News & Views

Q4 | 2018

Catch the right waves

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Welcome

After a surprisingly hot summer, it looks as if we might be back to business-as-usual this autumn – with schools and parliament re-opening, politicians behaving badly on both sides of the Atlantic, and the UK market still paralysed by the mysteries of Brexit.

Politically, it is certainly due to be a busy season, with an EU summit (where the powers-that-be are praying for a Brexit deal) and the autumn Budget – signposted to arrive earlier than usual. Across the pond, we face the final leg in the race to the midterm elections.

However, it is not all doom and gloom. In this edition's market review and outlook, Richard Champion explains that it is incumbent on us to be aware of these events, but more important to keep a close eye on the economic fundamentals really driving markets and ensure we take a global view. Based on this, we have plenty of reasons to look to the future and feel constructive in our outlook. As you will see on page 4, we still expect major equity markets to move higher over the rest of the year.

At our upcoming client event in November, entitled 'Predicting tomorrow's world', we will extend our focus on the future (see details on page 23). We are delighted to be showcasing some thought-provoking and inspirational speakers, from Baroness Ros Altmann to James Anderson, Manager of the famous Scottish Mortgage Investment Trust at Baillie Gifford, and Dan Holden, Research Fellow at the Longevity Centre. We hope you will be able to join us and hear how innovations in technology, communications and healthcare might affect your investments – as well as your future life.

As a teaser for our event, Justin Oliver's article on page 14 discusses the attractions of the global technology sector – and explains how AI and automation are causing massive disruption across the business world. As digital capabilities become hygiene factors for consumers today, we are also looking forward to launching our new, more intuitive and helpful Wealth Online app for clients to access information about their portfolios. On page 8, Michel Perera has written a piece on the potential new world order – the US is top of the leaderboard today, but could China challenge the US's supremacy as the top superpower?

How will millennials change the future and future investment? Having grown up in a world where information barriers that slowed down their parents have fallen, data that used to be buried is now unearthed, and social connections that used to be out of reach are now instantaneous, we are conscious that investing ethically will become increasingly important to them. On page 20, we look at the evidence to support taking a more diversified ESG (environmental, social and governance) strategy over a more exclusive ethical one.

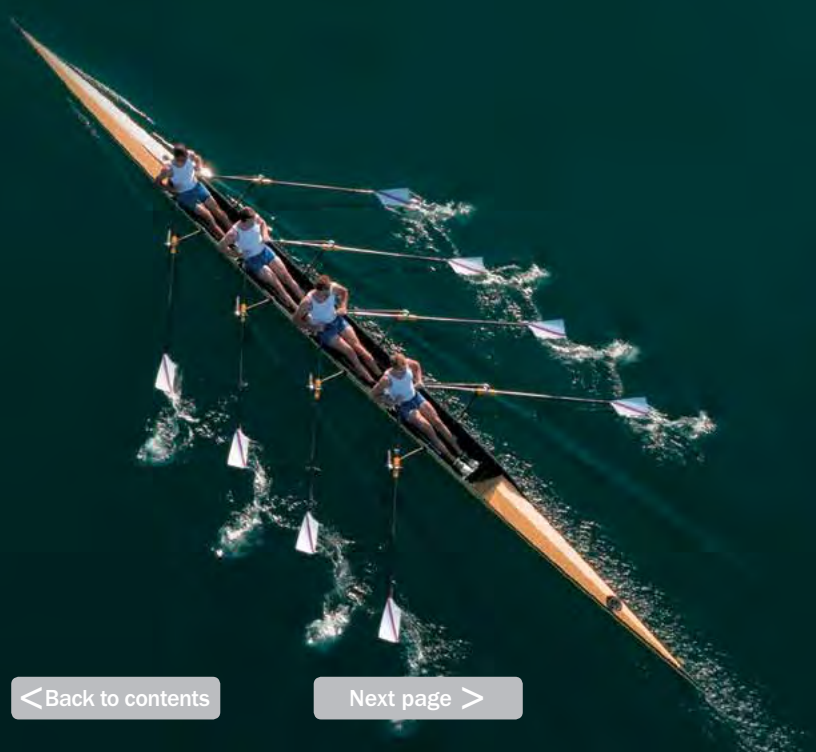
This quarter, our featured stocks are SAP (software applications), Admiral Group (insurance) and Compass (food services). Even within News & Views, we are committed to diversifying our selections! And don't miss our article on inheritance tax (IHT) which covers a frequently missed way of helping to mitigate IHT. This is particularly relevant as we await the outcome of the Office for Tax Simplification's IHT report this autumn. If you want to know more about IHT planning, please join our seminar on 6 November.

I hope you enjoy reading this edition of News & Views. As ever, we welcome your feedback; if you would like to get in touch with me or your Investment Manager, we would be delighted to hear from you. We hope to see you at our upcoming events.

David Esfandi,
Chief Executive Officer, CGWM

Richard Champion,
Deputy Chief Investment Officer, UK

The global market leaderboard



Over the last quarter – to the time of writing – there has only really been one place to be: US equities. Translated into sterling and including dividends, the S&P 500 is up by 9% over the period, while of the other major markets, only Europe and Japan have shown a gain – of around 3%. Bringing up the rear, with hardly any movement at all, are the UK and emerging markets, although the latter hides a developing bear market in China, with the local indices there down 22% since their high in January.

However, in economic terms this accurately reflects a fairly positive story and the relative momentum of growth. It also reflects the extent to which this growth is dependent on local drivers rather than global trade.

Certainly, the US economy has shown strong growth (bouncing back after a weather-hit first quarter) with a reading of 4.2% annualised in the second three months of the year. Momentum elsewhere has been weaker, with readings from Europe continuing to decelerate from the fast pace of the end of 2017, while Japan is showing few signs of lift-off (even if wages there are finally gaining some traction). China is clearly slowing down below targeted growth rates, while the UK is bumping along the bottom of the G20 growth table at an annual rate of 1.3%, hit by Brexit-induced uncertainty and political gridlock.

The rise in the dollar has also pushed up US returns relative to other countries and particularly hit emerging market assets and currencies. In addition, moves in China to curb the growth of internet gaming has hit the value of some of China's technology titans which had previously led the market. For example, the share price of Tencent, one of the largest such companies, has fallen almost 30% since its peak in January, wiping some US$170bn from its market capitalisation.

Trump slugs it out

President Trump's assault across multiple fronts against all America's major counterparts has dominated the news and investor sentiment. After starting in the first quarter of the year with an attack on his closest neighbours in Canada and Mexico, Trump then moved in the second and third quarters of 2018 to Chinese exports, where the focus of his beef lies, before widening his target list to his European trading partners, in particular the German automobile industry.

