Q1 2020 COMMENTARY
HIGHER INCOME FUND

QUARTER TO END MARCH 2020

PERFORMANCE

	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Fund Performance (B Class)	-20.92%	-17.65%	-14.49%	-9.38%	2.55%	57.38%
FTSE All Share TR GBP	-25.13%	-22.02%	-18.45%	-12.19%	2.89%	53.57%
IA Mixed Investments 40-85% Shares	-15.26%	-13.28%	-7.76%	-2.16%	11.62%	56.86%
Sector Quartile	4	4	4	4	4	2

Source: Morningstar. Figures compared on a Bid to Bid basis with Net Income Reinvested.

REVIEW

If there are adjectives that accurately convey the scale, scope, speed and severity of the coronavirus pandemic that has gripped the world over the last several weeks, we are unaware of them. Following the longest economic expansion on record, the coronavirus (COVID-19) pandemic has sent the global economy plunging into what may become one of the deepest but possibly also the shortest recessions in modern times. Consequently, global equity, bond and commodity markets fell sharply over the quarter as the virus spread and nations implemented containment and social distancing policies in a bid to contain the virus. Central banks and governments across the world have been bold and swift in their pledged policy responses to the outbreak and many initiatives signal an intention to do more if needed. Central banks are focused on plumbing the financial system and tightening financial conditions while fiscal policy in conjunction with monetary measures are aimed at bolstering public health service resources and helping to bridge cash flows to businesses and households that need them. If such bridging policies are effective, the propagation of the shock will depend on how long containment measures last and how long it takes for economic activity to recover.

In line with other central banks, the Bank of England (BoE) materially reduced interest rates, cutting by 65 basis points to 0.10% via two separate announcements during the quarter, with a commercial paper facility announced to assist with medium and larger enterprises. In response to a rapid spread of COVID-19 across the UK, the Prime Minister announced strict measures in order to prevent the spread of Coronavirus with strict social distancing measures enforced, non-essential travel reduced to a minimum and most shops closed. Chancellor Rishi Sunak also announced his first budget during the quarter, which was later overshadowed by an unprecedented intervention by the government in paying up to 80% of salaries of employees who have been furloughed, measures to help the self-employed and also business rates breaks and government grants to businesses.

Against this backdrop, UK equities tumbled (the FTSE All-Share falling 25.1% on a total return basis) and underperformed the broader global equity markets as efforts to deal with the coronavirus pandemic hit economic activity indiscriminately and simultaneously. The Energy sector was among the major laggards over the period, selling off on concerns surrounding the demand outlook for oil in the wake of the virus, as well as the failure of negotiations between OPEC (the Organisation of the Petroleum-Exporting Countries) and Russia to control the global supply of oil. The consumer services sector also performed poorly as investors sought to calibrate the effect of a sharp fall in consumer demand as the UK and other governments introduced lockdown measures. Within the domestic fixed interest market, corporate debt experienced heightened levels of volatility, while credit spreads widened over the quarter. UK government bond yields declined over the quarter, meaning bond prices rose, as investors favoured the perceived safety of this sector amid the growing likelihood of a deep global recession.

In continental Europe, nations across the region took steps to restrict the movement of people and shut down parts of the economy in an effort to slow the spread of the virus. Growth in Europe was already fragile, with the Eurozone economy growing by just 0.1% year-over-year in the fourth quarter of 2019, and forward-looking indicators released in March indicate that regional economic activity has collapsed. The flash Markit composite purchasing managers' index (PMI) for the month fell to a record low of 31.4, compared to 51.6 in February, indicating a significant level of economic contraction. The European Central Bank (ECB) announced the Pandemic Emergency Purchase Programme (PEPP), a €750 billion scheme to combat the economic shock. The

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PEPP will fund the purchase of government and corporate bonds until the end of the COVID-19 crisis. Governments across Europe also announced spending packages to help businesses and households bridge the gap between the loss of income during this period of disruption and the expenditures required to survive. Consequently, European stocks suffered their largest quarterly decline in history, with the Stoxx 600 erasing all gains posted since 2012. The benchmark fell 23% in local currency terms over the quarter, its biggest quarterly plunge since the creation of the gauge in 1998.

In the United States, the number of confirmed domestic cases of COVID-19 rose from 150 to over 100,000 in the final twenty-five days of the quarter. As a result, the nation has emerged as one of the worst hit by the virus to date. To combat the pandemic, like many other developed nations, many states in the US closed restaurants, retail stores and theme parks and cancelled scheduled flights, sporting events and conferences. On top of that, a hit on the manufacturing sector is likely to weigh further on growth. Policymakers have subsequently stepped in in an attempt to cushion the impact of the sudden halt in economic activity. The Federal Reserve (The "Fed") cut interest rates twice in March for the first time since the global financial crisis and announced unlimited quantitative easing (buying bonds). In addition to taking a page from its 2008 financial crisis playbook, by announcing an open-end programme to buy Treasury and mortgage backed securities, the central bank announced various new facilities to deal with this unique economic shock. Unlike the 2008 financial crisis, which hit banks and financial institutions, the non-financial corporate sector is the epicentre of this crisis. A very substantial fiscal stimulus package has also been agreed, worth approximately 10% of domestic GDP, which includes grants to small businesses. The package also provides government backing for credit to be provided by the Fed to investment grade companies. Against this backdrop, the S&P 500 Index suffered its quickest fall into a bear market on record, taking just 16 days to slump from all-time highs and bring an end to an 11-year bull market. Overall the index posted a 19.6% decline over the quarter (on a total return basis, in local currency terms), however, strength in the value of the US dollar relative to sterling reduced that decline for UK-based investors to -14%.

