

Investment Strategy Overview

Economic assessment

Since the end of the first quarter, reports on the global economy have painted a picture of slowing growth. In the US, the downturn in manufacturing in recent months, the slowdown in the pace of recovery in the labour market (although here, the latest US employment numbers were encouraging) and the effects of automatic government spending cuts present notable headwinds in the shorter term. Not surprisingly, consensus forecasts for US GDP growth in the second quarter have been revised lower and real GDP is now forecast to grow at an annualised pace of 1.7% during Q2. Also, previous estimates of US GDP growth in the first quarter have now been revised sharply lower.

The softening in global economic growth has also been evident in the major emerging markets. For instance, OECD composite leading indicators, designed to anticipate turning points in economic activity relative to trend, point to muted growth in Brazil and China, below trend growth in India and diminishing growth momentum in Russia. Economic reports from the Euro-zone have been mixed. In recent weeks, a number of surveys have indicated a nascent recovery across the region. However, strong regional variations persist.

The UK has bucked the trend in recent months with a series of better than expected economic data on a wide range of variables including retail sales, industrial production, business surveys, consumer confidence, inflation, housing market, car sales, and trade deficit. Looking ahead, composite leading indicators for the UK suggest ongoing positive growth momentum.

Financial markets & investment strategy

Despite the backdrop of slowing economic growth, since late May, financial markets have been preoccupied with concerns about an impending inflexion point in US monetary policy. Since then, investors' expectations that the US Federal Reserve Bank (Fed) would start to curtail its quantitative easing programme as early as September 2013 have resulted in substantial dislocations in financial markets (see the next article for details on financial market movements over the quarter).

Potential for policy errors pose risks to financial markets

As it prepares investors for the possible wind down of quantitative easing, the Fed has been at pains to stress that QE is data dependent and can be increased as well as decreased in line with the economic backdrop. Furthermore, Fed officials have insisted that tapering would not imply that the Fed has brought forward the timing of the first hike in the Fed funds rate. Not surprisingly, these comments have fallen on deaf ears. Investors are right to contend that any tapering carries information about how the Fed reads the data: it could imply greater confidence about the economic outlook or less confidence that the benefits of QE continue to outweigh the costs (or a combination of both).

There are plenty of reasons to be optimistic about the outlook for US economic growth over the next few years. These include the ongoing recovery in the housing market, the strengthening of the banking system, the easing in credit conditions and the

increasingly buoyant business investment climate.

However, evidence on the near term outlook is less conclusive. Indeed, incoming data and forward looking survey evidence suggest that growth momentum remains subdued. In essence, Fed tapering at this point could potentially coincide with a period of weakening growth. Such a move would represent a notable policy error. On the basis of the recent stream of weaker economic data and muted inflationary pressures, there is arguably insufficient case for tapering.

Implications for investment strategy

In our view, the elevated level of uncertainty about monetary policy undermines some of the bullish case for equities in the short term. However, equities remain the asset of choice for long term investors. Greater clarity on the future path of monetary policy will benefit equities. In this regard, recent comments by new Governor Mark Carney, designed to allay fears of a near term change in monetary policy stance by the Bank of England are much welcome.

In the fixed income markets, while the recent sell off in government bonds may have been overdone in light of the weak economic backdrop, the long term outlook for the asset class remains unattractive. Consequently, we continue to favour low duration strategies. Also, while the case for corporate bonds is no longer compelling, we still prefer that segment of the fixed income market to government bonds.

Abi Oladimeji
Head of Investment Strategy

TMI Asset Allocation Scorecard

	United States	Euro-Zone ex Germany	Germany	United Kingdom	Japan	Emerging Markets
Equities (overall)	0					
Equity allocation by region	0	0	0	0	0	0
Bonds (overall)	0					
Corporate bonds	+	+	+	+	0	0
High Yield bonds	0	0	0	0	0	0
Govt guaranteed bonds	0	0	0	0	0	0
Index-linked bonds	-	-	-	0	-	-
Alternatives (including ARFs*)	0					

The scorecard above represents our current tactical asset allocation position relative to portfolio benchmark. 0 =neutral, + =overweight, - =underweight.

