Investment Brief

October 2023

Introduction

Richard Whitehead
Chief Executive

This has been a particularly busy quarter for all of us at Dart Capital. We are delighted to now be part of Evelyn Partners, formerly the merger between Smith and Williamson and Tilney Group. As we will be discussing with you in person, the Dart "desk" will continue as normal to deliver the highest standards of personal service to you in our own distinctive way. Evelyn Partners allows us greater access to resources, more in depth investment research and broader opportunities for many of our young talent. It is an exciting period for all of us.

Whilst performing our role it is clear that the media have continued to be obsessed with short term politics, whether in the UK (north and south of the border), Europe or the US. Later in this Investment Brief Alex highlights the current mood music from central banks. The last three months has witnessed an improvement in the core inflationary backdrop within the UK, which as previously mentioned should begin to provide some positive sentiment towards some of the more undervalued sectors of the equity market.

Our role continues to look beyond this noise and seek opportunities from investing in quality companies for the long term. Thankfully we now have some particularly positive forward yields from government bonds too. The unfortunate downside of this is much higher than expected fixed rate mortgages, a particular burden for those stretching themselves to own their own home.

One of the areas of particular focus beyond managing portfolios continues to be actioning the surprise changes to pension lifetime allowances in the spring budget. For many individuals, these changes represent a potential window of opportunity that requires our advice over the next few months. We will engage where appropriate on this important area. Financial Planning has always been a core part of our role and something we incorporate in how we manage portfolios for you.

We look forward to next seeing you in person, whether this be in our current offices on Queen Street, our new home on Gresham Street, or at your home or office.

House View

Alexander George, CFA
Associate Director of Research

We continue to position portfolios with an emphasis on higher quality issuers within fixed income, and balance sheet strength within equities, reflective of the sharp rise in global interest rates over the last two years and our desire to be invested in the businesses which will thrive in the eventual market recovery. Allied to this long-term positioning, we bolstered portfolio resiliency early in the quarter by adding further to our US Dollar exposure following its sharp weakening over the prior 9 months.

We remain cautiously optimistic on the long-term opportunity in high-quality cyclicals and smaller company stocks, where there are a range of companies with solid balance sheets and strong positions within their respective industries, trading on low valuations.

Interest rates

Although inflation has slowed across developed economies over the first half of the year aided by beneficial base effects, resilient wage growth - which has reacted to the elevated level of headline inflation of the last two years – and the modest rebound in the oil price have slowed the decline. This is particularly the case in the US, where having declined from 10% at its peak last year to 3% in July, the inflation rate is expected to stabilise at around this level over the remainder of the year. In the UK, having peaked at c.10% in the fourth quarter of last year, UK inflation has only just started to decline sharply, currently standing at 6.7% in the 12 months to the end of August according to figures from the Office of National Statistics (ONS) and is projected to decline to below 5% by the end of the year.

Reflective of their significant interest hikes over the last two years, the major western Central Banks have started to signal the end of their respective rate hiking cycles, with both the Federal Reserve and Bank of England going on hold in their September meetings. However, we can't rule out further rate increases, given Central Banks are – following their errors of 2020-21 where they were too slow to take the inflationary threat seriously and tighten policy – most fearful that elevated inflation will become ingrained in the psyche of households and businesses, as it did in the 1970s.

Whilst many economists are increasingly talking about a sustained new normal for interest rates, we note that very few households and corporates have had to borrow at current interest rates, but this will change significantly over the next couple of years as mortgage terms expire, and corporates prioritise paying down debt over business expansion and hiring new workers. This confluence of factors may well serve to weigh on consumer spending and inflation over 2024 and 2025.

Portfolio construction

We increased our US Dollar exposure early in the quarter – by un-hedging the position in inflation-linked US Treasuries - following its sharp weakening against the Pound year-to-date, moving from $1.20 at the start of the year to $1.30 as of the time of the move. Whilst the US Dollar was only trading around fair value at that time, we felt the better fundamental position of the US economy – most notably its energy and food independence and the key role the US Dollar plays in global trade – allied with the traditionally strong performance of the Dollar during market sell-offs, justified us moving to an elevated position in the currency.

