R.C. BROWN
investment management plc

MARKET COMMENTARY NEWSLETTER

Q1 2019

Welcome to the new look Market Commentary Newsletter for 2019. The eagle-eyed amongst you might have noticed that we didn't publish one in Q4 2018, this was for various reasons, one of which was every time we tried to put pen to paper the markets went and made our prose somewhat irrelevant. So now that things have calmed down a little, we hope you like the revised layout.

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New for 2019

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AIM / IHT Portfolio Service

Following a specific client request in May 2018, we created a portfolio that only invests in AIM listed companies that qualify for business relief, and therefore has the potential to be exempt from Inheritance Tax (IHT) after 2 years.

We are delighted to announce that we are now making this service available to all Advisers and their clients.

Co-managed by Oliver Brown & Neil Whelan, the new service starts from £50,000 and follows our existing charging philosophy of an inclusive fee, with no upfront costs or additional trading or custody charges. The cost is a flat 1.25% pa + VAT, calculated at the end of each quarter.

"We have 20 years' experience of actively investing in AIM listed companies, through our involvement in IPO's and fund raisings, so are fully aware of the growth potential but also the pitfalls in the market" Oliver Brown said.

Neil Whelan added "The AIM market carries greater liquidity risk, so clients need to have taken professional advice before entering into such a scheme, but we are confident that we have the expertise to deliver a diversified portfolio at a very competitive cost"

Each portfolio will consist of 25 – 35 shares and will typically invest when companies are looking to raise capital. This is an example of the holdings in a genuine client portfolio as at 31st December 2018 (stock selection and sector weightings for a new client portfolio may be substantially different from this illustration):

Angling Direct Ord 1p
Applegreen Plc Ord Eur 0.01
Arena Events Group Plc Ord 1p
ASOS Ord 3.5p
Boku Inc Ord USD0.0001 (DI) Reg S
Breedon Group Plc Ord NPV
Brooks Macdonald Group Plc Ord 1p
Centralnic Group Ord 0.1p
Clinigen Group Plc Ord 0.1p
Codemasters Ord 1p
Creo Medical Group Plc Ord 0.1p
Diversified Gas & Oil Ord 1p
Eddie Stobart Logistics
Fevertree Drinks Plc Ord 0.25p
Fulcrum Utility SE Ord 0.1p
Gamma Communications Plc Ord 0.25p
IG Design Group Ord 5p
Imimobile Plc Ord 10p
Johnson Service Group Plc Ord 10p
Joules Group Plc Ord 1p
Knights Group Holding Ord 0.2p
Manx Telecom Ord 0.2p
Marlowe Plc Ord 50p
Mercantile Ports & Logistics Ltd Ord NPV
Midwich Group Plc Ord 1p
Premier Asset Management Group Plc Ord 0.02p
Premier Technical Services Group Plc Ord 1p
Rosenblatt Group Plc Ord 0.2p
Shearwater Group Plc Ord 1p
Strix Group Plc Ord 1p
The SimplyBiz Group Plc Ord 1p
Venture Life Group PLC Ord 0.3p

For more information, please either go to the dedicated page on our website (click here) or contact Robert (0770 294 2690) or Wayne (07734 693971).

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The World According to Glenn………….

Glenn Meyer
Head of Managed Funds

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A little while before Christmas I suffered the ignominy of having to report to my wife that I had managed to lose more than 10% of the value of her portfolio in just a few short months. Oh, thank you ESMA for creating such a short term focused and complex piece of regulation and thank you especially for introducing it after markets had clawed their way up and out of the financial crisis of 10 years before and were thus much more likely to see big falls at the end of the economic cycle.