* Absolute Return Funds

Market Overview

Most major global equity markets lost ground in the second quarter of the year, with the exception of the US, but some of the heaviest falls were focused on emerging markets and the BRIC nations (Brazil, Russia, India, China).

The catalyst was Federal Reserve Chairman Ben Bernanke's suggesting that the era of loose monetary policy may be over. It is suggested that the job of the Federal Reserve Chairman is 'to take the punch bowl away' if markets become over-exuberant, and his speech to the Congressional Joint Economic Committee in May looks like a classic instance of this.

The early part of the quarter began well, with most stock markets either flat or slightly higher in April after an exceptionally strong first quarter. Equity performance was underpinned by a very strong month for bonds, with all bond markets, both government and corporate, making new highs at the end of April.

However, bond yields began to rise in early May following a decent Non Farm Payroll figure in the United States. Stock markets initially seemed to pick up new and slightly surprising momentum, with the FTSE100 index reaching a 13 year high of over 6,840 on May 22 and the S&P500 index touching 1,669. US high yield bonds also gained in value, with the yield falling to an all time low of 5% by the middle of the month.

The surge of money into high yield bonds, compression in high yield spreads, the reappearance of 'covenant lite' loans for the first time since 2007, and the fact that stocks were making new all time highs, appears to have triggered a concern among the US authorities that markets were becoming over-ebullient.

When the Chairman of the Federal Reserve gave his testimony to Congress on May 22, he initially suggested that monetary policy was likely to remain loose into the foreseeable future. However, under subsequent questioning, Mr Bernanke suggested that the quantitative easing programme in the US could be curtailed 'within months'.

This was the excuse that many were looking for to take profits, and the sell-off in equity markets

over the next two weeks was rapid and violent, wiping 10% off gains that had been made up to mid May. Stock markets took a further dip on June 19, when Mr Bernanke again addressed the world at the Federal Reserve's press conference.

Between May 22, when markets peaked, and June 24, the FTSE100 fell 11.85% and the FTSE All Share and EuroStoxx 50 by a similar margin. The drop in the S&P 500 was more muted at 5.75%. Over the quarter the picture was better, with performances of -2.7%, -0.8% and +2.8% for the UK, Europe and the US. The S&P 500 remains up +12.6% for the first half, and the FTSE All Share +6.3%. European markets have fallen 1.2% year to date, with Spain and Italy down 5% and 6% respectively. The Dax was the only major European market to rally in the quarter, up 1.4%.

Japan was particularly hard hit following a spectacular surge in April after the Bank of Japan announced its own turbo-charged version of quantitative easing. The Topix fell 15% in a week, but is nevertheless up 33% over six months and 14% over three months.

In the UK, medium and smaller companies have performed better than large ones, and the FTSE 250 and the FTSE Small Cap indices are both up 11.5% in the first half; the FTSE 250 was down a marginal 0.3% in Q2. Sectoral performance was again diverse: leisure goods rallied 18%, while property stocks, general retailers, fixed line telecom and transport rose by 8-10%. In contrast, oil equipment fell 11%, technology hardware 13%, mining 18% and industrial metals 47%. Traditional defensive areas, food retailing and beverages sectors, disappointed, both falling 9%.

In the US, the utility sector – which tends to underperform when bond yields rise – was the worst performing, dropping 0.3%. 'Bond proxy' stocks – or high yielding, blue chip stocks where the dividend is perceived to have 'bond-

like' qualities – also came under pressure.

Emerging markets were the worst hit, and Asian markets have dropped 9% in the year to date. Chinese equities are down 12% this year, and have been badly hit by what looked on face value like a 'freezing up' of the interbank market in China. Korea and Mexico have lost 7% year to date, while Brazil's Bovespa has fallen 22% following a 15% drop in Q2.

This sell-off was different to most of those experienced over the past five years, in that bonds were hard hit as well as equities. Mr Bernanke's comments provoked an expectation of monetary tightening as well as an increase in risk aversion. In past sell-offs bonds have rallied, which has provided an off-setting hedge for portfolios to the equity falls. However, on this occasion there were few hiding places other than cash, although it is worth pointing out that commercial property proved its credentials as a low correlated asset and has held onto recent gains.