We took advantage of the US Dollar's weakness to add exposure at c.$1.30

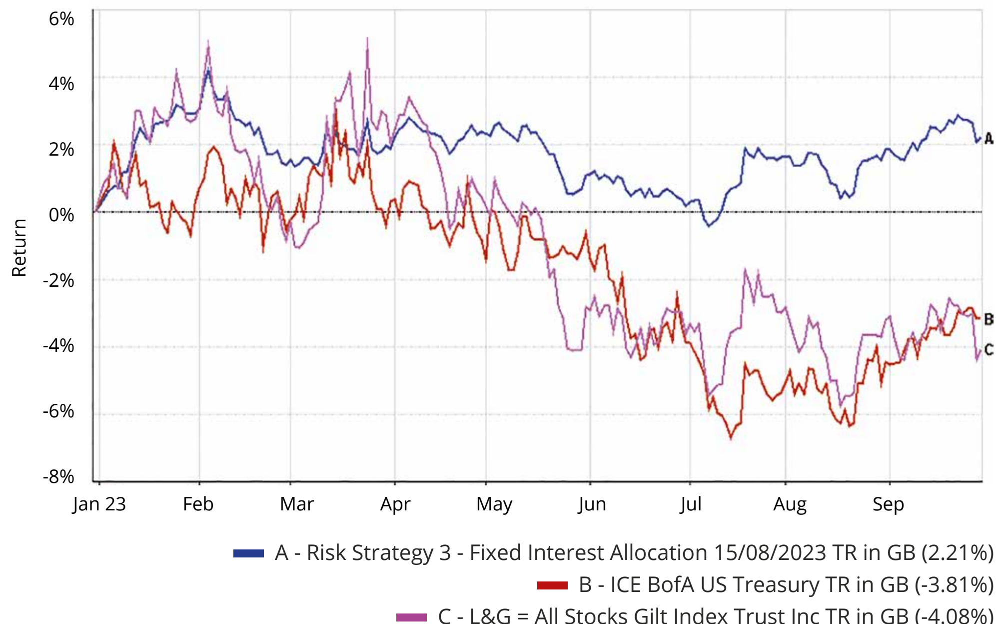
Source: Reuters Eikon

Fixed Income

Over the last 18 months, we have gradually shifted our fixed income positioning to a more defensive posture, building up a large weighting to short-dated Gilts which can provide much needed ballast during market sell-offs.

Fixed Income positioning has been a particularly key driver of relative performance across lower and mid-risk strategies this year, with the avoidance of direct long-dated nominal government bonds up until mid-July helping to protect portfolios as Gilt yields continued to rise. This can be seen on the performance chart below when comparing our mid risk fixed income performance to the standard government bond benchmarks for the UK and US. Sticking to our philosophy of moving counter cyclically and building exposure to out of favour assets, over the quarter we reduced our underweight position in this area, by adding a medium-dated UK Gilt - with a yield of c.4.4% - which matures in 8 years time. We particularly like holding direct Gilts such as this which have low coupons and are trading at significant discounts to par, as they would gain c.4% per year in a scenario where yields remain flat, whilst still providing the potential for capital gains should bond yields decline over coming months.

Our shorter-dated positioning in fixed income has helped preserve capital as government bond yields have continued to rise



30/12/2022 - 29/09/2023 Data from FE fundinfo2023
Past performance is not a guide to future performance.

We remain cautious on corporate bonds, particularly in the lower quality end of the market, reflective of valuations which are broadly in-line with historical averages, having strongly outperformed by taking advantage of widening credit spreads last October. Furthermore, with governments having such large funding requirements, and the tax benefits of owning government bonds when compared to equivalent corporate issues, we believe there is a risk that government borrowing crowds out the private sector, with investors demanding a greater yield premium to hold corporate bonds as a result.

