THOMAS MILLER INVESTMENT

IQ3

Global market intelligence, critical analysis and investor briefing

Investment Quarterly

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A NOTE FROM THE CHIEF EXECUTIVE

Recognising that the world was different five or ten years ago is easy, knowing that it will be different again in five or ten more years takes understanding, but planning for the future is the real challenge.

It is clear to see when looking at the history of the Thomas Miller Group that we have been able to successfully adapt to a myriad of changes over the last 129 years, and it is because of this ability to evolve that we sit today a financially secure and well diversified group that is looking to the future.

Thomas Miller Investment has just written the latest chapter of the Thomas Miller Group history by making an acquisition of a private client business; bringing this new business into Thomas Miller Investment increases our assets under management, our head count, our offices and widens our private client offering. The integration of the two businesses will be challenging, but offers us greater potential to evolve our wealth management offering over the next five or ten years.

Mike Balfour,
Chief Executive Officer

Investment Strategy Overview

In the latest edition of its World Economic Outlook (published 7th October 2014), the IMF once again downgraded its forecast for global economic growth.

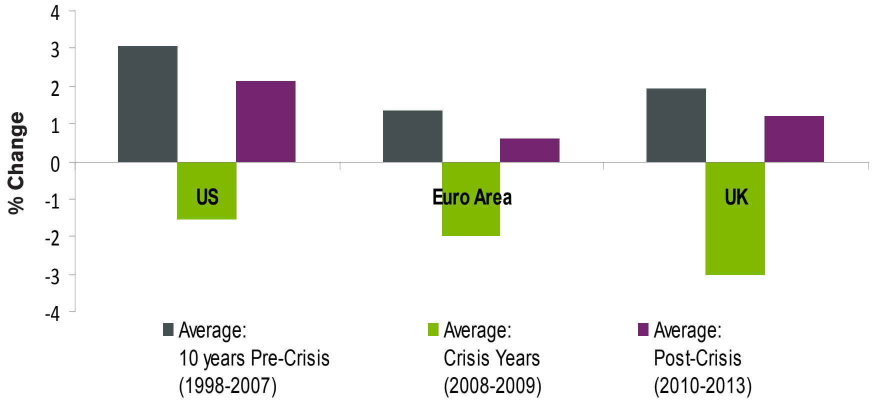
That marked the third time that the organisation has revised its 2014 forecasts lower, having previously done so in both April and July. For 2014, world economic output is now expected to grow by 3.3%, followed by a growth rate of 3.8% in 2015.

This pattern of progressive downward revisions to growth estimates is one that investors have become accustomed to in recent years. Five years into the economic recovery, the effects of the Great Recession linger. Global economic growth continues albeit at an uneven pace, with significant regional variations. In particular, over the past year or so, global growth has been heavily reliant on the strength of economic activity in the US and UK. Unfortunately, the outlook is for more of the same in the quarters ahead as potential growth rates decline across the globe.

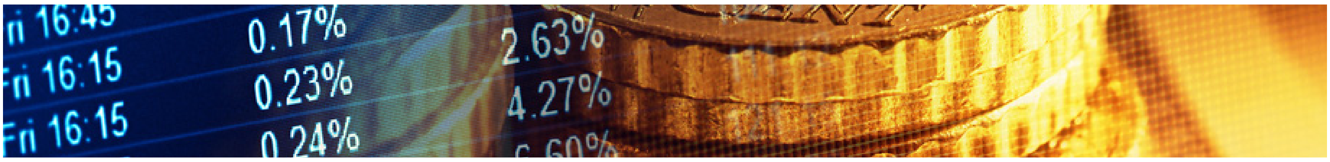
Figure 1 presents average annual real GDP growth rates for the US, UK and Euro Area over selected periods.

