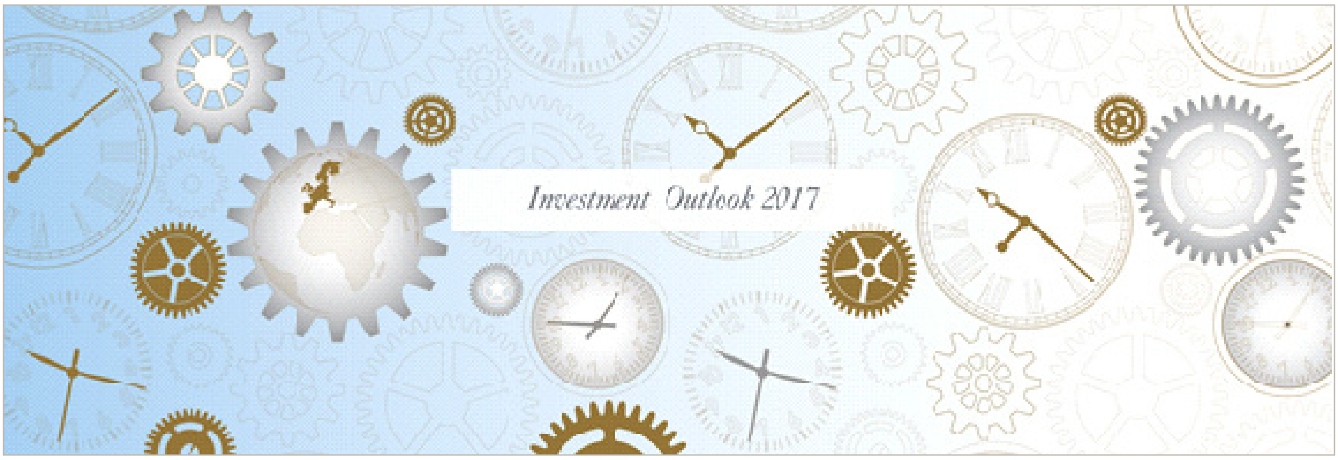
Coutts

Investment Outlook 2017

TIMELESS PRINCIPLES IN A CHANGING WORLD



Timeless Principles In A Changing World

Through the heightened uncertainty of 2016 and seismic shifts in the political landscape, our clients' investments have been remarkably resilient. In this year's Investment Outlook, we take a look at how we can apply the same time-tested investment principles behind this resilience to the dangers and opportunities we have identified for 2017 and the long term trends we believe will shape the investment landscape of the future.

What's Inside

An introduction from Mohammad Syed, Head of Financial Advice and Investment Solutions

2016 will be a year to remember for a long time to come. It started with a short-lived global growth scare and went on to deliver some seismic and surprising shifts in the global political landscape.

Through it all, our clients' investments have been remarkably resilient, not only bouncing back from the sell-off that ushered in the year, but pushing ahead with some strong gains. We put this down in large part to the deeply embedded investment principles that bring discipline and structure to our decision-making.

Our patience, and focus on quality and value, helped us remain on course during the panic that gripped markets at the start of the year. Sticking to our positive outlook for the global economy and markets has delivered results. We focused on the fundamentals, not shifting from our stance when the polls were confounded by the EU Referendum, or when the US presidential election winner was announced.

Looking ahead to 2017, we see the political landscape continuing to evolve. With a number of key elections scheduled in Europe during the year, most notably in France and Germany, we believe the populist vote will remain strong. At this stage, though, it's hard to tell whether populism will determine the overall outcome as it did in the UK and US this year – and in India and Indonesia in recent years.

Click here to watch a video intro with Mohammad Syed on coutts.com

If this populist trend continues we expect to see political tensions building up further, reflected in the geopolitical landscape and in economic policy. In our view this has the potential to increase the pace of policy change globally, but as these changes evolve, we will also see investment opportunities appearing. Regardless of how events unfold, we will remain steadfast in following our investment principles, focusing on assets that we believe are inexpensive relative to their long term value.

In our Investment Outlook 2017 series: Timeless Principles in a Changing World, we discuss our investment ideas for the coming year and also examine some of the long term trends that we believe will shape the investment landscape of the future.

Over the coming weeks we will be sharing our articles along with video content from the Coutts investment team on coutts.com and by email, which we hope you will enjoy. We begin today with "Investing for Change: Danger & Opportunity" and will follow on with changing demographics, the importance of alternative strategies, investing in private companies and how responsible investing can add value.

We look forward to discussing our investment views with you in the months ahead and wish you a happy and prosperous 2017.

Mohammad Kamal Syed

Managing Director, Coutts

Episode 1

Investing For Change: Danger And Opportunity

> *The Chinese use two brush strokes to write the word 'crisis.' One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger – but recognize the opportunity.*
>
> *John F. Kennedy*

Click here for this article and related video on coutts.com

Investing for Change means looking out for the dangers, but also embracing the opportunities

In June 2016 we had a vivid glimpse of what populism might mean for the world in years to come. At the time of the UK referendum there was little to indicate that this might be the start of a trend that seems to be taking hold around the world, moving the political dial from globalisation to the nationalism and economic protectionism we saw in the recent US elections.

But while this shift could influence longer-term trends in corporate and macro economic behaviour, our analysis also identifies a broad range of investment opportunities for the coming year. These include:

+ Sterling
+ Short-dated bonds
+ Financial debt
+ European equities
+ Global healthcare
+ Technology
+ Alternative investment strategies

Since the UK voted in June to leave the European Union, dark clouds have formed over sterling which was trading recently at its lowest level since a long and steep decline in the first half of the 1980s. For sterling-based investors, the silver lining in this cloud has been higher returns from overseas assets. But we see a different path for sterling in 2017 – and a different set of opportunities for UK investors.

