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Fund Managers Report 5th April 2017 to 5th October 2017

Pausing for breath

The last half year has been more subdued for global equities after a strong run with more muted returns from global indices such as the MSCI World Index, whilst bonds continued to produce negative returns, albeit at a slower pace. The returns remained respectable but there was a strong sense of moving from hope, to getting down to the nitty gritty of business that prevailed over the period. It was also notable that there was a difference between the returns of income and growth focussed investments.

Risks and Opportunities are rising in a number of areas

Politics

Over the last year we have seen a number of significant political events in many of the leading G7 countries. Elections in France, Germany, and the U.K. have drastically changed the respective political landscapes in these countries reflecting the increasingly polarised politics we are seeing in Europe and North America. Elections are due in Japan at the end of October.

In France there was relief that the far right did not win and the new French President came with a great deal of promise, but to date he has not delivered and we fear this may be a repeat of the last two Presidents. The German election was a disaster for the established parties and the only way forward is a 4 way Jamaica coalition. We expect the negotiations to continue into December and although popular with the electorate there are fears it will not last. Whilst what was supposed to be a shoe-in election for the UK government ended with a disastrous loss of seats for the current government, which in turn has raised the probability of a change in the UK government (in the next 5 years) from negligible to about 25% according to some analysts.

This is all happening as the world still comes to terms with a significant shift in U.S. politics, which is changing a number of global dynamics. Many companies now face a higher degree of political risk (as seen with US car makers, US healthcare, the Paris Climate agreement or UK energy companies).

Without a doubt the level of political risk has risen and although attempts have been made to dismiss the changes as a response to immigration it is increasingly clear that there is a deeper level of economic anger at play across the developed world. A combination of technology change has collided with increasing inequality and poorer prospects in the developed world to create a more polarised and hostile environment that is quick to blame any convenient scapegoat.

On the flip side of these risks are opportunities as politicians start to respond. In the UK we are seeing the response to the 25 year old housing crisis actually turn into more homes (even council homes); in the US there may actually be meaningful tax reform which is long overdue and was last seen in the days of Ronald Reagan; and in France labour reform to tackle the chronic high unemployment is on the agenda. Whilst we can be sceptical about all three, if they are actually enacted well we could see a significant improvement in economic growth.

Debt Risk

Whilst the issue of consumer debt has been raised by regulators and some politicians, markets are bracing themselves for a decrease in Central Bank's balance sheets. To quickly recap, after the financial crisis Central Banks balance sheets ballooned as the US Federal Reserve, Bank of Japan, Bank of England and later the European Central Bank all embarked on aggressive Quantitative easing. Whilst the US and UK have stopped adding to this debt, the Bank of Japan and ECB are still aggressively buying bonds.

The U.S. Federal Reserve is now moving to the next phase of normalisation, which is one of selling down their holdings. To give an idea of the scale, the Federal Reserve Balance sheet grew from below $1 Trillion in 2008 to its current size $4.5 Trillion, they now plan to start reducing this at a rate of US$10bln a month (rising to US$50bln), making this a slow and steady process.

With the US and global economy running well, and this move being well flagged, we do not feel there will be any impact in the market. This will change if we see the economy take a turn for the worse.

The Fed's actions and the recent improvement in the Eurozone economy is increasing pressure on the ECB to begin to taper its aggressive bond purchasing programme, and expectations that something will be announced soon are increasing. We are less convinced that the markets are really ready for this but also expect the ECB to procrastinate. In the UK the Bank of England is expected to reverse the interest rate cut it made last year before the end of this year.

All this means global markets are entering a new tightening cycle, something that has not been seen in over a decade. Again, as it is well flagged we do see any risk at the initial stage but should the recovery wobble we fear this will be the point at when markets may overreact.

Economic Growth

We are still enjoying a world where all the G7 countries are enjoying sustainable economic growth with expectations for 2018 ranging from 6.4% in China to 1.2% in Japan. The UK has dropped from being a growth leader to number 6, much of the blame for this being put on Brexit uncertainty, and as India's growth outstrips China and emerging markets remain the key growth area. In the developed world we still expect economic growth to remain more subdued around the 2% area.

