DART CAPITAL

Investment Brief

April 2019

House View

Alexander George, CFA
Associate Director of Research

Markets bounced back strongly over the quarter, with calming words from the US Federal Reserve helping to appease investor concerns over rising interest rates in the world's largest economy, at a time when the global economy has shown signs of slowing. On account of global equity markets largely recovering from what looked like oversold conditions at the turn of the year, we are slightly more cautious than we were three months ago however we still see potential for equities to deliver strong returns given the combination of reasonable valuations and accommodative Central Bank policy. We are increasingly cautious on long-dated bonds, as we do not believe that rock-bottom yields are sufficiently compensating investors for the likelihood that western governments will pursue increasingly aggressive fiscal policy over the coming years, which would eventually erode the value of these investments.

Even the most optimistic investors were likely surprised by how aggressively markets rebounded in recent months, as the change in tone from the US Federal Reserve – along with some signs of a pick-up in Chinese government stimulus - was sufficient to cause a sharp improvement in investor sentiment. We did not over-react to the fourth quarter's sell-off and used the market pullback to selectively add greater risk to portfolios. On a less positive note, some of the diversifiers we hold within portfolios that delivered positive performance over the fourth quarter, detracted from performance this quarter, as the strength of the market rebound took its toll.

Active vs Passive

Perhaps the biggest change in the investment management industry over the last 10 years has been the growing availability, and ever-decreasing cost, of passive strategies. Passive funds differ from active funds in that they aim to track an index, as opposed to trying to outperform the market, and tend to be far lower cost than equivalent active funds. We have long used passive funds in areas where we seek a core exposure and active managers have little ability to outperform, such as short-dated government bonds, and markets where active managers have traditionally struggled, such as large-cap US equities.

More recently, we have expanded this use to other areas where we believe that our favoured active managers are positioned to deliver a return which is not sufficiently better than the low-cost passive equivalent. A recent example here is within European equities, where the managers of a long-term holding in our model portfolios - JP Morgan Europe Dynamic ex-UK - had moved the fund's positioning increasingly close to that of the benchmark. After careful analysis, we came to the conclusion that the fund wasn't offering a sufficiently differentiated profile to that of the benchmark index to warrant the fund's fees, and we switched into a lower cost passive fund.

Whilst we are allocating slightly more capital to passive funds, we do this with our eyes wide open to the risks, as well as the benefits, of passive strategies. In particular, one common misconception with passive funds is that they are lower risk than comparable active funds. In actuality, passive funds are as risky as the index they track, and the lack of overlay from a fund manager, whose job it is to actively select the assets in the fund, can make passive funds prone to larger losses during challenging market periods.

Brexit

As of writing, the Brexit process continues to meander on, with the recent extension of the exit deadline to 12th April unsurprising given the lack of consensus emanating from Parliament. Pleasingly (at least from a market perspective) a no-deal Brexit appears to have become less likely, as Parliament's greater say in the Brexit process is seen as likely guiding it towards a softer Brexit outcome. However, we are by no means political analysts, and there remains room for the unexpected. Whilst holding overseas currencies remains an important source of diversification for us, we did trim our exposure to the US Dollar in mid-January through the addition of a GBP hedged US equity tracker. The US Dollar has appreciated significantly against sterling over the last 5 years, a move which was accelerated by the Referendum result. With sterling very cheap against the Dollar on most metrics, we are of the view that the confirmation of a more market-friendly outcome from the Brexit process could well see the Pound make decent gains.

The Pound still trades well below its pre-Referendum level

31/03/2014 - 29/03/2019 Data from FE 2019

Source: FE Analytics

Fixed Income

Since their most recent peak in early October 2018, a combination of weak equity markets over the fourth quarter and – more recently – an increasingly dovish US Federal Reserve have served to push government bond yields down globally. On a more domestic level, Gilt yields have joined this decline, with the 10 year Gilt falling around 70 basis points from around 1.7% to 1% today.

Although yields could certainly go lower in the short-term, we believe that at this point long-dated bonds carry little value. In the 1970s, as inflation hit double-digits amidst the oil crisis, bonds earned the nickname "certificates of confiscation" as yields rose ever higher, peaking at around 15% in the early 1980s, and bond investors racked up mark-to-market losses. Compare that to now, with the 30 year Gilt yielding only 1.5%, and one could be forgiven for thinking that bonds are again living up to that moniker.

Against this backdrop of declining government bond yields, it is notable that there is nascent ideological change taking place which we believe will have a negative impact on long-term holders of bonds which pay nominal coupons, such as conventional Gilts. In particular, both sides of the political aisle in a number of developed economies – led by the US – are starting to support the idea that perpetual government deficits are acceptable, and that the government should be able to finance spending through Central Bank money printing. Whilst such an approach is unlikely to become an official part of government policy any time soon, we believe it will gain greater support from conservative and liberal politicians alike as it avoids forcing incumbent governments to raise taxes or reduce entitlement spending. The greater use of pro-growth, inflationary policies across developed economies has the potential to erode the value of low yielding long-dated bonds over the coming decades.

