Insight INVESTMENT

MULTI-ASSET QUARTERLY

Insight Broad Opportunities Fund (GBP)

Q3 2019

SUMMARY

Our market narrative for much of the year has been 'policy hope vs. weak economic data', and, in some respects, that description still holds as we enter the final quarter of the year.

Continued evidence of weakness in global industrial production certainly has been met with efforts to provide more monetary accommodation. But, the root cause of a large part of the uncertainty – the breakdown in US-China trade relations – remains unresolved.

Indeed, to the extent that the tensions between the US and China are about much more than trade, no quick resolution of tensions between the two super-powers seems likely. But, some de-escalation of the trade front is arguably a requirement if what is now the longest economic expansion phase on record is going to endure.

Against that backdrop the portfolio returned +2.13% over the quarter. All main components of the portfolio contributed positively during the quarter, with allocations in total return strategies and fixed income leading the way.

Fund performance as at end September 2019

	3 month return %	1 year return %	3 year return % p.a.	5 year return % p.a.	Since inception % p.a.
Insight Broad Opportunities Fund	2.13	5.80	4.91	3.58	5.13
3-month GBP LIBID	0.16	0.70	0.47	0.46	0.51

Fund performance as per calendar year

	YTD %	2018 %	2017 %	2016 %	2015 %	2014 %
Insight Broad Opportunities Fund	10.35	-4.99	10.13	5.05	-1.19	6.40

Data sourced from Lipper. Returns are in GBP, gross of annual management charge and net of irrecoverable withholding tax, and are not grossed up for charges applied to underlying unitised holdings. Fund inception date: 30 September 2009.

Past performance is not a guide to future performance.

ECONOMIC AND MARKET REVIEW

Our market narrative for much of the year has been 'policy hope versus weak economic data' and, in some respects, that description still holds as we enter the final quarter of the year. Continued evidence of weakness in global industrial production certainly has been met with efforts to provide more monetary accommodation.

But, the root cause of a large part of the uncertainty – the breakdown in US-China trade relations – remains unresolved. To the extent that these tensions are about much more than trade, no quick resolution of tensions between the two super-powers seems likely. But, some de-escalation on the trade front is arguably a requirement if what is now the longest economic expansion phase on record (see Chart 1) is going to endure.

Risk assets have held up relatively well this year, helped by Government bond yields that have ratcheted lower as data has softened (see Chart 2 - US ISM versus the 10-year Treasury and central banks have shifted their policy stance to 'lower for longer' once again. Ultimately, however, the sustainability of the risk asset rally requires a stabilisation in the underlying economic data and an improvement in global growth prospects.

Readers will know our framework for assessing the investment implications of the economic environment in stylised form is as shown in the schematic in the following column.

In our recent publication, Asset allocation and growth cycles, we noted the importance of the structural decline in inflation in the story of longer business cycles. In brief, the lack of inflationary threat has allowed policy makers to use the tools at their disposal (monetary and fiscal) to set policy to sustain an economic expansion.

A stylised view of economic transmission mechanisms

Monetary/ financial conditions lead…

↓

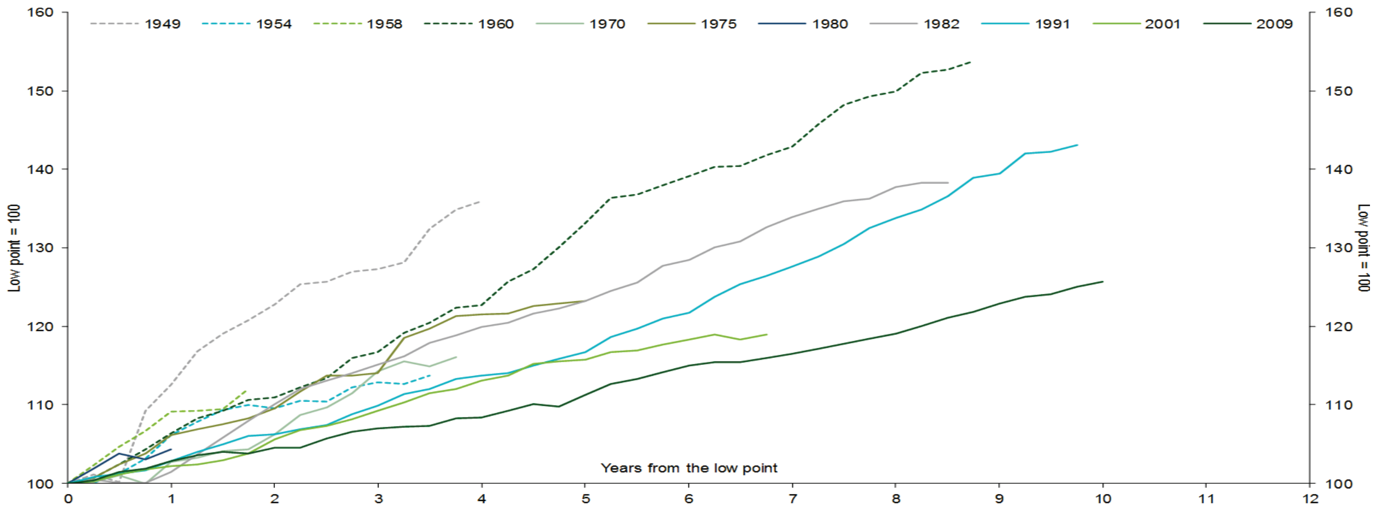
…economic growth, which in turn leads to…

