DART CAPITAL

Investment Brief

October 2019

House View

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Despite slowing global growth and growing tensions between the US and China, interest rate cuts by the world's major Central Banks have helped drive equity indices higher this year whilst bond market returns have also been flattered by declining yields. We retain an overweight position in equities, with stocks looking attractively valued relative to bonds whilst Central Bank policy remains supportive, but we do balance this position with defensive positions in short-dated bonds and gold. Given the extremely rich valuations within the bond market, we remain more cautious than some of our peers when it comes to holding long-dated bonds.

Politics

Even though a huge amount has happened in UK politics since our last House View piece in early July, including the ascendancy of Boris Johnson to Prime Minister, there remains a lack of clarity on the future relationship between the UK and the EU, most notably whether we will leave with or without a deal. Whilst we can't predict the outcome of the negotiations, it is important to note that our managed portfolios should remain resilient even if the least market friendly outcome – a "no-Deal" Brexit – occurs, given our significant exposure to overseas assets and overseas revenues within our UK equity holdings.

The political situation globally is also best described as challenging, not least because the steadying role the US has played in international affairs since World War II has been replaced with the more erratic approach favoured by President Trump, who appears willing to escalate geopolitical tensions at a moment's notice. This changing of the world order comes at a time when the world grapples with long-term threats, not least the impact of climate change. However, it is important to note that markets are never worry-free, and if these existential risks didn't exist equity market indices would likely be significantly higher than they are currently. Thus investors are – in our opinion - being adequately compensated for taking on these well-known risks with the future long-term growth provided by a multi-asset portfolio still expected to far exceed the return on cash deposits.

Fixed Income

Within fixed income, we remain far more comfortable taking risk within credit than duration, with our exposure heavily tilted towards short-dated investment grade and higher yielding bonds where we are generating a decent yield whilst not exposing ourselves to significant losses should there be a back-up in global bond yields.

Our lack of exposure to long-dated bonds did hurt us over the quarter given the continued move down in yields within the fixed interest market. Where investors have traditionally invested in government bonds (such as UK Gilts or US Treasuries) for their income generation and security, most investors now buy longer-dated government debt for its ability to deliver capital gains in the event that yields move even lower. Although the yield on the 10 year Gilt, which currently yields only 0.5%, could well move below 0% at some point (after all yields on German Bunds are already negative) thus conferring further capital gains for holders, we don't believe that investors are being sufficiently compensated for the risks involved in holding long-maturity nominal bonds.

The foremost risk we are wary of, which would likely cause a re-pricing within the bond market, is that inflation expectations will move upwards at some point over the coming decade from their extremely depressed current levels. In particular, we don't believe that western economies will tolerate the type of deflation that the Japanese economy has experienced over the last two decades, with policymakers in the US and UK having already shown a growing desire to accelerate fiscal stimulus measures.

UK Equities

Outside of internationally exposed "quality growth" companies, such as Unilever and Diageo, which are perceived as having stable growth prospects and trade on valuations in-line with their international peers, the UK market remains broadly unloved by international investors. Whilst this in-large part is due to Brexit-related concerns, the UK index's significant exposure to commodity producing companies and financials has also provided a headwind when compared to the more growth-biased US and global indices. The benefit of being out of favour is that the UK index, MSCI UK All-Cap, is still generating a dividend yield of over 4%, a particularly attractive level given the paltry yields available on cash deposits and Gilts, and we added slightly to our UK exposure on market weakness in August.

The valuation gap between UK equities and bonds continues to widen*

Source: Refinitiv Datastream

*The chart shows the yield on the index for the UK's 100 largest listed stocks minus the yield on the 10 year Gilt.

Whilst our UK equity blend retains a c.60% exposure to overseas revenue, our favoured active managers have been gently adding to domestically exposed stocks since the Referendum. Whilst this may sound concerning, in the domestic market investors are able to get exposure to companies with strong franchises in industries, such as building supplies, which will return to growth should the domestic economy improve, at far lower valuations than comparable companies in overseas markets.

