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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Had one been completely out of touch for the first three months of the year and come back to see the returns shown in the tables below, one might have thought that it had been an unremarkable quarter in the international equity markets where changes in the international indices in sterling, US dollars and euros, as well as in local currency terms, were relatively modest. Only when looking at moves in bond yields, currencies and gold might one have thought something more unusual was going on.

The tables below detail relevant movements in markets :

International Equities 31.12.15 - 31.03.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-3.0	+5.2	+2.6	-2.2
Finland	-8.0	-1.0	-3.5	-8.0
France	-4.9	+2.3	-0.2	-4.9
Germany	-7.0	N/C	-2.5	-7.0
Hong Kong, China	N/C	+2.4	-0.1	-4.8
Italy	-15.2	-8.8	-11.1	-15.2
Japan	-12.8	-4.3	-6.6	-11.0
Netherlands	-0.5	+7.0	+4.4	-0.5
Spain	-8.3	-1.4	-3.8	-8.3
Switzerland	-9.1	-2.6	-5.0	-9.4
UK	+0.2	+0.2	-2.3	-6.8
USA	+1.1	+3.7	+1.1	-3.6
Europe ex UK	-6.4	+0.6	-1.9	-6.5
Asia Pacific ex Japan	+1.0	+7.2	+4.6	-0.3
Asia Pacific	-6.6	+1.0	-1.5	-6.1
Latin America	+11.6	+22.0	+19.0	+13.4
All World All Emerging	+3.3	+8.8	+6.1	+1.1
The World	-1.4	+3.0	+0.4	-4.3

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +4.4%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	31.12.15	31.03.16
Sterling	1.96	1.54
US Dollar	2.27	1.81
Yen	0.27	-0.05
Germany (Euro)	0.63	0.15

Sterling's performance during the quarter ending 31.03.16 (%)

Currency	Quarter Ending 31.03.16
US Dollar	-2.3
Canadian Dollar	-8.3
Yen	-8.6
Euro	-6.7
Swiss Franc	-6.3
Australian Dollar	-7.2

Other currency movements during the quarter ending 31.03.16 (%)

Currency	Quarter Ending 31.03.16
US Dollar / Canadian Dollar	-6.2
US Dollar / Yen	-6.4
US Dollar / Euro	-4.5
Swiss Franc / Euro	-0.5
Euro / Yen	-2.0

Significant Commodities (US dollar terms) 31.12.15 - 31.03.16 (%)

Currency	Quarter Ending 31.03.16
Oil	+7.4
Gold	+16.8

MARKETS

A highly volatile quarter has ended up with only moderate changes in international equity market levels since the end of December 2015. In local currency terms, the total return on the FTSE World Index was -1.4%, in sterling terms +3.0%, in US dollar terms +0.4 and, in euro terms, -4.3%. Looking at the different markets in local currency returns, we see a remarkable change in sentiment with the outstanding performer being Latin America where the FTSE Latin America Index returned +11.6%. Emerging Markets, as a whole, outperformed developed markets with the return on the FTSE All World All Emerging Markets Index being +3.3%. Of the developed markets, the UK and USA held up best in local currency terms with the FTSE USA Index returning +1.1% and the FTSE UK Index returning +0.2%. The worst performers were Japan, where the FTSE Japanese Index returned -12.8% and Europe ex UK where the FTSE Europe ex UK Index returned -6.4%. However, currency adjusted moves were markedly different for sterling based investors as a result of the significant fall in sterling over the quarter. The performance of Latin America, in particular, but also emerging markets, was enhanced further so that, in sterling terms, the FTSE Latin American Index returned +22.0% and the FTSE All World All Emerging Markets Index returned +8.8%. Asia Pacific ex Japan also returned a good sterling adjusted performance with the FTSE Asia Pacific ex Japan Index returning +7.2%. Other than in the case of Japan (the FTSE Japan Index returned -4.3% in sterling terms), most developed markets outperformed the UK in sterling terms. The FTSE Australia Index returned +5.2%, the FTSE USA Index +3.7% and the FTSE Europe ex UK Index +0.6%.