Equities

US large-cap stocks had a more mixed quarter, as some of the hype around Artificial Intelligence ebbed. We continue to have long-term exposure to the dominant technology companies, led by Apple and Microsoft, which make up such a large part of the global index, but we have a modest underweight position based on their slowing growth, which we don't believe is reflected in their valuations. We ally our core positions in larger companies in less economically sensitive industries, with good quality cyclicals, and small- & mid-cap stocks where valuations are low and balance sheets are generally in good shape.

Our equity allocation has a lower valuation, and less debt, than the benchmark

	Portfolio	B-mark
Price/Earnings	14.07	15.85
Debt/Capital	35.29	39.76

Source: Morningstar, Dart Capital

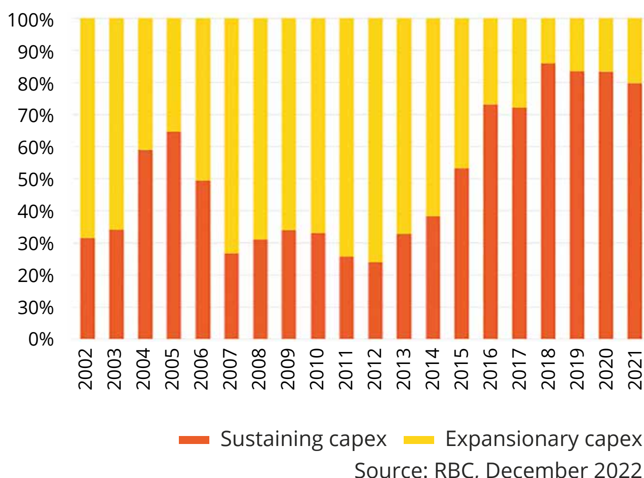
Shown for the Risk Strategy 3 portfolio.
Benchmark is 25% MSCI UK All-Cap, 75% MSCI ACWI.

Many cyclical industries have seen reduced capacity over the last decade as weaker companies have either exited or been acquired, which has allowed incumbent industry leaders to grow market share. Allied with this, due to decarbonisation requirements and the need to replace aging machinery and infrastructure, capital spending should be stronger than it was in the prior decade with cyclical businesses a direct beneficiary of this trend. An example of a business which has already experienced the benefit of this dynamic is John Deere, the US manufacturer of agricultural machinery and heavy equipment. With the benefit of strong demand for farming equipment and improvements in the technology of their product offering, along with reduced competition, the company's operating profit margin has doubled over the last decade. In the UK market, companies such as Jet2 and JD Wetherspoons are seeing many of their less well capitalised competitors forced to reduce their capacity, which has helped bolster their own pricing power for packaged holidays and pints respectively.

Commodity markets have also seen a significant reduction in investment over the last decade, with both the mining and energy sectors seeing management teams focus on cash flow and paying down debt, at the expense of investing in new exploration. As a result, there is tight supply across western oil and key metals markets, from copper and nickel through to gold & silver. Whilst this positive supply side dynamic does not make these sectors immune to the cyclical slowdown in the global economy, their strong balance sheets and low valuations do provide some protection, it should help drive a quicker recovery in share prices when demand rebounds.

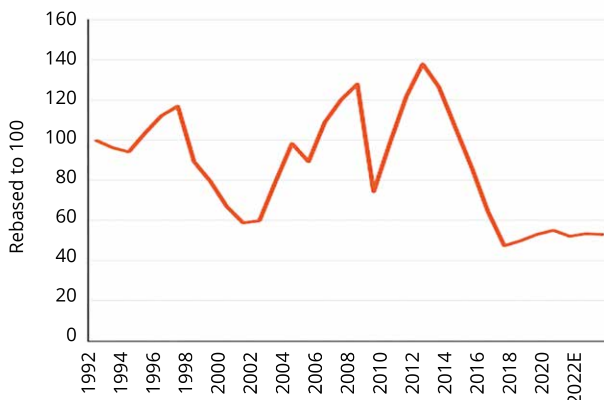
Commodity investment has declined over the last decade

Global mining sector capex: sustaining versus expansionary



Source: RBC, December 2022

Real global mining capex (US$) per unit of mine production (index to 100 in 1992)



Source: Bloomberg, company filings, Wood Mackenzie, ABARE, EIA, China NBS, Johnson Matthey, Jefferies Estimates

Although small and mid-cap stocks were generally weak across the UK and continental Europe over the quarter, this wasn't the case across all geographies, with our strongest performing funds across our portfolios as a whole actually being De Lisle America and Polar Capital Japan Value, both of which have sizeable exposure to smaller companies. Given the combination of profitable businesses with solid balance sheets and low prevailing valuations & market expectations, we believe similar performance will eventually come from our favoured managers in the UK smaller companies space.