By simultaneously attacking his military allies in NATO and placing sanctions on Turkey – a NATO member and key regional player in the Middle East – and cosying up to President Putin, the US president has unsettled investor sentiment and helped drive a sharp rally in the US dollar. Although there has been good progress in renegotiating NAFTA, the trade agreement that ties the US to Mexico and Canada, at the time of writing the US and Chinese administrations have been slugging it out toe-to-toe with identically sized tit-for-tat tariff measures.

> Brexit and the negotiations surrounding it have created unique threats, and possibly opportunities, for the UK economy.

Monetary policy moves

The increase in uncertainty prompted by trade worries has not, as yet, caused central bankers across the globe to step back from their very gradual move to policy normalisation. Both the US Federal Reserve (Fed) and the Bank of England are raising rates, with the Fed's move in September unlikely to be the last. Markets expect at least one more increase in the Fed funds rate before the end of 2018 and perhaps two or three further quarter percent increases in 2019.

In the UK, August's 0.25% rise may well be the last until the trajectory of the final Brexit deal or no deal is known, but it's clear that Governor Mark Carney and his colleagues would like to push rates somewhat higher than the current 0.75% level. In Europe, the ECB has indicated a desire to halt quantitative easing (QE) by the end of this year, with consideration of interest rate increases from the minus 0.4% level likely by the middle of 2019. Finally, even in Japan there have been some technical moves that might presage a reduction in the extraordinary level of liquidity provided to the market by the Bank of Japan.

The gradual tightening of monetary conditions has been reflected in the bond markets, which have struggled to make progress this year. In the UK, the total return from the benchmark FTSE Gilts All Stocks Index is -1%, and ten-year Gilt yields have risen from 1.19% at the end of 2017 to 1.55% today. In the US, the equivalent figures are from 2.41% to 3.06%. Corporate bonds have suffered as well, with UK issues below 15 years' maturity also returning -1% so far this year, even if they have risen slightly so far this quarter. Given the rises in interest rates, this flat performance is relatively reassuring.

The risks

Underpinning the performance of equity markets has been a strong profits performance from companies across the globe. Led by the US, where earnings have been boosted by corporate tax reform, profits reported in the last few months have beaten consensus estimates consistently. The positive picture for companies was repeated across all the major equity markets, even those without direct exposure to US profit streams and lower tax rates there.

However, the situation has not been without its risks, from trade wars, political risks and Brexit.

Trade wars

Obviously, foremost among these is the potential for President Trump's trade wars to spiral out of control, hurting company profits, increasing inflation and leading to tighter-than-anticipated monetary policy. There is also the potential for central banks to raise interest rates too far and too fast – it is notoriously difficult to manage interest rates at times of strong economic growth.

> Although we would expect some volatility as politics and trade issues hit headlines over the coming months, we would still expect major equity markets to move higher over the rest of the year.

Political risks

In Europe, these are centred on the populist government in Italy, which may well produce a rule-busting budget in defiance of her eurozone partners. In the US, with approaching midterm elections, it's possible that further legislative progress may become ensnared in political gridlock if the Democrats win the House of Representatives; and the rumbling progress of Special Counsel Robert Mueller's investigation into alleged collusion between the Trump campaign and Russia may yet produce sensational news.

Brexit

Of course, the most profound risks facing our UK clients centre on the progress, or otherwise, of talks on a final Brexit deal. Brexit and the negotiations surrounding it have created unique threats, and possibly opportunities, for the UK economy. At the moment, there is an increasing drumbeat of negative company news, with European headquarter relocations to the continent, the transfer of City financial functions to other European jurisdictions and evidence of slower company investment in the face of the prevailing uncertainties.

Despite all these risks, we remain optimistic about the prospect for equities over the coming months. As noted above, economic and corporate momentum is strong, and while rising gently, interest rates remain low by historical standards. This is alongside recent profits growth improving the valuations on the major equity markets so that they are no longer stretched compared with previous peak levels. Meanwhile, the recent rises in bond yields do not, as yet, offer attractive entry points, in our view.

So, although we would expect some volatility as politics and trade issues hit headlines over the coming months, we would still expect major equity markets to move higher over the rest of the year.

If you would like to know more about our views on markets and the outlook for your investments, please speak to your Investment Manager or call us on +44 207 523 4500. We'll be pleased to explain how our experts stay at the forefront of economic changes and opportunities.

Michel Perera,
Chief Investment Officer

China – the next superpower?

Ever since the collapse of the Soviet Union, the world has been waiting for another superpower to offer an alternative to untrammelled US economic and military power. China may be about to step into these shoes. The field could also become more crowded as President Trump's confrontational approach to US allies spawns a willingness by erstwhile friends to stop relying on the US.

The issue is rendered more complex by the interaction of economic, military and societal upheavals generated by the current populist wave. The trade war agenda has triggered a lot of noise which is obscuring the major changes already under way in this superpower race.

Defining the starting grid

China is the obvious competitor to the US, particularly due to its Made in China 2025 project, which aims to create its own technology in robotics, semiconductors, artificial intelligence, big data, electric vehicles, alternative power and biotech.

Europe and Japan should have been competitors too, owing to their strong technological capabilities in most of these sectors, but they are driven by a different set of objectives. They have always played by US rules so that their technology can dovetail with the US's. Crucially, they have chosen not to compete outright in the internet area, whereas China has created companies to replicate the US internet giants, with great success.

In addition, being dependent on the US for a large part of their defence has made developed countries less willing to build broad-based autonomous capabilities.

Lastly, the manpower, government spending and political will mustered by Europe and Japan are way behind China's. Just 20 years ago, China could not compete in high-tech high value-added sectors, but today advanced countries find Chinese competitors in the overwhelming majority of their technology exports.

The acid test for this distinction is that President Trump is criticising Europe and Japan for their automobile exports, not for their robotic or AI skills, whereas China is under the cosh for obtaining US intellectual property illegitimately, proving that the US fears China as a technological competitor.

A takeover bid?

China has also gone further by creating a network of supporting, and perhaps even subordinated, countries in a way similar to the US Marshall Plan – the US initiative set up after the end of World War II that provided over US$12bn (worth at least 100 times more in today's money) to help rebuild western European economies. China has secured sources of raw materials in Africa and created trade outlets for itself in many Asian countries in order to build a fully integrated industrial chain that does not depend on western tolerance. Somehow, China seems to have anticipated the arrival of someone like President Trump in the White House!

The network is deep and sophisticated and uses China's financial muscle to entice partner countries to the Chinese objective of total industrial autonomy.

China's Belt and Road Initiative (BRI) provides huge financial support to Asian and African countries in exchange for mining resources and trade route access. Countries like Pakistan, Bangladesh and Kenya are now highly dependent on Chinese finance as they build Chinese trade infrastructure.

