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The pick of 2013

Our Investment Committee looks back over the year

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Investment Committee review of the year

Unlike *Fund Strategy* reviews of the year of the past, for 2013, we are giving the floor to the *Fund Strategy* Investment Committee to get members' thoughts on the last 12 months. Each will cherrypick the regions that have contributed the most performance, the macro highlights and key funds which have done well for them. We also joined by two of our independent panellists, Neptune's chief economist James Dowey and Schroders' chief economist Keith Wade, who will give their take on the year while committee chairman Adam Lewis will provide a rundown of the key funds stories of 2013

Adam Lewis

From a funds perspective, 2013 was dominated by some high-profile fund manager comings and goings, which got everyone thinking about the term "keyman risk" again.

The star fund manager culture is nothing new in the funds management industry but the very high-profile departure of Richard Buxton from Schroders to Old Mutual Global Investors and the almost unthinkable announcement that Neil Woodford will quit Invesco Perpetual in April next year served to highlight the business implications of placing so much faith (and assets) in certain managers.

At the time of Buxton quitting Schroders in March after a 12-year stint with the firm, I described it as being similar in scale and shock value to the exits of Nigel Thomas and George Luckraft from ABN Amro to Framlington back in April 2002. Little did I know at the time just how similar the unfolding events would pan out.

Like ABN Amro, who faced intense pressure on making big name external hires to replace its golden duo and instead went out and merged with Artemis, Schroders was able to take the heat off itself via the acquisition route surprising the industry with its purchase of Cazenove Capital.

Not only did this invigorate its fund line up, with the additions of Julie Dean and Paul Marriage among others to its funds stable, but it bought the group time to find an appropriate replacement for Buxton on UK Alpha, eventually opting for Jupiter's Growth & Income fund manager Philip Matthews. As such, while the UK Alpha fund did lose some £2bn in assets after Buxton left, the addition of Dean's £2.3bn Cazenove UK Opportunities fund helped soften the blow.

Before we get to the other business of Woodford, 2013 also saw other significant changes to some of the most high-profile funds available to retail investors. In June, Anthony Bolton, manager of the £623.5m Fidelity China Special Situations investment trust for the last three years and famed for his stewardship of the open-ended Special Situations fund launched for him in 1979, announced he will be retiring from fund management duties in April next year. Dale Nicholls, current manager of the Fidelity Funds Pacific fund, will begin the handover of the China trust in January before Bolton leaves the industry in April.

Also at Fidelity, and related to Bolton's past, it was announced in September that Sanjeev Shah, manager of the UK Special Situations since 2008 – when Bolton's Special Situations fund was split into two – was stepping away from fund management duties. Alex Wright, a portfolio manager of the Fidelity Special Values investment trust and co-manager of the Fidelity UK Smaller Companies fund, took

over the £2.7bn mandate.

However despite all of the above taking several column inches in the press this year, they were eclipsed in October when Invesco Perpetual put out a statement announcing Woodford, who runs over half of their £70bn of assets under management across various mandates, is leaving the firm to set up his own business in April next year.

Mark Barnett, manager of the Invesco Perpetual Strategic Income fund, was the man tasked with taking over the reins and expect his name to be in the press a lot next year as Invesco hits the charm offensive to try and retain as much of the assets as possible.

In all April next year will be a fairly significant month, with Bolton and Woodford stepping down, new faces coming in and all eyes being on what the man who at present runs some 41 per cent of the IMA UK Equity Income sector will do next.

Keith Wade

"2013 has been a year of disappointing growth. When we look back at the forecasts that were made for GDP growth last year, they were much higher than what we are likely to have seen this year. It is true that the world economy is performing a bit better now as we are coming to the end of the year, but compared with the start of the year, growth is much weaker.

"One area where it has been particularly weak has been in the emerging markets, where about a year ago people were expecting 6 per cent growth and now it looks like it is going to be about 4.5 per cent.

"One of the reasons for that has been that the Federal Reserve has introduced the idea that they will begin to taper or end quantitative easing. When they introduced that idea back in May, there was sharp rise in bond yields and there was a big move in capital flows out of emerging markets that caused them to weaken quite considerably. I think the year will be remembered very much for that particular event."

James Dowey

This is the first New Year in three when the market's attention is not being dominated by a palpable big tail risk. No double dipping, no fiscal cliff, no life or death moment for the euro. At a conference of a few hundred global investors that I attended last week in London, when surveyed about the main tail risk currently on their mind the participants' voted for the Chinese financial sector but did not generally believe it be an imminent threat. I agree. It is the key medium-term risk to monitor in the global economy but it should not prevent you from being bullish today.