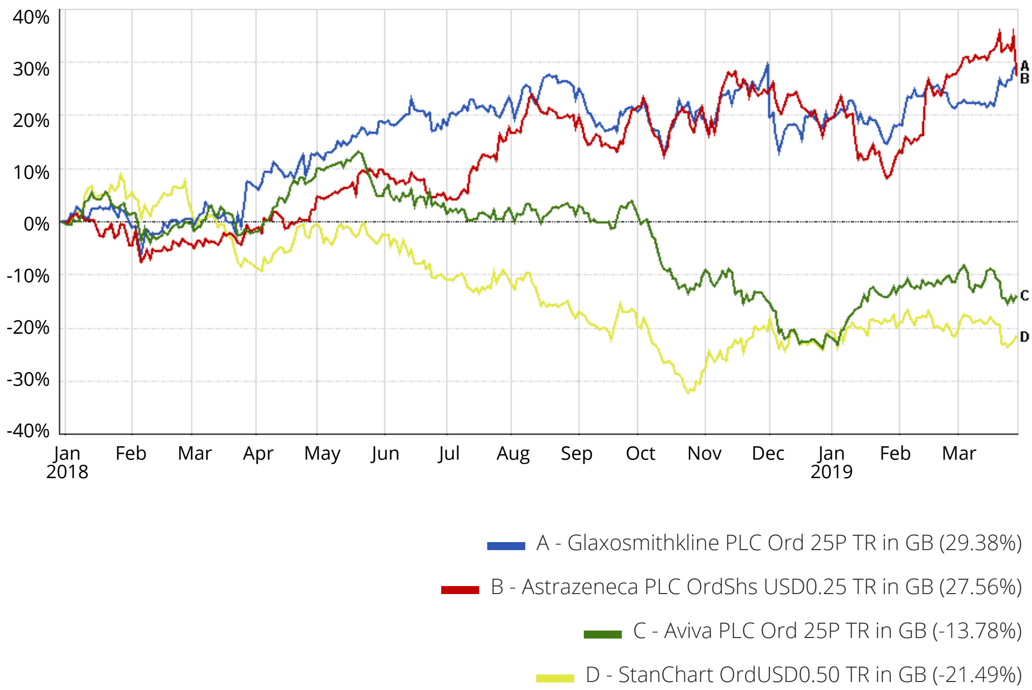
Credit markets found their feet over the quarter, as the credit spread widening of the fourth quarter reversed amidst the improvement in risk sentiment. With the yield on investment grade corporate bonds falling broadly in line with Gilt yields, in February we took steps to reduce exposure to longer-dated corporate bonds. Such a move allows us the flexibility to re-allocate to this area of the market when yields are more attractive. As we outlined in January's House View, High Yield bonds looked increasingly attractive late last year as the price of low quality bonds fell amidst the equity market sell-off and so it proved with the market rallying very strongly since early January. Given the illiquidity, and not particularly strong fundamentals, within the High Yield market we always prefer to allocate to this area on market weakness as we did in late November in lower risk strategies.

UK Equities

Domestically sensitive UK stocks enjoyed a stronger quarter, as signs from Westminster that a no-deal Brexit has become less likely helped bolster sentiment. Having said that, despite the obvious Brexit-related uncertainty, we still see significant value in UK exposed cyclical stocks, with companies which possess dominant positions in industries such as construction trading on low valuations at a time when profits are depressed.

Over the last year, we have tilted our UK allocation towards more cyclical sectors, as we view the combination of low expectations and attractive valuations - within sectors such as financials - as fairly compelling at a time when more defensive sectors, such as healthcare, look more fully valued following a period of strong performance. In this vein, it has been pleasing to see our decision to increase exposure to large-cap mining stocks in September has started to bear fruit, with the market starting to share our more benign view on the Chinese economy and start to price in the output cuts within the industry.

We have tilted our UK allocation slightly more towards unloved financial stocks



29/12/2017 - 29/03/2019 Data from FE 2019

Source: FE Analytics

International Equities

We increased exposure to US stocks in mid-January, on the belief that the rebound in risk sentiment would be led by the US market with the fourth quarter's sell-off providing a better entry point to buy into the capital-light, industry leading companies at the top end of the American market such as Alphabet (Google), Apple and Microsoft. Whilst these stocks continue to trade on elevated valuations, they are at the forefront of technological change and are generally cash rich. Within the American market, we have greater concerns over the middle tier of businesses which, aided by the low interest rates of the last decade, have been able to borrow extraordinary amounts – often to carry out share buybacks and pay higher dividends - despite operating in low-growth industries. This has left a number of companies with very high debt levels, and equity valuations which are expensive by historic standards. In recent years, we have already seen household names Kraft Heinz and Campbell Soup succumb to this combination of high debt and low growth, and we wouldn't be surprised to see more of these so-called "expensive defensives" struggle over the next couple of years.

In sharp contrast to the low-growth nature of the Japanese economy as a whole, the Japanese market is host to a number of companies which are leaders in growing areas of the global economy. This is well demonstrated by the automation sector, where companies such as Keyence and Harmonic Drive are at the cutting edge of technological advances, and are benefitting from the growing use of robots within factories across the globe. Continental European stocks appear almost as unpopular as their UK counterparts currently, with the profitability of industrial stocks particularly hard hit by the slowdown in the car industry and weaker exports to China.

Following a torrid 2018, Emerging Markets had a stronger quarter led by China, where exuberance over the inclusion of mainland-listed Chinese stocks in the FTSE and MSCI's Emerging Markets benchmarks, as well as the more stable US Dollar, helped drive the market higher. Valuations remain generally low across Emerging Markets, and we believe that the Federal Reserve's adoption of a more cautious approach to raising interest rates will help support this area of the market as it will help further stabilise capital flows into these markets.

With savings rates high, and household wealth growing far faster than in developed economies, we see a lot of opportunities within the technology and consumer goods sectors in Asia, with our favoured manager in the region focusing on companies which can exploit these opportunities.

Alternatives

Investing in gold is certainly not to everyone's taste. This is in large part because – unlike owning equities and bonds – a holding in gold generates no dividends or interest payments. This so-called "opportunity cost" for holding gold is even more significant when interest rates are high. Whilst we have sympathy with this view, we still believe that a small weighting to gold is appropriate as part of a balanced portfolio, with the asset tending to act as a safe haven and perform strongly when equity markets are struggling. This counterbalancing effect against equities, which remain the engine-room of our portfolios, is particularly attractive given that high quality government bonds, which would have traditionally played this role in portfolios, are yielding close to zero.

