THOMAS
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INVESTMENT

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Global market intelligence, critical analysis and investor briefing

Investment Quarterly **OCTOBER 2016**

A Note From The CEO

The last quarter has been dominated by political commentary both in the UK, where focus continues on the nature and impact of the Brexit negotiations, and in the US where the Presidential Election is being played out at full volume.

The Sterling currency markets have continued to feel the pressure, further extending the post referendum falls in value against other major currencies to levels not seen for many decades – indeed, the Sterling/US$ rate now stands at 1.22 against 1.50 in mid-June this year.

Whilst this currency movement is likely to result in upward inflationary pressure here in the UK as the higher cost of imported goods and services flow through, there is significant benefit to the Country's exporters and to other organisations with significant overseas earnings.

This, along with the dovish stance adopted by the Bank of England's Monetary Policy Committee which saw Sterling base rate cut to a record low of 0.25% in August, has provided continued stimulus to the UK equity markets, resulting in the FTSE 100 index extending its gains to a record high of just over 7,100 in early October.

As we continue into the final quarter of the year and anticipate the realisation of the Brexit referendum vote in the first quarter of 2017 as the UK Government follows through with the triggering of Article 50 of the Lisbon Treaty in line with its stated timetable, we should anticipate some volatility across the financial markets in the coming months.

We continue to be focused on delivering investment outcomes in line with your financial objectives

Hugh H Titcomb
Chief Executive Officer

and notwithstanding the market environment we anticipate there will continue to be attractive investment opportunities.

Please do speak with your investment manager or wealth management consultant should you wish to discuss your financial affairs.

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An Assessment of the Investment Landscape

Global economic growth: improvements ahead?

Following a disappointing start to 2016, global economic growth looks set to pick up over the rest of the year. In an encouraging development, having flagged weak growth momentum for some time, key leading economic indicators now show that growth is starting to stabilise. On that basis, we expect the pace of global economic growth to improve over the next couple of quarters relative to the pace recorded in the first half of this year.

In the US, early indications are that annualised real GDP growth rate will average over 2% in the second half of 2016, following a rate of less than 1.5% in the first half of the year. Such an outcome would support corporate earnings and boost financial markets.

In the UK, data released following the referendum have painted a picture of economic resilience as a broad range of economic reports have been better than initial post-referendum forecasts. But this is not the same as saying that 'Brexit' has no economic consequence. In practice, an objective assessment of the likely implications of Brexit for the UK economy will only be feasible once we know the nature of the post-Brexit relationship between the UK and the rest of the EU and the extent to which UK businesses will continue to have unfettered access to the EU.

