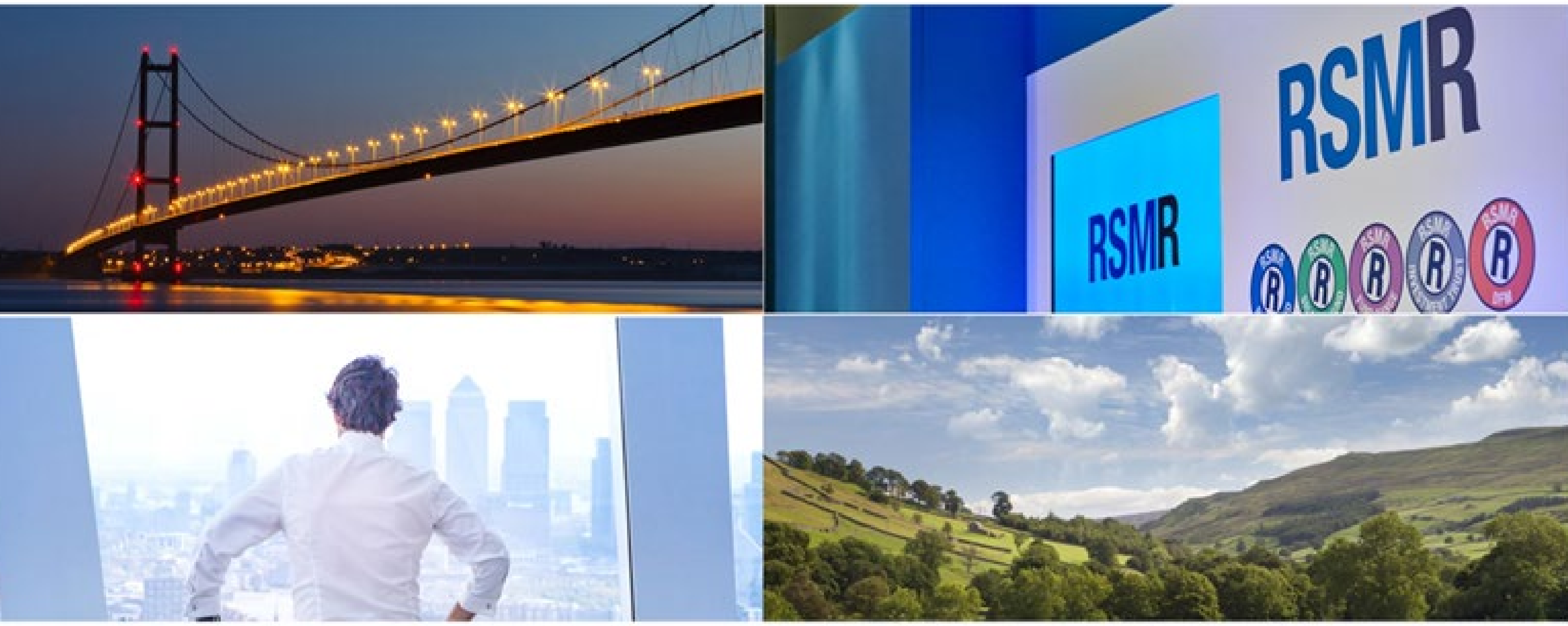
RSMR



PRIVATE & CONFIDENTIAL

Grayside
Quarterly Portfolio Review
January 2019

Background

The asset allocations and fund selections are reviewed formally on a quarterly basis. This Quarterly Review documents the review that has taken place and any changes resulting from it.

To put this review in context, it should be read in conjunction with our investment bulletin issued earlier in the month.

Quarterly Market Commentary

The final quarter of 2018 was difficult for investors with the majority of equity markets seeing significant falls – only selective fixed income markets, UK commercial property, some alternative asset classes and a few individual equity markets produced any sort of positive return. This followed two quarters of good equity returns. The concerns related to the slowing of global economic growth, the ongoing China/US trade tariff negotiations, geopolitics, US interest rate policy and the global reduction in quantitative easing, amongst others.

From a sterling investor's perspective, returns from the major equity markets were very weak with the main developed market regions, including the US, producing negative double-digit returns, with Japan being the worst performer. Emerging markets and Asia produced mid-single digit negative returns, but were the outperformers this quarter. Smaller companies generally underperformed globally and value generally outperformed growth, a notable exception being in the UK.

The UK stock market is undoubtedly being affected by the continued uncertainty surrounding Brexit with economic growth, exports, PMIs and consumer confidence all falling and future corporate investment being postponed. Large caps outperformed mid and smaller companies, representing a more risk-off attitude. The European economies are also affected by Brexit, but there were further political complications, mainly in Italy but also in France and Germany. Economic growth has been weakening, consumer confidence has been falling, exports are down (partly due to weakness in China) and, future investment is expected to fall. The ECB also officially ended its bond buying programme at the end of 2018 thereby reducing their monetary stimulus.

For once, the US market suffered alongside other global markets, as there were concerns about a slowdown from peak economic growth, overall market valuations (particularly in the technology sector), and the impact of further interest rate rises. Economic data remained strong but the government shutdown towards the end of 2018 may have a short-term impact in Q1, as will any resolution to the US/China trade tariff talks. The Fed has stated its intention to raise rates three times in 2019 but the fixed income market does not currently believe them.

There has been a slowdown in the Chinese economic data, which is seen negatively by many but is part of the government's plan to engineer a steadier, consumer-driven growth environment with less reliance on debt. Economic growth remains reasonable in the region with pockets of strength and weakness. The US/China trade negotiations are having a knock-on effect to the Asian region but any positive resolution would be a boost. Japanese equities were the worst performer but there has been little change to the economic backdrop with low but steady economic growth, low inflation, ongoing demographic issues but continued monetary policy support from the central bank.

