For clients

Q1 2018 rebalancing rationale

All models

This document summarises recent changes made to Thesis model portfolios. These changes were also recommended for Thesis clients with bespoke portfolios, and our investment managers will have considered and implemented the changes according to the individual objectives of each client.

This data reflects the current model as invested via Thesis nominee companies. As far as possible, model holdings are replicated on all investment platforms. Where the model cannot be replicated exactly (for example where a specific investment is unavailable for trading), a substitute holding will be used. This may affect asset allocations and performance.

Markets overview

Concerted growth has boosted equity markets
For the first time in many years there is a good level of economic growth in all the major regions of the globe. Europe is seeing an upswing in optimism and output, with spare capacity that has persisted since the financial crisis now being utilised. Emerging markets continue to see strong output, having not been disrupted as much as many feared by the level of the dollar or by President Trump's trade rhetoric. Japan and the UK are also doing well, boosted by overseas earnings. The US might be expected to begin to grow more slowly, as it is further through the recovery phase of its cycle and its interest rates are on an upward trajectory. Monetary policy remains relatively supportive however, and President Trump aims to implement growth-supportive policies. Chief among these are his programme of tax cuts, which were passed by Congress in December and include significantly lower corporate tax rates and incentivise companies to bring offshore profits back to the US.

Volatility squeeze and market correction
The volatility of equity indices has been at very low levels, however the volatility of individual stocks has been considerably higher. Companies whose results fail to beat expectations have frequently seen significant falls. This has been exacerbated by thin trading volumes. Stock selection is challenging at this stage in the cycle, when high quality stocks trade at expensive valuations.

February saw a correction of roughly 10% across equity markets, together with smaller movements in bonds and a significant spike in implied volatility which has resulted in a shake out of many investors that were holding short volatility positions. We have used the correction to add a moderate amount of cash into equity markets. Reasonable cash balances remain which could be deployed should equities fall further, but the higher weighting at this point gives the potential to benefit from any recovery. We have targeted the increases in the UK, Europe and Japan, seeing them as representing better value and/or growth prospects than global equity markets as a whole.

Monetary policy slowly returns to normal
Monetary policy remains an important influence on markets, but most major central banks are now cutting back their stimulus. The European Central Bank (ECB) has halved its rate of bond purchases from January, although the programme has been extended to at least September. The Federal Reserve raised interest rates again in December and is starting to reverse its quantitative easing (QE) programme. The rate rise in the UK at the start of November was widely expected and reversed the exceptional stimulus that was put in place after the EU referendum. Further rises are now on the agenda again, despite the potential political headwind from EU exit. The removal of the enormous stimulus that has been pumped into markets in recent years is an unprecedented event. So far it has been communicated well by the central banks and caused only modest falls in bond prices, however we remain cautious in our bond holdings. There is a significant risk that if the market's interest rate expectations head higher, bond prices could suffer significant falls.

Alternative assets continue to provide opportunities
We are more positive about the yields available from commercial property and infrastructure, believing that returns in these areas remain well supported by demand. The collapse of Carillion was concerning. Its ramifications for our infrastructure fund selections, which are more conservatively managed, are limited however. There is even a possibility that infrastructure investors could benefit from Carillion's demise, as its contracts are auctioned to other providers, potentially at higher yields.

We have instituted an allocation to gold for the first time in several years. It provides exposure to an asset with interesting diversification benefits and supportive technical indicators at the present time.

Sterling confidence has been justified
Sterling bore the brunt of adjustment for the UK following the EU referendum, falling significantly versus other currencies. We believed that the pessimism was too great and the pound had become over-sold. We have therefore maintained an overweight exposure to sterling in the expectation that as the terms of Britain's withdrawal from the EU become clearer, the pound was likely to appreciate. This has been the case in recent weeks, aided by a general weakness in the dollar. We have taken the decision to remove the remaining currency hedge from our European equity exposure, and the increased equity weightings and gold exposure also serve to reduce our overweight allocation to sterling.