In light of the evidence outlined in Figure 1, talk of secular stagnation and a lost decade marked by a ‘new normal’ of structurally lower growth rates no longer seem outlandish. Indeed, for some economies, most notably in the Euro Area, in the absence of a marked deviation from current policy, it is hard to see how the pattern of economic activity would be much different over the next 5 years. In this regard, it is notable that the IMF’s latest forecast is for the Euro Area to grow by 0.8% in 2014, followed by 1.3% in 2015 (revised lower from July

Figure 1 – Real GDP (YoY%)



Source: Bloomberg data & TMI analysis



estimates of 1.1% and 1.5% for 2014 and 2015 respectively). Low as those revised projections may seem, the risks to the outlook for the Euro Area remain largely on the downside.

Meanwhile, in the developed economies outside of the Euro Area, the momentum of growth continues to improve and leading indicators suggest that this trend should continue in the quarters ahead. Additionally, given that monetary policy remains broadly supportive (even if it tightens at the margin), business and consumer confidence continue to improve, and financial conditions remain benign. We expect the pace of global economic growth to remain reasonable over the rest of 2014.

Investment Strategy

So far this year, the combination of weaker than expected growth, falling inflation (and lower inflation expectations) and heightened geo-political risk have ensured robust demand for government bonds. The third quarter was no different as global bonds performed strongly, led by government debt which returned 1.4% in US Dollar terms, outstripping the 0.3% gain for global corporate bonds.

In light of the discussion above, the benign backdrop for bonds looks set to persist for the rest of the year. Consequently, while government bonds offer little value from a long term investment perspective, a sharp rise in bond yields (and corresponding decline in capital values) is unlikely in the shorter term. Furthermore, the regional variation in the outlook for growth and monetary policy warrants similar regional differentiation across markets. In this regard, the combination of weak growth and mounting deflationary pressures in the Euro Area should put ongoing downward pressure on government bonds in the region. This could also weigh on government bond yields in the UK and US too.

"For more risk tolerant investors, a bias in favour of risk assets, including equities and a selected range of alternative investments, such as infrastructure and private equity, remains appropriate."

Equity market volatility rose sharply in September which meant that stock market returns in the third quarter were lacklustre. Seasonal tendencies would suggest that the elevated level of volatility should persist through the middle of the fourth quarter. Looking beyond the shorter term though, it is noteworthy that monetary policy remains broadly supportive of risk assets and corporate earnings are still growing at a decent rate. On the other hand, equity valuations are not cheap, particularly in the US.

Overall, while equities offer better risk-reward trade-off than bonds, gains are likely to be more measured in the months ahead. On balance, the evidence suggests that conservative investors should not stray too far from benchmark allocations to the major asset classes for now. For more risk tolerant investors, a bias in favour of risk assets, including equities and a selected range of alternative investments, such as infrastructure and private equity, remains appropriate.

Abi Oladimeji
Director & Head of Investment Strategy

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD

	United States	Euro-Zone ex Germany	Germany	United Kingdom	Japan	Emerging Markets
Equities (overall)	+					
Equity allocation by region	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	0
Alternatives	0					

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

MARKET OVERVIEW

Stock markets had a poor third quarter of 2014, although the outlook appeared much better in early September when stocks were revisiting all time highs. The final three weeks of September witnessed significant losses.

Overall, the MSCI World index lost 2.6% in US Dollar terms over the three month period. However, the reporting currency is all important, and in Sterling terms world stocks actually gained 2.7% and in Euro terms world stocks rose an even better 5.5%.

This is down to a spectacular rise in the US Dollar over the period, which went from EUR1.369 to EUR1.263, a rise of 8.15%. The rise against the pound, from GBP1.71 to GBP1.62, was nearly as marked at 5.4%. The upshot was that, despite the US equity market making almost no progress, non-US investors registered substantial gains purely down to the effect of currency, given that the US equity market constitutes well over 50% of world stock market capitalisation.

Sterling actually bottomed at GBP1.61 shortly before the Scottish Independence Referendum (when one poll showed a slight majority for the Yes or pro-independence vote), but recovered a little ground later in September after a convincing No vote was registered. However, after an initial strong bounce, it settled back at the GBP1.62 level. The euro, meanwhile, has continued to hit new lows and shows no sign of bottoming as yet.

