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AUTUMN NOTE

Don't get sold!

20th October 2015

Analysts: Giles Rowe
Artur Baluszynski

During times of heightened volatility, media and hedge fund promoters compete to paint the most extreme scenario. Perma-bears scream "I told you so" and perma-bulls shout "buy on dips'. Predicting the future is a lucrative trade but mainly for the prophet. Some kind of map is necessary for investment but since nobody even knows where we are in the economic cycle until 18 months later, doses of salt should be added to economic and market forecasts.

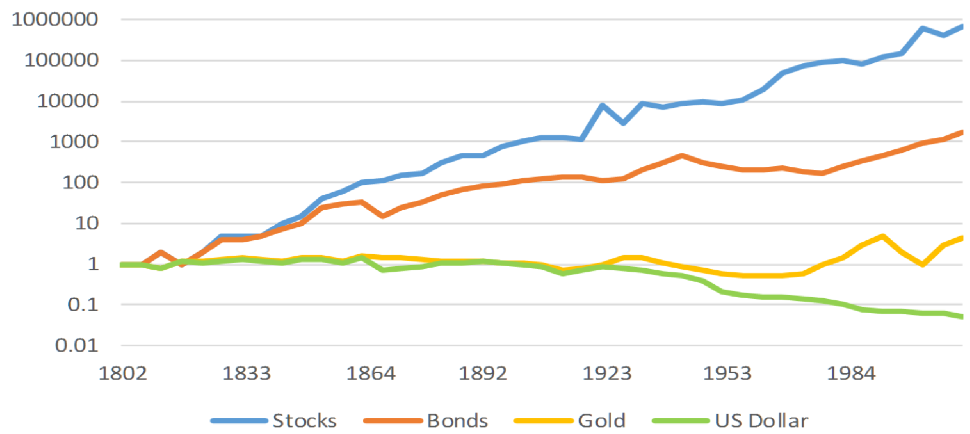
We believe there is one exception. This is the prediction that long run equity returns will remain as they have for the past 210 years. Professor Siegel's classic 'Stocks for the Long Run' examines the average annualised real returns of the main US asset classes from 1802 to 2012: Equities 6.6%; Bonds 3.6%; Bills 2.7%; Gold 0.7%, US Dollar -1.4%. The stability of equity returns is remarkable. No other asset is so consistent in the long run. This is so for the whole 210 year period, through all phases of US economic development and Siegel's findings are supported by studies in non-US markets. The reason? In the short term, equities are so volatile they can scare investors, who undervalue them as a result. In betting terms, equity investors have a long term 'edge'. See the chart below.

We invest in equities to capture that real return. This can best be achieved by what Warren Buffet calls "playing in the centre of the field". As soon as you venture to the edge you risk missing out. Stay invested and do not try to time the market.

When is the Fed going to raise rates? When will Emerging Markets start turning round? When will the S&P top? Great questions, and all over the headlines. But it is difficult to make money consistently on these kinds of calls and the consequence of getting them wrong is painful.

Speculating on extreme scenarios with leverage is very exciting but can go horribly wrong and every investor should be aware of 'risk of ruin'. At most, such strategies should be no more than part of a portfolio. We prefer to focus on returns and not bet the ranch on timing calls when we make them, which we do via tactical asset allocation moves. The evidence is that in the long run equity returns prevail.

Total Real Returns 1802 to 2012
on Stocks, Bonds, Gold and US Dollar. Log scale.



Source: 'Stocks for the Long Run' 2015 edition

Prices can go down as well as up. Past performance is not a guide to the future and estimates are subject to uncertainty. Please see the important notice at the end of this document.