Funds	Action taken	Models affected	Rationale
Fidelity MoneyBuilder Income	Sale	Securities 3-5 Collectives 1-5	After 30 years of falling interest rates, inflationary pressures in the USA are likely to drag global interest rates higher. Although the Fidelity fund has provided solid returns, and has taken some action to reduce its vulnerability to rate rises, we have decided to switch to another fund which, although providing less income, should provide more defence to capital if rates increase faster or higher than expected.
Vontobel 24 Absolute Return Credit Fund	Purchase	Securities 3-5 Collectives 1-5	Although the title suggests it uses a variety of derivative strategies, in essence the fund has a fairly straightforward approach in seeking to minimise volatility and capital loss. Around two thirds of the fund is invested in shorter dated investment grade bonds where stock selection is key and where the interest provides the bulk of the returns, however the manager has the flexibility with the remainder to use higher yield, longer dated or asset backed bonds. The manager is highly experienced, and extensive historical back testing suggests the process is resilient even in times of market declines, so the fund should provide both protection and useful returns in a rising interest rate environment.
Old Mutual Gold and Silver	Purchase	Securities 1-7 Collectives 1-7	Gold is an asset with interesting diversification benefits and supportive technical indicators at the present time. Our chosen holding is the Old Mutual Gold and Silver Fund, which blends highly secure bullion holdings with gold equities and seeks to vary the blend of bullion vs equities and gold vs silver to optimise its exposure over varying market conditions.
Fulcrum Income	Purchase	Securities 1-4 Collectives 1-4	This fund aims to generate absolute returns, including an income yield of 4.5% above the Bank of England base rate. Fulcrum's culture is centred on an analytical approach, a plurality of idea generation and an overall focus on risk control. The yield is gained via a natural income tilt to the holdings where possible, boosted by an option-writing strategy. By investing into the new fund at launch, Thesis has gained access to a very attractive fee rate.
Securities	**Action taken**	**Models affected**	**Rationale**
Micro Focus	Sale	Securities 3-7, UK Equity Strategy	Our view had been that a key attraction of Micro Focus was its long-term stickiness and cash generative nature of its products. Its $8.8 billion purchase of Hewlett Packard's Enterprise software business in 2017 however changed this rationale. To buy a business that is in decline and turn it around is going to be an uphill struggle. Recent results have confirmed our apprehension regarding the size of the integration challenge and with the possibility of further disappointment

			down the line we are taking the opportunity to sell.
Berkeley Group	Sale	Securities 3-7, UK Equity Strategy	Its astute investment in land post the financial crisis has been delivering good margins and returns. While this is testament to the quality of management, the key issue from here is the trading outlook and what the fundamentals look like over the medium term for Berkeley's key markets.
NEX Group	Purchase	Securities 3-7, UK Equity Strategy	NEX has become a focused financial technology business following the sale of its voice broking business to TP ICAP. It offers customers better ways to execute trades and manage risk with its products and services that underpin the entire trade lifecycle, pre, during and post execution. It is capital-light and operationally leveraged, allowing organic growth to deliver good margin expansion. While NEX has done a good job of increasing revenues generated from subscriptions in difficult market conditions, it now looks well placed to benefit from increased trading activity as FX and rate volatility picks up.
Rio Tinto	Purchase	Securities 3-7, UK Equity Strategy	Robust global growth presents what we believe to be a strong backdrop for commodities. Increasing our exposure to commodities as a late cycle play provides the additional benefit of inflation pass through. We are impressed with Rio's careful deployment of capital, with the big miner looking through the current upcycle and unwilling to risk capital efficiency (value creation) just to add more volume growth. We think Rio is a high quality producer with key sector exposure and the best balance sheet amongst its peers. It also has the clearest focus on shareholder returns.
Phoenix	Reduction	Securities 3-7, UK Equity Strategy	Phoenix's recent AXA Wealth acquisition is bedding in nicely and delivering cost synergies ahead of expectations. We are taking the opportunity to top slice the holdings as we await further strategic direction as to whether it will remain a closed fund consolidator, or seek to enhance future growth.
Lloyds	Increase	Securities 3-7, UK Equity Strategy	Increasing interest rates are likely to benefit banks, which have seen their profitability squeezed in recent years by low margins between borrowing and lending rates and by provisions for previous misconduct. Lloyds remains our favourite stock in the sector. Its focus on UK commercial and retail banking together with streamlining of technology and processes puts it in a good position for faster growth from here on. The shares remain at a reasonable valuation with an attractive dividend yield however, so we have increased our weighting.