DART CAPITAL

Investment Brief

October 2020

Introduction

Richard Whitehead
Chief Executive

We've enjoyed having our staff back at base despite London resembling a wilderness over the summer days. Anyone who commutes has found their trains largely empty. The irony of this was that people were using public transport to dine out in central London during the warm weather but not to go to work in their offices.

We've achieved high volumes of meetings and up until our Prime Minister's U-turn on office working we had enjoyed clients visiting us. This return to some form of normality for Dart Capital coincided with a substantial increase in new client introductions from you all for which we are very grateful.

It cannot be a coincidence that such a pick-up in new client activity occurred after an almost absent period for the previous three months whilst we were all working from home.

You will be pleased to know that we are expanding our team at Dart Capital. Daniel Patterson has recently joined Alex's research team and Emma Boorman has just accepted a Portfolio Management position in Anna's Team. We have chosen to expand because the current crop of superbly educated graduates has never been better, as so many graduate placement schemes are being deferred for a year.

In the previous Investment Brief I touched upon the need for all of us to remember the importance of personal development of our younger work force. We had 1:1 meetings last week with each colleague and the resounding outcome was that our team enjoy one another's company and miss one another when not at work. They feel our offices are a safe place to work and in the majority of cases they don't want to revert to working from home.

In the same vain I notice some of our key competitors have used the Government's furlough scheme and other business support mechanisms. We feel such support was designed for sectors that had principally been forced to close, such as hospitality or travel firms. I doubt most wealth management businesses actually need this financial support and my understanding was that our sector was meant to be financially resilient in times of market stress. I hope such use of state support is later exposed and when their clients ask the important question of ethics and corporate governance that it will be a differentiating factor in our favour.

As Alex explains later we await the US election with interest and of course the outcome of Brexit. The global stage is set to witness more theatricals from the leader of the free world and we hope if he loses that he will go quickly. At some point in the future we can hopefully put this awful virus experience behind us and learn that our country has to be better prepared both socially and economically.

House View

Alexander George, CFA
Associate Director of Research

With many markets having recovered most of their losses from March's violent sell-off, we have shifted portfolios to a slightly more resilient stance which reflects the contrast between the relative attractiveness of equity market valuations which is supported by very accommodative Central Bank monetary policy, and the challenges the global economy faces. As governments re-introduce partial lockdowns in order to slow the spread of coronavirus this winter, we expect them to continue to support their respective economies through exceptionally loose Central Bank policy and fiscal measures. Mindful of the risks around the Brexit negotiations, we have continued to use the recovery in the Pound – which has rallied strongly from its lows in March - to add more overseas currency exposure to our managed portfolios.

Politics

Whilst November's US election will certainly garner a lot of headlines, we don't see it having a seismic impact on markets unless the vote is so close that there is a contested outcome. Although most polls point to a Democrat victory, this was also the case in 2016's Presidential race when they failed to capture Trump's edge in the "rustbelt" of America. Notably, polling data struggles to capture the vagaries of the Electoral College system, in which a group of "swing states" usually dictate the winner of the election, and it is certainly not implausible that Trump could again secure the heavyweight states of Florida, Michigan and Texas which hold the key to election victory. While a Trump presidency is a known entity at this point, we don't believe investors have much to fear should Biden win, with his centre-left politics largely representing a return to the status quo when compared to the last four years, and a more predictable approach to geopolitics making up for a modest move back up in corporate tax rates.