Instead, the relative normality in the global economy as we begin 2014 means that boring developments in the good old belly of the probability distribution rather than action in the tail are what matter this January. As such, here are four important boring questions for 2014:

1: Will US capex pick up from its weak trend so far during the recovery? The consensus expects US consumption to accelerate somewhat in 2014, as fiscal drag abates. If weak capex has been due mainly to weak consumption – as we believe it has – then it should accelerate too, and US growth could easily be above trend and consensus.

2: Just how dovish really is Janet Yellen? Whether the Fed starts tapering in January, March or soon after is a red herring – the Fed wants out of QE and it wants to focus (and for us to focus) on other tools. So what matters is whether Yellen tries to strengthen forward guidance in early 2014 and if so by how much. We expect a reduction in the unemployment threshold to 6 per cent, which we think the market would take positively.

3: Which of the so-called "Fragile Five" emerging markets (India, Indonesia, South Africa, Turkey and Brazil) will navigate their required current account adjustments relatively smoothly in 2014 and which will not? India looks to be making the best progress – the current account deficit is falling and its superstar central bank head Raghuram Rajan is following enlightened policy to help the adjustment. In Turkey and South Africa, however, things are looking uglier, not prettier as time passes.

4: Will the eurozone successfully negotiate banking union? The longer-term viability of the euro depends on it, as do credit and therefore growth conditions in the medium term. We are bullish on Europe short term and are watching these negotiations closely for prospects beyond that.

Jonathan Davis

Looking at the macro highlights of 2013, firstly was the will they, won't they in regards to the taper. We said they would not in September. Everyone else said they would. They did not. As I type, taper is back on the table. I will believe it when I see it, given Yellen and Obama are the two most pro-QE in the US. Currently, we hold US treasuries.

We thought the US dollar would carry on rising, as it had since May 2011. But it did not and this did not help us.

Meanwhile, precious metals continued falling into the summer. Having sold 40 per cent of our mining holdings in 2010/11 (at the highs) and most of the remainder in January this year before yet another major move lower, we re-entered in the autumn. This was largely into Junior Gold Miners via MFM Junior Gold and Bullion. As at early December 2013, this looks shaky but, if it takes, it will be a big winner in 2014

In late summer, we bought a small ▶

amount into natural gas via US Commodity Funds UNG ETF. It fell over 90 per cent from 2008 to 2012 and it will be a slow theme but we have already made a bit and we will likely hold this for years. It could be a buy of a generation...

In the autumn, we entered into emerging markets via the XMEM ETF from Deutsche Bank after a circa 30 per cent crash from 2011 (and 40-plus per cent fall vis-à-vis the S&P, which is insanely priced). We are more comfortable buying after falls than after rises.

Funds-wise, we have been gradually reducing our holdings in Hugh Hendry's Eclectica's Absolute Macro multi-asset class fund for some of the entries above. As a low-risk fund, it did well, according to its remit, in 2010 and 2011 but was flat last year and is down this year. Teacher's remark – could do (should have done) better. Martin Gray at Miton – as usual – did us proud. As did Ruffer.

Overall, 2013 was not a great year but there are lots of bright spots and next year is shaping up very nicely. Roll on China collapsing at some point (you think not? Think again) and the Japanese yen strengthening v the US dollar. That should bring the Nikkei to the buy level we are looking for. Anything below 12,000 will be welcome but 10,000 is on the cards. That should set up a buy of a generation (hedge the currency).

Mike Deverell

This year has been a strange one in many ways. This has been the year when it has become startlingly apparent just how much QE is distorting both equity and bond markets. The big sell-off in May and June on the back of tapering rumours was quite dramatic.

In my view, government bonds yields will continue to rise through 2014 as stimulus is withdrawn but the base rate will not be touched. In fixed interest we favour small, flexible strategic bond funds and also some inflation-linked corporate bonds. Our favoured fund in this space is the TwentyFour Dynamic Bond fund, which has done extremely well in a difficult environment for fixed interest, principally due to their flexible approach and relatively small fund size.

While we have seen a welcome bull market in equities, QE has meant we have seen some strange behaviour as things that normally underperform in a bull market have outperformed and vice versa. For example, the typically defensive IMA UK Equity Income sector which normally does well in more volatile markets, has returned almost 22 per cent year-to-date compared with the FTSE All-Share at 17.6 per cent (Source: FE Analytics 1 January to 2 December 2013) Within equities, we have favoured small caps this year and have been particularly pleased with the great performance and low volatility of Miton's Multi Cap Income fund. We think that the small cap outperformance could continue as the economy improves.

Meanwhile, emerging markets which normally outperform in a rising market have actually fallen, with the MSCI Emerging Market index down 2.3 per cent. This strange bull market backs up the suspicion that traditional bond investors have gone looking for returns in the "safer" parts of the equity markets.

