Investment Strategy Overview

An overview of the global economic outlook

During the last quarter, the momentum of global economic growth improved as data from a broad range of countries, including both developed and emerging economies, beat consensus forecasts. Looking to the year ahead, the global economy looks set to expand at a moderate pace. In its latest Economic Outlook, the OECD forecast that the world economy would expand at a pace of 3.6% in 2014, following a projected growth rate of 2.7% in 2013. Likewise, in its most recent World Economic Outlook, the IMF projected a rise in the growth rate of the global economy from 2.9% in 2013 to 3.6% in 2014.

Overall, while there are notable downside risks to the outlook (particularly in the emerging economies), our central case is for the global economic expansion to pick up at a moderate pace. We expect emerging economies to account for an increasing share of global output over time but, in the shorter term, cyclical dynamics favour the advanced countries.

A summary of the UK outlook

UK economic growth accelerated in the third quarter as GDP grew at a rate of 0.8%, marking the fastest pace recorded in over three years. The strength of the UK's recovery has led to concerns about the outlook for interest rates. In this regard, it is worth noting that despite the recent turnaround, UK GDP in Q3 remained about 2.5% below the pre-recession peak recorded in Q1 2008. Indeed, of the G7 countries, only Italy underperforms the UK on this measure.

Having lagged its major peers for several years, the UK economy is finally in catch-up mode. Overall, in 2014, the UK economy is likely to recover some more of the lost ground. That could mean a pace of growth of about 2%-2.5% in the year ahead. With inflation on a downward path and with virtually no evidence that falling unemployment is fuelling inflation, the Bank of England has scope to persist with a loose monetary policy stance. Consequently, it seems unlikely that the Bank of England would be in a rush to raise interest rates before 2015.

Monetary policy and asset allocation

For now, from an asset allocation perspective, fundamentals favour equities over bonds. However, neither asset class is 'cheap' in absolute terms. While the longer-term outlook for government bonds remains unattractive, it is worth noting that the expected modest pace of growth and benign inflation, suggest that a protracted sell off remains unlikely in the near term. For global bond investors, the primary risk factor in the first half of 2014 is the outlook for monetary policy, particularly in the US. For equities, the key risk is that corporate earnings fall short of expectations and profit margins get squeezed.

In December, the US Federal Reserve (Fed) announced plans to cut back on asset purchases at a very gradual pace, starting in January 2014. The decision triggered a rally in risk assets as investors interpreted the US central bank's decision as a confirmation that the US economy was on a firmer footing.

A review of the Fed's forecasting record in recent years should give investors some food for thought. Despite rampant optimism on the economic outlook, investors must neither lose sight of the downside risks nor take the Fed's bullish projections as gospel. Ultimately, the impact of tapering on various asset classes will depend on realised economic growth. In particular, any signs of a growth disappointment after tapering begins will likely trigger a sell-off in equities while government bonds will benefit from safe-haven demand in such a scenario.

For now, we retain a moderately positive bias on equities. Valuation concerns mean we have reduced our weighting to the US. We also remain cautious on emerging market equities but we are more positive on the UK market. Within fixed income, we continue to favour corporate bonds over government bonds and we remain very cautious on emerging market government debt.

Overall, investors should expect a more volatile year for equities in 2014 as the Fed begins the process of winding down unconventional monetary stimulus. Importantly, owing to persistent variations in regional economic performance, 2014 seems likely to be a year of marked divergence in monetary policy stances by the major central banks. Investors will therefore need to pay close attention to regional asset allocation, as the rising tide may not lift all boats!

Abi Oladimeji
Director, Head of Investment Strategy

TMI Current 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
Bonds (overall)	0 / -					
Corporate bonds	+	+	+	+	+	+
High Yield bonds	+	+	+	+	+	
Govt guaranteed bonds	+	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.

Market Overview

World stock markets recorded their best gains since 2009 in 2013, as evidence emerged that the recovery had 'finally come through', with some markets –the US and Japan – enjoying their strongest rises in over a decade. In contrast, bonds were disappointing, putting in their worst performance since 2009.

The MSCI All Country index rose 22%. However, equity market performance was extremely diverse, and emerging markets – long favoured for their greater growth prospects, and normally high "Beta" markets – failed to generate decent returns.

The UK market made solid gains, with the FTSE 100 up 14.5% and the wider FTSE All Share up 16.5% in price terms. However, the market failed to regain the highs of late May when the FTSE 100 index reached a 13 year high of 6840. Performance for the mid-cap FTSE250 index was better than the large capitalisation index, with a rise of 28.5%, while small cap stocks were strong with a gain of just under 30%. Together, these gains reflected a rising risk appetite amongst investors.