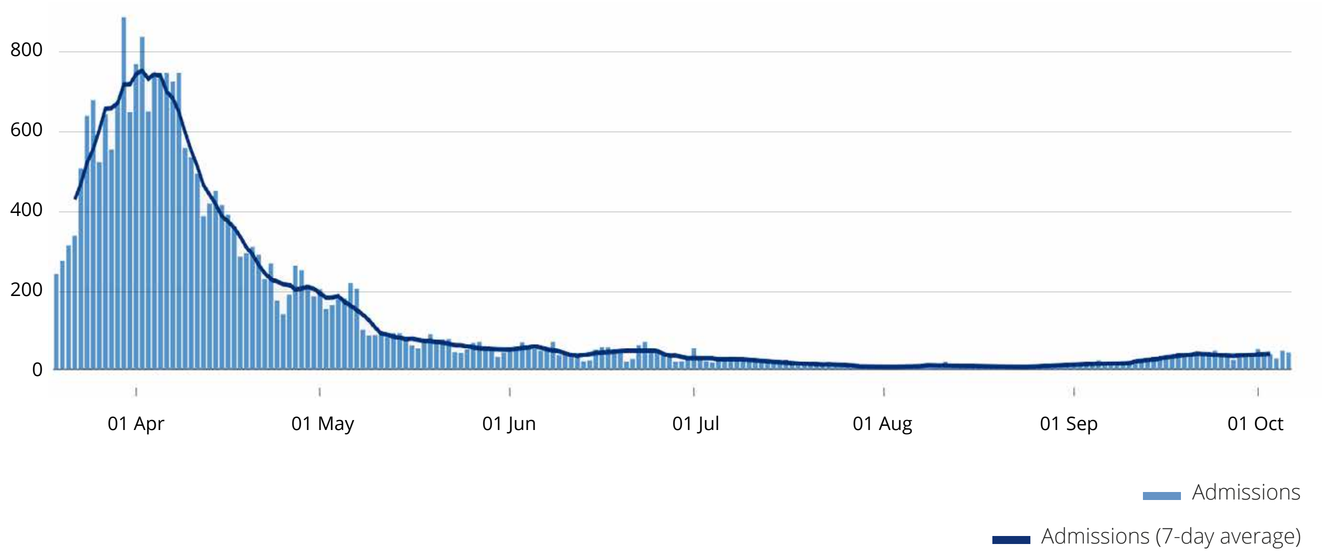
With the Brexit negotiations approaching another critical juncture, our expectation is that there will be further brinksmanship before any agreement is reached with the bad blood between the two sides likely leading to any agreement being of the bare-bones variety, with an increasing likelihood that it will not cover the hugely important services sector. Given this backdrop, we have continued to add to our overseas currency exposure across managed portfolios, most recently following this summer's rally in the Pound.

Coronavirus Update

Following a summer lull, the renewed pick-up in COVID cases over recent weeks has again left European governments with an unenviable choice between slowing infections through further lockdowns and allowing the economic recovery to continue, and we have already seen several governments re-introduce more restrictions. Whilst the recent pick-up in cases has surprised many, the data indicates that there is usually an increase in influenza cases across northern Europe each September as the climate transitions from summer to winter. Thus, with the more dangerous COVID-19 virus now actively circulating in most communities, it is unsurprising perhaps that we have seen a rise in coronavirus cases and hospitalisations over recent weeks.

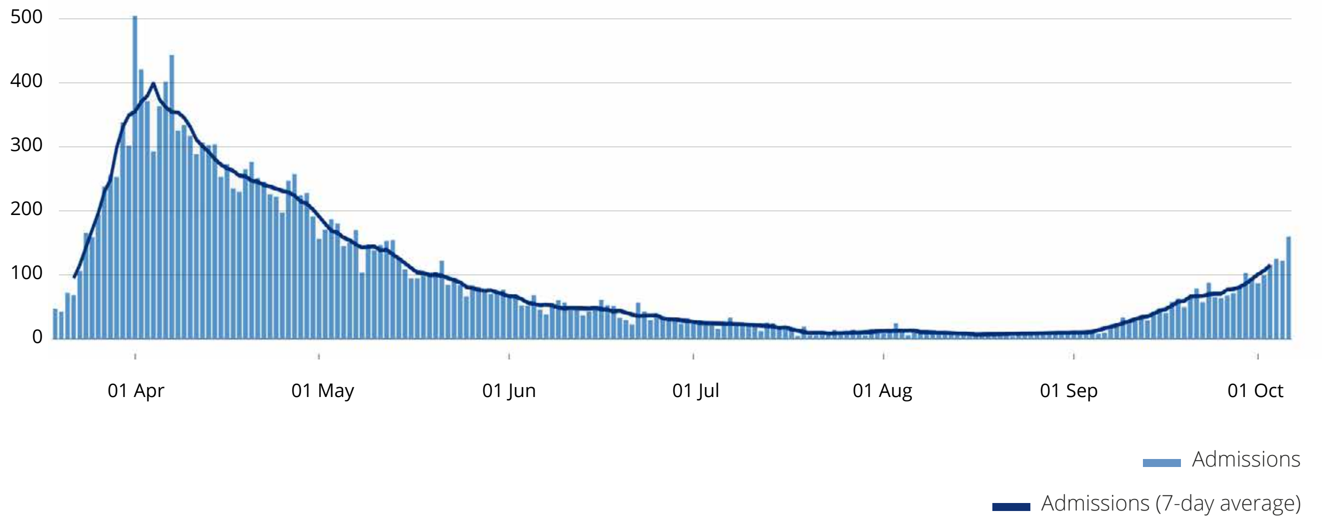
Whilst this pick-up has led the government to fear an exponential growth in cases similar to that experienced during the first wave in March, we note that there has already been a slowing of hospital admissions (which we believe is the most consistent measure for capturing both the spread and the severity of the virus) across London and the Midlands over recent days. Should this pattern eventually be repeated across the rest of the country, and other western countries, it is possible that governments will be able to avert the widespread lockdowns which had such a detrimental impact on the economy earlier in the year.

