DART CAPITAL

Investment Brief

January 2020

House View

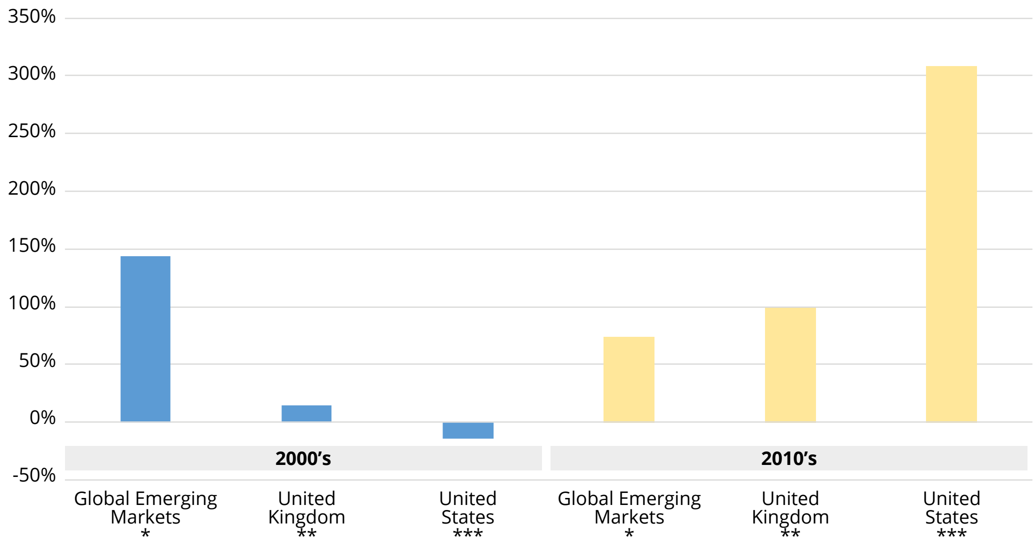
Alexander George, CFA
Associate Director of Research

The final quarter of 2019 saw the active tilts in our portfolios pay off, with our more optimistic stance on unloved UK assets and cautious view on long-dated bonds helping us deliver strong relative performance. Although stock valuations have moved higher than their level a year ago, with Central Bank policy globally remaining supportive, we retain a relatively optimistic stance on equities. That being said we continue to balance these positions with diversifying assets that can provide some protection should market conditions become more challenging.

A new decade

As we start the new decade, we reflect on the fact that although the decade marker is somewhat arbitrary, the asset class returns during any given decade tend to differ significantly from the returns over the 10 year period that preceded it. Intuitively this makes sense, with asset classes which perform well in any given decade starting the next decade at an elevated valuation which makes it harder to generate strong returns in subsequent years. With this in mind, it is notable that although the last 10 years have seen US assets outperform other major regional markets, whilst commodities have generally been weak, this trend will likely not last forever. After all, US stocks delivered minimal returns over the noughties (2000-2009) whilst other asset classes, in particular Emerging Markets and commodities, prospered. Given the potential for market leadership to change abruptly, we are keen to ensure that our portfolios retain some exposure to those areas which are out of favour and lowly valued as these are often the areas which go on to deliver the strongest returns.

Regional equity market returns over the last 10 years differ markedly from those over the first decade of the century



Source: FE Analytics

*Thomson Reuters Global Emerging Markets Index
**MSCI United Kingdom
***S&P 500
All Returns in GBP

Economic outlook

Having seen a cyclical weakening of the global economy through 2018 and the first half of last year, most economic indicators we look at indicate that the global economy likely bottomed over the summer with a moderate upswing now taking place. With most of the major Central Banks, led by the US Federal Reserve and European Central Bank, having cut interest rates over 2019 we believe that the backdrop for equity markets remains reasonably positive, although well-known headwinds to global growth – most notably aging demographics and high government & corporate debt levels – remain in place. Given the upcoming US election, we don't believe President Trump will look to escalate the trade tensions with China, particularly given the impact of any tariff escalation which appears to fall largely on US households.

