ALPHA

PORTFOLIO MANAGEMENT

Please see the following comments from our Head of Portfolio Management, Joe Dyer, covering the first quarter of 2014.

Events during the quarter focussed investor attention very much on the emerging markets, with a number of these countries seeing some quite profound volatility within their financial markets. Initial nervousness around countries such as Brazil, Turkey and South Africa was swiftly usurped by Russian actions in Ukraine and the annexation of Crimea. Away from the emerging markets, particularly harsh weather in the US made the interpretation of economic data and earnings releases very challenging for investors and policy makers.

Central banks continued their domination of the investment landscape, albeit the paths taken by the major ones continued to diverge. In the US and UK in particular, where economic growth has been quite encouraging the long path to a more 'normal' interest rate policy is now under way. Whilst the harsh weather in the US, the worst in 30 years has clouded the numbers, the economy still appears to be making reasonable progress and looking forwards the absence of the fiscal headwinds should be a further help.

Elsewhere the central banks of both Japan and the Eurozone look some time away from such a position and indeed in the case of the latter, looks likely to finally be in a position where there is now a chance of quantitative easing, some 5 years after the US commenced its own. As such whilst the US winds its programme down, it seems likely that there is a reasonable chance of further liquidity from elsewhere in the world.

It is probably fair to say that the first quarter of 2014 has been an underwhelming one for those investing in risk assets. Many of the major global stock indices failed to make any ground to speak of, with a number finishing in the red.

Sterling denominated bonds generally saw quite a decent quarter and having started the period with a yield in the region of 3%, the 10 year UK Gilt yield ended the period at around 2.7%. This strong performance was also seen amongst corporate bonds. The attractiveness of bonds has no doubt been helped by falling inflation, with the most recent numbers from February showing UK inflation at 1.7%.

Brent Crude Oil finished the quarter fairly close to where it started and indeed only a few dollars below the level of the year before. Some soft commodities were particularly volatile with some such as wheat and corn seeing fairly large rises in March, with the former rising some 16% and the latter up 10%. The dry weather in major US growing states and also in the case of wheat, the Ukrainian disruption helping to push prices up. Some of the industrial metal commodities notably copper got caught up with Chinese commodity financing concerns and the weakening of the Chinese Yuan, however even here the quarter end witnessed something of a rebound.

Emerging markets continued to be volatile over the period, something that has not been helped by a number of country specific factors, such as the Russian annexation of Crimea. Aside from navigating the various headwinds that Federal Reserve tapering has inflicted, many are having to make the quite difficult transition as their economies mature.

China serves as a good illustration in that it needs to evolve into a more open, consumer based economy in place of the still heavy reliance on investment fuelled growth. With this in mind China's first corporate bond default during March should ultimately be seen as a positive development. Whilst the task ahead for the Chinese is far from easy, some comfort can be taken from the likelihood that the short term headwinds resulting from these adjustments can be cushioned by economic stimulus measures from the Government.

UK Market Comment

We are continuing to experience a divergence in performance within the main UK market indices. Company earnings from the FTSE 250 are more domestically focussed compared to the typically, more overseas orientated FTSE 100. Indeed one of the notable trends of those companies who have reported earnings so far has been the weakness in emerging markets and the strength of Sterling, with the latter in particular leading analysts to generally revise their profit forecast expectations lower. This coupled with weak sector performances from Financials and Telecoms, important sectors for the FTSE 100, resulted in a fairly disappointing performance.

With the re-rating of equity valuations a key contributor to equity performance last year, it is perhaps unsurprising that in the face of the mixed earnings picture so far, markets have failed to make much headway. Current forecasts point to a forward price earnings ratio of 13.5x, which is not excessive but at the same time further stock market progress will likely need to see an improvement in the earnings growth outlook.

Investors clearly need to get used to a world without the largesse of the Federal Reserve, but at the same time a normalising interest rate environment should be a reflection of an improving economy and hence a better corporate backdrop. A key question will be whether the improving mood of companies to deploy their cash accelerates, and should this happen and should it find its way into the real economy then this should be supportive of economic growth and equities.

We enter the second quarter with increased volatility. Certain sectors of the global equity market particularly US technology and bio-tech had seen valuations become overstretched. Currency headwinds, Ukraine tensions and slowing Chinese economic data have created something of a reality check in recent weeks with some highly rated growth stocks off between 15%-20% from their highs.

We continue to focus on free cash flow as a key determinant of investment opportunity. Strong corporate cash flow and dividend growth comfortably ahead of inflation, together with, the potential for special dividends and share buybacks should continue to be supportive of equities. As such we remain cautiously optimistic that markets will move higher on a 12 month view, but would expect bouts of volatility along the way but would see this as an opportunity to add to our favourite investments.