The relative weakness of sterling improved returns from global fixed income markets for sterling-based investors, but reduced relative returns for any sterling hedging strategies. Globally, government bonds comfortably outperformed credit (investment grade and high yield) and long-dated bonds outperformed in the UK, all indicative of the risk-off environment. Inflation-linked bonds comfortably outperformed conventional bonds globally but the difference was minimal in the UK. Emerging market debt was one of the strongest performers.

UK commercial property continued to produce positive monthly returns with income being the main driver, as opposed to capital appreciation, and rental growth being more sector and regional specific. The industrials and offices sector continued to lead the way and there were ongoing concerns about the UK high street with more retail firms struggling financially, leading to underperformance and a negative return from the retail sector as a whole.

Comparative Performance - Benchmarks

Each of the portfolios has a composite benchmark for performance comparison purposes whose underlying constituents represent the sector averages for each fund selected within the portfolio (e.g. UK Gilt for any UK gilt holdings and UK All Companies for any UK equity growth).

Strategic Asset Allocations

We last made some changes to the high level asset allocations in the January 2018 quarterly review and we are not proposing any changes this quarter

Below are the current strategic asset allocation that became effective in February 2018:

Risk Level	Cautious	Balanced	Progressive	Adventurous	Specialist
Asset Allocation	**%**	**%**	**%**	**%**	**%**
Cash	2.00%	2.00%	2.00%	2.00%	2.00%
UK Equities	10.00%	23.00%	31.50%	36.00%	38.00%
International Equities	10.00%	23.00%	31.50%	42.00%	60.00%
Property	10.00%	10.00%	10.00%	10.00%	0.00%
Fixed Interest	68.00%	42.00%	25.00%	10.00%	0.00%
Absolute Return	0.00%	0.00%	0.00%	0.00%	0.00%
Others	0.00%	0.00%	0.00%	0.00%	0.00%
	100.00%	100.00%	100.00%	100.00%	100.00%

Growth Portfolios

The absolute performance of the Growth portfolios was negative across the board and relative performance versus their respective comparative composite benchmarks was mixed with the higher risk portfolios struggling more than the lower risk portfolios. The higher risk portfolios also struggled versus their most comparative IA sector averages.

The tables below show the model asset allocations of the Growth model portfolios, as at the end of December 2018, and the differences to the main strategic asset allocations:

Portfolio Allocations

Risk Level	Cautious	Balanced	Progressive	Adventurous	Specialist
Asset Allocation	**%**	**%**	**%**	**%**	**%**
Cash	2.00%	2.00%	2.00%	2.00%	2.00%
UK Equities	7.50%	18.50%	29.50%	34.00%	34.00%
International Equities	7.50%	25.50%	36.50%	47.00%	64.00%
Property	10.00%	10.00%	10.00%	10.00%	0.00%
Fixed Interest	53.00%	34.00%	22.00%	7.00%	0.00%
Absolute Return	20.00%	15.00%	0.00%	0.00%	0.00%
Others	0.00%	0.00%	0.00%	0.00%	0.00%

Differences to SAA

Risk Level	Cautious	Balanced	Progressive	Adventurous	Specialist
Asset Allocation	**%**	**%**	**%**	**%**	**%**
Cash	0.00%	0.00%	0.00%	0.00%	0.00%
UK Equities	-2.50%	-4.50%	-2.00%	-2.00%	-4.00%
International Equities	-2.50%	2.50%	5.00%	5.00%	4.00%
Property	0.00%	0.00%	0.00%	0.00%	0.00%
Fixed Interest	-15.00%	-8.00%	-3.00%	-3.00%	0.00%
Absolute Return	20.00%	15.00%	0.00%	0.00%	0.00%
Others	0.00%	0.00%	0.00%	0.00%	0.00%

Cautious Growth Portfolio

The Cautious Growth Portfolio produced a negative return but outperformed its composite benchmark this quarter and also outperformed its most comparable IA sector average. The latest annualised portfolio volatility figure is slightly below that of the benchmark.

The main contributors to performance, both positive and negative, are highlighted within the sections below.

Multi-Asset, Absolute Return

The allocation to absolute return in favour of fixed income was negative, but was positive in relation to equities based on their relative performances.

The Church House and Invesco funds both produced a negative return but the former did outperform its sector average by a reasonable margin. The Jupiter fund performed particularly well this quarter, producing a reasonably good, positive return and significantly outperforming its peer group average. Its relative performance had been suffering from its positioning of being short US stocks, short beta, short duration, and long volatility, most of which were positive factors this quarter.

Fixed Income

From an absolute return perspective, UK and global bonds were the best performers and produced good, positive returns whilst credit investments produced negative returns. The underperformance of sterling meant that sterling-based fixed income investments generally underperformed their overseas counterparts and that having mainly sterling-based fixed income funds in the portfolio was more negative for absolute performance.

The very small exposure to conventional UK gilts and the lack of exposure to UK index-linked gilts were both very negative, as they produced solid, positive returns and outperformed UK corporate bonds. Fund selection within sterling credit (investment grade and strategic bonds) was negative, as all four funds underperformed their respective sector average. Specific high yield exposure was negative, as the asset class underperformed higher grade credit, but the M&G Global Floating Rate High Yield fund did outperform its peer group.

