DART CAPITAL

Investment Brief

January 2023

Introduction

Richard Whitehead
Chief Executive

As we firmly consign into history 2022 there is reason to feel better about the prospects for 2023. As Alex and the team discuss later in this Investment Brief, interest rate expectations still perplex the minds of analysts but at least the starting yield now is considerably more attractive than a year ago. This makes discussions about investment in bonds a more interesting opportunity after so many years of low yields.

At times like this it is easy to be drawn into the immediate political world that covers our media but markets have a habit of looking beyond this. Clearly there is a lot at stake with the ongoing war in Ukraine and of course the active tensions around Taiwan.

From a business perspective Dart Capital continues to grow in terms of clients and we exceeded £700m of assets under management at year end through the great support of you all. This is despite one of the toughest years for markets that I can remember for a very long time. Within our business we also seem to defy the strange culture in my industry of young talent being encouraged to learn and progress by working from home. We have everyone working together in one office in the same way as pre-Covid and are fortunate with the great group of people we work with. It provides a real sense of pride when you see day by day the development, knowledge and maturity of younger colleagues. I have concerns that if the current recession bites harder and larger financial companies begin to make redundancies around the country that some of the young who work from home will be the first casualties. We witnessed it in 2008 but then people had physical networks, not just LinkedIn. Unemployment will be a very lonely place for some who have only known full employment in their careers and may not have the contacts to quickly find a new home.

Alex closes our views on 2023 with a positive thought on specific valuation opportunity within targeted areas of the equity market and highlights the fact that we appeared to fare considerably better than most in 2022 on a relative basis. From my own perspective I know we get paid to increase the values of portfolios in absolute terms and that ultimately is what we get paid for. I firmly understand this.

House View

Alexander George, CFA
Associate Director of Research

Although the fourth quarter was a positive one for portfolio performance, 2022 as a whole was undoubtedly a challenging year for global markets, as both bonds and equities declined in unison as valuations re-calibrated amidst the sharp increase in global inflation and interest rates. In this particularly difficult environment, our more valuation-focused investment approach helped us mitigate some of these losses and outperform our peer group.

Notably, last year's sell-off gave us the opportunity to buy attractively valued assets outside of equities – such as investment grade corporate bonds - which had suffered sharp price declines and we believe are now priced to deliver inflation-beating returns over coming years. We funded these moves by trimming from areas within equities which had held up far better during the market sell-off.

Our view remains that with government and household debt levels as high as they are, keeping interest rates below long-term nominal GDP growth (real GDP growth plus inflation) will be the desired course of action for governments and Central Banks over coming years, as they seek to inflate away their significant debt loads. Against this backdrop, we believe that owning a combination of attractively valued stocks with strong balance sheets, high quality bonds with an average yield of c.4.5% and selective commodities with constrained supply and growing demand, stands us in good stead to continue to deliver resilient long-term returns whilst also appropriately managing risk.

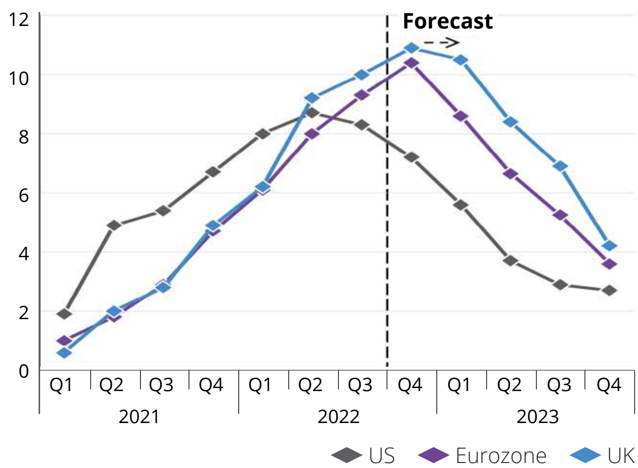
Inflation and Interest Rates

We expect the first half of this year will see declining inflation from its very high current levels, driven largely by the moderation in commodity prices. Combined with weaker labour and housing market data, we expect this will be sufficient to give the US Federal Reserve and Bank of England the confidence to cease interest rate hikes by the middle of this year, with the European Central Bank to follow suit by the end of the year.