Elevated returns from overseas assets this past year imply lower sterling-based returns in 2017 if, as we suspect, we see the sterling exchange rate moving back towards its longer-term average. A recovery in sterling could turn many of 2016's winners into losers in 2017. These include almost all investments in overseas equities. So how can we mitigate this risk?

Hedging against currency risk

First, we can look to take profit on some of our overseas investments and re-invest the proceeds in sterling-denominated assets, while still maintaining a diversified portfolio. Where possible, we might also hedge against moves in exchange rates.

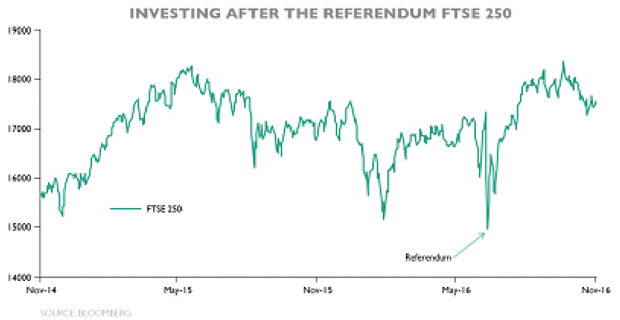
This can be done by using hedged share classes of funds investing in overseas equities, thus maintaining exposure to non-UK markets while hedging out the currency risk. In some instances, hedging out currency risk via the use of derivatives, such as currency futures, will allow investors to lock in future exchange rates at particular levels.

This would mean, of course, that in times when sterling was weakening, as it has post Brexit, these investments would miss out on currency-related gains. Conversely, they would be protected from losses if sterling were to revert back to its longer-term trading range, a view we will outline in a subsequent feature in our Investment Outlook 2017 series: 'Sterling's dependence on the kindness of strangers.'

Looking for the opportunities

Since the EU referendum in the UK, we have also been looking at asset classes that suffered most from the vote to leave, and may offer value today. Apart from sterling, the main asset classes that suffered were small to mid-size domestically-focused UK shares, like those in the FTSE 250 and commercial property.

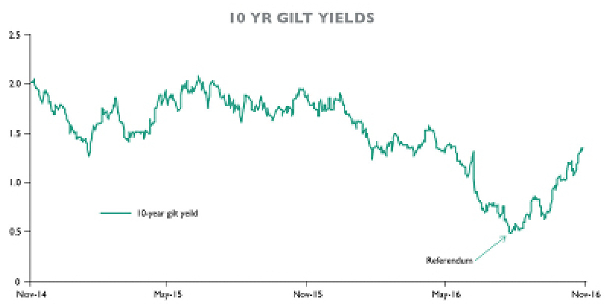
While the FTSE 250 plunged post the referendum result, it has surged since, as the chart below shows. This mid-cap index has produced stronger and more stable earnings growth than the FTSE 100 since the global financial crisis, reflecting the solid performance



of the UK economy relative to most of the developed world.

We believe, though, that the FTSE 250's sharp recovery from post-referendum lows has discounted a better outcome for the UK economy outside the EU than feared. Given ongoing uncertainties about what form Brexit ultimately will take – 'hard' or 'soft'? – we prefer to wait for better buying opportunities.

Commercial property is a favoured income diversifier given the ultra-low yields from government bonds and should remain solid if the UK economy remains strong. But UK commercial property funds have already surged since August, with some only slightly down for the year at the time of writing, after being down about -15% at one stage. Transaction costs are high for these funds (i.e. they are expensive to buy), and though we regard existing holdings as attractive, we are inclined to wait for better buying opportunities in this area as well.



The other side of the coin

On the other side of the coin, safe-haven UK government bonds (gilts) enjoyed a strong rally post-referendum (see graph). But these gains have now evaporated, with 10-year gilts, for example, down 6% from their highs in just two months. With an annual income of only 1.4% at the time of writing, this 'safe' asset looks decidedly unattractive.

We still see gilts having a role in providing liquidity (they can be easily sold if cash is needed) and helpful diversification away from equities (they tend to rise in value when equities are falling). However, we see better solutions for providing income and diversification, which we will address in a later instalment of Investment Outlook 2017: 'When safe-haven gilts look ghastly.'

Sterling's Dependence On The Kindness Of Strangers

Big Mac prices say that sterling is good value; more serious valuation measures agree

Sterling fell by about 15% in the four months after the UK voted to leave the European Union, with the world seeming to have turned against the currency. But our investment principles – based on long-term thinking and a willingness to diverge from the crowd to find good value – lead us to view sterling in a different light.

Relative to other major currencies, we now see sterling as significantly undervalued in terms of purchasing power parity (PPP). PPP, measured via what is termed the real effective exchange rate, gives a measure of the purchasing power of one currency compared to another.

The Big Mac index of real purchasing power, invented by The Economist magazine in 1986, compares the prices of McDonald's Big Mac burgers around the world. The Big Mac index is partly a joke but can be suggestive and confirms our suspicions that the pound is undervalued – according to the Big Mac Index purchasing power parity works out at $1.70 and €1.30.

The graph below shows that after adjusting for inflation, sterling is trading close to 30-year lows relative to its trading partners, reflecting market concerns that a 'hard' Brexit could discourage foreign investors and trigger a flight of capital out of the UK. The problem for sterling is that the UK's hefty current-account deficit (mostly due to the UK importing more than it exports) means it is dependent on overseas capital flows. As Bank of England Governor Mark Carney put it, the UK is dependent on "the kindness of strangers".

Sterling At Rock-Bottom Prices

The UK current account deficit is large, at about 6% of gross domestic product, but we view these concerns as overplayed, in part because we expect the key trade-deficit component of the current account to begin falling soon. To put this in perspective, the currency which is currently most favoured in the financial markets is the dollar, and the US has run a trade deficit every year since 1975.