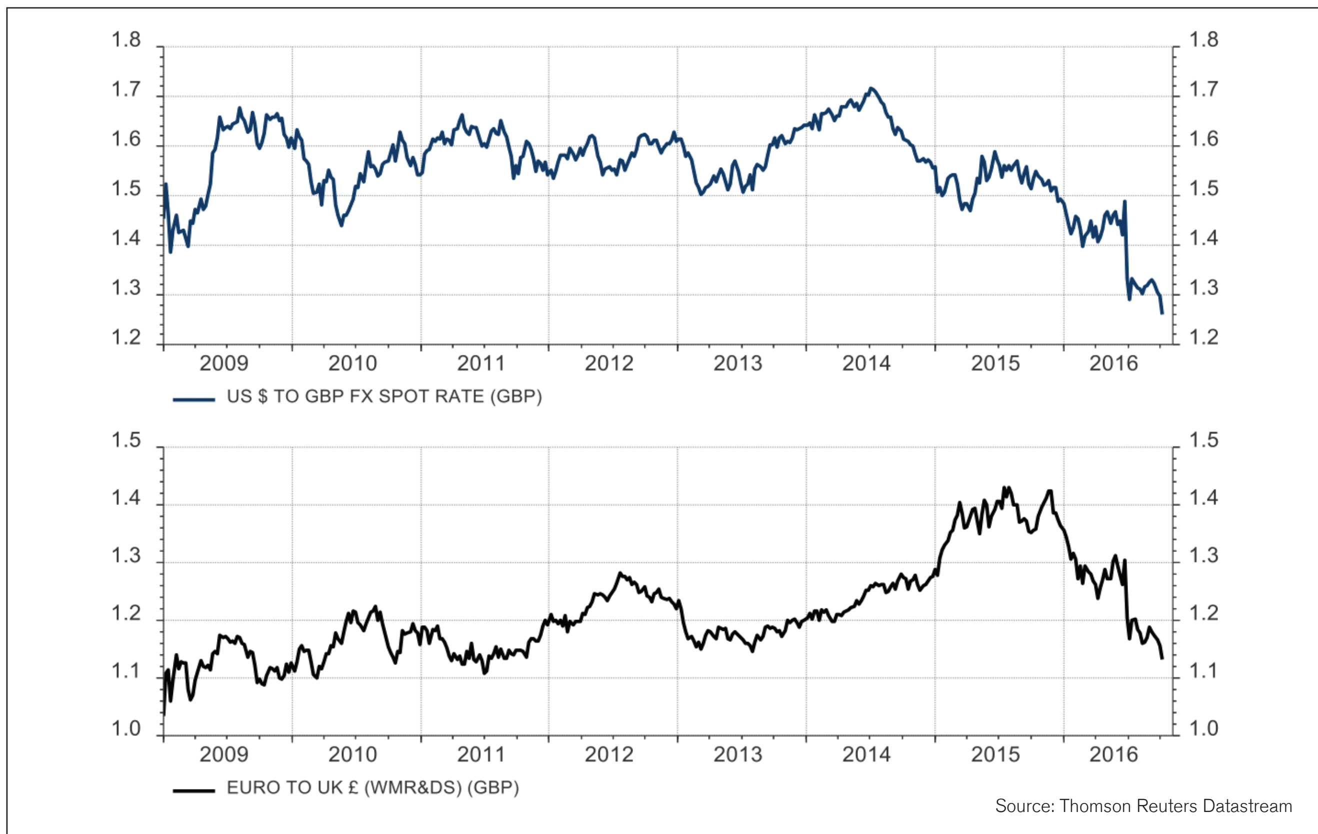
Sterling bearing the brunt of Brexit

So far the impact of Brexit has been felt mostly in the currency markets where sterling has declined across the board. Against the euro, sterling has weakened from over €1.30 just before the referendum to around €1.11 at the time of writing. Against the US$, sterling has fallen from around $1.50 just before the referendum to a current multi-decade low of $1.23. These moves are illustrated in Chart 1.

Fundamentals & investor sentiment

The trigger for the current leg down in sterling has been the comments by Theresa May (and other UK ministers), at the recent Conservative Party Conference. More broadly, sterling has been weakened by a combination of the fallout from the Brexit vote, the monetary policy response to the outcome of that vote (rate cut and further QE by the Bank of England), the increasing likelihood of a rate hike by the US Federal Reserve Bank (Fed)

Chart 1: FX market moves – sterling v US$ and euro



before the end of this year; and the fact that these latest economic and political developments are set in the context of the UK's ongoing weak current account balance.

Given the severity of recent declines, sterling could well experience temporary episodes of strong recovery rallies. But over the next few months, as investors get more information about the nature and terms of the likely UK negotiating position in the period leading up to Article 50 being triggered, currency markets will remain very volatile and sterling seems likely to remain under pressure.

Policy backdrop & outlook

In September, the Fed persisted with its cautious stance on US interest rates and decided to leave rates unchanged. In addition to that, the Fed reduced its growth expectations and lowered its interest rate projections for 2017. It is worth setting the US central bank's decision in some context.

When the Fed raised interest rates in December 2015, the consensus expectation was that the pace of growth would pick up sufficiently to warrant four rate hikes in 2016. Indeed, the Fed's median forecast was for real GDP to grow by 2.4% over the course of the year. At the time, private sector forecasts were even higher – with consensus in the region of 3.0%. Well, nine months later, in September 2016, the Fed revised its GDP growth forecast down to 1.8%. It should be noted that real GDP growth averaged about 1.5% during the first half of this year, meaning that the Fed's September revision has factored in an acceleration in the pace of growth during the second half of the year. While that acceleration currently seems likely (as discussed above), it is by no means a foregone conclusion. And neither is the widely anticipated rate hike in December 2016.

Overall, the data shows that the Fed has been right to refrain from further rate hikes so far this year. Looking ahead, if the tentative upturn in key leading economic indicators is sustained, that should provide some cover for the Fed to go ahead with one hike later in 2016.