While UK market returns were above average, they were put into the shadow by spectacular gains elsewhere. Japan was the world's best performing major equity market, rallying over 56% in response to easy monetary and fiscal policy, two of the 'three arrows' that Prime Minister Abe is relying on to re-energise the economy. This was the Nikkei's best year since 1972. Most of the rise was seen in the first half, although after the mid-year sell-off the Nikkei did make a new high in December. However, it was only domestic or fully-hedged investors who benefited from the full extent of the rally, and Yen depreciation cut the return for Sterling (and Dollar) investors in half.

The S&P index finished up 29% for its best year since 1997. It is a curiosity that the much-discussed "tapering" in US monetary policy has had greater impact on other markets (particularly emerging markets) than on the US itself. US stocks have also been surprisingly unvolatile, with no sell-off of more than 5% during the year, even during peak stock market volatility during May and June. US stocks made new all time highs in all the major indices, the S&P breaching 1800 and the Dow Jones Industrial achieving 16,000. The Dow managed a 26% gain, while the Nasdaq index climbed 37% reflecting a strong performance from the technology sector. Internet stocks were particularly strong, with Google reaching $1,000 for the first time, and Facebook doubling in price, while 2013 was the year that new companies like Twitter came to the market.

After lagging in the early part of the year, European stock markets made steady progress in the second half, as the Eurozone emerged from recession in the third quarter after 18 months of economic contraction. The Eurostoxx 50 index rose over 17%, with the Dutch, French and Italian markets performing roughly in line with the market. Spain was better with a 21% gain, while there were strong performances from other peripheral nations like Ireland (+32%) and Greece (+22%). Eastern Europe was the big disappointment, with the negative performance here mirroring the generally poor performance from emerging markets as a whole. Germany performed strongly, its 25% rise being the best of the major markets.

The more pedestrian performance of UK stocks is partly down to high exposure to resource shares, which have been hampered by concerns over growth in China. UK equities have also suffered from the unexpected rise of Sterling over the year, and from expectations that the strong economic rebound in Britain will cause UK interest rates to rise before those in any other markets.

Tapering of the asset purchase scheme in the US was confirmed at the mid-December Federal Reserve FOMC meeting (not as expected in September), when the Fed announced that it will cut its bond purchases by $10bn starting in mid-January. However, the news had been fully discounted, and did little to unsettle bond or equity markets.

Final quarter performance bore out the trends in the year as a whole, with the US up 8%, Europe up 6%, Japan up 10% and the UK 3.5% (all in local terms). Emerging markets lagged again with an average rise of 1.5% to 2.5%.

Government bond returns were generally poor in 2013, as previously noted. UK government bonds lost 3.9% and US governments 3.4%, with US index-linked being particularly hard hit. Reflecting the risk appetite seen in the equity markets, the best performances in fixed income markets were seen in high yield, followed by investment grade corporate bonds. In the last two asset classes, contraction in the credit spread and the high coupon payable offset the rise in the risk free rate to permit respectable returns.

The other notable success was the European peripheral bond markets, with strong gains for the Spanish and Italian government markets. Meanwhile, the Fed's tapering perhaps had its biggest impact further afield with emerging market bonds losing over 6%. This mirrored the general lack of interest in emerging market equity which is however starting to look increasingly cheap on a historical valuation basis.

James Penn
Senior Portfolio Manager

Historic Market Rates*

As at 31st December 2013

	Close	3 month % Change	6 month % Change	1 year % Change	3 years % Change
FX					
GBP/USD	1.6566	2.37%	8.89%	1.99%	6.11%
EUR/GBP	0.8323	-0.46%	-2.68%	2.44%	-2.92%
EUR/USD	1.3789	1.90%	5.99%	4.49%	3.03%
USD/JPY	105.2600	7.18%	6.17%	21.52%	29.76%
USD/CNY	6.0543	-1.09%	-1.36%	-2.83%	-8.37%

	Close	3 month Change	6 month Change	1 year Change	3 years Change
BOND YIELDS					
US 10 YR	3.028	0.418	0.543	1.271	-0.265
UK 10 YR	3.022	0.301	0.579	1.194	-0.374
GERMANY 10 YR	1.929	0.150	0.201	0.613	-1.034
JAPAN 10 YR	0.741	0.055	-0.112	-0.050	-0.387
SWISS 10 YR	1.073	0.052	0.046	0.54	-0.679