In Asia Pacific, China was the first country to enter the COVID-19 crisis and the nation has seen a downward trend in the number of new cases. High-frequency trackers of daily economic activity show that economic activity is resuming. Traffic congestion in Shenzhen and Shanghai has returned to normal levels and coal consumption by power generators is trending higher. Government stimulus is coming, with local provinces announcing infrastructure projects, and the People's Bank of China has cut interest rates and the reserve ratio requirement several times. Banks have been encouraged not to call in loans while there is pressure on cash flows. The main uncertainty is whether the combined monetary and fiscal stimulus will be as large as in 2015/16, which created a V-shaped recovery in 2016. Meanwhile, Japan's economy was weak at the end of 2019, weighed down by the October value-added tax (VAT) increase and a natural disaster caused by the largest typhoon in half a century. The COVID-19 disruption has almost certainly pushed the economy into recession. Japan faces an extra virus-related risk as the Olympia games, scheduled for 24 July to 9 August, has now been postponed. Stimulus measures are underway. The Bank of Japan has limited firepower, but has increased its purchases of government bonds, corporate bonds, and equities via exchange-traded funds (ETFs). The government is likely to announce emergency fiscal measures. Japan's structural weaknesses in terms of weak monetary policy and persistent deflation mean it will likely remain an economic laggard relative to other developed economies.

PERFORMANCE & ACTIVITY

Over the three-month period to the end of March 2020, the Higher Income Fund declined by 23.5% on a total return basis, materially outperforming the FTSE All-Share Index by 422 basis points but underperforming the IA sector by 566. For the first quarter of the year, all allocations at an asset class level, negatively contributed to absolute performance. With regards to the fund's performance relative to the benchmark, allocations away from the domestic equity market benefitted relative returns, with both international equities and UK fixed interest markets outperforming the former over the period. Most notably, within the fund's fixed interest portfolio, capital is primarily allocated to defensive areas of the market (consumer services, telecommunications, financial institutions and utilities) and in turn, we favour high quality, cash generative businesses with strong balance sheets. Most notably, the fund has a large exposure to Permanent Interest Bearing Shares (PIBS), which includes institutions such as Coventry Building Society and Nationwide, which have common equity tier one (CET1) ratios in excess of 30% versus most retail banking institutions, which have regulated capital ratios in the low to mid-teen range.

Within UK equities, an underweight allocation to the UK Energy sector also positively impacted relative performance, as oil prices crumbled to their lowest levels in 18 years, hit by the dual shock of the biggest demand drop in history as lockdowns cut consumption and a surge in supply following the start of a price war between Saudi Arabia and Russia. Similarly, an underweight allocation to the Materials sector, one of the major laggards over the period, enhanced relative performance. The prices of industrial metals fell significantly, led by copper, as the global demand outlook deteriorated.

In terms of investment activity over the course of the period, the fund took profits from its positions in the UK-based real-estate investment trust (REIT) LondonMetric Property and the global semiconductor chip manufacturer Taiwan Semiconductor Manufacturing Company (TSMC), following a sustained period of strong share price performance in both holdings. The fund used the proceeds to augment existing positions in UK-based consumer retailer Tesco and the global oil exploration and production firm BP.

OUTLOOK

The global economic backdrop has undoubtedly darkened in the wake of the coronavirus outbreak and has led to a significant increase in uncertainty surrounding economic activity, and thus in turn, corporate profitability in the near-term. Ultimately, the depth and breadth of the current downturn remains unknown and largely determined by the success of current efforts to contain and even cure COVID-19. There are tentative signs that the spread of the virus may be decelerating and even hopes that warmer, sunnier weather could help slow the spread of COVID-19, which may provide respite for struggling health services as the Northern Hemisphere moves towards summertime, whilst the potential for a vaccine would likely help calm market nerves. A crucial point of note is how the situation unfolds as restrictions begin to be lifted and whether this leads to a second wave of cases. In the meantime, policymakers have sought to use their government and central bank balance sheets to preserve the structure of their economies over a near-term, variously guaranteeing subsidised business loans, providing grants to SMEs and households, underwriting the private sector wage bill, and implementing a range of regulatory and accounting forbearance measures.

While large fiscal and monetary packages cannot cure a global health pandemic, these programmes can address cash flow pressures at a business and household level, and resolve some of the dislocations seen in markets. Ultimately, the longer the economic stoppages last, the higher the risk of persistent damage to the economy.

Geopolitical concerns also continue to present risks to our outlook, and this includes the escalation of the trade war between the two global economic superpowers, the US and China. Finally, we remain concerned about the levels of debt in the world, particularly sovereign and corporate debt, with net debt to GDP in the likes of China looking increasingly unsustainable. However, while as ever, some political and economic risks lie ahead, we remain focused on finding new long-term investment opportunities in companies that have a sustainable competitive advantage, are run by strong management teams with a history of good capital allocation and prudent balance sheet management.

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