International Equities

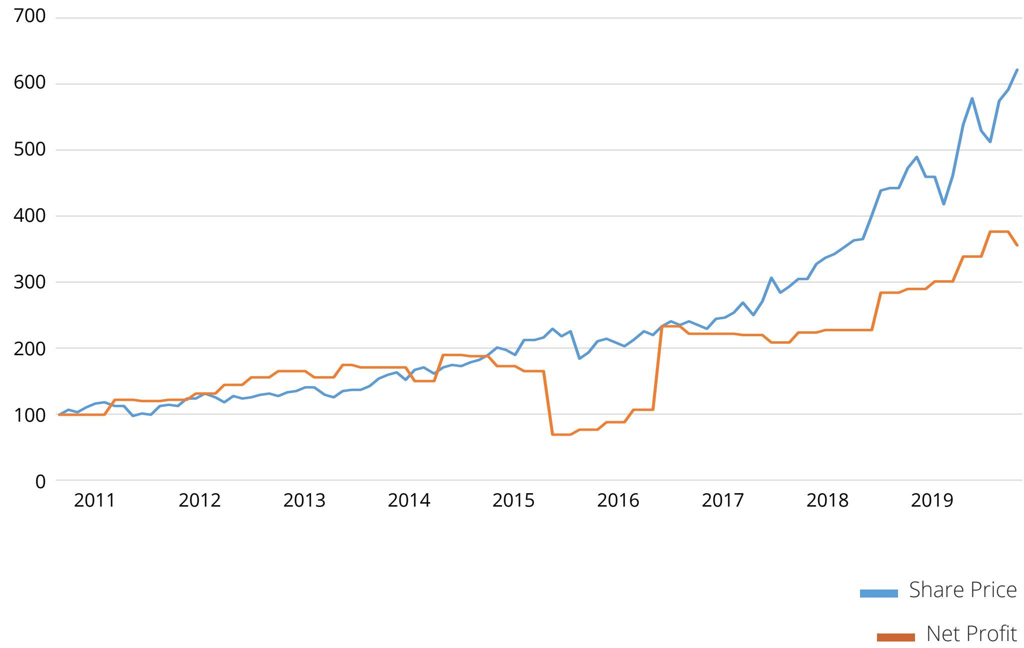
Having previously been too cautious on the region, we have selectively added to US equities over the last two years, using the brief periods of market pessimism to gain exposure at attractive entry points. These moves have proven to be beneficial, with the US market continuing to deliver robust returns, led by the country's plethora of mega-cap technology-driven companies, such as Amazon, Apple and Microsoft, with investors continuing to be attracted by the secular growth prospects of many companies in the sector.

We do note however that certain industries within the American market, most notably consumer staples, software and medical technology (med-tech), look more than fully valued having enjoyed spectacular share price growth over the last decade. This intuitively makes sense, as economic growth has generally been weaker than expected over this period, which has caused investors to bid up stocks which are perceived as offering stable and dependable future profits. Furthermore, the declining yields in the bond market have also made "defensive" stocks even more attractive in comparison to their more cyclical peers.

Whilst this dynamic has been a boon for some of the best performing global equity funds, such as Fundsmith Equity, which invest heavily in these industries, we are wary given the degree to which the share prices of the leading stocks in these industries have outstripped their level of profit growth. Thus, it could well be argued that the quality of many of these businesses is more than reflected in their respective share prices in a way that simply was not the case a decade ago.

To illustrate this point, investors in the US software company Intuit, a provider of accountancy software for small businesses, are now paying $45 for each Dollar of profit the company produces this year, compared to only $20 at the end of 2010. Notably, this move up in valuation has come despite the company's growth rate remaining broadly unchanged. This far higher starting valuation will make these types of companies far less profitable investments than they would be in a more normalised environment where investors have placed less of a premium on growth companies.

Software company Intuit has seen its share price move well ahead of its profit growth



31/12/2010 - 30/09/2019
Source: Refinitiv Datastream

The European market has seen many of the same dynamics as the US this year, with defensive stocks significantly outperforming their more cyclical peers owing to investors seeking companies which are less exposed to the global economic slowdown.

