meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Our table below of international equity performances over the quarter shows a full house of pluses as markets take the UK's EU referendum result in their stride and monetary policy becomes even looser in important centres. On the other hand, conditions in bond markets have become less settled with the concern in the background about the unsustainability low yields on bonds. In currency markets, sterling continued to weaken due to post Brexit uncertainty but there was little change in commodity prices as measured by the oil and gold price.

The tables below detail relevant movements in markets :

International Equities 30.06.16 - 30.09.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.5	+11.5	+8.4	+7.2
Finland	+6.2	+10.6	+7.5	+6.2
France	+5.3	+9.6	+6.5	+5.3
Germany	+8.9	+13.4	+10.2	+8.9
Hong Kong, China	+11.7	+15.0	+11.8	+10.5
Italy	+1.1	+5.2	+2.3	+1.1
Japan	+7.5	+12.1	+8.9	+7.7
Netherlands	+7.1	+11.5	+8.3	+7.1
Spain	+8.2	+12.7	+9.5	+8.2
Switzerland	+2.0	+5.5	+2.5	+1.4
UK	+7.3	+7.3	+4.2	+3.1
USA	+4.0	+7.1	+4.0	+2.8
Europe ex UK	+5.0	+9.0	+5.9	+4.7
All World Asia Pacific ex Japan	+7.5	+12.4	+9.2	+7.9
All World Asia Pacific	+7.5	+12.3	+9.1	+7.8
All World Latin America	+8.0	+8.9	+5.8	+4.6
All World All Emerging Markets	+7.3	+11.2	+8.1	+6.9
All World	+5.1	+8.5	+5.4	+4.2

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +2.3%

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

Currency	30.06.16	30.09.16
Sterling	1.00	0.75
US Dollar	1.46	1.59
Yen	-0.23	-0.08
Germany (Euro)	-0.13	-0.19

Sterling's performance during the quarter ending 30.09.16 (%)

Currency	Quarter Ending 30.09.16
US Dollar	-2.2
Canadian Dollar	-1.2
Yen	-3.9
Euro	-3.6
Swiss Franc	-2.8
Australian Dollar	-5.0

Other currency movements during the quarter ending 30.09.16 (%)

Currency	Quarter Ending 30.09.16
US Dollar / Canadian Dollar	+1.1
US Dollar / Yen	-1.7
US Dollar / Euro	-1.4
Swiss Franc / Euro	-0.8
Euro / Yen	-0.3

Significant Commodities (US dollar terms) 30.06.16 - 30.09.16 (%)

Currency	Quarter Ending 30.09.15
Oil	-0.2
Gold	+0.2

MARKETS

It has been a strong quarter for international equity markets with positive returns across the board. In local currency terms, the FTSE All World Index returned 5.1%, in sterling terms 8.5%, in US dollar terms 5.4% and in euro terms 4.2%. Looking at local currency returns first, there was a fairly narrow dispersion of performances. The strongest areas were Latin America where the FTSE All World Latin America Index returned 8.0%, Japan, where the FTSE Japan Index returned 7.5%, the UK where the FTSE UK Index returned 7.3%, as did the FTSE All World All Emerging Markets Index, whilst the FTSE All World Asia Pacific ex Japan Index returned 7.5%. There were no significantly below average performances in our table. With post Brexit weakness in sterling continuing, sterling investors saw their sterling returns enhanced assuming they held overseas investments. The UK then became a below average performer. The best return in sterling adjusted terms came from the FTSE Japan Index which returned 12.1%. Australia, too, performed very well with the FTSE Australia returning 11.5% in sterling terms. The FTSE All World Asia Pacific ex Japan (12.4%) and the FTSE All World Emerging Markets (11.2%) indices also performed very well. Whilst slightly below the return in sterling terms on the FTSE All World Index, the FTSE USA Index still put in a strong performance returning 7.1%.