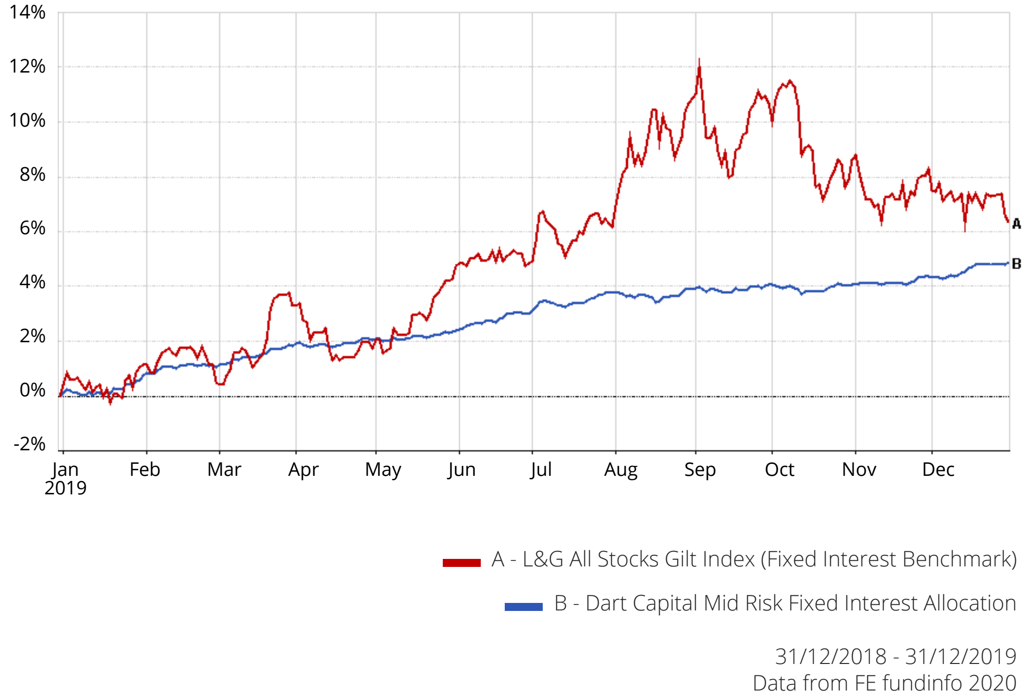
Domestically, now that the Conservative party have won a sizeable majority in Parliament, all eyes will be fixed on the progress of the trade talks between the UK and the EU, particularly now that Prime Minister Boris Johnson has ruled out extending the transition period beyond December 31st of this year. Our expectation is that a trade deal of some description will be reached by that point, although tensions will obviously be raised the closer we get to the deadline.

Fixed Income

Although bond yields moved up moderately over the fourth quarter, yields remain close to record lows across most major developed economies. Using the 10 year Gilt as the reference point, the yield currently sits at 0.8% having started 2019 at around 1.2%. We remain shorter-dated within our fixed income exposure, having reduced our duration (interest rate) exposure over the last 5 years as the yields on offer from longer-dated bonds have continued to decline. We have not made these moves because we believe that short-term interest rates will rise significantly over coming years, but rather that there is a decent chance – albeit definitely not a certainty – that investor's perception of inflationary risks will eventually increase such that they start demanding more compensation for holding long-dated nominal bonds. Should yields start to rise to a level which prices in some inflationary risk, we will likely look to buy long-dated Gilts and high quality corporate bonds.

In the meantime we prefer short-dated investment grade and High Yield corporate bonds which offer a positive yield in real (inflation-adjusted) terms. Given that default risk is far higher when investing in the latter, we prefer experienced active managers which can navigate the challenges within this space, and we have used our size to access the founder share classes of two funds – Artemis Short Dated High Yield and Investec Global Total Return Credit - which provide exposure to this area. Our preference for short-dated Investment Grade and High Yield bonds helped our bond allocation deliver a positive return over the fourth quarter, despite the Gilts index declining 4% over the period.

Our bond exposure held up well despite the rise in government bond yields over the quarter