Following a pick-up in early September, COVID hospitalisations in London are not accelerating



Source: UK government

But the situation is worse in areas, such as the North-East, which experienced a weaker first wave in March



Source: UK government

Fixed Income

With long-dated government bonds continuing to offer little in the way of yield and plenty of interest rate risk, we prefer short-dated Gilts and medium-dated US Treasuries, with the former acting as a liquidity buffer within portfolios whilst we would expect the latter to generate capital gains in the event of a renewed sell-off across equity markets.

Within our sizeable corporate bond exposure, we have moved to improve the quality of our credit exposures now that valuations have normalised from their very attractive levels of mid-March. Notably, although all areas of the corporate bond market have rallied markedly from their lows, we believe that the outlook is increasingly bifurcated between Investment Grade bonds – the issuers of which tend to have good access to capital markets and have lower debt loads – and High Yield issuers, which are more heavily indebted and are thus more exposed should lockdown measures become more widespread over coming months. As a result, following the bounce-back in High Yield bonds, we have reduced the weighting to this area significantly and directed the capital into a more defensive Strategic Bond fund which has a bias towards higher quality bonds.

Equities

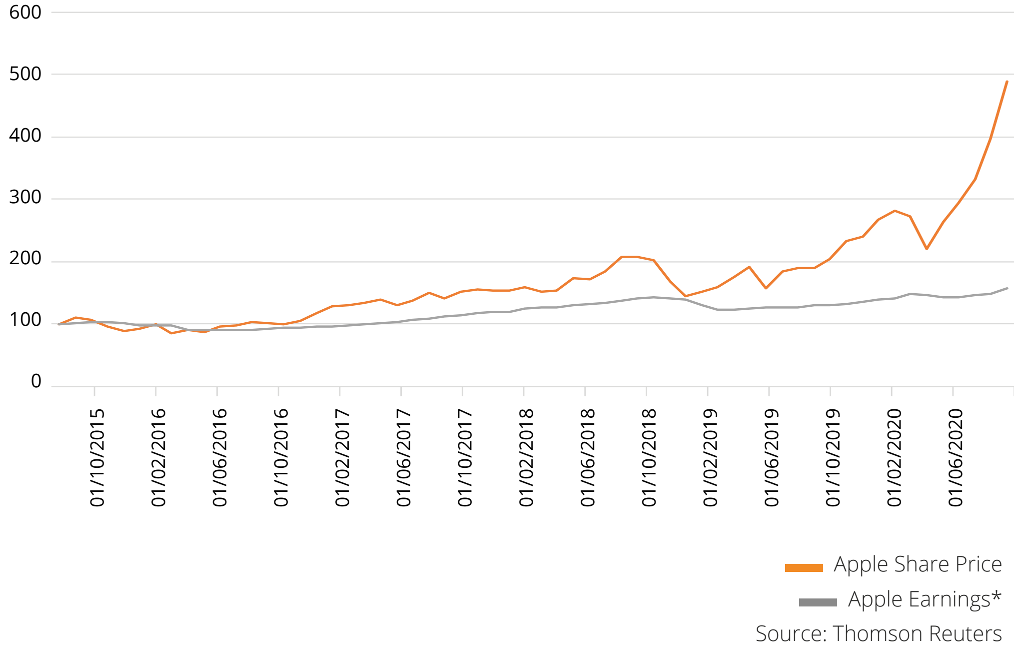
We retain an overweight position in equities on valuation grounds, with stocks offering – we believe - far better prospective returns than bonds over the longer-term. However, we do temper this position with an emphasis on balance sheet strength in order to ensure that our underlying equity exposures can withstand the weak global economy which likely will be the norm until there is either a widely available vaccine, or tangible signs that the dangers posed by the virus have diminished sufficiently. Whilst it is certainly tempting to try and time a tactical increase in equity exposure for when the outlook looks clearer, we note that equity markets remain forward looking and will – we believe – rally significantly once markets can see light at the end of the "COVID tunnel".

