Parallel
Investment Management

Money Wise Portfolios Quarterly Update – July 2017

Market Backdrop

Global stock markets, in the main, rose in April, driven by some encouraging first quarter corporate earnings results in the US and Europe, the release of a broad outline of President Trump's proposed tax reforms, and geopolitical events in North Korea, Syria and Europe. After a generally lacklustre beginning markets were boosted on 23 April as Emmanuel Macron's success in the first round of the French presidential election pointed to ongoing European recovery. European bourses rose strongly encouraging other markets to follow suit, but also supported by data indicating a strengthening in manufacturing conditions globally. Despite this, for UK investors April was disappointing as a softer dollar caused most currencies to record gains, so that out of the major markets only continental Europe recorded a positive return in sterling terms. The somewhat mixed performances were also influenced by continuing concerns over the glut in oil supplies which saw the price of Brent crude fall by over 6% in the month.

Following a mediocre April, a wave of investor optimism in the global economy on the back of strong corporate earnings boosted global equity markets in May, with many ending the month just shy of record highs. Perhaps markets could have moved higher were it not for an undercurrent of political concerns with elections scheduled for the UK, Germany and Italy, as well as the backdrop of the forthcoming Brexit negotiations. In the US, markets were held back by the worries over whether President Trump would be successful in implementing his spending and tax reforms. For sterling investors, European equity markets proved to be the top spot, although the UK blue chip index reached a record high as the pound weakened and commodity prices strengthened boosting the overseas earnings of a significant number of constituent companies.

The UK equity market experienced a turbulent month in June following the surprise result of the general election. Sterling fell sharply causing the share prices of UK-listed internationally exposed companies to advance, just as they did following the Brexit vote in 2016. June also heralded the second rise in interest rates this year from the US Federal Reserve Board, despite mixed signs for the outlook for the US economy, and this seemed to shift the tone from the central banks of a number of advanced economies. The suggestion that monetary policy (interest rates) may tighten sooner than expected, despite weaker inflation expectations, caused bond yields to move higher leading to a softening in prices. Currencies also moved sharply, with both sterling and the euro gaining ground, resulting in the primary equity markets wiping out all of the gains made earlier in the month.

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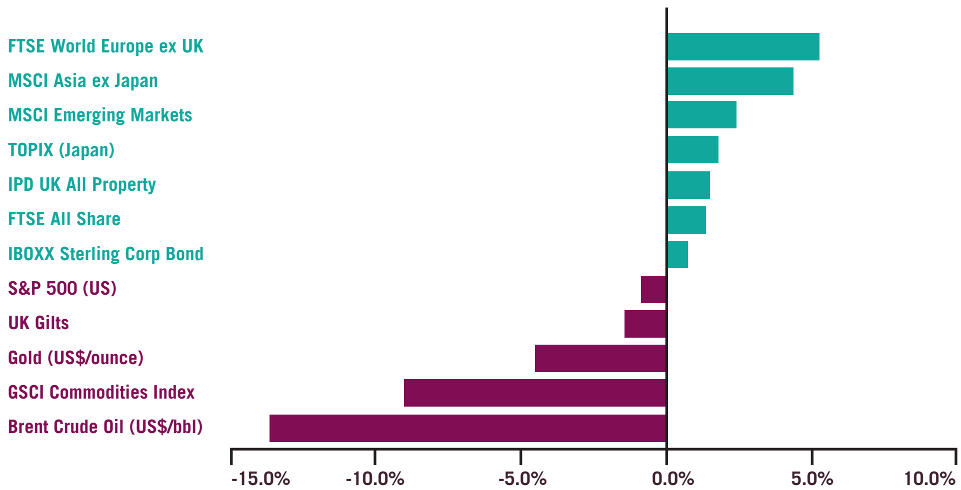
Asset Class Returns – Q2 2017



Data source: FE Analytics – rebased in Pounds Sterling

Market Insights

Now that we have reached the half-way point of 2017 it seems appropriate to confess to being a little surprised over how well the equity markets have performed so far this year, despite a little hiccup in the last few days of June. Although we are pleased with the returns achieved by our portfolios we are increasingly aware of how often the 'expected' events morph into the 'unexpected', adding to the challenge in balancing risk with return.