Having made money over the fourth quarter, our long/short bucket gave up ground over the quarter as the bounce-back in equity markets hit the defensive positioning of these funds. This environment was particularly challenging for the Jupiter Absolute Return fund, which holds short positions in a number of companies which saw explosive share price performance. Somewhat counterintuitively, many of these stocks performed strongly despite having high valuations and, in some cases, weak earnings profiles as the risk-on environment led investors to dive back into lower quality companies.

Fuelled by low interest rates and optimism around internet-based businesses, some investors are willing to pay nose-bleed valuations for companies with questionable economics. The current poster child for such exuberance is the online furniture retailer, Wayfair, which is one of the largest short positions in the Jupiter fund. Despite being yet to turn a profit and operating in a highly competitive and cyclical industry, Wayfair have seen their shares gain 70% this year and its market cap increase to $15bn as the market focuses on the company's strong sales growth. Notably, whilst outside investors appear excited about the company's prospects, the company's management are selling stock at a remarkable rate, likely wanting to cash in on the market's enthusiasm for what is still a loss making business. Although investors are willing to support these businesses during the good times, we believe that they would experience a dramatic decline should market conditions become more challenging as they were in the fourth quarter.

We retain an underweight position in UK commercial property, when compared to our long-term strategic weighting. Whilst the asset class continues to provide a reasonable starting yield – with cash flows that are linked to inflation – the sector is heavily exposed to the domestic economy. Furthermore, the industry continues to struggle with oversupply within the clothing and food retail space, with many household name stores and restaurants having recently entered Company Voluntary Arrangements (CVAs) in order to cut their rents. Our favoured managers are mainly focused on affluent towns and cities, such as Exeter and Manchester, where there remains demand for high quality retail and leisure space.

Closing thoughts

Although equities delivered strong gains over the quarter, we do not take this as a sign that all is well with the world and we believe that a balanced approach remains appropriate. For one thing, debt levels remain high across developed economies, whilst the world's second largest economy – China – continues to grapple with corporate debt levels which have grown far faster than the underlying economy. Across our range of managed portfolios, we continue to balance a moderate overweight position in equities, with short-dated bonds and alternative strategies and assets that can provide genuine diversification should market sentiment deteriorate. As always we look to take advantage of opportunities where we believe the market is thinking too short term or focusing on the wrong factors.

Market Commentary – Q1 2019

Alexander George, CFA
Associate Director of Research

Equity markets regained much of their losses from the very weak fourth quarter, with supportive Central Bank policy the primary driver of improved market sentiment.

UK

Harold Wilson once said that a week is a long time in politics, and for Theresa May each week must feel like a lifetime at this point. Despite her best efforts, Prime Minister May was unable to push her Withdrawal Agreement through Parliament, with two further rejections to follow the initial rejection in November. Despite this, a no-deal Brexit on the planned departure date of the 29th March was avoided, with a new departure date of the 12th April set by the EU by which time the UK is faced with a potential no-deal Brexit unless the Withdrawal Agreement is voted through Parliament or a further extension can be agreed. Despite this threat, it does appear that a no-deal Brexit is unlikely, with a majority of MPs in parliament having already voted (albeit in a non-binding indicative vote which took place in mid-March) to avoid a no-deal outcome. Despite the lack of consensus emanating from Westminster, sterling was remarkably stable over the quarter, gaining 2.2% against the US Dollar and ending the period at c.$1.30.

Notwithstanding the uncertainty created by the ongoing Brexit process, the economic indicators for the domestic economy paint a mixed picture. The labour market looks strong, with the unemployment rate having declined to 4% and wage growth reasonable at 3.4% year-on-year (y-o-y) in the most recent data release. Furthermore, having spiked in the aftermath of 2016's Referendum, the inflation rate declined to 1.9% in February from 2.3% in November, as the roughly 30% fall in the oil price which took place over the fourth quarter fed through to lower petrol prices. On a more negative note, business investment has remained weak and there have been high profile examples of multinationals relocating staff out of the UK in anticipation of the UK's eventual departure from the EU, whilst growth in consumer spending has also slowed amidst a decline in consumer confidence.

Faced with the mixed economic backdrop and the lack of clarity over the direction of the Brexit process, the Bank of England look set to delay raising the base rate further from its current level of 0.75% until the second half of the year at the earliest. Having bounced around for most of the quarter, Gilt yields declined markedly alongside all developed market bonds over March as the US Federal Reserve's pivot to more accommodative policy and concerns over global growth more generally drove yields lower. The 10 year Gilt yield declined 27 basis points (bps) over the quarter, ending the period at 1%. UK equities enjoyed a positive quarter, with domestically exposed cyclical stocks – such as banks and homebuilders – outperforming over the first half of the period as international investors returned to UK stocks amidst hopes that a no-deal Brexit has become less likely. However, this trend did fade in March as declining bond yields globally drove investors into more stable stocks in sectors such as consumer staples and healthcare, sectors which tend to be dominated by companies which generate their revenue overseas. MSCI UK All-Cap gained 8.3% in capital return terms over the period.

US

The revised estimate for US GDP indicated that the US economy grew at an annualised pace of 2.2% over the final quarter of 2018, which brought the growth rate for the 2018 calendar year down to 2.9%. This pace of growth is unlikely to be repeated this year however, as the one-off "sugar high" of President Trump's tax cuts will no longer help boost the data. Despite the unemployment rate declining to 3.8% in February, inflationary pressures remain benign with the inflation rate falling to a 20 month low of 1.5% in the 12 months to February.

March's meeting of the US Federal Reserve's FOMC saw the Committee push ahead with their recent tilt towards a more accommodative stance, with committee members on the whole reducing their forecasts for future rate rises whilst the Chairman, Jerome Powell, further indicated that they have put further rate hikes on hold for now. Cover for the Fed's more cautious stance has been provided by the aforementioned sluggish inflation backdrop, as well as the weakness in the European and Chinese economies. Perhaps most noteworthy from the Fed's recent messaging is the indication that the volatility within equity and credit markets over the fourth quarter also influenced the committee's thinking, a confirmation that will certainly embolden some equity investors to believe that the Fed will not allow equity markets to fall too far before reacting with looser policy. The US equity market powered ahead over the quarter, with the S&P 500 gaining 13.1% in US Dollar terms. The change in interest rate expectations by the FOMC helped drive US Treasury yields lower, with the 10 year Treasury ending the quarter with a yield of 2.41%.