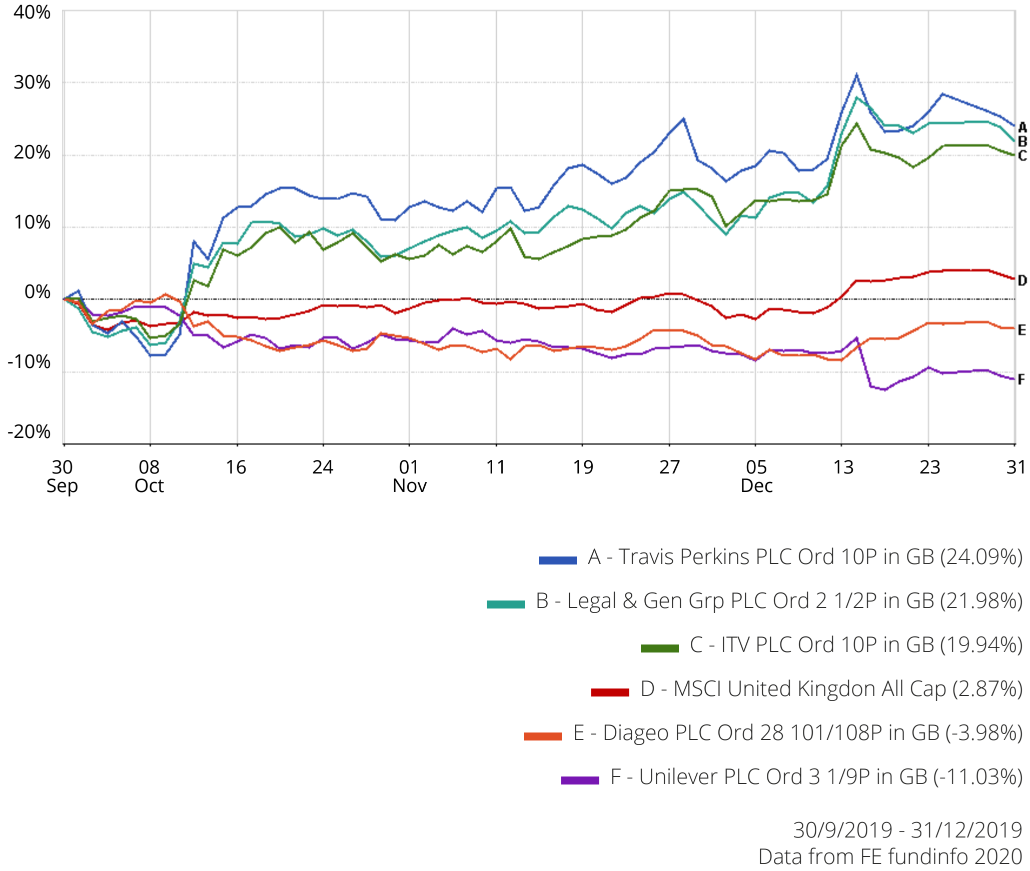


UK Equities

Supported by our expectation of a continuation of supportive Central Bank policy, we moved to increase our tactical overweight equity position during the market volatility of early August by adding to our already sizeable exposure to UK equities. These moves benefitted our managed portfolios over the quarter as UK stocks delivered robust returns. Notably, unlike in the bond market, investors are able to generate a reasonable yield from investing in stocks, with the UK market still yielding over 4% even after delivering a double-digit gain over 2019, and we believe that this valuation gap helps underpin the investment case for the UK market.

When investing in UK equities, we employ a number of experienced fund managers with clear and proven investment styles to select stocks, alongside a smaller passive exposure to provide a core exposure to the market. It was a strong quarter for our favoured active managers, aided by the fact that most of these managers have added to unloved domestic cyclical stocks since the 2016 Referendum result, an event which led to a sharp de-rating of all stocks deemed to be exposed to the UK economy. These strong returns over the quarter are in stark contrast to international earners, such as Diageo and Unilever, that lagged. When investing in domestically exposed companies, our active managers generally favour companies which possess a true franchise value, and they have added to stocks in industries as diverse as media (through stocks such as ITV), insurance (Legal & General), and building supplies (Travis Perkins).

Domestically sensitive stocks enjoyed a strong quarter, bolstered by the General Election result in mid-December



Overseas investors have been largely avoiding the UK market amidst the threat of a socialist Labour government and the ongoing Brexit process, and we believe that our incumbent holdings in UK domestic stocks will continue to benefit over coming months as international investors close their underweights to the UK market now that the threat of the former has been neutralised. In fact, less than a week after the election result, one of the holdings in our favoured UK smaller companies fund - Artemis UK Smaller Companies fund - received a bid at a 10% premium to its current share price from Private Equity firm Blackstone. The recipient of the bid, property REIT Hansteen, is an example of the sensibly financed companies which we believe look very cheap in an environment where investors are looking to increase exposure to UK stocks.

International Equities

The US remains by far our largest international regional exposure having added to our North American weighting during periods of market weakness, most recently in January of last year in the aftermath of the almost 20% peak-to-trough decline in US stocks which took place over the fourth quarter of 2018. Owing in large part to the innovative technology-driven companies that have been founded in Silicon Valley, the US market remains home to most of the world's dominant industry leading companies and this has – along with favourable tax changes and shareholder-friendly share buybacks – helped the US market deliver far stronger profit growth over the last decade than other regions. However, in addition to the upcoming election in November, there are certainly some clouds on the horizon, with corporate debt levels having risen significantly over recent years (due in large part to the aforementioned share buybacks). Furthermore, regulatory risks face those dominant internet companies, such as Facebook and Google, which derive much of their revenue from using customer data.