Further, the collapse of the Trans-Pacific Partnership after the US pulled out has given China the opportunity to remould a Pacific organisation to its own purpose. The Regional Comprehensive Economic Partnership (RCEP) comprises 16 countries, from Australia to India, and covers close to 40% of global trade activity. Its initial negotiations stalled but may well be revived in light of the trade fight with the US.

Last, but not least, China has also made overtures to the EU and Japan about trade links that bypass the US. The EU and Japan are in two minds about it. They do share the US view about being victims of intellectual property theft but wonder whether they can trust the US to abide by WTO rules or any other trade regulations.

This shows a clear purpose. China wants to compete head-to-head with the US and even overtake it. So, can China take pole position, and what are the considerations?

Somehow China seems to have anticipated the arrival of someone like President Trump in the White House.

Answering questions on China's future

Will other Asia-Pacific countries join China economically and ditch US protection?

This is a big ask and would never have been considered were it not for the aggressive trade and military attitude of the current US administration with its allies. China seeks to capitalise on that feeling of abandonment. And let's not forget China's size. In 2011, China passed Japan in GDP and is now more than twice the size of Japan. This size and growth can attract willing partners.

Would China beat the US at technology?

It's not a foregone conclusion. In the 1970s, most Europeans and Japanese assumed that America was a spent force, only to witness the US swamping the world with biotech and information technology feats in the 1980s and 1990s. The US still has too many strengths to be written off.

Whether China can develop its own technology without the notorious technology joint ventures with US companies depends on education. The West is less enamoured with learning than Asia. Oxford colleges are now having to ration the number of Chinese students who could otherwise easily make up the whole student intake, and other world-class universities face the same predicament.

Europe may have the technology and sophistication but its current populist outbursts do not bode well for education, or for respect for science, experts and governmental elites. Japan does share many of China's cultural traits and could join in the project, but for the frayed history between the two countries.

Competing with Silicon Valley will be tough but the Chinese are fast learners and, unlike the US and Europe, their whole population is united behind the aim of being number one in the world.

Can China excel in other growth sectors?

Besides information and health technology, the US dominates the world in agriculture and entertainment, but misses out on quite a few other growth sectors. If President Trump has any long-term plan for the US, it's the quixotic idea of bringing back metal-bashing jobs to the rust belt, which could have the indirect benefit of boosting new manufacturing ideas elsewhere. The US may have financial and entrepreneurial infrastructure but it has not revamped its physical infrastructure, whereas China has created a world-class transport and manufacturing infrastructure that will be hard to replicate by any would-be superpower.

What about China's military capabilities?

There is a difference between China's path and the former Soviet Union's. The USSR had military strength but little else to offer economically to its allies, making the defunct Council for Mutual Economic Assistance a doomed endeavour from the start. To be fair, China lacks Russia's strong military capabilities and could not face off the US. Even in the South China Seas, China has resorted to a stealth approach by building artificial islands in order to obviate its naval weakness.

Can China fail in its attempt to become a superpower?

Certainly. Capital allocation in China is based on top-down political imperatives rather than the ruthless verdict of the market. There's also no guarantee that the top government echelon will be capable of solving burning issues (pollution, leverage, corruption, social discontent, etc).

Ironically, China's future place as a superpower may well be determined by the US, but perversely not in the way the current US government assumes. The more trade spats become full-fledged trade wars, the more existing US allies are pushed into the arms of a soft-talking Chinese government.

Will Russia feature in that world? Russia still has military strength and natural resources galore, but has never managed to diversify its economy away from energy and therefore resembles Saudi Arabia more than the US. The definition of superpower will depend on whether we have war or peace. Russia could feature in the former scenario but hardly in the latter.

Another BRIC that could be expected to join the ranks would be India, but it seems quite a long shot. India is still way behind China in economic might and it may take a generation to catch up. Importantly, it looks as though India has no geopolitical ambitions beyond the subcontinent and is not in a position to follow the tried-and-tested Asian Tiger path of export-led growth.

What does this mean for investors?

It depends on your time horizon. If the endgame of the current US administration is to lower tariffs worldwide, then all the trade tension is only noise and should be used as an opportunity to position oneself in beaten-down equity regions, like emerging markets, with China at the centre. The massive discrepancy between China's stock market size and its economic size could well shrink and give better long-term returns for Chinese shareholders, assuming all governance concerns are allayed.

If, on the other hand, the US really has a protectionist agenda and starts the process of unwinding globalisation, the road to success for China will be longer, bumpier and beyond the scope of most investors. Ultimately, though, this could drive Europe and Japan towards a rapprochement with China.

As ever, we will continue to take a worldwide macro view and analyse what it could mean for our client portfolios.

