Arrow Financial Services

SQUARE MILE
INVESTMENT SERVICES

Market and Portfolio Update

Financial markets were remarkably composed over the quarter and brushed off several potentially destabilising situations. However, as happened in the second quarter, much of the positive progress faded towards the end of the period. The Bank of England has put markets on notice that interest rates will be raised shortly and this both knocked government bond prices and lifted sterling in the foreign exchange markets. The strengthening pound reduces the value of the international businesses that constitute the main body of the portfolios' equity component. Fortunately, we hold no UK government bonds in the portfolio and our fixed income positions made small but steady advances. The portfolios eked out a positive return as a result over the quarter.

We are unsurprised by the slow progress made so far in the Brexit talks. Time and time again in EU negotiations, decisions are only agreed upon as deadlines loom. We expect the ongoing discussions to become fraught at times, and even once the talks have been finalised, it will be very difficult to work out what the practical implications will be. Share prices of businesses reliant on the UK economy are typically cheaper than those more focused internationally but we fear that there is potential for domestic stocks to underperform further. We believe that we can make reasonable returns from more internationally focused firms, which are not saddled with the Brexit uncertainties and we are biasing the portfolios towards these names.

The situation with North Korea is serious but hopefully containable. The North Korean leadership must be delighted with Trump's reaction to the crisis since this merely reinforces domestic support. North Korea has been a nuclear power for almost a decade and while this is deeply disturbing, if America could do anything about it, it would surely have done so by now. What is fascinating to observe is the geopolitical implications that this crisis brings. In Japan, Abe's premiership has been weakened by scandals this year but he has taken advantage of the crisis and called a snap election. He has a long cherished aim to re-militarise Japan and this is likely to be a central policy for his campaign.

Calm markets despite potentially unsettling events

From its outset, we did not have great expectations from the Trump Presidency but even we have been disappointed by his lack of progress so far. Trump has a clear mandate to shake up some of the vested interests entrenched in the American political system but so far his handling of the reins of power has been woeful. Towards the end of the quarter, he put forward proposals for long overdue tax reform. The American tax system is monstrously complex (there are more professional tax preparers than police officers in the US) and there is crying need for simplification. This would help the American stockmarket and we can only hope that Trump's Administration has the wherewithal to get this done.

We are conscious that this quarterly review is rather longer than usual. The next few paragraphs describe some of the funds that are held in your portfolios. These are intended to both highlight some of the challenges we face and provide a little more colour of our underlying investment approach. If wished, you can jump to the outlook in the final paragraph of this review with little interruption to the narrative.

The dollar has been considerably weaker this year. US interest rates have gradually been pushed higher, however, the market is beginning to price in a slowdown in the pace of rises and now only expect the Federal Reserve to make one or two quarter point rises by the end of next year. In contrast, the rebound in the European economy has increased expectations that the quantitative easing programme can be drawn in. This currency move has not been particularly helpful for the portfolios, which are more biased towards the dollar than the euro. However, it has been helpful to the performance of the portfolios' emerging markets positions and the recently purchased M&G Emerging Markets Bond fund has made an encouraging start, growing by 2.7% over the quarter.

Some of the underlying fund positions have not fully captured the rise in markets. Stewart Investors Asia Pacific Leaders has lagged the strong growth in markets in Asia this year. These markets have been led higher by several large internet stocks such as Baidu and Alibaba, the Chinese equivalents of Google and Amazon. We use Stewart Investors because they are conservative investors who favour investments in established sustainable businesses that are reasonably valued. Stewart Investors avoid glamorous market darlings such as internet stocks yet still have built one of the best long term track records in the industry as a result. It is not unusual for their approach to lag in markets such as these.

The Polar Capital Global Insurance fund invests in property and casualty insurance companies that are principally based in the US. These rather dull businesses provide products such as home insurance and personal liability policies. The fund price was impacted by the large hurricanes that devastated the Gulf Coast of the US. The actual exposure of the fund's current holdings is actually very small to such events nevertheless the entire insurance sector was marked down in the aftermath. Half of the 6% dip suffered in early September has already been recovered and we expect the fund to catch up with the market once sentiment towards the sector improves.