Continental European markets have similar characteristics to the UK market, with cyclical sectors – such as financials and energy – trading on cheap valuations as investors have had a strong preference for those businesses which aren't as exposed to the sluggish domestic and global economy. Japanese stocks enjoyed a strong year, albeit lagging the US market. Japanese corporates differ markedly from their US counterparts in that they have been more conservatively managed, with far lower debt levels (relative to their level of revenue and profit) which may allow them to come out of the next global downturn in better shape than their more highly leveraged US peers.

When compared to the strong gains for US equities over 2019 (and for much of the last decade for that matter), returns from Asian stocks have looked mundane with concerns over the US-China trade war and the strong US Dollar largely to blame for Asian markets lagging. However, it is important to note that with most Asian countries having strong fiscal positions and low inflation which will allow for a pick-up in government spending and monetary stimulus that could well feed through to an improvement in profit growth for Asian stocks. Emerging Markets more broadly would also benefit from a weaker Dollar, however it is notable that stock valuations and currencies are far cheaper now than they were when Emerging Market stocks were in vogue in the run-up to the Financial Crisis. These depressed valuations provide the potential for strong returns as and when capital returns to Emerging Market assets.

Asian stocks trade at a sizeable discount to Developed Markets

Source: Bloomberg and Investec Asset Management
Figures are as of 30/09/2019

Property

With the announcement made in early December that the M&G Property fund had suspended dealing, our decision made four months prior to sell down exposure to all open-ended property funds (and implement the move over the course of the subsequent week) proved to be beneficial. In addition to the challenges with liquidity we highlighted at the time, the ongoing shift from physical to online retail continues to have a marked impact on property values in the retail sector, with shopping centre and high street shops seeing a sharp decline in values. This transition has had an outsized impact on open-ended commercial property funds, including those in which we used to be invested, in large part because their reference index has a c.30% weighting to the retail sector.

Alternatives

Gold remains a source of diversification within our portfolios, although even we were surprised to see it gain 18% in US Dollar terms over 2019 given that equities also performed so strongly over the year. Reflective of their desire to move away from their reliance on the US Dollar and having previously been net-sellers of gold, Central Banks have stepped up their purchases of the precious metal over the last year. With this trend expected to remain in place for some time to come, along with geopolitical risk it could provide further support for the gold price over the coming months.

Whilst long/short remains an element of our portfolios, we did reduce exposure to this area in June through our sale of the Merian Global Equity Absolute Return fund, with this disposal proving to be beneficial as the fund has gone on to lose a further 8% since the point it was removed from portfolios. On the other hand, we have maintained our holding in the Jupiter Absolute Return fund, which, having performed well during the sharp fall in equity markets over the fourth quarter of 2018, did struggle during the strong market conditions of last year albeit to a far lesser degree than the Merian fund.

Although we certainly are not wedded to the Jupiter fund, unlike with the Merian strategy we can see a clear catalyst for the fund's performance to turnaround. The Jupiter strategy is net long lowly valued sectors of the stock market, most notably the energy and mining sectors where companies are increasingly focusing on cash flow generation and expectations are low. There has been minimal new investment in new oil production since the oil price collapsed in 2014 & 2015 amidst concerns over profitability and environmental factors, whilst there are signs that growth in US shale oil production has started to wane as the easiest to drill wells have started to run dry. With regards to the mining sector, mined industrial metals – such as cobalt and iron ore – are vital for, amongst many other uses, the production of electric vehicles and building of new cities in Emerging economies, both of which should provide a source of demand growth over coming decades.

This prudent approach to stock selection is shown by the fact that the fund's largest long positions include BP, which has a dividend yield of 6.5% which is fully funded by cash flow, whilst its largest short position is a loss-making online furniture retail company which is seeing declining revenue growth amidst fierce competition within its industry.

Closing thoughts

We expect returns to be more moderate this year than that experienced over 2019, although the relatively attractive valuations in the equity market and supportive Central Bank policy continue to justify a preference for equities over bonds. Our focus remains on ensuring that our managed portfolios remain resilient to changes in the market environment.

The events of 2019, foremost among which were the well-publicised implosion of Woodford Investment Management and more latterly the gating of the M&G Property fund, demonstrate the importance for all investors of having close oversight of the holdings within their portfolios and the risks associated with a laissez faire approach to portfolio management. When managing portfolios we look to strike the right balance between acting decisively when we believe that action is required, and having patience when we believe that short-term market movements are not reflecting long-term fundamentals.