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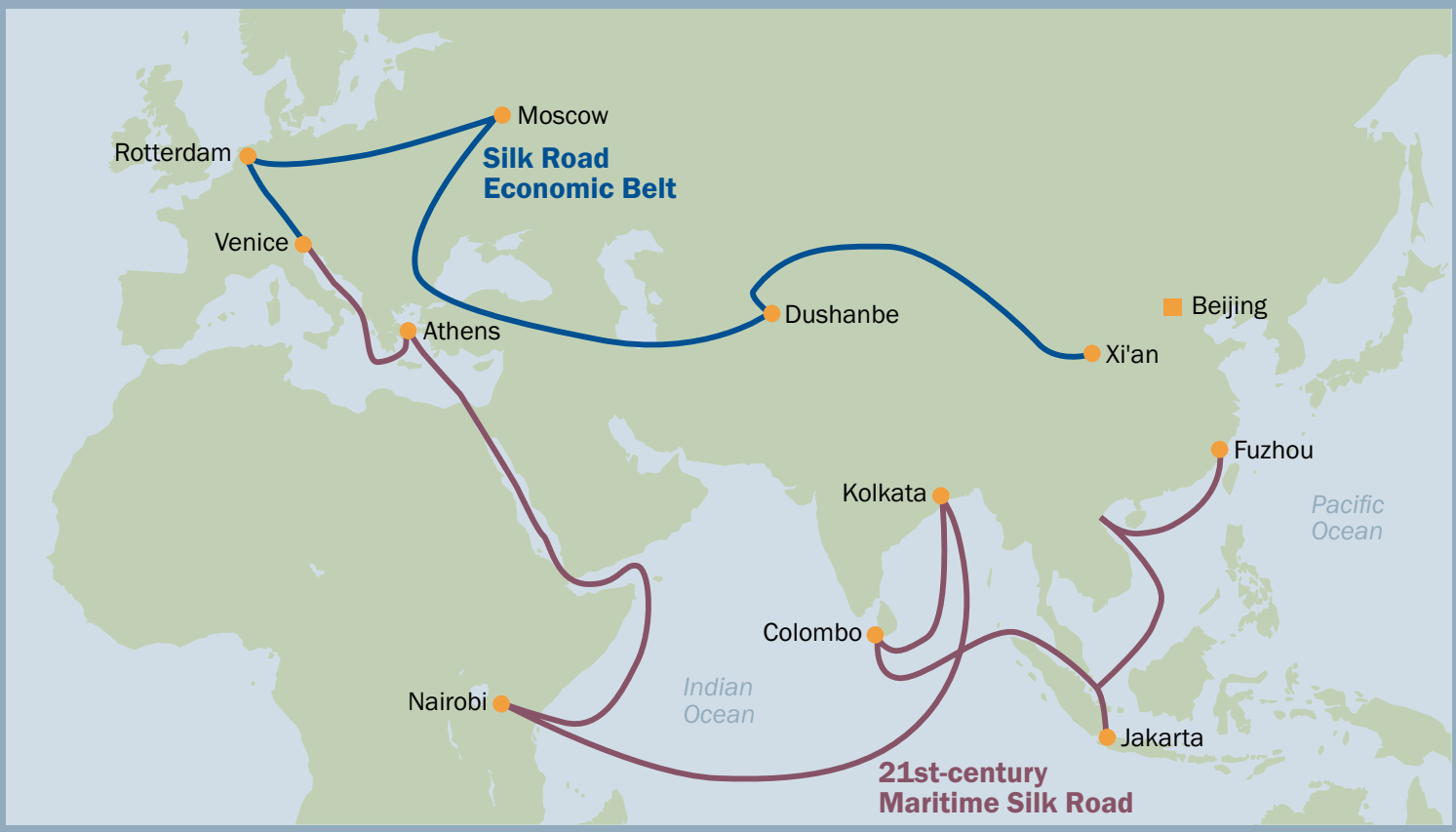
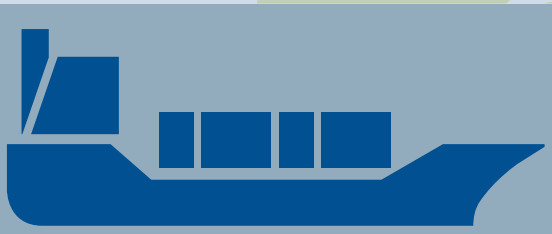
China's Belt and Road Initiative

The Belt and Road Initiative (BRI) is a development strategy, designed to encourage co-operation between countries in Asia and Europe, and to accelerate economic growth. Adopted by China and unveiled by Xi Jinping (General Secretary of the Communist Party of China) in late 2013, it is made up of two interconnecting infrastructure corridors: the old Silk Road and the 21st-century Maritime Silk Road. The 'belt' is the economic belt surrounding the old Silk Road, while the 'road' is the sea route followed by the newer maritime component.





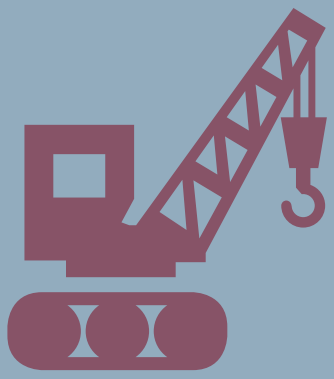
US$4trn

trade volume between China and the countries involved[1]

200,000

jobs for the countries involved[3]

65% of the world's population covered[4]



US$8trn

potential infrastructure investment by China[2]

68 countries involved[5]

40% of global GDP covered by the BRI[5]

Justin Oliver,
Deputy Chief Investment Officer, Offshore

Back to the future

In the course of any one year, we are presented with a host of potential investment opportunities from representatives of the fund management industry. These range from the mundane – an 'undiscovered' equity manager whose performance shouldn't be ignored – to the specialist – a biotech or premium brands fund, for example.

> A myriad of factors attract us to the sector, and we believe there are fundamental reasons why technology should remain a rewarding area for investment over the long term.

Sometimes, meetings with fund managers give us an opportunity to revisit a theme that we have invested in previously. This was certainly the case with Polar Capital Global Technology, which we have re-introduced across many of our investment strategies this year.

As an investment theme, the attractions of technology are widely appreciated. However, from our perspective, this allocation is more than just an investment into the 'FAANGs' – Facebook, Amazon, Apple, Netflix and Google (Alphabet), even though these stocks tend to dominate the headlines. In addition, from September, Alphabet and Facebook have been classed as communication stocks, rather than technology.

A myriad of other factors attract us to the sector, and we believe there are fundamental reasons why technology should remain a rewarding area for investment over the long term.

From a corporate perspective, 2017 was an extremely strong year for technology company earnings, and 2018 is likely to be just as supportive. In the fourth quarter of last year, earnings had demonstrated 22.5% year-on-year growth, with 89% of companies beating revenue expectations.

As things stand now, the global technology sector still offers the highest return on equity of the 10 main sectors of the global market, and 90% of tech companies in the S&P 500 reported earnings above expectations in the second quarter of 2018. According to data from FactSet, the information technology sector in the US recorded year-over-year earnings growth of 32.5% for this period.

While the forward price-earnings ratio at 19.3 times stands above its 10-year average of 14.6, implying valuations are high, this charge can be levelled at the market as a whole, while two sectors – telecom services and energy – have ratios below their 10-year average. This level of valuation must also be considered in the context of a sector which is generating very high levels of free cash flow and is awash with cash.

While these equity market fundamentals are encouraging, it's the structural drivers which most excite us.

> Regardless of short-term noise and market movements, technology is not going to go away, or become less influential in our personal lives or from an investment perspective.

A disruptive influence

The simple fact of the matter is that technology is causing massive disruption across almost all areas of the business world. This view is shared by the McKinsey Global Institute, who have estimated that 60% of all occupations could be automated by at least 30%. One of the areas of technology which has the greatest potential is the field of robotics and artificial intelligence, and again McKinsey estimates that this market may be worth over US$10trn by 2025.

It has also identified 12 disruptive technologies which will increasingly come to the fore over the next 10 years. These include intelligent software systems that can perform tasks where subtle judgements may be required, using developments in voice recognition and artificial intelligence. Autonomous cars, trucks and drones will automate travel and transportation to a far greater degree, while 3D printing will be increasingly used within the industrial manufacturing process.

Advanced robotics and surgical robots also have the potential to greatly improve the success rate of medical interventions. Between 2016 and 2020, Gartner, a leading research company and consultancy, forecasts that the 3D printing market will demonstrate 98.5% annualised growth, while the medical robot market is expected to be worth US$18bn by 2020.