Within UK equities, having cut exposure to funds with greater levels of cyclical exposure in our manager changes at the end of March, we have maintained our pared down exposure to lowly valued domestically-listed stocks which we believe are positioned to deliver very strong returns once a semblance of normality returns to the global economy. However, we did use the rally in sterling – which reached as high as $1.34 against the US Dollar in early September - to trim exposure to a UK dividend fund (which has minimal exposure to the aforementioned cheap cyclical stocks) in favour of a defensive global equity strategy, which had lagged the summer rally in the markets and provides a broader industry exposure than is available in the UK market.

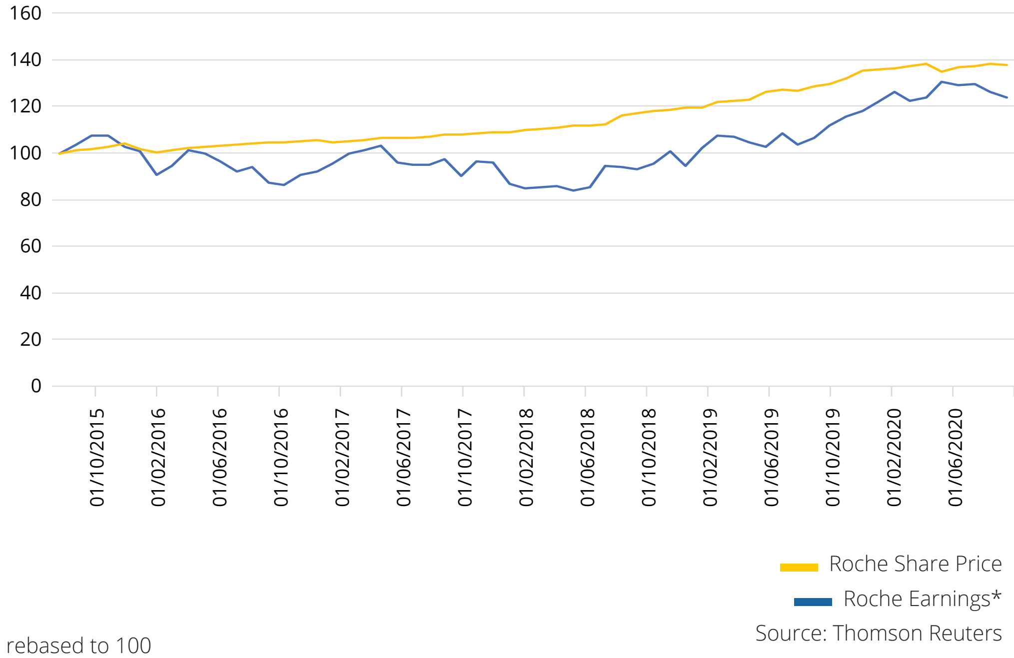
Where 6 months ago we had a strong preference for the technology-heavy US market, we broadened out our overseas exposure in September through adding to global equity funds which have significant exposure to European equities. We made these moves in response to the increasingly stretched market positioning in the so-called FANMAG (Facebook, Amazon, Netflix, Microsoft, Apple and Google) group of stocks which had led the US market higher up to that point, fuelled in part by increasingly speculative activity by retail investors. The strong performance of these technology leaders is certainly not surprising, given that they are all – to one degree or another - benefitting from buoyant demand for their products and services as the world adapts to the "stay-at-home" economy. Furthermore, with generally high profit margins and strong cash flow generation, it is perhaps not unexpected that these stocks have been seen as a source of dependability in an uncertain environment.

However, with the valuation of some of these technology behemoths becoming increasingly extreme, as demonstrated by Apple which, after rallying over 100% from its March low, was trading on around 40x this year's projected profits which was over double its average valuation over the last decade. This stood in contrast with dependable stocks that sit outside the technology sector, such as Roche and Pfizer, which largely trod water over the summer and trade on far more conservative valuations.

Apple's share price has moved well ahead of its expected profit growth, whilst companies such as Roche have seen a far more muted increase in valuation



Source: Thomson Reuters



Source: Thomson Reuters

* 12 Month Forward Earnings
Share price and earnings both rebased to 100

Alternatives

Gold remains an important diversifier for us within portfolios with the long-term investment case further bolstered by the ever lower interest rates, and money printing, being employed by Central Banks. However, we do note that the rally in the gold price has led to many short-term speculators taking sizeable positions in the precious metal, which could reverse should there be a strong risk-off move in markets.