We believe that it is particularly notable that, having learnt the harsh lessons of the financial crisis of 2008-09, many listed smaller companies used the subsequent period to pay down debt, whereas larger companies – which had greater access to corporate bond markets – took advantage of the low rates on offer and increased their borrowings. Thus, our favoured smaller company funds have around half the debt/capital ratio of most large-cap indices, such as MSCI UK All-Cap and the S&P 500. Despite this, following a period of underperformance over the last two years, smaller companies are now trading at close to their cheapest ever level vs large-caps, which we believe more than reflects the likelihood and magnitude of a decline in profits amidst a global recession. Furthermore, the historical evidence shows that this area of the market tends to start outperforming well before the end of a recession, with much of the outperformance coming early in the recovery period for the market.

Whilst we retain a broadly neutral weight in Emerging Markets, Chinese stocks look increasingly interesting at this juncture, given how weak market sentiment is and indications that corporate governance is starting to improve. Whilst our position here is constrained by the risks caused by government policy and the ongoing weakness in the property market shouldn't be understated given its significant contribution to Chinese employment and GDP, it is promising that Chinese companies have started to focus more on returning capital to shareholders, through increased dividends, at the expense of excessive capital spending.

Property

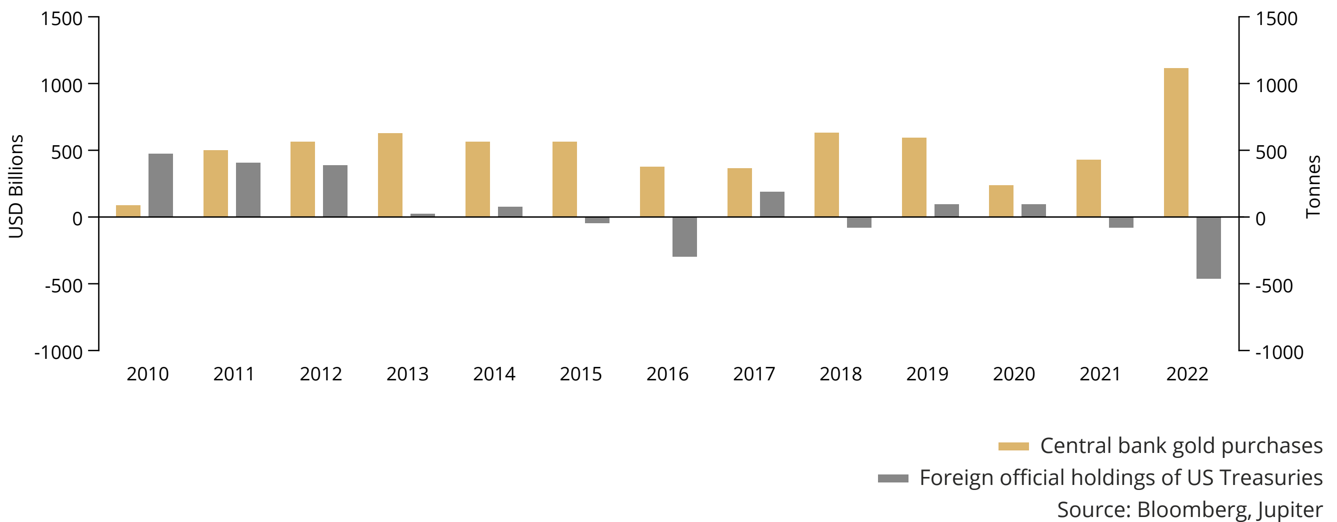
In the face of very negative market sentiment towards property Real Estate Investment Trusts (known as REITs) and Investment Trusts more broadly, the updates from our favoured REITs were reassuring. Perhaps most importantly, our largest holdings in the sector, Tritax Big Box and Balanced Commercial Property (BCPT), demonstrated solid operational performance, with the former selling a large asset at book value, and the latter announcing a number of new lettings. The prevailing message from both remains a disconnect between the fundamentals on the ground – with still strong demand for logistics and retail warehouses - and negative investor sentiment, which is solely driven by concerns that the sector will crumble under the pressure of higher interest rates.

