Watson Moore's Monthly Investment Update

February 2019

Contents:

PERFORMANCE UPDATE

- **Global stock markets recovered somewhat in January with the FTSE 100 rising 3.63%. This helped our portfolios grow between 0.75% and 7.00%.**

- The FTSE 100, and other global stock markets, are much more volatile than normal and, despite recovering somewhat, are still significantly off their summer highs. Since 9th August, the FTSE 100 has fallen 8.77%, having reached a low of nearly 14%.

- The uncertainty surrounding Brexit negotiations is causing greater volatility in our overseas holdings as Sterling is fluctuating significantly. Over the last month Sterling has actually risen, which indicates we will have closer ties with Europe rather than a 'no deal'. However, does anyone really know what the end outcome will be?

- Most stock markets remain below trend and our portfolios are positioned much more defensively. Investors remain fearful that this correction could turn into a much bigger correction, despite the small January recovery.

- On the positive side, stock markets appear to be good value and if we don't get a global recession then this could be a great time to invest. For example, the FTSE 100 is now paying a dividend yield of over 4.5%.

- The performance of the portfolios over the last month and year is shown below:

Portfolio	Performance % 1 month	Performance % 1 year
Foundation	1.67	-1.34
Cautious	0.95	-6.80
Balanced	0.75	-6.44
Adventurous	1.51	-5.83
Dynamic Equity	4.40	-0.22
Income Generating	3.25	-2.59
Third Industrial Revolution	7.00	0.11
Retirement Investment Solution 1	1.69	-4.27
Retirement Investment Solution 2	2.05	-3.89
Retirement Investment Solution 3	2.40	-3.52

Please note that these figures do not include the Standard Life platform or Watson Moore's fees.

Trend Following Signals

The table below shows whether the asset class is either in a positive trend (✓) or a negative trend (✗). The portfolios will have more exposure to those asset classes in a positive trend and less (if any) to those in a negative trend. These are the main asset classes we monitor:

Asset Class	Trend Signal	Asset Class	Trend Signal
Global Equity	✗	Emerging Market Equity	✗
UK Equity	✗	Commodities	✗
Europe ex UK Equity	✗	UK Corporate Bonds	✓
US Equity	✗	UK Corporate Bonds (Short dated)	✓
Japan Equity	✗	UK Index Linked Bonds	✓
Pacific Equity	✗	Global Bonds	✗
Gold	✓	UK Gilts	✓
Global Property	✓	Emerging Market Bonds	✓
		Overseas Corporate Bonds	✓

Summary of Portfolios

After a torrid 2018, all the major risk assets performed strongly in the first month of 2019. A major event occurred in the final week of the month when the Federal Reserve Board (the people in the US responsible for setting US interest rates as well as the amount of money in the economy) signalled a halt to its interest rate rises and from reducing the amount of money in the economy (Quantitative Tightening). The reason for this is that they have concerns for global growth not least on account of slower growth in China. This is exactly what Trump has been tweeting for months! He therefore has got what he wants and this should help the US economy and stock markets.

Cautious, Balanced and Adventurous portfolios

Whilst we have seen a small recovery, global stock markets remain generally below trend. The portfolios have therefore been positioned relatively defensively, with less equity exposure than 'normal'. What this means to your wealth is that these portfolios normally take the first hit during a correction but as more money moves into cash they are somewhat protected from further falls.

The downside of holding excess cash now, is that you will not fully benefit from the start of any new upward trend. This month we saw global property companies move above trend and exposure was added in the three portfolios. Until we see more stock market trends become positive our portfolios will be less volatile, meaning that you will experience lower losses and gains during this difficult period.

Dynamic Equity portfolio

The momentum philosophy that forms the core of this portfolio attempts to invest more money in those markets that are experiencing the strongest growth. In the November rebalance, we added global property companies and they rose over 7% during December. This shows that by investing into the strongest performing asset classes, you can make significant gains. No changes were made this month to the portfolio.

Foundation portfolio

The Foundation portfolio increased its exposure to global property companies as they moved above trend. In addition, exposure was increased in UK Corporate Bonds. This resulted in less cash within the portfolio.

