Parallel
Investment Management

Quarterly Update – October 2015

Market Backdrop

The quarter began with a clear divide forming between developed equity markets and those of the developing world. Economic growth gained momentum in developed economies, especially the US and the Eurozone, which resulted in equity markets posting positive returns. This was in contrast with the markets of both Asia Pacific and Emerging Markets where equities pulled back, led by China and Brazil, the former continuing the rout which began in June and the latter because of weak oil and commodity prices. The continued improvement in economic growth in the US caused the focus to shift to when the Federal Reserve (Fed) might raise interest rates; this strengthened the dollar pushing commodity prices to multi-year lows.

The improvement in developed equity markets proved short-lived, however, with global equites falling sharply in August as concerns over the trajectory of Chinese growth dominated investor sentiment. These concerns were aggravated by weak economic data and the Chinese authority's decision to devalue the renminbi. The sell-off in China's stock markets spilled over into emerging markets, commodity prices, and in turn developed equity markets. The impact of the heightened market volatility was to cool investors' expectations of a US interest rate rise in September.

Two factors dominated investors' minds at the start of September: the slowing economy in China and whether the Fed would begin to hike interest rates. Both of these factors led to a spike in volatility and investors started to lean towards risk aversion, reducing their exposure to risk assets in favour of perceived safe-haven securities such as developed market government bonds. Although it is widely accepted that there is a disparity between official Chinese economic data and data compiled by economists, Chinese growth has actually been slowing for longer than recent headlines would suggest, and over recent months growth has not slowed as much. The Fed's eventual decision to leave interest rates on hold in September divided market commentators as to the wisdom of its decision.

The quarter ended with the global economy seemingly in a fragile state of equilibrium evidenced by low growth and low inflation. The current outlook is for interest rates to stay lower for longer, with gentle increases beginning in 2016 in both the US and the UK. At the same time we expect financial market volatility to feature strongly, with the markets prone to periodic shocks as investors hang on every snippet of data released.

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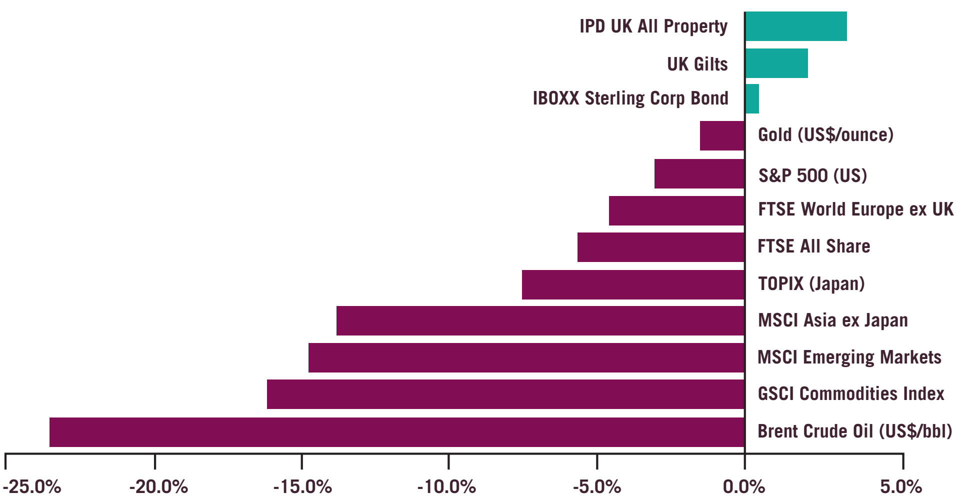
Asset Class Returns – Q3 2015



Data source: FE Analytics – rebased in Pounds Sterling

Market Insights

Equities

UK : Neutral

The quarter got off to a strong start with equity markets reacting favourably to positive company results, some merger and acquisition activity, as well as the temporary fix to Greece's financial situation. Although mining and oil stocks continued to struggle reflecting concerns over slowing Chinese growth, it was the larger companies which outperformed both mid- and smaller cap stocks in June.

However, the positive returns were soon reversed as investors focused more on falling commodity and oil prices and the timing of a rise in US interest rates than any positive UK economic and company specific news. Indeed the quarter closed with equities pulling back further on the back of overseas negative macro-economic data.

UK inflation continues to hover around zero, and although wage growth has been running at around 2% this has been offset by lower clothing, food and fuel costs. The outlook for UK equities remains mixed reflecting the contrast between domestic focused companies, likely to benefit from improving consumer demand, and those companies more reliant upon exports, where slowing demand and the strength of sterling will act as headwinds.

US : Neutral

Strong growth in Q2, as well as news of a Greek deal, cheered the equity markets and the S&P 500 Index grew strongly in July. However, it was not long before speculation about the timing of a rise in US interest rates dominated investors' minds following comments by the Fed that there were 'risks in holding off for too long' as they presented an upbeat picture of the US economy.