Within global bonds two of our fund selections, M&G Global Macro Bond and Vanguard, outperformed their sector average. The Schroder Absolute Return Bond fund has been selected for its defensive qualities but its absolute and relative performance was negative this quarter, as it underperformed the average investment grade, global and strategic bond fund.

UK Equities

The portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main UK equity market plus the marginal underperformance of UK equities on a global basis.

The average IA UK All Companies fund underperformed the main UK equity index by a reasonable margin this quarter, as larger companies comfortably outperformed mid-cap companies. The Investec fund performed in line with its sector average but still produced a double-digit negative return.

International Equities

The portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main global equity market.

The average IA Global fund underperformed the main global equity index this quarter. Fund selection was marginally positive, as the Artemis fund outperformed its sector average.

Property

Both property funds continued to produce solid, positive returns with the BMO fund outperforming the sector average and the Janus Henderson fund very marginally underperforming.

Changes

In December we recommended switching from the Kames Investment Grade Bond fund to the **Rathbone Ethical Bond** fund but, as per an e-mail from Mike Seddon on 4th December, this was to be delayed until this review. We continue to recommend this switch.

We would also like to introduce further diversification into the fixed income part of the portfolio. This includes the addition of the **Pictet Emerging Local Currency Debt** fund, which is already in other portfolios and will provide different exposure within global bonds. The M&G, Vanguard and Standard Life weightings will be reduced to accommodate this. The second addition is the **TwentyFour Monument Bond** fund, which invests predominantly in lower-risk asset-backed securities, and this weighting will be taken from the M&G Global Floating Rate High Yield fund.

Balanced Growth Portfolio

The Balanced Growth Portfolio produced a reasonably large negative return but marginally outperformed its composite benchmark and performed in line with its most comparable IA sector average. The latest annualised portfolio volatility figure is slightly above that of the benchmark.

The main contributors to performance, both positive and negative, are highlighted within the sections below.

Multi-Asset, Absolute Return

The allocation to absolute return in favour of fixed income was negative but was positive in relation to equities based on their relative performances.

The Church House and Invesco funds both produced a negative return but the former did outperform its sector average by a reasonable margin.

Fixed Income

From an absolute return perspective, UK and global bonds were the best performers and produced good, positive returns whilst credit investments produced negative returns. The underperformance of sterling meant that sterling-based fixed income investments generally underperformed their overseas counterparts and that having mainly sterling-based fixed income funds in the portfolio was more negative for absolute performance.

The very small exposure to conventional UK gilts and the lack of exposure to UK index-linked gilts were both very negative, as they produced solid, positive returns and outperformed UK corporate bonds. Fund selection within sterling credit (investment grade and strategic bonds) was negative, as all three funds underperformed their respective sector average. Specific high yield exposure was negative, as the asset class underperformed higher grade credit, but the M&G Global Floating Rate High Yield fund did outperform its peer group.

Within global bonds two of our fund selections, M&G Global Macro Bond and Vanguard, outperformed their sector average. The Schroder Absolute Return Bond fund has been selected for its defensive qualities but its absolute and relative performance was negative this quarter, as it underperformed the average investment grade, global and strategic bond fund.

UK Equities

The portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main UK equity market plus the marginal underperformance of UK equities on a global basis.

The average IA UK All Companies fund underperformed the main UK equity index by a reasonable margin this quarter, as larger companies comfortably outperformed mid-cap companies. Fund selection was mixed, as the Franklin fund underperformed the sector average, the Investec fund performed in line and the Merian and Schroder funds outperformed with the latter performing particularly well on a relative basis. Sector/asset allocation was the main positive with the cash holding providing marginal downside protection plus positive contributions from being overweight Utilities and underweight Industrials. Stock selection was also positive, but less so, with the main contributors being holdings in Pearson and Anglo American and not holding BAT.

International Equities

The portfolio overweight versus the strategic asset allocation was negative given the large negative return from the main global equity market.

The average IA Global fund underperformed the main global equity index this quarter. Fund selection was mixed with the main negative being the underperformance of the Merian fund and the main positive being the strong relative performance of the Troy fund. The former suffered from negative overall contributions from the underlying factors/strategies, mainly Company Management and Dynamic Valuation, regional allocation (all negative but US the largest contributor) and stock selection, particularly in the Healthcare sector. The latter benefited from having a structural higher exposure to ‘quality’, as determined by return on equity, return on capital and operating margins, which typically means the fund outperforms during more difficult market conditions.

Property

Both property funds continued to produce solid, positive returns with the BMO fund outperforming the sector average and the Janus Henderson fund very marginally underperforming.

Changes

In December we recommended switching from the Kames Investment Grade Bond fund to the **Rathbone Ethical Bond** fund but, as per an e-mail from Mike Seddon on 4th December, this was to be delayed until this review. We continue to recommend this switch.

We would also like to introduce further diversification into the fixed income part of the portfolio through the addition of the **Pictet Emerging Local Currency Debt** fund, which is already in other portfolios and will provide different exposure within global bonds. The Vanguard and Standard Life weightings will be reduced to accommodate this.

Progressive Growth Portfolio

The Progressive Growth Portfolio produced a large negative return and underperformed both its composite benchmark and its comparable IA sector average. The latest annualised portfolio volatility figure is above that of the benchmark.

The overweight to equities and underweight to fixed income was a key negative this quarter. The other main contributors to performance, both positive and negative, are highlighted within the sections below.

Fixed Income

From an absolute return perspective, UK and global bonds were the best performers and produced good, positive returns whilst credit investments produced negative returns. The underperformance of sterling meant that sterling-based fixed income investments generally underperformed their overseas counterparts and that having mainly sterling-based fixed income funds in the portfolio was more negative for absolute performance.