Income Generating portfolio

We are beginning to see income generating asset classes outperform and, with a yield of between 4.5% to 5% on the FTSE 100, we took advantage of this by purchasing a high yielding UK equity fund. We purchased the Man GLG UK Income fund which has yielded 4.41% historically but going forward could be paying an income closer to 5%. We believe that the high yields being offered are due to the recent market sell off but also the fact that oversees investors have been shunning UK stock markets whilst Brexit is negotiated. We also purchased the M&G Emerging Markets Bond fund which has started to grow significantly in the short term and is yielding 6.46%. We have invested in the hedged share class which takes the currency risk out of the investment i.e. a softer Brexit won't hurt returns.

In order to fund this, we sold the Invesco Perpetual European Equity Income fund because European equities are low on our momentum scale (they have started to underperform), as well as half our holdings in the Standard Life UK Property fund. UK commercial property funds have grown over the last year but over the last few months have stopped rising. We therefore want to reduce exposure to an asset class that could be adversely affected by a "no deal" Brexit.

The changes will increase the income that is being generated by the portfolio.

Third Industrial Revolution portfolio

No changes were made this month and the portfolio was our strongest perfoming one, rising by 7% in January. The portfolio is proving to be much more volatile than other portfolios with higher gains and losses each month. This can be demonstrated when comparing it to the FTSE 100 and you can see that by taking a higher level of risk, the returns have been significantly greater:

Retirement Investment Solution portfolios

The trend following part of these portfolios invested in global property companies this month and thus reduced their cash position. The Retirement Investment Solution portfolios are invested in not only a trend following portfolio, but the Foundation and Dynamic Equity portfolios as well.

Summary

We saw a small recovery in global stock markets in January, but the majority remain below trend. Global property companies moved above trend and exposure was increased within some of our portfolios. The article below demonstrates we must remain wary that after stock markets experience a sharp correction and recovery, they are more vulnerable to a crash and a significant fall.

ASSET CLASS REVIEW

This section will give you an insight into our current thinking, and we have attached some charts that look interesting. We have recently experienced the second global stock market correction within a year but are beginning to see a recovery. We therefore look at whether we will experience a strong recovery and new stock market highs or further falls from here.

Which markets are recovering the best?

Certain stock markets have recovered reasonably well and are close to breaking above trend again. The main two are the US and Emerging Markets (the trend line is in red):

US

Emerging Markets

Some stock markets have only slightly recovered and look as though they are susceptible to further falls

The chart below is the main European stock market (blue line). The trend line is the thin red line and we have drawn a thicker red line to show the direction of the short-term highs. Clearly you can see that the downward trend accelerated recently and the recovery hasn't yet broken above any previous short-term highs.

Will this correction turn into a crash?

Although we don't believe that you can predict when a crash will occur (the media tend to predict one will happen every year and eventually they are correct!), but we do see some commonality of how a stock market behaves before the crash. The majority of crashes occur after a strong upward trend, but before they crash, we see a short sharp correction followed by an equally sharp recovery, leading to a V shape in the chart. The V shape is a sign that there is a problem which panics investors who then sell quickly, but many investors don't believe that the problem will cause a crash and therefore buy back in to the cheaper market. Eventually more investors believe that there is a real problem and start to sell. The buyers who stepped in last time become less and less bullish until eventually there is no one left to buy and markets crash.

The charts below show the recent V shaped fall and recovery in the FTSE 100 last February, as well as those that preceded the last two crashes:

In Summary

We have experienced a second correction in the last 12 months and are currently seeing markets recover somewhat from their lows. However, most markets are still below trend and the V shaped pattern that we have seen before previous crashes remains an ominous sign. Our main investment philosophy will not predict the next crash and we have no idea whether we will experience another strong recovery or a crash, but by increasing cash levels when a market breaks below trend, we hope to be able to protect wealth in the event of a further deterioration in stock markets.

GLITTERING GOLD

Gold is respected throughout the world for its value and rich history, which has been interwoven into cultures for thousands of years. Coins containing gold appeared around 800 B.C. and the first pure gold coins were struck during the reign of King Croesus of Lydia about 300 years later.