↓

…inflationary pressures

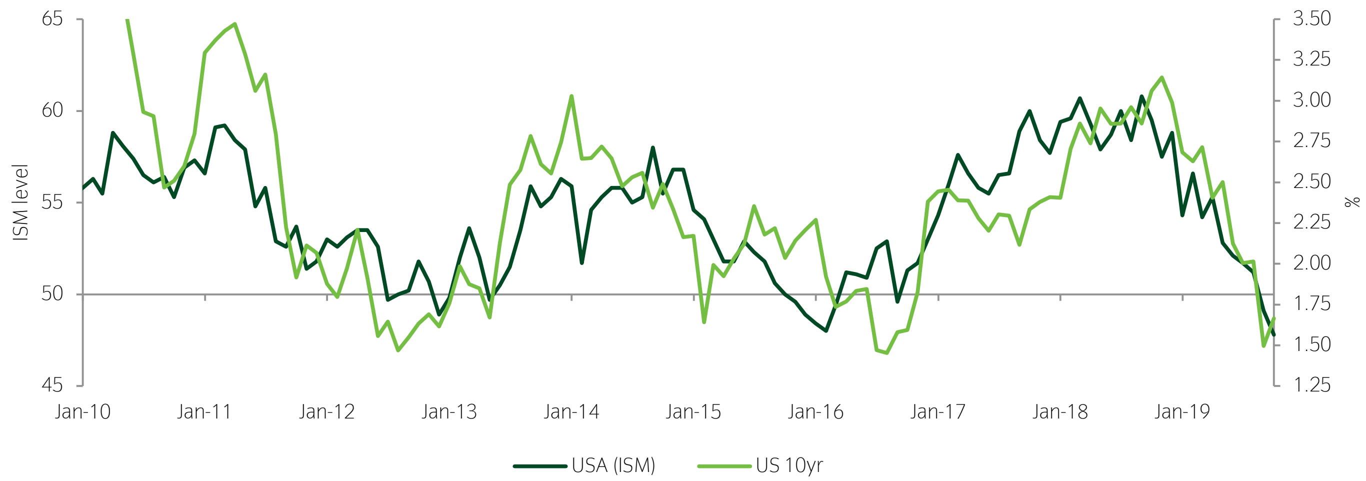
From a practical perspective, this has meant the dynamic between financial conditions and growth has been the key influence in guiding our asset allocation decisions. So, looking at the world through this lens what do we see? (continued page 5

Chart 1: US economic growth – the longest (and most subdued) expansion phase on record



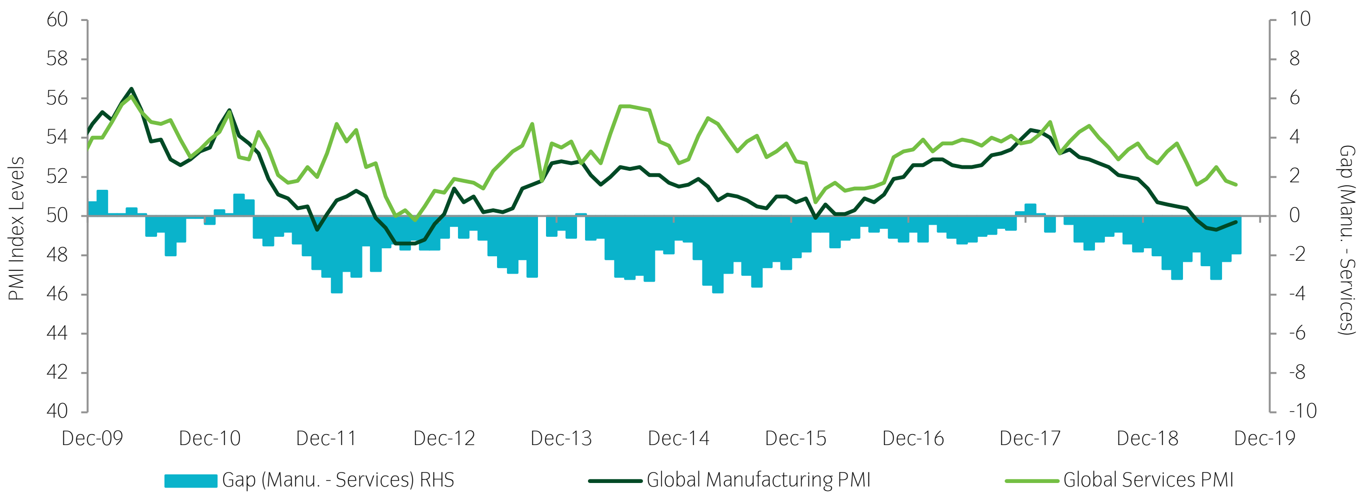
Source: Bloomberg and Insight Investment as at 18 October 2019.

Chart 2: US bond yields track the US ISM lower



Source: Bloomberg and Insight Investment as at 18 October 2019.

Chart 3: Global manufacturing and services activity – starting to converge?



Source: Bloomberg and Insight Investment as at 18 October 2019.