The volatility of equity markets in the first quarter benefited bonds. Taking ten year government bonds as a benchmark, the gross redemption yield on UK gilts fell by 42 basis points to 1.54%, on US Treasuries by 46 basis points to 1.81%, on the German Bund by 48 basis points to 0.15% and on the Japanese government bond by 32 basis points to show a negative gross redemption yield of 0.05%, an astonishing situation. Long dated government bonds were the star performers during the quarter but carrying with them an immense downside risk when yields start to rise to less abnormal levels.

In currency markets, as alluded to above, sterling was a major casualty, partly, no doubt, caused by EU referendum uncertainty. Against the yen, sterling fell by 8.6%, against the Canadian dollar by 8.3%, against the Australian dollar by 7.2%, against the euro by 6.7%, against the Swiss Franc by 6.3% and against the US dollar by 2.3%.

One of the reasons for the fall in stock markets at the beginning of the year was a concern about the extent of the fall in commodity prices but they did begin to pick up as the quarter progressed. Oil, as measured by Brent crude, rose by 7.4% whilst gold, which had been out of favour for a long time, rose by 16.8%.

ECONOMICS

At this time it is difficult to comment on the economics of the world and where the investor’s attention should be drawn without devoting some time to the trajectory of interest rates and how their movements, along with less conventional monetary policy, such as quantitative easing, is being used as a tool to adjust the economic machine. Since the collapse of Lehman Brothers in September 2008 central bankers around the world have cut interest rates over 600 times as a support measure for the global recovery. Added to this, quantitative easing from the U.S., Japan and the euro area on their own accounts for an injection of something like $12 trillion into the global economy since the same starting point. There is no precedent for anything like this and, in that respect, history cannot inform us about where we now find ourselves. The interest rate environment we are currently experiencing was unforeseeable ten years ago and, if viewed as a necessary consequence of the financial crisis - which started around eight years ago, underlines the damage which was done at the time. A consistent feature of the recovery, discussed in previous iterations of this memorandum, has been the need to revise downwards the pace of recovery and also to revise downwards the lower bound of the interest rate environment as our central bankers seek to invoke policy that continues to have an effect.

With the Bank of Japan recently adopting negative rates for certain accounts held by financial institutions with the central bank and, in March, the European Central Bank reducing its headline deposit rate to -0.4%, it's worth reminding ourselves of the challenges over which economists and politicians fret and what this course of action is aiming to achieve. The interest rate is often referred to as the price of money with the cost of obtaining money (through borrowing it) or reward for supplying that money (by depositing it or lending it), being the interest rate paid. Traditional central bank policy is to raise rates in the good times to act as a brake on an over-heating economy, or to lower rates, to stimulate demand in a weak economy. The entrepreneur will find it more compelling to invest in the economy if the borrowing costs are lower. Amplified across a country the sum of those individual decisions will lead to more investment, more job creation, more spending power and economic growth. From the saver's perspective, lower interest rates act as a disincentive as leaving money in a deposit account will earn a lower interest rate and the would-be depositor may be more inclined to spend it or invest it elsewhere, with the consequences, intended and otherwise, that that may have.

It is worth applying these simple economic fundamentals to the situation in Japan at present, a country which has, through Shinzo Abe's government and the Bank of Japan, been aggressively applying policy in a committed attempt to jump start the faltering economy. Japan, until the 1980s a powerhouse of economic growth, noted for its industrial might, corporate ambition and its diligent workforce, has failed to continue to grow at anything like the rate it would like for many years. There are no other countries which find themselves in the same position. It is a wealthy country whose government is more indebted than any other in the world, at around 230% of GDP. It has very low immigration, a low birth rate and poor demographics where the ratio of workers to retired people is shrinking at the fastest rate in the world. Working practices are often restrictive, female participation in the workforce is low and corporate governance can be old-fashioned and introspective. This is not the ideal starting point when aiming to kick start the economy.