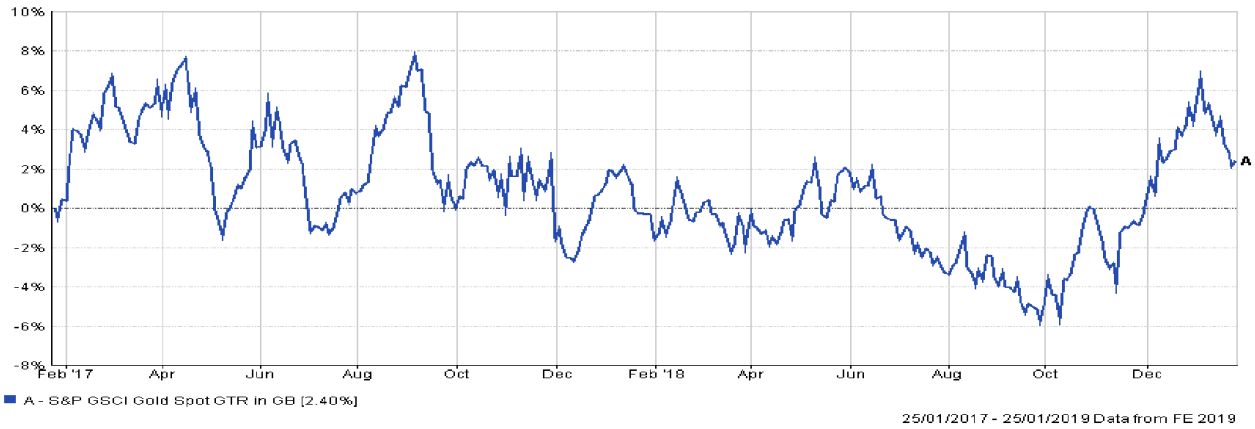
Throughout the centuries, people have continued to hold gold for various reasons. However, gold is one of those marmite investments that some people love, and some people hate. Those that are gold fans believe that you should invest 10% of your portfolio in gold. They point out the fact that gold adds diversification to a portfolio as it is not correlated to the stock markets. In fact, the 1970s were great for gold but terrible for stock markets; the 1980s and 1990s were great for stocks but terrible for gold. In 2008 stock markets crashed whereas gold did well, growing by over 40% in Sterling terms. Currently some investment commentators are promoting gold as a hedge against economic collapse. They are saying that Governments have created so much debt that currencies and economies will crash, and the best medium of monetary value will be gold.

Those that don't believe in holding gold point to the fact that it doesn't create a dividend, the long-term returns have been low when compared to stock markets and it is only worth what the next person will pay for it and therefore prone to booms and busts.

How do we invest in gold?

Gold's volatility is evident in the chart below which saw it grow from under $900 in 2009 to nearly $1900 in 2011, before falling back to $1100 in 2015 (please note that this price is in Dollars and not Sterling):

We have therefore seen clear upward and downward trends over the last 10 years and, due to this, gold is a good asset class to enact trend following on. However, before we decide whether gold is on an upward trend or downward trend, we convert the price into Sterling - there is no point investing in gold when it is going up in Dollars but down in Sterling. Currently gold has been trending sideways in Sterling but has just started to advance higher and is above trend, so we have exposure to it within our portfolios:



Summary

Gold is a great asset class for our investment philosophy as it is prone to booms and busts and therefore trend following works very well on it. We may be about to see the start of a new upward trend in Dollar terms but need to convert the price into Sterling before deciding if it is on an upward trend. This is particularly important to do during the Brexit negotiations as Sterling is much more volatile than normal.

FINAL COMMENT

2018 saw some of the poorest returns for equities and bonds since 1994. Whilst 2019 has seen a small recovery, we do remain wary that most stock markets remain below trend and have suffered two corrections within a year. Our objective is to try and minimise losses once we have experienced the first significant stock market falls. This is the reason why we have much more cash in the trend following portfolios and less invested in equities. Whilst we do not know what the future direction of stock markets will be in 2019, our investment philosophy is flexible to increase risk if they move up and somewhat protect wealth if they fall further.

We do not apply trend following to the Dynamic Equity, Income Generating and Third Industrial Revolution portfolios and therefore they are liable to fall more if we do indeed experience a stock market crash but also gain more if this recovery strengthens in the short term.

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