PORTFOLIO PERFORMANCE AND ACTIVITY

DRIVERS OF PORTFOLIO PERFORMANCE

Against a backdrop of continued economic fragility, notable in the weakness of global industrial production, and efforts by central banks to provide more monetary accommodation, the portfolio delivered +2.13% over the quarter.

All portfolio components delivered positive returns in July, led by fixed income and relative-value positions. Our preference for US over emerging equity markets and positions designed to benefit from a flattening in the German government bond yield curve made notable gains. Currency positions designed to benefit from an appreciation in the Japanese yen and sideways moves in the Brazilian real, Swiss franc and the South African rand contributed to returns. Infrastructure holdings within the real asset component were positive, with a notable recovery in social infrastructure exposures.

In the midst of the turbulence in August, the portfolio was resilient generating a positive return, led by fixed income, real-asset holdings and total return strategies including notable returns from positions designed for volatile but range-bound markets. Our equity exposures detracted from returns, led by weakness in the UK and emerging markets.

The recovery in sentiment in September helped our equity exposures deliver positive returns, while a de-escalation of trade tensions reversed some of August's yield moves in government bonds, detracting from returns. Total return strategies were a small positive in aggregate, with certain option positions recovering performance from August, particularly those aimed at capturing a move higher in certain equity and credit markets. Dividend futures were also positive as the deteriorating sentiment in Europe abated slightly. Within real assets, infrastructure holdings were a small detractor as a few holdings saw weak price performance as they announced incremental capital raises.

PORTFOLIO ACTIVITY

We were again active in managing portfolio cyclicality during the period. While ending the quarter with equity exposure broadly the same as at the start, managing this intra-period helped smooth returns, particularly during August, as bond yields rallied markedly and equity markets fell.

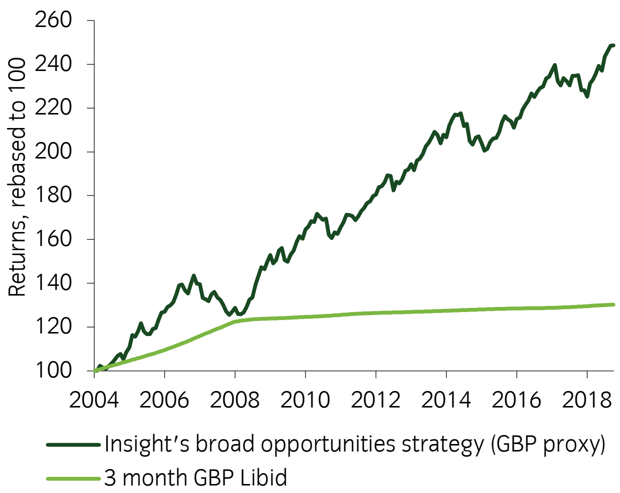
With some stabilisation in the rate of economic contraction and de-escalating trade tensions as we ended the quarter, we increased the cyclicality of the portfolio, mainly through raising equity and reducing government bond exposures.

For real asset exposures we retained the broad mix of positions in commodities and infrastructure.

We anticipate that a number of assets will remain volatile but range bound in the near term, and have added positions on a number of equity and credit markets, and currencies, to capture this.

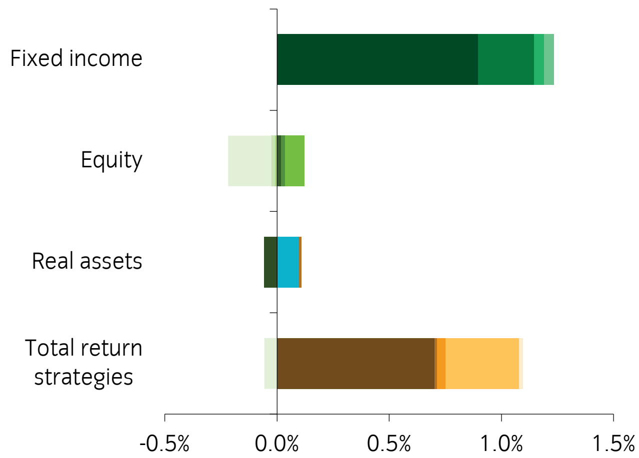
We also adjusted the composition of our duration exposure, replacing some futures with a more attractive option based position, and reducing the extent of curve flattening trades.

Chart 4: Insight broad opportunities performance (GBP)



