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Higher Income Fund – Q1 2019 Commentary

Quarter to end March 2019

Performance

	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Fund Performance (B Class)	5.29%	-1.79%	3.21%	24.29%	30.63%	152.28%
FTSE All Share TR GBP	9.41%	-1.80%	6.36%	31.32%	34.47%	186.82%
IA Mixed Investments 40-85% Shares	6.52%	-1.91%	4.37%	24.59%	33.80%	131.64%
Sector Quartile	4	2	3	3	4	2

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

Review

Global investment markets rebounded from the weak end to 2018, with all major asset classes ending the opening quarter of 2019 in the black. Global equities (+9.6% on a total return basis) recorded their strongest start to a calendar year since 1987 and significantly outperformed global fixed interest bourses over the period, as concerns surrounding the US-China trade dispute eased and major central banks grew more accommodative. Global commodity markets also rallied strongly over the opening three months of the year, most notably in crude oil markets, where production cuts from OPEC and other oil producers, together with the implementation of US sanctions on Venezuela, served to tighten supply and push oil prices higher. The industrial metals component also moved higher amid positive signs emanating from US-China trade talks.

UK equities (as measured by the FTSE All-Share index) climbed 9.4% over the period, marginally underperforming global equities but nevertheless delivering the strongest opening quarter returns for domestic equities in six years. Against an increasingly uncertain outlook for the global economy, equities perceived to offer superior and defensible earnings growth outperformed. This was reflected in the strong relative performance of the UK's Information Technology sector and select consumer goods companies, including the large-cap tobacco and beverage groups. During the period, the Office for National Statistics revealed that the UK economy grew 1.4% in 2018, the lowest rate for several years. Looking forwards, the Organisation for European Co-operation & Development (OECD) predicted UK economic growth would decelerate to 0.8% in 2019 (assuming an orderly Brexit) while the Bank of England cut its 2019 GDP growth projection from 1.7% to 1.2%. UK government bonds recorded another strong quarter on the back of safe-haven demand as geo-politics and trade uncertainty weighed on the prospects for global growth. Earlier hopes that a parliamentary consensus could be reached on the terms of the UK's withdrawal EU, which had lifted bond yields in February, were dashed as the quarter drew to a close. The 10-year gilt yield fell from 1.28% to a low of 0.99% in March, having touched a high of 1.35% in January, before ending the period at 1.00%.

In continental Europe, regional growth worries continued to linger during the quarter. The eurozone economy grew by just 0.2% in the final three months of 2018 as Germany delivered zero growth while Italy slipped into recession. Additionally, forward-looking data continued to point to weakness, especially in manufacturing sectors. The flash manufacturing purchasing managers' index dipped to 47.6 in March from February's final reading of 49.3 (a reading below 50 indicates contraction). Consequently, the European Central Bank (ECB) responded with renewed dovish rhetoric, stating that benchmark interest rates would remain at current levels until the end of the year at the very least. Previously it had said rates would stay on hold until the end of this summer. Economically sensitive areas of the regional equity market such as Industrials and Information Technology performed well, but the perceived safe haven areas such as Consumer Staples and Real Estate sectors were also among the top performers.

US equities (as measured by the S&P 500 Index) delivered a total return of 11.5% (in sterling terms) over the quarter. The strong rebound in the market was largely driven by the Federal Reserve's increasingly accommodative commentary, which concluded midway through the quarter with the central bank confirming that it will adopt a more "patient approach" as it weighs future interest rate hikes to compensate for deteriorating economic momentum. The "dot plot" (a visual representation of how many members think rates will hit a given level over the short, medium and longer run) now implies that there will be no rate hikes this year and only one in 2020. In terms of economic data, Q4 2018 GDP (quarter-on-quarter, annualised) was adjusted downwards to 2.2% from the initial 2.6% reading. Meanwhile, a resolution to persistent US-China trade tensions also appeared more likely.

In Asia Pacific, the Federal Reserve's dovish comments and the US's decision to suspend tariff hikes on $200 billion of Chinese goods, together with ongoing government support for the Chinese domestic economy, were all supportive for regional equity markets over the period. Economic data confirmed that China's economy grew at a rate of 6.6% in 2018, its weakest pace since 1990 while forward looking indicators in January and February pointed to a continued slowdown. The Chinese authorities subsequently responded by lowering their full-year growth target to 6-6.5% (from a firm 6.5% goal) and outlined higher public spending and tax cuts, while the central bank cut the reserve requirement ratios for banks. Against this backdrop, markets in China and Hong Kong fared best. Meanwhile, in Japan, the domestic equity market delivered a return of 5% (in sterling terms), which was somewhat muted compared to other developed markets. The primary driver of regional underperformance was a weaker-than-expected corporate earnings results season for the quarter ended in mid-February. Overall, most of the negative surprises were driven by the sharper-than-expected slowdown in the external environment, especially in China. This particularly affected results in the automotive sector while many tech stocks were also impacted by the slowdown in smartphone sales.