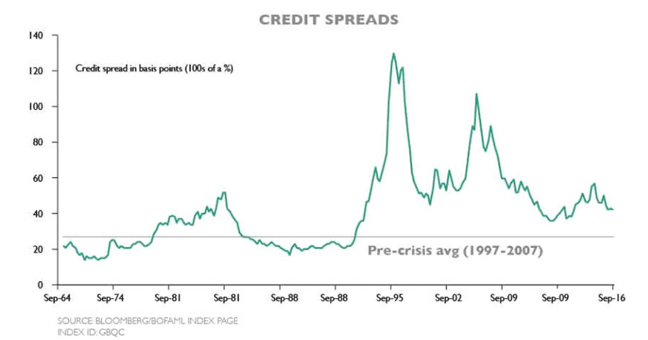
Our investment principles direct us to look for good quality assets at reasonable prices, which should perform well in the long run. Our sterling-based investment solutions have made significant gains in 2016 as the weakness of sterling has boosted returns from overseas assets. We think it's time to take some profits on these currency-related gains and to raise our strategic allocations to sterling.

Time To Take It Easy On Interest-Rate Risk

The days of taking lots of interest rate risk may be over – take it easy with low duration

Holding lots of duration, a measure of interest-rate risk, has paid off over the last few years. But as US rate rises look increasingly likely, 2017 may be time to take it easy on interest-rate risk by focusing on shorter-duration debt.

In an environment where many assets appear expensive, it may seem surprising that the compensation for taking on the additional risk of default on corporate bonds (i.e. credit risk) compared to government bonds (the 'credit spread') is roughly in line with its long-term average. By contrast, the general level of yields across all bond sectors is near historical lows, with ultra-low Swiss and Japanese government bond yields at the bottom.



Spreading Your Risks

Given that expensive and low-yielding government bonds are the traditional core of bond investing, what can we use as an alternative? A key area for us is short-dated credit, which minimises interest-rate risk and reduces the potential losses if government bonds fall. By contrast, longer-dated and higher-duration credit remains more sensitive to interest rate risk and is likely to follow sovereign bonds down if rates rise.

For what is effectively zero interest-rate risk, floating-rate bonds look like a good place to be if our forecast of rising US rates materialises in 2017. This form of short-dated debt pays interest at a rate that moves up or down in tandem with underlying central bank rates. So if rates go up, so does the interest paid on these bonds.

One area where we can employ our core investment principles – being selectively contrarian and willing to go against the crowd and find value in unpopular places – is the much-overlooked and unloved sector of asset backed securities (ABS). ABS were the poster children for excesses during the 2008-09 financial crisis but contrary to popular opinion, the vast majority of ABS sailed through the financial crisis with minimal (and in some cases close to zero) defaults. They are based on a range of lending activities and we see them as providing good value, over-compensating investors for default risk and paying attractive incomes.

Bad Memories Lead To Good Yields

Subordinated financial debt may not have a nice ring to it, but we like its higher income

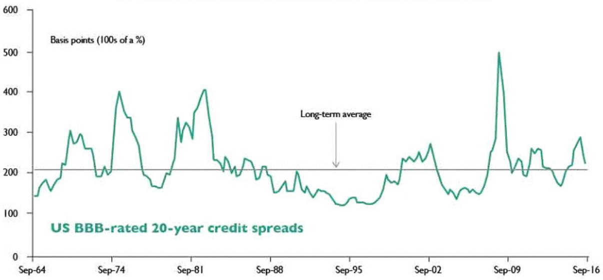
One asset class in which we have a lot of conviction for the next few years is subordinated financial debt. We like it because it is relatively insensitive to changes in interest rates and continues to look undervalued – largely due to widespread negative sentiment toward banks.

As the name suggests, subordinated debt ranks behind an issuer's more senior (unsubordinated) debt in the credit structure. However, we believe the higher income from these types of bonds more than compensates for the additional credit risk.

Subordinated bonds are typically structured with a high fixed interest payment for five years, before becoming callable, which means the issuer has the right to redeem them, typically at par (100% of the original principal). The issuer may also choose to pay a penalty interest rate to redeem them early.

Amply Compensated For The Risk

MOODY'S BAA 20 YEAR CORPORATE SPREADS



SOURCE: PIMCO

To gain good quality exposure to subordinated financial debt, we generally buy regulated pooled funds that invest in large European 'national champion' banks considered systemically important to their home country, limiting the possibility of any defaults. In our view the key challenge for Europe's banks at the moment is weak profitability rather than solvency. Banks have raised a great deal of capital since the financial crisis, have significantly improved their capital adequacy ratios and are lending more conservatively, all key features of a sustainable business model.

With scary memories of the global financial crisis still fresh in many investors' minds, subordinated financial debt isn't being embraced by the crowds. We believe this is an investment opportunity being overlooked and see the attractive yields (which move inversely to prices) over-compensating investors for the risk involved.

Wiill Europe Be 2017'S 'Most Improved Player'?

Being positive on European equities requires patience, but we still see potential

European equities remain among the most fairly valued in the developed world, and given that the region's economy and corporate profits are in the early stages of recovery, there is also more upside than elsewhere. We're the first to admit that this investment thesis didn't pay off in 2016, but remain patient – and evidence has been mounting recently that the long-awaited recovery may finally be underway.

When we laid out our investment case for European equities in 2014 we saw the beginnings of an economic recovery and a positive turn in the corporate earnings cycle. The European economy has a healthy trade surplus, a competitive currency and improving government fiscal positions following solid turnarounds in Spain and Italy.

Since then, growth has improved – driven mainly by strong consumer spending – though production, exports and investment are lagging. Germany has had the strongest recovery, but in Spain unemployment is also falling sharply, and we are now more positive about not just Germany but also the periphery.