UK Bonds experienced their worst quarterly performance since 2009, the FTSE All Stocks Gilts index dropping 3.76% while US Treasuries fell 2.33%. Short dated gilts fared better, losing just 0.9%. Index linked bonds were particularly hard hit, with the FTSE All Index Linked Gilt index falling 6.51% and the 5-15 year index 8%. Gilts have been the worst performing bond market in recent months, as some of the 'safe haven' status has been lost. Eurozone government bond markets performed better.

Possibly the worst performing asset class was gold and other precious metals. Gold fell 24% over the quarter, its worst quarterly performance since 1968. Overall, this was a very challenging quarter for investors.

James Penn
Senior Portfolio Manager

Historic Market Rates

As at 30th June 2013

	Close	3 month % Change	6 month % Change	1 year % Change	3 years % Change
FX					
GBP/USD	1.5213	0.16%	-6.34%	-3.15%	1.67%
EUR/GBP	0.8552	1.32%	5.26%	6.05%	4.40%
EUR/USD	1.3010	1.47%	-1.42%	2.71%	6.14%
USD/JPY	99.1400	5.39%	14.45%	24.25%	11.92%
USD/CNY	6.1375	-1.24%	-1.49%	-3.41%	-9.50%
BOND YIELDS					
US 10 YR	2.486	0.637	0.728	0.841	-0.445
UK 10 YR	2.443	0.675	0.615	0.709	-0.912
GERMANY 10 YR	1.728	0.439	0.412	0.145	-0.849
JAPAN 10 YR	0.853	0.340	0.062	0.016	-0.238
SWISS 10 YR	1.027	0.311	0.501	0.362	-0.455
EQUITIES					
S&P 500	1,606	2.36%	12.63%	17.92%	55.84%
DOW JONES	14,910	2.27%	13.78%	15.76%	52.54%
NASDAQ	3,403	4.15%	12.71%	15.95%	61.35%
FTSE 100	6,215	-3.06%	5.39%	11.57%	26.41%
FTSE ALL-SHARE	3,290	-2.69%	6.35%	13.77%	29.34%
DAX	7,959	2.10%	4.56%	24.05%	33.42%
NIKKEI	13,677	10.87%	31.57%	51.86%	45.77%
HANG SENG	20,803	-6.71%	-8.18%	7.00%	3.35%
COMMODITIES					
GOLD	1,234.57	-22.69%	-26.31%	-22.71%	-0.62%
CRUDE OIL - WTI	96.56	-0.69%	5.16%	13.65%	27.67%
S&P GS SOFT CMD	672.97	-5.33%	-9.03%	-8.16%	33.64%
S&P GS IND METALS	1,313.47	-9.86%	-16.27%	-12.03%	-10.24%

Dividend Income Is A Key Determinant Of Long Term Equity Returns

Equities have enjoyed a solid recovery from the dark days of 2008 and 2009. Indeed, from the low point reached on 3rd March 2009 the UK's FTSE All Share Index has risen 91.4% in capital terms and 123.8% including reinvested dividends. This sits against a 25.1% rise in the index for UK Treasury stocks (or gilts)¹.