When preparing myself for the inevitable kicking I considered to be my well deserved due I searched out, and found, an old school-style exercise book. As a portfolio manager with more than a few years experience, I am well aware of the need always to have some downside protection. In this instance, I was also concerned with protecting my backside and before I slipped the exercise book into the back of my trousers in order to cushion the blows of righteous wifely indignation, I made a few notes to explain why I'd got things so badly wrong. I'm pleased to tell you that, having explained why her portfolio was positioned in the way it was and the long term potential benefit from a high equity exposure when interest rates are rising, I have not had to invest in a standing desk and, just like Thomas the Tank Engine, I don't have a tender behind. This piece is the essence of my grovelling apology.

2017 was a stellar year for markets and better still, it was a year in which our portfolio positioning and fund selection added considerable value. Over many years I have learned that a trend doesn't last for ever and that it is prudent to take some profit on a regular basis and to reinvest by adding to areas that have been out of favour. This strategy has the dual benefits of not allowing one section of the portfolio to become so big that if anything goes wrong you are looking potential disaster in the face. It also ensures that if and when the out of favour areas begin to attract new buyers because they represent good value, that the starting position in the portfolio is big enough to make a difference. Having identified that US equities were expensive relative to their forecast growth and after wondering whether some US tech stocks were entering bubble territory, profits were taken throughout 2018 and the profits were reinvested into European equities, where valuations were low relative to the quality of the underlying businesses.

This was wrong on both counts. Yes, the US market was expensive, but ten years of QE and financial repression had distorted normality to such an extent that we were fooled by the interplay of US Fed market guidance and Trump's protectionist sabre rattling. Our view was that the greatest risk to markets came from the planned reduction of the Fed's balance sheet coupled with US interest rates rising back to somewhere approaching "normal" causing a sharp fall in US bond prices and an increase in the cost of borrowing for corporates. To us, this scenario meant that US bonds were best avoided (not a bad call) and that an already expensive US equity market looked increasingly unattractive when growth was likely to be slowed by rising interest rates. What we didn't expect was a politically motivated stimulus package at the tail end of a long slow growth cycle. Having been wrong footed by the politics, we were tripped up by the wall of money flooding into the US, largely from selling emerging market investments, on the back of $ strength.

US protectionism also affected our positioning in Europe. The imposition of tariffs was largely aimed at hurting China, which it did. Any self respecting mature western democracy would bite your arm off for the chance to report 6% economic growth, but when China delivered this it was met with a universal raspberry, as 6% was achieved on the way down from a peak of more than twice that. And all those German car purchases that aspirational Chinese consumers had set their hearts on had to be deferred. The impact on the German economy, and European stock markets, meant that our normally robust process of rebalancing was hit by a double whammy. And we suffered. Until December.

In December the US equity market did a pretty good impression of Icarus escaping with his father from imprisonment by King Minos. Having flown too close to the sun, the wings came off and the market crashed into the sea. The fall was such that forward valuation multiples once again looked reasonable and we have started rebuilding our US equity position. There has been a change to one of the funds we use. The Artemis US Smaller Companies fund has a focus on domestic rather than international businesses and replaces the Jupiter North American Income fund, which was sold when Sebastian Radcliffe left. We are happy to have had the opportunity to buy back in to the US after the fall, and in a relatively defensive area to boot, and even happier to have seen some benefit from the nascent recovery thus far.

Meanwhile, being of a mature vintage (drinking well but not yet at it's best, according to my cellar notes), we continue making steady progress and fly Daedalus like (not too close to the sun to melt our wings or too close to the sea to get our feathers bogged down) on to a place of relative safety.