Closing thoughts

Now that valuations have normalised across most asset classes, we have tilted portfolios towards a more defensive position with an emphasis on balance sheet quality across both equities and fixed income. Looking ahead, whilst the near-term economic outlook is certainly clouded, we remain confident that equities will outperform cash and bonds over the longer-term given far more favourable starting valuations and government policy which will continue to lean towards inflationary

Market Commentary – Q3 2020

Alexander George, CFA
Associate Director of Research

UK

Following GDP data for the second quarter which was predictably dire given stringent lockdown restrictions were in place for much of the period, it is promising that the domestic economy picked up significantly over the quarter with survey data indicating that both the services and industrial sectors have enjoyed a rebound in activity (albeit operating at a far lower base level of output than was the case entering the year). However, as outlined in the House View, it is unlikely that this pick-up will be sustained with recently re-imposed regional lockdown restrictions already starting to impact business and household confidence.

Despite the best efforts of the Chancellor of the Exchequer, Rishi Sunak, who announced several schemes over the quarter to try and incentivise businesses to retain workers, foremost among which was a job support scheme which will see the government subsidise the wages of workers who are now working reduced hours, the end of the government's very generous furlough scheme is expected to result in a sharp pick-up in unemployment over coming months as businesses – particularly those in the hospitality and leisure industries – move to reduce their workforces.

Long-dated Gilt yields edged upwards over the quarter, although the Bank of England's Quantitative Easing (bond buying) programme and the weak near-term outlook for the global economy serve to suppress yields. The Bank of England's Monetary Policy Committee (MPC) continue to consider moving the base rate (which currently sits at only 0.1%) into negative territory, a move which – whilst theoretically beneficial to economic growth - has shown little benefit in economies, such as the Eurozone and Japan, where they have been employed for some time. Helped by the weakness of the US Dollar over the period, the Pound ended the quarter 4.2% higher at $1.292. UK large-cap stocks, as represented by MSCI UK All-Cap, ended the quarter down 4.3%.

US

Having moved quickly in March to support household finances as the COVID outbreak took hold in the US, Congress are yet to finalise a second fiscal stimulus package to replace the CARES act – which amongst other measures had boosted unemployment benefit to $600 per week - that expired at the end of July. The two parties remain far apart in their negotiations, with the Democrat party pushing for a package which is worth over $2trn in value whilst the Republican party – likely emboldened by the recovery in the US stock market – are pushing for a smaller package of c.$1.5trn. Despite the two parties remaining at odds in their proposals, it is seen as likely that a stimulus bill will be signed into law before next month's election given politicians in both parties will be keen to curry favour with the electorate before polling day.

In a move which has been signposted for some time, in their August meeting the US Federal Reserve outlined plans to target average inflation over the long run, a move which implies they are more likely to allow inflation to run above this level for a sustained period of time before they raise interest rates. Aided by the prospect of interest rates remaining lower for longer and the strong performance of technology stocks, US large-cap stocks performed strongly over the quarter with the S&P 500 gaining 8.5% in US Dollar terms, although this return was reduced to 3.7% in sterling terms owing to the weakness of the Dollar over the period.

Eurozone

Having initially rebounded strongly in May and June as the Eurozone economy re-opened from lockdown, survey data for the currency bloc moderated over the summer with the services sector, in particular, showing some signs of slowing. Inflationary pressures within the currency bloc remain muted, with the most recent figures from Eurostat – which indicated that consumer prices declined 0.2% year-on-year in August – increasing the likelihood that the European Central Bank will further expand their asset purchase programme.

Despite resistance from the so-called "Frugal 4" which is made up of the Netherlands, Sweden, Denmark and Austria, in July the EU were able to agree a €750 billion stimulus package, spearheaded by Chancellor Angela Merkel of Germany and French President Emmanuel Macron. The package included €390bn in grants, which will not have to be paid back by the recipient, and €360bn in low interest loans. Importantly, member countries will raise the capital through issuing debt collectively rather than individually with significant amounts of the capital being spent in areas that have been hardest hit by the pandemic. This marks a significant change in the structure of the European Union which sees the currency bloc taking a step towards a fiscal union, as opposed to just a monetary union. The European commission will issue €750bn of bonds between now and 2026 via capital markets creating a large new pool of high quality European debt. Optimism over the stimulus package helped drive European stocks higher before pulling back later in the quarter, with MSCI Europe ex-UK gaining 1.5% in local currency terms over the quarter.