From a global standpoint, a hike by the Fed will simply emphasise a divergence in monetary policy across the major central banks because no other major central bank is even contemplating tightening policy at this point. Importantly, in the US and elsewhere, it now seems clear (finally) that monetary policy is no panacea and will not by itself solve the problem of depressed economic growth rates. Looking to 2017 and beyond, it seems likely that a broader policy mix, blending both monetary and fiscal policy measures, will be adopted.

Investment strategy summary

Our assessment of the economic and financial market landscape leads us to a neutral stance on the major asset classes relative to long term weightings. Our caution on equities pertains to concerns that the strong rally that we have enjoyed in recent months now needs to be matched by a recovery in fundamentals, including a sustained recovery in economic growth and a return to earnings growth following a period of earnings recession. We retain a negative duration position on UK gilts as we see scope for further push up in yields; and we retain a negative outlook on sterling on the basis of the discussion outlined above.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 6th October 2016)

	United States	Euro-Zone ex UK	United Kingdom	Asia ex Japan	Japan	Emerging Markets
Equities (overall)	0					
Equity allocation by region	0	0	0	0	0	0
Bonds (overall)	0					
Agency/Supra	0	0	0	0	0	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
Alternatives	0					

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

A More Disparate Quarter for Bonds

After an exceptional first half, the third quarter of the year was a more disparate one for bonds. While government yields dropped to even lower levels in the UK, yields actually rose a little in the US and Japan.

The UK 10 year yield began the period at 0.86% following the shock of the Brexit vote, and made a low of 0.52% in August after the Bank of England surprised with the extent of the additional stimulus on offer.

On August 4th, the BOE not only cut the base rate by 0.25%, setting a new all time low rate of 0.25%, but also announced £70bn of bond purchases in an extension of the Quantitative Easing programme.

For the first time the Bank also included the purchase of £10bn of corporate bonds. The purchasing of credit has been tried elsewhere by the central banks of Europe and Japan, but not in the UK.

The stimulus was, unsurprisingly, good for Gilts, and the corporate bond market as well, and investment grade spreads tightened to about 1% at one point, their narrowest in years, though they have risen a little in September.

Corporates have not been slow to take advantage of the low yields on offer. This is not just true of the UK but around the globe more broadly, and it is thought that some $4 trillion of corporate debt has been issued so far this year.

The BOE announcement in early August showed the Bank's intention to do everything in its power to stimulate confidence and stave off a post-Brexit slowdown.

Members of the Monetary Policy Committee have since maintained the dovish tone in public pronouncements, and it may be the case that the base rate is cut further to zero in coming months. The probability of a rate rise in the UK over the next two years was zero in August, though by early October this had risen to 40%.

The other area where the dovish stance had a big impact is on the currency. Sterling initially fell to $1.29 a week after the Brexit vote, then dipped back to that level in mid August. Following a bounce in early September, it fell below USD1.29 again when Theresa May outlined the timetable for leaving the EU in early October.

The other focus in the period was the middle of September, when both the Federal Reserve and the Bank of Japan made their latest statements on monetary policy within a matter of hours of each other.

The Fed, as anticipated, left interest rates in the US unchanged, though it reiterated that the economy was showing continuing improvement and that a rate rise could be warranted before the end of the year.

The picture was slightly clouded through the contradictory messages of different governors. The 'dot plot' of anticipated rate hikes showed that three governors now expect no change in rates in 2016. However, at the same time three voting members of the committee openly dissented and voted for a rate hike at the meeting. The probability of a rate hike in December has risen back over 50%.

Meanwhile, in Japan there was much riding on what the Governor of the JCB, Haruhiko Kuroda, would do given the disappointing impact thus far of the negative interest rate policy introduced at the beginning of the year.

In the event, the BOJ maintained government bond purchases at an annual pace of JPY80 trillion, and announced an intention to keep the 10 year yield at zero, and let the 30 year yield find its own level. It also specified an aim that core inflation should 'overshoot' the 2% level.

Allowing higher long term rates should allow banks to become more profitable by lending further out.