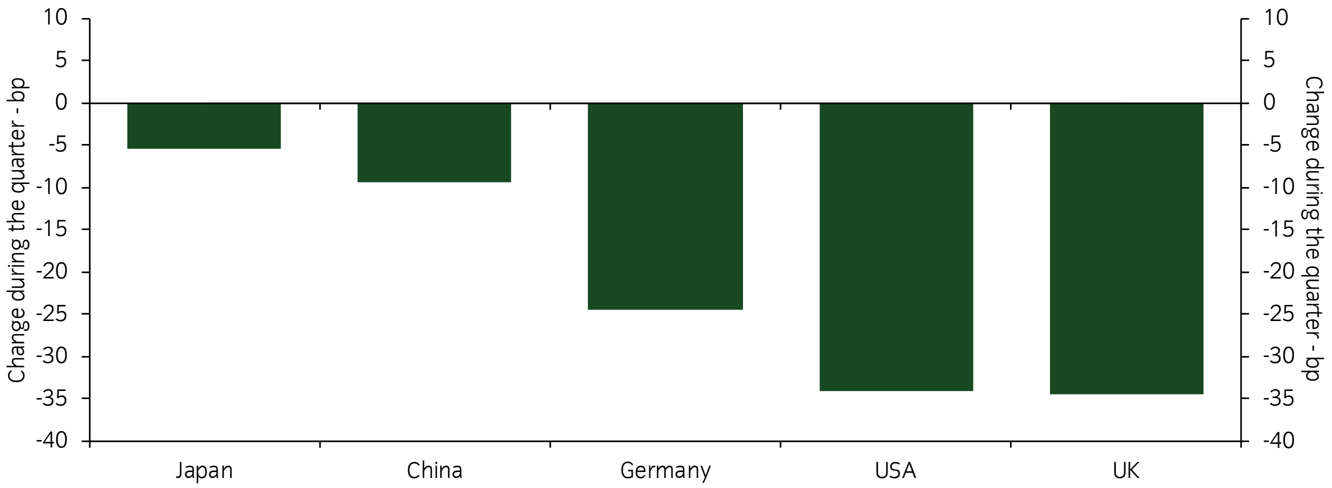
Source: Insight Investment. Data as at 30 September 2019, gross of fees. Performance rebased as at 31 December 2004, as a result of a change in investment team leadership. The long-term track record of the Insight broad opportunities strategy has a base currency of USD. This performance record has been adjusted by interest rate differentials to derive a GBP proxy. No currency adjustments have been made to the underlying investments.

Chart 5: Attribution over Q3 2019



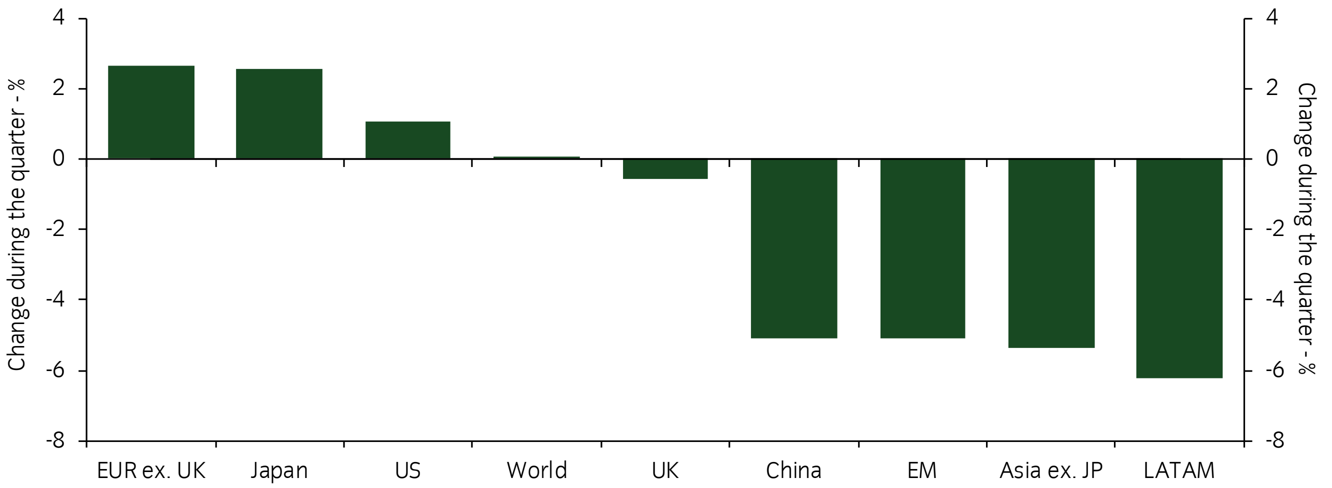
Source: Insight Investment. Gross of fees. Shaded areas are returns generated by different strategies and asset classes within each investment category.

Chart 6: Global 10-year bond yield change during Q3 2019



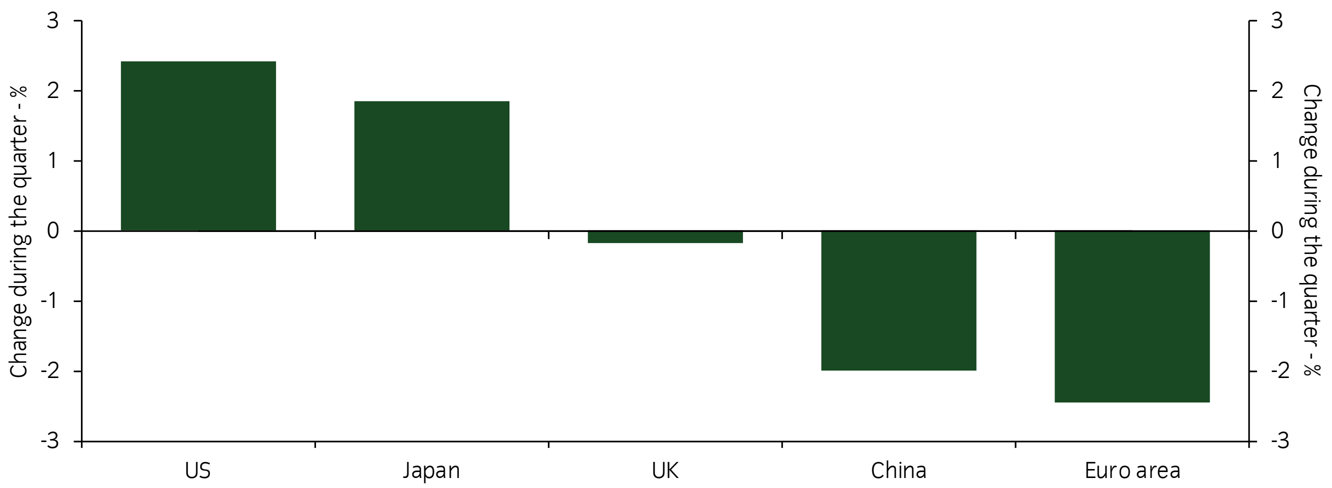
Source: Bloomberg and Insight Investment as at 18 October 2019.