Asia

The Chinese economy returned to growth over the second quarter according to official government data, with particular strength from the industrial sector which has benefitted from government stimulus measures. Having enjoyed an exceptionally strong second quarter, Chinese stocks made further gains over the quarter, with MSCI China A, which represents the performance of stocks listed onshore in China, gaining 8.8% in local currency terms. Despite struggling with the ongoing spread of COVID-19, the Indian economy showed signs of further recovery with the economy posting a 20-year high current account surplus (aided by the weak oil price) whilst hopes over agriculture and labour market reform helped to bolster sentiment towards the domestic stock market. Indian equities enjoyed a strong quarter, with MSCI India gaining 9.5% in sterling terms.

Commodities

Despite signs of constraints in global supply, the sluggish demand outlook continues to keep the oil price at historically low levels, ending the quarter broadly unchanged at $41 per barrel. Having started the quarter at $1780, the gold price pushed to a record high of over $2000 per oz as investor demand was fuelled by the weaker US Dollar and concerns over Central Bank "money printing", before falling back late in period to close at $1885.

Fund Spotlight Fidelity Global Dividend

Launch Date:	15/10/2012
Fund Size:	£1.78 billion
Asset Class	Global Equity
Manager:	Daniel Roberts

Daniel Roberts

The Fidelity Global Dividend fund was recently added across our range of model portfolios. As indicated by the name, the fund has a global remit and invests in companies that pay a dividend. The fund is managed by Dan Roberts who has managed the fund since its inception in 2012. Dan is supported by the wider analyst team at Fidelity who are sector specialists and are the main source of stock ideas for him, with this very broad analyst team particularly valuable given the global nature of the fund.

Whilst the fund focuses on dividend paying companies, it takes a total return approach to investing meaning Dan will not look to prioritise dividends over the total return of the fund which includes both dividends payments and capital appreciation. The building blocks that Dan uses to put together the portfolio are valuation, visibility and portfolio construction, which is further illustrated below.

1. **Valuation**
    - Valuation looks at the price that you pay relative to the price the team believe the stock is worth based on fundamentals such as earnings, the strength of their balance sheet and the cash flow of the company.
    - The team take a keen focus on cash flow as it's often the most reliable metric when assessing the profitability of a company.
    - The approach recognises the long term nature of the assets and believe valuation is the single most important determinant of future returns.
2. **Visibility**
    - Companies that offer a predictable return profile that are persistent and resilient are particularly attractive to the fund.
    - Naturally, a company with these characteristics will be more likely to offer a sustainable dividend in several different market environments.
3. **Portfolio Construction**
    - Dan then looks to build a portfolio with the right balance of conviction and diversification.
    - The portfolio typically has around 50 stocks all weighted between 1% and 5%.
    - Dan only looks to invest where he sees opportunities, not where a company has a large weighting in the index. This unconstrained approach can lead to large deviations from domicile benchmarks weights, as shown on the next page.