Global inflation is expected to decline over 2023, driven by the moderation in commodity prices

Median of economists' forecasts for headline CPI

% change year on year, quarterly average



Source: JP Morgan Asset Management

However, although interest rate hikes will likely abate later this year, rates will still remain at higher levels than was the case over the 2009-2021 period, and we can't rule out a rebound in inflation next year given the tightness in global labour and commodity markets. As a result, we take significant comfort from the balance sheet strength of our underlying companies, with solid profitability and low debt levels, and increasingly low valuations following last year's de-rating of equity markets. In contrast, we remain particularly wary of private equity strategies, where the cocktail of high debt levels and delayed valuation on their assets following a decade of huge asset raising, will inevitably be a source of much negative press over coming years.

Fixed Income & Currency positioning

2022 saw a dramatic re-pricing in the bond market, with the UK government bond (Gilts) benchmark ending the year down 23%, with the yield on the 10-year maturity Gilt increasing from 1% to 3.6%. Although our bond allocation held up significantly better than this, aided by our low exposure to long-dated government bonds where losses were greatest, the losses were still far larger than we would like.

In October we took advantage of the sharp move down in prices to buy more UK investment grade corporate bonds, with our favoured strategy in this area, Artemis Corporate Bond, yielding over 7% at that time amidst the market sell-off. We allied this with inflation-linked US Treasuries, which have the benefit of not being exposed to corporate credit risk, and with real (inflation-adjusted) yields of c.1.6% at the time of purchase, will deliver inflation-beating returns even if the next decade sees a higher level of inflation. These positions sit alongside short-dated Gilts and investment grade corporate bonds, which carry less interest rate risk and are providing yields of 3.5% and 5% respectively. In contrast, we remain generally wary of lower quality corporate bonds, as although most High Yield issuers have termed out their debt and this reduces the risk of imminent stress, there will be growing vulnerabilities if Central Banks keep interest rates at, or above, current levels for a sustained period of time, as highly indebted issuers are forced to issue new debt with coupons which are far higher than their expiring debt which will place further stress on already stretched balance sheets.

Having been cautious of how expensive the US Dollar had become, we used the sharp fall in the US Dollar over the quarter to add back to the currency through un-hedging a global equity holding. Despite higher inflation in the UK, we expect short-term UK base rates to remain at lower levels than those in the US as the Bank of England are unable to match the rate hikes of the Federal Reserve, with the former having already noted their caution over the impact of rising interest rates on the domestic housing market. We believe this upcoming divergence in monetary policy has the potential to put renewed pressure on the Pound.

Equities

In a very tough environment for equities over 2022, our equity allocation benefitted on a relative basis from its strong bias towards companies trading on lower valuations, with this so-called "value bias" helping us mitigate some of the damage from the extreme market sell-off. In particular, value-oriented strategies in UK, Global, Emerging Markets and Japan – several of which were brought into portfolios towards the end of 2020 following the sharp underperformance of this style over the prior 3 years – were particularly resilient performers, driven in large part by the combination of low starting valuations and solid operating performance of the underlying holdings. Furthermore, core positions in profitable, dividend paying large-cap stocks – through funds such as Fidelity Global Dividend– proved to be significantly more defensive than the broader global equity market, successfully protecting capital over the year.

Regional views

We continue to have lower weighting to the US market than its c.60% weight in the global index, owing to the crowded investor positioning in the American market and lower valuations available on non-US stocks.

Last year saw the first marked underperformance of US technology stocks since the early 2000s, with sharply rising interest rates helping to finally quash the bubble in "speculative stocks", led by the likes of Tesla, which took hold over much of the prior two years. As you will know from our previous notes, this is an area of the market we have been particularly wary of, with our exposure to US large-cap stocks heavily biased towards the likes of Microsoft and Apple, which, whilst not cheap, are at least highly profitable, proven businesses with strong balance sheets. The sell-off in less profitable, high valuation stocks caused sharp losses in some of the most widely held US and global equity funds, with Baillie Gifford's American and Scottish Mortgage funds ending the year down 50% and 45% respectively, having started the year with combined assets of over £25bn.