The latest measure announced in February was the decision to move interest rates to -0.1% with one of the goals being to liberate dormant and under-utilised money by making the act of depositing in banks a penal activity. The country's savings rate, which historically has been very high, has now fallen. In fact the household savings rate - the share of savings as a percentage of total disposable income of households dipped into negative territory in 2013, for the first time since records began in 1955. Indeed the Swabian housewife tendencies of the Japanese attracted international criticism in the 1980s when the country had its large trade surplus and exporters to Japan highlighted the propensity to save as a constraint on trade. After peaking in 1975 at 23.1% the rate has more recently been hovering between 5% and 0%. It would seem that there is limited scope to increase consumer spending by diminishing the value of saving even more. Perhaps the intention is more in spurring corporate spending where Japanese companies have extremely high levels of cash on their balance sheets. Recent changes to corporate governance rules have also been introduced to encourage Japanese firms to increase below average dividend rates and return excess capital to shareholders, if the alternative of investing the money in the real economy is not possible. From the Japanese borrowers' perspective the question is how effective will an ever lower interest rate be in increasing lending? Loan demand is low and the practice does not seem to be following the theory. Aggregate demand is not being driven up despite the considerable efforts of the central bank. Quantitative easing has led to Japan's money supply increasing by a larger percentage than in the U.S., Europe or the U.K. but the intended coercing of capital out from banks has not 'multiplied' into economic growth or inflation.

Moving from the lender's perspective to the borrower (in savings deposit terms), the position in which banks find themselves is that they are awash with cash, partly as a consequence of quantitative easing, and it is usual for banks to deposit short term excess liquidity beyond their day to day requirements and lending needs with the central bank. A negative rate of interest there is effectively a tax on those deposits, and banks are sensitive to passing those negative rates on to their customers for the controversy it would attract. This worsens the interest rate squeeze as the banks' lending rates fall more than their deposit rates which has an effect on their profitability. The risk that policymakers are trying to avoid is that banks start raising their lending margins to mitigate the cost on excess reserves. This would run contrary to the primary goals of increasing liquidity and the supply of lending.

The Prime Minister of Japan launched his three arrows of reform in December 2012 and it is the third, structural reforms, which is by far the most difficult to implement. Figures released in March showed that fourth quarter 2015 economic growth was revised up to a still disappointing -1.1% annualised rate, with consumption being particularly disappointing. Momentum is lacking which may lead to further fiscal stimulus, which along with the interest rate cuts and monetary policy represent the first two arrows, but the slower and more exacting task of awakening 'animal spirits' and removing constraints from the workplace remains a work in progress.

Whilst stimulating 'animal spirits' can be done by both central banker and central government, the central banker is principally charged with achieving this by means of monetary policy and it is hard to criticise the current cohort for the lengths to which they have gone in order to meet their current ambition. Fiscal stimulus and structural reform lay purely in the hands of government and it may well be that the politician's job is much tougher than the central banker's. The central banker works under the assumption that his or her motive is purely driven by the greater good and is not inconvenienced by the need to be re-elected, something which comes round, to the politician's mind, annoyingly frequently. As Jean-Claude Juncker, President of the European Council said "We all know what to do, we just don't know how to get re-elected after we've done it". Any government, even freshly elected with an absolute majority, faces difficulties in pushing through legislation that improves competitiveness, opens up the business environment and removes barriers to trade. It is the so called supply side factors that may be the area needing most work and the ability of a government to influence these is far beyond the narrower reach of its central bank's monetary policy. Positive trends in areas of investment, productivity and innovation are three such indicators of economic wellbeing. Governments will seek, within the bounds of what the electorate and interest groups will allow, to encourage investment, spend effectively on infrastructure and help firms to reduce costs and expand production. In many countries we are currently seeing poor improvements in productivity and, perversely, falls in unemployment. This means that, if unemployment falls or employment rises by a far greater percentage than the economy grows, more man hours are being spent to achieve only marginally greater economic output. Productivity is improved by education, training and, most significantly, investment. Thirdly, technological advances are the product of a culture of innovation, research and development spend and education and will, in the longer run, contribute to higher economic growth. Ultimately economic progress will be limited by the extent to which productivity can be improved and in the case of Japan, and in many other developed countries too, we may be reaching the point that the balance of responsibility for creating the conditions for economic growth is more in the hands of the politician than at any time since the financial crisis.

