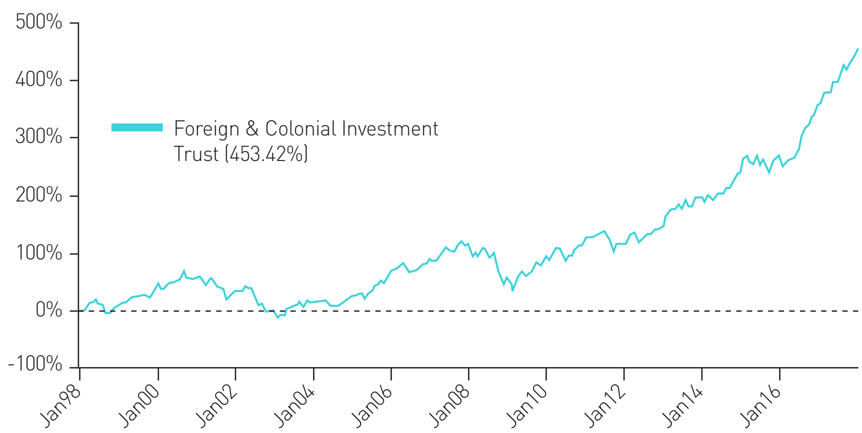
"A mix of reasonable growth with low but modestly rising inflation and rates should be broadly supportive for equities. Nonetheless, volatility has been extremely low and we should expect some pick-up here," he said.

"This will create both opportunities and risks for investors as we move through the year. We continue to invest in a range of diversified underlying stock selection strategies and believe that we remain well placed to withstand any further short-term volatility in markets."●

FILE

MANAGER: **Paul Niven**
LAUNCHED: **1868**
DISCOUNT: **-4.2%**
OCF: **0.54%**
FE CROWN RATING:

PERFORMANCE OF TRUST OVER 20YRS



Source: FE Analytics

OFF TARGET

Adam Lewis says investors need to be selective in the IA Targeted Absolute Return sector, where many funds are failing to deliver on their aims

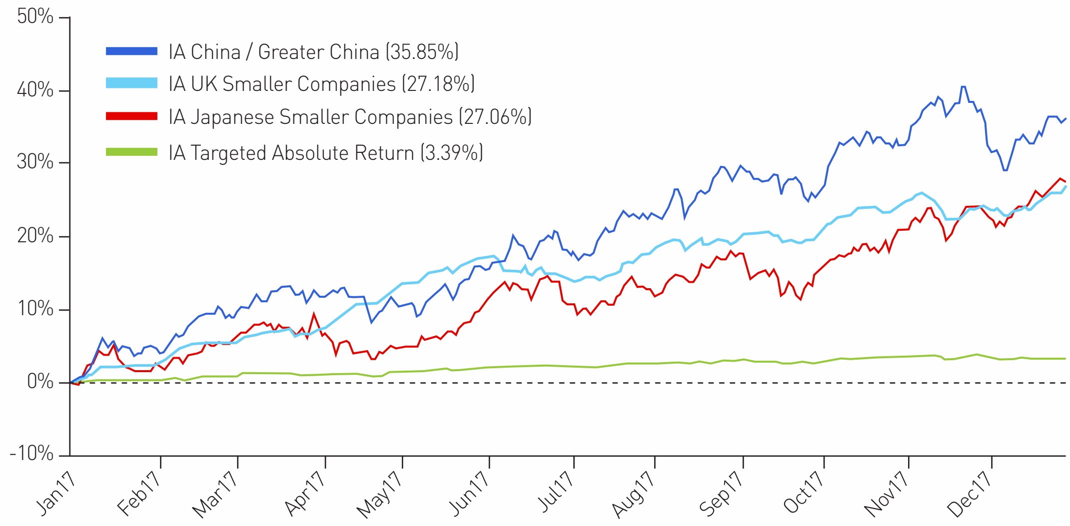
EVEN THOUGH 2017 WAS GENERALLY A STRONG YEAR FOR EQUITIES, a sense of nervousness among UK investors regarding politics and worries about their own domestic market saw them once again pile into absolute return funds.