Brexit remains an insatiable source of political and media hot air, but both details and progress remain scarce. The fact it remains such a large threat to the Eurozone as well as the UK economy means we regard the current noise as posturing rather than a conclusion.

The currency market remains the shock absorber for all these bumps whilst equities and fixed income prefer to focus on facts.

Portfolio Changes

Having reduced fixed income last year, it was left alone over the last period. Inflation has been lower than we expected (in the UK) and index linked bonds have also drifted back as a result along with the wider bond market. Whilst we remain neutral to the bond market overall we feel the pullback we have seen over the last year has been healthy. The next six months will be an important time for bond markets as the process of normalisation moves into a new phase.

We have made three key changes to property exposure since our last report and finish the period with higher exposure to this sector. In June we sold the only conventional REIT, British Land from portfolios. Whilst we were happy with the post Brexit shock recovery and given that central London office and retail is still in high demand we felt this was fully priced in. Our main concern remains the ownership of a number of provincial supermarkets.

We added two residential property REITS which is why exposure is higher. One investment is in quality new affordable homes for rental, seeking to answer the chronic property shortage that is holding back the UK economy, as too much disposable income is being spent on rent or high mortgage payments, thereby depriving savings and discretionary consumption whilst raising debt. The properties are modern, affordable and in convenient metropolitan areas.

The second new investment was in a social housing REIT and the funds here are used for building new social houses. About two thirds of this is for tenants who need assistance and one third for conventional socials homes. These are let to regulated social housing providers.

Equity exposure is also unchanged over the period as we have reduced holdings into the rally. Overall equity markets have returned about 5% over the period, however this does disguise a very diverse range of returns. The more growth focussed investments generated very strong returns, notably the likes of Cranswick and Leroy Seafood (if held on ethical grounds) in food or Biffa and Renewi in recycling. Whereas the larger, more income focussed and defensive stocks underperformed with low or slightly negative returns, so the likes of Pennon, SSE and GlaxoSmithKline (if held on ethical grounds) all generated mildly negative returns. With each of these an element of political risk also weighed on the companies. Although there is a lot of noise on Brexit we saw some UK focussed investments do well and some global focussed companies do poorly over the period.

We have used some of the weakness in some environmental sectors to add to wind turbine exposure, mainly Vestas Wind Systems and the newly formed Siemens Gamesa.

Outlook

Having seen that the global recovery is picking up steam we remain positive in our outlook. However as we see markets have priced much of this in, we expect income to become more of a component in returns going forward. We have seen the risks become more political than economic, but so far the impact has been limited to healthcare and the environment. We see this spreading as politics change in Europe and matters such as taxation and budget come to a head in the US. The party congress in China will see a second term of President Xi, where we may see more assertion from China on the global stage.

From an ethical perspective, despite the political attempts to unwind environmental reform in the US, companies remain keen to maintain and improve their environmental performance as it matters to their consumers. Regardless of greenwash, there are some real changes happening.

Specific Ethical Sectors

Each portfolio has distinct ethics and different risk profiles and objectives, therefore some of the companies and strategies listed below may not be relevant to your portfolio. We actively encourage you to review your ethical stance by completing and returning the Values Based Questionnaire (VBQ) when applicable, as this is an important part of our investment process. A copy can be downloaded from our website www.ksep.co.uk.

Follow www.ksep.co.uk/PDF/Discretionary%20Questionnaire.pdf

Renewable Energy

As mentioned above we used the post-merger share price weakness to add Siemens Gamesa to portfolios, this is a merger of the Spanish wind turbine group Gamesa (who used to feature in portfolios a number of years ago) and the onshore and offshore wind turbine operations of the German industrial conglomerate Siemens. We also added a smaller amount of Vesta Wind Systems.