Alongside our holdings in profitable large-cap stocks, we see a particularly attractive opportunity in well financed US smaller companies, where, in our view, a lack of investor attention and low valuations make for a strong runway for future performance over coming years. We are using a boutique fund manager, De Lisle America, to provide this exposure, with the manager's nimble approach well suited to investing in this area of the market. For much of the last decade, investors have made the best returns in larger companies, led by the technology heavy Nasdaq 100, where exceptional profit growth, and low interest rates, combined to drive very strong performance. However, with higher interest rates and slowing profit growth for internet businesses, we believe investors will be forced to return to areas which can also deliver growth but at far more modest valuations. This happened in the 1970s, when smaller companies delivered spectacular outperformance, and we would not be surprised to see a similar dynamic play out over coming years.

The opportunity in UK equities remains attractive, with the outflows from the asset class creating a value gap for long-term minded investors. It is also noticeable how sensibly-run UK listed companies now are, with the vast majority having improved their balance sheets and streamlined their operations over the last decade. In sharp contrast to overseas investors in listed equities, private equity firms remain keen buyers of UK listed assets, with one recent deal seeing FTSE 250 listed property company IWG selling part of the business at a significant premium to its implied valuation.

However, these positives are offset somewhat by the lack of direct currency diversification we get when investing in our home market. Furthermore, similar to countries such as Australia and Canada which have also experienced explosive growth in their respective property markets over the last three decades, domestic consumer spending will continue to come under pressure from rising mortgage costs and weaker property prices during this period of monetary tightening.

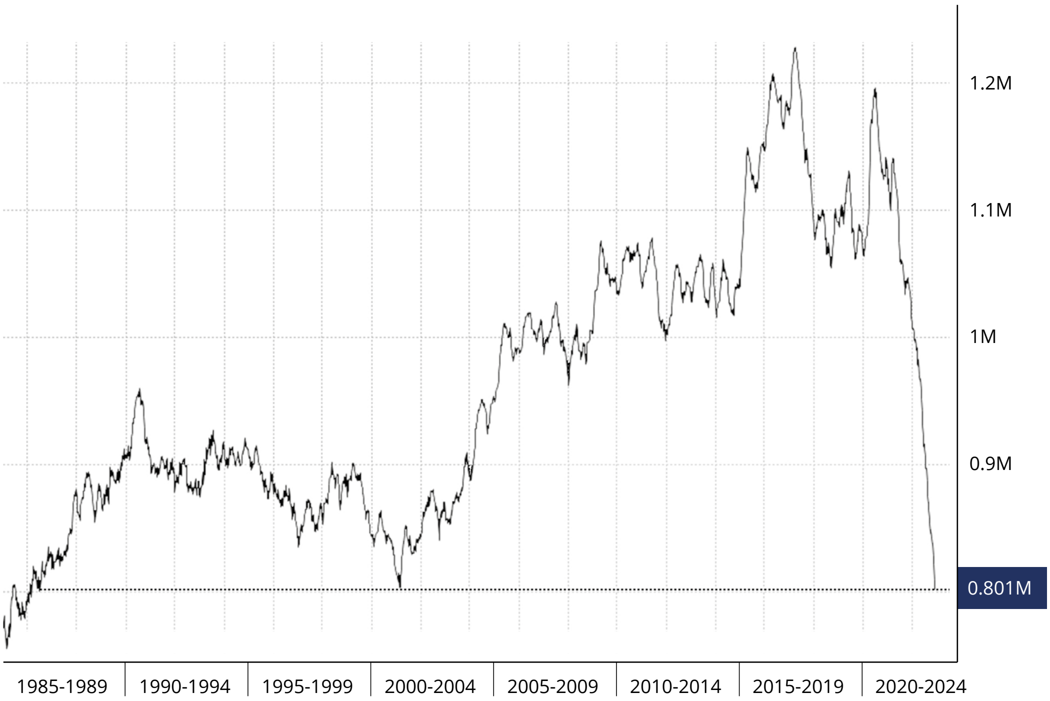
Valuations across Emerging Markets and Asia as a whole remain attractive, with most western investors remaining underweight the region, although we believe this could well change should the recent underperformance of the US market continue. Having struggled for the last two years, our view on Chinese stocks has started to improve somewhat, as the combination of the government's departure from its "zero-COVID" policy, and President Xi's more conciliatory tone towards President Biden have bolstered the outlook somewhat, although these factors continue to be set against the regulatory challenges of investing in the country.

