THOMAS MILLER INVESTMENT

IQ Q1

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **APRIL 2015**

A Note From The CEO

Mike Balfour
Chief Executive Officer

Thomas Miller Investment has enjoyed a good start to 2015: we were delighted to have won 'Best DFM' at the prestigious 2015 Professional Adviser Awards, gained a 5 Star Rating from Defaqto for Thomas Miller Investment Ltd's Bespoke DFM service and we organised and hosted a Burns Night Supper for over 180 guests on the Isle of Man which raised £11k for Hospice Isle of Man (thankfully the photo opposite is not one of me addressing the haggis!). We have also continued with the integration of the business we acquired in late 2014, creating a Wealth Management division in the process.

As investors it's always refreshing to see your portfolio benefiting from strong market conditions, such as the ones we have seen so far in 2015. As investment managers whilst we enjoy positive markets, we must never forget the risks associated with investment. This quarter's Investment Quarterly highlights some of the reasons for the positive start to 2015, but also raises some of the risks that may present themselves over the next quarter and beyond. Risks always seem greater when they aren't understood; we communicate regularly with all our clients, and we constantly look to improve the way this is done, be it face to face, on the phone, electronically and more recently on social media. You can follow us on:

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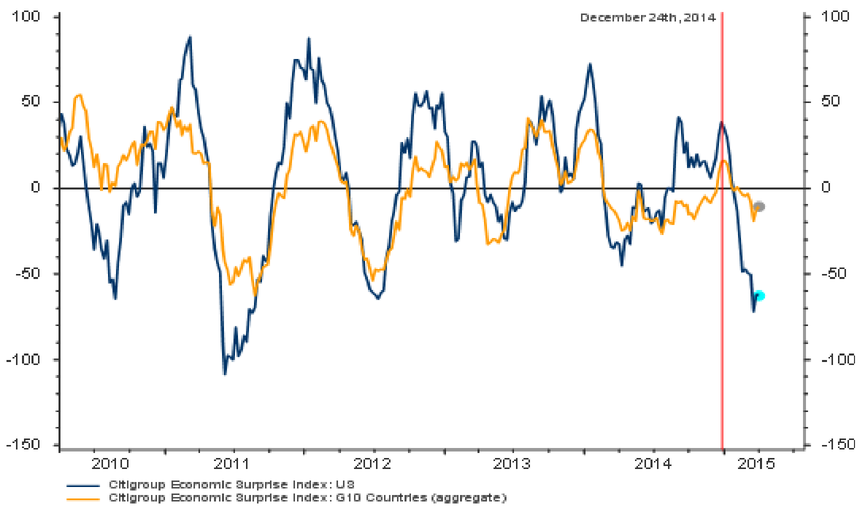
Investment Strategy Overview

Although there have been some notable bright spots (e.g. labour markets in the US and UK), since late December 2014 reports on the global economy have indicated a slowdown in the momentum of economic growth.

This is illustrated by the figure to the right which charts the Citigroup Economic Surprise Indices (ESI) for the US and G10. The ESI tracks the deviation of economic data from market consensus forecasts. Negative readings of the index indicate that economic releases have on balance been weaker than expected.



Source: Thomson Reuters Datastream

In addition to the relatively slower than expected pace of economic activity in the US, UK and Japan, reports have also showed disappointing levels of economic activity in China; combined with ongoing concerns about the outlook for Brazil and Russia. India remains a bright spot among the key emerging market economies.

From a global standpoint, perhaps the most positive development in recent weeks has been the stronger than expected performance of the Euro-zone economy. Although we're still talking about recovery from a very low base, it is increasingly clear that the region is benefitting from a combination of lower oil prices, weaker currency, easier credit conditions and extensive monetary policy stimulus. Looking ahead, the evidence from various leading economic indicators suggests that we should see a modest pick-up in the pace of global growth over the next two quarters.

The behaviour of financial markets during the first quarter confirmed the enduring dominance of monetary policy as the primary driver of market direction. Specifically, the ongoing divergence in the outlook for monetary policy across the major developed economies is driving significant dispersion in financial market performance. So, while the US Federal Reserve is widely expected to start raising rates later this year, the European Central Bank and the Bank of Japan are implementing Quantitative Easing; and the Bank of England sits in the middle—being widely expected to remain on hold for the rest of 2015.

"The behaviour of financial markets during the first quarter confirmed the enduring dominance of monetary policy as the primary driver of market direction. "

The result has been a sharp increase in the value of the US Dollar across the board against other currencies, notably the Euro; a broad-based decline in government bond yields across the developed economies; and strong rallies in European and Japanese equity markets. The chart below shows the movements seen in selected financial markets over the past quarter.