Market Commentary – Q4 2019

Alexander George, CFA
Associate Director of Research

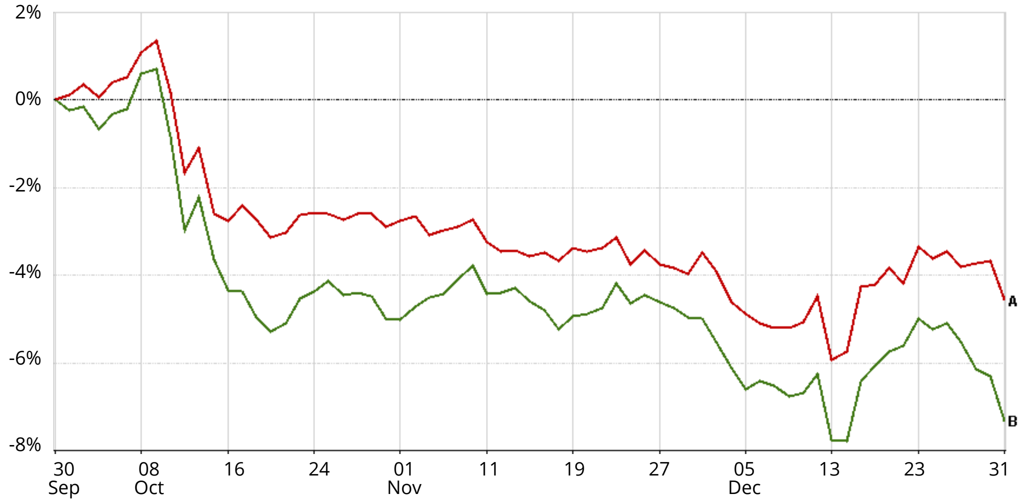
It was a reasonable quarter for equity markets as further monetary easing by the world's major Central Banks helped support sentiment across global markets, although returns for UK investors were more muted owing to the 8% appreciation of the Pound against the US Dollar over the period, a move which was catalysed by the progress on the domestic political front. Government bond yields pushed up over the quarter, leaving investors in long-dated bonds with negative returns.

Market dynamics

Over recent months, monetary policymakers have delivered a decisive response to the weakening outlook for global growth, with a whole swathe of Central Banks – led by the US Federal Reserve (The Fed) and the European Central Bank (ECB) – cutting interest rates. Such a coordinated monetary response has traditionally been positive for equity markets and so it has proven this time around, with the US equity market continuing to reach new all-time highs throughout the quarter. These moves were further bolstered by the US and China signing a Phase 1 trade deal in December which led to a delay in the imposition of tariffs on c.$155 billion worth of products imported from China.

Interestingly, closer assessment of equity markets shows that the change in market leadership that started when bond yields troughed in early September has continued, with "quality" stocks, such as Nestle and Diageo, which are deemed to be largely immune from the economic cycle, underperforming whilst cyclical stocks have outperformed, having lagged the rising market up until then. From a domestic perspective, with the Pound making strong gains against the US Dollar and the Euro, UK stocks with higher levels of domestic revenue exposure delivered far stronger returns than those businesses which generate most of their sales overseas.

The Pound made gains against the US Dollar and Euro



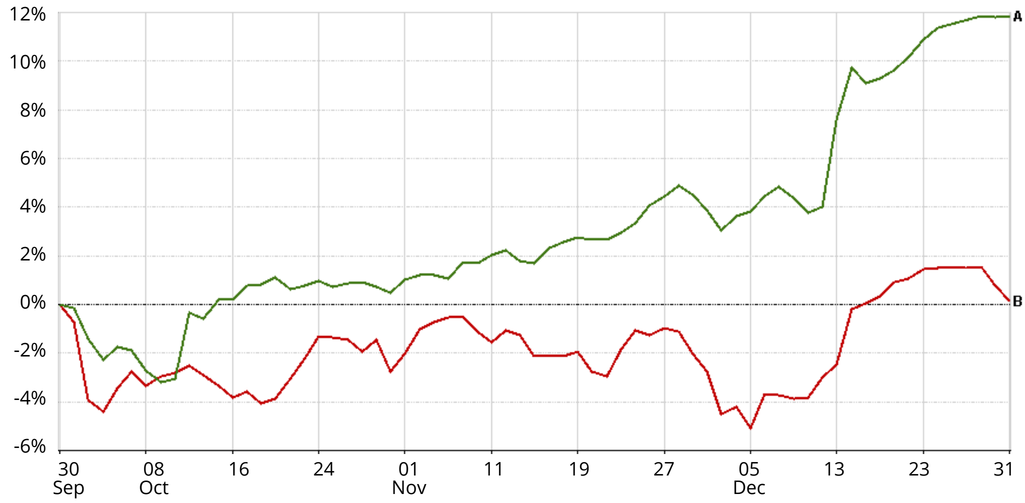
30/09/2019 - 31/12/2019
Data from FE fundinfo 2020