Having been the top-selling IA sector in net retail terms in both 2015 and 2016, sales of IA Targeted Absolute Return funds were again strong in 2017, pulling in some £3bn between January and October.

Sales figures are not yet available for November and December and it is unlikely the sector will take the award for top seller three years in a row – IA Strategic Bond took £5.77bn in the first 10 months. However, what is clear is that investors appear willing to forego some of the returns offered by the global market rally for the comfort offered by these funds.

FE Analytics data shows the average fund in the IA Targeted Absolute Return sector was up just 3.39 per cent in 2017, making it the fourth worst-performing sector in the calendar year. Instead, 2017 rewarded those who took more risk, with the IA China sector top of the pops with a

PERFORMANCE OF SECTORS IN 2017



Source: FE Analytics

> "It is worth noting positive returns are not guaranteed and the experiences of investors can vary hugely"

return of 35.85 per cent, UK Smaller Companies second with 27.18 per cent and Japanese Smaller Companies completing the top three with a gain of 27.06 per cent.

MISSING THE POINT

The question on most investors' lips heading into this year is can these gains be repeated? If not, the next 12 months could prove to be another strong period for absolute return funds. However, if the bull run is just getting started, it could be argued that such an approach is risky in itself and misses the point of what these funds set out to do.

Amaya Assan, a research manager at Square Mile, says that the 116 funds in the IA Targeted Absolute Return sector use a wide variety of different approaches, from the more racy to the more conservative.

As a result, she argues that given the diversity of risk profiles and the complexity of some strategies, those investors using absolute return funds to give their portfolio a bit of stability may not actually be reducing risk as much as they think they are.

"The IA has specified funds must state the time frame in which they aim to deliver their objectives but this must be within the set maximum of three years," she says. "It is worth noting that whatever level of returns these funds are aiming for, such positive returns are not guaranteed and the experiences of investors can vary hugely."

A CRUDE EXAMINATION

Assan says a crude examination of these strategies over the past three years shows returns have been quite mixed, with the best-performing fund up 90.28 per cent, while the worst was down by 11.77 per cent. Additionally, there was a wide divergence in maximum drawdown, from ...

31.22 per cent to 0.75 per cent, and volatility too, which ranged from 0.92 to 13.9 per cent.

She adds: "Of course, we appreciate it hasn't been an easy environment for fund managers to balance the many varied risks inherent in markets with the need to meet their goals, as who would have predicted the outcomes of the UK referendum or the US election?"

As a result, Assan says it may be more useful to categorise funds managed with an absolute return mandate based on the outcome that investors are likely to receive.

"For example, funds that are focused on capital preservation would include lower risk fixed income offerings, such as AXA Sterling Credit Short Duration Bond. Despite sitting in a different IA sector, this fund is focused on preserving capital over the longer term and aims to deliver consistent, incremental returns over cash."

"There are of course more complex strategies to choose from, such as the Aviva Investors Multi Strategy Target Return fund, which sits in the IA Targeted Absolute Return sector and uses a multi-asset approach, meaning it can be exposed to a combination of equity, credit, currency, derivatives and interest rate risks."

"The number of ideas in the portfolio, the way they work together and the means by which they are implemented (which can include the extensive use of derivatives) mean this fund may be more suitable for sophisticated investors."

"Points made about the height of equity markets compared with many metrics could have been made at the end of 2016, and in fact we made them"

OVERSTRETCHED

Chris Metcalfe, managing director at IBOSS, has been increasing his funds' exposure to the IA Targeted Absolute Return sector for the last couple of years in the belief that markets may have overstretched themselves.

"Points made about the relative height of equity markets compared with many metrics could have been made at the end of 2016, and in fact we made them," he says. "The problem is that bonds look even more expensive, but as multi-asset managers we need to keep a high level of non-correlated assets."