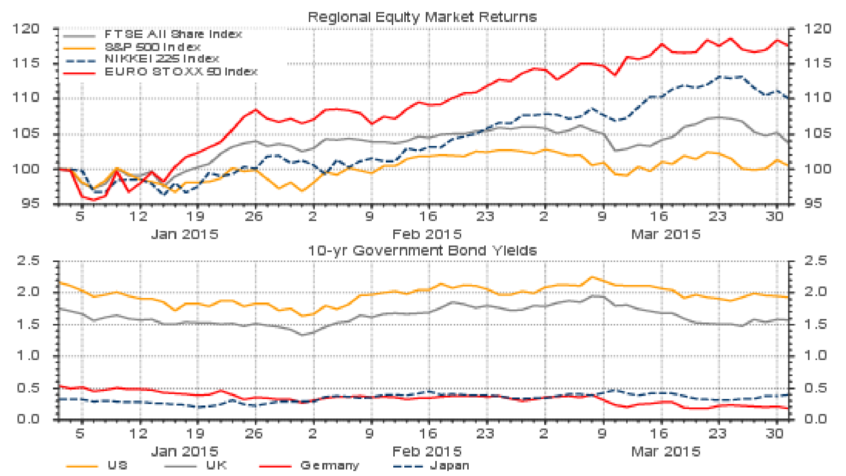
In light of current valuations, it is clear that neither equities nor bonds are "cheap" or "undervalued" in an absolute sense. Indeed, some longer term valuation metrics suggest that both are quite stretched at current levels. Nevertheless, from a longer term perspective, relative valuation favours equities over bonds.

INVESTMENT STRATEGY OVERVIEW

Looking out to the rest of the year, it seems likely that the combination of quantitative easing in the Euro-zone and Japan, low (and falling) inflation across the globe, and various geo-political concerns would ensure that government bond yields remain atypically low. Likewise, the global backdrop of accommodative monetary policy and resulting surplus liquidity could drive equity prices notably higher in the months ahead. But we expect the uncertainty surrounding the outlook for US interest rates to drive volatility higher too.

Overall, we believe that the long term outlook for equities remains attractive. We also continue to favour selected alternative investments, such as infrastructure and private equity. In the fixed income markets, we still prefer corporate bonds to government bonds. In the currency markets, we believe that the current global economic backdrop points to further strength in the US Dollar. In the UK, the forthcoming General Election should fuel greater volatility in the Pound Sterling.

Abi Oladimeji
Head of Investment Strategy



Source: Thomson Reuters Datastream

“Overall, we believe that the long term outlook for equities remains attractive. We also continue to favour selected alternative investments, such as infrastructure and private equity. ”

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD

	United States	Euro-Zone ex Germany	Germany	United Kingdom	Japan	Emerging Markets
Equities (overall)	0/+					
Equity allocation by region	0	0	0	0	0	0
Bonds (overall)	0					
Corporate bonds	0	0	0	0	0	0
High Yield bonds	0	0	0	0	0	0
Govt guaranteed bonds	+	0	0	+	0	0
Index-linked bonds	+	0	0	0	0	0
Alternatives	0					

The scorecard above represents our current tactical asset allocation position relative to portfolio benchmark. 0 =neutral, + =overweight, - =underweight.

A Strong Start to 2015

Bonds had a good first quarter, and to use the words of Mark Twain, once again 'reports of its death have been greatly exaggerated.'

The FTSE All Gilts index returned 2.2%, with the market led by the fall in yields at the long end. Returns for other components of the Gilt market were lower, reflecting the lower degree of exposure to long dated bonds. Thus, the 0-5 year Gilt index returned 0.56%, and the 5-15 year index 1.68%.

Index linked Gilts underperformed in the first three months, failing to match the spectacular returns of 2014. The FTSE Gilt 5-15 year index returned -0.06%, while the short dated 0-5 year index noticeably underperformed, returning -0.54%. Corporate returns were also good, with spreads still tight and no defaults to speak of, and the Merrill Lynch Sterling Non-Gilt index gave 3.31% over three months.

The US Treasury market returned 1.83%. Returns for European bond markets were also strong, despite the fact that yields are already at ultra-low levels. The 10 year Bund yield fell to 0.2% in the period, while Switzerland managed to sell a new 10 year issue with a negative nominal yield – in other words, the investor is paying the Swiss government to lend money to it. Investors being rational, of course, the reason for this has to be the expectation of currency gains, or the lack of available alternatives (shorted dated bonds are even more negative, and deposit rates are at -0.2% or lower).