The situation in Japan is referenced from time to time as a cautionary sign to other developed countries. As an economic entity its success, or otherwise, is of interest as it is the third largest economy in the world and prosperity in one part of the world will have a spillover effect on other parts. It now finds itself in an unhealthily long period of low growth, low inflation and low interest rates. It is a country that has a mature economy and whose population is forecast to shrink from the current 127 million to 100 million in fifty years and at the same time the working age population will shrink by 40%. Only 2% of the population is non-Japanese compared with around 13% in the U.S. and Germany. As well as the areas of supply side reform mentioned earlier there is work to be done on influencing the birth rate, child care provision and encouraging a higher participation rate in the workforce.

The European Central Bank's policy decisions in March acknowledged that extending interest rates further and further into negative territory may be increasingly ineffective in achieving the bank's goals and with unintended consequences becoming more apparent; an example would be the effect on bank profitability in a period of capital building and de-risking. The focus of attention was not the reduction to -0.4% in its deposit rate, which represented a well signalled cut of -0.1% but, rather, the expansion of its quantitative easing programme in both size and breadth. It was raised to €80bn. per month from €60bn. per month though the end date was not extended beyond March 2017. The programme will, for the first time, now include non-bank investment grade corporate bonds. The pressure on Europe's banks is also eased slightly by the announcement of a new round of targeted longer term refinancing operations (TLTROs). This is a way for banks to satisfy their deposit requirements by taking loans from the ECB for periods up to 4 years on which they will have to pay interest of 0%. They can, however, take deposits and pay a negative rate of interest to the ECB provided they increase the quantum of eligible customer loans. Under this arrangement the ECB is paying Europe's high street banks to lend more to its customers. Mario Draghi's comments after the policy decision suggest that the ECB may have reached a floor in its interest rate policy and that further support for the economy will come from a range of measures which, in themselves, seem intended to reassure that policy response has not been exhausted.

It must be said that the rules on what corporate debt will be bought are not clear and will have to be written with great care as the effect of bond pricing could create very unfair distortions in the debt market. In comparison, it is fairly straightforward to introduce a policy to buy sovereign issuance and agree to buy national debt on a pro rata basis, proportionate to the amount of capital each has contributed to the European Central Bank. It is also worth noting that this is a bond market where liquidity is not what it was, as brokers and banks have found it more costly to hold inventories of bonds on their balance sheets under new regulations. Some perspective can be gained on bonds as an investment at this time by looking at two areas of the bond market. Demand for German government bonds is so high that prices have risen to the point that the yield on a 10 year Bund is now around 0.15%. If yields rise by around 5 basis points, i.e. to 0.20%, then a whole year's income will be wiped out; the situation in Japan is even more extreme where it would only take a 1.6 basis point rise to have a similar effect. In the corporate world, on the 30th March, Sanofi, the French pharmaceutical company, sold bonds in euros with the lowest yield on record for a non-financial company at 0.05% for three years.