Metcalfe says IBOSS's current defensive position is built around four strategies: it is overweight cash, underweight US equities, its fixed income positions have a short duration, and it has a bigger allocation to absolute return funds than ever before.

"The four funds we currently use in the absolute return space are Janus Henderson UK Absolute Return, Old Mutual Global Equity Absolute Return, Threadneedle UK Absolute Alpha and the Old Mutual UK Specialist fund, the last of which is now closed to UK

investors," he says.

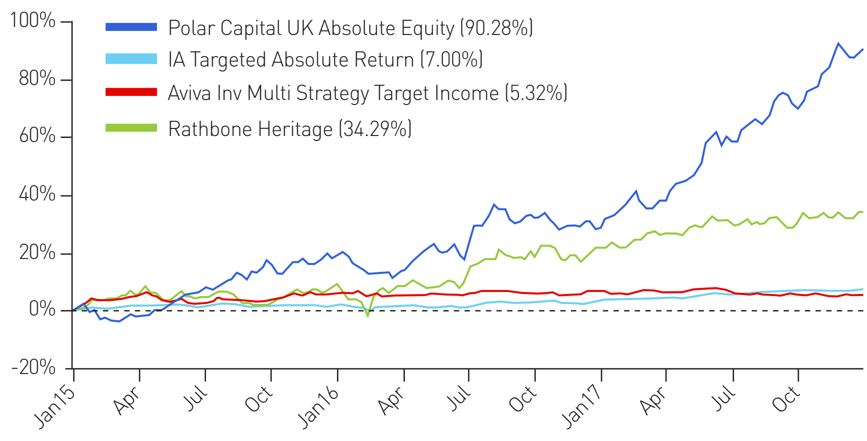
"None of these funds have a high correlation to either the IA Global Bond or Equity sectors and there is a low correlation between the group and, in some cases, they are negatively correlated. We have also steered clear of the three behemoth funds managed by Standard Life, Invesco Perpetual and Newton, as in general we prefer small funds, though this is not always possible and size is never the only driver."

If markets continue to become more expensive, with the only justification being a lack of inflation which translates into a limited chance of interest rate rises, Metcalfe says IBOSS will increase exposure to absolute return funds in 2018.

In doing so, however, he says he would seek out funds with "truly wide and unconstrained remits" such as the Rathbone Heritage fund, which sits in the IA Unclassified sector.

"We feel it can be a mistake to get too hung up on the IA sectors themselves and their associated definitions," he concludes.●

PERFORMANCE OF FUNDS VS SECTOR OVER 3YRS



Source: FE Analytics

The top dog
POLAR CAPITAL UK ABSOLUTE EQUITY

While the average IA Targeted Absolute Return fund produced a muted gain in 2017, Polar Capital UK Absolute Equity proved the diversity of the sector, rising 47.51 per cent. Guy Rushton's £487m fund also tops the sector over three years with a return of 90.28 per cent. It is definitely on the riskier end of the scale, however, achieving these gains with a maximum drawdown of 7.67 per cent, compared with 2.1 per cent from the sector average. And, at less than four years old, its strategy has yet to be tested in a full-blown market correction.

The income option
AVIVA INVESTORS MULTI STRATEGY TARGET INCOME

Proving the sector is not all about capital returns, Aviva Investors Multi Strategy Target Income tops the charts in terms of income produced and is currently yielding 4.5 per cent. The £2.25bn fund, managed by the Aviva multi asset team, aims to deliver an annual yield of 4 per cent above the Bank of England base rate before tax, regardless of the prevailing market environment. While its maximum drawdown of 4.01 per cent over three years is much lower than that of the Polar Capital fund, however, it can struggle in terms of capital performance and fell 1.88 per cent in 2017.