Japanese corporates have far stronger balance sheets than their western counterparts, with many companies having net cash positions. This puts Japanese companies in a powerful position to continue to increase dividends and share buybacks, and we expect these moves to help support the Japanese market over coming quarters.

When investing in Asian stocks we continue to favour funds which can benefit from growth in domestic consumption, a theme which we believe will be maintained regardless of the US-China trade war. This is well demonstrated by two of the top holdings in the Matthews Asia Pacific Tiger fund, Ping An and China Resources Beer, which are set to benefit from growing demand for insurance and branded-alcoholic beverages respectively. Across Emerging Markets more broadly, valuations are depressed due to the strength of the US Dollar and the aforementioned trade tensions, and we believe this region could perform strongly should either of these headwinds abate.

Property

In early August we removed commercial property from our range of model portfolios. Whilst we have been long-term investors in commercial property, we took the view that the ongoing concerns regarding the liquidity of this asset class, particularly given the current political climate in the UK, were too significant to overcome at this time. Whilst it is too early to judge the success of this move, we note that the property funds which we sold out of have continued to see downward revisions in their valuations since we sold.

Alternatives

Gold remains an important source of ballast within our portfolios, with the precious metal having moved from being heavily out of favour with many other investors this time last year to becoming one of the best performing assets over the last 12 months. We remain pragmatic on gold, well aware that unlike equities, it is not a wealth-generating asset, instead acting as a store of value. However, it is this very characteristic which we believe remains highly valuable given the aggressive money printing by Central Banks which we believe will remain a feature of markets for a long-time to come.

Pleasingly, we have seen a pick-up in performance from our holding in the Jupiter Absolute Return fund, which we hold within our Long/Short allocation alongside the Artemis US Absolute Return fund. The Jupiter strategy is positioned to benefit from a shift to a more risk averse market environment where investors place greater emphasis on balance sheet quality and profitability, with the fund having significant short positions in companies with either high debt levels or minimal free cash flow. In contrast, we continue to avoid Absolute Return funds which are heavily reliant on momentum factors, as these funds tend to provide no protection during declining markets when the engine room of our managed portfolio – equities – are struggling.

Closing thoughts

2019 has been a strong year for equity markets so far, with markets reacting positively to the powerful stimulus of lower interest rates. We do however believe that a note of caution is required, with volatility levels likely to remain high as the market deals with political tensions and a global economy which is far from firing on all cylinders. Against this backdrop, we retain reasonable exposure to diversifying assets which can help cushion portfolios should market conditions become more challenging.

Market Commentary – Q3 2019

Alexander George, CFA
Associate Director of Research

It was another positive quarter for equity markets, aided by continued support from the world's major Central Banks with both the US Federal Reserve and European Central Bank announcing interest rate cuts.