Performances in the international government bond markets as measured by ten year benchmark bonds, were mixed. The UK government bond saw its gross redemption yield fall by 25 basis points to 0.75% but elsewhere bond prices fell. The gross redemption yield on the US Treasury bond rose by 13 basis points to 1.59%, on the Japanese government bond by 15 basis points to -0.08% and, on the German Bund, by 6 basis points to -0.19%, still an incredible position.

In the currency markets, whilst the fall was not as sharp as in the immediate post EU referendum period, sterling was still noticeably weak. Against the Australian dollar it fell by 5.0%, against the yen by 3.9%, against the euro by 3.6%, against the Swiss franc by 2.8%, against the US dollar by 2.2% and against the Canadian dollar by 1.2%.

In the commodity markets, oil and gold hardly changed in price over the quarter.

ECONOMICS

Almost all of our clients receive quarterly valuations as it is generally considered to be an appropriate period over which to report on short term changes and to attempt to spot nascent trends. This notwithstanding, we will regularly stress the need to view investing over a much longer period and five years would be considered the minimum period over which equities should be held if we are talking about our clients' portfolios which are particularly or totally invested in that asset class. It is now over three months since the historic referendum where 17.4 million voters took the United Kingdom on a path to leave the European Union. This is an opportunity to consider how markets have reacted over July, August and September to this and other events and to reflect on what can be taken from this period.

The first comment to make relates to the rise of the pound immediately before the vote with the pound strengthening as many market participants had decided, in their minds, the outcome and bet on the perceived safety of a remain vote. The evidence from pollsters was that the outcome was too close to call; a poll of those working in financial markets, however, may have predicted an outcome heavily skewed towards remain as, for example, every central London constituency voted remain and seven out of ten of the areas with the highest share of the vote for remain were in London. Polls amongst academics and some other city dwellers also revealed similar statistical bias and the power of consensus, where decision-making in complex situations is determined by the actions of those nearby, may have driven pre-vote behaviour. This pattern of 'group think' is well recognised by academics and is reinforced in groups where participants consider themselves similar, e.g. those working in the same profession.

In the immediate aftermath of the vote there were political casualties as government changed to reflect the democratic will of the people and sterling fell immediately. The days before the referendum had seen the opposite with sterling rising in value against the US dollar from $1.42 to, briefly, $1.50 on 23rd June. The pound then plummeted, trading as low as $1.32 on 24th June and then continuing to fall to a low of $1.28 on the 6th July. At this point there was a clear divide in equity market sentiment with any UK-exposed assets seen as being less attractive and any non-UK assets becoming significantly more attractive to sterling investors as their value was translated into more pounds due to the currency's weakness.

Whereas the last days of June were confused, the latter summer months were, surprisingly, a period of relative calm with sterling stabilising at its lower level and equity markets regaining their poise. Looking at the fallers in the FTSE 100 index in the first week following the vote, all 10 of the largest fallers were banks, construction-related or airlines, with Royal Bank of Scotland falling over 30%. It was the 'least British' companies that gained the most over the same week with Mexican silver mining company Fresnillo rising 42%; some switching, non-sterling and non-UK income and a predilection for precious metals in difficult times all helping the price higher. By the end of September, the FTSE100 index had risen gently to 6899.33 as knee-jerk fears retreated. Looking further afield over the same period, the S&P 500, the index of the 500 biggest U.S. companies, recorded its longest run of days with no overall movement exceeding 1%. It is unlikely that what was happening in the UK had much to do with that but it does illustrate how this has been a period of relative calm.

What can market movements tell us about the decision of late June? UK share prices have seen two influences in this period. Firstly, those businesses which operate in markets that are more vulnerable to change have fallen. Travel, house-building and financial services would be sectors where there continues to be a larger question mark than elsewhere, relatively speaking. Will travel to and from the UK reduce, become more complicated or be subject to new taxes? Will demand for housing in the UK fall, along with house prices? Is London's prized title of leading international financial trading centre at risk? The falls in these sectors have moderated over the summer but prices remain significantly lower than in early June, though other changing influences must also be factored in.