The Japanese economic and stockmarket revival has been a big story and this should continue as Abe pushes through more reforms and as the central bank continues to add increasing stimulus. Yet more distortion from a central bank!

We expect emerging markets to play catch-up in 2014 but many developed markets are starting to look expensive.

While equity and bond markets will continue to be driven by QE, this year has also seen a resurgence in a previously out of favour asset class where tapering has had little impact. That asset is UK commercial property, which has seen some excellent returns over the past few months as the UK economy recovers.

We see property continuing its strong trend well into 2014 with the added bonus that it does its own thing while bonds and equities have become increasingly correlated.

James Calder

2013 was not only characterised by a first half of "risk-on", which was then suddenly reversed by the potential for tapering and then back to "risk-on" for the remainder of the year as it failed to materialise but also for a strong divergence in equity market returns. The market turned its back on the usual beneficiaries of "risk-on" namely South-east Asia and global emerging markets to reward the developed markets.

Within fixed interest, a short duration strategy was rewarded as generalist fixed income managers struggled. Owing to our real return philosophy, alternatives tend to feature strongly within our portfolios. As a whole, they performed in line with expectations but those with an income bias were rewarded, particularly those in the infrastructure space

> We expect emerging markets to play catch-up in 2014 but many developed markets are looking expensive

In terms of our allocation, we were not rewarded by the pullback in SEA and GEM but the reverse was the case for our increased confidence within the developed markets. We continue to have confidence in both the SEA and GEM markets and believe that owing to their positive demographics, rising middle class and attractive valuations they make for a continued and compelling investment opportunity.

One new fund worthy of note within the developed markets is the CF Miton UK Smaller Companies fund, which at the time of writing is up over 43 per cent year-to-date. Other strong performers within the developed markets include the Ardevora UK Equity and the Saracen Global Income & Growth funds.

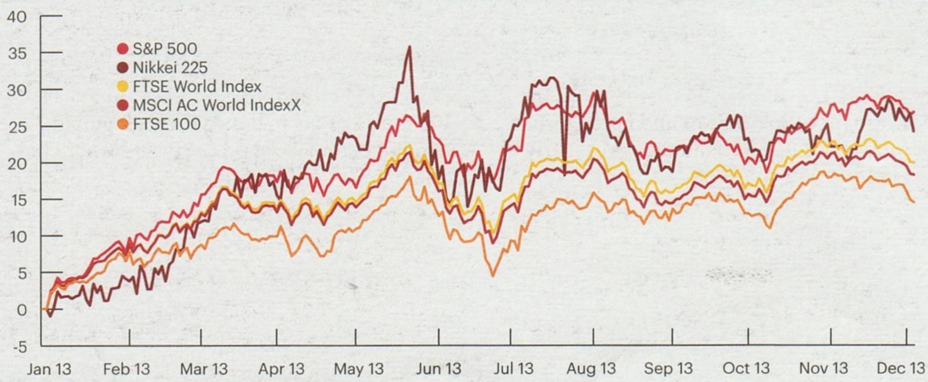
Within fixed income, we reduced our weight to the asset class but also modified our exposure by introducing funds or, in this case, an investment trust that has a floating rate nature – the Neuberger Berman Global Floating Rate Income fund. We believe this approach will continue to be attractive in a low-yielding environment and will benefit when the global economy moves back to a rising rate environment. Of particular note within our generalist alternative exposure was the addition of the Morgan Stanley Diversified Alpha Plus fund, which follows a global macro approach.

We have been well rewarded by our fund selection over 2013, with asset allocation also adding value, leading to outperformance of our Consumer Price Index benchmarks through the year.

John Husselbee

Never a dull year in financial markets and over the last five this has been underwritten by the words and actions of our global central bankers. To taper or not to taper, that is the question? And since Ben Bernanke's

The stockmarkets in 2013



The main indexes of the Madrid and Lisbon stock exchanges in the past 12 months

Source: FE

comments in May, investors have been trying to second-guess when and by how much the Fed will taper? Some investors decided a pre-emptive tactical move was necessary. US government bond yields rose sharply, large price declines were not in tune with the perception of a defensive asset class. That is not to say that alternative defensive asset classes fared much better in the year, with the US dollar unexpectedly weakening despite the prospect of tightening monetary policy.

Elsewhere, few had predicted a weaker global economy at the beginning of the year. This has stalled the commodity super-cycle, not helped by China continuing to promote a consumer rather than an investment-led economy. In another twist and turn, some emerging market economies are now grappling with stagflation.

In the eurozone, many had hoped that the lack of economic growth and high unemployment would improve after Mario Draghi had vowed last summer to do "whatever it takes". While clearly not fixed, economic activity is accelerating and borrowing costs for the peripheral economies have significantly fallen. All in all, confirmation that financial markets continue to be conducted by central bank action rather than fundamental analysis.