In anticipation of the central bank meetings, September was a trickier month, with a sharp sell off in bonds in the first two weeks. US Treasuries and US corporate bonds had dropped -1% and -1.4% respectively by September 13th. In contrast to the earlier part of the year, the falls in the bond markets on this occasion were mirrored in the equity markets as correlations between the two turned positive. But after the Fed held rates sentiment improved, and bonds made up most of their losses later in the month.

Corporate bonds generally outperformed government bonds over the three months, given the additional kicker of spread tightening. High yield and emerging market bonds also continued to make good gains.

James Penn
Senior Portfolio Manager

The Central Bank Put is Alive and Well

Q2 finished on something of a tear for equity markets, certainly in sterling terms The Bank of England's intervention after the UK vote to leave the European Union pushed gilts yields to historic lows and gave UK equities a fillip – the Central bank put is alive and well.

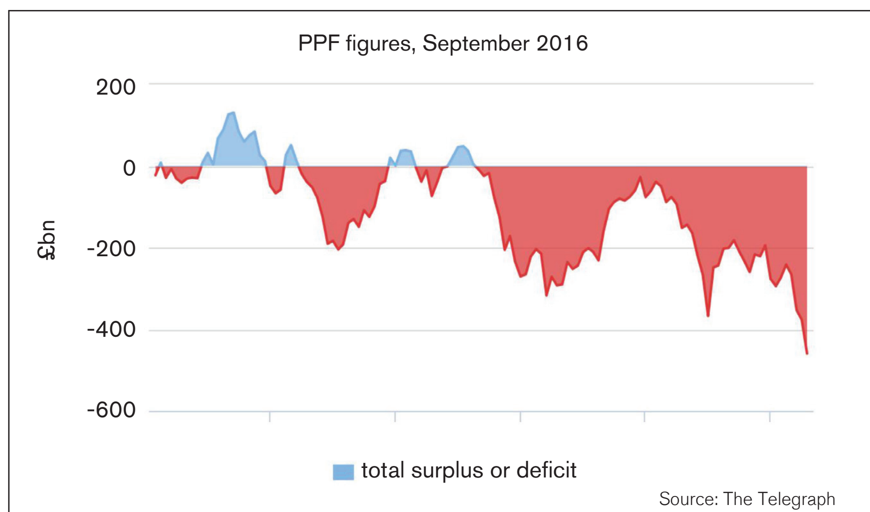
One feature of the quarter's returns was the regaining of some ground by UK mid caps against the large cap names. The FTSE All Share rose 7.8% with the mid cap index up 8.5%, the FTSE 100 4.9%. The healthy overall rise masked some large sector dispersion. IT rose by over a quarter (albeit it is only 3% of the overall index) with metals and mining up nearly a fifth. On the other hand, telcos fell 3% as both Vodafone and BT struggled.

One reason behind this underperformance is BT's pension scheme. With some estimates of BT's pension deficit at over £12bn on a £40bn scheme, the fall in gilt yields is some explanation of its 10% underperformance. Lower gilt yields mean higher pension deficits and some investors worry about the security of its dividend in the face of potentially higher contributions. Which brings us to the other side of the effect of the Bank's ongoing suppression of interest rates. It has been effective on terms of inflating asset prices, but a side effect has been the ballooning of defined benefit pension deficits. It is difficult to find a definitive number as to the total level of deficit but the Pension Protection Fund estimates the figure at £460bn while PWC 's figure comes in over £710bn. Both sources agree that the deficit has jumped by over £80bn in the month of September. In the very short term, this has no effect on the underlying companies, but if the interest rate environment persists, then companies will be forced to contribute higher cash levels in order to address the position. This is cash that could be used either to fund dividends or to fund investment for further growth and in neither case is it good news for equities or the broader economy. Attempts to address the issue will be fraught. One option is to use a lower measure of inflation to calculate pension payment growth, but that penalises pensioners. Another is to change the methodology of calculating the liabilities associated with pension funds. There is an argument to say that these deficits are artificial constructs and that gilt yields are not the correct way to make the calculation, however defining the methodology to retrospectively deliver a more palatable answer does not seem terribly satisfactory either. A return to a "normal" level of interest rates will, of course solve the issue, but in the meantime we will continue to see headlines that raise concerns. As yet we are not seeing meaningful impacts on company cashflows, but as we cycle through the regular pension funding reviews and companies commit to higher levels of contribution, we may see pressure on dividends or capital spending. Some sectors and companies are more at risk than others here. Essentially this issue affects primarily older companies with legacy defined benefit schemes – and often with a huge cohort of pensioners (again, BT has 300,000 members). Particularly hard hit are some traditional industrial companies whose pension fund liabilities reflect much more labour intensive operations and where scheme members drawing pensions often vastly outnumber current employees.