Whilst property is naturally interest rate sensitive, the loan-to-value levels of the REITs we own are conservative, and can handle rising debt costs. Whilst it is easy to make sweeping generalisations about the sector as a whole, the gap between high quality offices in good locations and low-quality stock in secondary locations has grown significantly over recent years. For instance, BCPT – which has c.30% exposure to offices – owns several offices in desirable locations in the West End of London, where tenant demand remains reasonable and there is limited new supply, with recent data indicating vacancy rates for West End offices are considerably lower compared to the City and Canary Wharf (Source: KnightFrank). Demonstrating the cash flow generation of the trust's assets, the BCPT board have raised the dividend by 10% from October, which brings the prospective dividend yield to over 7%.

Precious metals

The price movements in gold and silver are heavily driven by short-term movements in bond yields and the US Dollar, with most algorithmic trading programmes fine-tuned to sell down precious metals when yields or the Dollar are rising. Whilst these factors are important, we note that price level – as measured by the Consumer Price Index and Retail Price Index – has risen by 20-30% across developed economies since the start of 2020 which, in our view, has permanently increased the value of gold when priced in currencies such as the US Dollar and the Pound. Furthermore, the demand for gold - as a longstanding store of value - appears to have been permanently bolstered following the US government's seizure of Russia's US Treasury holdings in the aftermath of Russia's invasion of Ukraine last February, which has led many non-western Central Banks to seek alternatives to US Treasuries when recycling their trade surpluses.

Central Banks have stepped up their purchases of Gold



Central bank gold purchases
Foreign official holdings of US Treasuries
Source: Bloomberg, Jupiter

On the supply side, high quality gold and silver deposits have become increasingly scarce, with industry heavyweight Newmont's purchase of Newcrest Mining likely to be the first of many large acquisitions in the sector as they try and make up for declining production across their existing portfolio of mines. Our favoured fund in this area, Jupiter Gold & Silver, is positioned to benefit from this theme, as it owns many of the mid-cap mining companies with strong production growth which are likely to be highly attractive to potential acquirers.

Closing thoughts

We moved dynamically to take advantage of opportunities in bond and currency markets over the quarter, with our counter cyclical approach to capital allocation, and focus on fundamentals as opposed to recent performance, again aiming to help portfolios benefit from the short-termism which often drives market moves.

Market Commentary – Q3 2023

Alexander George, CFA
Associate Director of Research

UK

The Bank of England's Monetary Policy Committee (MPC) decision to keep the base rate unchanged at 5.25% in their September meeting was a close call, with five members voting in favour of no hike, with the remaining four voting for an increase of 25 basis points. The Committee noted that the domestic data had been weaker than they had expected since their meeting in early August, with signs of growing slack in the labour market, whilst the below expectations inflation figures for August, which were released a week prior to the decision, showed core inflation declining to 6.2% year on year, from 6.7% in the July figures, based on figures from the Office of National Statistics (ONS).

However, it is notable that not all of the data fits the MPC's assessment, with wage growth remaining elevated, with the most recent ONS data showing wage growth (including bonuses) growing at an annualised pace of 8.5% in the three months to the end of July, bolstered by wage settlements for public sector workers. Following their September meeting, the Governor of the Bank of England, Andrew Bailey, noted that the committee would not rule out further hikes, noting that the MPC will be "watching closely to see if further increases are needed", further noting that they will "need to keep interest rates high enough for long enough to get the job done".