Putting this point to one side, what does this programme of asset purchases mean for the companies whose shares we may hold? The euro corporate bond index includes around €1 trillion of assets, so the pool is finite and lower borrowing costs will result from increased demand for this issuance. A 2022 BMW Finance bond was yielding around 0.80% before the ECB decision and this fell to around 0.50% after the announcement. A similar 2021 bond issued for Renault was yielding around 1.30% beforehand and fell below 1.10% by the close of business that day. For the bond issuers this is clearly a positive as increased demand meets unchanged supply meaning raised bond prices and lower yields, which are, of course, a reduced cost to the businesses concerned. Lower interest rates and yields are a positive as are lower rates for longer, which looks increasingly likely. Over time companies will re-finance existing more expensive debt at this lower level and the benefits will be enjoyed over the life of the debt. Sanofi, like many others, raised more money than it originally planned and used it to pay down existing debt and extend the average maturity.

Less positively, lower inflation expectations increase the real rate of interest and mean that companies' debt levels do not reduce in value in real terms as much as at high rate of inflation. As well as announcing the various quantitative easing measures, the ECB also reduced its inflation forecast for the coming years. The ECB's revised staff forecast now shows inflation rising to 1.3% in 2017 and 1.6% in 2018. This must be viewed against its own long term target which is "below, but close to, 2% over the medium term". This would suggest that either more is yet to be done, or it has no issue not pushing for 2.0% by 2018 as there are extraneous factors at play at present, such as energy and commodity prices, which will fall away from the figures and will then provide an inflationary input once they start to normalise. More broadly, the value of companies' dividends are always relative to the alternatives so depressed savings rates and bond yields will make dividends more appealing. Finally, as well as interpreting these central bank decisions in terms of the effects they may have on companies and their share prices, the effect on bond markets is also comment worthy. By any historic measure bond prices are high, meaning that a higher unit price must be paid to receive a certain flow of fixed interest payments and the less the company pays the bondholder to finance its lending requirements, the less the bondholder receives. As yields fall and prices rise the market becomes more and more distorted and whilst at the highest level of credit risk, such as AAA-rated sovereign debt, the financial loss is likely to be limited to a paper loss (where the bond is carrying a negative gross redemption yield) there is a transmission along the credit spectrum where lower grade credit risk is not reflected in the price, meaning that a change in sentiment may cause a sharp fall in market value and, secondly, a flat yield curve means long dated bonds are vulnerable to any pick up in inflation expectations. Both will happen at some time and the best hope is that the change in sentiment or perception is well signalled and very gradual. Bond funds may be vulnerable to deteriorating liquidity where they hold lower grade or thinly traded bonds and are forced to meet redemptions. The UK regulator, the FCA, in light of 2016 bond volatility, has urged bond fund managers "to evaluate the tools, processes and underlying assumptions they make when dealing with periods of mass redemption", adding that investors should be made aware of the potential impact of low liquidity on the volatility of returns and the fact managers can temporarily compromise their redemption rights by taking exceptional measures during periods of illiquidity. In all cases a very gentle move towards the exits is preferable to a desperate rush.

A term which is used at present is secular stagnation. This is a prolonged period of low growth (as opposed to cyclical stagnation), often in high income countries where high levels of savings are more significant than the level of investment which is required to drive forward economic growth. In short, the consumer's inclination to save money may be too great to build consumer demand. A remedy, it would seem, is to make saving a less and less attractive activity and it would seem natural to do this by progressively lowering the interest rate until saving is completely unattractive. The theory carries us so far but when the practice reaches the point at which we find ourselves today, where we are effectively in an experimental stage in monetary policy with no historic precedent, economic theorists are forced to formulate and postulate based on the practice in action. A key question here is 'what is the lower bound for interest rates?' This has been tested in early 2016 with Japan's policy decision to move to negative rates, the Federal Reserve to maintain its 'one step off the bottom' rung level and manage down expectations of the number of further rises and, somewhere in between, the Bank of England deciding to keep rates at 0.5% and suggest the next rise is likely to be upwards rather than downwards. The European Central Bank, discussed earlier, is making it clear that it considers its arsenal far from empty but that further interest rate cuts are unlikely. Evidentially it would seem that the downward trajectory has flattened significantly and the focus for monetary policy may move elsewhere.