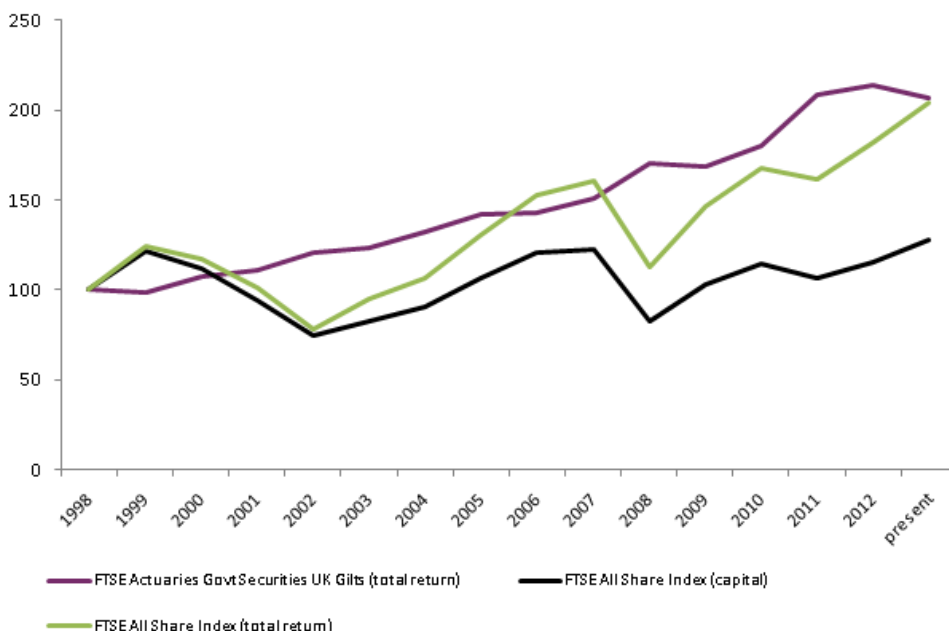
In a slightly longer context however, the equity story has been less compelling. Since the end of 1998, equities have delivered a meagre 1% annual capital return (not adjusted for inflation). Some would then go on to tell you that gilts delivered 5.6% annually during this same period, but this is not a fair comparison. Add reinvested dividend income to the story and equities recover some ground. From 1998 to 2012 equities grew 4.4% annually, and this during a period which saw two major market setbacks (2001-02 and 2008-09). While the time horizon is somewhat arbitrary, the conclusion is not. Dividends are an important, but often overlooked, component of equity returns.

Extend the time horizon to the post World War Two period and the outcomes widen. According to the Barclays Equity Gilt Study, by 2012, £100 invested in 1945 would be worth £190 in real terms if invested in cash deposits, £207 if you had been in gilts but £4,027 in equities² (had you not reinvested income, your £100 would be worth £2 in real terms if invested in gilts and £227 in equities). Over history, profit appears to accrue to the creators of value, not the lenders of capital.

Should a long term investor then look at anything but equities in a world where inflation is a constant uncertainty? Well, yes. The chart to the right illustrates why fixed interest assets such as gilts do have a place in portfolios – they help reduce risk and also deliver a level of certainty about income which equities cannot match.

As you can see, since 1998, the range of annual outcomes has been widely different between these two asset classes. Annual returns for UK gilts varied from -1.2% to +15.6%, but the capital value of a UK equity portfolio fell nearly 33% in 2008, rallying 25% in 2009 (two admittedly extreme years in the market), and posting strong gains in years such as 2012.

Chart 1: UK equity and gilt returns from 1998



Source: Bloomberg

Looking simply at the start and end points in 1998 and 2012, returns from investing in UK equities or in UK gilts (and reinvesting income) have been broadly equivalent. However while you may have arrived at the same place, the journey was markedly different. A fair amount of volatility for equities, a gentler progression for gilts.

So, gilts have offered reduced volatility and provided greater certainty on income. However, with the UK equity market currently yielding 3.6%³, and with UK Treasury 10 year gilts delivering returns to maturity of 2.5% (these returns having been as low as 1.4%), the reduction in risk from gilts comes at the price of reduced potential portfolio returns going forward.

Yields can change in two ways – either the asset price changes or the dividend/coupon amount changes. With a fixed interest security, by definition only the asset price can change, so rising market interest rates drive falling bond prices. With equity, while the asset price is more volatile, payments can, and do, change too.

Our long term expectations are for interest rates to normalise (i.e. rise) from current low levels, implying an eventual fall in capital value in gilts. Simultaneously though, as we see the global economy growing, company

earnings and the cash available to pay dividends will grow commensurately. The market may assign different values to the companies delivering that dividend income, but we are confident that the underlying level will grow over time.