But it was a sense of deepening gloom over the global economy and the sell-off in Chinese equity markets which sent shockwaves through global financial markets and acted as the catalyst for the US equity market to fall by 4.7% (in sterling terms) during August. The impact of this turbulence began to reduce expectations that the Fed would raise rates in September, with global risks becoming increasingly influential on any decision, despite healthy domestic economic data.

Although the Fed chose not to raise interest rates in September, and may now not hike rates until early 2016, the strong US dollar is a likely headwind and so, despite the US economy continuing to expanding strongly, the scope for a significant upward movement in the equity markets may be limited.

Eurozone : Neutral

European equities also rose in July as investor confidence grew on the back of the agreement struck between Greece and its creditors, releasing the previous deadlock. All sectors recorded gains as improving economic data showed the recovery was well on track, albeit several laps behind the US and the UK. Worries of a potential spill-over from Greece diminished as leading economic indicators confirmed that the region's economy was expanding both in manufacturing and services.

Unfortunately, the Eurozone was not immune to the global growth scare which hit equity markets in August and European equity markets fell into line with other regions in September, posting a negative return.

The corporate world was rocked by one of the biggest scandals in history, when Volkswagen was accused of cheating US exhaust emission tests, causing its share price to lose 43% of its value in September.

The quarter ended with evidence that the region's economic outlook is improving, albeit with marked differences on a country level and, although it is likely that the European Central Bank will need to administer additional monetary stimulus, on a relative basis the region's equity markets remain attractive.

Japan : Neutral

The Japanese equity market began the quarter only marginally in positive territory and although macro-economic data has been disappointing, corporate results have been encouraging. Nevertheless, the pace of change is slow and consumers appear to have saved rather than spent their windfall from lower energy prices. Despite this, the rotation into domestic equities by Japanese pension funds remains a supportive factor.

August began with the Japanese equity market soaring to record levels for the year after the government hinted at further policy steps to support growth, including lower corporate tax rates and attempts to reach a Trans-Pacific trade deal. However, it soon became caught in the global equity sell-off compounded by the release of economic news indicating a broad-based weakness in demand across the economy.

Further disappointing data was released in September which showed no growth in retail sales and core inflation turning negative. Wages and demand for jobs appear to be on the rise, but it is likely that the Bank of Japan will need to apply additional monetary policy easing to support the economy because the very positive changes made to Japanese corporate governance will take time to reap rewards.

Asia Pacific : Neutral

The instability in the Chinese equity market together with some downwards revisions in company earnings and generally weak macroeconomic data caused Asian equity markets' performance in July to be mixed. Despite country variations the impact of what was beginning to unfold in China could not be ignored given its importance as the primary driver of the region's economy.

Asian markets had a torrid August. The decision by the People's Bank of China to devalue the renminbi by 3% against the US dollar triggered a sell-off in other Asian currencies, and, as global equity market volatility erupted, Asian equity markets were hit the hardest.

Although Asian equity markets had a better September, it is likely that regional growth will remain broadly flat unless global growth improves markedly. Low commodity prices will act as a major headwind for commodity-exporting economies, however there are a few bright spots in the region, such as the Philippines, Vietnam and Bangladesh which are establishing themselves as low-end manufacturing bases.

Outlook for Asset Classes	
Equities	Positive
Fixed Interest	Negative
Property	Positive
Commodities	Negative
Absolute Return	Positive
Cash	Negative

Emerging Markets : Neutral

The equity markets of all emerging market regions, namely Emerging Asia, EMEA (Europe, Middle East & Africa) and Latin America, all posted losses in July. The marked fall in commodity prices helped to undermine support whilst the strengthening US dollar created pressure for emerging market currencies. Latin America was the weakest performing equity region.

This pattern was repeated for the remainder of the quarter with huge volatility witnessed in both commodity prices and emerging market currencies. Brazil officially fell into recession and had its credit rating downgraded. India was the only major bright spot helping to offset weakness in Asia.

It would seem that having been too optimistic on the outlook for the emerging world over the last five years the pendulum of investor sentiment may now have swung too much the other way. Although a number of countries are vulnerable to both economic and financial crises, it is unlikely that we will see a systemic collapse in growth in the emerging world. That said, we do expect a prolonged period of slower growth.

Fixed Interest

The protracted, and at times acrimonious, discussions between Greece and its creditors was the main focus of the fixed interest market at the start of the period. Investors adopted a 'risk off' approach resulting in safe-haven core government bonds rallying. High quality corporate bonds followed their lead, but as soon as an agreement was reached core government bonds sold off and high yielding bonds rallied.

However, this was relatively short-lived as the slowdown in China and severe correction in its equity market began to drive bond market performance, with the growing uncertainty positively benefiting core government bonds such as US Treasuries and UK Gilts at the expense of corporate bonds.

As the focus began to drift towards the US and whether the Fed would start to raise rates, bond markets started to display heightened volatility. In the event US interest rates were kept on hold and government bonds rallied on the news. The concerns over global growth which influenced the Fed's decision caused the 'riskier' corporate bonds to come under pressure, and so the quarter ended with sovereign debt generating a superior return to corporate debt.