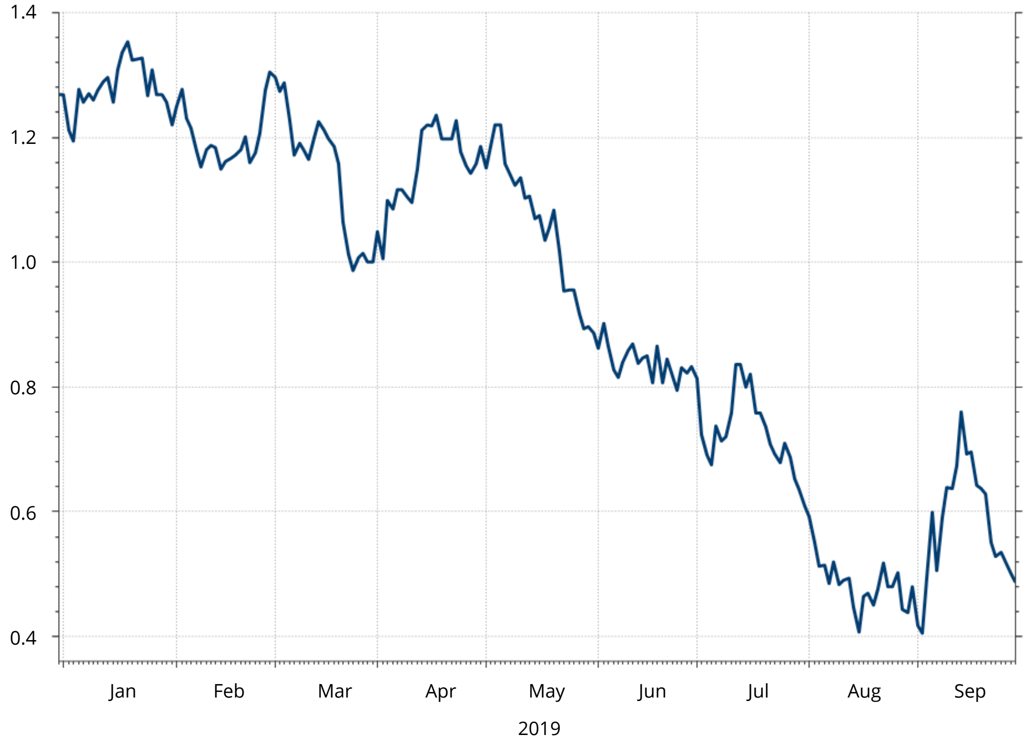
UK

The UK economy shrank over the second quarter, with GDP (Gross Domestic Product) declining 0.2% according to the Office of National Statistics (ONS). Whilst it is easy to blame Brexit-related uncertainty, and it certainly has played a role in delaying business investment and knocking household confidence, the primary source of weakness has been the manufacturing sector, which has been a recurring theme across all developed economies.

Despite this, there have been more positive signs from the labour market, with the most recent ONS figures indicating that average wages grew 3.9% from its level a year earlier in the April-June period, although the figures were flattered somewhat by the late payment of pay rises for NHS workers last summer. Furthermore, the unemployment rate remains at a healthy 4%, having held fairly steady for much of the last year. Despite this, domestic inflation (as measured by the Consumer Price Index) declined to 1.7% year-on-year according to the August figures. Below-target inflation and Brexit uncertainty has given the Bank of England (BOE) the cover to move to more dovish policy, with the Governor of the BOE, Mark Carney, having already indicated that rate cuts would follow any no-Deal Brexit outcome. Sterling declined from $1.27 to $1.23 against the US Dollar over the quarter.

By the end of the quarter, the yields on Gilts of all maturities had fallen to levels last seen in the immediate aftermath of the EU Referendum in 2016, with the yield on the 10 and 20 year Gilts falling to 0.5% and 0.9%, having started the year at 1.2% and 1.7% respectively. This move down in yields has driven spectacular returns for long-dated bonds, with iBoxx Sterling Gilts All Maturities gaining a further 5.8% over the quarter (in capital return terms). In contrast, owing to its far lower sensitivity to market interest rates, the shorter-dated iBoxx UK Sterling Gilts 1-5 year index ended the period down 0.2% on the same basis. UK stocks, as represented by MSCI UK All-Cap, ended the quarter down 0.3% in capital return terms.

Gilt yields continued to decline over the quarter



US

US economic growth slowed to an annualised pace of 2% over the second quarter according to revised figures, with this slowing blamed largely on the impact of tariffs and weaker overseas demand. However, household spending remained a source of strength within the figures, with personal consumption growing at an annualised pace of 4.3%, whilst government spending also helped bolster growth. With inflation still below the US Federal Reserve's target, and a domestic and global economy that has slowed over the last year, at least one interest rate cut by the Federal Reserve (the Fed) had become an increasing certainty by the time of the Fed's meeting on the last day of July, with the prospect of looser monetary policy helping spur equity indices higher across the globe over that month.

The Fed's monetary policy committee (known as the FOMC) met the market's expectations by cutting interest rates twice over the quarter, agreeing to cut the Federal Funds Rate (base rate) by a total of 50 basis points, from 2.5% to 2%, with the moves being the first rate cuts by the Fed since 2008. In his comments following the first rate cut, the Chairman of the Fed, Jerome Powell, indicated that the cut was likely to be a "mid-cycle adjustment", which was a disappointment to some – including President Trump – who had hoped that the Fed would announce the start of a more prolonged rate cutting cycle. Despite this, the market is pricing in further rate cuts in December and through next year as the Fed bows to market and political pressure to ease policy further.

