Q2 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

Mostly business as usual
After their falls during the first quarter, equity markets mostly turned positive again around the end of March and have recovered most of what they had lost since the start of the year. US economic data is still supportive, with initial Q1 GDP coming in at 0.6%, for an annualised rate of 2.3% (versus 2.7% for 2017) and lower initial jobless claims numbers. There does appear to be some fracturing of the synchronised global growth story this year, but with these US numbers and China reporting 6.8% GDP growth, the two main engines of global economic activity appear to be ticking over nicely. With the trade war rhetoric between these two countries easing off and scandals such as the Facebook / Cambridge Analytica face-off blowing over, investors' nerves have calmed down and they have focused once more on fundamentals.

In advance of an expected May rate hike in the UK, Sterling traded at its highest level against the dollar since the Brexit vote almost two years earlier. However, dovish comments from Governor Mark Carney in the run-up to the MPC meeting, along with softer inflation data, reduced the odds on a rate rise significantly and Sterling began to sell off. This boosted the performance of the largest companies in the UK market, which derive the majority of their earnings from overseas. In the event, the MPC voted 7-2 to keep the base rate at 0.5%.

Falling inflation but rising oil price
The latest numbers showed annual UK CPI inflation at 2.5% and wage growth at 2.8%, which means wages are now outpacing inflation for the first time in a year. The Bank of England's inflation report revealed a forecast for inflation to fall to 2.1% in a year's time.

The US, France and UK bombed research centres in Syria in response to the Assad regime's use of chemical weapons; however the strikes don't appear to have escalated tensions very much and the only real market impact was on the oil price. President Trump's new sanctions on Iran and comments regarding OPEC also pushed up the price of oil, with Brent crude rising to over $70 a barrel by the end of the period. Combined with a weaker Sterling, that could put a real dent in the Bank of England's inflation forecasts.

Repositioning in alternative assets
February's spike in volatility showed that equity and bond prices can fall together, which makes it all the more important to be positioned defensively in fixed interest. Other than that, we added to our exposure to gold and sold some of our UK commercial property investments to take advantage of lower prices amongst infrastructure assets. Growth has slowed a bit, which has boosted asset values on reduced expectations of interest rate hikes, but is also a worry when rates are already historically low and central banks have few tools left to fend off any recession. We are mindful that we are now in the late stages of this prolonged economic cycle.

Funds	Action taken	Models affected	Rationale
Legal & General Sterling Corporate Bond Index Fund	Sale	Securities 1-2 Collectives 1-2	Upward pressure on US interest rates is likely to have global implications. We sold this tracker fund to reduce portfolios' overall vulnerability to possible UK rate rises.
Royal London Corporate Bond Fund	Reduction	Securities 1-5 Collectives 1-5	Although a rise in UK interest rates has been deferred for now, this fund has a higher sensitivity to rate rises so we have switched some of our holding to "strategic" bond funds, which have a more global focus and a wider range of options to cope with rising rates.
24 Dynamic Bond Fund	Sale	Securities 1-5 Collectives 1-5	This fund has performed well, but we have decided to reduce our exposure to 24 Asset Management as a fund house. We have two other specialist funds with them and this fund is more easily replicated elsewhere.
Investec Global Total Return Credit Fund	Purchase	Securities 1-5 Collectives 1-5	This fund invests globally in corporate bonds, mostly with relatively high yields, and is likely to yield around 4.5%. It can take an unconstrained and dynamic approach to adapt to changing economic conditions, and is currently defensively positioned ahead of expected interest rate rises. This is a new UK version of an existing fund, and Thesis has obtained access on attractive terms.
Artemis Strategic Bond Fund	Purchase	Securities 1-3 Collectives 1-3	This fund is similar to the 24 Dynamic Bond Fund and is run by an experienced manager we have known for a long time. Although the fund can invest in both government and corporate debt, the manager is currently cautious on US and European government debt, preferring higher yielding and financial company bonds.
Stewart Investors Global Emerging Markets Sustainability Fund	Sale	Securities 4- 7 Collectives 4-7	Stewart Investors have a sound record of investing in Asia and other emerging markets. That success, however, means that they are now having to restrict their choice of investments to larger companies and 8% of this fund is in Unilever. This was diluting our exposure to the exciting opportunities available and have switched to funds with greater exposure to those. A recent pull-back in prices presents an opportunity to switch the emphasis in our portfolios.
Aubrey Global Emerging Markets Opportunities Fund	Purchase	Securities 5- 7 Collectives 5-7	This fund provides the contrast we wanted to the Stewart Investors fund, which it replaces in our higher risk models. It has a greater emphasis on mid-sized companies targeting the growing middle classes in China and India in particular, such as better food, housing, transport, healthcare, education, entertainment, and lifestyle. Aubrey is an Edinburgh-based boutique, with experienced managers.