Chart 7: Global change in equity markets during Q3 2019



Source: Bloomberg and Insight Investment as at 18 October 2019.

Chart 8: Global change in trade-weighted exchange rates during Q3 2019



Source: Bloomberg and Insight Investment as at 18 October 2019.

FINANCIAL CONDITIONS

In the third quarter, global financial conditions were driven by fluctuations in the market's assessment of the state of trade negotiations between the US and China, and by conditions in manufacturing around the world – particularly those in the US (to say nothing of the deepening Brexit crisis and the proposed impeachment of President Trump).

Most of the components of our US financial conditions index were initially adversely affected by poor news on the geopolitical front, but rate cuts from the Fed that were strongly linked to the deterioration in the global economy, became a powerful force pushing bond yields lower (see Chart 9, below) .

Indeed the initial rally in bonds was so sharp that it was ultimately seen to have gone too far, so that it partially unwound in the latter part of the quarter. This, and the impact of a stronger dollar, meant that US financial conditions ended the quarter a little less supportive than at the start.

Similar moves in the components of the financial conditions indices that we produce for the major economies/regions around the world meant that global financial conditions excluding China eased over the quarter. Indeed, looking at the year-to-date as a whole, the easing in conditions should have a stabilising influence on global growth trends.

But when? Changes in financial conditions affect activity with lags that are variable through time and between countries/regions. At the global level, our analysis suggests activity is affected by changes in financial conditions with a lag of around two quarters. Given that, growth over the next few months should first be affected by the sharp loosening in financial conditions that was seen through most of 2019 – see Chart 10, below.

GROWTH

But is that right? Regular readers will know we've been expecting the lagged impact of looser financial conditions in China to have a positive impact on global activity around the end of the year. Some are saying that might not happen because the relationship between Chinese financial conditions and economic activity appears to have broken down.

That's perfectly possible – the trade dispute between China and the US could clearly be an important offsetting factor. But, we still expect a positive effect to be felt by the time we move into 2020 – see Chart 11. More policy support will have to be given in order for any nascent recovery to continue, but there is already enough support in the system for stabilisation/improvement to happen soon. Indeed, the latest PMI outturns for some of the Asian economies, suggest this might have already started.

Another concern appears to be that service sector activity around the world might be dragged down by the decline in manufacturing – particularly after the surprisingly weak ISM outturn. We are currently doing some in-depth work on this issue, and will report back at a later date. In the meantime, we would say two things.

First, the Markit survey of US manufacturing has a stronger relationship with actual production growth than the ISM balance, and this is far less concerning. Second, the lesson of ISM history is that service sector activity is not usually significantly affected by what's going on in manufacturing – see Chart 13, in the middle of page 7.

Put all of this together, add in the fact that central banks around the world appear committed to further policy support (the ECB via more QE, the People's Bank of China via recent cuts in the Required Reserve Rate, and the Fed via a dot plot that shows the largest group of members expect to cut the target rate again by the end of the year), and it seems likely to us that growth should stabilise then recover over the next year or so.

INFLATION

On the inflation front, it would appear that the spike in input prices that occurred around the middle of 2018 has now worked its way through the price chain, so it should no longer have an impact on targeted inflation rates (Chinese pork prices are an obvious exception, but not at the core level).

Oil prices spiked up during Q3 2019 on the back of the attacks on Saudi Arabia's largest oil production facility, but that was extremely short lived and we expect oil prices to have a fairly benign effect on both headline and core inflation around the globe over the next few quarters (oil prices have second round effects on core prices).

China's decision to use its exchange rate to try to offset some of the impact of US tariffs on its products may have had partial success, but, it will also have increased import prices (meaning Chinese consumers have, 'paid' for tariffs as well as US consumers). That will have raised pressures at the start of the Chinese price chain, some of which probably still have to work through. Having said that, we don't expect any further significant inflation via this source over the next few quarters.

In many countries the sharp fall in the labour share of national income, along with tight labour markets/a shortage of skilled labour has seen wage growth rise over the last year.

Further increases are a risk, but in an era where the world is dealing with the impact of slower world demand and trade war uncertainties we'd be surprised if wage growth rises too much from here. Put another way, we continue to believe that flat Phillips Curves will help keep inflation fairly limited – see Chart 14.

Our latest views on inflation have been used to update our US margin scenario analysis. The margin profiles have changed a little, but the work still suggests there will be a medium-term contraction in margin growth.