In the retail market, the introduction of RDR has dominated the activity of financial advisers, fund managers and their service providers. Industry consolidation has been talked about for many years and is now happening, maybe accelerated by the RDR.

Outsourcing investment management has continued to thrive together, with a greater focus on model portfolios which some commentators have said has resulted in soft closure of some of the larger funds. Fund managers argue that closing funds is necessary to protect the interests of existing unit holders, time will surely tell.

Finally, no year in the funds industry is complete without the annual fund manager merry-go-round, the most significant being the high-profile fund managers Richard Buxton and Neil Woodford, who tendered their resignations either side of the summer months.

The FS Investment Committee


Adam Lewis, committee chairman and associate editor


Keith Wade, chief economist at Schroders


James Dowey, chief economist at Neptune


Jonathan Davis, managing director, Jonathan Davis Wealth Management


Mike Deverell, investment manager, Equilibrium Asset Management


James Calder, head of research at City Asset Management


John Husselbee, head of multi asset at Liontrust


Tim Cockerill, head of collectives research, Rowan Darington


Lee Robertson, CEO, Investment Quorum

Tim Cockerill

It has been a good year on the whole for us as investors. The recovering US economy has led most markets higher, with the US itself up nearly 30 per cent. The main exceptions have been the emerging markets. The MSCI EM index having fallen marginally - the difference is stark and not one that we anticipated at the start of the year. Likewise, we had not expected Japan to perform strongly but were overweight on valuation grounds. Baillie Gifford Japanese Smaller Companies was our best-performing fund.

Market sentiment became far more positive during the course of the year; a change that was galvanised by improving economic numbers in the developed world, with Europe being the last region (not surprisingly) to report better GDP figures. All of which was a welcome change from the persistent negativity of previous years. Investors rewarded those economies that were doing better and backed away from those which looked like they were going to struggle.

At the stock level, there was a move from high quality defensive stocks to cyclical plays in the second half of the year, as the appetite for risk crept back, driven by the same improving sentiment.

Our performance was helped by UK smaller companies, Japanese and US exposure and a reduction in our emerging market holding during the year, which helped to soften the blow from their poor performance. But the soft and hard closure of funds has been a challenge particularly in emerging markets where the dominance of Aberdeen and First State has left investors with relatively poor alternatives.

As the end of the year approached, the US was still grabbing everyone's attention with the debt ceiling soap opera and the subsequent declining popularity of the political players.

Yet the market remained calm, knowing an agreement had to be reached and will have to be again in January. The real show is tapering – the markets' reaction earlier in the year to potential tapering provided a clue as to how the market might react when it happens for real and it will. Consequently, global performance in the second half of the year has been driven by tapering talk as will the start of 2014.

Lee Robertson

This year we have seen the developed markets outperform those of the developing but with uncertainties surrounding the tapering and eventual withdrawal of the US QE programme which draws ever nearer.

In terms of the equity markets we have seen Wall Street repeatedly record new all-time highs, alongside a 50 per cent rise in the Nikkei 225 Index (adjusted in local currency) and a strong recovery in many of the European markets. In the UK, a turnaround in the economy has led to a double-digit rise in both the FTSE 100 and All-Share indices, with the small and mid-caps outperforming their larger counterparts by substantial margins.

In terms of the emerging markets, investors have been withdrawing capital in favour of the developed world while reducing their asset allocations towards government bonds in favour of riskier asset classes. Unquestionably, the biggest force at work has been the influence of central bank policy which has affected the direction of equities, bonds and currencies.

In terms of Investment Quorum's strategic and tactical asset allocations for 2013, we have been overweight global equities favouring the US, UK, Europe and Japan. Within that arena, we have focused upon funds that have had exposure to multi-nationals and exporters along with UK small and mid-caps.

Undoubtedly, we have benefited from these regions through funds such as Lindsell Train UK Equity, Cazenove UK Opportunities, Franklin Templeton Mid-Caps, BlackRock European Dynamic, Baillie Gifford Japanese, Fundsmith Equity and the exchange traded funds of Lyxor ETF FTSE-All-Share and the iShares S&P 500 Index all contributing well to client portfolios.

Other successful themes that have run through some of our portfolios have been equity income funds like Cazenove UK Equity Income, JOHCM UK Equity Income and the M&G Global Dividend funds, all of which have contributed to overall performances. We took a proxy to bonds through global and UK commercial property and where risk tolerance allowed Real Estate Investment Trusts.

Finally, while bonds have been less favoured this year, we have been advocates of holding some index-linkers and global macro bond funds so as to play out macro events and the eventual rise in inflation which will undoubtedly return at some stage as the global economy picks up a head of steam over the coming years. All in all, it has been a very satisfactory year.