Europe

Following a stellar 2017, the steady decline in the Eurozone's manufacturing sector experienced by the currency bloc through almost the entirety of 2018 has continued into this year according to survey data released in the first quarter of 2019. This slowdown over the last year has been caused in large part by the fact that net trade has turned from a substantial tailwind to a small drag on growth. Most notably, in the month of February the survey indicated the manufacturing sector actually contracted with the ongoing trade war between the US and China, concerns over global growth and Britain's ostensibly imminent departure from the EU all cited as reasons for the weakening of demand. To further compound these challenges, the Eurozone's largest member, Germany, has struggled with slowing demand for their auto sector, particularly within China. Whilst manufacturing remains fairly weak in the Eurozone, the services sector has remained comparatively strong and kept growth from falling into negative territory.

In reaction to this darkening of the growth outlook, the President of the European Central Bank (ECB), Mario Draghi, has elected to reverse course by putting off plans to "normalise" policy through increasing interest rates, instead unveiling more cheap funding for banks. The cheap funding scheme offered to banks consists of two-year loans, a move which is aimed at helping to avoid a squeeze on bank lending which could impact on activity within the real economy. MSCI Europe ex-UK gained 7.4% over the quarter in sterling terms.

Asia

There have been signs of a pick-up in the Chinese economy over recent weeks, with a widely watched survey indicating that factory activity grew unexpectedly in March for the first time in four months, whilst infrastructure spending has also been accelerated. Alongside this improvement in economic data, as noted in the House View the prospect of greater inclusion in global equity indices helped further bolster sentiment in Chinese stocks over the period. The benchmark gauge for onshore Chinese stocks, MSCI China A, gained 30.2% in local currency terms, whilst the index for Hong Kong listed stocks, MSCI China H, returned 12.1% on the same basis. Having been one of the few markets to deliver a gain over the challenging fourth quarter, Indian stocks were more muted as the upcoming national elections, and the rise in the oil price, dampened sentiment. MSCI India gained 4.4% in sterling terms.

The Japanese economy actually grew at a faster pace over the fourth quarter than initially anticipated, growing at an annualised pace of 1.9% according to the revised estimate. However, inflationary pressures remain weak and the Bank of Japan remain committed to their negative interest rate policy. MSCI Japan gained 6.6% in Yen terms.

Commodities

The oil price rebounded from a weak first quarter, increasing from $54 per barrel to $68 (as measured by Brent Crude) by the close of the period. The market has been boosted by the imposition of sanctions by the US government on Venezuela and Iran, both major oil producers, and by hopes over a trade deal between the US and China. The iron ore price also gained strongly increasing 24% in US Dollar terms over the period, as the tragic dam collapse in Brazil compounded concerns over supply shortages. Having enjoyed a strong end to 2018 amidst the risk-off market environment, the gold price delivered a far more muted gain of only 0.7% in US Dollar terms, ending the period at $1292 per oz.

Fund Spotlight – Liontrust Special Situations

Launch Date:	01/11/2010
Fund Size:	£4.5 billion
Asset Class:	UK Equities
Managers:	Anthony Cross & Julian Fosh

Anthony Cross

Julian Fosh

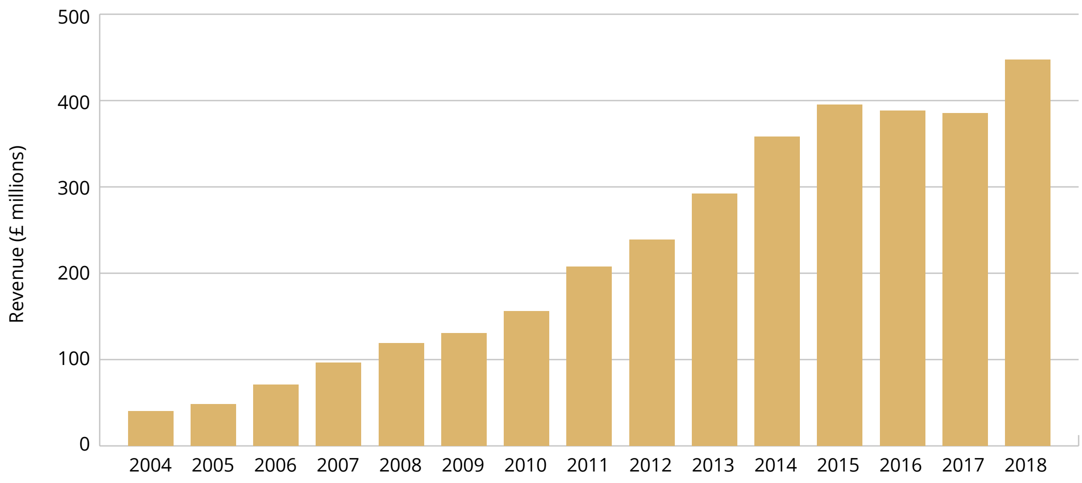
The Liontrust Special Situations team believe the secret to successful investing is to identify companies that can sustain a higher than average level of profitability for longer than the market expects. The team believe this can be achieved by investing in companies that have one of the following three economic advantages: significant amounts of intellectual property, a high proportion of recurring revenue and strong distribution networks. Each of these characteristics provides the company a hard to replicate barrier to entry making it difficult for any new company to enter the market and erode profits or steal market share. The Economic Advantage investment process has been applied to the management of funds at Liontrust for over 20 years with Anthony Cross and Julian Fosh, the two fund managers on the fund, having worked together since 2008 and have over 55 years of combined investment experience.