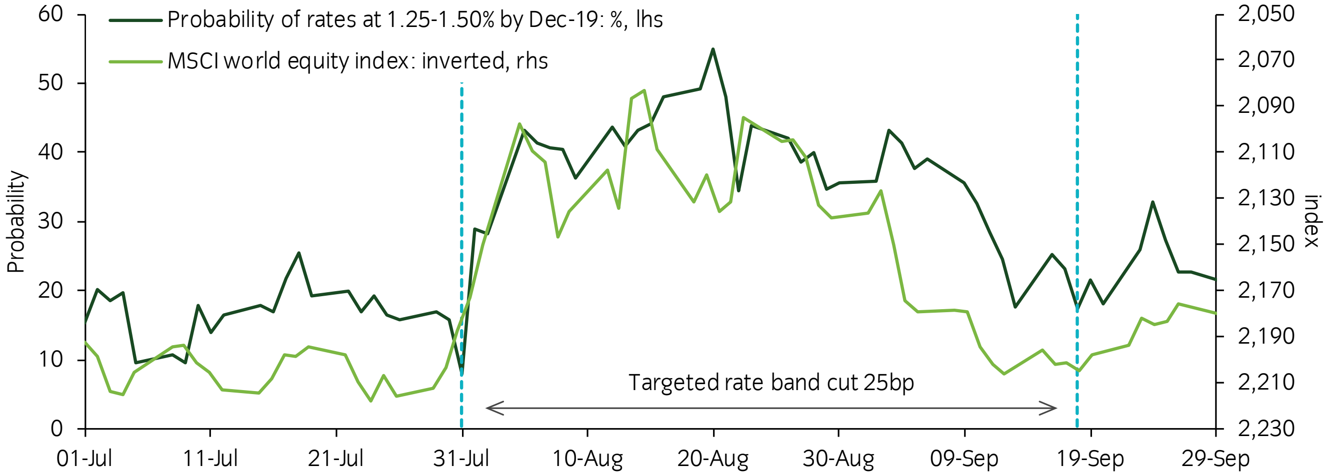
The analysis also continues to suggest the timing of this slowdown is far from imminent in all but the fairly extreme 'stagflation' scenario. We assessed a range of scenarios with various degrees of adjustment both to demand (shocked downward) and costs (shocked upward) to see where we would get a material squeeze on margins. .

The work is important in its own right – not least as we enter the latest earnings series. But, it's also important from a cycle point of view. In simple terms profit margins affect corporate confidence which, in turn, affects hiring and investment. Put another way, profit margins lead the economic cycle.

If our work is correct, and the stagflation scenario is avoided, US profit margin growth should drop back steadily through to the end of 2021. With capex growth already weakening – particularly for investment in equipment and structures – we'll have to keep a close eye on corporate activity in case this falls back to recession-prompting levels.

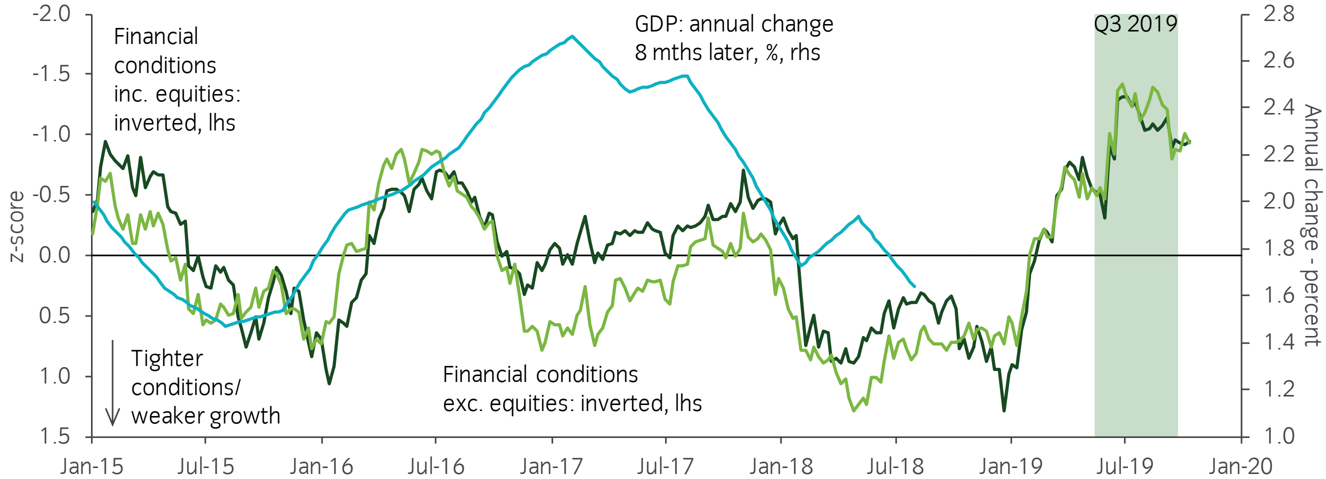
To be clear, this is not our central view – we expect investment and hiring to underpin fairly steady, if unspectacular, rates of growth – more a key area to monitor/a downside risk.

Chart 9: US rate probability versus global equities



Source: Bloomberg and Insight Investment as at 18 October 2019.