Giles Rowe
Chief Investment Officer

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EQUITIES

20th October 2015

Analysts: Giles Rowe
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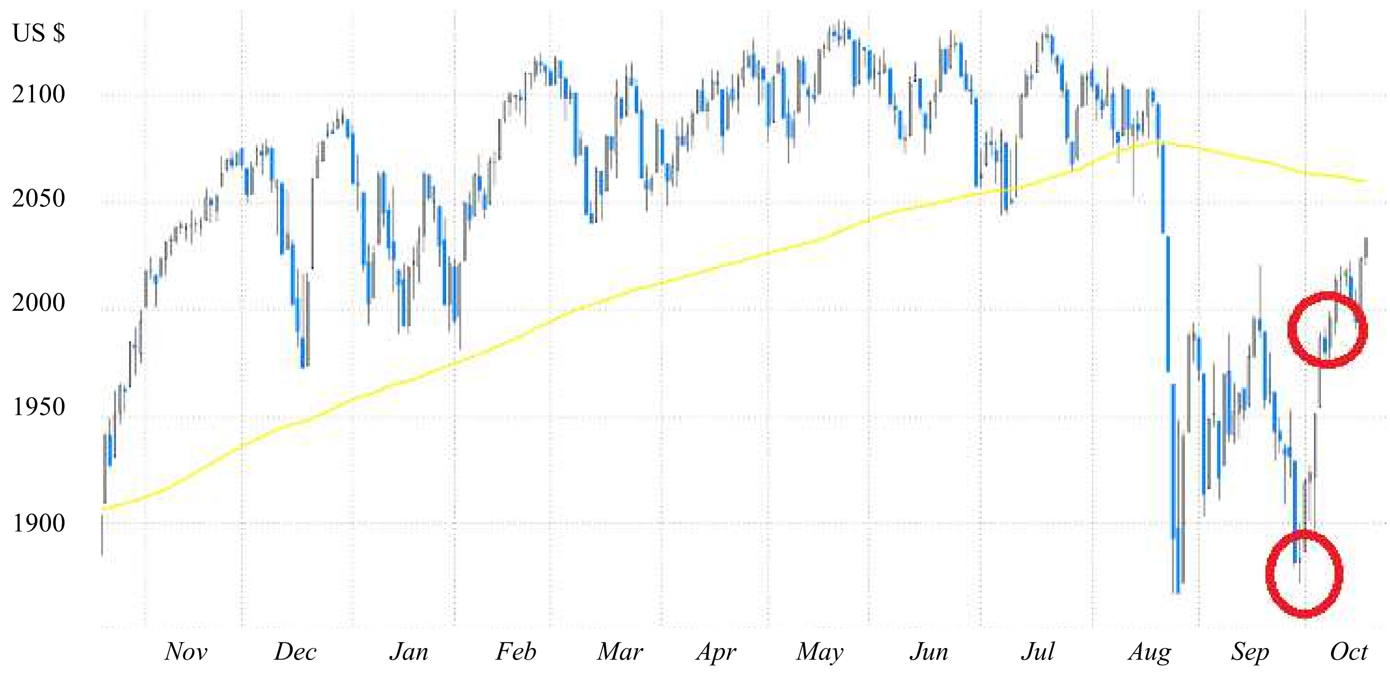
With the US slowly coming back on stream, China has carried the flag for growth over the last few years but has visibly crumbled from its 15% peak in 2007. China's latest GDP growth is 6.9%, massaged to beat the 6.8% estimate and buoyed by an 8.4% increase in the service sector. The message is that rebalancing towards consumption and services is steadying decline.

The equity decline in August anticipated a Fed rate rise and became a panic when rates stayed flat, as investors assumed things must be worse than thought. Markets are now rallying again on the prospect of continuing low US rates and another round of ECB QE, together with the evidence that China still has ammunition for more stimulus. Given the S&P500's position as global equity market bellweather, we use it as a proxy for the tone of equities in general. The chart below shows it failed to breach August's sharp low at the end of September (lower circle), despite poor employment data, and in October (upper circle) broke through September's high point. The macro background remains stable, and we continue seeking growth ideas at good value. Janet Yellen has stressed the possibility of rising core inflation and underlying US economic data, including the Michigan sentiment index, is more positive than markets allow.

Our asset allocation is now back to slightly overweight equities. The high levels of sovereign debt create an enhanced sense of risk but corporate debt is not high. QE has had the effect of 'crowding out' risk pricing, a typical effect of state interference, and for now continues to do so.

In the US we recently bought Valeant when it fell after comments on drug prices by Hillary Clinton, and in the UK Redrow. We sold Volkswagen in August due to its high Emerging Market exposure.

The S&P 500:12 months to 19th October.