	Close	3 month % Change	6 month % Change	1 year % Change	3 years % Change
EQUITIES					
S&P 500	1,848	10.50%	16.30%	32.38%	56.78%
DOW JONES	16,577	10.22%	12.55%	29.65%	54.91%
NASDAQ	4,177	11.13%	23.58%	40.17%	63.74%
FTSE 100	6,749	5.19%	10.46%	19.18%	29.80%
FTSE ALL-SHARE	3,610	5.55%	11.56%	21.34%	33.11%
DAX	9,552	11.14%	20.01%	25.48%	38.15%
NIKKEI	16,291	12.76%	19.93%	59.28%	68.94%
HANG SENG	23,306	2.20%	13.13%	6.56%	12.22%
COMMODITIES					
GOLD	1,205.65	-9.28%	-2.34%	-28.04%	-15.14%
CRUDE OIL - WTI	98.42	-3.82%	1.93%	7.19%	7.70%
S&P GS SOFT CMD	606.58	-6.70%	-9.86%	-18.00%	-26.56%
S&P GS IND METALS	1,366.78	-0.36%	4.06%	-12.87%	-31.40%

*Total Return from capital and income, in local currency, income reinvested.

Source: Bloomberg

Thoughts On Equities

A number of our clients invest in individual UK equities and so we thought it would be helpful if we explained how our Equity Team researches the market and how our managers then choose stocks for portfolios.

We are long term investors, believing that cash flows are the key driver of investment returns and that risk declines with longer holding periods. Accordingly, we look ahead at least five years when valuing an investment. In contrast, many market participants are much shorter term in their approach, which means that markets can become distorted by "noise" and by "herding" behaviour. Fashion can often dominate fundamentals, and it is this distortion which can create opportunities for the long term investor.

Our equity process seeks to identify companies where the current share price does not fully reflect the long term prospects. Initially, we apply five filters to the UK equity market, as shown below. Essentially, these filters look for companies which have a strong record of returns, are not "expensive" by traditional measures, and which have a low risk of falling into financial distress. We then harness the power of Bloomberg technology to generate a list of the stocks within the FTSE All Share Index which meet our criteria. This currently reduces the 623-name Index to around 65 possible investments, which are then subjected to detailed research by the team.

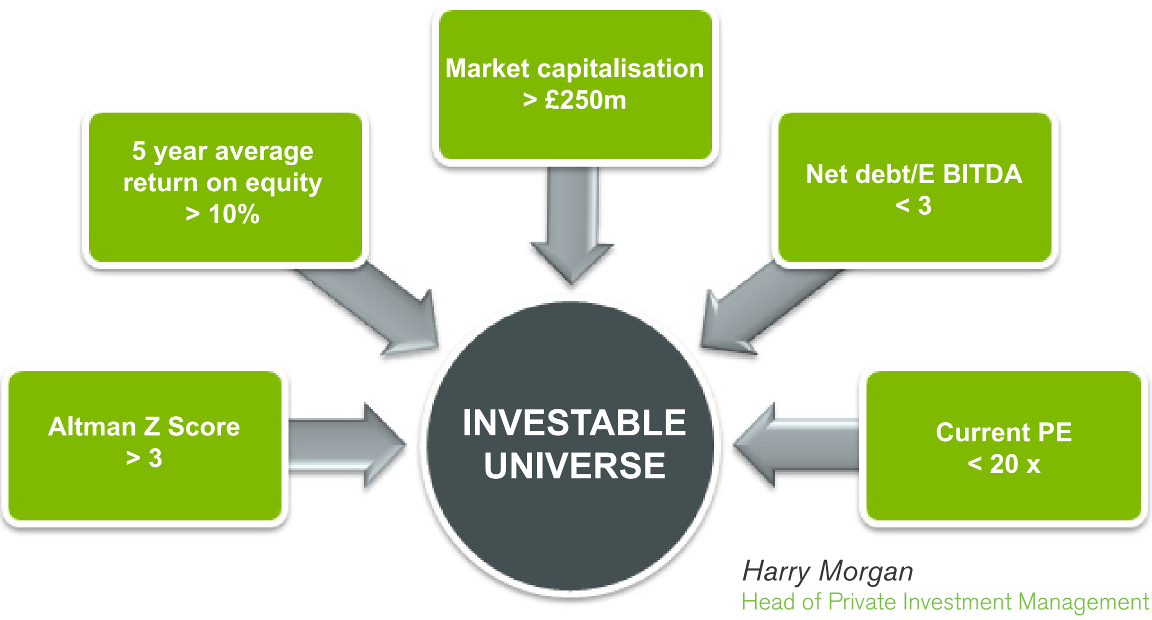
We analyse a company's strategy, product, and core financials, a process which involves looking at such factors as the threat of substitute products, the ability of competitors to enter the market, the nature of the relationship between the company and its suppliers and customers, and the net present value of expected future cash flows. As well as stocks which emerge from the screening process, we will also look at a small number of situations which do not meet all the screening criteria yet where we think there is scope for a re-rating. An example here would be bank shares, whose balance sheets and returns have not met the criteria, yet where the outlook may now be improving.