As one of the most successful investors of our time, Warren Buffett, said, "If you've got a wonderful castle, there are people out there who are going to try and attack it and take it away from you. I want a castle that I can understand, but I want a castle with a moat around it." Whilst I am sure Mr Buffett could afford a castle or two, what he is actually referring to is the need of a company to be able to defend itself from market competition which resonates with the process implemented by Anthony and Julian. Take Blackberry which to the unaware investor ten years ago may have seemed like an attractive investment given the popularity of the BlackBerry brand of smartphones; however fast-forward ten years and the company's inability to maintain market share has seen the share price fall c. 85%.

Domino's Pizza is a great example of a company that has built a strong distribution network with approximately 930 outlets. This strong physical presence allows great coverage of the UK with combined preparation and delivery times 10-23 minutes quicker than competitors. This barrier to competition provide a durable competitive advantage as the initial start-up costs for a new company to enter that market and to build the necessary infrastructure would outweigh the potential returns, making the project not economically viable. The pizza delivery market has grown by c. 8% p.a over recent years with Domino's Pizza capturing c. 90% of this market growth, showing their ability to maintain their market share.

Recurring revenue is the portion of a company's revenue that is highly likely to continue in the future. Recurring revenue is revenue that is predictable, stable and can be counted on in the future with a high degree of certainty. Hargreaves Lansdown plc is a financial service company based in Bristol that sells shares and related products via its website to retail investors in the United Kingdom and typically charge 0.45% on any investments held on their platform. The nature of Hargreaves Lansdown's business plan makes recurring revenue highly likely and, as shown below, they have not only been able to maintain revenue, but grow it at a stable pace.

Hargreaves Lansdown Revenue Growth

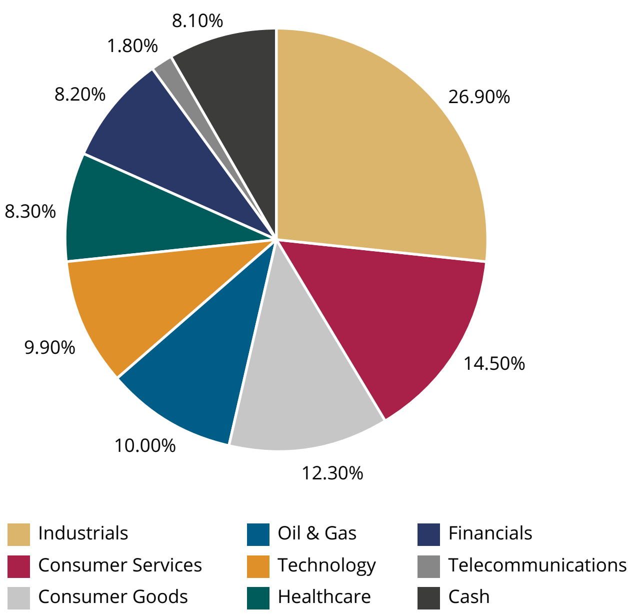


30/06/2004-30/06/2018 Source: Thomson Reuters

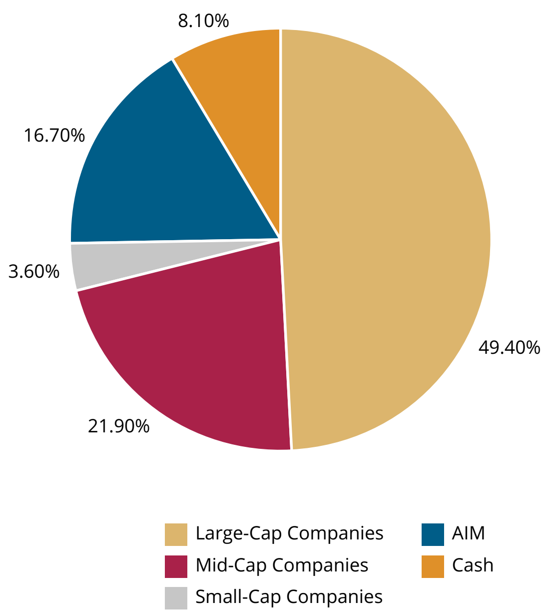
Renishaw, a company that designs and supplies products and services in applications from jet engine manufacture to brain surgery, takes a different approach to ensuring that no one 'attacks their castle'. Through decades of commitment to Research and Development, Renishaw has built intellectual property that would be incredibly difficult to replicate regardless of the expense. Intellectual property is a broad categorical description for the set of intangibles owned and legally protected by a company from outside use or implementation without consent. Intellectual property can consist of patents, trade secrets, copyrights and trademarks or simply ideas. In addition to this, Renishaw has the privilege of possessing two of the three Economic Advantages after building strong custom relationships and developing a global distribution network, only reinforcing their market position.

The Liontrust team have the flexibility to invest across the UK market with the market capitalisation breakdown shown below alongside the sector breakdown. Whilst the team do not actively look to favour certain sectors, the characteristics the team desire often lead to overweight positions in sectors such as Industrials, Technology and Consumer Services.