Despite our objective of always wanting to maintain a broadly diversified portfolio with exposure across as many asset classes and geographies as is practical, we have also reduced exposure to commercial property. The role of property in our portfolios has long been one of introducing exposure to an asset with relatively low correlation to equities. The rental income is only small but keeping property in the mix reduced the overall portfolio volatility. However, the FCA has questioned (perhaps rightly) whether retail investors should take exposure to an illiquid asset (i.e. commercial buildings, which tend to change hands only infrequently and then in expensive lumps) through buying an open ended fund with daily liquidity. As professional investors, we have always monitored the amount of cash held in a property fund before buying or selling units and we also consider carefully whether any transaction we make will be likely to trigger a dilution levy. But the regulator's policy of seeking to protect idiots from themselves, by questioning whether retail investors should be allowed to buy open ended property OEICs, led us to believe that the likelihood of funds being gated has gone up. So we have reduced the risk of being stuck in something we want to sell, but acknowledge the portfolio volatility has gone up marginally as a result because it is less well diversified. We have considered whether our property exposure should be through holding some of the large closed ended funds, but the jury is still out on this as we can imagine a situation where the price paid for immediate liquidity is a huge discount to the published asset value of the fund. We have also done some work on whether holding property shares would be a suitable alternative to open ended funds. We remain concerned that in the short and medium term the correlation of property shares is mainly to movements in the stock market. Only in the long term does the performance of a property share correlate more to the commercial property market. We will always encourage investors to take a long-term view of investment but it doesn't help them if they have an unexpected need to raise capital and both their equity and property exposure has been hit by a short-term market fall. So, for the time being, we believe the right response is to maintain a low exposure to commercial property through a large open ended fund with good liquidity.

Looking to the future, we believe that after the recent correction the UK equity market is as cheap as it has been for many years and that the potential for multiple expansion when international investors come back to the UK when our political leaders have ended their game of political Hokey-Cokey over Brexit is huge. I have a feeling that whatever is done to break the logjam needed to reach a decision acceptable to parliament, the UK will be poorer in future than it need have been if things had been handled differently. I also believe there will be long lasting divisions between those who wanted to be either in, out or to shake it all about. But the great news is the huge level of uncertainty around Brexit has frightened away international investors in droves, so that when we do whatever we decide to do, the high degree of certainty that positive macro growth expectations will be delivered or exceeded will see our home market rise strongly. It's even possible that in the doom and gloom of the current infighting that bottom up profits growth forecasts will need to be upgraded. And there is already some potentially good news on this contained in recent unemployment stats.

Apparently, more of us Brits are working than ever before and the percentage of the working age population with a job is at the highest level it's ever been. In the past, when employment fell below about 4% the Phillips Curve kicked in and wages started to rise rapidly, putting money in consumer's pockets and stimulating yet more growth (and inflation) through an increase in the velocity of circulation of money through the economy. Recently the long-term relationship between unemployment and wage growth has apparently broken down and economists started to worry whether central bankers would ever be able to deflate away the value of the debt they took on to save us from the financial crisis. Inflation has been stubbornly low for a long time now and if the NAIRU (non accelerating inflation rate of unemployment), a sort of long term Phillips Curve, also showed signs of flatlining at close to zero, what hope is there of getting growth back up to the levels needed to pull us out of the excreta? David "Danny" Blanchflower, ex of the MPC and currently a professor at Dartmouth College, may have hit on something interesting. He and David Bell have written a lot on the economic effects of underemployment (ie where lots of people have a job but don't work for long enough and/or don't get paid enough to sustain a decent standard of living). They have postulated that the possible breakdown of the relationship between the rate of unemployment and the rate of wage rises is because of the impact of the "gig economy" where, because of the reverse auction effect, the lowest bidder wins the work. They also identified the fall in US owner occupancy as a reason for low wage growth stating, "We also find evidence for the US that falls in the home ownership rate have helped to keep wage pressure in check. Underemployment replaces unemployment as the main influence on wages in the years since the Great Recession." (Source: NBER Working Paper 24927).

We think it's more likely that the effects of QE constrained mortgage lending pushed up asset prices to levels where low paid employees could no longer buy (or continue to own) property but their lack of willingness to ask for a pay rise has probably more to do with the "gig economy" than anything

else. Blanchflower may have found an interesting correlation but there is less likely to be a causation between low owner occupancy and lack of negotiated wage rises.