Polar Capital itself is incorporating themes such as e-commerce, digital marketing, cyber security, cloud infrastructure, and rising semiconductor complexity, with a firm belief that the 'internet of things' – a network of physical objects that communicate, sense and interact with the external environment – will transform our daily lives.

It's highly unlikely that all these grandiose predictions will pan out exactly as expected, and ultimately areas and companies which we haven't even considered – or may not exist yet – may prove to be the true technological stars of the future.

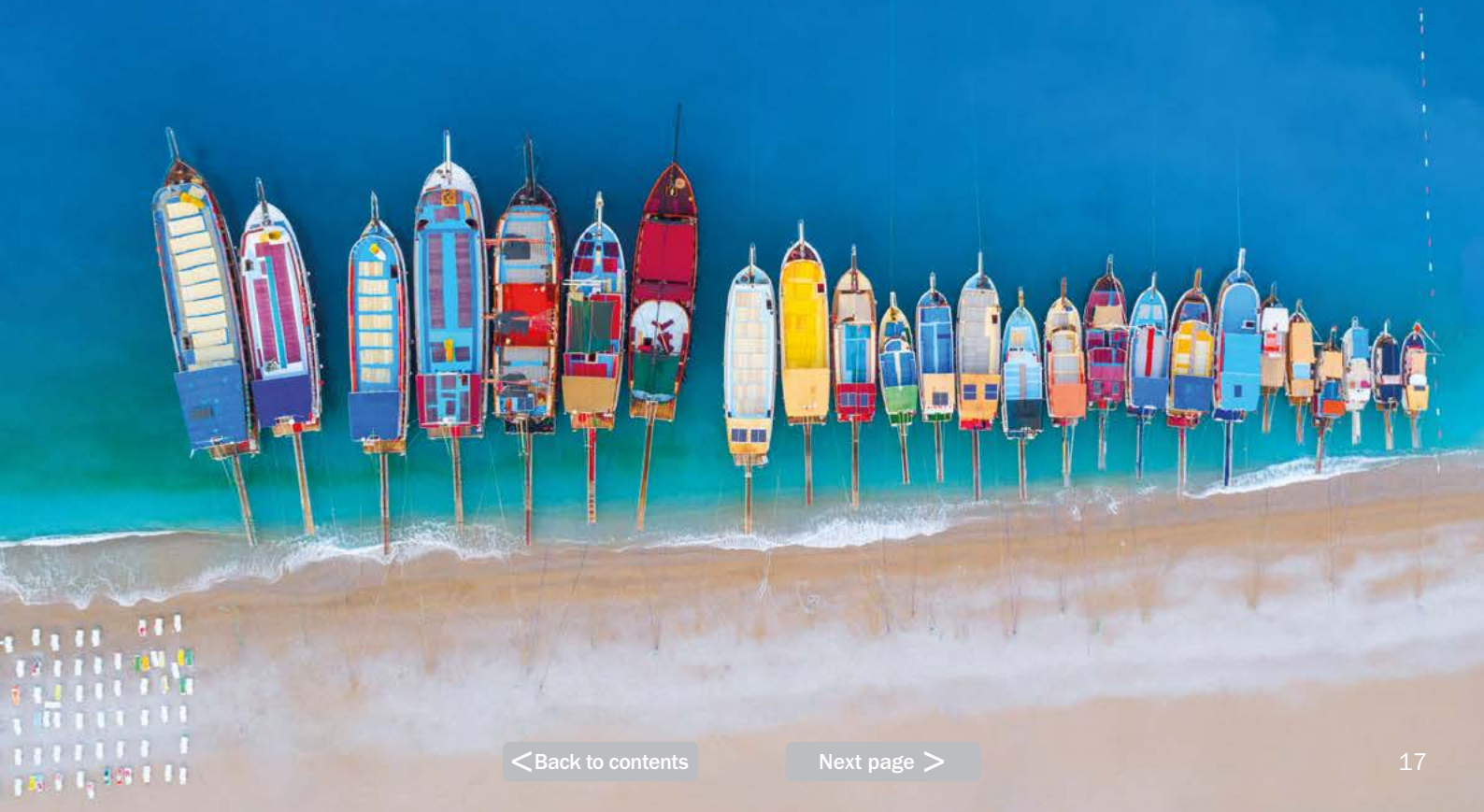
One thing is certain, however: regardless of short-term noise and market movements, technology is not going to go away, or become less influential in our personal lives or from an investment perspective. This is why we believe it's important to incorporate technology as a long-term investment theme.

We will be writing more about technology and 'the future' in the coming months.

Angela Lloyd-Read,
Wealth Adviser

Keep it in the family

Benjamin Franklin famously stated that 'nothing is certain but death and taxes'. While the former is still unavoidable, careful financial planning can substantially reduce the inheritance tax (IHT) on your estate when you die. A useful way to do this is by making gifts – from your capital or from income.



You may already be familiar with these tax-exempt gifts from capital:

- Husband and wife or civil partners can give gifts of any value to each other during their lifetime, as long as they're both domiciled in the UK
- You can make gifts to other people, up to £3,000 in total in each tax year – although you can carry over one year's unused allowance, allowing a maximum exemption of £6,000
- You can make any number of gifts of up to £250 (one per person each tax year)
- You can make gifts to people getting married, up to: £5,000 from each parent of the couple, £2,500 from each grandparent or more remote relative, £2,500 from bridegroom to bride (and vice versa) and between civil partners, or £1,000 from anyone else
- Gifts to charity are exempt from IHT.

Anything more substantial may be subject to tax if you don't survive seven years after making the gift.

However, many people are unfamiliar with gifting as part of their 'normal expenditure' i.e. giving away money from surplus income. This has the added benefit that you're not giving away large capital sums that could provide you with ongoing income.

Reducing IHT through excess income

You need to show that you intend to make regular gifts which will not affect your normal standard of living, and which will come from income rather than capital (see 'things to consider' on opposite page).

Case study 1

Mrs Garnet, a widow aged 65, has substantial assets, and a large part of her estate will probably be subject to IHT. She is not concerned with negating the entire IHT bill but wants to leave certain high-value items to her beneficiaries.

Therefore, Mrs Garnet wants to ensure a lump sum is available to her children before probate is granted so that the high-value items won't need to be sold to pay IHT. She has excess income each month, and she expects this to be the case for the rest of her life.

Mrs Garnet's Wealth Adviser helps her to buy a £2m 'whole of life' policy which is medically underwritten and ensures that, as long as premiums continue to be paid, the policy will pay out the sum assured on her death. It's written into trust, so the proceeds won't form part of her estate and the funds will be paid to the trust beneficiaries (currently her children) before probate is granted. The policy premiums, which are purchasing a benefit for others, will not be subject to IHT as they would be from her excess income.

Many people are unfamiliar with gifting as part of their 'normal expenditure' i.e. giving away money from surplus income.

