Marlborough
International

Market Update: Review of 2018

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From an investment professional's viewpoint, 2018 demonstrated that you can't predict market moves by merely extending a trendline on a chart.

2017 had already been a bumper year for stock markets, and yet many commentators were predicting even more record highs, citing the impact of US tax cuts and a potential 10% growth in earnings. Ominously perhaps, the degree to which markets rise and fall - volatility - had been very low during the previous five years. For example, the FTSE All-Share Index, which is comprised of over 630 companies that account for 98% of the value of the UK stock market, has over the past five years seen the lowest average volatility since the index commenced in 1962.

This implies a degree of hubris among market professionals and overconfidence about the future; exceptional events are the exception by definition and things sooner or later return to 'normal'. This phenomenon is known as 'reversion to the mean', and with the benefit of hindsight this process began in September 2017 when the frequency of days when the market fell by more than 1% in a day began to rise.

By the beginning of February 2018 this frequency had accelerated, but so did the number of days when the market bounced back by 1% or more, as investors responded in a knee-jerk manner to uncontrolled news 'noise', particularly from the US president regarding relations with North Korea, threats to trade with China and latterly losing control of the US Congress. Market signals about rising interest rates, an end to the US business cycle and recession on the horizon blew hot and cold; all this served to make equity markets continually reappraise valuations as the news got noisier. Trump's shutdown of the Government in December (by refusing to sign off a budget that refused to fund his Mexican Wall) remains (at the time of writing) yet another negative influence.

Among the hardest hit sectors were those containing funds with a bias towards smaller companies. Most susceptible to changes in market sentiment, these funds tend to do exceptionally well in rising markets but suffer the most in downturns. Smaller Companies funds focused on the UK, US, Europe and Japan fell by as much as 25%.

Marlborough Risk-Targeted Portfolios

All in all, of 35 FE Offshore Mutual fund sectors investing in non-Cash assets, only four rose in value in 2018 - direct holdings in Property, Technology Equities, Global Bonds and UK Gilts. I suspect that many investors who've had better things to do recently than pore over market data, may be dashing to check their valuations given these revelations, however the typical investor using a financial adviser is likely to hold a portfolio comprising a diverse array of assets across multiple geographies.

That said, funds in the Balanced Managed sector fell by as much as 42% over the year and over 20% in the last 3 months of the year, and investors in the Marlborough International Fund of Funds may have had an understandably nervous quarter. However, Marlborough's equity performance pedigree is based on investing in companies that have the most potential for long-term growth. Smaller and medium sized companies' shares tend to rise more than large companies - simply put, large companies are already large while small companies have more scope to grow. When a bull market contracts, almost by definition, the share prices of smaller and medium sized companies tend to fall by more than large companies. These price cuts have nothing to do with the strength of the companies concerned - good companies don't all become bad companies overnight and at the same time - but the market makers do not want to hang on to less-traded stocks, so price the shares to tempt buyers and deter sellers.

Performance of the Marlborough portfolios evidences this phenomenon - despite the trauma of the second half of 2018, the funds remain ahead of their sector averages since launch in 2016 because of their ability to provide stellar performance in positive market conditions.

While relieved long-term investors may have sensibly chosen to maintain their market exposure, industry statistics tell us that many potential investors remain on the side lines. According to funds transaction network Calastone, new flows into funds fell by over 99% last month, versus December 2017. It is understandable perhaps that some potential investors might sit on the fence, perhaps waiting for the outcome of the Brexit negotiations; these individuals may hope to catch a 'bounce' in the stock market. However, you can't bounce if you're not on the trampoline; experience shows that prices in depressed markets whipsaw, very quickly recovering lost gains - those that have been heaviest hit tend to rebound the fastest. Potential investors often miss this recovery and indeed come back in at higher prices.

The key point here is that markets generally rise as companies and economies grow. Negative years are far outweighed by positive years - long term investment (versus say gambling) would be pointless were that not the case. Reinvested dividends dramatically enhance those returns over time. I referred earlier to 'reversion to the mean' and the tendency for extreme events to revert to the norm. This also applies to downsides - markets at some point resume their upward journey. For most people, trying to time that inevitable rebound is almost impossible.

In 2019, whatever the outcome of Brexit, President Trump's shenanigans or otherwise, a key point is that at the time of writing, the FTSE All-Share Index is 9% cheaper than at its high in May 2018. While some side line investors may balk at taking the plunge and reallocating all their cash, others might consider dipping a toe in the water and engaging with markets gradually perhaps over several months, as the investment conditions become clearer.