In mid-September there was a much publicised spike in overnight interest rates within the US repo market with rates rising as high as 10% at one point. The repo market is over $3trillon in size and sees banks and other financial institutions manage their liquidity, by agreeing with each other to sell and buy back government bonds. The cause of the spike in rates has been attributed to the lack of liquidity in the banking system, in large part because the Fed's Quantitative Tightening (QT) programme has reduced the amount of cash in the system. This was then exacerbated by the fact that mid-September sees a very high level of bond coupon payments, and the end of the tax year, which further increase demand for cash. The S&P 500 gained 1.2% over the quarter in US Dollar terms.

Eurozone

Eurozone economic growth slowed through the second quarter of 2019, with the preliminary reading for the period showing the economy grew at a mere 0.2% as economies across the region lost steam with the currency bloc's largest economy, Germany, actually contracting. Most notably, Germany's manufacturing sector has struggled over recent months with output undoubtedly hit by the ongoing US-China trade war, along with weakness within the very large automotive sector.

In an attempt to kick-start the ailing Eurozone economy, the European Central Bank (ECB) eased monetary policy in September as was widely expected by the market, cutting rates by 10bps, to -0.5%, and announcing plans to restart their Quantitative Easing programme with the ECB set to buy €20bn of debt a month from the 1st November. Whilst bonds rallied initially on the announcement, yields actually rose later in the day with some investors seeing the ECB's move as the "last throw of the dice" before the Eurozone's governments take on the baton and embark on fiscal stimulus.

The rate cut was the ECB President, Mario Draghi's, last major act in his role with Christine Lagarde set to replace him on November 1st following the EU's Finance Ministers signing off on her nomination. Lagarde, a lawyer and former politician, recently resigned from head of the International Monetary Fund (IMF) in anticipation of her new role and whilst Lagarde's approach to monetary policy has not been overly publicised, her public comments over recent years suggest she supports the unconventional stimulus measures taken by Draghi over recent years. MSCI Europe ex-UK gaining 2.7% in local currency terms.

Asia

Asian stocks were shaken in August by the Chinese government's move to weaken the Renminbi below the level of 7 Renminbi per US Dollar which the Chinese authorities have historically not wanted to breach, in an attempt to lessen the impact of higher tariffs on exports to the US and the strength of the US Dollar. These concerns weren't helped late in the period by leaked plans from the US government, which have since been denied, that they may try and limit US investors' investment in Chinese companies. Alongside their loosening of monetary conditions, the Chinese authorities have pulled a number of policy levers in an attempt to support the economy, most notably tax cuts and increased infrastructure spending. MSCI China H ended the quarter down 7.6% in local currency terms.

The Indian government announced late in the quarter that they will cut corporate tax rates in an effort to spur investment and boost growth. Finance Minister Nirmala Sitharaman said the base corporate tax rate would be lowered to 22% from 30%, a sizeable reduction and a welcome boost for Indian businesses. MSCI India declined 2.6% over the quarter in sterling terms.

Commodities

Prior to some profit taking on the last day of the quarter, it was another strong period for the gold price, with demand bolstered by the US Federal Reserve having shifted to cutting interest rates whilst the European Central Bank have pushed rates even further into negative territory. The gold price gained 4.2% in US Dollar terms. The oil price spiked 15% in mid-September on the news that airstrikes on Saudi Arabia's oil fields had reduced crude oil production by 5.7 million barrels a day - about half the kingdom's output. Despite the market's initial reaction, a fairly speedy recovery in output was expected and this has proven to be the case with almost all lost output having already been recovered. The oil price, as measured by Brent Crude, ended the quarter down $5 at $61 per barrel.