Commodities

Although many commodity prices, led by oil, declined over the quarter in anticipation of slowing global growth, and a potential recession this year, we do note that oil demand does not tend to collapse during recessions and the re-opening of the Chinese economy is estimated to add around 2 million barrels to daily global oil demand. Furthermore, on the supply side, oil production from OPEC members has tended to undershoot their agreed quotas, in large part due to supply problems, whilst the US government's decision to release oil reserves from their Strategic Petroleum Reserve (SPR) is a short-term measure which can't be repeated. As a result, we are comfortable adding to funds which own companies which are helping increase supply in areas such as liquid natural gas, fertiliser, and oil, where the structural under-investment in these areas should provide strong support for revenue growth.

The US government have been drawing down their oil reserves

US crude inventories (commercial plus Strategic Petroleum Reserve)



Source: Bloomberg Opinion

Gold & Silver

Although rising interest rates deterred many institutional investors from allocating to gold last year, it is notable that many eastern countries, led by China, have stepped up their purchases of gold following the US government's decision to cancel Russia's holdings of US Treasuries in the aftermath of the former's invasion of Ukraine. Furthermore, from a long-term perspective, we expect the huge unfunded future liabilities that governments owe to their populations – led by state pensions and healthcare programmes – will eventually be paid for using Central Bank-funded deficit spending. As result, we expect that assets which can preserve their purchasing power - such as gold and silver which have acted as alternative stores of value for thousands of years – to become increasingly valuable, particularly when bought at current levels.

Property

Our favoured UK listed REITs are discounting a c.30% decline in commercial property valuations from their peak level early last year. The operational performance of the likes of Tritax BigBox – which was added to portfolios in September following a significant share price decline - has remained solid, with strong tenant demand and rental growth still expected for this year. With loans-to-value of 20-25%, these property companies are not highly leveraged, a far cry from the c.50% level most REITs had prior to the financial crisis, whilst their dividend yields of c.5% provide a strong valuation underpinning.

Closing thoughts

We continue to tilt portfolios towards those areas where valuations are attractive, and our analysis indicates that fundamentals are better than the market perceives. This counter-cyclical approach has helped us deliver resilient performance over a turbulent period for global markets, and we believe positions us well to take advantage of the increasing short-termism which dominates movements in global stock and bond markets.

Market Commentary – Q4 2022

Alexander George, CFA
Associate Director of Research

The fourth quarter was more positive for global equity markets, aided by inflation figures falling below economist expectations in the US, and a warmer than expected start to the European winter.

UK

October saw some stability return to UK politics, with Liz Truss eventually resigning as Prime Minister, and replaced by former Chancellor Rishi Sunak. Sunak, and new Chancellor, Jeremy Hunt, committing to withdrawing the stimulus measures of the previous administration, and this has helped provide support for both the Pound and domestic asset prices. The fiscal update, having been set rather ominously on Halloween - 31st October - was delayed to the 17th November, in order to provide the new leadership time to assess the best course of action. The fiscal update when it finally arrived saw the announcement of tax rises for workers, and fixing of income tax bands, which, whilst it should go some way to shoring up the government's finances, will create a drag on household spending over coming years.

The survey data from both the services and manufacturing sector over the quarter indicated a modest contraction in economic activity, with the former dealing with weaker demand from households and the latter elevated input costs. Despite this, the unemployment rate remained at low levels, with the most recent figures seeing it stand at 3.7% in October, although there are nascent signs that wage growth has started to slow. The inflation figures remained very elevated, with the Consumer Price Index increasing 10.7% in the 12 months to the end of November, although the recent decline in oil and gas prices should push these figures lower over coming months.