This would support the view that there is still some distance to travel before event-driven uncertainties will be known. We must remind ourselves that, of course, nothing has changed in 2016 other than a change of intention; the cross border trade of goods and services has not seen any rule changes and the U.K. remains a full member of the European Union. Everything is still in front of us. The second influence on share prices has been a positive one with the hit to sterling having a positive effect on those companies whose income is in non-sterling currencies and, given the international nature of the FTSE 100 overall, somewhere around 70% of those companies' revenue is in currencies other than sterling. If a hypothetical company had a sterling share price but received all of its income in US dollars, following a devaluation of sterling by 10%, all other things being equal, you would expect its share price to rise reflecting these factors.

A good illustration of the greater effect on companies with UK /sterling exposure can be found by comparing the FTSE 100 with the FTSE 250, which are the 250 companies next in size after the FTSE 100. Whilst the FTSE 100 companies are more international - with some companies that have a listing in London but no business in the UK, the FTSE 250 tends to reflect companies with a higher exposure to the British economy. Two trading days after the result was known, the FTSE 100 was down around 5% with the FTSE 250 down 13%. By 30th September, the FTSE 100 was up 8.9% and the FTSE 250 up 3.1%, compared with the 23rd June. These reflect the weakening of sterling and this is shown when the same indices are re-based into US dollars - FTSE 100 down 4.7% and FTSE 250 down 9.3%. Measured in euros, the FTSE fell almost 3.6% since the 23rd June and the FTSE 250 8.7%. For the first nine months of 2016 the FTSE 100 is up 10.5% and FTSE 250 is up 2.5% in sterling terms.

Post-Brexit UK economic data has been under great scrutiny, though it would be fairly difficult to discern any change in short term trends pre- and post-referendum, with unemployment and numbers employed continuing to move in the right direction, consumer confidence measured by the GfK Consumer Confidence Indicator recovering after its July post Brexit drop and industrial output seeing some improvement. Data on house prices and mortgage advances were less positive but the fall of sterling aside, these items of data suggest the fears could have been over-stated, though the full implications will not be known for some years.

This monthly piece is titled an economic review but it is striking how it is a sequence of political events that shapes so much of what is written, because of the scale of the reaction markets could have to certain outcomes. This month we consider Brexit and next there is the Presidential and mid term elections in the United States followed by the referendum in Italy in December. Moving into 2017, we have the French Presidential election and, over an undefined timescale, there is the need to establish settled governance in Spain. Whilst some of these events are scheduled and some are one-offs, they all could be disruptive because of their potential to create change where companies, generally, would prefer to trade within the status quo, rather than consider an unscripted future. As investors, seeking to value these companies, we must also factor in the actions and words of central bankers, whose influence, and desire to influence, is greater now than at any time in the recent past.

The superstructure of the European Union has been weakened by Brexit but the potential for Italy to cause more damage, closer to the centre of the project, will be seen after their referendum. The Five Star Movement has established itself alongside the two established parties of Italy and it is leading the ‘no’ vote which could conceivably topple europhile Prime Minister, Matteo Renzi. This could lead to a snap general election where it could ride the momentum of the hour and take power. The consequences of a new direction of travel in Italian politics could cause irreparable damage to the European Union and ultimately to its break up though, it should be stressed, that this is offered as one potential scenario, and not because it is the most likely outcome, but because the potential for such an outcome contributes to thinking in markets. The referendum was scheduled for October but has been pushed back to December. Whilst the referendum is purely about reforming the process of government, something that is much needed, Renzi’s offer to resign, should he not win, has transformed the significance of the event and stirred the populus and their thinking.

The purpose of highlighting this sequence of political events is to emphasise the need to exercise caution when investing. Whilst there is always an argument for not investing, and for many, not investing in equities, if investments are made in a structured and diverse portfolio and are held for a suitable period of years, history supports the rationale for this type of investment. A high quality, highly diversified international food producer, for example, should be sufficiently resilient and flexible to accommodate the events and political change which come year after year. A similar validation can be applied to very many other goods and service providers.