The CF Woodford Equity Income fund has also suffered a rocky couple of months. A number of the fund's investments have suffered from specific problems. Rather like London buses, these have come all at once and has left the manager looking rather accident prone. Neil Woodford is a high profile manager and there have been many articles in the financial press and on line expressing concern about the recent performance. Many investment managers are criticised, rightly so in our view, for generating average performance. If you wish to generate a different performance you must invest with a different approach. Woodford invests in a contrarian manner to the market consensus and builds positions in cheap shares that are widely avoided by other investors. This approach has generated an impressive track record going back 25 years but the process is not infallible and from time to time the fund goes through embarrassing spells such as these. Investors typically have short memories; only in June was Woodford feted for being the number one investor in the sector over the prior three years. Fortunately, we had removed exposure to this fund from many portfolios at the beginning of the year as part of our general reduction in UK equity exposure.

Despite the issues, these positions have still generated positive returns so far this year. We have also benefited from holdings that have performed rather well such as the aforementioned emerging markets holdings as well as the CF Lindsell Train UK Equity fund. This latter fund is focused on UK based international companies that have business models that protect them from excessive competition. This has been a successful long term strategy and the fund is up by 14%, which compares to the FTSE All Share's 8% advance this year. We hold a wide spread of investments in the portfolio and we expect to have a few positions lagging the average along with some that are doing better. Over time we expect to hold a greater position in those that do better but there will be periods in the short term where this is not the case.

The global economy and corporate performances are generally doing well. Encouragingly the economic recovery is becoming broad based. Interest rates have been gradually increased in the US and the American economy has withstood these well so far. This provides some grounds for optimism. However, valuations in markets are high and this suggests that prices are fully up with events. As always in financial markets, moves come in fits and starts, but if inflation can be kept at bay and interest rates aren't forced to go up quicker than expected, markets have the potential to grind out further returns over the coming months and quarters.

Markets have the potential to grind out

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To 30 September 2017

Economic review

	GDP Latest Growth Rate %	GDP 2017 Economist %	CPI Latest %	CPI Year Ago Economist %	Unemployment rate %	Current Account Balance % GDP	Budget Balance % GDP 2017
UK	1.5	1.5	2.9	0.6	4.3	-3.4	-3.6
US	2.2	2.1	1.9	1.1	4.4	-2.4	-3.4
Euro Area	2.3	2.0	1.5	0.4	9.1	3.2	-1.3
Japan	1.4	1.6	0.6	-0.5	2.8	3.6	-4.5
China	6.9	6.8	1.8	1.3	4.0	1.5	-3.9

As at 30th September 2017

Source FE Analytics and Square Mile

Markets review

	3 Month %	1 Year %	3 Year %	5 Year %
Equity (Local Currency)				
FTSE All Share	2.1	11.9	27.8	61.2
FTSE Small Cap (ex IT)	3.5	17.8	41.9	117.0
S&P 500	4.3	17.9	33.5	88.3
TSE TOPIX	4.7	29.3	34.3	151.2
MSCI EUROPE ex UK	4.1	20.4	26.2	75.3
MSCI EM (EMERGING MARKETS)	7.6	21.8	27.7	46.3
MSCI AC ASIA PACIFIC ex JAPAN	5.4	20.4	29.1	56.0
MSCI WORLD	3.9	17.9	29.3	82.4
Fixed Interest (GBP)				
FTSE Actuaries UK Gilts All Stocks	-0.5	-3.6	17.5	20.4
FTSE Actuaries UK Index Linked All Stocks	-0.7	-3.8	31.9	51.8
The BofA ML BBB Euro Non Sovereign Hedge GBP	1.5	2.4	11.7	34.6
The BofA ML BB B Global High Yield Hedge GBP	1.9	7.3	18.5	37.4
Property				
IPD UK All Property *	2.6	9.5	32.2	66.4
Currency				
Euros in GB	0.4	1.9	13.1	10.6
Japanese Yen in GB	-3.4	-12.9	17.8	-16.8
Swiss Francs in GB	-4.2	-3.0	19.3	16.9
US Dollars in GB	-3.2	-3.2	20.8	20.4
All Returns are shown in Local Currency Terms unless otherwise stated				Source FE Analytics and Square Mile

As at 30th September 2017

* Data to 31st August 2017

Performance figures are calculated with net income (dividends) reinvested