The Bank of England raised the base rate twice over the quarter, with a 75 bps hike in early November followed by a 50 bps increase in mid-December, the latter of which brought the base rate up to 3.5%. Following the December move, the Committee signalled that further rate hikes may be necessary in the new year. However, with two members voting for no interest rate increase, there are growing signs that the Bank of England are far less committed to further monetary tightening than their American counterparts, largely reflective of the weaker domestic growth backdrop and the feedback loop into the property market from rising mortgage costs.

The UK equity market, as represented by MSCI UK All-Cap, gained 8.1% in capital return terms over the quarter, with broad based gains across large and small-cap stocks.

US

US economic data over the quarter was fairly mixed, with weak housing market data contrasting with labour market data which, at least on the surface, remained reasonable. Particularly notable was that job openings remained extremely elevated when compared to pre-pandemic levels, with indications being that this is being driven predominately by lower paid roles where firms are struggling to find able workers, whereas initial jobless claims have started to move higher, led by financialised area of the economy - financial services, information technology and the property market – which have started to weaken markedly. The Federal Reserve expect the unemployment rate to increase to 4.6% next year, from its current level of 3.7%.

The Federal Reserve raised interest rates twice over the quarter, with the hikes of 75 and 50 basis points bringing the Federal Funds rate to 4.5% by the end of the year. The second meeting of the Federal Reserve's monetary policy committee, known as the FOMC, in mid-December saw the average FOMC member expecting the base rate to peak at just over 5% early next year whilst the committee's Chairman, Jerome Powell, re-iterated that the Committee's main goal remains bringing inflation back down to 2% and keeping long-run inflation expectations well anchored. Whilst Powell did acknowledge the slowing rate of inflation in the two most recent inflation releases, he further noted that "It will take substantially more evidence to give confidence that inflation is on a sustained downward path". In the meeting, the Federal Reserve lowered their expectation for next year's GDP growth from 1.2% to 0.5%, whilst the inflation forecast was revised up to 3.1% from 2.8% previously.

Our view is that the Federal Reserve will remain committed to fighting inflation until the political pressure being applied to them shifts to jobs losses and business failures, and we expect this pivot to happen later this year. This happened in the 1970s, when the Federal Reserve were similarly using interest rate hikes to fight inflationary pressure, before the economic weakness took over.

The most market positive news over the quarter was that the closely-watched inflation figures came in below expectations in both October and November, with the most recent inflation figures, which covered the 12 months to the end of November, showing the year-on-year increase in the Consumer Price Index (CPI) slowed to 7.1%. from 7.7% in the October figures. The benchmark for large-cap US stocks, the S&P 500, gained 7.1% over the quarter in US Dollar terms, although this was reduced to a decline of 0.6% in sterling terms owing to the weakness of the US Dollar over the period.

Eurozone

French and German GDP growth both came in above economist expectations, with the former benefitting from lower energy prices than most of their fellow European states. Eurozone inflation came in above expectations throughout the quarter, with the Consumer Price Index increasing 10.1% in the 12 months to the end of October in the latest reading. European governments made significant progress in filling their energy storage, which has been further helped by the spell of warmer than usual weather that Europe have experienced so far this winter.

The European Central Bank (ECB) raised the deposit rate 50 basis points to 2.5% in their December meeting, with the Committee noting that they expect multiple further hikes of the same magnitude through this year. In a surprise to some, the ECB also announced plans to follow the Federal Reserve and BoE in starting Quantitative Tightening, in which they will start reducing the size of their balance sheet. MSCI Europe ex-UK gained 10.8% in local currency terms over the quarter.

Asia

The quarter started with China's party congress disappointing many investors, with President Xi's re-appointment for a third term, and selection of inner circle loyalists seemingly dashing hopes of an imminent end to the zero-COVID policy. China's equity markets struggled on the back of the news, with renewed selling pressure, particularly across technology stocks. Later in the quarter, under pressure from a populous which are increasingly tired of the stringent zero-COVID policies, there were signs that the Chinese authorities are starting to loosen their previously inflexible stance. In particular, the government's downgrade of the severity of COVID, and reduced quarantine times for overseas travellers provided hope that the government are moving in a more market-friendly direction. MSCI China H rebounded over the quarter, gaining 12.3% in local currency terms.