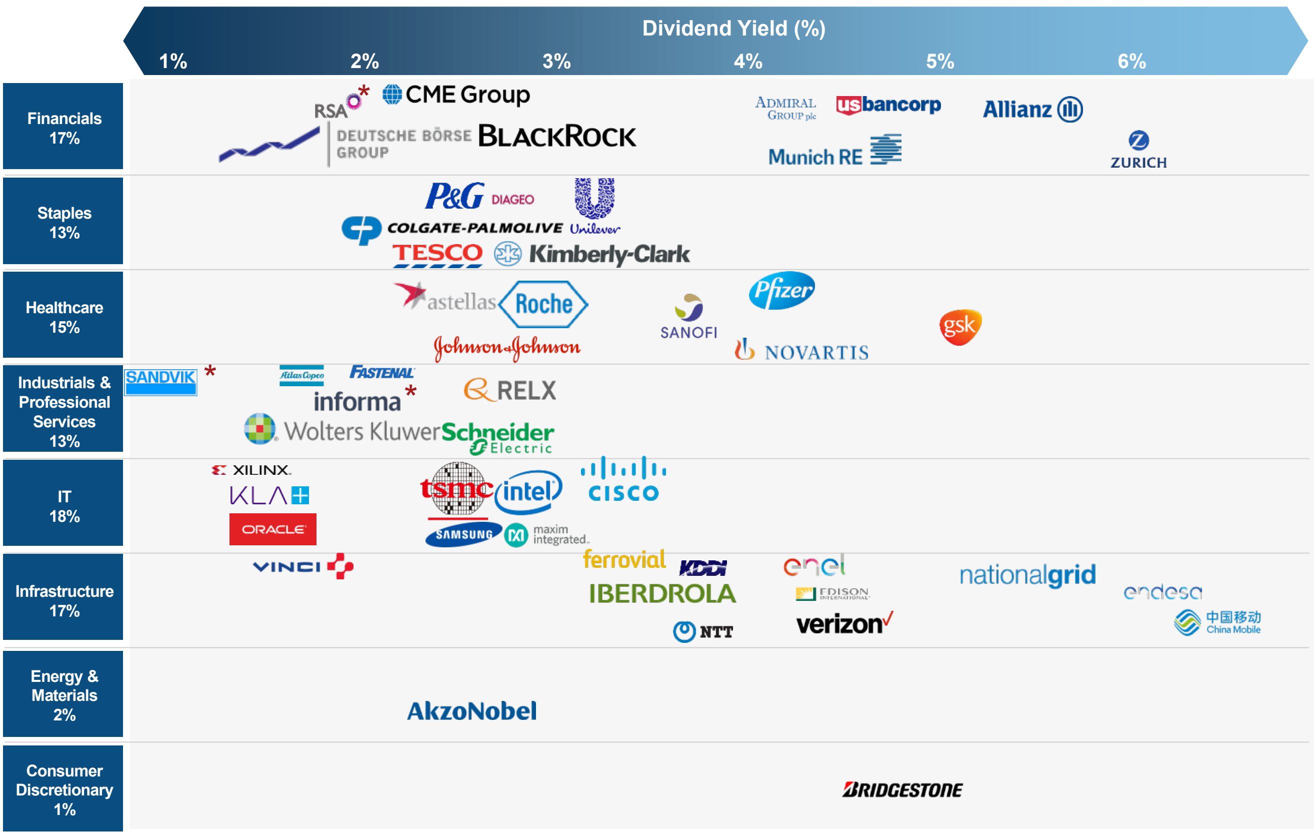
Geographical Exposure

	Fund	Index	Relative
USA	31.3	58.7	-27.3
United Kingdom	16.9	3.6	13.3
Switzerland	7.9	2.7	5.2
Germany	6.3	2.6	5.1
Spain	5.5	0.6	5.7
France	4.9	2.9	2.6
Japan	4.8	6.6	-1.8
Netherlands	4.7	1.1	3.6
Taiwan	2.4	1.5	3.2
Italy	7.7	0.6	1.8
Others	6.3	19.1	-12.7
Total Geographic Exposure	98.7	100.0	

Source: Fidelity - Data as at 31/08/20

Dan tries to avoid having the portfolio yield concentrated in a few names and aims for a more even distribution across the portfolio with his yield sweet spot for a holding in the portfolio typically around 2%-3%. The positioning of the portfolio is driven by the three aforementioned 'building blocks' with the portfolio shown below.

Portfolio positioning by dividend yield and industry

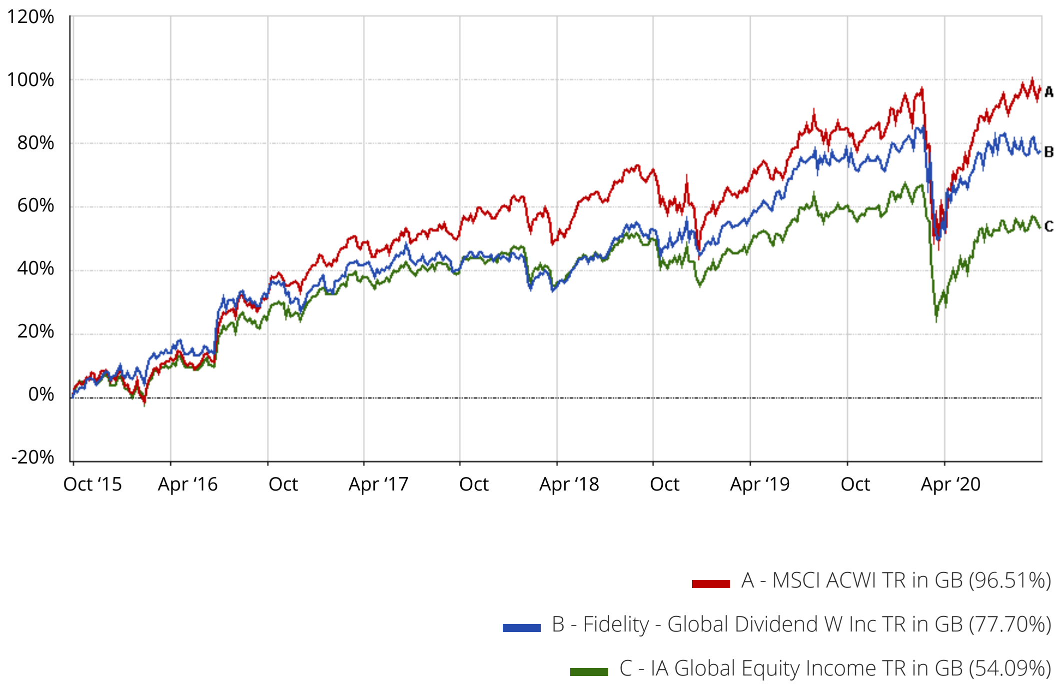


Source: Fidelity International, 30 June 2020. Sector weightings do not sum to 100% due to rounding and cash.
*Dividend currently suspended.