The lack of exposure to conventional UK gilts and UK index-linked gilts was very negative, as they produced solid, positive returns and outperformed UK corporate bonds. Fund selection within sterling credit (investment grade and strategic bonds) was negative, as all four funds underperformed their respective sector average.

Within global bonds the Templeton fund performed strongly, comfortably outperforming its peer group.

UK Equities

The small portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main UK equity market plus the marginal underperformance of UK equities on a global basis.

The average IA UK All Companies fund underperformed the main UK equity index by a reasonable margin this quarter, as larger companies comfortably outperformed mid-cap companies. Fund selection was mixed, as the Franklin fund underperformed the sector average, the Investec fund performed in line and the Merian UK Alpha and Schroder funds outperformed with the latter performing particularly well on a relative basis. Sector/asset allocation was the main positive with the cash holding providing marginal downside protection plus positive contributions from being overweight Utilities and underweight Industrials. Stock selection was also positive, but less so, with the main contributors being holdings in Pearson and Anglo American and not holding BAT.

The main negative was very significant underperformance from the Merian UK Mid Cap fund. Sector allocation was actually positive but stock selection was negative across a number of sectors, most notably Consumer Goods and Technology.

International Equities

The portfolio overweight versus the strategic asset allocation was negative given the large negative return from the main global equity market. Specific exposure to Asia and Emerging Markets was positive given their outperformance but having the largest regional exposure to Japan was negative, as this was the worst performer of the major regions.

The average IA Global fund underperformed the main global equity index this quarter and the performance of the average fund across many equity regions was below that of the relevant index. Fund selection within global equities was mixed with the main negative being the underperformance of the Merian fund and the main positive being the strong relative performance of the Troy fund. The former suffered from negative overall contributions from the underlying factors/strategies, mainly Company Management and Dynamic Valuation, regional allocation (all negative but US the largest contributor) and stock selection, particularly in the Healthcare sector. The latter benefited from having a structural higher exposure to ‘quality’, as determined by return on equity, return on capital and operating margins, which typically means the fund outperforms during more difficult market conditions.

Regional fund selection was very mixed. Positives included outperformance from the BlackRock Asia, Lazard and Man GLG funds with the latter benefiting from the general outperformance of large cap value in Japan. The other two funds underperformed their sectors by reasonably large margins. The BlackRock European Dynamic fund suffered from negative sector allocation (overweight Industrials and Financials, underweight defensive sectors) and very negative stock selection across sectors (Healthcare, Industrials, Consumer Goods) and countries.

Property

The BMO property fund continued to produce a solid, positive return and outperformed the sector average. The performance of the Threadneedle fund was affected by the move from an offer pricing basis to a bid pricing basis in December, which had a negative impact of approximately 6.1%.

Changes

In December we recommended switching from the Kames Investment Grade Bond fund to the **Pictet Emerging Local Currency Debt** fund but, as per an e-mail from Mike Seddon on 4th December, this was to be delayed until this review. We continue to recommend this switch but are not recommending any further changes.

Adventurous Growth

The Adventurous Growth Portfolio produced a large negative return and underperformed its composite benchmark and its most comparable IA sector average. The latest annualised portfolio volatility figure is above that of the benchmark.

The overweight to equities and underweight to fixed income was a key negative this quarter. The other main contributors to performance, both positive and negative, are highlighted within the sections below.

Fixed Income

From an absolute return perspective, UK and global bonds were the best performers and produced good, positive returns whilst credit investments produced negative returns. The underperformance of sterling meant that sterling-based fixed income investments generally underperformed their overseas counterparts and that having mainly sterling-based fixed income funds in the portfolio was more negative for absolute performance.

The lack of exposure to conventional UK gilts and UK index-linked gilts was very negative, as they produced solid, positive returns and outperformed UK corporate bonds. Fund selection was negative, as both funds underperformed their sector average.

UK Equities

The small portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main UK equity market plus the marginal underperformance of UK equities on a global basis.

The average IA UK All Companies fund underperformed the main UK equity index by a reasonable margin this quarter, as larger companies comfortably outperformed mid-cap companies. Fund selection was mixed, as the Franklin fund underperformed the sector average, the Investec fund performed in line and the AXA, Merian UK Alpha and Schroder funds outperformed with the latter performing particularly well on a relative basis. Sector/asset allocation was the main positive with the cash holding providing marginal downside protection plus positive contributions from being overweight Utilities and underweight Industrials. Stock selection was also positive, but less so, with the main contributors being holdings in Pearson and Anglo American and not holding BAT.

The main negative was very significant underperformance from the Merian UK Mid Cap fund. Sector allocation was actually positive but stock selection was negative across a number of sectors, most notably Consumer Goods and Technology.

International Equities

The portfolio overweight versus the strategic asset allocation was negative given the large negative return from the main global equity market. Specific exposure to Asia and Emerging Markets was positive given their outperformance but having the largest regional exposure to Japan was negative, as this was the worst performer of the major regions.

Fund selection was very mixed. There was strong outperformance in Asia from the First State fund, which benefited from positive country allocations, particularly an overweight to India and underweight to China and positive stock selection within countries (mainly India) and sectors (Financials, Healthcare and IT). Other positives included outperformance from the Artemis, BlackRock Asia, JPM, Lazard and Man GLG funds with the latter benefiting from the general outperformance of large cap value in Japan. The other three funds underperformed their sectors by reasonably large margins. The BlackRock European Dynamic fund suffered from negative sector allocation (overweight Industrials and Financials, underweight defensive sectors) and very negative stock selection across sectors (Healthcare, Industrials, Consumer Goods) and countries. The Schroder fund suffered from negative stock selection, as sector allocation was positive and regional positioning was mildly negative. Selection was negative across a number of sectors but the main contributor was Oil & Gas with a number of stocks seeing large negative returns.