Data sources: Bloomberg.

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BONDS

20th October 2015

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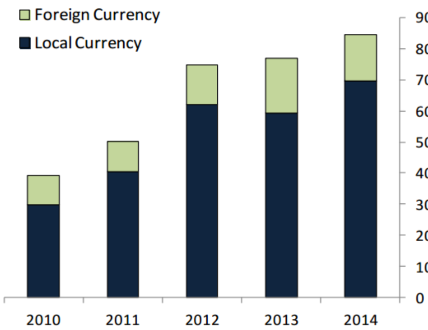
With the labour market improving, many businesses expect the Federal Reserve eventually to raise short-term interest rates. Companies based everywhere have been rushing to issue Dollar corporate debt before the Fed moves. According to PIMCO, a staggering $1.15 trillion investment grade corporate bonds have been issued this year, an increase of 15% from last year. Investors who put money to work four or five years ago have been lucky to lock in attractive yields but those looking to invest now are facing dismal returns. Some market commentators are pointing to possible opportunities in High Yield but we would be very selective with this asset class.

High Yield (HY) bonds promise fantastic returns but are called “junk bonds” for a reason. Unless you do your homework you can be left with a worthless piece of paper. After the recent sell-off most non-commodity related HY bonds are still trading at around par with approximately 5% to 6% YTM. We do not think this is cheap enough to buy yet. However, some good value is appearing in Emerging Markets (“EMs”) as well as commodities and energy, and for disciplined and patient investors these sectors could become a good hunting ground. Once interest rates normalise, weak companies will find it difficult to refinance and will head for default. As with equities, any initial market overreaction may create attractive opportunities for stock or bond pickers. We prefer not to use passive funds when investing in the high yield market because they have never been tested and the underlying assets could be impossible to sell in a downturn.

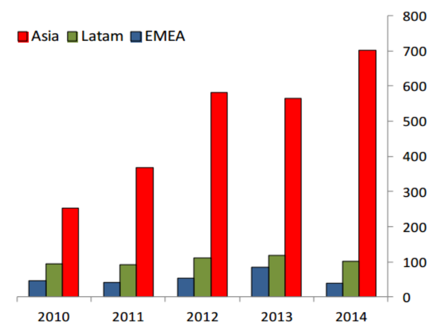
Emerging market local bonds and currencies have been punished across the board. Even countries with good balance sheets have not been spared. The world is still sensitive to the US Treasury market. If and when the US raises interest rates, money will flow “back home” to the Dollar. As of this year there is $9 trillion owed by borrowers outside the US, up 50% from $6 trillion at the end of 2008. A big chunk of this issuance will have to be rolled over in the next three to four years. Although we do not expect another EM currency crisis, it is good to know where the fault lines lie. If the Fed moves in December or early next year, volatility should spread to the EM US$ denominated bond market creating a good entry point.

Not much has changed in our bond asset allocation since last quarter. We expect some inflation to come through within the next six to twelve months as the deflationary effect of the fall in oil prices fades with time. This is why we still hold some inflation linked bonds in balanced and conservative portfolios. Our average duration on corporate bonds is around four years and we have some built-in protection against a steepening of the yield curve with the Alliance Trust Monthly Income Bond Fund.

EM Bond Issuance by currency (in US$ bn)



EM Bond Issuance by region (in US$ bn)