Facing a weakening currency having come under pressure from financial speculators, the Japanese Central Bank altered their yield curve control policy late in the quarter, widening the band on 10-year government bonds (known as JGBs) to an upper bound of 50 basis points from 25 basis points, which led to the yield on the same government bond rising from 0.25% to 0.45% almost instantaneously. The move caused a sharp rally in the Yen, gaining 3% against most major currencies on the day of the move. MSCI Japan gained 3% in Yen terms over the quarter.

Commodities

The gold price recouped some of its losses from the previous two quarters to end flat on the year, with its price increasing 9.4% in US Dollar terms to end the quarter at $1800 per oz, with sentiment aided by the weakening of the US Dollar. The oil price, as represented by Brent crude, declined 2% in US Dollar terms, to the end the quarter at $86 per barrel.

Fund Spotlight – Premier Miton UK Value Opportunities

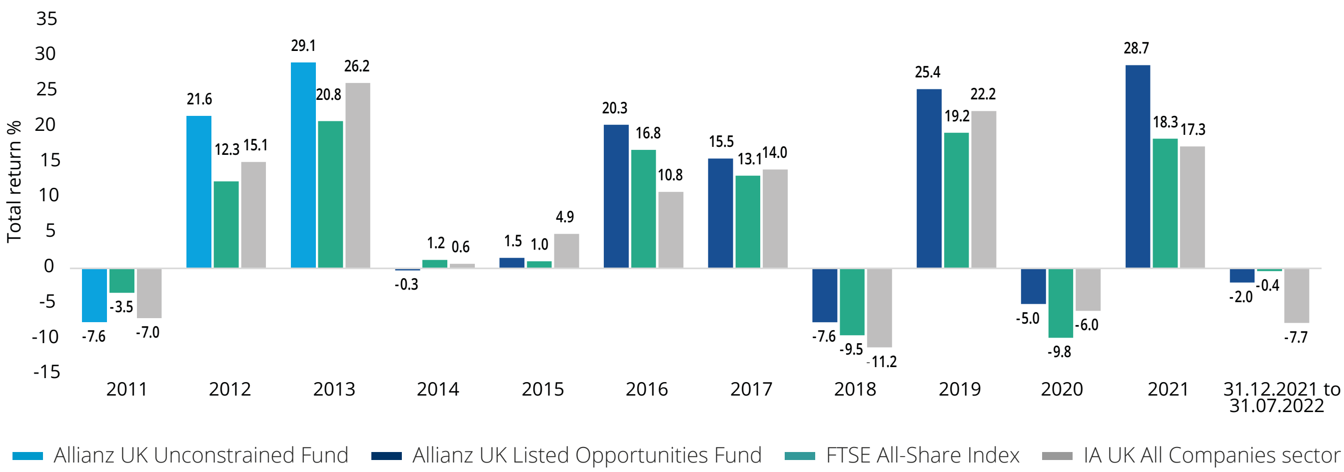
Joe Healey
Investment Analyst

Launch Date:	25/03/2013
Strategy Assets:	£362m (30/12/22)
Asset Class:	UK Equities
Manager:	Matthew Tillett (Joined 1st Nov)

Matthew Tillett

The Premier Miton UK Value Opportunities strategy was added across all model portfolios in December 2022, after the arrival of fund manager Matthew Tillett, who had managed the UK Listed Opportunities fund at Allianz Investors since 2013. The strategy focuses on identifying mispriced opportunities across the UK market. We believe the UK currently offers an attractive hunting ground for active managers, with depressed valuations relative to other developed markets, despite providing access to internationally-exposed, high-quality companies. Because of this, the all-cap mandate, combined with Matthew's strong track record in a variety of market conditions, gives us confidence in the strategy's potential to perform well looking forward.

Matthew Tillett's past performance against the benchmark and sector managing UK Multi-cap funds.



Source: FE Analytics. Based on UK sterling, class C shares, on a total return basis for the Allianz UK Unconstrained Fund from 31.12.2010 to 31.12.2013. Allianz UK Listed Opportunities Fund from 31.12.2013 to 31.07.2022. Performance is shown net of fees with income reinvested. Matthew Tillett was a manager of the Allianz UK Unconstrained Fund from 01.07.2010 to 13.04.2017, and the Allianz UK Listed Opportunities Fund from 01.07.2013 to 31.07.2022. The Allianz UK Unconstrained Fund merged into the Allianz UK Listed Opportunities Fund on 13.04.2017. Past performance is not necessarily a guide to future performance.