Property

The BMO property fund continued to produce a solid, positive return and outperformed the sector average. The performance of the Threadneedle fund was affected by the move from an offer pricing basis to a bid pricing basis in December, which had a negative impact of approximately 6.1%.

Changes

We are recommending a couple of portfolio changes this quarter.

We would like to introduce further diversification into the fixed income part of the portfolio through the holding of a more globally-orientated fund. We have no issues with either of the existing funds but the recommendation is to add the **Templeton Global Total Return Bond** fund in place of the Artemis fund.

The AXA Framlington UK Select Opportunities fund has undergone a recent change of fund manager and, although we currently retain an RSMR rating, we would like to switch into a smaller, more nimble fund. Our recommendation is the **LF Miton UK Value Opportunities** fund.

Specialist Growth Portfolio

The Specialist Growth Portfolio produced a double-digit negative return and underperformed its composite benchmark and its most comparable IA sector average. The latest annualised portfolio volatility figure is above that of the benchmark.

The main contributors to performance, both positive and negative, are highlighted within the sections below.

UK Equities

The portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main UK equity market plus the marginal underperformance of UK equities on a global basis.

The average IA UK All Companies fund underperformed the main UK equity index by a reasonable margin this quarter, as larger companies comfortably outperformed mid-cap companies. Fund selection was mixed, as the JOHCM fund marginally underperformed the sector average, the Investec fund performed in line and the AXA, Man GLG and Schroder funds outperformed with the latter performing particularly well on a relative basis. Sector/asset allocation was the main positive with the cash holding providing marginal downside protection plus positive contributions from being overweight Utilities and underweight Industrials. Stock selection was also positive, but less so, with the main contributors being holdings in Pearson and Anglo American and not holding BAT.

The main negatives included very significant underperformance from the Merian UK Mid Cap fund and the inclusion of a specific smaller companies, plus reasonable underperformance from the Franklin fund. For the Merian fund sector allocation was actually positive but stock selection was negative across a number of sectors, most notably Consumer Goods and Technology. For the Franklin fund stock selection was the key driver, particularly in the Consumer Services sector with Patisserie Holdings falling almost 90% due to fraudulent activity and a few other fund holdings falling over 30%.

International Equities

The portfolio overweight versus the strategic asset allocation was negative given the large negative return from the main global equity market. Specific exposure to Asia and Emerging Markets was positive given their outperformance but having the largest regional exposure to Japan was negative, as this was the worst performer of the major regions.

Fund selection was very mixed. There was strong outperformance in Asia from the First State fund, which benefited from positive country allocations, particularly an overweight to India and underweight to China and positive stock selection within countries (mainly India) and sectors (Financials, Healthcare and IT). Other positives included outperformance from the Artemis, BlackRock Asia, JPM, Lazard and Man GLG funds with the latter benefiting from the general outperformance of large cap value in Japan. Four of the other funds underperformed their sectors by reasonably large margins. The BlackRock European Dynamic fund suffered from negative sector allocation (overweight Industrials and Financials, underweight defensive sectors) and very negative stock selection across sectors (Healthcare, Industrials, Consumer Goods) and countries. The Schroder fund suffered from negative stock selection, as sector allocation was positive and regional positioning was mildly negative. Selection was negative across a number of sectors but the main contributor was Oil & Gas with a number of stocks seeing large negative returns.

Changes

We are recommending one portfolio change this quarter.

The AXA Framlington UK Select Opportunities fund has undergone a recent change of fund manager and, although we currently retain an RSMR rating, we would like to switch into a smaller, more nimble fund. Our recommendation is the **LF Miton UK Value Opportunities** fund.

Income Portfolios

The absolute performance of the Income portfolios was negative across the board and relative performance was generally close to their respective comparative composite benchmarks. All three portfolios outperformed versus their most comparative IA sector averages.

The tables below show the current asset allocations of the Income model portfolios, as at the end of December 2018, and the differences to the strategic asset allocations:

Portfolio Allocations

Risk Level	Cautious	Balanced	Progressive
Asset Allocation	**%**	**%**	**%**
Cash	2.00%	2.00%	2.00%
UK Equities	8.00%	19.00%	28.50%
International Equities	12.00%	25.00%	33.50%
Property	10.00%	10.00%	10.00%
Fixed Interest	58.00%	34.00%	21.00%
Absolute Return	0.00%	0.00%	0.00%
Others	10.00%	10.00%	5.00%

Differences to SAA

Risk Level	Cautious	Balanced	Progressive
Asset Allocation	**%**	**%**	**%**
Cash	0.00%	0.00%	0.00%
UK Equities	-2.00%	-4.00%	-3.00%
International Equities	2.00%	2.00%	2.00%
Property	0.00%	0.00%	0.00%
Fixed Interest	-10.00%	-8.00%	-4.00%
Absolute Return	0.00%	0.00%	0.00%
Others	10.00%	10.00%	5.00%

Cautious Income Portfolio

The Cautious Income Portfolio produced a negative return, marginally underperforming its composite benchmark but outperforming its most comparable IA sector average. The current historic yield is just over 3.8%. The latest annualised portfolio volatility figure is above that of the benchmark.