In the second quarter of 2016, earnings upgrades outnumbered downgrades for the first time in 15 months, and the positive trend continued into the third quarter. With expectations for earnings still quite low in Europe, even signs of stabilisation can be a positive.

CAPE

SOURCE: BLOOMBERG

European equities remain inexpensive in terms of cyclically adjusted price-to-earnings ratios (CAPE), which are based on equity prices relative to average earnings over the past 10 years, adjusted for inflation. The latest Bank of America/Merrill Lynch Fund Manager Survey also suggests that investor sentiment is turning more positive toward Europe, with global investors now moderately overweight.

We remain positive on European equities. Valuations are still favourable and the outlook for earnings growth looks attractive.

Episode 2

Keeping An Eye On The Future

An ageing global population provides interesting investment opportunities but reinforces the 'new normal' of lower expected returns for investors

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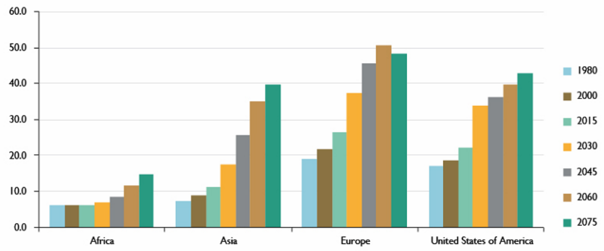
One of our core investment principles – patience – seems to have gone out of fashion in today's digital world with its insatiable appetite for more and faster information. Investors seem to be neglecting longer-term trends that can influence the economic outlook and investment performance. We believe changing demographics are one such long-term driver – as an ageing population, particularly in developed economies, reinforces the 'new normal' of lower expected returns.

Longer lifespans + declining birth rates = ageing populations

By the year 2030 the world's population is expected to rise by 16% to about 8.5 billion people, and to 9.7 billion in 2050. The growing population is also expected to get older as life expectancy continues to rise and birth rates drop over the period. This will be a feature not only of developed economies but of some emerging economies too – and the pace is expected to be much quicker in the latter.

For example, while it took 150 years for the percentage of France's population older than 60 to grow from 10% to 20%, countries like Brazil and China are likely to manage this in about 25 years (see chart below).

How Rapidly Is The Over-60 Population Increasing?



SOURCE: WORLD REPORT ON AGEING AND HEALTH, WORLD HEALTH ORGANISATION 2015

This combination of rising life expectancy and falling birth rates raises the dependency ratio – the number of people aged 65 and older divided by the population aged 15 to 64. For the world as a whole, the United Nations forecasts that this ratio will triple over the next 84 years, driven by rapid ageing in less-developed countries. For example, the UN projects that China's dependency ratio will increase five-fold between 2015 and the end of the century. In more-developed countries like Europe, Japan and the US, the ratio will double over this period.

That's not to say we won't see some regional differences in areas such as the Middle East and Africa, particularly in the short term, where a rapid expansion in the younger population is expected.

Falling birth rates lead to slower growth of the working-age population, which is a headwind for economic growth – usually described as a function of labour, capital and productivity. To make matters worse, productivity growth worldwide has plunged in the last 10 years or so, hence it's unlikely that productivity can offset the negative demographic trends.

Baby boomers and asset prices

In many developed countries like the US, population growth surged in the two decades after the Second World War, as couples who could not afford families earlier made up for lost time. These 'baby boomers' are now beginning to retire, which could influence asset prices. As investors retire, they sell assets to finance their retirement; if enough people are retiring at the same time, like the baby boomer generation, it's been suggested we could get an asset-price 'meltdown' as would-be sellers outweigh potential buyers.

But this theory is exaggerated. The main factors limiting the meltdown effect are increased longevity, leading retirees to hold onto their investments for longer, the need in an ageing society for more capital to replace labour, and demand from international investors.

Moreover, equity assets are concentrated in the richest part of the population, who are unlikely to sell them all. But investors in the developed markets should expect some headwinds to asset values and returns over the next fifteen years, as a large segment of the population enters retirement.

One study found that a 1% rise in the share of 50-54 olds in the population raises equity returns by about 1% per year, while a 1% rise in the share of the 70+ age group cuts equity returns by about 2% per year. The results for bonds are similar but less pronounced, partly because many investors switch from equities to bonds as they age.

In our following articles below, we examine how demographics may affect the healthcare sector and what the future may hold for US technology.

Healthy Long-Term Returns

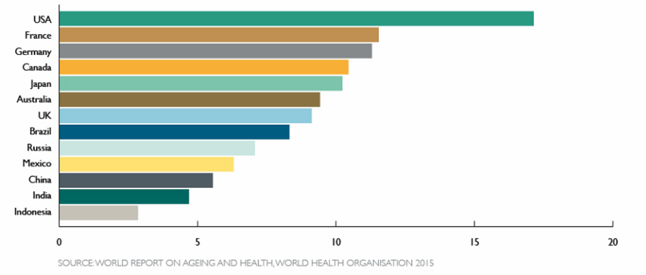
Rising living standards and an ageing global population could be a good combination for healthcare stocks

Secular trends like an ageing global population and the growth of emerging markets are raising healthcare spending worldwide, and should benefit companies that cater to this demand.

The demographic trends described in the previous article (see "Keeping an eye on the future") are largely a headwind for economic growth, but are likely to be a tailwind for healthcare companies that cater to the ageing population.

The potential impacts of growing and ageing populations on healthcare systems are profound and probably underestimated by many countries. Increasing longevity across the world will lead to an increase in chronic diseases that hit the elderly hardest, such as cardiovascular diseases, cancer, diabetes, Alzheimer's, hearing loss, vision care and so on.

Total Expenditure on Health as a Percentage of Gross Domestic Product (As of 2014)



While healthcare will have its ups and downs, secular trends are likely to ensure that the sector grows faster than the global economy. Current forecasts suggest that global healthcare spending could grow more than 6% per year over the next decade. Not only should public spending on healthcare grow, but so should private demand as people pay for more and better healthcare services.