The capital preserver
RATHBONE HERITAGE

Carl Stick's £29m Rathbone Heritage fund is up 10.22 per cent over one year and 34.29 per cent over three. The fund currently has a 25 per cent cash weighting, with the rest made up of global equities. Chris Metcalfe says its focus is very much on capital preservation, which he argues seems prudent given the global macro backdrop and in light of equity and bond valuations. "While not managed on an absolute return mandate, the fund would have a top decile max drawdown over three years if it were in the IA Global sector and has a beta of 0.73 to global equities," he says.

TIMING CRISIS

John Blowers has some words of warning for anyone who may be tempted to call the top of the market

AS THE RECORD BULL-RUN CONTINUES APACE and stock markets achieve fresh all-time highs around the globe, it is time for the doomsayers to predict the next crash.

And they will (at some point) be right, because the market is cyclical and goes down as well as up. In fact, it has historically been a rollercoaster-ride for investors and that's the way you should view the journey.

So, should investors bank the gains they have made, move into cash and wait for the next correction, then pile back in?

We have had almost 10 years of growth since the financial crisis in 2008, where markets plummeted 50 per cent in just a few weeks.

Events such as this one are terrifying for investors, particularly those approaching retirement who will see their life savings drop at the very point they need to access them.

CASHING IN

The point to make here is that with the new pension freedoms and drawdown broadly replacing annuities, there is no longer any hard "cashing in" date at retirement.

If there happens to be a crash the day before your planned retirement date, then that isn't helpful, but it's not as if you have to liquidise your investments at this point and crystallise the loss. Historically, markets recover over time and it's best to resist selling anything until your investments come back into profit.

More recently, markets have quickly recovered any losses sustained after sharp falls.

There is much speculation about whether professional investors, such as fund managers, can spot an impending market crash or euphemistically named "market correction". And if the professionals can, could private investors follow suit?

Wouldn't it be great if we all cashed in our investments at the very top of the market and then watched values tumble, only to reinvest at the bottom?

NIGH ON IMPOSSIBLE

Boom! You'd make a fortune, as you would have doubled your holdings in a few short months before watching with glee as your now larger shareholding surfed on the wave of the next bull run.

Surely, this is what we pay for expert fund managers to do on our behalf, but the reality is that timing the market, even for seasoned professionals, is nigh on impossible.

Although corrections are cyclical, they happen for different reasons, whether event-driven (wars or natural disasters), macro-economic, or simply because markets get overvalued (as in the case of the dotcom bubble). Therefore, the market is unpredictable.

Most of the reasons that cause a crash or correction are easier to spot with the benefit of hindsight, but hard to understand at the time. The top of the market is not like

...

GAINS AND LOSSES DURING BULL AND BEAR MARKETS

Event	Date	FTSE 100 (price only)	Drop or rise	Duration
Dotcom "bubble"	1-Sep 2000	6,795	-	-
Dotcom crash bear-run	7-Mar 2003	3,491	-49%	30 months
Post dotcom bull-run	12-Oct 2007	6,730	+92%	55 months
Financial crisis	6-Mar 2009	3,530	-48%	17 months
Post-crash bull-run	29-Dec 2017	7,687	+117%	106 months

Source: Google Finance

the top of a mountain with a big flag on top.

Similarly, the bottom of the market is equally difficult to spot.

Investors trying to time the market tend to sell too early or too late and have the same problems when they buy back in, missing peak growth periods.

When you add the cost of buying and selling investments and the time spent trying to manage your portfolio, you may find that it's better just to leave things alone and ride out the peaks and troughs.

Timing the markets for maximum gain is to be discouraged, but letting emotion dictate when you buy in – and sell out – of the market is even less helpful

BUY AND HOLD

At a fund manager level, this mantra of buy and hold is best exemplified by Terry Smith, who runs the spectacularly successful Fundsmith Equity fund. His motto is: "Buy good companies. Don't overpay. Do nothing."

He is suggesting that, over the longer term, good investments will go up and down but should ultimately end up higher.

His strategy seems to work – his portfolio of global blue-chip stocks has risen by more than 250 per cent since launch at the end of 2010, more than double the gains of its IA Global sector.