The latest survey data for the services and manufacturing sectors was particularly weak, with the services sector now in contraction based on the figures released by IHS Markit, although our external economists at Pantheon believe that this may be in part due to an unusually harsh seasonal adjustment which negatively impacted on the figures. Currency and bond markets reacted to the data, with the Pound falling significantly against the US Dollar over the second half of the quarter, ending down 4% to end at $1.22, whilst Gilt yields rose far less than equivalent US Treasuries, with the yield on the 10-year Gilt only rising 7 basis points, to end the period at 4.44%. UK large-cap stocks were one of the strongest performers over the quarter, with MSCI UK All-Cap gaining 1.1% over the quarter in price return terms.

US

In their meeting a day prior to the Bank of England's MPC meeting, the US Federal Reserve held the Federal Funds rate at 5.5%. Whilst the decision itself was not a surprise to markets, the fact that a majority of Committee members forecasted a further rate increase before the end of the year did catch markets off guard, in addition, the Committee are now expecting only one rate cut next year. US Treasury yields saw a renewed move higher in September, driven by the rebound in the oil price, whilst a high-profile strike in the automotive sector exacerbated concerns over wage inflation. The nuances of the US political system have also created the risk of a partial government shutdown from the end of September, as Democrats and Republicans struggle to agree on spending plans, although this is likely to be resolved, albeit after much political wrangling.

One factor which is providing the Federal Reserve with some comfort is that the labour market appears to be normalising, with the number of job openings having fallen back to far more normal levels, whilst wage increases for jobs movers also slowed considerably. The unemployment rate moved up to 3.8% in August, from 3.5% in July, according to the Bureau of Labour Statistics (BLS). The standard inflation rate, as measured by the Consumer Price Index collated by the BLS, moved back up to 3.7% in the 12 months to the end of August, from 3.2% in the July figures, largely reflective of the rebound in the oil price and less supportive base effects.

Having performed well over July, large-cap US indices pulled back over August and September, driven largely by rising Treasury yields – with the yield on the 10-year Treasury rising 75 basis points over the quarter as a whole to end at 4.57% - which places pressure on valuation multiples within the equity market. The S&P 500 ended the quarter down 3.6% in US Dollar terms.

Eurozone

The European Central Bank, having been slower to initially increase interest rates, continued in their hiking cycle, raising the deposit interest rate to 4% in their most recent meeting. Guidance that mirrored that of the Federal Reserve and Bank of England, indicated that a further rate hike may be required if inflation figures surprise to the upside over coming months. Inflation figures released on the last day of the quarter by Eurostat showed Eurozone inflation fell to its lowest level in two years in the 12 months to September, with a year-on-year increase of 4.3%, which was below economist expectations of 4.5%. The important German industrial sector has showed significant signs of weakness over recent months, with the manufacturing sector seeing particularly weak business sentiment and new orders. European equities – as represented by MSCI Europe ex-UK - ended the quarter down 3.6% in local currency terms.

Asia

Concerns over the Chinese property sector continued to dominate the headlines over the quarter, with further evidence that the weakness in this area of the economy has negatively impacted on household and business confidence. MSCI China H ended the quarter down 5.8% in US Dollar terms. Japanese stocks were one of the stronger performers over the quarter, aided by growing recognition that corporate governance reforms are accelerating, and hopes that rising Japanese government bond yields will boost the profitability of the nation's financials. MSCI Japan gained 0.8% in US Dollar terms.

Commodities

The oil price gained over the quarter, with Brent Crude increasing 22% in US Dollar terms, driven in part by the extension of voluntary production cuts by Saudi Arabia and Russia, and demand from air travel and China. The gold price was more muted over the quarter, with the rally in the US Dollar and rising US Treasury yields weighing on the price of the precious metal, ending down 3.7% over the period in US Dollar terms at $1848 per oz.