Given the implications of ageing and longevity on global healthcare costs and government budgets, there will clearly be public pressure to reduce these costs and raise the quality of services. Efficient and sustainable healthcare systems will become a priority for many governments in the developed world – providing opportunities to generic drug producers, new technology and new therapies, as well as new business models in healthcare.

In 2015-16 the US healthcare sector underperformed the broader market amid fears of increased regulation of drug pricing if Hillary Clinton became president. We raised exposure to healthcare shortly before the election, given our view that the sector was trading at an attractive discount and that investors were exaggerating regulatory risks. We see the sector benefiting from sustainable earnings growth for a long time to come.

In the following article below, we examine what the future may hold for US technology.

[1]Based on IMF World Economic Outlook Database and World Bank World Development Indicators data on health expenditures.

Us Technology: Disappointment, Dinosaurs And Decacorns

Smartphones disappoint and dinosaurs are reborn; will the 'decacorns' deliver?

Smartphone mishaps prompt a change of focus, while 'old' tech witnesses a rebirth under a new guard of management. After a fallow year for technology IPOs in 2016, the 'decacorns' may be coming. But beware of increasing equity supply and high expectations.

Smartphones lose their lustre

2016 certainly had its share of surprises in the smartphone industry. Previous years saw new smartphone releases leapfrog earlier versions with faster processing and better specifications. But manufacturers struggled to push the bar meaningfully higher this year.

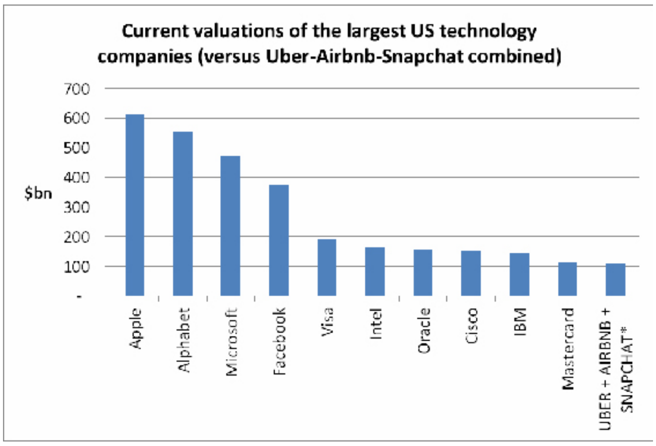
Heavyweight rivals Samsung and Apple had mixed fortunes in their core smartphone business. Apple's iPhone 7 was launched in September with far less euphoria than earlier models. What had been removed (the headphone socket) got as much attention as what was added. Rival Samsung has had to deal with its own problems, most notably a global recall of its Galaxy Note 7 due to some devices catching fire.

This may help explain a shift in focus to a new wave of consumer technology, from voice-activated 'assistants' (like Amazon's Alexa) to virtual reality headsets and wearable devices.

Return of the dinosaurs

2016 also provided an important lesson for investors – don't write off the 'has-beens' – as the share prices of a number of 'old technology' firms surged. After it spun off its printer and PC business, the 'new' Hewlett Packard soared as investors reassessed it in its new guise as a focused enterprise-services business. Yahoo!, another name from the past, also benefited from the announcement of the sale of $4.8bn of assets to US telecom giant Verizon in July. Meanwhile, Microsoft has been reborn as a cloud-computing behemoth.

All three of these companies have new management. And in all three the new guard has decided that their past industry dominance that has yielded abundant cashflows can be used to fund acquisitions and targeted capital expenditure. Alongside this, less profitable and lower growth businesses can be sold or shut down, boosting profit margins and growth from what remains. We expect this playbook to be followed by more 'old' technology companies in 2017.



Source: Bloomberg, as at 31 October 2016

Make way for the decacorns?

The technology sector's outperformance versus the wider market over 2016 presents an increasingly favourable environment for private start-ups to raise capital from investors via initial public offerings.

Private start-ups with an estimated valuation of more than $1bn are termed 'unicorns' but over the past few years we have seen the emergence of the 'decacorn', where the estimated valuation exceeds $10bn. This exclusive club includes mobile messaging app Snapchat, property rental platform Airbnb and taxi booking app Uber. Taken together, they are valued at over $100bn, which would rank them alongside Mastercard, the 10th biggest US technology company (see chart).

Any of these decacorns could float in 2017, after a relatively fallow year for technology IPOs in 2016. However, we would see a rise in IPO activity as a warning sign for the wider market – increasing equity supply while raising expectations to what may be unsustainable levels.

We have been overweight US technology for a couple of years, since the sector looked inexpensive by historical standards and was growing strongly. Our views have not changed, partly because the performance of the sector has been driven largely by healthy cashflows.

Episode 3

When Safe-Haven Gilts Look Ghastly

Long-term investors in gilts are almost certain to lose money in real terms; we prefer various alternative investments

Click here for this article and related video on coutts.com

Inflation used to be the enemy of the investor. In the 1970s and 1980s, the major goal was to find investments that could beat inflation, which peaked at 26.9% in August 1976, and even as late as October 1990 spiked up to 10.9% .

The index-linked gilt market emerged in the early 1980s to protect investors against the depredations of inflation. If you expect to retire in 30 years' time, for example, you can buy a 30-year index-linked gilt whose value is guaranteed to move with Retail Price Index inflation over the next 30 years, thus protecting your savings against inflation.

But this insurance has become expensive recently. At the time of writing the 30-year UK index-linked gilt trades at a negative yield of -1.6% (see graph). So if you hold it to maturity the government guarantees you that you will lose about 23% of the real value of your investment over that period, measured via the Consumer Price Index (which we view as a better measure of the cost of living than the RPI).