Despite the above, and the turbulence of the last decade, it has been a good period for equities and it is a well-observed fact that much of what is happening elsewhere has and is supporting equity prices. A good example of this is the prevailing conditions in bond markets which, historically, have formed a significant part of many private investors' portfolios. Legally the claim on a company by being one of its on-balance sheet creditors (through being a bond holder) is stronger than contributing to its capital base through equity ownership with no defined certainties around dividend payments or the formal repayment of the capital amount. Bonds have traditionally been categorised as a lower risk, lower return investment and their inclusion in portfolios supported by their steady, income-generating characteristics. Over the last thirty years, however, bonds have enjoyed particularly high returns as interest rates have fallen around the world. The Bank of England's official base rate peaked at 17.0% in November 1979, by 1992 the interest rate fell below double digits for the last time and there were nine cuts between 2007 and 2009, when rates reached 0.5%, where they remained until August this year and the most recent cut to 0.25%. This has created benign conditions for bonds as a hypothetical long-dated gilt issued in 1979 with a 17% fixed coupon would become more and more valuable as interest rates fell and the 17% annual income becomes progressively more attractive. Each subsequent seller of the same bond would have profited from its rise in value on the basis that it had been possible to sell it on at an ever higher price. The consequence of this fall in interest rates to their current level is that bonds are, by any measure, exceedingly expensive, with prices that have been driven ever higher by the will of central banks. The effect on the investor is that each fall in market interest rates is reflected in a rise in the value of bonds and a fall in the corresponding yield. The investor who sells crystallises a gain and the buyer is locked in at the lower yield. For some time, the yields have been so much lower than the dividend yield on quality equities that the attractiveness of bonds as an investment has diminished greatly, yet this has been masked, to a certain extent, by the ongoing gains in value for the long standing bondholders.

Our view at Meridian is that bonds cannot at this time be considered a lower risk investment as there is increasing evidence that the appetite to continue lowering interest rates, which consequently raises bond prices, is, like the yield on many bonds themselves, close to zero. Monetary economic theory dictates that lowering interest rates will shift the momentum in an economy away from saving and towards borrowing. Individuals acting in a less constrained way and companies finding investment projects more attractive as their cost of funding falls should lead to economic expansion. The paradox of thrift, however, states that in straitened times (when you are most likely to experience low interest rates) individuals will save more, out of caution, which will decrease demand for goods and services leading to a drop in gross output which will lead to a drop in overall savings. Negative interest rates have been with us for around 2 years now and there is growing feeling that the stimulus effect of each marginal cut is now questionable, with growth rates and inflation rates remaining far from target and, in fact, more pernicious consequences are being seen. Two examples of this would be the distortion of bond markets and the effect on banking profitability. Admittedly neither of these resonate with the public greatly until they move from the financial pages to the front page.

The market has, for some time, seemingly been in denial about there being a lower limit for bond yields such is the distortion to normal market patterns created by the forced buyers in it - central banks, banks holding reserves and insurers matching liabilities. At what point does an asset's return represent such a poor investment that is should be ruled out? In the case of huge swathes of the bond market it is a certainty that bondholders will lose money in nominal terms and in all likelihood in real terms if those bonds are held to maturity. There is a growing risk that the lower limit for bond yields will (finally) be reached and a reaction against that floor may lead to a buyers' strike amongst those who can choose whether to buy. This could be very dangerous as investors seek to sell bonds before prices fall more and this would create a rush for the exits.