UK

It was a very eventful quarter for UK politics, with sentiment towards UK assets first surging on Prime Minister Boris Johnson securing a revised Withdrawal deal with the EU in mid-October. Sentiment then improved further as December's General Election delivered a resounding result, with the Conservative party securing a sizeable majority. Although the Tories were expected to win the most seats, an overall majority was by no means a certainty and, having started the quarter at $1.23 the Pound rallied reaching a peak of $1.35 against the US Dollar, before falling back to $1.325 by the end of the year. As we noted in our update the morning after the election, leaving political allegiances aside it is certainly market friendly that we now have a stable government which can move us beyond the Brexit impasse as well as start to implement greater stimulus spending and encourage business investment, which can boost the economy. The domestic economy certainly requires some positive impetus, with the most recent GDP reading – which covers the three months to the end of October – showing no growth over the period. The breakdown of the figures showed the services sector output grew 0.2%, although this was offset by small falls in the output from the production and construction sectors.

Smaller company stocks outperformed over the quarter, as capital returned to domestically exposed UK stocks. The Numis Smaller Companies index gained 11.9% over the period in capital return terms, whilst the MSCI UK Large Cap index gained only 0.2%. Gilt yields rose over the quarter, with the 10 year Gilt yield rising from 0.49% to 0.83%. The L&G Gilts All Stocks Index ended the quarter down 4.5% in capital return terms.

The smaller companies' index outperformed amidst the supportive environment for UK assets



A - Numis Smaller Companies plus AIM (excluding investment companies) in GB (11.87%)

B - MSCI United Kingdom Large Cap in GB (0.16%)

30/09/2019 - 31/12/2019
Source: FE Analytics

US

Despite the manufacturing sector remaining weak, the broader US labour market remains in reasonable shape, with the unemployment rate declining from 3.7% in August to 3.5% in November (the most recent reading) whilst non-farm payrolls far exceeded expectations when released in early December with 266,000 jobs added. However, the strength in the figures was not enough to perturb the Federal Reserve (the Fed) from cutting interest rates for the third time in four meetings in their meeting at the end of the October, as subdued domestic inflation and economic weakness overseas provided sufficient justification for a further rate cut. Following the meeting, the Chairman of the Fed, Jerome Powell, indicated that they would likely hold fire on further rate cuts for now unless there is a significant change in the strength of the economy or inflationary pressures. Adding further fuel to the idea that investors shouldn't expect a change in the Federal Funds rate any time soon, later in the quarter he stated that they would need to see a persistent pick-up in inflation before they even consider raising rates.

Amidst low expectations for third quarter corporate earnings, around 75% of the constituents of the large-cap S&P 500 index beat profit forecasts over earnings season. Particularly strong earnings reports have come from some of the technology behemoths which dominate the top end of the US market, with Microsoft and Apple beating the market's expectations for revenue and profit growth. Both stocks made strong gains over the period, ending up 13% and 31% respectively. The S&P 500 gained 8.5% in US Dollar terms, although this declined to 1% in sterling terms owing to the strengthening of the Pound. Yields on US Treasuries rose moderately over the period, with the yield on the 10 year Treasury increasing from 1.67% to 1.91% by the end of the quarter.

Eurozone

Mario Draghi concluded his eight-year term as President of the European Central Bank (ECB) in October, making way for ex-lawyer and politician, Christine Lagarde, to take over. Draghi will undoubtedly be remembered for his "whatever it takes" speech in 2012 where he vowed to do whatever was necessary to preserve the Euro, a vow which has ultimately led to the unprecedented monetary policy we see in the Eurozone today. This year alone the ECB have cut the deposit rate to its lowest ever level, -0.5%, as well as introducing a further bout of Quantitative Easing, in an attempt to boost the economy. These moves have started to see some traction, with an improvement in the survey data for both the manufacturing and services sectors over November and December, although the former remains in a state of contraction. Despite these more positive signs, in November the EU Commission lowered their expectation for Eurozone growth next year to 1.2%, down from their previous estimate of 1.4%. MSCI Europe ex-UK gained 5% in local currency terms (and 0.7% in sterling terms).

Asia

The Chinese economy grew 6% year-on-year over the third quarter according to official data, slightly below the market's expectations and a moderate slowing from the previous quarter, although it should be said that these figures likely overstate the current level of growth given the Chinese government's penchant for "smoothing" the quarterly growth figures. The ongoing pro-democracy riots in Hong Kong have caused further challenges for the Chinese authorities, with the world's media now focused on whether China will retain the principle of "one country, two systems" upon which Hong Kong has been managed since it was returned to Chinese ownership in 1997. Despite these factors, MSCI China A (which represents the returns of onshore listed Chinese stocks) gained 7.7% in local currency returns, aided by the perceived lessening of the country's trade tensions with the US. Japanese economic growth slumped to a one year low over the third quarter, with the country's exports showing continued strain from the slump in global trade. MSCI Japan gained 8.1% in Yen terms, although this return fell to 0% in sterling terms.