Despite strong performance last year, the UK continues to trade at depressed valuations relative to global peers and its own history despite earnings remaining broadly resilient. The uncertainty caused by the mini-budget crisis in September has reduced investor appetite for UK assets, but we believe such uncertainty has presented an opportunity now that fiscal discipline has been restored and the Pound is more stable. It's important to remember that the UK market is much more internationally exposed than many would expect, with the FTSE 100 and 250 generating around 75% and 60% of their respective sales from regions outside the UK. This not only provides attractive diversification benefits, but also offers better growth prospects for UK companies to take advantage of.

The UK market currently exhibits the lowest forward P/E of any sector category at just over 7.5x.

Name	YTD (%)	Forward P/E	10Yr Z-Score
MSCI UK Value NR LCL	15.89	7.63	-1.96
MSCI EM Value NR LCL	-9.12	7.88	-2.08
MSCI Europe Value NR LCL	2.28	7.98	-2.40
MSCI United Kingdom NR LCL	8.66	9.10	-2.29
MSCI Japan Value NR LCL	12.10	9.36	-1.71
MSCI EM NR LCL	-13.82	10.25	-1.40
MSCI Europe NR LCL	-5.99	11.00	-2.24
MSCI ACWI Value NR LCL	-1.68	11.04	-1.73
MSCI India Value GR LCL	4.77	12.01	-1.16
MSCI Japan NR LCL	0.74	12.41	-1.29
MSCI USA Value NR USD	-3.27	13.38	-1.13
MSCI ACWI NR LCL	-11.80	14.10	-1.19
MSCI EM Growth NR LCL	-18.08	14.52	-0.70
MSCI India NR LCL	6.68	15.95	-1.02
MSCI UK Growth NR LCL	-3.19	16.13	-0.79
MSCI USA NR USD	-14.80	16.74	-0.74
MSCI Europe Growth NR LCL	-14.08	17.91	-0.62
MSCI Japan Growth NR LCL	-9.88	18.44	-0.27
MSCI ACWI Growth NR LCL	-21.58	20.14	-0.28
MSCI India Growth GR LCL	9.67	23.19	-0.68
MSCI USA Growth NR USD	-26.06	23.38	-0.09

Source: Morningstar
YTD figures from 01/01/22 - 30/11/22.
10Yr Z-Score: Displays the number of standard deviations the current forward P/E is from the indicies' 10 year average.

In our view, Matthew Tillett stands out among UK equity managers due to his contrarian, value-oriented, and all-cap mindset. Most small and mid-cap focused UK equity funds tend to be heavily tilted towards companies with higher growth prospects, often accompanied with elevated valuations – something we continue to remain cautious on in a higher rate environment. Therefore, we believe Matthew's differentiated approach to portfolio construction, and the benefits of being able to initiate positions as valuations return to more reasonable levels will help enhance downside protection and forward-looking returns.

The wide sector exposure within the fund also helps to naturally diversify the portfolio, particularly with strong performing Energy names in 2022 helping to offset other weaker areas of the market. Currently, we believe a more eclectic, value-oriented approach is better suited to the current environment, offering the ability to take advantage of de-rated growth names whilst also being exposed to structurally cheaper areas of the market such as energy & materials, where many active funds are still yet to allocate.

The fund is approximately 30% exposed to consumer and reopening stocks, which have seen significant share price weakness over the last 12 months due to global uncertainty and changes in monetary policy that have weighed on sentiment. As a result, valuations are now at levels similar to those seen during the 2008 global financial crisis. Despite the negative outlook, Matthew believes that much of this negative sentiment is already reflected in the price, presenting an opportunity to gain exposure to higher quality names with high margins often with net cash balance sheets, at discounted valuations.

In summary, we believe that Matthew's proven process and the current valuation opportunity in the UK market makes the Premier Miton Value Opportunities fund, which is multi cap and sector agnostic, well-positioned to take advantage of this opportunity.

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