Q3 2020 COMMENTARY
HIGHER INCOME FUND

QUARTER TO END SEPTEMBER 2020

PERFORMANCE

	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Fund Performance (B Class)	-2.41%	7.29%	-11.66%	-6.20%	19.40%	60.36%
FTSE AllSh TR GBP	-2.92%	6.95%	-16.59%	-9.33%	18.57%	63.90%
IA Mixed Investment 40-85% Shares	1.88%	15.22%	-0.04%	9.95%	39.09%	80.53%
Sector Quartile	4	4	4	4	4	4

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

REVIEW

Global investment markets delivered positive returns over the third quarter of 2020, supported by accommodative policy measures deployed by global central banks, the gradual re-opening of certain economies and signs of progress in the COVID-19 vaccine trials. While elevated volatility persisted, the FTSE World Index climbed 3.3% in the third quarter (on a total return basis, in sterling terms), taking it further in to positive territory year-to-date. Fixed interest markets also climbed higher over the period, although the asset class failed to keep pace with equity bourses. Meanwhile, commodity markets broadly delivered a positive return in the third quarter, aided in part by US dollar weakness. Industrial metals posted a strong gain, led by steel, iron ore and zinc, while the positive return from precious metals was driven mainly by a rally in the silver price. Energy was the only component to finish in negative territory, posting a slight fall.

In the UK, renewed fears surrounding a disorderly "Brexit" weighed on investor sentiment during the quarter, as did worries around the implications of a second wave in COVID-19 infections towards the end of the period. Rising infection rates necessitated the re-imposition of restrictions in certain parts of the country following similar measures taken by several nations in continental Europe. Notwithstanding these new measures, the country's economic recovery continued as COVID-19 restrictions were generally eased. The second quarter of the calendar year reporting season underlined increased corporate confidence with many companies resuming guidance on their anticipated financial performance for the rest of 2020. Additionally, a number of corporations also resumed the payment of dividends that they had deferred in the spring, as many of these distributions had been deferred prior to the AGM season and at a time of peak uncertainty, related to the global pandemic. Consequently, the UK equity market fell by 2.9% over the three-month period (on a total return basis, in sterling terms), materially underperforming global equities. However, the index return somewhat masked the divergence in the performance of the underlying groups, with both the FTSE 250 Mid-Cap Index and the FTSE Small Cap Index delivering positive returns and the FTSE 100 Index falling by 4.0%, as sterling strength against a weak dollar weighed on the internationally exposed large caps. Within sterling denominated fixed interest markets, corporate bonds enjoyed a positive quarter, as riskier assets were broadly buoyant and monetary policy helped anchor yields at low levels. Conversely, UK gilts delivered a negative return over the period, with the UK 10-year yield climbing six points higher to 0.23% as Brexit uncertainty resumed.

In Europe, the European Union (EU) approved a €750 billion fund to help member states recover from the pandemic. The fund will be made up of €390 billion of grants and €360 billion of loans to be distributed among member states. The funds will be borrowed by the European Commission and guaranteed by all EU member states. The funds will be used to reach the EU's objectives of climate neutrality and digital transformation, to offer social and employment support as well as to reinforce the EU's role as a global player. Meanwhile, COVID-19 infections rose rapidly in several countries as the quarter progressed, notably Spain and France, and new restrictions to contain the virus were announced. These restrictions were localised, rather than the blanket countrywide measures seen in the first phase of the virus. Consequently, equity markets in Europe were broadly flat over the quarter as the rate of improvement in economic data slowed and concerns mounted over the sharp rise COVID-19 infections in many European countries.

Across the Atlantic, in the US, the recovery in the domestic economy continued, and the Federal Reserve's messaging remained highly accommodative. The Fed will now use average inflation targeting (AIT) in setting the policy interest rate, allowing for temporary overshoots in inflation. Furthermore, the Fed's latest policy rate projection suggested

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that policymakers see rates at the zero lower bound through to the end of 2023. Meanwhile, the US unemployment rate dropped to 8.4% in August, down from 10.2% in July and below consensus expectations of 9.8%. The labour force participation rate also improved, but remains still below its February pre-pandemic level. These developments aided in significant gains for the US equity market, which rallied 8.9% over the period, however dollar weakness tempered gains for sterling-based investors to 4.4%.