This is an issue that is not going away anytime soon. It is bad enough in the private sector. The fact that most public sector pensions – which are more generous and still accruing – are entirely unfunded seems to receive little publicity but the systemic risk here is far higher.

Andrew Herberts ASIP
Head of Private Investment Management (UK)

Pension deficits have soared



Listed Private Equity: Still Undervalued?

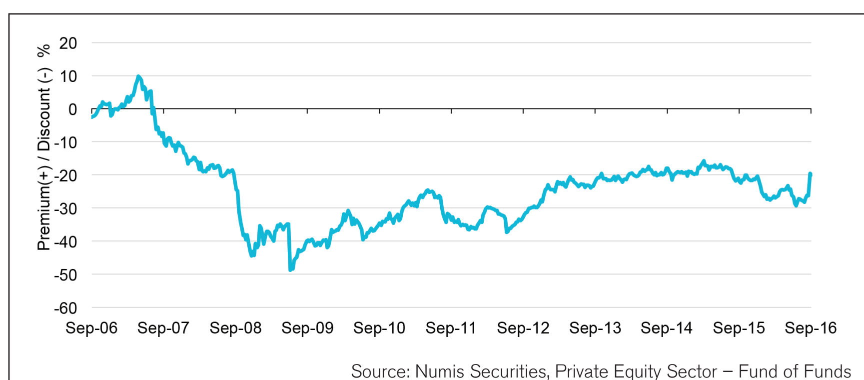
Performance of listed private equity (LPE) across the sector has been remarkably strong in recent years, despite some notable exceptions.

Investment companies managing private equity portfolios that we characterise as being of high quality have had multiple years of stellar returns, with most of them outperforming the quoted equity space. The LPE sector has rebounded strongly from the low of 2009, yet the discount to Net Asset Value (NAV) remains attractively large.

Listed private equity companies are not a new market development and many have track records of 20 years or more, including ICG Enterprise Trust (previously called Graphite), HgCapital Trust, and Pantheon International. Listed, closed-ended, private equity vehicles allow investors access to private equity markets by offering tradable exposure, with daily liquidity and with no minimum investment or further funding commitments, factors which are often barriers to entry for potential investors. Despite this, these funds have been trading on wide, and one might even argue excessive discounts to NAV. One could also argue that some natural level of discount is warranted due to the nature of the underlying, however we would contend that discounts of c.20% offer an element of value alongside prospects for future valuation growth.

2016 has been, so far, another year of strong growth. Key positive influences on returns are earnings growth at underlying portfolio companies, realisations of investments providing good uplifts over prior valuations and recent corporate activity. An additional positive influence on returns this year has been the devaluation of Sterling. This is expected to be fully captured in the latest set of valuations post the Q2 2016 reporting period as a high proportion of the underlying portfolios within the sector are allocated to non-sterling assets.

Absolute Discounts – 10 Year History



Source: Numis Securities, Private Equity Sector – Fund of Funds

Furthermore, recent corporate activity would indicate that we may be entering a period of consolidation for the sector. HarbourVest recently announced a full and final cash offer of 650pps for the entire issued share capital of SVG Capital, thereby valuing the company at £1.015bn. SVG subsequently released an updated NAV, insisting that the offer undervalued the portfolio and that they would be seeking an alternate bidder. At the time of writing it seems likely Goldman Sachs and Canada Pension Plan Board will purchase the portfolio at a discount of 7.5% to the July NAV. This activity has given a further boost to returns across the sector during September as markets are beginning to digest the latent store of value held within these private equity strategies.

Beyond the likely takeover of SVG Capital there is further notable activity in the sector with Candover in wind-down mode and Electra Partners on notice as managers of Electra Private Equity. All of which suggests the LPE sector may see fewer quality assets being offered to investors seeking listed liquid structures. These factors may be a catalyst for ongoing discount narrowing and additional valuation growth.