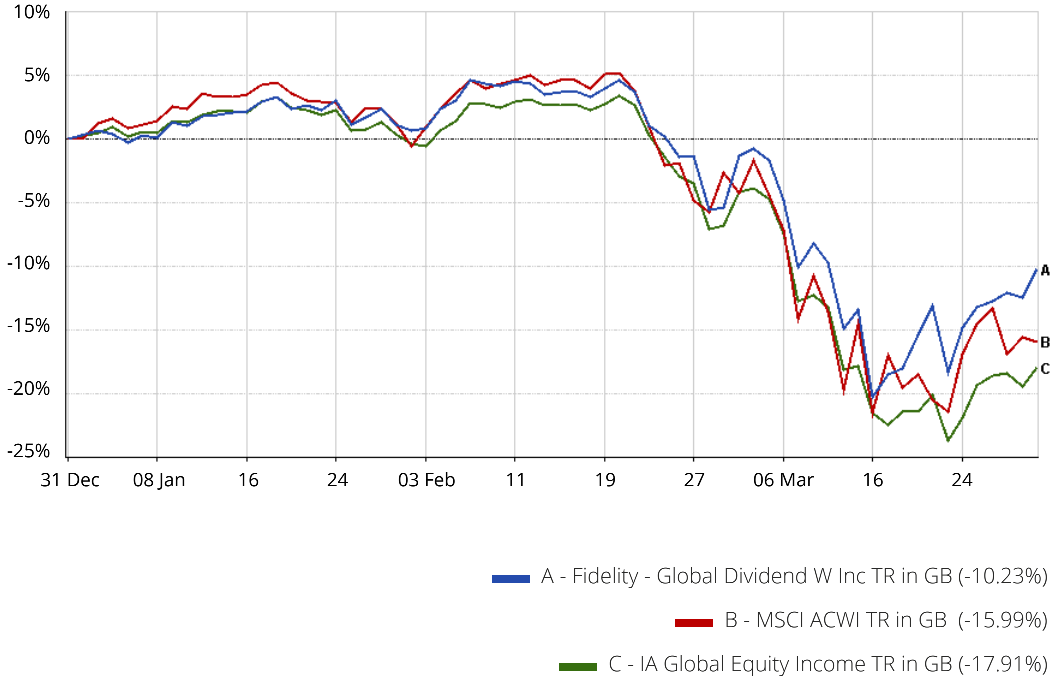
Impressively, the fund has only 3 holdings in the portfolios which have seen their dividends suspended, which given the events of the year is quite the achievement and speaks volumes about the analysis the team are carrying out on the underlying companies. When a holding has its dividend suspended, its triggers a review of the position and a reappraisal of the long-term investment case. If the team believe the investment case holds, the team will continue to hold the name despite it not offering a dividend, which shows the focus on total return. Notably, the portfolio has significant exposure to Consumer Staples, Healthcare and Infrastructure, which make up the core of the fund. The process implemented by Dan leads him to investing in these specific areas of the market due to their strong and predictable cash flows.

A focus on fundamentals and a conservative style means the fund typically lags slightly in rapidly rising markets but has proved more resilient in falling markets as shown by the charts below. Notably, dividend investing has lagged over recent years, however the fund has been able to keep pace with the wider market over the last 5 years through strong stock selection whilst notably outperforming its peer group (the IA Global Equity Income benchmark).

Strong performance relative to the peer group over the last 5 years



30/09/2015 - 30/09/2020
Data from FE fundinfo 2020



31/12/2019 - 31/03/2020
Data from FE fundinfo 2020

Notably, dividend investing has struggled over recent years on a relative basis, largely due to the fact that high growth US technology companies (that often don't pay a dividend and are significant weightings in the index) have performed particularly well. Whilst we do still see some opportunities in this area of the market, we believe it remains as important as ever to be well diversified and have exposure to areas of the market that can perform well in a variety of different market environments.

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