However, back to wage and, by implication, productivity growth. The shift to a low cost employment model has potentially profound implications for long term aggregate growth. There may be an analogy with Keynes "paradox of thrift" in that although an individual employer may benefit from low pay rates for staff, the aggregate growth of the economy will be lower than the optimal rate if workers cannot afford to consume as much as they would if their disposable income (ie after subsistence costs) was greater. Henry Ford was well aware of this constraint on growth and ensured that Ford employees were paid enough for them to buy the products they made.

Data recently published in both the UK and US suggest that only at very low rates of unemployment does the Phillips Curve now begin to work, but the good news is that we may be close to that level. So, in order to stimulate growth, I am advocating paying a well trained full time workforce a high and (preferably growing) salary while also investing in productivity enhancements. By dint of growing productivity markets will recover and the UK market is well placed to be one of the best performing major markets. Client portfolios are already set up to benefit from this and the yield they receive rewards patience, but recovery is unlikely to be linear and predictable "it won't be easy, you'll think it strange". (Ah, the lyrics of Tim Rice are so apposite if taken out of context.)

How we have performed (as at 31st December 2018)

Private Client portfolio past performance data
As at end December 2018
(FOR PROFESSIONAL ADVISERS ONLY)

Risk category		3mths	12mths	3 Years	5 Years
Cautious	**Managed Funds**	**-7.01%**	**-6.24%**	**10.92%**	**23.57%**
	Direct	**-5.59%**	**-6.08%**	**12.55%**	**22.66%**
	**FTSE Private Investor Conservative*	*-2.17%*	*-1.37%*	*18.57%*	*32.30%*
Cautious Balanced	**Managed Funds**	**-8.81%**	**-7.66%**	**13.25%**	**26.00%**
	Direct	**-7.11%**	**-6.92%**	**18.35%**	**27.59%**
	FTSE Private Investor Income	*-4.35%*	*-2.79%*	*21.16%*	*33.36%*
Balanced	**Managed Funds**	**-9.75%**	**-8.22%**	**17.16%**	**29.05%**
	Direct	**-8.67%**	**-8.02%**	**20.54%**	**30.76%**
	**FTSE Private Investor Balanced*	*-5.66%*	*-2.84%*	*24.46%*	*37.45%*
Balanced Growth	**Managed Funds**	**-10.88%**	**-9.21%**	**17.39%**	**29.82%**
	Direct	**-9.13%**	**-9.24%**	**20.53%**	**29.42%**
	**FTSE Private Investor Balanced*	*-5.66%*	*-2.84%*	*24.61%*	*37.45%*
Growth	**Managed Funds**	**-8.84%**	**-6.72%**	**22.43%**	**35.68%**
	Direct	**-9.16%**	**-8.52%**	**22.39%**	**29.43%**
	**FTSE Private Investor Growth*	*-7.40%*	*-3.80%*	*27.72%*	*40.03%*
Market data					
	ARC £ Balanced	*-5.67%*	*-4.22%*	*13.14%*	*22.77%*
	ARC £ Steady Growth	*-7.42%*	*-4.80%*	*18.42%*	*29.20%*
	ARC £ Equity Risk	*-8.39%*	*-5.02%*	*22.63%*	*32.76%*

ARC (Asset Risk Consultants) are an industry provider of research and peer group portfolio performance reporting. ARC returns have been adjusted to a "before fees" basis

(After all underlying fund charges, but before RCBIM fees, * the benchmark is the relevant corresponding FTSE Private Investor Total Return)

This document is for general information only and is a representative sample of our client base, across all risk profiles as defined by RCBIM. It does not take into account the specific objectives, circumstances or needs of any individual. It is not a personal recommendation and should not be regarded as a solicitation or an offer to buy or sell any of the investments or services referred to. The views expressed are opinions only and are subject to change without notice. RCBIM cannot guarantee the accuracy or completeness of any information on which its opinions are based. Past performance is not a reliable guide to the future. The value of investments and the income from them can go down as well as up and investors may not get back the amounts originally invested.

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