Commodities

The gold price moved up 3% in US Dollar terms over the period, with a late surge over the Christmas period which some have put down to the impeachment proceedings for US President Trump. The oil price increased from $61 per barrel to $66 (based on Brent Crude), driven in large part by further output cuts from OPEC.

Fund Spotlight Artemis Short-Dated Global High Yield

Launch Date:	20/06/2019
Fund Size:	£130 million
Asset Class:	Fixed Income – High Yield
Managers:	Stephen Baines & David Ennett

Stephen Baines

David Ennett

Over recent months you may have noticed that the Artemis Short-Dated Global High Yield fund has been added to your portfolio. The fund, which was only launched in June of last year, looks to invest in High-Yield bonds that are maturing in the next 5 years. High-Yield bonds are bonds with a lower credit rating than investment-grade bonds, as determined by credit rating agencies such as Standard & Poor's and Moody's. To compensate investors for the higher degree of default risks, these bonds pay a higher yield thus the name, High-Yield bond. The fund is managed by Stephen Baines and David Ennett who have a record of generating attractive returns for investors from their time together at Kames Capital, which is where we first met and invested with the team. Both David and Stephen are experienced investors, who take a pragmatic and risk-averse approach to investing in the bond market, and when the team moved to Artemis in early 2019 we believed the firm would be a good home for their team.

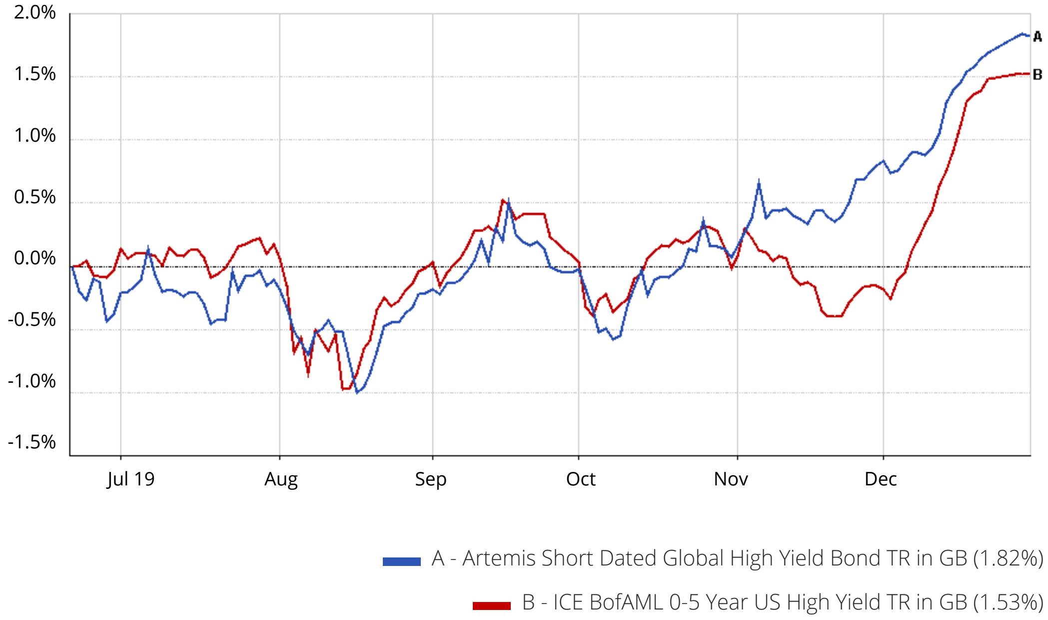
The team's primary aim is to produce a positive real return in a low volatile manner. The team are unrestricted geographically (although they do have a preference for Developed Markets due to concerns over corporate governance and transparency in Emerging Markets), meaning they can invest in bonds issued by companies all around the world and are also benchmark agnostic so will only invest in the most suitable securities, regardless of the holdings (and their weighting) in the index. Notably, indices are weighted towards larger issuers of debt which is typically an unfavourable characteristic and in our opinion a poor way to allocate capital in High Yield. The team instead look to allocate capital based on two factors, risk and reward. Reward is the return that can be generated from a holding; importantly, when investing in bonds the upside is capped and can be forecasted out with some certainty. Risk however is a function of the loss if the company defaults and the probability that this occurs. Default losses permanently impair capital, so avoiding catastrophic downside risk takes precedence over achieving any particular return in the fund.