As the former head of the U.S. central bank, Ben Bernanke, wrote recently "When I was at the Federal Reserve I occasionally observed that monetary policy is 98% talk and only 2% action…" which is a reminder that the most effective policy tool is steering market expectations through public statements and may even be an admission that there is a limit to how much practical effect policy can have whereas changing mindsets is the larger part of job in hand. In the early spring of 2016 the investor is probably spending as much time picking through the pronouncements of central bankers as at any time in the past, which is a reminder that there is still much restorative work to be done.

Returning to the subject of those savers, both individual and corporate, by remaining in cash it is now difficult to derive any significant income in real terms over time. For the corporate treasurer there is no value in holding cash but there is the opportunity to borrow at extremely low cost and in some cases at negligible cost, given the interest rate environment and demand for debt, both real and synthetic. It is simple mathematics to borrow at 1% to fund share buy backs where the dividend is 2% and this is income positive every year and can even become more attractive over the period of the loan if the dividend is growing and the loan rate is fixed, as is usually the case. The growing popularity of share buy backs is indicative of a subdued inclination to invest and ultra-low interest rates, though not all share buy backs are paid for by borrowings. This is very much of this time but will not contribute directly to economic growth.

For the equity investor the effect of almost all of the above has been positive in terms of raising valuations. The share buy backs have concentrated corporate earnings across fewer shares, raising the earnings per share figure and increasing the values of those stock. The poor return on deposits has highlighted the value of dividend income. The drop in inflation has increased the real value of those dividends and the pressure cooker environment in bond markets makes them currently an unattractive place to invest. Sitting alongside all of this is the fact that trillions of dollars, pounds, euros, yen and other currencies have been created which have percolated out into the real economy where they have ultimately been used to buy real assets, with real changes in price evident in many asset classes, whether that is property, bonds, equities, antiques or classic cars. This memorandum contends that, given what has been stated above, equities remain our preferred asset class. Equities have risen in price fairly significantly over the past years but their attraction is twofold for the long term investor. Dividend income in a diversified high quality portfolio can provide a good annual return, in real terms and relative to the alternatives and this income provides fair recompense for the volatility that we have seen and are likely to continue seeing in 2016 and beyond. Secondly, it is likely that, over the medium to long term, capital values will increase, though to what extent and at what rate is very difficult to say. For these reasons we continue to favour companies with a progressive dividend policy, resilient earnings, adequate diversification and which are well placed to benefit from economic growth around the world.

Returning to our opening comments in this review, an investor who had been out of touch with events in financial markets for the first three months of the year might have made better decisions (i.e. do nothing) than those who were glued to the media during the first part of the quarter where endless tales of gloom about the billions being shaved off share prices could have induced panic and the unwise decision to be intimidated by market movements into selling good quality securities only to suffer the frustration of seeing equities rebound sharply whilst retaining the cash raised at lower prices. The recovery in international equity markets in the second half of the quarter has not, of course, made the headlines because it is "good news" and therefore not newsworthy. It is important to emphasise that nothing really changed early in the quarter, yet investors were looking at the "glass half empty" story. It is important that investors do not take their eye off the fundamentals and capitulate in the face of short term movements. Our view remains that cheap money and plentiful liquidity are supportive of shares and that bonds are seriously overpriced. For reasons mentioned earlier in this review, the latter are receiving plenty of support but, at some stage, the bond bubble will burst and there will be some painful losses incurred. Our view remains that international equity markets will grind higher this year but with some setbacks and negative quarters in the face of disturbing political and economic news. For sterling based investors, the uncertainty over the result of the EU referendum and the UK's worryingly large current account deficit, 7% of GDP in the final quarter of 2015, make geographical diversification essential as the sterling adjusted returns from international equity markets in the first quarter show.

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