The main positive and negative contributors are highlighted within the sections below.
Fixed Income

From an absolute return perspective, UK and global bonds were the best performers and produced good, positive returns whilst credit investments produced negative returns. The underperformance of sterling meant that sterling-based fixed income investments generally underperformed their overseas counterparts and that having mainly sterling-based fixed income funds in the portfolio was more negative for absolute performance.

The lack of exposure to both conventional UK gilts and UK index-linked gilts was very negative, as they produced solid, positive returns and outperformed UK corporate bonds. Fund selection within sterling credit (investment grade and strategic bonds) was negative overall, as only the BlackRock and Janus Henderson funds outperformed their respective sector averages. Specific high yield exposure was negative, as the asset class underperformed higher grade credit, but the M&G Global Floating Rate High Yield fund did outperform its peer group.

Within global bonds the Templeton fund performed strongly, comfortably outperforming its peer group. Emerging Market Debt exposure was also positive with strong returns from the Pictet fund.

UK Equities

The small portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main UK equity market plus the marginal underperformance of UK equities on a global basis.

The average IA UK Equity Income fund underperformed the main UK equity index this quarter, as larger companies outperformed mid-cap companies. Fund selection was very marginally negative overall, as the Premier fund performed in line with the IA sector average whilst the Threadneedle fund underperformed.

International Equities

The average IA Global Equity Income fund outperformed the main global equity index by a reasonable margin this quarter. Fund selection was very mixed, as the Fidelity fund significantly outperformed the sector average but the Artemis fund underperformed by a significant margin. The former benefited from positive sector positioning, particularly the overweight to Consumer Staples and Healthcare and underweight to IT, plus strong stock selection at both sector (Industrials, Financials and Consumer Staples) and regional level. The latter suffered from having too much exposure to cyclical stocks and sectors

Property

Both property funds continued to produce solid, positive returns with the BMO fund outperforming the sector average and the Janus Henderson fund very marginally underperforming.

Others

The Investec and VT Gravis funds both produced small negative returns and underperformed the main fixed income markets and UK commercial property funds.

Changes

In December we recommended switching from the Kames Investment Grade Bond fund to the **Rathbone Ethical Bond** fund but, as per an e-mail from Mike Seddon on 4th December, this was to be delayed until this review. We continue to recommend this switch.

We would also like to recommend switching from the Premier Income fund into the **Premier Optimum Income** fund, a higher income fund with the same manager and the same underlying strategy that also uses a derivatives overlay strategy to generate additional income.

Balanced Income Portfolio

The Balanced Income Portfolio produced a negative return but marginally outperformed its composite benchmark and also outperformed its most comparable IA sector average. The current historic yield is just over 3.9%. The current historic yield is just over 3.8%. The latest annualised portfolio volatility figure is above that of the benchmark.

The main positive and negative contributors are highlighted within the sections below.

Fixed Income

From an absolute return perspective, UK and global bonds were the best performers and produced good, positive returns whilst credit investments produced negative returns. The underperformance of sterling meant that sterling-based fixed income investments generally underperformed their overseas counterparts and that having mainly sterling-based fixed income funds in the portfolio was more negative for absolute performance.

The lack of exposure to both conventional UK gilts and UK index-linked gilts was very negative, as they produced solid, positive returns and outperformed UK corporate bonds. Fund selection within sterling credit (investment grade and strategic bonds) was negative overall, as only the Janus Henderson fund outperformed its sector average. Specific high yield exposure was negative, as the asset class underperformed higher grade credit, but the M&G Global Floating Rate High Yield fund did outperform its peer group.

Within global bonds the Templeton fund performed strongly, comfortably outperforming its peer group. Emerging Market Debt exposure was also positive with strong returns from the Pictet fund.

UK Equities

The portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main UK equity market plus the marginal underperformance of UK equities on a global basis.

The average IA UK Equity Income fund underperformed the main UK equity index this quarter, as larger companies outperformed mid-cap companies. Fund selection was negative overall, as the Premier fund performed in line with the IA sector average whilst the Threadneedle and JOHCM funds underperformed, the latter by a reasonable margin. Sector allocation was negative but stock selection was the main driver of underperformance, particularly in the Financials and Industrials sectors.

International Equities

The average IA Global Equity Income fund outperformed the main global equity index by a reasonable margin this quarter. Fund selection was negative overall, as only the Fidelity fund outperformed the sector average, albeit by a significant margin. It benefited from positive sector positioning, particularly the overweight to Consumer Staples and Healthcare and underweight to IT, plus strong stock selection at both sector (Industrials, Financials and Consumer Staples) and regional level. The Artemis fund suffered from having too much exposure to cyclical stocks and sectors. The Saracen fund also underperformed by a reasonably large margin with the fund's more cyclical positioning a key negative.

Property

Both property funds continued to produce solid, positive returns with the BMO fund outperforming the sector average and the Janus Henderson fund very marginally underperforming.

Others

The Investec and VT Gravis funds both produced small negative returns and underperformed the main fixed income markets and UK commercial property funds.

Changes

In December we recommended switching from the Kames Investment Grade Bond fund to the **Rathbone Ethical Bond** fund but, as per an e-mail from Mike Seddon on 4th December, this was to be delayed until this review. We continue to recommend this switch.

We would also like to recommend switching from the Premier Income fund into the **Premier Optimum Income** fund, a higher income fund with the same manager and the same underlying strategy that also uses a derivatives overlay strategy to generate additional income.

Progressive Income Portfolio

The Progressive Income Portfolio produced a reasonably large negative return and underperformed its composite benchmark but outperformed its most comparable IA sector average. The current historic yield is just over 4.2%. The latest annualised portfolio volatility figure is above that of the benchmark.