Now, it should be noted that Fundsmith Equity has not yet encountered anything more taxing than a mild correction in its lifetime and it will be interesting to see how the fund performs throughout a full market cycle.

The rise of passive funds is also relevant to this discussion as many private investors have succumbed to the appeal of low-charges in an environment when everything has rallied. Many people see this type of fund as a one-way bet, but the good trackers will also track the market down in a correction or full-blown crash. Active managers will have some sort of plan to mitigate falling markets, although this will depend on each fund and their strategies may not work.

No one wants to see stock markets fall, but it is a natural part of the investment cycle and I for one will be interested to see how passive funds perform in negative markets against their actively managed counterparts. After such a lengthy bull run, it may be a sobering experience for passive fund investors and a chance for active managers to justify their fees.

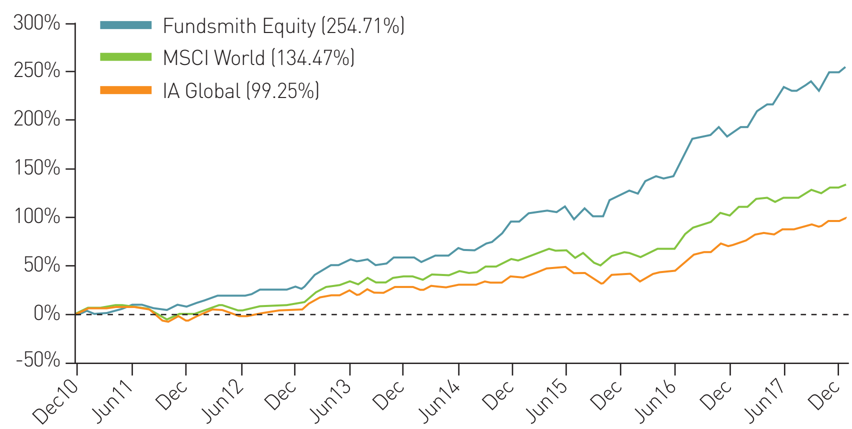
THE MEDIA

Finally, a quick mention of the role of the media. Steady growth in the stock market rarely generates much media comment (although some journalists like to stir up a buying frenzy when markets hit all-time highs), but you can bet your life that when there's a crash or correction, the press will generate a blizzard of headlines about billions being wiped off pensions and company values. Bad news sells papers.

Investing is still an emotional process for most private investors and the media can propagate feelings of fear and greed, causing people to buy when markets are high and sell when they are low. This is poor behaviour and should be resisted. Timing the markets for maximum gain is to be discouraged, but letting emotion dictate when you buy in – and sell out – of the market is even less helpful.

If you treat investing like a rollercoaster ride, then you know there will be ups and downs – it's all part of the thrill. But trying to jump on and off a rollercoaster will only end in tears. ●

PERFORMANCE OF FUND SINCE LAUNCH VS SECTOR AND INDEX



Source: FE Analytics

TALKING SHOP

Unicorn UK Growth's **Fraser Mackersie** names three stocks that are providing the "picks and shovels" of the online retail boom

THE UNICORN UK GROWTH FUND focuses on identifying companies that are well placed to benefit from long-term structural growth drivers – and one of the largest and longest-running themes we are backing within the portfolio is the growth in online retail.

The ecommerce market in the UK is one of the strongest in the world – on average, each person in the UK spends more than $4,000 a year online, more than any other country, and as a percentage of GDP (6.1 per cent), we rank second only to China.

This strong market backdrop has created a number of interesting opportunities for UK equity investors. We don't hold any pure-play online retailers in the fund – preferring the "picks and shovels" approach of backing companies that provide the infrastructure needed to support this growth.

Clipper

CLIPPER LOGISTICS PROVIDES ECOMMERCE LOGISTICAL SUPPORT TO RETAILERS.
It handles all European returns for ASOS and manages a significant element of John Lewis's online orders, including a joint venture to provide a next-day click-and-collect service in all of its stores. We backed the company at IPO in 2014 and although the shares have re-rated significantly, its long-term organic growth prospects are compelling. It also pays a well-covered and growing dividend.