Fund Spotlight – Investec Global Total Return Credit

Launch Date:	11/05/2018
Fund Size:	£171 million
Asset Class:	Fixed Income
Managers:	Garland Hansmann & Jeff Boswell

Garland Hansmann

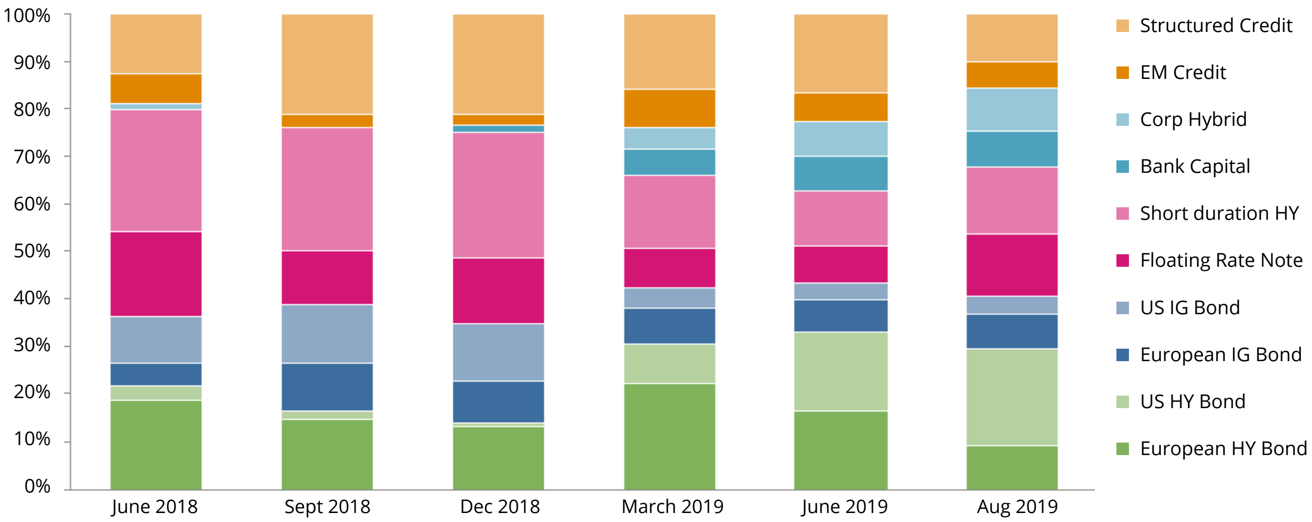
Jeff Boswell

You may have noticed the addition of a new bond fund within your portfolio in recent months, the Investec Global Total Return Credit fund. The fund was added to the model portfolios in June, in the anticipation that the prospect of interest rate cuts by the US Federal Reserve would help support credit markets. Unlike more traditional bond strategies, the managers of the fund, Garland Hansmann and Jeff Boswell, have the ability to invest across the entire fixed income universe however they choose to do so in a very disciplined fashion, following a well-defined process. The Investec Global Total Return Credit fund was launched by Garland and Jeff in May 2018 with both having run the Investec Multi-Asset Credit fund (with effectively the same process) for US investors since January 2016. Garland and Jeff previously worked with each other at Intermediate Capital Group and the two are well supported with credit analysts split between New York and London. Each analyst is a sector specialist on a global basis, which allows them to compare issuers across geographies and assess relative value on individual credit issuers.

The fund takes an unconstrained approach to investing in the fixed income universe meaning it takes little notice of the composition of benchmarks and takes a greater focus on providing an attractive absolute return. The strategy has a gross total return target of cash +4% through the credit cycle and looks to do this through allocating to bonds that can provide a reasonable yield through taking on moderate credit risk. This predominantly includes bonds issued in developed credit markets however the team will also allocate on an opportunistic basis to certain other specialist areas of the fixed income market, including EM credit and structured credit.

Credit risk is the danger that the issuer of the debt is unable to make the required payments and defaults on the bond. Notably, all debt carries some form of credit risk however the Investec team believe the key to investing in this space is balancing each bond's credit risk with its prospective return – pulling the portfolio towards credits that are more attractively valued where the ratio of return to credit risk is high. Certain areas of the fixed income market can, over short time periods, go out of favour with the wider market for a whole host of various reasons including liquidity events, lack of demand or even over-supply which can provide the team the opportunity to increase their exposure to this area on the cheap. The below chart shows the areas the team look to invest in and the portfolios exposure to them at different time periods. Notably, the allocation changes very dynamically dependent on where the opportunities lie at that moment in time.