Things to consider

Making regular gifts out of excess income can be a useful way to prevent further increases in your estate's taxable value. As well as funding whole of life policies or school fees, you could use regular gifts to fund pension contributions for adults or minors, building up ISA or JISA subscriptions, or simply sending the family on regular holidays every year.

The exemption is claimed by the executors after the death of the donor and it must be shown that the gifting meets three conditions:

- There is clear evidence of an intention to make regular gifts out of normal expenditure
- The gift was made out of net income and not a transfer of capital assets; common sources are employment, rent from property, pension income, interest and dividends
- The donor must be left with enough income to maintain their current standard of living, so they don't need to resort to capital to meet their needs.

Keeping good records is the key to making a simple and successful claim for the exemption. Form IHT403 (available from the HMRC website) requires the details of annual income and expenditure in each year gifts were made. An annual record-keeping exercise, which your accountant can help with, will make the process much easier than trying to backdate records later.

What next?

IHT rules are complicated and constantly changing. Your CGWM Wealth Adviser can help you make sure your financial arrangements are up-to-date and take account of the latest legislation.

Case study 2

Mr and Mrs Jasper are both retired with generous final salary scheme pensions, plus investment portfolios and a savings account. They are now finding themselves with excess income each month.

Rather than let excess income build up in their estate and potentially create a future IHT liability, the Jaspers want to make regular gifts to help pay for their twin grandchildren's school fees.

Mr and Mrs Jasper write a letter to their daughter (the mother of the twins) informing her of their intention to make the gift on a continuing basis. They also keep a record of their ongoing income and expenditure, to demonstrate that the gift is being made out of regular excess income.

After six years of making the regular gifts, Mr Jasper needs funds for private medical care and the regular gifting is no longer affordable. If circumstances change and gifting stops, the exempt status of gifts made previously does not change, as long as they have already qualified.

Join our free IHT seminar

If you want to know more about IHT planning, please join our seminar at 41 Lothbury on 6 November when our financial planning experts will be demystifying the potential ways to secure the future for your family. Contact CGWMevents@canaccord.com to register your interest or find out more.

Current IHT rates

IHT is charged at a rate of 40% on assets passed to beneficiaries (other than a spouse or civil partner) over and above the 'nil-rate band' of £325,000. A new separate allowance, 'the main residence allowance' was introduced in 2017 which applies when someone leaves their main residence to direct descendants, or the spouse of a direct descendant. This allowance is currently £125,000 meaning an individual's allowances could reach up to £450,000 before their heirs have to pay IHT.

Patrick Thomas,
Head of ESG Investments

The good, the bad and the ethical

How investing ethically can impact investment returns

Whilst millennials might have raised the profile, investing responsibly is now a mainstream issue. Charities, institutions and individuals are adopting more ethical investment approaches to ensure their capital is aligned with their values – and investment managers need to meet this growing demand.

Historically, ethically minded investors simply avoided investing in deemed 'sin' sectors such as tobacco, alcohol, weapons, pornography and gambling. More recently, awareness of climate change has sharpened the focus on fossil fuels, with high interest rate 'payday' lending and obesity being two newer areas which some investors may prefer to avoid.

However, while ethical investors have chosen to avoid, exclude or 'screen out' certain 'sins', there are relatively few studies showing the impact of 'screening out' on investment returns. Here we look at how excluding certain sectors ('sin screening') over the last decade might have impacted investment returns – and what alternative approach investors can now take when concerned about the nature of their investments.

Multiple sin sector screening

At first glance, 'sin screening', where sectors like tobacco, alcohol, weapons and pornography are all excluded together, has barely reduced returns over the past decade for developed markets as a whole.

But look closer and there are significant geographical variations. For the UK and US, there is a more pronounced reduction in returns compared to Europe (excluding the UK) and Asia Pacific, where there is a positive impact.

Picking and choosing a combination of areas to remove can also be problematic. Excluding weapons, pornography and gambling at the same time has very little impact across geographic areas but doing the same with tobacco and alcohol has the largest negative impact on risk-adjusted performance.

Individual sin screening

Individual screens – where one thing at a time is excluded – also show significant regional variability.

Taking out one of the following five areas – tobacco, alcohol, weapons, pornography and gambling in Europe (excluding the UK) – has again a neutral impact but elsewhere there are nuances.

- Excluding alcohol in the US has a broadly neutral effect, while in the UK it benefits performance significantly
- Excluding tobacco is also neutral in the US, while conversely in the UK it has historically reduced performance.

Sector-wide screening vs materiality or threshold-based screening

It's easy to implement a sector-wide screen in some sectors (e.g. tobacco), while others (e.g. pornography or gambling) really need a 'materiality threshold' to identify businesses deriving significant revenue from these activities. Think of ITV, which shows gaming content after midnight, or a network like Sky, which offers risqué channels to certain subscribers.

This means that portfolios which implement materiality or threshold-based screens exclude more of the investable universe by market capitalisation when compared with sector-wide screens.

Theoretically, the more one reduces an investable universe, the greater the impact on volatility (given the reduced opportunity set) and therefore investment returns.

Clients focused on 'screening out' need to understand that there are varying definitions of what 'out' means and there is a potential performance impact.

Screening out fossil fuels

There has been a rise in charities and institutions applying climate change related restrictions to their investment portfolio – but how does applying a fossil fuel screen impact investment performance?

For developed markets, excluding fossil fuels had no significant impact on portfolio returns in the last decade. This is surprising given oil and gas is one of the best yielding sectors. In fact, during periods of sustained fossil fuel price weakness (e.g. 2013-2016), there was a significant benefit of avoidance.

Interestingly, emerging market portfolios have generally benefited significantly by avoiding fossil fuels. Such exclusions actually increased portfolio returns and reduced

> To many ethical investors, ensuring their capital is aligned with their values is the most important thing.

volatility. This is partly related to a relatively weak decade for broad commodity prices. Many emerging market oil companies are also under state control, and not necessarily managed with shareholders' best interests in mind.

Screening in the macro-economic context

The macro-economic backdrop, including crisis periods, will undoubtedly play an important part in the impact of screens over time. During the six months following the collapse of Lehman Brothers, 'sin stocks' outperformed the broader market. Why?

- During periods of growth or expansion, investors may be happy to invest in growth-oriented sectors of the market
- Conversely, during periods of depressed growth and heightened levels of uncertainty, investors may seek 'havens' such as sectors traditionally characterised by higher yields and greater liquidity – e.g. tobacco and oil and gas producers.

That said, these havens may start to change as smoking numbers decline and renewable energy gets cheaper.

To screen or not to screen?