There were three main factors driving the bond market: a further fall in the oil price to $45 per barrel, the European Central Bank's announcement of its own Quantitative Easing programme, and the Federal Reserve's dovish statement at the latest FOMC meeting on March 18th.

On January 25 the Greeks elected the left wing Syriza party to power. Negotiations over debt reductions are still continuing but we stick with our view that there is no immediate risk of a 'Grexit'. In late February Syriza was given a four month extension of its bail-out programme.

On January 22 the European Central Bank introduced its own Quantitative Easing programme (QE), with €60bn of central bank bond purchases each month expected until the end of September 2016. This was a bigger programme than expected (€50bn per month was flagged in the press), while its duration was longer and the overall aggregate increase in ECB assets was bigger. The programme kicked into action with the first bond purchases on March 6th.

"We still believe that interest rates will finally rise in the US this year after six years of ZIRP"

Perhaps the biggest surprise was the Fed. While it dropped the 'patient' language, as was expected, it drastically reduced its 'dot plot' forecast of anticipated rate rises for 2015 and 2016.

US growth slowed in Q1, and there were a series of negative economic surprises, some of them we believe weather related. Despite this, we still believe that interest rates will finally rise in the US this year after six years of ZIRP (Zero Interest Rate Policy), given our anticipation that US GDP growth will pick up to a 2.5-3% rate. We believe an increase in rates is fully factored in, and we don't anticipate it upsetting the bond market.

Some time ago a rate rise was expected in the UK following the election, but we see this as being delayed until the end of the year given uncertainty over policy following the election.

Growth in Britain's dominant services sector eased back in February but firms hired staff at the second-fastest rate on record, wages rose and new orders increased, a further sign that the economy has got off to a strong start in 2015. Real pay growth has increased but inflationary pressures remain minimal.

James Penn
Senior Portfolio Manager

Can Markets Sustain Current Growth Levels?

If you were a Sterling investor, equities enjoyed strong returns in the first quarter of 2015, with global indices returning 7.5%. However, over a third of that performance was down to currency (specifically Sterling weakness against the US$ and the Yen).

The UK FTSE ALL Share Index delivered 4.7%, its strong start to 2015, faltering slightly in March. The range of returns globally was large, as Greece fell over 26% while Germany rallied over 22%. Japan rose almost 11% in Yen terms, but Yen strength added 5% on a Sterling basis.

The Eurozone equity market, despite the drag from Greece, rose almost 19% in Euro terms, so as you can see, investor fears over the possible Greek Eurozone exit have been largely confined to Greece itself, with a low risk of any contagion being priced. It remains to be seen whether this is too sanguine a view.

At a sector level, not surprisingly, commodities sectors lagged markets, and in the UK and US, utilities also fell.

We have seen increasing levels of merger and acquisition activity, with the move of Royal Dutch Shell on BG Group the most prominent. This sits alongside continued activity in the IPO market though so far without the monster deals such as Alibaba that we saw in 2014.

With all this going on, the FTSE 100 pushed through its previous high (set in 1999), though then fell back (as at writing, it has pushed through again).

As we look into the next quarter, it is difficult to believe that the market can continue to rise at the same pace as it did in Q1. An annualised 20% in markets is a hard pace to maintain, particularly given current valuations (not exactly stretched, but not out and out cheap either), geo-political risks and muted, though positive, outlook for economic growth. Nevertheless, with equities offering arguably better value than bonds and certainly cash, there is still room for further progress.

In the UK, investors are likely to focus on the coming general election, but the outcome of that election is unlikely to reduce certainty as minority parties dance round coalition agreements.

"We should see some further growth in equity markets globally as recovery continues and monetary conditions stay loose."

The current coalition has been remarkable in its stability though the compromises made mean that both may pay a price at the polls. While not expressing a political opinion, it is clear that the markets would react more favourably to a Conservative led than to a Labour party led coalition, but given the constraints imposed by the debt burden the actual outcomes may be very similar no matter who ends up governing.

So, in the UK we expect the early part of the next quarter to remain volatile, and it may well lag the global markets due to the uncertainty engendered by the election. We should see some further growth in equity markets globally as recovery continues and monetary conditions stay loose. It strikes me that familiarity with the geo-political risks abounding has bred some complacency, if not contempt, in investment markets and so markets could be vulnerable to an external shock. It is this more than anything that keeps us from recommending a heavy overweight to equities versus the other available asset classes.