The International Monetary Fund has revised down its forecast for world growth every year for the last seven years and is not alone in doing so. Despite what has been done, and interest rate policy would be a core facet of the response, the effectiveness of the measures taken has fallen short of what had been anticipated. It now seems that there is less appetite to continue in the same direction of travel and the level of concern about a potential halting or even a reversal of central bank monetary policy reflects the extent of artificial support that the policy has provided. It is a truism that the more distended a price in any market becomes, the more volatile it will become and the more sensitive to any new news. One leading example within the bond market at this time would be the Japanese Government Bond (JGB) market and in August there was a timely reminder of the risks which prevail across large parts of the fixed interest market. Over a three day period yields on 10 year JGB rose from around -0.3% to -0.1%, an abrupt movement which was caused when bondholders were disappointed by the size of the increase in the bond buying programme of the Bank of Japan. In the distorted market that exists we are at the point where large market movements are based on the nuanced and over-anticipated policy statements and actions of central banks, at a time when their appetite to keep doubling the dose of medicine seems to be running out. Whilst Japan is highlighted here and, compared with other G8 countries, it is the most indebted, with the lowest interest rates and the lowest growth rate forecast for 2016, with the exception of Russia, and the lowest of all next year, other bond markets show similar vulnerabilities due to the reliance on continuing central bank action. Yields have since remained at the higher level and longer dated JGBs' yields are at their highest level since March as the Bank of Japan has suggested it may buy fewer long dated bonds as it seeks to steepen the yield curve. The steepening yield curve has been observed to a lesser extent in Europe and the U.S. and under normal conditions it would be symptomatic of a healthy economic outlook as buyers of bonds anticipated higher interest rates and inflation in the future. It would be less positive if the steepening is simply because of the central bank decision to buy fewer longer bonds.

Two other factors that raise the level of concern regarding bond markets are, firstly, the global nature of markets and, secondly, the possibility of the change in direction in interest rates. The inter-connected nature of international markets is, broadly speaking, a positive in that it is now possible for an investor in one country to buy assets originating in a second country on the other side of the world, with secure settlement, transparent costs and good market knowledge of the security. One negative is that the openness of markets means that the risk of contagion is greater. If there is a fear regarding a particular asset, similar assets in other connected markets are likely to experience some price movement. This was seen in the sovereign markets in August. Secondly, the greater fool theory, where an asset can be bought at a high price if there is the knowledge that there is always a buyer who will pay even more for it, quickly unravels when interest rates turn. Such a point of inflection could be triggered by policy, market or economic data or a change in sentiment or one or more of these acting in concert but with prices of the highest grade bonds at record levels, their riskiness is affected not by the issuer's creditworthiness but by the unrecoverable loss when yields rise from historic lows. Turbulence in high risk markets is expected and priced in but turbulence in what are traditionally low risk markets is inherently more dangerous.

A further element to the contagion debate is whether significant movements in bond markets would translate into falls in the equity markets. There are two trains of thought here. Either a rout in bond markets would lead to a desertion of other risk assets and lead to inflows into precious metals, Swiss francs and the Japanese yen - and other perceived safe havens. Perhaps less likely is that investors would either take profits or accept losses on their bonds and transfer across to equities, as, in this topsy-turvy world, they are seen as reliable income generators (and, as if to emphasise the displacement in markets, some investors have been buying low/no yielding bonds for capital gains!). It would be wrong for equity holders to get spooked by a sell-off in bond markets but there is always a risk that sentiment can change quickly if other parts of the financial markets suffer a degree of turmoil. The immediate consequence of a bond sell off would be an implied increase in longer term interest rates which would provide a test for central bankers. As mentioned earlier, it has been their explicit aim to lower the cost of borrowing, alongside improving borrowers' access to funding. It may prove that, at this point, bankers would be prepared to allow rates to rise as it would create some space should we be faced with a deep economic downturn and would expand the period over which rates might rise to something approaching 'normal'. Central banks are, of course, mandated to oversee financial stability and this would include managing volatility in bond markets. Should bond prices fall significantly, central banks would seek to calm markets, probably by buying into the falls, much as they became lenders of last resort to avoid runs on banks. Their capacity to buy assets is not limited in financial terms but at some point the policy will need to be unwound. At this stage it would be worrying if policy is predicated on even more extreme intervention.