This year has continued (until recent weeks) to be a slow year for wind and one where we have seen solar emerge and we have been pleased with the returns from Foresight Solar (5.42%) over the period.

One area of concern was events at Good Energy. Since investing in them we have always engaged with management at the company (it is after all our job) and remain supportive of them, however we did vote against a number of the motions at the AGM. The drama around board places has to some extent been an unwelcome distraction.

Political risk manifested in the sector in two ways. The US withdrawal from the Paris accord and attempts to undermine environmental legislation and boost coal have had some impact, but less than feared as the renewable energy has grown from far more than just environmental to being an unsubsidised financial and strategic one as well. The UK decision to cap electricity bills (being 10 year too late) has had more of an impact on the share price of retailers such as SSE and Good Energy. Low wind speeds and an overhang of shares continue to weigh on Thrive Renewables. We continue to have dialogue with management at Thrive on a regular basis.

The very high risk end of this sector has seen mixed results, from very good at ITM Power to disappointment at Ilika.

Transport

A large part of your transport exposure is in bonds, both the Index linked Network Rail Bond and the fixed Deutsche Bahn and SNCF bonds. The rest is in equity in National Express and Go-Ahead Group. We have made no material changes in this sector.

Social Housing

This sector has seen the most changes in the last six months. Housing remains one of the leading economic and social issues in the UK. Too much disposable income in the UK is spent on high rents or mortgage payments, depriving consumption and more importantly savings and investments for the future. The Grenfell Tower tragedy further highlighted the results of a chronic 30 year problem of under supply in the UK housing sector.

During the period we added two investments, the PRS REIT is a property fund focussed on new affordable homes for private rental and the Triple Point Social Housing REIT focussed on new social housing (about two thirds of this is housing for people with needs). We sold British Land as we felt the stock had recovered well from the Brexit shock but that changes in retail behaviour would eventually impact the out of town supermarkets they hold.

Although Mears Group had no involvement with Grenfell Tower, they were impacted by the delays that this has caused in the social housing sector and they warned the market to that effect. We used the weakness after the warning to add to the holdings. Overall exposure to social housing (Mears, Triple Point, PRS and Places for People) is now about 10% of most portfolios.

Construction and Property

There have been no material changes to investments in this sector

Environment, Waste and Water

We added Renewi (formerly Shanks) to portfolios to complement the holding in Biffa and Pennon. We see the recovery in their core markets, the Low Countries, as an opportunity for this investment.

We continue to use United Utilities as a secondary income investment alongside Pennon.

As a leading producer of catalytic convertors Johnson Matthey was more vulnerable to the diesel scandal and we sold the holdings. We remain invested in Tesla (where ethics permit), Spectris and the Impax Environmental Investment Trust.

Financial

The only conventional financial investment we hold in this sector is Aviva, who are best of class in the insurance sector. Like other insurance companies they have been involved in financing renewable energy and social housing projects.

Our other investments in this sector have been more ethically focused with the unlisted and smaller (as well as riskier) investment in Triodos Bank. We are also invested in their microfinance fund, providing micro loans in the developing world. In addition most larger portfolios will have an investment in Innovare notes, these notes help finance the leasing of farming equipment to midsized farmers (too big for microfinance and too small for banks) to enable them to keep more of the value of their crop in their local area. They operate in five East African countries.

Food

In many cases we trimmed the investment in Leroy Seafood (where held on ethical grounds), we still like the company but the recent returns were very strong. Cranswick and Unilever remain unchanged. Recently we have been re-visiting some organic food companies in this sector following Amazons takeover of Whole Food Markets.

Healthcare

We have sold MedaPhor after losing confidence in the investment. We recently added Fresenius SE to portfolios that permit it on ethical grounds. In addition to being a leading dialysis and I.V. company they own a number of acute municipal hospitals in Germany and Spain.

Retail

Early on in the period we sold the investment in Sainsbury's as the retail outlook changes, we are only invested now in the internet pioneer retailer ASOS.