In Asia, the quarter was somewhat dominated by the change in Japan's prime minister. Shinzo Abe announced his resignation as prime minister of Japan, due to the resurgence of a long-standing health problem, just four days after he recorded the longest continuous term of any Japanese prime minister. Following his resignation, Yoshihide Suga, the Chief Cabinet Secretary, quickly emerged as the frontrunner and he duly won the LDP's leadership election on 14 September. His position as the new prime minister was then confirmed on 16 September. These developments, paired with a corporate quarterly earnings season that brought more positive surprises than anticipated, helped boost returns for the Japanese equity market, which delivered a local currency return of 4% over the quarter. Meanwhile, in China, economic data signalled an ongoing recovery and corporate earnings season for the calendar year second quarter were broadly positive. However, geopolitical tensions with the US escalated, including new restrictions on Chinese telecoms company Huawei, and as President Trump signed an executive order to prevent US companies from doing business with TikTok and WeChat.

PERFORMANCE & ACTIVITY

Over the three-month period to the end of September 2020, the Higher Income Fund fell by 2.4% on a total return basis, marginally outperforming the FTSE All-Share Index by 51 basis points but underperforming the IA sector by 429 basis points. For the third quarter of the year, all allocations at an asset class level, with the exception of fixed interest, negatively contributed to absolute performance. With regards to the fund's performance relative to the benchmark, the allocation to UK fixed interest markets was the primary contributor to overall outperformance during the quarter. Most notably, the fund benefitted from the strong returns posted by holdings in the corporate bond and preference shares sectors, which were supported by a broad "risk on" environment and monetary policy that helped anchor yields at low levels.

Relative weakness in the domestic equity market was largely attributable to the fund's underweight allocation to the economically sensitive areas of the market such as Industrials and Basic Materials, which outperformed amid a general improvement in investor sentiment, largely driven by global considerations. The continued bifurcation of returns between "Value" and "Growth" equity baskets also provided an additional headwind for the fund's relative performance, as the latter outperformed the former by approximately 11.4 percentage points over the period. Conversely, the fund's relative performance over the second quarter was boosted by allocations to international equities, which were broadly lifted by improving investor sentiment as major global economies continued to re-open. At a regional level, the fund delivered strong returns in Asia Pacific (TSMC, Weiss Korea Opportunity Fund and Boustead Singapore).

In terms of investment activity, the fund took profits from its position in the Swedish listed specialist packaging company BillerudKorsnäs, UK-listed pharmaceutical giants AstraZeneca and the Singapore-listed real estate investment trust (REIT) Mapletree Logistics, following a sustained period of share price appreciation in each of these names. During the period, the fund allocated some these proceeds to existing investments in HICL Infrastructure PLC and participated in the share issue of Greencoat UK Wind.

OUTLOOK

The initial economic contraction related to the COVID-19 pandemic is larger than the great financial crisis (the "GFC"), however, we believe that its cumulative impact on the global economy could be shorter in duration as long as the policy response from governments and central banks remains strong enough to cushion the blow. 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. In Europe and the UK, hospitalisations were very low for most of the summer, but have started to creep up, with Spain and then France and the UK seeing a rise in cases. This has prompted concerns that, as summer turns to autumn and temperatures drop, hospitalisation and death rates could start to rise more meaningfully. On a more positive note, vaccine trials have been progressing, with the Oxford trial recommencing quickly after a brief pause. Clearly, positive news on this front in the coming months could be material for investment markets, potentially leading to a significant rally in some of the areas that have lagged this year.

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 small and medium sized businesses as well as households, underwriting the private sector wage bill, and implementing a range of regulatory and accounting forbearance measures. While a 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 many developed nations 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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