In 2016, we expected two political events: the UK referendum and the US presidential election, to disrupt markets – they didn't, and markets continued to strengthen. As we entered 2017 we questioned if it was safe to assume this pattern would be repeated given the prospect of French, German and Italian elections? So far, the outcome of the French election has been greeted positively by investors given that President Macron's policies are expected to be supportive of the already improving European economy. We didn't expect Theresa May to call an election, and, like her, did not foresee the outcome, but markets have generally taken the result in their stride accepting that the post-election returns are perhaps more to do with sterling's weakness than the underlying strength of the UK economy.

With summer upon us there is the usual slowdown in company news and so the headlines will be filled with political and economic developments. The weakened position of the UK government, albeit temporarily propped up by the Democratic Unionist Party, is likely to lead to heightened uncertainty, especially given the backdrop of the Brexit negotiations. Across the pond, President Trump's attempts to get his election proposals onto the statute book seem to be floundering, as much caused by opposition from within the Republican party as the Democrats; all this whilst the Federal Reserve Board seeks to 'normalise' interest rates.

As we reported in our last newsletter, the outlook for the global economy is reasonably good, with China the only major economy which is clearly losing momentum as the authorities seek to temper credit growth. World trade is relatively buoyant and labour markets continue to tighten almost everywhere. However, wage inflation remains weak in virtually all major economies outside the US, and with little sign of productivity improvements, and the dependency of so many advanced economies on consumer spending, corporate earnings growth may be more limited from here thereby potentially slowing much further advance of the markets.

Some eight years on from the Great Financial Crisis the global economy still lies in the shadow of low growth and low inflation. At the same time, innovative businesses continue to cause challenge and disruption to established enterprises, such as Amazon's recent purchase of Whole Foods, adding to the already deflationary trends. Given the economic outlook companies need to become self-sufficient, evolve their businesses and be more adaptive to the new environment, fully embracing technological change.

The businesses that are prepared to move with the times, that seek to offer the highest quality of goods and services, that put the customer first, that operate sensible financial management, and which put long-term investment before short-term profit are the ones most likely to generate strong cash flows and dividend growth over the longer term. Such companies will be highly prized by investors. Unfortunately, the media headlines have a propensity to focus on political manoeuvrings, the words of central bankers and the plethora of economic data rather than these corporate good news stories.

The recent see-sawing in the prices of a wide range of assets and the currency markets points to an increasing fragility in the markets. This supports our approach in providing portfolios that are highly diversified, and emphasises the importance of conducting thorough fundamental research in selecting the underlying constituents.

UK Equities In Focus

With all the uncertainty surrounding the UK following the Brexit referendum and the surprising general election result, the attraction to the investor of UK company shares might be questioned. The prospects for the UK economy appear to have waned, demonstrated by the fall in the value of sterling, often seen as a barometer of international confidence.

However, commodity and energy businesses listed on the UK stockmarket, together with British companies with global brands have benefited from the pound's fall when they repatriate overseas earnings, evidenced by world leaders such as GlaxoSmithKline, Diageo and Unilever delivering record earnings.

Product sales to overseas countries have become more attractively priced after a 15% 'price cut' due to the fall in sterling, helping exporters to boost volume. Furthermore, even if we cannot strike a tariff-free trade deal with Europe post-Brexit and have to fall back on World Trade Organisation trade rules, the tariffs on UK exports to Europe would likely average about 4.8% which has already been more than made up for by the fall in sterling.

In a global equity market, the price of UK companies has also been cut stimulating increased interest from overseas-based buyers for UK businesses. This should provide support to the share prices of UK companies by stimulating merger and acquisition activity.

Of course, it is all too easy to focus on those global brands in the top flight of UK stocks, where much of the headline market returns have been seen over the last twelve months. However, many mid-sized and smaller UK companies are leaders in their own sectors but their share prices have not benefitted as much as their larger peers. This presents an opportunity for the active UK fund manager, as well as those overseas buyers.

We have no doubt that the UK economy faces a significant number of challenges in the coming months but are convinced that the UK stockmarket remains an attractive investment for the discerning buyer.