Performance

Over the three-month period to the end of March 2019, the Higher Income Fund returned 5.3% on a total return basis, underperforming the FTSE All-Share Index by 412 basis points and the IA sector by 123 basis points. For the opening quarter of the year, all allocations at an asset class level positively contributed to absolute performance, however, our positioning away from the domestic equity market was the primary driver of underperformance relative the benchmark. Within fixed interest, we generated a robust set of returns over the period, benefitting from its tilt to corporate bonds as risky assets rallied. Additionally, the fund's niche holdings in permanent interest bearing shares (PIBS) and preference shares bounced in tandem with the rally in risky assets and recovered the bulk of their weakness registered in the previous quarter as global central banks adopted a more supportive monetary policy stance. However, the overall returns of the fixed interest portfolio failed to keep pace with the domestic equity market during the quarter, thus negatively impacting relative performance. Within overseas equities, our allocations delivered a positive absolute return (contributing 30% to the fund's total return), however, on a relative basis the segment failed to keep pace with broader market returns. This was largely attributable to allocations in continental Europe, where regional economic and political concerns weighed on a number of our individual holdings based in the area.

Turning to UK equities, the fund underperformed the domestic market over the quarter, which was largely attributable to an underweight allocation to the consumer-focused sectors. As previously highlighted in the "market review" commentary, the beverages and tobacco sectors were among the standout performers in the UK over the quarter, boosted by better-than-anticipated economic data surrounding employment and wages, as well as the relatively defensive attributes of many the sector's incumbents. Additionally, an underweight allocation to Materials negatively impacted relative performance, as the sector was boosted by improved sentiment over the outlook for global growth. Conversely, we benefitted from the strong returns posted by its holdings within Financials (3I Group, Lloyds Banking Group and Legal and General) and Real Estate (LondonMetric Property and Target Healthcare REIT), which were among the portfolio's strongest contributors over the quarter.

In terms of investment activity over the course of the period, we added to number of existing positions within its UK equity portfolio. While we remain cognisant of the fact that there is a great deal of uncertainty surrounding Britain's departure from the European Union, for many businesses based in the UK, the outcome is somewhat irrelevant given their internationally diversified and established

operations. Concurrently, the steep devaluation in the value of sterling relative to other major currencies provides a material tailwind for those companies that generate a significant portion of their earnings from overseas. We have therefore capitalised on the indiscriminate de-rating in UK-listed equities in recent months to augment some of our long-term positions in the likes of HSBC Holdings, GlaxoSmithKline, Prudential, BP and Aviva, which are all examples of companies that boast a sustainable competitive advantage within their respective industries, are run by strong management teams and have a history of good capital allocation alongside prudent balance sheet management.

Outlook

We continue to believe that the current economic cycle is nearing its conclusion, however, we do not believe that the end is a near-term event, as the warning signs that we monitor do not suggest a sharp turnaround in the economic environment is imminent. Rather, our central case is that global growth moderates over the course of the year as the impact of loose monetary stimulus gradually rolls off. Globally, this expectation of middling economic growth should allow firms to continue generating healthy profits and cash flow, a positive backdrop for equity investors in particular. Rising interest rates could impede both the equity and credit markets, prompting negative returns from duration on the credit side and weighing on equities as investors search for yield from less risky assets. That said, we maintain a preference for equities over credit given the favourable relative valuation of the former. Within equities, we continue to hold a positive stance towards UK, continental Europe and Asia and negative view on the US on valuation grounds.

There are a number of risks that we continue to watch closely that could affect this outlook. Firstly, an overstimulation of the US economy, in order to continue its strong growth, could become inflationary, forcing the Federal Reserve to tighten monetary policy more aggressively than is currently expected, which could consequently unsettle global investment markets. 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. Within Europe, a key risk is if the European Union fragments in some way, either due to the Italian budget, the rise of right-wing politics, or ripples from whatever “Brexit” deal is agreed. While the uncertainty of the Brexit outcome poses additional risks, arguably a Corbyn-led Labour government would have a greater impact on the domestic UK market. 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.

Further Information

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