You can't predict a short-term rising trend by extending a line on a chart, and the same applies to falling markets. One thing we can be certain of is that 2019 will be different again from 2018. As a consequence, and considering the political and economic uncertainties that remain unresolved, Marlborough's Fund of Funds team has made revisions to the Defensive and Adventurous funds' asset allocations:

Marlborough Defensive

- **Bond Income**
  Reduced from 70% to 50%
- **Global Bond**
  Increased from 15% to 20%
- **High Yield Fixed Interest**
  Increased 5% to 10%
- **Global**
  Reduced from 5% to 0%
- **Multi Cap Income**
  Increased 5% to 10%
- **UK Multi-Cap Growth**
  Increased 0% to 10%

The changes to the Defensive fund were made to further diversify the portfolio and recent market volatility presented an opportune time to make the changes. The team increased exposure to UK equities, to what they see as being closer towards their 'neutral' target allocation. The UK market is now out of favour, is under-owned and therefore attractively valued in relative terms. Sterling has also been weak, trading towards the bottom of its long-term range. Although we could see further weakness in the short term, we believe this could be limited and as the stock market tends to move ahead of events, we could see a significant stock market reaction to the hint of any positive Brexit-related news.

Marlborough Adventurous

- **Far East Growth**
  Reduced from 25% to 20%
- **US Multi-Cap Income**
  Increased from 15% to 25%
- **Global**
  Reduced 15% to 10%

As a partial risk-reduction, in the highest-risk global equity Adventurous fund the team has increased exposure to US equities, which tend to have more defensive qualities in volatile markets. In tandem, they have reduced exposure to the less-developed areas of global markets which can be found within the Far East Growth and the Global funds.

Allocations in the Balanced and Cautious portfolios remain in place for 2019.

Underlying Fund Updates:

Special Situations Fund

2018 was a notably poor year for risks assets with a record percentage (over 90%) posting a negative total return in USD. All major equity markets declined, bond markets (sovereign and corporate) fared little better and it was cash that was one of the few positive performers.

For the calendar year 2018, the P class units of the fund finished down 11.54%, compared to declines of 13.80% for the FTSE SmallCap (ex-IT) Index, 13.25% for the FTSE 250 Index and 17.12% for the FTSE AIM Index. The 'Santa Rally', a term for the stock market rally that often occurs in December, never materialised. Indeed, the S&P 500 Index declined in December the most it has done since 1931. During December, the fund's P class units declined 5.78%, compared to declines of 3.50% for the SmallCap, 5.13% for the FTSE 250 and 7.59% for AIM.

Top performer in December was Amerisur Resources (+20%), the oil & gas producer and explorer with operations in Columbia and Paraguay. Drilling results at a well in its Llanos basin "significantly exceeded the group's expectations" with "a very significant oil column encountered". While further data, pressure readings and samples are required, the initial findings coupled with a tentatively stronger oil price could augur well. Other winners in the month were DX Group (+17%), the provider of delivery solutions, which remains on track with its turnaround plans and Creo Medical (+12%), the innovative medical device company that is developing and commercialising minimally invasive surgical devices. Creo Medical has seen the first successful use of its Speedboat device in Europe.

Losers in the month saw some high growth companies such as Learning Technology (-28%) and Future Plc (-17%) continue to de-rate, while Chinese speciality pharma company Hutchison China MediTech (-33%) fell as one of its Phase III studies will cease owing to a low likelihood of success.

Larger trades in December saw us increase our position in Polymetal, the precious metal mining company with operations in Russia, Kazakhstan and Armenia. The gold price has been resilient recently, acting as a relative 'safe haven'. Furthermore, the outlook for the gold price has arguably improved as the US Federal Reserve's rhetoric regarding its interest rate outlook has become slightly less aggressive. We also increased our position in car retailer Lookers, one of the best managed companies in the sector in our view. The group has thus far managed the WLTP ('worldwide harmonised light vehicle test') admirably. This has weighed on the new car sales market even if demand has existed. More importantly, an increase in higher margin used car and aftersales revenue has meant that the company has not changed its expectations for the full year. Absent a recession or Brexit shock, we believe the worst may have passed for the UK new car sector while a P/E of c. 7x, a dividend yield of >4% and a FCF yield in the mid-teens provides an acceptable margin of safety. Larger sales saw us reduce our positions to the designer brand Ted Baker and oil and gas exploration & production company Faroe Petroleum, post the takeover approach from Norwegian firm DNO.

Equity market declines in Q4 2018 were persistent and though largely indiscriminate it was arguably those stocks with a higher growth profile that were hardest hit. Investors' concerns have appeared to focus on the Federal Reserve's stated aim of normalising interest rates via further increases and continuing Quantitative Tightening to reduce its balance sheet (in effect, reversing 'Quantitative Easing'). Against a backdrop of ebbing growth and volatile markets, this is not an easy task.