Andrew Herberts
Head of Private Investment Management (UK)

Investing in Infrastructure: The Road to Recovery?

Much has been written about the implications of precariously positioned government balance sheets and the consequent focus on reducing fiscal expenditure. Infrastructure is the backbone for economies to develop and remain competitive.

McKinsey has forecast that a US$57 trillion investment is required in core infrastructure between 2012 and 2030 just to keep pace with projected global GDP growth*. An inevitability of this situation is that the private sector will have to play an increasing role in undertaking infrastructure investment.

This backdrop has given rise to a significant and ongoing opportunity and investing in infrastructure has become increasingly mainstream over recent years. As the characteristics and benefits are becoming better understood so too is the asset class becoming more accessible. Proactive governments and regulators have created schemes to provide stable and attractive return frameworks to encourage the private sector in recognition of this need.

However not all infrastructure investments are created equally, and an appreciation of the differing risks is imperative.

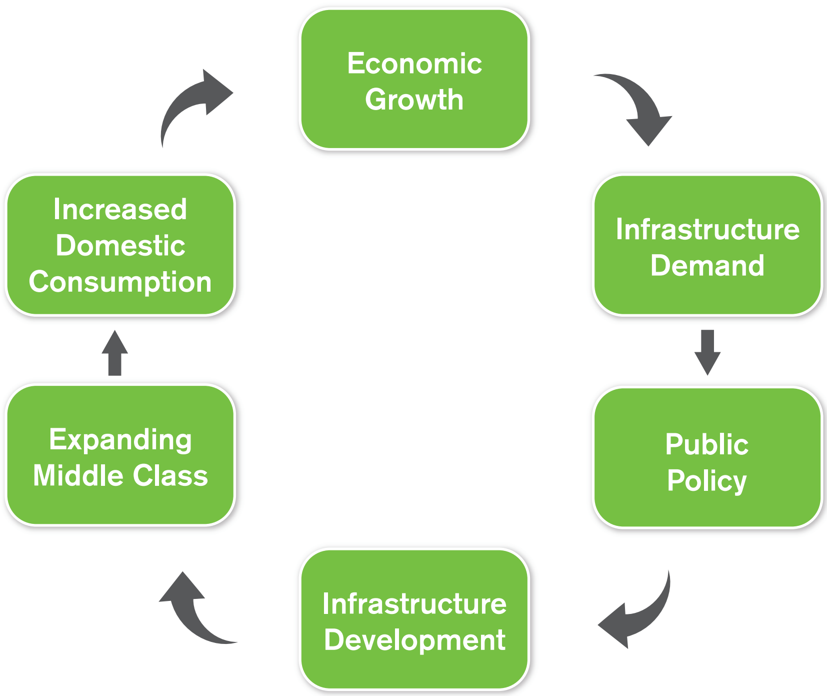
The broad definition of infrastructure is uncontroversial; the OECD glossary entry lists as 'the system of public works in a country, state or region, including roads, utility lines and public buildings.' In an investment context the sector is typically broken down into 'economic' infrastructure and 'social' infrastructure. Economic infrastructure covers areas such as transport, utilities, communications and renewable energy. Social infrastructure focuses on educational facilities, healthcare facilities and defence and judicial buildings.

Economic characteristics of infrastructure assets include high barriers to entry, economies of scale, inelastic demand and long project duration. This confers a range of attractive investment characteristics on the asset class. These include low sensitivity to economic swings, a good inflation hedge, low correlations to traditional asset classes and attractive returns. All of these qualities add up to make a strong long term investment case for the sector. It is an ideal candidate for inclusion within an alternative allocation designed to provide diversification benefits to a balanced portfolio.

Whilst having a positive outlook on infrastructure in general, we favour the social infrastructure space for the stable and highly predicable cash-flows. Investment companies we allocate to in order to access this space, such as 3i Infrastructure Plc and HICL Infrastructure Company, have enjoyed double digit returns over recent years and 2015 has seen further positive gains. Against a backdrop of extremely low bond yields a dividend of 4-5%, covered by government backed-revenue streams, is an attractive proposition.

Whilst prices may appear elevated at current levels, those who wait on the side-lines anticipating a more attractive entry point may be left disappointed. The fundamental support for infrastructure is becoming increasingly entrenched and there would appear little imminent threat that the positive sentiment being enjoyed by the sector is likely to abate.