A dynamic asset allocation across fixed income



Source: Investec

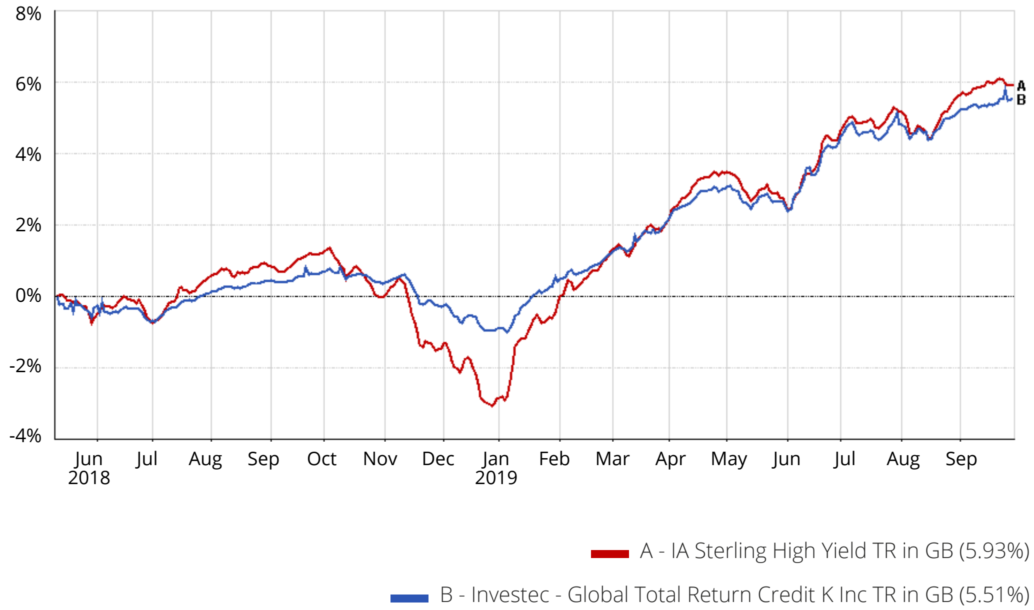
So how do the team assess credit risk? Each sector analyst will carry out in depth analysis on a potential bond that may be added to portfolios. The team focus on the underlying cash flows of the bond, look at the bonds relative value compared to the market and then produce a one page credit snapshot with a supporting financial model. If the analyst has conviction in the bond, the potential holdings will be debated by the team over a roundtable and may be added to the portfolio. This process ensures the Investec portfolio is built from the bottom-up with only the best ideas making it into the portfolio.

Another key characteristic we looked for when allocating to a strategic bond was low duration. A bond's duration is its sensitivity to a change in interest rates, with bonds with higher duration falling more aggressively when interest rates rise than bond with low duration. As mentioned in the House View, we continue to believe that the risks far outweigh the potential benefits of investing in longer duration fixed income. The areas that the Investec team look to invest in naturally give the portfolio a low duration which we believe is an attractive trait.

Given that many asset allocators are more hesitant to allocate to a fund before it has a three year track record, we were able to secure the Founder Fee rate when we allocated to the fund. With anannual management charge of 0.45%, the Founder share class is very competitive when compared to other funds in the sector which have comparable investment remits. Whilst carrying out our extensive due diligence process, we were able to feel comfortable allocating to the fund despite it not having a three year track record, as we met with the managers of the fund where we discussed the process implemented by the team in depth and through also carrying out analysis on the fund that was run by Jeff and Garland for US investors.

Since the funds launch back in 2018, the fund has delivered an attractive return profile. The below chart shows the performance of the Investec Global Total Return Credit fund relative to the IA Sterling High Yield bond sector. Whilst the fund is technically a strategic bond fund, we believe the high yield sector provides a better benchmark for the fund given its lower duration, which is not the case for much of the strategic bond sector. Importantly, the fund did a better job of protecting capital in Q4 2019, whilst offering reasonable upside in stronger market conditions.

The Investec Global Total Return Credit funds return since launch



11/05/2018 - 30/09/2019 Data from FE 2019

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