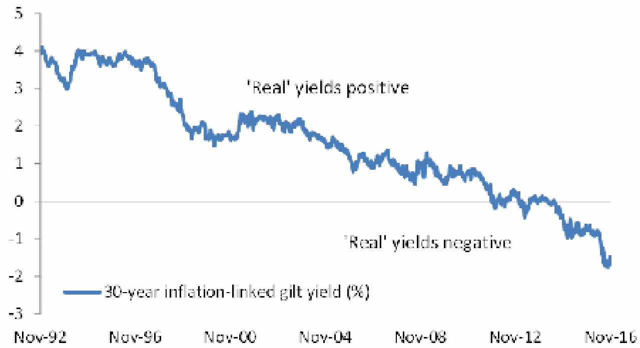
This is one of the most remarkable distortions in the world of finance. By contrast, back in 1992, the yield on a 30-year index-linked gilt (UK government bond) was 4.6%, so investors were guaranteed to quadruple the real (inflation-adjusted) value of their money by the year 2022.

The madness of pension funds

Who would buy a gilt with a negative real yield? The answer is simple: pension funds! UK defined-benefit pension schemes have liabilities of £1.9tn (August 2016) linked to inflation by government regulation. They have an insatiable demand for inflation-hedging products that will help them manage

their interest rate and inflation risk – albeit at the cost of losing their investors lots of money.

An Investment That Is Guaranteed To Lose After Inflation



Source: Bloomberg

We consider this to be highly unattractive. In our view, pension funds should favour risk assets like equities with positive expected returns in the long run. Unilever shares, for example, pay a 3% dividend and the prices of the firm's products like Lipton, Magnum and Omo move quite closely with inflation.

The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment.

Index-linked gilts are an extreme case. But even conventional gilts offer little to investors. The 10-year, for example, yields 1.25% at the time of writing, even after a recent sharp rise. Like the Bank of England, we expect UK CPI inflation to average around 2% p.a. over the next 10 years, after being pushed up by the fall in sterling this year. In that case, investors in 10-year gilts can expect to lose 7% in real terms if they hold the bond until maturity.

Government bonds have traditionally been the bastion of defensive investing, providing inflation-beating returns to investors and often performing best when economies slowed or went into recession and equities were weak. At current levels of interest rates, though, we expect gilts to lose in real terms in most plausible economic scenarios, and have cut our holdings to a minimum.

Alternatives

Instead, we are increasingly investing in alternative strategies – ways of generating returns that are not closely linked to the direction of equity and bond markets. These include:

- Global macro, a 'go anywhere' approach seeking to benefit from macroeconomic trends across the world
- Equity market-neutral, balancing long (positive) positions in promising companies and short (negative) positions in what are seen as the weakest ones
- Trend-following, by which managers seek to buy when markets are rising and sell when they're falling (see next article)

We expect that a basket of such strategies will outperform government bonds over two or three years and have a reasonably defensive returns profile, preserving their value in periods when equities fall.

Trending Markets Can Be Good For You

The role of trend-following strategies

Buying winners and selling losers

Trend-following is straightforward, at least in principle. Buy a security if its price is up over a period (e.g. 12 months); sell if its price is down. The idea is that if a market is rising or falling then it's more likely to continue rising or falling for a while.

Researchers have discovered that most asset classes trend a little. According to Clifford Asness from AQR, a US quantitative house, the risk premium (i.e. the potential additional return investors might receive for taking on additional risk) associated with trending "is the most pervasive risk premium in finance." So "the trend is your friend," as the old investment adage has it. Buy winners, sell losers.

While many investors are sceptical, the evidence is clear: in the long run, a broad range of managers following such strategies have made money. One study found that US trend-followers generally outperformed US equities over the 1980-2015 period, with smaller ups and downs. That's not to say there won't be times when returns are negative.

But while market trending is pervasive it also requires highly skilled managers who are experts in their field in order to invest successfully. History shows that winning trend-following managers trade lots of different markets, trade quickly and efficiently, and manage risk tightly.

Why should markets trend? One reason is that investors respond to information at different speeds. If for example there's a news event that should trigger a rise in the price of gold, traditional hedge funds might buy within hours; mutual funds within days; while sovereign wealth funds and pension funds might still be buying a month later. As a result, rather than jumping to its new equilibrium in the short term, the gold price might drift there over two months – i.e. it will trend.

Crisis alpha?

Markets often trend most strongly during crisis periods like the second half of 2008 when many markets moved up or down at the same time. These strong trends, usually accompanied by a steep sell-off in equities, are generally good news for trend followers and are sometimes described as providing 'crisis alpha' to investors. This means that they can play an important role for investors, acting as a good diversifier for multi asset solutions. This is particularly relevant where there are meaningful allocations to equities. In fact, trend followers can at times be better at diversifying equity risk than government bonds.

Coutts has carried out detailed research of the sector, along with due diligence on individual managers. We have identified a number of trend-followers that we believe will do well during difficult markets and are likely to outperform super-expensive government bonds over a two to three year period (see previous article).

Episode 4

A Very Private Affair

At Coutts, we believe being patient, long-term investors and being sensibly diversified are some of the best ways to help cushion portfolios through the short term ups and downs of a rapidly changing world. And for those able to lock in capital for a long period, investing in a private company can be a rewarding experience – financially and personally.

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Private company investments may be illiquid and there may be no recognised market for them and it may therefore be difficult for you to deal in them or obtain reliable information about their value or the extent of the risks to which they are exposed. The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment.

With government bond yields and cash returns hovering near zero, and structural changes in the economy likely to keep them below historical norms (see our **14 December Outlook article on demographics**), private company investing has become an increasingly popular alternative and could be a valuable component of investment portfolios.