Sector Breakdown

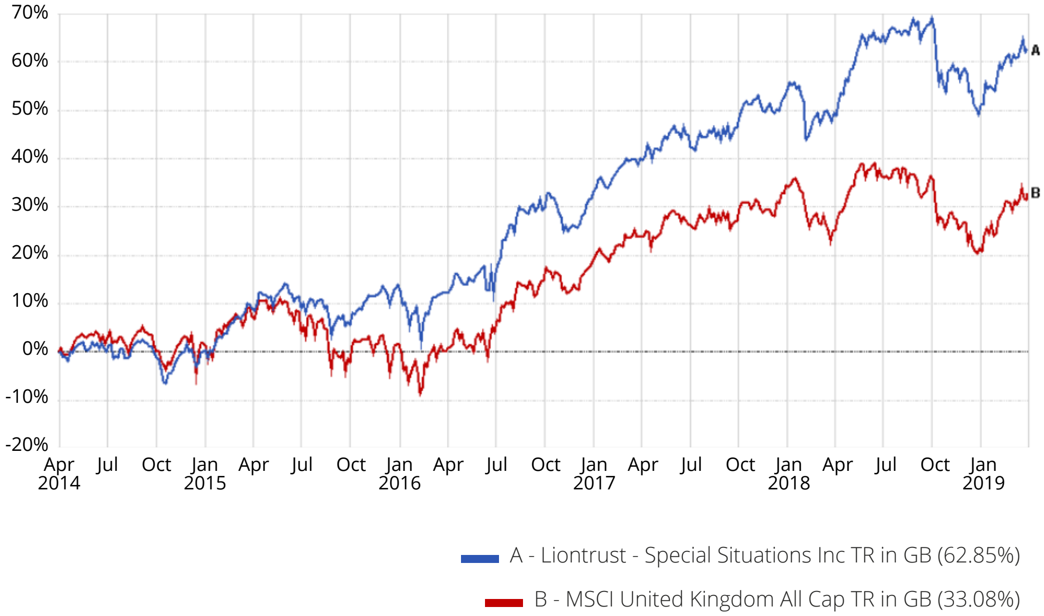


Capitalisation



As at 28/02/2019 Source: Liontrust Asset Management

Over recent years, the market environment has been particularly accommodating to funds that have taken a 'quality growth' approach to investing which somewhat describes the process implemented by the Liontrust team and this has aided the performance of the fund. This accommodating environment alongside strong stock selection from the Liontrust team has led to the strong performance of the fund over recent years as shown below. Impressively the fund has notably outperformed the MSCI United Kingdom All Cap benchmark by just under 30% over the last five years to the end of Q1 2019. The nature of the investment philosophy leads to many of the holdings in the portfolio becoming natural targets for acquisition with, since launch, 24 holdings in the portfolio leaving due to acquisition by another company. Some of the most recent success stories include Shire, Nex Group and Fidessa which all recently positively contributed to the performance of the fund having been the subject of bid activity.



31/03/2014 - 29/03/2019 Data from FE 2019

Source: FE Analytics

Investment Portfolio vs Buy-to-let properties

Andrew Savage
Investment Manager

Throughout recent history, the Government has been instrumental in shaping the property market that we experience today. From the 1980 Housing Act, designed to promote home ownership by providing the opportunity for council tenants to purchase properties at a discount to the market value, to the recent help to buy initiatives designed to help first time buyers onto the ever illusive first rung of the property ladder. Although these schemes have often achieved their objectives, they have also led to unintended side effects. When Margaret Thatcher left office in 1990, home ownership in the UK had increased to 67%, before peaking at 71% in 2003. However, this also led to speculators and property investors purchasing these properties and an increase in rents as a lack of new homes were being built. Sceptics of recent government initiatives such as the help to buy equity loan would argue that it has not dealt with the real problem of house price affordability for first time buyers, keeping house prices elevated and supporting the bottom lines of house builders.

With the 1980 Housing Act sewing the seed for an increase in buy to let investors, buoyed by the change in 1988 to the assured shorthold tenancy, the private rental sector has gone from strength to strength as investors have benefitted from strong house price growth. Since the financial crisis however, we have seen home ownership collapse, with the 'UK experiencing the largest fall in home ownership of any country in the EU' (Independent 21/08/18). At the same time, property price inflation has been spectacular with average property prices reaching all time highs in 2017, mainly due to the ultra low interest rate environment. This coupled with high rental demand from millennials, who have experienced little in the way of real wage growth, has boosted returns for buy-to-let investors and certainly a large number of our clients have shared in these gains. In this environment of falling home ownership, cue the Government with further legislation changes, however this time not only through supportive policies but also by introducing punitive taxes on current and prospective buy-to-let investors.

Since 2015 in an attempt to rebalance the housing market, the tax changes implemented by George Osbourne were designed to not only deter new entrants through the increase in stamp duty, but also to hit existing landlords' profits with more stringent tax legislation. Previously, buy-to-let investors could reduce income tax on rental income by 10% based on wear and tear, even if they did not spend funds on maintenance. From 2016, landlords have only been entitled to deduct allowable expenses for work actually carried out. Mortgage interest tax relief is being phased out at a rate of 25% a year from 2017, although to provide a degree of relief, a new 20 per cent mortgage interest tax credit is being introduced. Capital Gains tax rates have also been kept at 18% and 28% (depending on your tax status) for second properties.

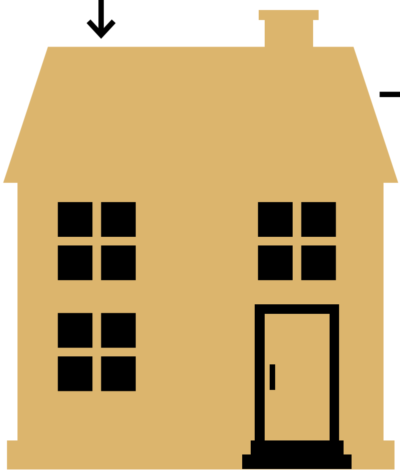
Tax Year	Percentage of mortgage interest payments deductible from rental income	Percentage of mortgage interest payments qualifying for the new 20% tax credit
Before April 2017	100%	0%
2017-2018	75%	25%
2018-2019	50%	50%
2019-2020	25%	75%
After April 2020	0%	100%

Source: www.moneysupermarket.com

As when investing with us, cost is an important consideration and we will always quote our performance net of all fees; the same must be done when investing in a buy to let property. Therefore, the return generated from a buy-to-let property is more complex than simply capital growth plus the rent a tenant is paying.