Investment Views

Asset Class	Current View	Comment
Equities	⊕	Equities continue to look attractive against a backdrop of reviving, if unexciting, global growth. Global corporate earnings could be further supported by any US fiscal stimulus as long as revised US trade policies or geopolitical issues do not interfere with markets.
Fixed Interest	⊖	With a rising interest rate trend the outlook for government debt is poor. Better value can be found in corporate debt where the yield premium provides a cushion. We remain focused on the defensive qualities in the corporate bond and inflation-linked sectors.
Property	●	Whilst UK commercial property may face headwinds as interest rates rise it is supported by real yields. Sterling weakness may also present an attractive entry point for overseas investors. Global property may also offer better opportunities to UK investors.
Commodities	⊖	As the global economy grows we are seeing supply re-emerge as the driver of commodity prices, though these have also become volatile. Opportunities exist as commodity companies focus more on profits rather than volume growth, but a selective approach is demanded.
Absolute Return	●	Although Absolute Returns funds provides a useful diversifying tool to reduce portfolio risk in what may prove to be a 'bumpy' period, the wide range of returns within the sector tempers our enthusiasm.
Cash	⊖	With a negligible return on cash we see the asset class solely as a tactical holding given its defensive qualities, though this is tempered by a vulnerability to rising inflation.

Equity Regions	Current View	Comment
UK	●	Despite low real wage growth slowing UK consumption, sterling weakness and poor yields from other assets provide support for UK equities. However, headwinds are expected to strengthen as Brexit uncertainty grows.
US	●	The rate of US growth appears to be easing, and whilst the outlook remains positive, the US market may be up with events. Tax cuts and increased spending could improve growth prospects for US companies but require greater political consensus. We believe US exposure is still warranted but are conscious of valuations and the room for disappointment.
Europe	⊕	As the European economy enters its fifth year of recovery, the impact on growth and employment is becoming broader-based. With the prospect of political upheaval and issues in the banking system also receding, European equity markets have become more attractive, although any withdrawal of the ECB's current stimulus will be the test.
Japan	●	Japan's business investment is now at a 9 year high and the country has enjoyed its best period of growth for a decade. However, the economy's reliance on exports makes the equity market vulnerable to any US dollar weakness against the yen.
Asia Pacific and Emerging Markets	⊕	Despite geopolitical tensions, a number of key emerging economies have returned to growth, with receding fears of US protectionism and exchange rates with the US dollar also adding support. A managed rather than sharp slowdown in China, with Chinese shares and bonds more accessible to global investors, should support regional markets.

KEY:
⊕ Positive ● Neutral ⊖ Negative

Portfolio Overview

Performance (%) for the period ending 30 June 2017

Portfolio	Quarter	1 Year	3 Years	5 Years
Money Wise Cautious	1.70%	12.36%	21.74%	39.11%
Money Wise Balanced	2.13%	17.13%	28.14%	57.22%
Money Wise Adventurous	2.49%	17.18%	35.19%	76.34%
Money Wise Income	1.11%	12.02%	20.39%	42.63%
Money Wise Higher Income	1.19%	13.68%	22.90%	51.61%

Figures quoted net of management fee. Source: FE Analytics

Fund Selection: Contributing Funds

Unicorn UK Income – The Fund's bias towards small and mid-cap businesses helped it to outperform both its sector average and the FTSE All-Share Index in Q2. The Fund continues to target companies that are consistently profitable, cash generative, dividend paying and demonstrate strong organic growth and balance sheet strength. Despite negative sentiment towards the outlook for the UK economy, the team at Unicorn maintain conviction in their strategy of seeking out companies which can thrive irrespective of macroeconomic 'noise'.

Fundsmith Equity – This highly concentrated (maximum 30 stocks) global equity portfolio had a strong quarter outperforming both its sector and the MSCI World Index. The 'buy and hold' strategy is based on targeting companies that dominate their sectors and which are resilient to change.

Fund Selection: Detracting Funds

Artemis Global Income – The Fund underperformed the MSCI World Index in the period reflecting its approach of seeking income in underappreciated and undervalued areas of the market. The Fund's underweight allocation to financials stocks and to emerging markets has suppressed performance of late, however, we consider the Fund's style-agnostic approach and strategy is complementary to our other global equity holdings.

Trojan Fund – Despite posting a marginally positive return in the quarter the Fund has lagged the FTSE All-Share Index for a number of months. Despite the Fund's contribution to downside protection during periods of heightened volatility we consider the return achieved during more benign conditions does not represent good value, and so we decided to remove the holding from our portfolios.

Portfolio Activity

A summary of some of the main changes during the quarter:

Reduction of US equity exposure – Following our increased allocation to the US earlier in the year as part of a short-term momentum play we considered there to be better value outside of the region, particularly in Europe and Asia, as geopolitical risks dissipate and regional economies strengthen.

Reduction of allocation to cash – We reduced our allocation to cash in all but our most cautious portfolios as we considered its defensive qualities were insufficient to make up for the drag on performance. The improving macroeconomic backdrop prompted us to amend our asset allocation to capitalise on the growth opportunities within the equity market.