Chart 10: Insight global excluding China financial conditions and GDP

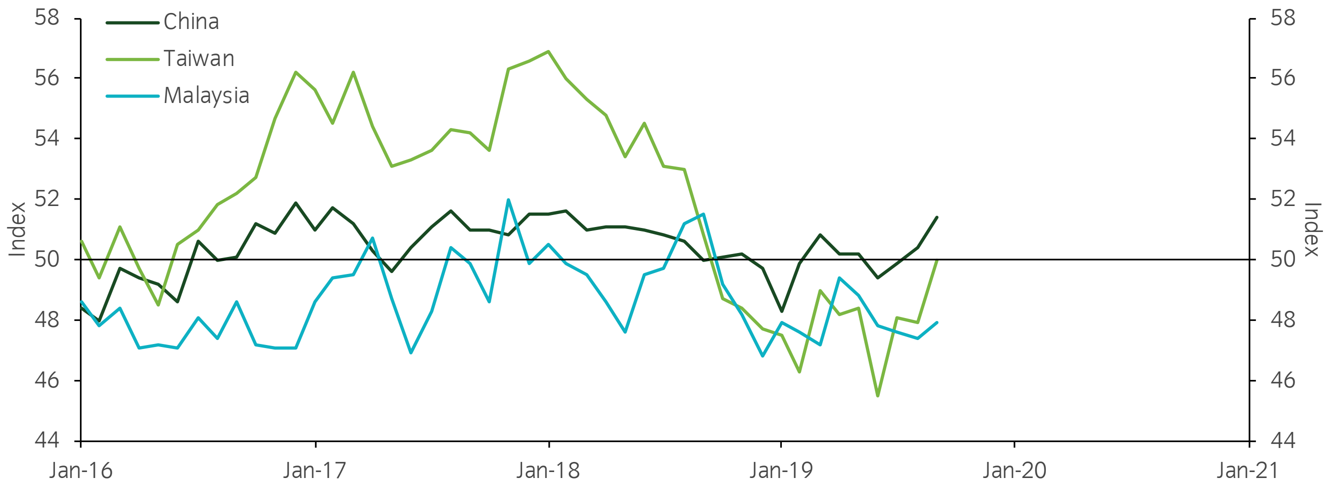


Source: Bloomberg and Insight Investment as at 18 October 2019.

Chart 11: Global manufacturing PMI versus Chinese financial conditions

Source: Bloomberg and Insight Investment as at 18 October 2019.

Chart 12: Asia purchasing managers' indices of manufacturing activity

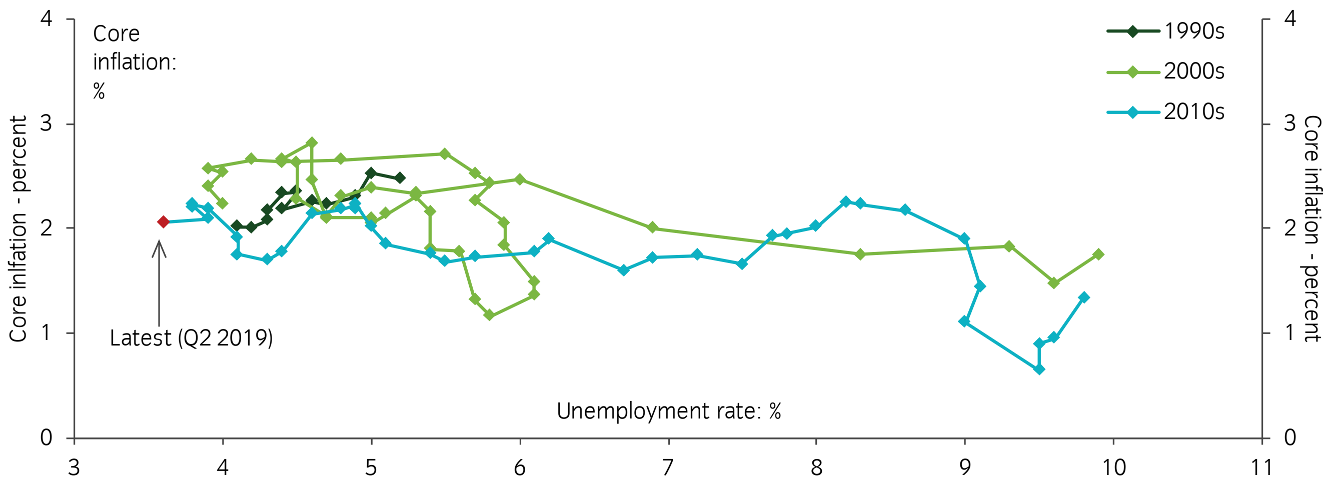


Source: Bloomberg and Insight Investment as at 18 October 2019.

Chart 13: US ISM measures of activity

Source: Bloomberg and Insight Investment as at 18 October 2019.

Chart 14: US: post-1997 Phillips curve



Source: Thomson Reuters and Insight Investment as at 18 October 2019.

GEOPOLITICS IN FOCUS

A few political flashpoints (such as the European parliamentary election) are in the rear view mirror but geopolitical uncertainty remains elevated, and, with the US using tariffs as their foreign policy tool of choice, the insecurity caused by the US-China trade frictions is one of the key reasons cited behind the slowdown in global manufacturing and world trade.