The final stage is for the team to agree on the Recommended List of UK equities, a List which is actively monitored, contains around 35 names, and is well-diversified across the various sectors. Our portfolio managers select stocks for client portfolios from the List, with typical holdings including the likes of Royal Dutch Shell, Diageo, Rolls Royce, Reckitt Benckiser, Aggreko, BG, Smith & Nephew, and IMI. Although client holdings will not be identical (after all, objectives and risk profiles will differ from client to client), there is a commonality across many of our client portfolios.

We are continually looking for new ideas and fresh insights and the following two situations illustrate our long term approach in action. First, the announcement that BT had outbid BSkyB to secure the rights to broadcast the UEFA Champions League football from 2015 caused a sharp sell-off in the BSkyB share price. We believe that BSkyB showed commendable discipline in its bid, that it continues to have a formidable sports portfolio, and that its non-sports portfolio and production capability continues to strengthen. Given its strong cash generation, Sky can either invest for growth or return capital. Either way, the next five years should see a crystallisation of value which is not currently priced in by the market. So, and having done the analysis, we added BSkyB to the Recommended List in November, since we can see considerable price upside potential from the current level.

The second example is Vodafone, where we have believed for many years that this was an undervalued company, given its market share, powerful cash generation, and attractive dividend. In March 2013, the stock met our screening criteria and fully merited its place on our Recommended List, with the strong cashflows from its US joint venture (Verizon Wireless) underpinning the share price. We valued the long term dividend stream at around 240p, which at the time offered the potential for substantial capital gain.

Since the announcement in September of the sale of its stake in Verizon Wireless business to Verizon, Vodafone's share price has moved up to our earlier assessment of fair value. Our current work on Vodafone focuses on the value of the business after the Verizon stake is sold and the strategic options available to management. As a consequence, we are retaining the stock where it is held in portfolios but we will not hesitate to remove it from the Recommended List, and from portfolios, if we cannot identify meaningful further potential performance.



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Investment Markets - Where Do We Go From Here?

2013 was a continuation of the post-2008 stock market bull-run and turned out to be a stellar one for equity investors, despite some early predictions to the contrary. Most major blue chip equity indices produced double digit returns and, other than any stock specific issues, equity portfolio clients should have had good reason to be happy with their overall capital and income returns.

Clients with any exposure to small and mid capitalised stocks might well have found some extraordinary opportunities to generate high levels of returns, albeit at increased levels of volatility. On the other hand, those hoping to use the emerging markets as the traditional geared play on developed market growth were generally disappointed as these markets reminded them that they offer higher levels of pricing sophistication than a simple 'risk on/off' mechanism.

Bond investors might well have breathed a sigh of relief at the end of the year. With 10 year United Kingdom Treasury yields starting 2013 at around 1.8% per annum, close to all time historical low levels, there was much talk of an impending blood bath as and when the yield curve shifted upwards. However, despite yields ending the year at around 3%, most investors in United Kingdom Gilts of medium maturity should have ended the year not far from flat when income returns are included. Those bond investors positioned with shorter duration and over-weighted to corporate credit compared to their benchmarks had the greatest likelihood of producing low positive total returns including income, if invested over the whole year.

Our fully invested private client portfolios generally fared well in 2013. Major calls included a top level under-weight to cash and over-weight to equities versus bonds. At the second level, favouring corporate debt rather than government generally helped, as did tilts towards the United States equity region/currency and trimming emerging market equity exposure in favour of Japanese and/or global themed funds.

2014 will be interesting. We start the year with a positive outlook on equities, with a small bias towards the United Kingdom which was the developed market laggard last year. Bond yields have now moved perhaps halfway towards 'normal' levels and there is at least a bit of value in government debt but nonetheless we retain our bias towards corporate credit for the time being. Emerging market assets and currencies remain under-weight but at some point valuations will start looking attractive again. In the main, we continue to favour 'traditional alternatives' including property and listed infrastructure funds compared to hedge fund alternatives, particularly single strategy, and gold.

How authorities manage the process of reducing their asset purchases with consequent increasing yields across the length of the curve will be crucial for ongoing stable market growth this year. However, all great equity bull markets start during times of recession and, with current prices not looking excessive given mid-cycle valuations, we remain generally optimistic.

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