The main positive and negative contributors are highlighted within the sections below.

Fixed Income

From an absolute return perspective, UK and global bonds were the best performers and produced good, positive returns whilst credit investments produced negative returns. The underperformance of sterling meant that sterling-based fixed income investments generally underperformed their overseas counterparts and that having a majority of sterling-based fixed income funds in the portfolio was more negative for absolute performance.

The lack of exposure to both conventional UK gilts and UK index-linked gilts was very negative, as they produced solid, positive returns and outperformed UK corporate bonds. Fund selection within sterling credit (investment grade and strategic bonds) was negative overall, as only the Janus Henderson fund outperformed its sector average. Specific high yield exposure was negative, as the asset class underperformed higher grade credit, but the M&G Global Floating Rate High Yield fund did outperform its peer group.

Within global bonds the Templeton fund performed strongly, comfortably outperforming its peer group. Emerging Market Debt exposure was also positive with strong returns from the Pictet fund.

UK Equities

The portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main UK equity market plus the marginal underperformance of UK equities on a global basis.

The average IA UK Equity Income fund underperformed the main UK equity index this quarter, as larger companies outperformed mid-cap companies. Fund selection was negative overall, as the Premier fund performed in line with the IA sector average, the Marlborough, Threadneedle and JOHCM funds underperformed, the latter by a reasonable margin, and the Schroder fund comfortably outperformed. For the JOHCM fund, sector allocation was negative but stock selection was the main driver of underperformance, particularly in the Financials and Industrials sectors. The Schroder fund benefited from positive sector positioning across a number of different sectors and also positive stock selection.

International Equities

The average IA Global Equity Income fund outperformed the main global equity index by a reasonable margin this quarter. Fund selection was negative overall, as only the Fidelity fund outperformed the sector average, albeit by a significant margin. It benefited from positive sector positioning, particularly the overweight to Consumer Staples and Healthcare and underweight to IT, plus strong stock selection at both sector (Industrials, Financials and Consumer Staples) and regional level. The Artemis fund suffered from having too much exposure to cyclical stocks and sectors. The Saracen fund also underperformed by a reasonably large margin with the fund's more cyclical positioning a key negative.

Property

The BMO property fund continued to produce a solid, positive return and outperformed the sector average. The performance of the Threadneedle fund was affected by the move from an offer pricing basis to a bid pricing basis in December, which had a negative impact of approximately 6.1%.

Others

The VT Gravis fund produced a small negative return and underperformed the average UK commercial property fund.

Changes

In December we recommended switching from the Kames Investment Grade Bond fund to the **Artemis Strategic Bond** fund but, as per an e-mail from Mike Seddon on 4th December, this was to be delayed until this review. We continue to recommend this switch.

We would also like to recommend switching from the Premier Income fund into the **Premier Optimum Income** fund, a higher income fund with the same manager and the same underlying strategy that also uses a derivatives overlay strategy to generate additional income.

SRI Portfolios

Strategic Asset Allocations

We made some changes to the high level asset allocations in the first quarter of 2018 and we are not proposing any changes this quarter

Below are the current strategic asset allocation that became effective in February 2018:

Risk Level	SRI Cautious	SRI Balanced	SRI Progressive
Asset Allocation	**%**	**%**	**%**
UK Equities	12.00%	24.50%	33.50%
International Equities	11.50%	24.50%	29.00%
Specialist Equities	0.00%	0.00%	4.00%
Fixed Interest	74.50%	49.00%	31.50%
Cash	2.00%	2.00%	2.00%

The tables below show the model asset allocations of the SRI model portfolios, as at the end of December 2018, and the differences to the main strategic asset allocations:

Portfolio Allocations

Risk Level	SRI Cautious	SRI Balanced	SRI Progressive
Asset Allocation	**%**	**%**	**%**
UK Equities	9.00%	19.50%	27.00%
International Equities	14.50%	29.50%	39.00%
Specialist Equities	0.00%	0.00%	0.00%
Fixed Interest	74.50%	49.00%	32.00%
Cash	2.00%	2.00%	2.00%

Differences to SAA

Risk Level	SRI Cautious	SRI Balanced	SRI Progressive
Asset Allocation	**%**	**%**	**%**
UK Equities	-3.00%	-5.00%	-6.50%
International Equities	3.00%	5.00%	10.00%
Specialist Equities	0.00%	0.00%	-4.00%
Fixed Interest	0.00%	0.00%	0.50%
Cash	0.00%	0.00%	0.00%

Performance

All three portfolios produced negative returns and underperformed their respective composite benchmarks. Below are comments relating to positive and negative fund contributors.

Fixed Income

From an absolute return perspective, UK and global bonds were the best performers and produced good, positive returns whilst credit investments produced negative returns. The underperformance of sterling meant that sterling-based fixed income investments generally underperformed their overseas counterparts and that having mainly sterling-based fixed income funds in the portfolio was more negative for absolute performance.

Most ethical fixed income funds do not invest in conventional UK gilts or UK index-linked gilts, so this was very negative, as they both produced solid, positive returns and outperformed UK corporate bonds. Fund performance versus the respective sector averages was positive overall with only the Rathbone and Liontrust funds underperforming.

UK Equities

The portfolio underweight versus the strategic asset allocation was positive given the large negative return from the main UK equity market plus the marginal underperformance of UK equities on a global basis.