Legg Mason RARE Global Infrastructure Income Fund	Sale	Securities 1- 7 Collectives 1-7	This fund has proved to be more volatile than anticipated, falling more than expected in the general market weakness earlier this year. For Securities models, we currently prefer the investment trusts INPP and 3i Infrastructure, with their direct holdings in underlying projects rather than equities, which this fund holds. The daily stock market volatility could make those equities more vulnerable to rising interest rates.
Lazard Global Listed Infrastructure Equity Fund	Purchase	Collectives 1-3	We have reintroduced this fund in lower risk portfolios to provide further diversification. While it has a greater exposure to equities than the equivalent VT Gravis fund, the managers have positioned the fund in anticipation of higher interest rates, so we would expect it to prove relatively defensive in any market downturn.
Legal & General UK Index Trust	Sale	Securities 2-7 Collectives 2-7	This fund, tracking the FTSE All-Share Index, has been a useful tool in the portfolio by providing beta (exposure to general market movements) when most of the market has moved in unison and volatility has been historically low. We think this picture is changing, with the difference in performance between the winners and the losers becoming more severe. This should create better opportunities for active managers to outperform an index.
RWC UK Focus Fund	Purchase	Securities 2-7 Collectives 2-7	This is a concentrated portfolio that has delivered superior long-term capital growth. The manager continues to position the portfolio towards companies that should benefit from a stronger global economic backdrop and which have management teams working hard to enhance shareholder returns.
Russell 2000	Sale	Securities 6-7 Collectives 6-7	This US smaller companies index has performed well as expectations of higher earnings from President Trump’s tax reforms have fed through to equity prices. At the index level, we are more cautious on the prospects of companies that borrowed heavily for short term gains while rates were low. As interest rates continue to rise, refinancing the debt will hurt earnings. Margins will also come under pressure from wage inflation, so we prefer to allocate to active managers, who are better placed to navigate this environment.
Miton US Opportunities Fund	Purchase	Securities 4-7 Collectives 4-7	This responsive and nimble multi-cap fund is very different to most US funds as it doesn’t hold any of the 10 largest companies of the S&P 500 in its top 10 holdings. The manager is positioning the portfolio to benefit from the strong domestic economy with a “Made in USA” theme by being overweight in Industrials, Financials and Consumer Discretionary stocks.

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NEX Group	Sale	Securities 2-7	US exchange operator CME Group offered $5.5 billion to buy NEX Group to create a cross-border powerhouse for investors trading foreign exchange and government debt. With the share price reflecting a high probability of success, we took the opportunity to bank the proceeds.
Just Group	Purchase	Securities 2-7	A decline in individual annuities sales due to the pension freedoms has meant many companies have exited the market, creating attractive opportunities for retirement specialists like Just Group. The merger of Just Retirement and Partnership has also accelerated a move into the defined benefit (de-risking) market, which has been particularly successful, having grown its market share in that area over the past two years.
Smurfit Kappa	Sale	Securities 2-7	Smurfit Kappa, Europe's largest paper packaging producer, rejected two bids from US-based International Paper. With a lack of engagement by the Irish company's directors and management, we saw little prospect of the deal proceeding and decided to lock in the bid premium.
British American Tobacco	Purchase	Securities 2-7	Sentiment towards tobacco has turned increasingly negative over the past year and the sector has materially underperformed the broader market. With the rationale behind some of the challenges the sector faces more than priced-in to valuations, we think this makes for a good entry point.