The movement in the currency markets has much to do with monetary policy and divergent growth trends. The US looks to be well out of recession now and a rise in interest rates over the next 12 months is widely expected. In the Eurozone, however, most nations are still mired in recession, with even Germany registering a -0.2% decline in second quarter GDP. France was flat while Italy sank back into recession for the third time since 2008.

To counteract these forces the ECB initiated a further concoction of monetary easing in early September, cutting the main repo rate to 0.05% and the deposit rate to -0.2%. this penalises banks parking excess reserves at the ECB with negative interest rates, the hope being that instead they lend into the real economy. It also introduced further TLTROs (Targeted Long Term Refinancing Operations) given the original ones extended in 2011 and 2012 are coming to an end. The ECB also made tentative steps towards unconventional policies, stating that it would buy up to €1trn in covered bonds and asset backed securities over a two year period in an attempt to free up bank balance sheets.

Q3 2014 Highlights:

- **MSCI World index lost 2.6% in US Dollar terms over the quarter. However, in Sterling terms world stocks actually gained 2.7%.**
- **The US looks to be well out of recession now and a rise in interest rates over the next 12 months is widely expected.**
- **For the quarter as a whole, the FTSE100 fell 2.7%.**
- **The worst performing sector was Food and Drug Retailers, which fell 27%.**
- **Both the Dow Jones Industrial (+0.7%) and the Nasdaq (+1%) outperformed the S&P500 (which was flat).**

Late July was marked by a sharp sell-off in equity markets, driven by ongoing geo-political concerns in the Ukraine and Iraq, a second default by the Argentinian government on its national debt, and the collapse of one of the largest Portuguese banks, Banco Espirito Santo, where depositors and senior bond holders were honoured, but shareholders and subordinated bond holders left with virtually zero residual value.

However, the sell-off did not last long, and investors soon refocused on remarks by ECB President Mario Draghi at the Jackson Hole conference for central bankers. He stated for the first time that longer term inflationary expectations were too low and indicated that the bank would take action to prevent any deflationary trends from becoming entrenched. That spelt more monetary easing for investors, and stock markets by early September had recovered all their July losses and were back at all time highs.

However, the optimism was short lived and global stocks underwent a significant correction in the final weeks of September. The FTSE100 lost 2.8% in the final week, its worst performance in 15 months.

For the quarter as a whole, the FTSE100 fell 2.7%. The All Share fell by a similar amount. The worst performing sector was Food and Drug Retailers, which fell 27%. Historically, this has been a defensive sector, but supermarkets have reported the most challenging conditions in 30 years as competition intensifies. Tesco cut its interim dividend by 75% and has called in the accountants after overstating first half profits by £250m. Sainsbury's has said it is reviewing its dividend and may cut it too. Industrial Engineers also underperformed, dropping 5% as the manufacturing cycle weakens. The UK Manufacturing PMI index is still above 50, but is well down from the highs of 57 shown earlier in the year. Engineering stocks have been falling in the US too, where companies are having to cope with the stronger Dollar as well as a slowdown in new orders.

Both the Dow Jones Industrial (+0.7%) and the Nasdaq (+1%) outperformed the S&P500 (which was flat). The Eurostoxx 50 index fell 1% over the period but this masked divergent country performances. Germany fell -4%, Italy -3%, and France -1%. In the year to date the Eurostoxx is still up 4%. The best performing European markets, were Poland and Iceland, up 5% each, with the Danish and Swiss markets next best, up 2.5%.

Emerging markets fell sharply in September, the MSCI Emerging market index dropping 8.6% in US Dollar terms since its high earlier in the month. Over the quarter it fell 4.4%. However, in Sterling terms it rose 0.9% reflecting the Dollar strength noted above. China was the strongest individual market, up 15%. The Hang Seng was flat. In Japan the Nikkei rose 5% to make it the stand-out developed market.

Global bonds performed solidly, particularly government bonds which gained 1.4% in US Dollar terms versus a 0.3% gain for global corporate debt. UK Gilts had their best quarter since 2011, rising 3.7%.