On the domestic front in the US, the implications of a split Congress going into the 2020 election already meant little hope of bipartisan policy action on areas such as infrastructure or drug prices, but, the move to impeach President Trump probably means further obstruction between the Republicans and Democrats. Congress will likely do the bare minimum to keep government funded and running at already-agreed-to levels. At the margin, areas where the Executive can act without interference (such as trade) look set to remain the focal point and policy here may become even more unpredictable.

Ultimately, a Republican controlled Senate is unlikely to remove President Trump from office, irrespective of the impeachment findings. Its impact on the election is unclear and probably small. The President is likely to highlight his action compared with his perception of congressional inaction, while, for those who already disapprove of him, the impeachment proceedings simply add more weight to that view.

Brexit uncertainty has already dealt a heavy toll on UK business confidence, and the country is stuck in a constitutional crisis of unprecedented proportions. The unanimous decision by the Supreme Court that the government cannot prorogue (suspend) parliament without good reason reinforces parliamentary authority over the Executive, and, as such, makes it harder for PM Johnson to force through a no-deal Brexit on 31 October.

That could change again, but, for now, with his government a long-way short of a majority, and parliament aiming to control the legislative agenda, a general election seems likely as soon as a Brexit extension is agreed. The UK political battleground remains centred on Brexit and, with public opinion deeply divided, the outturn is still uncertain.

MARKET OUTLOOK

We have adopted a more tactical approach to the management of our broad directional exposures this year. Ultimately, the broader trends in the macroeconomic data are likely to dictate market movements but, at turning points, asset allocation decisions can become more nuanced particularly when political events have the capability to have a material impact on a global economic environment which is close to a tipping point.

From a risk asset perspective, our broad equity exposure has risen to around the average level we have run in recent years. As discussed earlier, the gap between weak global manufacturing data and service activity is a key focal point. The extent of the divergence, both in terms of duration (months) and magnitude (for example distance from the neutral 50-point going back to our PMI analysis) will be a key consideration in driving our asset allocation preferences.

Service-heavy economies can live with a contracting manufacturing sector for some time, but if it remains under water for a long time, the whole economic ship is likely to list. Set against the obvious downside risks is our assessment of financial conditions which have eased considerably this year as rates have rallied. Also, some of our forward-looking indicators point to stabilisation, so it is equally plausible that these early green-shoots proliferate – which would imply a more constructive run into year-end, exogenous shocks notwithstanding.

The 3Q 2019 corporate earnings season will allow us to assess the ability of companies to absorb or pass on rising input costs (be they wages or tariff induced). This is a key longer-term concern to us. In the shorter term, the stock price reaction to corporate earnings releases often gives us an indication of market positioning i.e. whether the investor base is under-or over invested.

Last month we flagged the message from our favoured (de-trended) dividend yield gap framework which saw pro-equity triggers being hit from a pure valuation perspective. Historically, falling stock markets have been an important driver of such signals and at the time we interpreted them more as a warning of how extreme the recent moves in government bonds have been.

We have brought down portfolio duration but we retain an above-average allocation to government bonds. While yields might be low, we believe any further signs of moderating growth or uncertainty on the trade front will enable them to remain attractive diversifiers in a portfolio context. Rising inflation could clearly undermine this narrative, but we see that as a low probability outturn in the near term.

The extent of any retracement in yields should growth anxiety dissipate seems likely to be tempered by medium term central bank guidance and we expect the hunt for yield will lead investors towards the riskier end of fixed income. We maintain our above-average exposure in credit, and are likely to continue to do so while growth fears remain contained.

Within real assets, our preference remains infrastructure investments. Specifically, they offer attractive attributes (long-term predictable revenue streams, low levels of economic sensitivity and an element of inflation linkage) that are attractive in their own right and from a portfolio diversification standpoint

The level of exposure we are running in the total return strategies component of our portfolio is high. This incorporates trades spanning a variety of asset classes which we expect to have some embedded diversification. In relative-value positions, we have a range of currency positions (in favour of the Yen and the US dollar), a bias for government bond yield curve flattening and for developed-market equity relative to emerging markets.

In terms of option strategies, we have positions that offer a high degree of asymmetry, or wide buffers, to help protect against unexpected moves in their underlying markets. In aggregate, we believe they should help us deal with the current period of uncertainty.

We have a number of trades that will return a profit if markets remain within their recent trading ranges and also several trades that will perform well if markets move modestly higher. These strategies span equity, currency and bond markets and either offer a high degree of asymmetry in their pay-off profiles, or wide buffers to protect us should risk asset price weakness return.

THE INVESTMENT TEAM

Insight's broad opportunities strategy is managed by a team of 10 dedicated portfolio managers. They sit within Insight's investment division which comprises over 200 front-line investment professionals. The team is able to harness investment ideas from all the specialist investment units within the firm ensuring that the strategy benefits from a rich source of investment ideas. The team is specialised in asset allocation, macroeconomic analysis and portfolio construction and has developed a clear and transparent investment process that allows ideas to be channelled into a robust portfolio specifically designed to meet its objectives.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Funds which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Multi-asset

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

Property assets are inherently less liquid and more difficult to sell than other assets. The valuation of physical property is a matter of the valuer's judgement rather than fact.

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