We continue to consider listed private equity as an important component of the alternative investment space. There are multiple reasons why this sector, given current market conditions, is attractive for investors seeking to allocate to growth-driven investments. However a number of these investment companies now also pay a dividend. They are able to this as they have diverse and mature portfolios with regular realisations generating cash flow which they are subsequently able to distribute to shareholders. As such they may also be attractive to investors for whom income is a primary driver of investment. Despite the recent strong performance we would still contend that market prices remain below fair value and are cheap by historical standards. Within the sector the attractiveness of individual company valuations is disguised by averages and so stock selection is an important factor. This dispersion creates opportunities to invest in cheap but high quality and mature assets that have the potential for outsized returns and can also add diversification to existing portfolios.

Mark McKenzie
Portfolio Manager

Thomas Miller Investments Voting Record 1 January 2015 – 31 July 2016

Thomas Miller Investment is a signatory to the Stewardship Code, a code of conduct for investment firms and asset owners, which is intended to influence the way in which they monitor their investments.

The code has seven main principles. Without going into great detail on all of them, one of the principles is that signatories should vote on their shareholdings as a way of showing their engagement and demonstrating that they have a clear interest in the way companies are managed. The aim is that the investee companies will take note of this interest, and that the monitoring process will help to endorse effective corporate governance. The code is an adjunct to the Corporate Governance Code, which was introduced several years ago to improve the governance of companies and to reduce the principal/agent problem.

The Stewardship Code has had a big impact on the behaviour of asset management firms since its introduction six years ago. Looking back historically, many firms did not bother to vote on their shareholdings at annual and ordinary meeting. The voting record is now much better.

Another of the stipulations of the Stewardship Code is that signatories report to their clients on a regular basis about how they have exercised their votes. The intention of this article is to do exactly this for the period since the beginning of 2015. The comments below cover votes on both institutional and private client portfolios. It is worth pointing out that a large proportion of TMI's equity holdings are in the form of passive investments, where voting on the underlying companies would be carried out, if at all, by the manager of the ETF. It is also worth pointing out that TMI is a small investor, in terms of its direct equity holdings. But it is the principle that is important.

Over 2015 TMI voted on 1085 resolutions – most of these were the regular resolutions at Annual General Meetings, though there were some ordinary and extraordinary meetings as well. We approved the vast majority of resolutions over the year, voting in favour 99.63% of the time, and against 0.37% of the time. In absolute terms, we voted against a resolution on four occasions out of 1085 votes. All four of these were shareholder resolutions, which we did not feel were in the long term interests of the company involved.

In the current year to the end of July, we have voted against resolutions on eight occasions, or 0.65% of the time (eight out of 1237 votes). Six of these were shareholder resolutions at General Electric, where activist groups with small shareholdings were making propositions that we did not feel squared with the long term future of the company. The only one we felt any sympathy with was the proposed splitting of the role of chairman and CEO at the company. We had voted in favour of this division of roles in previous votes in respect of US companies. However, in the case of GE we felt that Jeffrey Immelt has done a good job holding both positions, and that the aggregation of power in one person was justified.

In 2016, in relation to Royal Dutch Shell, we also voted against a shareholder proposition to turn the company into a renewable energy company, which we did not feel was appropriate or would benefit shareholders.

More controversially, we voted against a resolution to approve the Compensation Committee report at WPP's annual meeting, against the management's recommendation. This issue was well covered in the press earlier this year. The Committee awarded CEO Martin Sorrel a further £70m in total remuneration for 2015, which we considered excessive. Sorrel is the company's founder, and is important to the company's future, but we felt that the financial package being awarded was not reflective of his value to the firm. Sorrel did invest some of his own money in shares and options in order to make this sum, it is true. Nevertheless, we felt that the original awards of options, made when the share price was depressed, were overly generous. Overall, 34% of the shareholder base voted against the report.

This summarises our voting behaviour. It is also worth discussing our engagement practices over the period, where we met with companies in order to air any potential concerns we may have had.

Over the course of 2016 to date we have held meetings and met the management of a number of companies where we invest or are thinking of doing so, including Babcock, Standard Chartered, Avon Rubber, RPC Group, Hogg Robinson, Shawbrook Bank, Portmerion, INTU, Phoenix Group, Workspace Group, Hill & Smith, Smith & Nephew, Lloyds Banking Group, British Telecom and Persimmon.

James Penn
Senior Portfolio Manager

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

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