James Penn
Senior Portfolio Manager

Equity Markets - The Death of Geo-politics?

With the Scottish vote on independence now having been resolved, we can, at least, tick off one geo-political event that was hovering over financial markets. Unfortunately, from Eastern Ukraine, to Syria, Gaza and Iraq, to name but a few, there seem to be plenty more flashpoints to worry markets.

However, despite these 'hot spots' there appears to have been a surprisingly muted response from overall equity markets, with volatility during the summer continuing to be at low levels. Even the increasing instability in the Middle East seems, at least up to now, to have been largely shrugged off. On that basis, is it reasonable to pose the question… 'do geo-political events still have the ability to have the same impact on equity markets as they used to, and if not, why not?'

As is usual with such questions, the answer is not a simple one. By their very nature, geo-political events are often unpredictable and can arise (and subside) relatively quickly and sometimes without much warning. Hence, the more dramatic and the more unexpected the event, the more severe the short term market reaction tends to be. Conversely, the faster they are resolved or absorbed, the more transitory is the effect on equity markets.

A good example of this is the dramatic events surrounding '9/11' and its immediate aftermath in 2001. The initial attacks resulted in a sharp initial retreat in global equities, but this had been reversed by the end of 2001. The longer term impact resulting from the sea-change in American policy however, had a less dramatic on-going impact on markets. In essence therefore, what has to be borne in mind is that geo-political events in themselves rarely change the primary trend of markets and, in that sense, their overall impact is often relatively short term and transitory in nature within a broader cyclical, or secular, trend.

Turning back to the original question posed earlier, the following may help explain some of the reasons why recent geo-political events have seemingly been shrugged off by equity markets:

1. In this continued period of extremely low interest rates and accommodative central bank policy, any pull-back in equity markets has been seized upon as an opportunity to buy. This may have lessened the short term widespread downside pressure, although it may affect markets on a more localised basis (such as the current Hong Kong unrest).

2. Many of the current geo-political events are so complex that many investors, including seasoned ones, are either wearied by them or are just thoroughly confused about how many of these issues can be resolved. On that basis, such issues have tended to be treated as on-going problems that can be only be addressed over a medium/longer term period. For example, looking at the current situation in Syria and Iraq, it is difficult to know who is fighting whom or who one's enemies or allies are. In such an environment decision making can almost come to a halt or move, at best, by osmosis.

3. The pressure/volatility has been absorbed more by other asset classes such as currencies and fixed income. In particular, currencies have seen some greater volatility recently, suggesting much of the strain may have been taken by them.

The point about other asset classes taking the strain is particularly interesting. Clearly, the US Dollar remains the 'safe haven' currency and so some of its recent strength may be due to this factor, although it may just as well be the result of increasing confidence in the economic recovery that has taken hold in the US that will likely lead to higher interest rates within the next 12 months. The action and direction of fixed income yields has also been of note since, until recently, fixed income in the US and the UK have performed well despite the prospect of looming interest rate rises in these Anglo-Saxon economies. Whilst this seemingly perverse movement may be down to simply a disbelief in the strength of global economic recovery, it is possible that, at least in some measure, investors wary of geo-political problems have used fixed income as a 'bolt hole' rather than gold, which has performed relatively poorly in recent months. In essence, geo-political factors have helped to dampen, or mask, more fundamental analysis, particularly in the fixed income arena.

In summary therefore, in this complicated geo-political and economic environment, it may be that investor concerns are being dissipated through other asset classes more than would be the case in 'normal' circumstances. If that is the case, then, for equity investors, the geo-political part of the equation may currently be relatively benign. However, nothing is forever and therefore, as we move gradually back to economic normality then, for equity investors, these geo-political forces are likely to reassert, with the inevitable increased volatility that this will entail.

David Thomas
Managing Director, IOM

Listed Private Equity: Value in an expensive world?

Very few financial assets can be considered cheap at present. Bond yields are stubbornly low, corporate spreads are tight and, despite recent weakness, equities are still at historically high levels. Given this scenario investors may wish to consider exploring the world of alternative assets to bolster returns and increase the diversification of their portfolios.