Private equity firms tend to focus on institutional capital, charge management and performance fees and retain sole discretion to invest in private companies as they see fit. This makes it harder for individuals to participate, especially if they are looking for hands-on involvement. But there are other ways for individuals to make a direct investment into an unlisted company and diversify their portfolios away from cash and the public markets.

Angels Are Welcome

The emergence of crowdfunding and the growth of investor clubs are helping bring companies and individual investors together. Small businesses are receptive to private capital from high-net-worth individuals, and not just because they want patient investors who can provide financial support on flexible terms. Many are also looking for the valuable advice and important contacts that these 'angel investors' can provide as mentors or non-executive directors.

Investing in a company at an early stage can be very attractive but investors must be comfortable with the risks involved. Notably, private investments are illiquid - investors cannot easily sell or value their holdings - and the timing for exiting is often over a decade. This can be a problem if the investor needs cash.

The direct route can also be tax-efficient through a number of government-backed structures, including the Enterprise Investment Scheme (EIS) which offers entrepreneurs and individual investors attractive and valuable tax relief from certain qualifying, unlisted companies.

Get Closer To Your Investment

Small and medium-sized companies (SMEs) power the UK economy. Yet eight years on from the financial crisis, many are still finding it difficult to raise sufficient capital for growth from banks, particularly where the funding needed carries more equity-like risk. Private investors are helping bridge this gap by backing enterprises that are vital for the country's economic future and, in doing so, creating jobs in an increasingly competitive global economy.

There are many considerations involved in making a private investment, and one of the most important is the quality and experience of the people managing the business. Do they have their own wealth invested so that there's an alignment of interests to maintain focus and dedication?

It's essential for investors to conduct their own thorough due diligence and consider any existing information that's available. A key difference from investing in public markets is the ability of investors to ask very detailed questions directly to management teams, with the expectation of receiving an equally detailed response.

What Prospective 'Angels' Should Consider:

- *Can you justify the valuation? Are you being asked to pay "tomorrow's price" today?*
- *Beware of aggressive business plans as projections almost always differ from future reality*
- *Be prepared to make follow-on investments, or have your shareholding diluted*
- *Some may take comfort in knowing there are other investors. Is there already a lead investor? What are their terms? Have they done due diligence?*

The value of investments can go down as well as up, and you may not recover the amount of your original investment.

Join An Investment Club

To help some of our more financially experienced investors find private company investment opportunities, the Coutts Investment Club connects clients with highly selective, potential high growth opportunities. The Club leverages Coutts' unique strengths to source proprietary deal flow. Our brand and reputation means companies approach us everyday seeking advice about high-net-worth investors.

We believe the most interesting opportunities are coming from our own highly successful clients. Whether they are entrepreneurs or super-angels, they are looking to bring in like-minded shareholders. Coutts also receives numerous referrals from NatWest (also part of the RBS Group), which has a leading market share in providing banking services to SMEs in the UK.

As an introduction-only, non-advised service, our club members select the companies in which they want to invest and decide on their level of involvement. These businesses typically require capital to make strategic acquisitions, scale their operations or attract and secure the best talent. Deals are typically between £2-10mn, EIS-qualifying and require individual investment 'tickets' of £250,000 and above.

Coutts' Strategic Solutions team sources and reviews opportunities before they are introduced to clients. These involve companies across a range of sectors that includes some of the most innovative and fastest-growing areas of the economy.

"We consider a broad range of factors when looking to find opportunities to introduce to our clients," says Hans Prottey, who leads Strategic Solutions. "But one aspect is fundamental in every situation – the calibre of the management team. Angel investors back people and they need to have complete confidence and trust in management to make the right decisions and to lead the business through both good and bad times."

With opportunities to become actively involved in small fast growing businesses and perform your own detailed hands on analysis, a private company investment is an exciting way to diversify and potentially enhance investment returns - as well as helping the next generation of entrepreneurs.

Private company investments are illiquid - investors cannot easily sell or value their holdings - and the timing for exiting is often over a decade. This can be a problem if the investor needs cash. As with any investment, past performance should not be taken as a guide to future performance, the value of investments can go down as well as up, and you may not recover the amount of your original investment.

Episode 5

Responsible Investing For Sustainable Returns

Evidence is mounting that investing responsibly could improve long-term returns

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Companies that minimise their environmental impact, respect their workers and customers, and are managed in transparent ways can deliver improved financial returns for investors who factor in these principles. So says a growing body of research into what drives sustainable profits and, therefore, investment returns over the long term.

Traditional measures of a company's performance, such as earnings per share and return on capital, tend to get a lot of focus around the quarterly reporting cycle. Responsible investing offers a longer-term perspective – transcending short-term gyrations in the markets – through three factors that affect financial performance and make up the abbreviation ESG:

- Environmental. Reducing damage to the environment that could limit a company's ability to operate in the future, such as approaches to forestry or fishing. Does a company incorporate broader issues including climate change, which could have far-reaching consequences for all businesses and markets?
- Social. Ensuring fair and sustainable relationships with workers, customers and the communities in which a company operates. Does it pay sufficient attention to issues in its supply chain – such as child labour, adequate working conditions, and health and safety – that may attract negative publicity or regulatory intervention?
- Governance. Implementing transparent and prudent management policies that are always in the interests of shareholders. Are there clear lines of accountability with regards to executive remuneration, bribery controls and shareholder rights? Is there an adequate separation between the chairman and chief executive? Is the workforce suitably diverse, particularly at senior levels?

Why Invest Responsibly?

Investing responsibly is becoming increasingly popular because the link between responsible investing and long-term financial performance has been established and validated through numerous academic studies. As a result, fund managers are beginning to use responsible investment screens as standard practice — and investors are starting to expect them to offer this option.