The team look to calculate the risk and reward of a bond by carrying out in-depth research on the bond itself, which includes reviewing the bond covenants and where the bond sits in the company structure as well as analysing the company, which focuses on cash flow analysis and valuing the asset owned by the company. Notably, the global high-yield market is of a considerable size so rather than carrying out analysis at random, the team focus on areas that are likely to be inefficient. Some areas the team look at are shown below.

Opportunity	Example
Credit Rating Changes	Bonds that have been downgraded from investment grade to high yield (aka fallen angels) often face significant selling pressure from investors that, for various reasons, cannot hold a high yield bond and often become oversold.
Geographical Issuance	Over 2019 a 'Brexit Effect' impacted all GBP corporate bonds, regardless of their exposure to the UK economy making multi-national companies cheaper than they perhaps should be.
Industry Opportunity	Cyclical sectors over recent months have become increasing attractive due to the market's concerns over the broader economy, despite some companies still exhibiting strong fundamentals.

Whilst the strategy has no set yield target with the yield being an output which arises from market conditions and the opportunity set available, we anticipate the fund to be able to provide a yield premium to that of investment grade bonds through the cycle. At launch the fund had a yield of c.3.6% which we viewed as being attractive given the fund's low level of interest rate sensitivity and the prevailing low yield environment. Whilst it is still early days, the fund since launch has performed well as shown below. Despite the fund being benchmark agnostic, we look to gauge the performance of the fund against the ICE BofAML 0-5 Year US High Yield Benchmark which provides a proxy for short dated high yield.

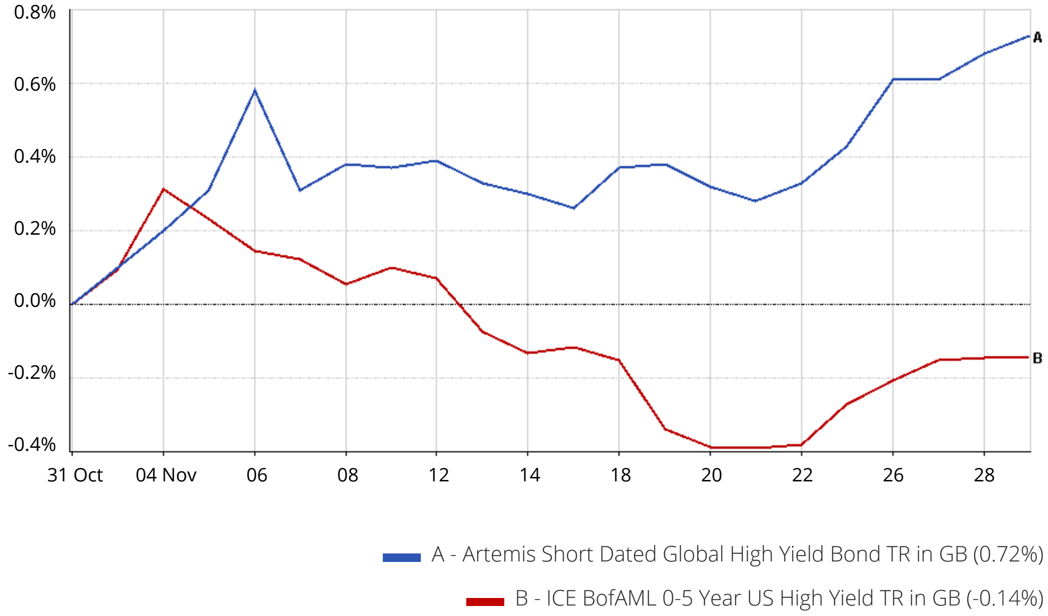
Performance of the Artemis Short Dated Global HY Bond fund since launch



20/06/2019 - 31/12/2019
Data from FE fundinfo 2020

Whilst the fund has been running for a relatively short period of time, the fund has performed broadly in line with our expectations. Importantly, over November when the High Yield market sold off, falling slightly, the fund was able to achieve its goal of providing an absolute return as highlighted on the next page.

Strong Performance of the Artemis fund over November



31/10/2019 - 29/11/2019
Data from FE fundinfo 2020

Dart Capital was one of two companies to seed the Artemis Short Dated Global High Yield fund and received an attractive founder fee rate of 0.31% for doing so. With the fund now growing to a size of £130 million it is pleasing to see the fund gaining some traction amongst other investors. Here at Dart we don't often seed new funds as the lack of information on the fund often makes it harder to carry out our extensive due diligence process. However given that we had previously invested with the team whilst at Kames Capital, we already had a degree of comfort when allocating to the new fund, which was further confirmed when we met once again with David prior to the fund's launch where we were able to quiz him on the shape of the new fund and run through the fund's largest holdings.

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