Investment companies offer an interesting way to access certain sectors within the alternative investment landscape where traditionally liquidity has proved a barrier for many investors. One such sector is listed private equity (PE).

Having suffered a widespread capitulation during the financial crisis which left investors understandably wary, listed private equity has been a strong performer in recent years. Balance sheets are strong and are markedly improved from 2009, with gearing levels having been drastically reduced. Many portfolios are now mature and set against an improving economic backdrop this provides a fertile ground for realisations.

With many investment companies trading at substantial premiums listed private equity is one of the few areas where significant discounts remain. There is considerable differentiation amongst the investable universe both in terms of operational structure and investment style, thus stock selection is of paramount importance to achieving the best results.

Fundamentally we look for companies with strong, appropriately incentivised management teams who operate within a prudent corporate structure. We favour HgCapital Trust in the direct PE space which, whilst not having the most mature profile in the sector, is a company with an excellent long term track record with a focus on quality growth companies in Northern Europe.

The fund of funds space also offers some attractive characteristics. For investors looking for greater diversification then a fund of fund structure offers this in a single investment vehicle. We favour fund of funds with a concentration of underlying vintages pre 2009 such as Pantheon International and HarbourVest Global Private Equity. These vintages are now maturing and have been a significant contributor to realisations in recent years. If we continue to see a broad economic recovery then this trend is likely to persist.

Despite the investment case for the sector it is important to emphasise that the listed PE sector has a relatively high degree of correlation to equity markets compared with other alternative sectors. Consequently any investment should be viewed primarily from a return generative rather than portfolio diversification perspective within an alternative allocation.

The combination of attractive discounts and a supportive backdrop for NAV growth creates a compelling argument for the risk tolerant investor to allocate to private equity within a bucket of alternatives. In an environment where few assets look cheap, listed private equity may prove to be one of the few areas still offering value in an expensive world.

Mark McKenzie
Portfolio Manager

MARKET RATES

Historic Market Rates

As at 30th September 2014

	Close	1 month % change	6 months % change	1 year % change	3 years % change
FX					
GBP/USD	1.6219	-2.28	-2.77	0.22	4.07
EUR/GBP	0.7786	-1.59	-5.69	-6.88	-9.35
EUR/USD	1.2629	-3.83	-8.30	-6.67	-5.66
USD/JPY	109.65	5.34	6.38	11.65	42.29
USD/CNY	6.1394	-0.07	-1.25	0.30	-3.79
BOND YIELDS					
US 10 yr	2.489	0.146	-0.229	-0.121	0.573
UK 10 yr	2.425	0.057	-0.311	-0.296	-0.005
Germany 10 yr	0.947	0.057	-0.619	-0.832	-0.940
Japan 10 yr	0.531	0.035	-0.111	-0.155	-0.501
Swiss 10 yr	0.487	0.045	-0.465	-0.534	-0.455

Source: Bloomberg

	Close	1 month % change	6 months % change	1 year % change	3 years % change
EQUITIES					
S&P 500	1,972	-1.40	6.42	19.72	86.01
Dow Jones	17,043	-0.23	4.76	15.29	68.60
NASDAQ	4,493	-1.82	7.68	20.67	93.93
FTSE 100	6,623	-2.79	2.42	6.45	45.67
FTSE all-share	3,534	-2.77	1.38	6.40	49.41
DAX	9,474	0.04	-0.85	10.24	72.20
NIKKEI	16,174	5.37	9.78	13.66	96.34
Hang Seng	22,933	-6.93	6.90	4.28	45.70
COMMODITIES					
Gold	1,208.16	-6.18	-5.91	-9.09	-25.60
Crude oil – WTI	91.16	-5.00	-10.26	-10.92	15.10
S&P GS soft cmd	498.07	-10.82	-29.16	-23.39	-27.99
S&P GS ind metals	1,344.53	-6.11	3.93	-1.98	-11.60

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