(Market return figures are from FE Analytics unless otherwise stated)

Important Information

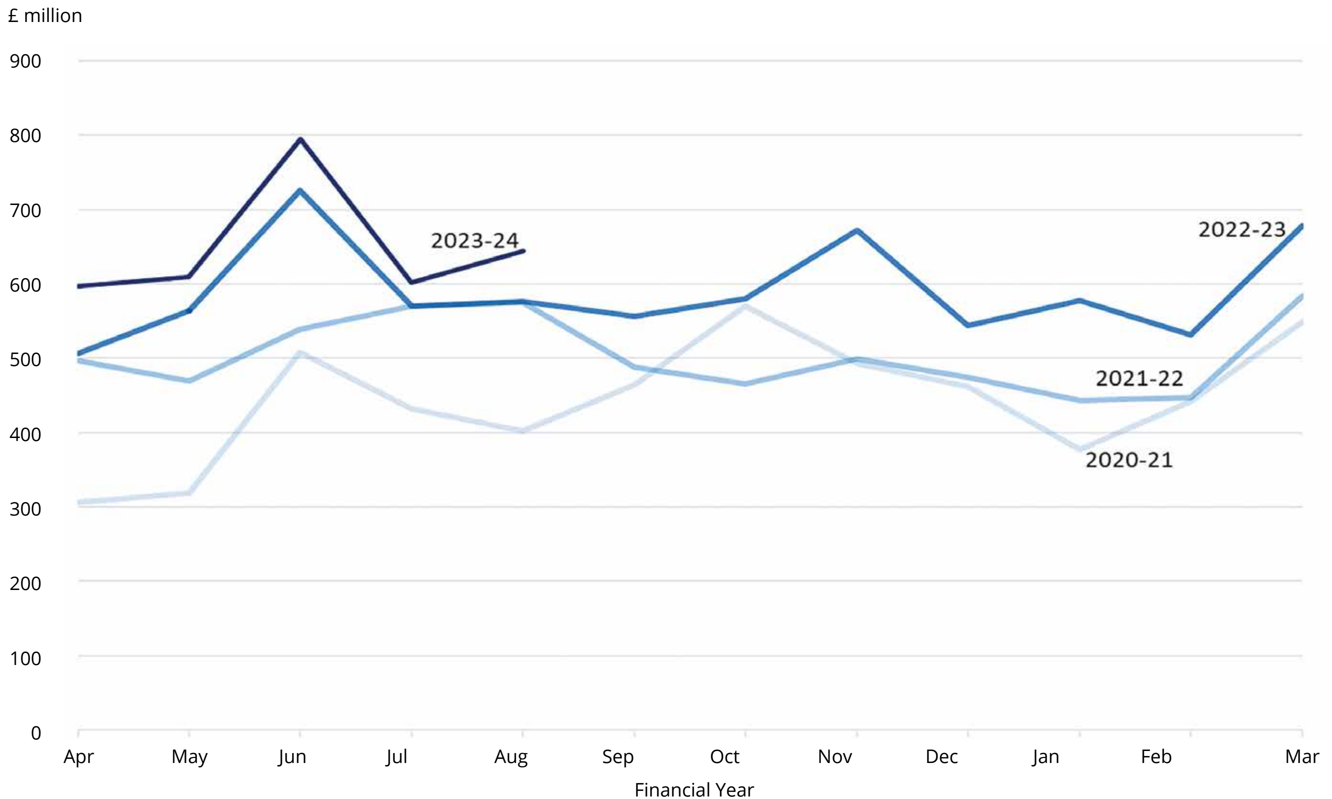
- The value of investments and the income from them are not guaranteed and can fall as well as rise. Clients may not get back their original investment.
- It should be remembered that past performance is not necessarily a guide to future performance.
- The opinions and conclusions given are those of Dart Capital Limited and are subject to change without notice.
- This is not advice to invest. If you are in doubt as to a course of action please seek professional advice.
- The return on investments denominated in foreign currencies may increase or decrease due to the movements in exchange rates between sterling and the foreign currency.
- Investments in cash, bonds and gilts will reduce in value if the return is less than the rate of inflation.
- Some investments e.g. commodities, emerging market funds and property funds may be less liquid and investors may not be able to realise their investment immediately or the price may reflect a forced seller discount.