Data sources: Bloomberg; Chart source: IMF

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REAL ASSETS

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Analysts: Giles Rowe
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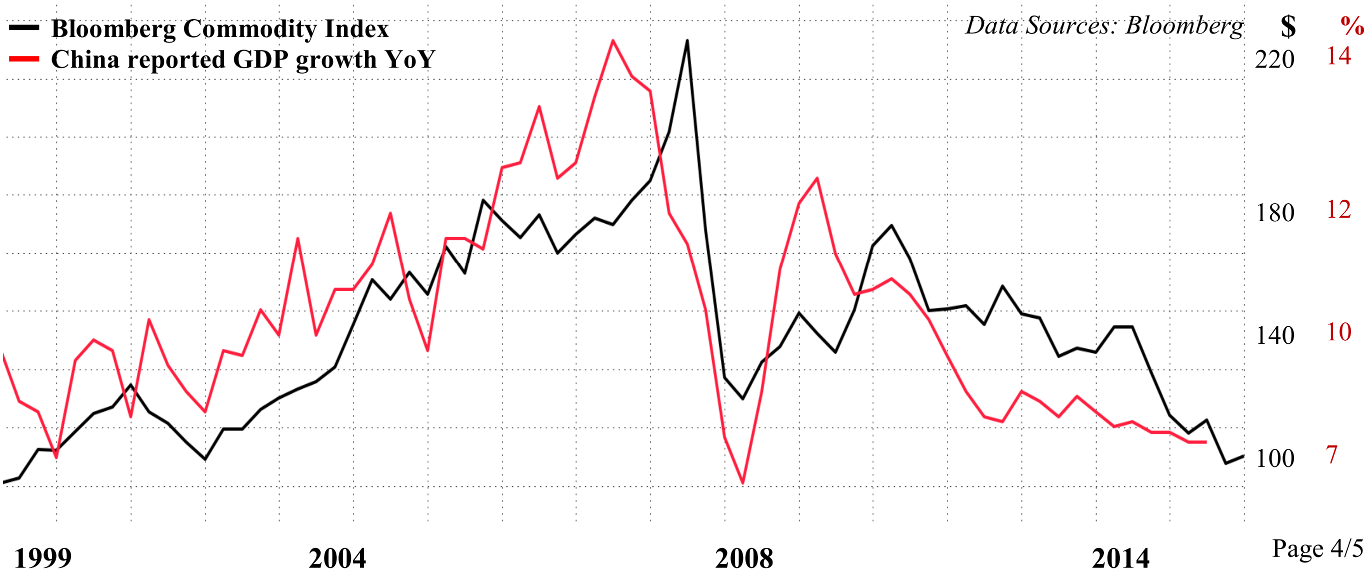
Commodity trader Glencore's CEO Victor Glasenberg has discovered that trying to offload a mine in a buyers' market is harder than shifting inventory for commission. He had been trying to build a better positioned and diversified portfolio with an oil and base metal hedge. Most analysts predicted these would rise on the back of a Chinese recovery in 2015. Instead the whole commodity market followed oil's descent taking mining asset prices with it. Last month's monster fall in Glencore's share price was driven by liquidity and solvency worries, not just by commodity prices. Of course Mr Glasenberg did not help by conceding that he was unable to read China's economy. Estimates of Glencore's liabilities now range between $30bn and $100bn with uncertainty over derivative and counterparty exposure. So Glencore's recent sell-off was self inflicted and driven by complexity, overconfidence and bad communication.

There are only two certainties about commodities; they are very cyclical and they tend to be self correcting. It is almost impossible to time the top and bottom of any market so investors should focus on avoiding bad management teams and excessive leverage. It was just a year ago that Rio Tinto rejected Glencore's merger offer citing lack of synergies and very little upside for their investors. In fact while BHP Billiton and Rio Tinto were trying to reduce debt and simplify their business, Glencore was taking on leverage and acquiring non core assets. One thing to remember about leverage is that it can turn a good investment into a bad one but it will not turn a bad investment into a good one. Even if the trader is right in the long run he faces ruin in the short run if he has too much debt. When investing in commodity companies one should not try to predict the price movement in the short to mid term. Pay attention to balance sheets and stick to companies with assets in politically stable countries to have a chance of surviving volatility. We are still underweight commodities and see a volatile sideways range as the most likely scenario. Being cyclical we expect commodities to make a firm comeback only when excess capacity disappears, and this means closures or a demand pickup.

Property's rise is linked to general economic recovery and, like commodities, is a class fuelled heavily by debt. We hold both via listed equity. We still like a number of property stocks with low gearing, reasonable Price to Book, and commercial strategies in areas of high demand. We currently hold Hammerson in retail infrastructure, Carillion in construction and support services, Segro and GLP in logistics, Redrow in housing. Segro has the highest gearing at 59%, Hammerson is on 46% and the others are all below 20%. As a group, Price to Book is 0.9x. Yield ranges from 6.6% for Carillion to 1.5% for Redrow, and we see all as offering value at reasonable risk.



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