Excluding sectors from your portfolio can obviously have an impact on returns. This can be positive, negative or neutral depending on what's excluded and where. Further, the data does not show the impact of manager discretion on narrower investment mandates.

The narrower the universe of companies available, the narrower the potential ability to diversify return sources. What's more, sinful areas often have financial advantages. Think of the resilience of tobacco sales during a recession, as well as their good corporate governance. If you decide to screen out, what matters is finding suitable substitutes to mitigate the impact of excluded areas.

However, to many ethical investors, ensuring their capital is aligned with their values is the most important thing – and sin screening is the only way they will invest, no matter the impact on their investment returns.

For other investors, they want to consider both the financial and non-financial aspects of investing – i.e. financial returns alongside their wish to invest more responsibly.

Screening in (and out) with ESG investing

ESG (environmental, social and governance) investing offers a realistic alternative to simply sin screening.

Rather than screening out a broad sector of companies, ESG investing actively 'screens in' companies that either already are, or are working to become, more environmentally friendly, a better employer and community member, and more transparent in the way they run their business.

At Canaccord Genuity Wealth Management, our ESG portfolios use both negative (screening out) and positive (screening in) filters to select investments, and use ESG standards in their decision-making process. Our ESG portfolios currently have zero exposure to tobacco, armaments, gambling or pornography, and many of the underlying fund managers also limit exposure to alcohol, animal testing and companies with poor environmental or human rights records. Others adopt even more stringent criteria.

While it is comforting to know that sensible portfolio exclusions can be managed with limited effects on investment returns, it is even more reassuring to know that negative screening can be combined with positive screening approaches to ensure there is a more diversified approach to investing responsibly. As a result, ESG investing tends to be more profitable than traditional ethical investing, and there is mounting evidence that companies that manage ESG issues well tend to outperform those that don't, by a significant margin.

If you want to find out more, please contact our Head of ESG Investments, Patrick Thomas, on patrick.thomas@canaccord.com or +44 20 7523 4988.

Contact your Wealth Manager or email us on CGWMevents@canaccord.com.

Admiral

Simon McGarry,
Senior Equity Analyst

Admiral Group plc (Admiral) is an insurance holding company. Through its subsidiaries, it offers private motor insurance and related products throughout the UK. Its portfolio of products includes car insurance, multicar insurance, home insurance, van insurance, and motorbike insurance.

Admiral began as a start-up UK motor insurer in 1993. From the beginning, the company led the market in terms of expense and loss ratios. It sold motor policies directly over the phone and online, and used its underwriting expertise and expense advantage to offer lower prices than the incumbents, growing market share rapidly. Its capital-light structure enabled Admiral to invest in distribution and to improve its underwriting advantage through better data analysis. Its UK insurance brands include Admiral, Elephant, Diamond and Bell, as well as Gladiator for commercial vehicles.

Fast forward 25 years and Admiral's business model remains as resilient as ever. It continues to generate excellent returns on equity for shareholders. This is achieved through lucrative terms offered by its co-insurers and re-insurers, who are happy to offer these terms because of Admiral's excellent underwriting track record.

This underwriting superiority is founded on a demonstrably lower claims ratio than the industry, underpinned by a consistent record of substantial reserve releases[1] and a structurally lower expense ratio. While the former may gradually erode over time as the rest of the industry improves, we expect the latter to be sustainable. Through flawless execution, Admiral has continued to take market share from less nimble rivals with its UK motor insurance market share of more than 17% compared to just 6% in 2010.

Despite Admiral becoming increasingly dominant in UK motor insurance, there are multiple other competitors with potential to create value for shareholders over time.

The company entered UK household insurance five years ago. Although this business has yet to turn a profit, Admiral is growing its policy count twice as fast as it did 25 years ago when it entered UK motor insurance. Once it attains sufficient scale we see scope for household insurance to be a material contributor to group profits.

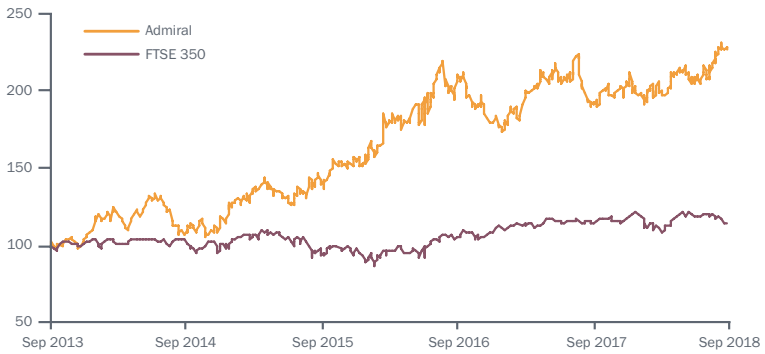
Admiral is also in the process of building direct motor underwriting businesses in Spain, France and the US. While it's still too early to tell whether these will be a success, the losses from these businesses have narrowed significantly in recent years.

Finally, Admiral is in the enviable position of being the only UK insurer that owns not one but two price comparison websites, the well-established and highly profitable Confused.com in the UK, and a nascent Compare.com in the US. Whether Admiral is best placed to make the level of investment required to conquer the US market against giant incumbents such as Geico and Progressive is unclear. However, if they choose to bring in an outside investor, it would act as a good way of putting a value on Compare.com, which we believe the market is at present attributing little value to.

With the shares trading on a 12-month forward dividend yield of 5.85% and having grown the dividend at an average annual rate of 25% over the last five years, Admiral remains one of our preferred UK income stocks.

[1] Insurance companies are required to 'save for rainy days' by holding profits and releasing them gradually over time.

Share price	**2019p**
12-month high	**2057p**
12-month low	**1683p**
P/E 12-month forward	**16.6**
Dividend yield 12-month forward	**5.8%**
Dividend cover 12-month forward	**1.1**
Net debt (cash) as at 31/12/2017	**(£103m)**



Source: Bloomberg and Quest®
Note: Data above and performance data as at 20 September 2018.

Past performance is not a reliable indicator of future returns.

SAP

Marc Pullen,
Senior Equity Analyst

Since it was founded in 1972, SAP has grown to be the world leader in enterprise software applications. With 156 million cloud subscribers, it is now the world's largest enterprise cloud company.

During its 46-year history the company has successfully turned technology paradigm shifts (such as the move from mainframe computing to the PC/server model) to its advantage as it has gone from start-up to global enterprise. Today SAP is in the middle of another one of these paradigm shifts driven by the internet, cloud computing and the explosion of data being created by mobile and internet connected devices (aka the 'internet of things' – IoT).