Ultimately, even if you are not targeting specific levels of income from your portfolio, dividends are an important factor in determining long term returns to equities. In a taxed world, some of the multiplying effect is diminished – which serves to emphasise the benefits of available tax free savings plans.

For us as managers, ignoring one of the key pillars of equity performance is not an option. Hence a dividend's level, sustainability and potential growth are among the metrics upon which we base our stock analysis and decisions. Additionally, in constructing portfolios, we also believe that a diligent portfolio manager must consider those risk mitigating features of fixed interest assets that make them important components of many diversified portfolios.

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¹ UK government debt, represented in this analysis by the FTSE Actuaries Government Securities UK Gilt Total Return Index

² Source Barclays Equity Gilt Study 2012 – figures to year end 2011.

³ Bloomberg

Offshore Asset Management For UK Resident Non-Domiciles



The internationalisation of the UK's economy has brought with it a dilemma for the UK Government. How should it tax those individuals who live and work in the UK, but are not UK domiciled? Balancing the desire to encourage high net worth individuals to bring wealth and create jobs in the UK with the desire to raise taxation revenues is not an easy task. However, for many reasons the UK is attractive to foreign high net worth individuals and there are some very simple ways for them to effectively structure their assets offshore.

Thomas Miller Investment is neither regulated nor authorised to offer specific tax advice, however, we are cognisant of the taxation environment in which we conduct business. Over recent years, in the acknowledgment that its taxation treatment of non-domiciles has always been somewhat complicated, the UK Government has tried to significantly simplify its arrangements. Whilst keen to ensure that non-domiciles make a 'fair' tax contribution, encouraging them to invest their wealth into the UK economy and help job creation is also an objective.

At present, non-domiciles who live and work in the UK are liable to UK tax on all income

and capital gains which arise in the UK but only liable to UK tax on 'overseas' income and capital gains if they are remitted into the UK. The present Government's package of reforms were announced in the 2011 Budget with the promise that, to provide stability for non-domiciles, there will be no further substantive changes to their taxation for the remainder of this Parliament. The following measures were adopted:

- Increasing the previous £30,000 annual charge to £50,000 for non-domiciles who claim the remittance basis in a tax year and who have been UK resident in 12 or more of the 14 years prior to the year of claim.
- Allowance for non-domiciles to bring overseas income and capital gains to the UK, tax-free, for the purpose of commercial investment in UK businesses.
- Simplification of many aspects of the rules.

Ideally, effective planning of tax affairs begins long before the taxpayer becomes resident and ordinarily resident in the UK, but even if planning is commenced after arrival there are a significant number of tax benefits still available for UK resident non-domiciles. We work closely with a number of specialist providers in the Isle of Man and Channel Islands who offer advice in this area with regard to the creation and administration of offshore structures and holding of UK assets and investments.

Looking at the investment management part of this offshore service, it is oft-quoted that the tax tail shouldn't be allowed to wag the investment dog. Indeed, there is little gain in delivering to the client a small tax bill coupled with heavy investment losses. However, as the investment manager we would be

negligent if we didn't take into account each client's individual taxation situation and we have positioned the offshore part of our business to be able to operate effectively in this environment. Benefits here include our offshore office location, asset custodian and reporting package, effective segregation of clients' capital and income, and lack of remittance of offshore clients' assets into or through the UK.

Looking at the portfolio management process, the situs of assets held is a critical issue and offshore domiciled active and passive collective funds are the usual instruments of choice for our UK resident non-domiciled clients. For those clients for whom situs of investments is less of a concern, our investment palette can then also include direct equity, bond and investment trust assets. Effectively catering for the client's investment goals is each manager's objective, but managing the portfolio in a tax efficient manner either as a bare account or when held within an offshore structure forms a vital part of that.

In an increasingly global world in which the UK offers many opportunities for wealth creation within its stable economy, it is difficult to see the inflow of UK resident non-domiciled individuals slowing in the near term. Indeed with Sterling's trend of devaluation, real assets such as property and listed equities are steadily becoming more attractive to those who have the freedom to move to the UK. Offshore asset structuring and management, whether for taxation or estate planning reasons, will remain an attractive option for those who take appropriate advice.

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