We consider the immediate outlook for the asset class is mixed given the current low level of yields, the prospect of rising interest rates, liquidity issues, and bonds questionably no longer the refuge from volatility.

Alternatives: Commodities/Absolute Return/Property

Commodities struggled in the third quarter with the S&P GSCI Commodity Spot Index (a composite of hard and soft commodities) falling by 14% in sterling terms. Both industrial metals and agricultural commodities fell, but it was energy that was hardest hit. Sentiment towards the sector may have become too pessimistic as recent supply cuts will at some point start to take effect. Furthermore, if Chinese demand stabilises then commodity prices should begin to recover, although we expect a bumpy ride.

The **Absolute Return** sector posted a marginal negative return for the quarter and although this was disappointing, the defensive qualities of our selected funds proved beneficial when compared with the equity markets. We expect the current phase of volatility to present investment opportunities to make a positive contribution to return whilst also providing some downside protection.

Over the last quarter **Property** generated a positive return. However, there was a contrast between the performance of 'bricks and mortar' property funds and property securities funds, with the former generating steady, if unexciting, returns and the latter offering greater potential returns but subject to equity market volatility. We believe that the asset class remains attractive on a total return basis but expect a more volatile environment.

Summary Outlook

- **Fears of global growth collapsing are overdone**
- **The true rate of growth in China appears to be stabilising**
- **Commodity prices may be bottoming out**
- **Growth in developed economies is more robust than in emerging markets**
- **Lower energy costs continue to support household consumption in advanced economies**
- **Inflation to stay below target in the short term despite wage growth beginning to pick up**
- **Interest rates to stay low for longer but will begin to gently creep higher**
- **Corporate earnings growth and dividend cover to act as a headwind to a significant rise in equity prices but selective opportunities remain**
- **The equity markets remain prone to shocks over data releases and so volatility expected to increase**
- **Relatively low asset class returns but beating cash and inflation**

Portfolio Overview

Performance for the period ending 30 September 2015 (%)

Portfolio	Descriptor	Quarter	1 Year	2 Years	3 Years
Parallel Multi Asset A	Defensive Growth	-0.68	1.25	4.84	7.30
Parallel Multi Asset B	Conservative Growth	-0.89	2.85	8.98	14.94
Parallel Multi Asset C	Cautious Growth	-2.20	2.96	10.02	18.92
Parallel Multi Asset D	Balanced Growth	-3.07	4.22	11.62	24.92
Parallel Multi Asset E	Adventurous Growth	-4.53	2.57	9.44	23.29
Parallel Multi Asset F	Global Opportunities	-6.14	0.23	7.11	20.38
Parallel Multi Asset B Income	Conservative Income	-0.91	1.26	6.10	7.97
Parallel Multi Asset D Income	Balanced Income	-2.79	1.09	6.96	16.55
Socially Responsible Growth		-5.80	0.40	6.29	23.69

Figures quoted net of management fee. Source: FE Analytics

Fund Selection: Contributing Funds

Premier Pan European Property – in volatile markets our property funds held up well, demonstrating the benefits of investing in the asset class. The standout performer was the Premier fund which delivered a return of 5.5% over the quarter, putting it firmly in the top quartile of the IA Property sector.

L&G UK Property – our pure 'bricks and mortar' fund also performed well generating a return of 2.9% and was also a top quartile performer.

Jupiter European – strong stock selection, particularly from European financials, helped this fund deliver a positive return of 2.2% against a negative return from its benchmark index. The fund was ranked fifth in its IA sector over the quarter.

Fund Selection: Detracting Funds

Neptune Japan Opportunities – this fund fell a disappointing 17.9% over the quarter, partly attributable to the fund's hedging strategy and also an underweight position in domestic stocks which have outperformed multinationals, where the fund has an overweight position.

Fidelity Emerging Markets – whilst this fund could not escape the wider stock market falls, down 10.9% over the quarter, its defensive positioning meant the fund actually outperformed its benchmark and was ranked in the top quartile in the IA Global Emerging Markets sector.

Standard Life UK Equity Unconstrained – this fund fell 7.6% over the period with the fund's two mining positions largely responsible for the underperformance, however the fund still remains ahead of its benchmark over six and twelve months.

Portfolio Activity - a summary of some of the main changes that have taken place during the quarter:

Increased exposure to property – the relative supply/demand imbalance in the UK and European property sectors together with investors' continued search for yield enhances the potential returns from this asset class. With the expected rise in UK interest rates being pushed further out and EU rates expected to remain low, the yield from Property is attractive in comparison with that offered by bonds. We initiated a new fund holding in the F&C Property Growth and Income Fund.

Increased exposure to active US equity funds – we began reducing our passive exposure in the US in favour of active funds in February, believing that the extent of the US economic recovery and current valuation of the S&P 500 Index indicates we are increasingly moving in to a phase of the recovery where the best equity returns are likely to come from active stock picking. This strategy has proved to be successful and we believe the outlook for the US economy necessitates a continuation of this move.