Inheritance Tax

Clare Hough
Senior Paraplanner

At the time of writing, rumours persist that Rishi Sunak is planning to scrap inheritance tax (IHT) should the Conservative Party win a further term in office. Whilst taxation is not a popular subject, IHT is particularly disliked, perhaps through lack of understanding or for some it is that, on death, you are being taxed on assets that have been built up over a lifetime for the majority of people and have therefore likely been subject to tax at some point, be that income tax or capital gains tax.

Death duties were introduced in 1796 although more 'modern' IHT appeared in 1894 when estate duty was established in a bid to raise money to pay off a government deficit. *(source: National Archives).* IHT receipts for April 2023 to August 2023 are £3.2 billion, which is 0.3% higher than the same period a year earlier. The table below illustrates the monthly receipts pattern in each financial year since 2020/21. Receipts from March 2022 are higher and HMRC expect this to be due to a combination of higher volumes of wealth transfers following recent IHT liable deaths, recent rises in asset values and the fact the IHT tax free thresholds remain at 2009 levels.



Source: HMRC tax receipts and National Insurance contributions for the UK (monthly bulletin), updated 21/09/23.

IHT Tax Free Thresholds

Everyone has a nil rate band (NRB), which is essentially the amount of your estate that can be left free of IHT after death. The current nil rate band is £325,000 and, under current rules, is due to be fixed at this level until April 2028.

In addition, no IHT is payable if your estate passes to your spouse or civil partner. In this case, any unused NRB can then be transferred to the surviving spouse or civil partner meaning that, on second death, £650,000 can be passed tax free to beneficiaries.

In addition to the NRB, an additional Main Residence Nil Rate Band (RNRB) may be available, assuming certain qualifying conditions are met. This extra NRB applies where the deceased's estate includes a residential property and is currently £175,000, fixed until 2026. As with the NRB, any unused RNRB can be transferred to the surviving spouse as a percentage of allowance remaining.

The property must be left to a direct descendant, namely children (including step children, grandchildren etc) and must have been, at some point, the residence of the deceased. Buy to let properties are excluded.

Where the net value of the estate is over £2 million, the relief is restricted and the RNRB tapered by £1 for every £2 that the £2 million is exceeded. Therefore, tapering can reduce the RNRB to zero.

As well as your annual exemption of £3,000 worth of gifts each tax year, it is also currently possible to reduce future IHT liabilities by making an outright gift known as a potentially exempt transfer (PET), which is the simplest form of IHT planning. Whilst interspousal gifts are IHT free, PETs enable you to make a gift of unlimited value to other individuals that will fall outside of your estate if you survive for a period of 7 years. Gifts made in the 3 years before your death are taxed at 40% however, gifts given 3 to 7 years before your death are taxed on a sliding scale – the 'taper relief'. Taper relief only applies if the total value of gifts made in the 7 years before you die is over the £325,000 tax-free threshold.

As well as the various tax reliefs and exemptions, it is worth remembering that personal pensions and SIPPs currently fall outside of your estate for IHT purposes.

What happens next?

Clearly, whilst abolishing IHT appeals to many people, the question remains as to how the 'lost' income would be replaced. Increasing income tax across the board would offer one solution although it would be unpopular as more people would be impacted by this tax increase than are currently affected by IHT. Capital gains tax (CGT) is a fairly simple tax that could also be considered as a replacement, however, this is to some extent a voluntary tax as individuals can choose when to sell assets with a capital gain.

Rather than remove IHT completely, another consideration could be to increase the £325,000 NRB in line with inflation as this has been set at the same level since April 2009.

And, of course, it is important to remember that tax rules are subject to change in the future and although the Conservatives may amend the IHT legislation, any new government could reinstate or change it at any point.

As always, if you have any questions, please don't hesitate to contact your Investment Manager.

Important Information

- Examples of how tax or tax relief may apply are based on our understanding of current tax legislation. Whether any tax will be payable, at what level it is charged and whether you qualify for tax relief will depend upon individual circumstances and may be subject to change in the future.

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