To capitalise on this change, SAP adopted a cloud-based growth strategy in 2010, leveraging off machine learning, artificial intelligence, blockchain and advanced analytics. At the heart of its strategy sit its flagship in-memory database, SAP HANA, and the SAP Cloud. SAP HANA enables customers to process and analyse huge amounts of live data (up to a petabyte) in real time, while the SAP Cloud integrates both cloud and on-premise applications. It also enables customers to run their applications across third-party data centres such as Amazon, Google and Microsoft.

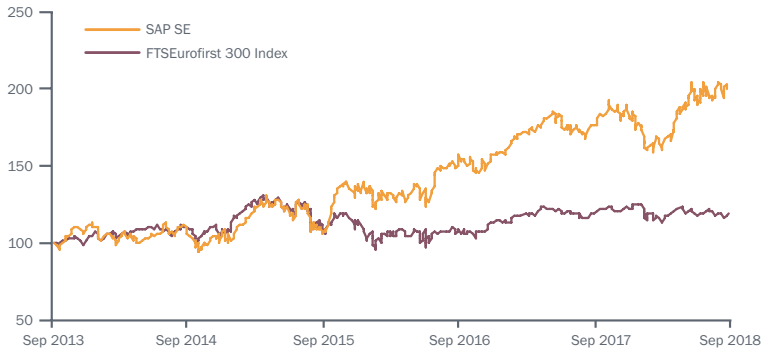
SAP's applications and services address key business areas, including finance, human resources, sales, service, procurement, manufacturing, asset management, supply chain and R&D. Although these applications can be run as standalone solutions, they are designed to integrate tightly with SAP S/4HANA, the company's integrated enterprise resource planning system, which is often the backbone of clients' information processing systems. Furthermore, these applications are built on open platforms, enabling customers to link them easily with third-party applications.

SAP's strategy is not without risks, with the cloud and SAP's open architecture platforms reducing barriers to entry for new competition, while enabling clients to cherry-pick the services they require from a cloud smorgasbord, rather than paying for a full service. However, on the plus side, SAP's strategy represents a huge opportunity for the company to broaden and deepen its relationships with its extensive existing client base, while the open architecture and modular approach to its cloud-based applications should make its individual services far more accessible (both in terms of cost and complexity) to smaller companies.

So far, SAP's strategy appears to be paying off. Between 2009 and 2017, group revenue and operating profit have more than doubled to €23.5bn and €6.8bn respectively, while SAP Cloud revenue is up more than 40-fold to €3.8bn. Furthermore, after a number of years of declining profit margins (courtesy of upfront investments in the cloud and the effect of customers moving from one-off licences to a subscription model), SAP is now entering a margin expansion phase as these investments tail off and the benefits begin to ramp up.

Finally, while the shares are hardly cheap in absolute terms, trading on 27.0x 12-month forward earnings, they are relatively reasonable compared to the Quest® global software and services sector on a 12-month forward price-earnings ratio of 47.9x.

Share price	**€101.6**
12-month high	**€104.7**
12-month low	**€81.3**
P/E 12-month forward	**26.9**
Dividend yield 12-month forward	**1.5%**
Dividend cover 12-month forward	**2.4**
Net debt as at 30/12/2017	**€2.3bn**



Source: Bloomberg and Quest®
Note: Data above and performance data as at 20 September 2018.

Past performance is not a reliable indicator of future returns.

Compass

Simon McGarry,
Senior Equity Analyst

Compass Group (Compass) is a global food services company with annual revenues of £23bn last year. It's the world's largest contract catering company, serving 9.8 million meals a day, with its customers including 99 of the Fortune 100 companies. Compass operates in 28 sectors and sub-sectors with c.20 brands, a strategy that is very different from the single-brand approach of its peers.

The model stems from operating on-premise catering facilities, rather than centralised industrial kitchens. Although Compass continues to focus on delivering outsourced catering and hospitality services it has, in recent years, become better at cross-selling a range of soft support services to existing customers, such as cleaning, reception and building maintenance. This market has substantial organic growth potential given the scale benefits (e.g. procurement of supplies) on offer to Compass as the global market leader.

Although Compass operates in over 50 countries, the US (c.60% of revenues) has, for more than a decade, been the main driver of growth for the group. Indeed, last year it delivered organic revenue growth in the US of +7.8%, well ahead of the group average. This was achieved through its disciplined approach towards sectorisation that has enabled the group to drive best-in-class organic growth over the last five years.

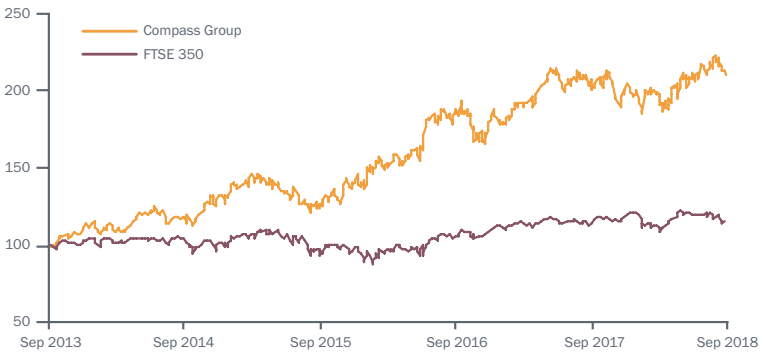
Compass' global reach makes it one of the few vendors that can fulfil the needs of multinational companies with diverse locations. It also enjoys a well-balanced portfolio towards its different market segments and no single client represents more than 3% of total group sales.

The structural growth within the food outsourcing industry remains solid, as more than half of the market is still served by small regional players or is self-operated.

Although this sectorisation strategy leads to additional complexities, it also gives Compass advantages in winning contracts, as clients perceive its underlying brands to be specialist providers in their respective industries. Further, all back office functions are carried out centrally which helps boost margins.

The group is consistently cash generative, with free cash flow easily covering capital expenditure needs, progressive dividend (average annual growth of 12% over the last 10 years) and bolt-on acquisitions. The management also has a track record of returning excess cash to shareholders through special dividends. In the absence of any large acquisitions, the balance sheet has scope for c.£500m (2% of current market capitalisation) to be returned to shareholders annually on a sustainable basis. In addition to the ordinary dividend this provides an annual dividend income to shareholders of c.4.4%. It's also worth noting that if the company can continue to grow the dividend by 12% annually, it will take just six years for it to double. With the shares trading on 20x current year earnings compared to an average of 22x last year, Compass provides long-term growth to investors at a reasonable valuation coupled with an attractive income.

Share price	**1,671p**
12-month high	**1,709p**
12-month low	**1,425p**
P/E 12-month forward	**20.2**
Dividend yield 12-month forward	**2.4%**
Dividend cover 12-month forward	**2.1**
Net debt as at 30/9/2017	**£3.6bn**



Source: Bloomberg and Quest®
Note: Data above and performance data as at 20 September 2018.

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