LONDONMETRIC PROPERTY PLC

LONDON METRIC IS A REIT SPECIALISING IN LOGISTICS AND RETAIL PROPERTY.
The growth in online retail has increased demand for well-located distribution centres to support increased volumes and shorter delivery times. With approximately 70 per cent of London Metric's property portfolio invested in long leases in this area, and around half benefiting from fixed or RPI-linked rental uplifts, dividend payments should grow steadily. It also has an attractive yield (above 4 per cent).

MACFARLANE GROUP

MACFARLANE IS THE LARGEST DISTRIBUTOR OF PROTECTIVE PACKAGING IN THE UK.
As more people shop online, the requirement for high-quality and flexible packaging solutions will grow. In addition to attractive long-term organic growth prospects, the company is well placed to consolidate its market through earnings-accretive bolt-on acquisitions. Macfarlane has a strong balance sheet and an attractive and growing dividend yield of about 3 per cent.

iSHARES EDGE MSCI WORLD QUALITY FACTOR UCITS ETF

River and Mercantile's **Tamsin Evans** says this fund addresses the lack of global strategies offering truly diversified exposure to defensive equities

WE ADDED THE iSHARES EDGE MSCI WORLD QUALITY FACTOR UCITS ETF to our fund towards the end of 2017, as the case for turning defensive in our wider portfolio became clearer.

After such an extensive period of gains for equities, the question of "when does the downturn come?" is being asked by many investors, with more and more signs of exuberance becoming evident as equity markets climb ever higher.

The surge in Bitcoin and other cryptocurrencies and the performance of technology stocks compared with the wider market are just two such indications of late-stage cycle behaviour.

Therefore, we are tilting our portfolio towards more defensive companies, but via strategies that still allow a degree of participation in the upside, as these trends are capable of continuing for much longer than is rational.

What the market calls quality stocks – but which we view as equities with defensive characteristics – have a number of key features, including a high return on equity, high free cash-flow yield, low earnings variability and high interest cover. They also operate with high margins and often offer products or services that are unique.

Companies of this type offer less upside than cyclical stocks when markets are rising but provide a high degree of protection in sell-offs. While they tend to outperform broad global equity markets in one-third of months when markets rally, they outperform in 80 per cent of months in which there is a correction. They also capture less than 85 per cent of the downside experienced by these wider markets.

Arguments have been put forward in recent years that such stocks are overvalued and they certainly look expensive compared with broader equity markets on traditional valuation measures. However, we focus on such companies' ability to make a return on equity over the longer term, and on this basis valuations still look acceptable.

Valuations are also less of a priority when investors are looking for defensive assets in times of market stress.

We like the passive option in this space for a number of reasons. The iShares Edge MSCI World Quality Factor UCITS ETF is well diversified, made up of 299 stocks spread across the globe, mitigating sector risk to a degree.

While some of the world's biggest names feature in the top-10 – including the likes of Apple, Roche and Novo Nordisk – the largest one accounts for just 3.66 per cent of the ETF, limiting stock-specific risk.

The number of active strategies offering exposure to defensive equities in the way we want is also limited and when investors consider the attractive price (it has a TER of just 0.3 per cent) and the reasonable liquidity, the passive option stacks up well compared with active alternatives.●

Tamsin Evans *is the manager of the River and Mercantile Dynamic Asset Allocation fund*

TRUSTNET magazine

FEBRUARY PREVIEW

The (post) January sales

The next issue of Trustnet Magazine will look at the UK consumer-focused sector as it struggles to move on from Brexit-related uncertainty. But is the market pricing in a lot of fuss over nothing and is this creating opportunities for investors?

Our sector focus will fall on IT UK Smaller Companies – in light of the current bull run, is this one of the last high-growth areas of the market that still offers value?