The UK equity market trades on a P/E ratio of c. 11.6x in 2019 and c. 10.8x in 2020, down from a cycle peak of c. 16.0x in 2015/16. Within the UK market, the predominantly smaller company indices (Numis Smaller Companies, AIM, and FTSE SmallCap) are over 10% cheaper than the indices with the larger companies (FTSE 100, FTSE 250). This is despite earnings growth of the smaller companies forecast to be over 10% in the next two years, versus 7%-8% for the larger companies.

The market sell-off has presented some enticing opportunities and we have been able to add to some of our favoured positions at what we deem to be attractive prices. Currently, seven of the top twenty holdings in the fund have a PEG ratio of under 1. This was last seen over five years ago.

Being fundamentally cheap is not necessarily a catalyst for price appreciation. However, the UK market trades at a notable discount to other international markets, particularly the US (which trades on a 25% premium to the UK).

The UK market is very much out of favour among global asset allocators. And this is unlikely to change ahead of some form of Brexit negotiation resolution. Provided a palatable to favourable Brexit outcome can be achieved, accumulating names at this time of heightened uncertainty could prove fruitful.

We will strive to position the portfolio to capture the long-term appeal of the smaller companies asset class in a sensible risk-adjusted manner. This will be via a diversified portfolio that includes many companies that are leaders in a niche area who have a customer base that extends well beyond the UK shores.

Multi Cap Income

During December, the price of the fund's 'P' class shares fell 5.0%. Our performance benchmark, the FTSE All-Share Index, fell 3.8% over the month. As is the norm for our fund, the closing prices as of noon on the penultimate business day (28th December in 2018) are used to mark the calendar year end, whereas the indices are priced until market close of 31st December. As such, the fund did not get the benefit of the afternoon rally (28th December), nor the performance of 31st December in its price detailed above. It does instead roll into the price of the fund on the first business day of 2019.

For the calendar year 2018, the FTSE All-Share Index was down 9.5%. Our fund's P class share was down 13.6%.

Since inception in July 2011, the fund is up 98.5% compared to a rise in the FTSE All-Share Index of 55.4%.

The trading update from Plus500 (-9.6%) was a pleasant surprise as it confirmed the 'strong momentum' from its November update had continued despite the implementation of tougher ESMA regulatory rules. Hence, it will see full year profits 'ahead of current market expectations'. We do not believe the market has fully priced in this good news and the shares still trade on a low P/E of 7.4x 2019e and yield of 10.9% (Bloomberg consensus). The share price performance for the month is at odds with the progress in profits.

Stobart Group (-27%) was a disappointment as they cut their dividend 67%. This was despite a meeting with management where we had been told a capital review in March would detail their findings on the best allocation of resource to generate optimal returns for shareholders. We now find they have decided to step up their investments into Biomass (a distraction from the core airport business that has the most upside potential); an area where they have previously underperformed and seen cost over-runs and delays. Corporate governance issues have been well publicised and one may wait to see what a new Chairperson does next.

Winners this month include Hollywood Bowl (+19.5%), as the bowling operator released like-for-like sales growth of 1.8%, record profits, EBIT margin improvement of 120bps, ordinary dividend growth of 7% and a special dividend that was 30% higher y-o-y. This was all achieved in a year when it faced extremes of weather (colder than expected Q1 and a warmer summer), better-than-expected football World Cup performance for England and a generally weak consumer retail environment that hurt footfall. It could have understandably profit warned but management action on cost control, dynamic pricing, improved technology and selective refurb, rebrand and roll-out of the estate delivered us the desired results.

Telecom Plus (+4.8%), detailed in the previous monthly report, continued its upward march as news emerged of competitors, Spark (290k customers) and Extra (129k customers) going bust. OFGEM is proposing new tests (financial and customer services) for licensing energy suppliers. These requirements play nicely into the hands of Telecom Plus.

We exited Hastings, Paddy Power, Ted Baker, Photo-me and Direct Line Group in December. Both motor insurers, Hastings and Direct Line Group, suffered from dual running costs and delays in the implementation of Guidewire. Photo-Me profit warned again after our last sale (the share price is 18% lower since). Ted Baker got itself into a corporate governance issue with senior management facing employee harassment charges. Paddy Power is one where we had a small position; booking the profit to modestly raise cash levels as market volatility increased during the month.