The average IA UK All Companies fund underperformed the main UK equity index by a reasonable margin this quarter, as larger companies comfortably outperformed mid-cap companies. This was particularly negative for ethical/SRI funds, which are typically very overweight to mid-cap and smaller companies. Only the BMO fund outperformed its sector average with large underperformance coming from the Kames and Standard Life funds. The former suffered from its more cyclical sector exposure and lack of exposure to sectors such as Mining and Pharmaceuticals but stock selection was the main performance driver. The latter also suffered from its natural sector biases (no Mining, overweight Industrials and Retail) and general exposure to more cyclical and high growth stocks such as Fevertree and Boohoo.com.

International Equities

The portfolio overweight versus the strategic asset allocation was negative given the large negative return from the main global equity market.

The average IA Global fund underperformed the main global equity index this quarter. The risk-off environment, including the general underperformance of small companies and higher growth stocks was a headwind for ethical/SRI strategies. This meant that fund selection was negative overall but there was a distinct positive from the significant outperformance of the Stewart Investors fund. It benefited from very positive sector/asset positioning, including the large overweight to Consumer Staples and a large cash position, plus positive regional allocations and positive stock selection within sectors and regions.

Changes

We are recommending the addition of one fund to the Cautious and Balanced portfolios, which is the **Threadneedle UK Social Bond** fund, to provide further, more specialist diversification within the fixed income holdings.

Summary

There are concerns about the outlook for global economic growth with many commentators believing we may have passed peak growth levels for this cycle. The ongoing US/China trade tariff negotiations will hopefully be resolved but with both sides unwilling to give much ground this cannot be seen as a given. If there is a positive resolution this should help risk assets and give Asian and EM equity markets in particular a boost. Geopolitics more generally has become more of a factor. The recent US mid-term election has led to a change of control in the US Senate, which should make it more difficult for President Trump to enact some of his more controversial/extreme policies, as has been seen with the budget negotiations for the Mexican 'wall'. The stand-off between Italy and the EU about the former's budget seems to have reached an amicable conclusion but this is something to monitor. There are demonstrations in France and there will be political change in Germany when Angela Merkel steps down, so Europe is likely to remain a relative hotbed of political activity.

The US has continued to raise interest rates into a period of strong economic growth but there are some concerns about the reduced effect of US tax cuts, and corporate debt levels have been rising. Any weakening in growth may cause the Federal Reserve to pause interest rate hikes, which would likely cause weakness in the US dollar, and would be positive for Asia and emerging markets. Inflation seems to be relatively well contained globally despite increasing wage growth numbers across different regions, with the structural factors of debt and demographics possibly putting a lid on significantly rising inflation, for now.

Our favoured asset class over the medium to longer-term is equities – they are looking much more attractive following the significant short-term falls. The fundamental backdrop of reasonable global growth and contained inflation remains positive, with valuation levels factoring in realistic levels of corporate earnings growth. The main concerns relate to the impact of further withdrawal of monetary policy support and/or the impact of higher interest rates and higher bond yields. We are slightly more positive on 'value' versus 'growth', supported by many of the same factors mentioned, although relative valuation levels have narrowed with the recent market falls.

Our favoured region remains Japan with reasonable economic growth levels (short-term weakness can be attributed to one-off factors), very attractive valuations both relative to their history and versus comparable markets, and ongoing monetary policy support. We are marginally positive on European equities, as markets have arguably over-reacted to the downside with valuations now looking attractive against earnings forecasts that look realistic. We are also marginally positive on Asian equities where the impact of the US factors could easily recede if US growth slows and, given current valuation levels and earnings expectations, this would be positive for markets. We retain a neutral view on US equities, as the market looks better value following the recent falls and corporate earnings are forecast to remain strong. The amount of money invested into passive strategies remains a potential issue and market returns are still being driven by a relatively narrow set of stocks and sectors, both positively and negatively.

We have moved to a relatively neutral position on UK equities, as the market is pricing in a lot of pessimism surrounding the Brexit outcome and any indicators to the contrary could be very positive for the stock market. Many businesses are reluctant to commit to longer-term spending plans and some are making contingency plans that are affecting the value of sterling versus other currencies, particularly the US dollar. Currency weakness is positive for a large part of the UK market due to the level of overseas revenues but should negotiations go better than expected then sterling could strengthen and domestic stocks could perform well, so a balance of exposure is appropriate.

In fixed interest we are relatively negative on investment grade credit and high yield, as spreads remain relatively tight versus government bonds, making them vulnerable to any increase in the underlying government bond yields plus any further widening of credit spreads. The high yield asset class has a higher correlation to equities, corporate leverage levels have increased in places and higher bond yields/interest rates may affect some companies' ability to repay their debts and achieve future refinancing at acceptable rates. Government bonds had a strong quarter with yields moving much lower and we continue to believe credit offers a better risk/return than government bond markets. UK government bonds is our least preferred sub-asset class, as yields levels moved much lower this quarter and remain unattractive – we are negative on global sovereign debt as a whole, but would prefer to take global exposure due to the greater opportunity set.

The significant falls in equity markets have provided investors with a greater margin of safety due to much better valuation levels and, combined with reasonably good fundamentals, the entry point for equities is much more attractive. Risk still needs to be considered, as when an economic downturn does occur high levels of leverage are likely to impact negatively, and operational gearing for some companies will have risen. This suggests investors should continue to hold diversified portfolios rather than trying to win by making a few big calls. There remains the possibility of policy mistakes by central banks and whilst it is accepted that the sensitivity of the global economy to a rise in interest rates has increased, it is impossible to measure the extent of this.

Stewart Smith
Investment Research Manager
RSMR
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