The semantics of the word 'normal' can be complicated as there is a need to apply context to circumstances and ultimately to establish a consensus view on those circumstances. An example of this difficulty can be seen when trying to consider the economic conditions which apply at this time and to try to consider how likely they are to prevail. In terms of the historic trends which have applied over many decades, it would be nigh on impossible to argue that there is anything normal about the current economic conditions. However, is it possible that we need to get more used to them and, as we move through the current decade, the current low interest, low inflation, low growth pattern embeds itself into the medium to long term. The lowering of interest rates as a tool of economic policy is something which has been common practice in periods of economic slowdown for a very long time and the acceleration of this process since the financial crisis has been eye-catching. As mentioned earlier, rates have been on a downward trajectory for thirty years as factors other than policymaking have played a part. The IMF in its World Economic Outlook in 2014 explained some of the factors it saw contributing to this gradual lowering of rates as a pretext for understanding if rates around the current level will become 'normal'. It concludes that there have been three factors which have led to lower interest rates since the late 1990s. Firstly, a steady increase in income growth in emerging market economies led to substantially higher savings rates. Secondly, the demand for perceived safe assets such as bonds has increased and, thirdly, there has been a sharp decline in investment rates in advanced economies since the financial crisis. It concludes that interest rates are expected to rise in the medium term, but only moderately, as these factors are unlikely to reverse substantially.

Summary: Nothing much has changed since 23rd June. There has been neither a financial implosion nor post-event euphoria. Economic data has followed a pre-referendum pattern with a mix of relatively good and slightly underwhelming data and those on both sides of the debate have maintained their positions regarding their views of what may unfold in the future. In summary, it would seem that, excepting the decision, there is a sense of 'wait and see'. There is consensus that there is a higher degree of uncertainty associated with life outside the E.U., if that is what eventually happens, but the process that takes us to that point is likely to be very long.

This quarter should have translated into a positive quarter for our clients with the FTSE All-World Index returning 8.5% in the three months to the end of September, when measured in sterling terms. The same benchmark, when measured in local currency, returned 5.1%, still a very healthy performance.

In the context of investing on behalf of clients it is worth considering the value of speculating on how the UK's relationship with its immediate neighbours will develop, against the ability to manage such potential risks through portfolio management. It has been Meridian's long held view that the UK should be viewed as just another investment market and not given undue weighting through overfamiliarity. Looking at this hypothetically, a portfolio that solely held smaller UK companies with no overseas exposure i.e. a very high exposure to the UK, would be more vulnerable to high volatility and potential losses than an internationally diverse portfolio with high levels of overseas exposure and income. Equally, there is a possibility that the more domestic portfolio could show more significant gains should the outcome for the UK economy be very favourable. As things stand, for the sterling-based investor, the first nine months of 2016, greatly helped by the fall in value of the pound, shows the FTSE All-World Index returning 21.5%, the FTSE 100 Index14.1%, and the FTSE 250 Index 4.9%. In addition to this, the low interest rate environment continues to be helpful to the companies in which we invest, primarily in that the access to inexpensive funding over the medium to long term is of great value to those businesses and the relative attraction of those companies' dividends, in real interest terms i.e. compared to the effective interest rates available through other assets, provides a tailwind for their shares.

Whilst equities still represent our preferred asset class, returns so far this year have been way ahead of what we expected at the beginning of this year when we suggested that shares would grind higher this year, interspersed with some setbacks due to disturbed economic and political conditions. We had not factored in Brexit, although we had continued with our policy of spreading the risk by diversifying portfolios geographically. Whilst returns have been very high, these have not been achieved for the best of reasons, with a significant, but not total, part of the rise being caused by sterling's extreme weakness. But with bonds extremely overvalued, in our view, and little, if any return on cash deposits, an internationally diversified portfolio of equities, unless the mandate specifies differently, seems to us to be the best way to address highlighted risks to the UK caused by Brexit. This is not to give a view one way or the other on whether Brexit will be beneficial to the UK, rather it is to point out that the risks to the UK are elevated in the foreseeable future. Unhedged international equities still appear to us the best way to address this issue and, of course, dividend yields are generally higher than available on good quality bonds. Investors cannot reasonably expect the same rate of returns as have recently been seen and there are bound to be setbacks along the way but we see no reason to alter our policy.