There is plenty to worry about in 2019 with Brexit chatter, US-China tariffs, currency impacts and potential UK inflation should there be a shortage of key supplies post March. Stock-piling combined with currency devaluation and a lack of adequate interest rate rises in the UK could exasperate inflation further. Both domestic consumption and the net trade balance via a weak sterling could flatter the GDP number, albeit temporarily.

Socio-economic, political and self-inflicted factors aside, the companies we meet are generally performing fine, paying dividends as promised. Where we have seen a couple of mishaps in this last year, one may argue moral hazard would have occurred anyway. The good stocks have surprised and grown dividends double digits with similar forecasts once again e.g. BCA Marketplace, Cineworld, DCC, Filta, FDM, 3I Group, Integrafin and Intermediate Capital, amongst others. A number of these are small to mid-cap biased, which has also been the case historically. It reinforces our view on asset allocation within the fund and will serve to compound income generation.

Although we are mindful of the Q1 risks, once the market prices in details of a Brexit deal, it can then start its price recovery phase post stabilisation. Oversold pockets of the market should mean-revert to their respective (normal) valuation metrics. While we do not expect this to be an instant rebound, 2019 may turn out to be better than feared. It does require the appropriate policy responses to stimulate the economy, which is the one caveat to our outlook. Having now seen a few different forecasts for UK GDP, the typical range is still positive at 1.4% to 1.5% growth for 2019, which is of some comfort.

The FTSE All-Share Index yield is 4.45% (at the time of writing), which is our target hurdle, as per the IA UK Equity Income Sector rules. The prospective portfolio weighted yield is 4.99% including cash. The estimated dividend per share growth is c.2% to 31st January 2019 (P income share class) based on accrued income to date and our assumptions for stocks due to be marked ex-dividend by the end of the month.

European Multi-Cap

The European equity market declined in December as investors remained concerned about a global slowdown and the impact of this on corporate profits in Europe. MSCI Europe ex UK index returns were -4.76%, -5.42% and -5.01% for the standard, small and microcap indices respectively while the fund's P class share returned -3.68% (all in sterling).

For the full year 2018, MSCI Europe ex UK index returns were -9.87%, -14.85% and -12.67% for the standard, small and micro-cap indices respectively, while the fund's P class share returned -11.53% (all in sterling). It should be noted that sterling weakened against the euro during the year by 1.45%.

During December, the best performers for the fund were Spanish restaurant operator Telepizza (bid at €6 from majority shareholder), Norwegian financial terminal provider Infront (acquisition of Italian terminal business), Swedish telecom software group Enea (accretive acquisition of software relating to 4G and 5G), German online real estate and automotive marketplace Scout24 (speculation of takeover interest from several private equity firms), French producer of plastic packaging Groupe Guillin (expanded offering through the acquisition of cardboard packaging business) and Danish based European ferry operator DFDS (strategic customer cooperation agreement on Mediterranean routes).

The worst performers were French fastener manufacturer LISI (concerns over slowing airline orders), German adhesives and ultraviolet printing equipment group Dr Hoenle (concerns about impact of slower iPhone sales on its adhesives business), Italian industrial laser cutting machine manufacturer Prima Industrie (weaker demand from automotive industry), Swedish balcony manufacturer Balco Group (doubts over the order backlog growth for 2019), Swedish automotive safety systems manufacturer Autoliv (provision made for EU antitrust investigation from 2011) and Swedish automotive fastener group Bulten (concerns that WLTP impact will be felt into Q1 2019).

We took advantage of share price weakness to add to Italian gas cooker components vendor Sabaf (strategy to expand into adjacent product categories is developing well) and Swedish cash handler Loomis (making progress with cost efficiency programs and increasing penetration of Safepoint product). We also reduced the holding in Finnish forestry machinery group Ponsse, taking profits after a strong share price run. Complete sales were made of French electronics e-tailer Groupe LDLC (concerns of ongoing margin pressure with increasing levels of debt) and French prepaid voucher business Edenred (recent acquisitions were made at high multiples).

While the threats to world economic growth (trade wars, slowing growth in China, expected slowing of US economy) remain, the expectation of institutions such as the IMF is that there will be a slowing of growth rather than a contraction (IMF European GDP growth forecast reduced to 1.9% for 2019 citing weaker external demand and higher energy prices).

We have seen a recent uptick in M&A activity in Europe from a mixture of private equity funds and industrial buyers. This indicates that there are good investment opportunities to be found thanks to the more nervous market sentiment, particularly among the less well researched European smaller companies. For example, the KKR takeover bid for fund holding Telepizza was at a 33% premium to the last traded price and other recent bids have been made at similar premiums. Therefore, we look forward to 2019 with anticipation despite the above-mentioned concerns.

Regulatory Information