Upfront costs:

- Stamp Duty (SDTL) – From 1st April 2016, anyone purchasing a property in addition to their main home will pay an additional 3% SDLT on top of the standard rates (although this can be offset against capital gains tax (CGT) in event of sale).
- Standard costs associated with buying a property, including survey fee, legal costs and mortgage fees, should you require one.



Rent

Ongoing costs:

- Letting agent/ management fees + setup or administration fees. Full property management fees may be around 10 to 15 percent of monthly rent. Should you opt to do this yourself, you will need to factor in the cost of your time.
- Maintenance costs, although some of these can be offset against tax
- Buildings & Landlords insurance
- Potential void rental periods
- Specific legal requirements eg gas safety certificates
- Rental guarantee insurance
- Mortgage interest costs (if funded by debt)
- Income Tax on rental income

Exit costs:

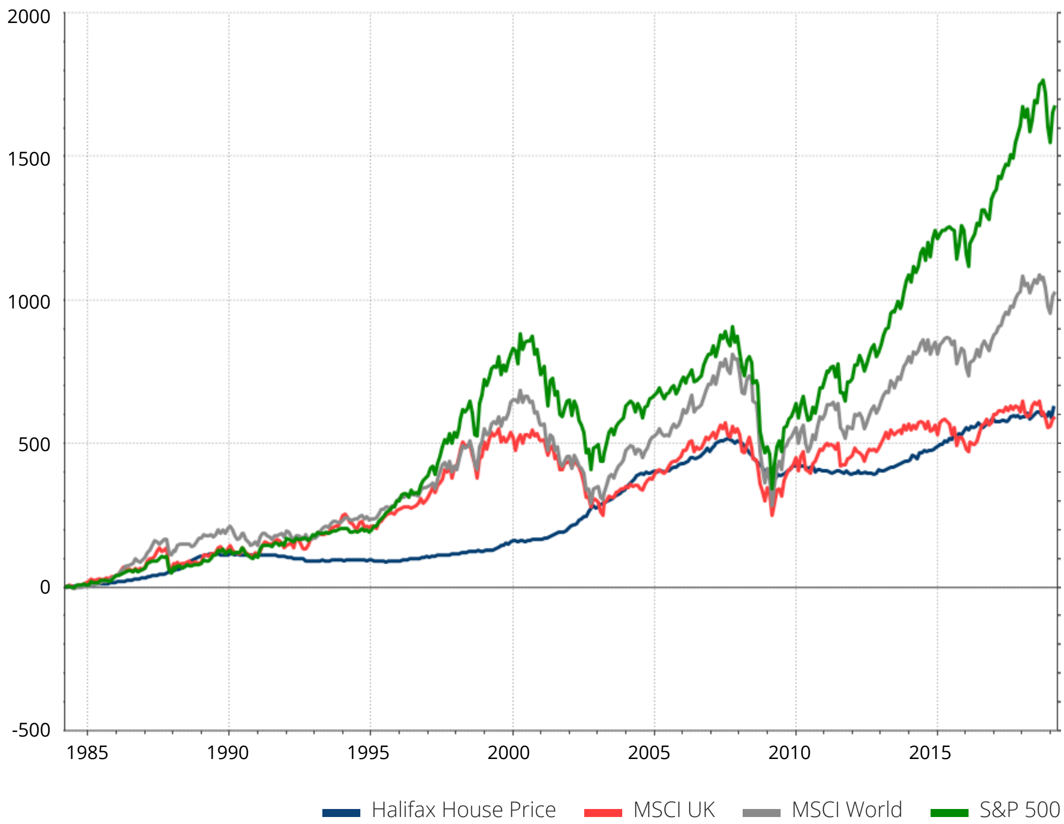
- CGT on disposal kept at 18% and 28% depending on tax status.

When compared to Investment Portfolios, property has a number of distinct disadvantages:

- Due to the high cost of property it is hard to diversify your exposure, with your capital likely to be tied up in 1 or 2 properties.
- You cannot hold your buy to let property in an ISA or pension to provide tax efficient income and capital growth.
- Although you can utilise your CGT allowance on the sale of a property, you cannot make use of this each tax year, which would be possible with a General Investment Account within an Investment Portfolio.
- Property is an illiquid asset class and the price you receive will not be known until it is actually sold.

Whilst other types of investment have a number of distinct advantages over property, such as tax efficiency, liquidity and clear price discovery, we feel that property can still form part of a well diversified retirement income plan. Recent government policy has certainly made new buy to let property investments considerably less attractive for prospective property investors, especially for higher rate tax payers, looking to fund a purchase through debt. However, it can still work well if you are a basic rate tax payer or you are using rental income to utilise part of your annual tax free allowance. With capital growth within the residential property sector predicted to be modest over the short/medium term, and taking into consideration the costs highlighted within this article, we urge potential buy-to-let investors to proceed with caution and ensure a full analysis of costs is undertaken before committing to any purchase.

The below chart shows the increase in average UK house prices from 1984 – present compared to a number of equity market benchmarks (price return)



31/12/1983 - 31/03/2019

Source: Thomson Reuters Datastream

A Cautionary Tale: London Capital & Finance Plc

Kirsty Stone
Investment Manager

Public confidence in the Financial Services industry has once again been shaken following the insolvency of London Capital & Finance Plc (LCF), leaving over 11,500 investors at risk of losing a large proportion of their savings.

Bondholders invested in excess of £237m into bonds, which promised returns of between 6.5% and 8% per year, an offering that immediately raises questions as to the risk taken within this product. In their report dated 25 March 2019 the Administrators, Smith & Williamson, confirmed that LCF do not hold any immediately realisable assets, other than cash of c£3.6m. At present, they estimate a return of capital to investors to be as low as 20% of their original investment.

What was on offer?