Mark McKenzie
Portfolio Manager



*McKinsey Global Institute, 2013. Infrastructure Productivity: How to save $1 trillion a year.

Discount Shopping and (The Auld) Alliance

One trend that has caught our attention this year has been widening 'discounts' (differential between the net assets and the share price) across many investment trusts during 2015.

Almost two thirds of the quoted universe has seen their discounts widen since the start of the calendar year. This is all the more surprising against a backdrop of strengthening equity markets – the Global Equity Income sector has endured a 4% widening and the UK Equity Income sector 3% according to data from the Association of Investment Companies over the first quarter.

See the chart below for the Aberforth Smaller Companies Trust which shows a progressively widening discount since the start of the year. This Trust is held reasonably widely across client portfolios and whilst a discount has been a regular phenomenon for this particular company, the magnitude of the latest softening suggests a heightened aversion to risk; events in the wider sector add further substance to this conclusion.

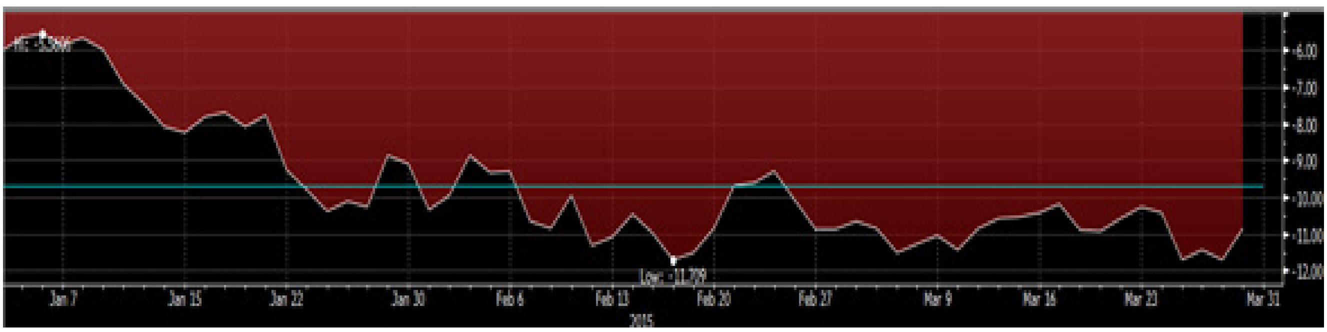
This begs the obvious question – why? Trying not to sound trite, discounts are a function of investor demand for the shares of investment trusts and clearly this has weakened recently. Granted, discounts have been at historically low levels in recent times but there doesn't seem to be any obvious antagonist. The search for yield trend remains firmly in place and therefore the behaviour of the equity income sectors highlighted above remains all the more baffling. Could this portend a deterioration in the outlook for risk assets by investors – perhaps. Could it be that uncertainty surrounding the UK's General Election is beginning to influence investor behaviour – maybe? Time will be the ultimate arbiter of events and meanwhile, as active investors we will view such fluctuations as a potential opportunity for our clients.

"Discounts are a function of investor demand for the shares of investment trusts and clearly this has weakened recently."

It would be remiss of us in discussing investment trust discounts not to pause and consider circumstances unfolding with the 127-year old Alliance Trust. The Dundonian investment company has once again received unwanted (at least by its Board) advances from the Americans, this time Elliott Advisors who have proposed the appointment of three new Independent Directors. The US-based activist investor has built up a significant stake in the Trust and, not for the first time, has been agitating for change.

Such advances are not entirely unwarranted given Alliance's recent meandering tendencies - they have lacked any clear strategic direction for many years. Remuneration packages also appear to be overly generous which jars with the austere climate in which we live. In this latest bout, both parties are being a little disingenuous with shareholders – Elliott pretending to be in it for the long-term when ultimately looking to make a fast buck for its investors and Alliance, rather weakly, pointing to short-term out-performance in the face of longer-term under-performance. Frustratingly for Elliott the discount for the Trust remains stubbornly large albeit it has not widened in-line with the rest of the sector. As I write the share price suggests that holders are likely to reject Elliott's proposals although one suspects there is an underlying acceptance by many that change is needed.

Scott Baikie
Senior Portfolio Manager



Source : Bloomberg (discount of share price to NAV for Aberforth Smaller Companies Trust - 2nd Jan 2015 to 31st Mar 2015)

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Professional Adviser 2015 awards
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Thomas Miller Investment Ltd's Bespoke DFM service has been rated 5 Star by Defaqto.

CONTACT US

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