Institutional investors are increasingly favouring companies that sign up to voluntary ESG benchmarks. They include guidelines set out by the Principles of Responsible Investment, the leading independent organisation supported by the United Nations, and the UK Stewardship Code, which promotes high corporate governance standards.

As part of our ongoing efforts to seek out fresh ideas and innovative strategies as well as meet the changing needs of private clients, Coutts is exploring ways of incorporating ESG principles into our investment process. These principals are also well aligned with our focus on preserving and growing wealth over multiple generations.

> *80% of the studies show that stock price performance of companies is positively influenced by good sustainability practices.* [4]

Implementing Responsible Insights

Insights from responsible investing can be used to inform our portfolio management decisions in several ways.

For funds we select, this could include considering how the managers use ESG factors in their own security selection process. For individual securities, we might assess the ways a company deals with these elements themselves.

Growing evidence suggests companies who score high on responsible investing measures also perform well financially over the long term – we believe embedding responsible investing principles is likely to enhance long-term returns for investors too.

[4] "From the Stockholder to the Stakeholder: How Sustainability Can Drive Outperformance", University of Oxford and Arebesque Asset Management Ltd,

Episode 6

The Art & Science Of Fund Selection

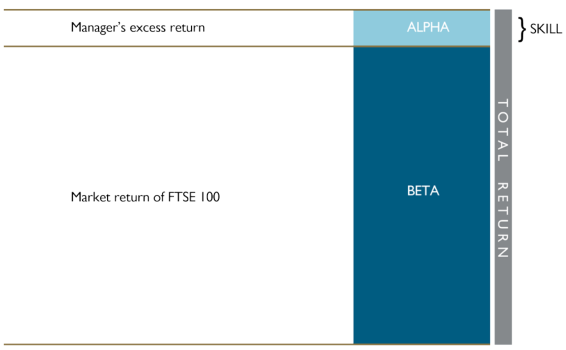
Identifying fund-manager skill is a blend of art and science

Throughout our Investment Outlook 2017 series we have identified a range of investment opportunities as well as dangers for the coming year. At Coutts we also believe how our views are implemented in our investment solutions is becoming more import than ever before. In our final article of the series we will be looking at why investing requires the analysis of numerous factors – some within our control, but also some that are not –particularly given some of the big shifts in the geopolitical landscape that we've been considering.

To navigate often complex markets, we believe it is important to be able to employ the experience of skilled fund managers. Skilled managers do exist, and we focus our own skills, experience and efforts on uncovering those who we believe can deliver on their objectives for our clients over the long term. There is no correct or incorrect approach to active fund management, it's more a case of matching the right approaches with the right skills.

Before we set out to find these managers, it is important to understand what makes up the returns of a fund. At the most basic level, fund returns can be divided into the market return, or 'beta', and a return in excess of the market, or 'alpha'. Alpha, which may also be negative, can be regarded as a measure of skill. When we assess a manager's skill we are analysing their ability to deliver positive alpha over the long term.

ALPHA = SKILL



We are very mindful that longer-term outperformance (or alpha) will almost always come at the expense of short-term periods of underperformance and we cast our eye over the full market cycle when judging managers.

Typically, a greater degree of long-term outperformance brings with it a greater possibility of short-term underperformance. It's often the case that past performance is not a reflection of future performance potential, and we have regularly seen top-ranked managers falling down the performance rankings, and vice versa. What we seek to understand is whether the manager's alpha-generating ability is repeatable.

This can be boiled down to identifying and understanding a fund manager's particular 'edge', and why this is likely to add value over the long-term. Equally important is to understand a manager's area of competence, so we can determine whether they are straying from their core competency. We must truly understand what we are buying, and how it complements other portfolio holdings. Diversification across fund managers that have different 'edges' can help produce better and more stable long-term returns as well as reducing overall risk.

For example, we recently invested in a manager who experienced short-term negative performance in an environment that wasn't rewarding his particular edge, playing to one of our core investment principles – going against the crowd. We maintained our confidence in his ability to deliver alpha over the long-term and saw this as a good opportunity to buy the fund at a reduced price. Subsequently, the fund has begun to produce positive returns from a market environment that has become more conducive to his particular approach and skills.

We employ both quantitative, or statistical, analysis and qualitative research of the fund management team and the business they work for. For example, a continuity of key people and investment process is crucial for replicating past successes. It is also paramount to ensure we have access to the fund manager and the investment team to allow us to make a true assessment of their character and personality, which can be key qualitative components in fund due diligence.

We prefer to select fund managers who own the businesses they work for, or at least are significantly invested in the funds that they manage. This ensures long-term alignment of interest between manager and investor. Those managers that own their own businesses have essentially 'self-selected', based on their belief in the ability of the team and process to generate good long-term results.

A good example of this is a fund we invested in recently with a demonstrated ability to generate alpha over the very long term. The fund managers are rewarded on a four and eight-year cycle, tying their remuneration to long-term outperformance. We believe this ensures the interests of fund managers and their employees are very closely aligned with investor interests and timeframes.

All of the above factors are assessed and determined at the outset of selecting funds, but continual monitoring is just as important to ensure we maintain our conviction that a manager can preserve their ability to deliver long-term outperformance.

Finally, much the same as we view our own responsibility to our clients, we look for good stewards of capital. This leads us towards individuals and businesses that are going to 'take care' of the capital which has been invested with them. We seek those who recognise that they have been 'entrusted' with their investors' capital, not 'given' it, and understand their clients' needs.

The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment.

Past performance should not be taken as a guide to future performance.

In the case of some investments, they may be illiquid and there may be no recognised market for them and it may therefore be difficult for you to deal in them or obtain reliable information about their value or the extent of the risks to which they are exposed. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. Investments in emerging markets are subject to certain special risks, which include, for example, a certain degree of political instability, relatively unpredictable financial market trends and economic growth patterns, a financial market that is still in the development stage and a weak economy.

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