LCF were selling a series of mini-bonds with a range of high interest rates and duration. To provide some background, a mini-bond is an unlisted debt security typically issued by small businesses to raise funds. In exchange for the risk of investing in small businesses and their associated high failure rate, investors are incentivised with high interest rates. Importantly, unlike listed retail bonds, mini-bonds are typically illiquid as they are not transferrable, making any comparisons between the two misleading.

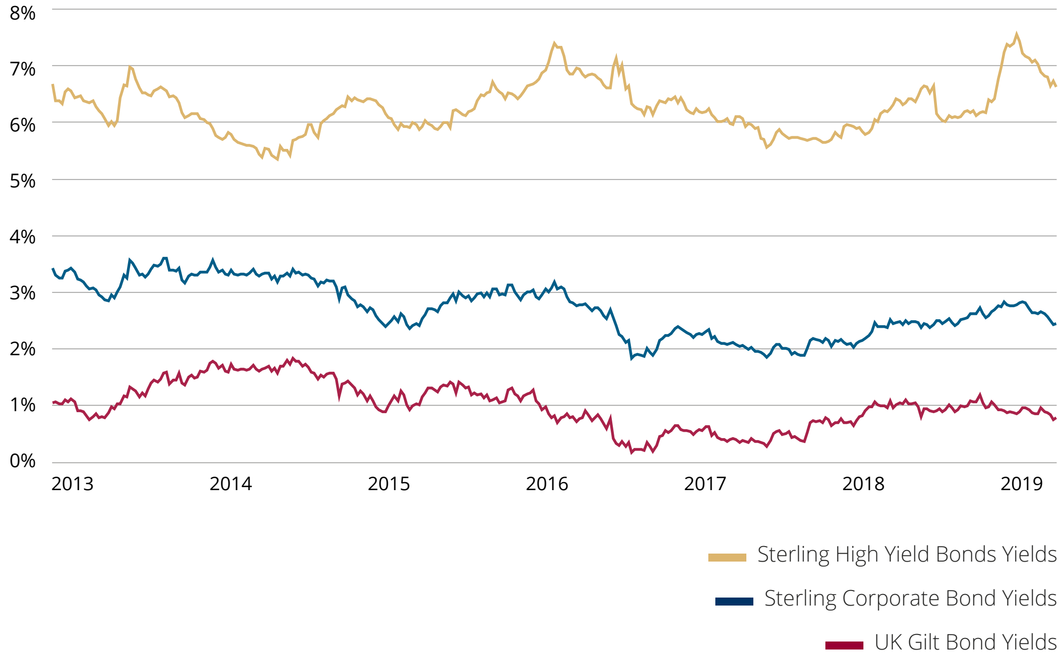
LCF had been selling mini-bonds for a number of years before its collapse, although a large proportion of investors engaged with LCF from 2016 onwards. LCF invested heavily into marketing the bonds, outsourcing both this and the administration of the bonds to a company called Surge. It transpires that 25% of all money invested into the bonds was actually paid straight to Surge who received a total of £58m in commission from LCF.

The rush towards a heavily marketed bond that offered such a high interest payment could partially be attributed to the nominal returns offered through Gilts and higher quality Corporate Bonds. Investors may have been seeking greater returns for their savings with little understanding of the risk taken to achieve this higher return. Outlined below are the yields available from conventional bonds over the past five years. As can be seen, the rates of return offered by LCF, which were as high as 11% in 2014, are in excess of the rates which could be received from even high yield bonds.

To offer some perspective on the returns sold to investors by LCF, Unilever offered a yield of 1.3% on their February 2017 issue with a duration of 5 years. HSBC also issued a bond in October 2017 offering a yield of 2% with a duration of 3 years. In the same year, LCF sold c. £25m mini-bonds with a duration of 3 years and an interest rate of 8%. While experienced investors will have likely been sceptical of the returns offered by LCF, people investing for the first time may **not** have realised that achieving this level of return without taking significant risk was simply too good to be true.

As outlined in the Administrator's report, the capital invested with LCF was in turn invested into predominantly highly speculative companies and projects including developments in Cape Verde and the Dominican Republic. Even more alarmingly, the funds invested were only spread across 12 companies who themselves sub-loaned to other companies. Smith & Williamson have described some of the transactions to be highly suspicious, with the Serious Fraud Office opening its own investigation into LCF, saying it had arrested four people associated with the firm. Smith & Williamson have further noted that their initial findings on the recoverability of the loan book is that a large number of the borrowers do not appear to have sufficient assets with which to repay the company.

Yields available on Conventional Bonds



31/12/2012 - 31/12/2019

Source: Thomson Reuters

The FCA intervened on 10 December 2018 by issuing a Supervisory Notice directing LCF to cease any form of regulated activity, deal with, or dispose of any assets and withdraw promotional material on the basis that the FCA believe the marketing of the bonds was 'misleading, unfair and unclear'.

Moving Forward

Many investors will have unfortunately believed they were protected by the Financial Services Compensation Scheme, however will be frustrated to discover that they were investing in an **unregulated product** which attracts no such protection, even if undertaken by a regulated firm. This point has drawn particular scrutiny, with investors likely to have been reassured by LCF confirming they are authorised by the FCA. It's certainly an understandable presumption made by the average investor that this authorisation would have awarded some level of protection against the events which have transpired.

Questions have also been raised as to the FCA's supervision of LCF and whether action could have and should have been taken earlier to protect investors from the scandal. On 1 April 2019, the FCA announced that they are commissioning an investigation by an independent person considering the following:

- Whether the existing regulatory system adequately protects retail purchasers of mini-bonds from unacceptable levels of harm
- The FCA's supervision of LCF

We await the findings from the Administrators and the FCA and are hopeful that lessons will be learnt and steps taken to ensure future potential investors are not caught out in a similar way and are better equipped to understand the risks they are about to take or if they are, they have some means of recourse and protection under the regulatory system. For now, we're saddened that so many investors will likely be further disillusioned with our industry as a result of the actions of LCF. It is again a salutary lesson that what appears too good to be true, probably is just that.

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