ISSUE 44

CITYWIRE

INVESTMENT TRUST INSIDER

OPENING THE DOOR TO INVESTMENT TRUSTS

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This year's success stories revealed

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GLOBAL PROSPECTS
What lies ahead for stock markets

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Why Technology Will Transform Healthcare

Douglas Brodie, manager of Edinburgh Worldwide Investment Trust, looks at some of the newest remedies, including how something as simple as paint could dramatically reduce disease.

The US spends $3.5 trillion a year on healthcare, yet it lags behind many developed countries in terms of life expectancy and child mortality. In the UK, our healthcare system is grappling with its own challenges. Healthcare professionals do an admirable job, but are hampered by overly-centralised systems and pharmaceutical companies, chasing scale with huge sales forces and an obsession with 'blockbuster' drugs. The prevailing thought has been that cheaper healthcare equals inferior. But technology is set to change this and will help to ensure that the cost per person, per treatment, falls.

Over the last few years we have noticed a dramatic increase in companies which use innovative technology to prevent, diagnose and treat diseases. Breakthroughs often come from unusual sources. Kansai Paint has launched an odourless paint containing insecticides that repel more than 80 per cent of mosquitoes, which could save billions of pounds in healthcare costs.

Technology also offers the prospect of much greater automation. This could be a more cost effective approach – particularly in clinics, GPs and pharmacies, where around 90 per cent of patients interact

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with healthcare professionals. Teladoc is a leader in telemedicine which uses remote healthcare services through mobile devices and online video-based consultations. While not appropriate for all GP consultations, it is estimated that between 30 and 50 per cent of visits could be dealt with accordingly. The technology is fairly crude but think of the future when it can extract pulse and blood oxygenation levels, and patients will be able to upload data for doctors to assess.

Another frontier is transforming medical testing and monitoring, which includes predictive testing and diagnostics, where it is estimated that less than 5 per cent of healthcare research and development is targeted towards. Again, this is symptomatic of the sometimes skewed incentives in the industry, favouring blockbuster drug development. However, there are some very interesting developments as technologies converge. Sensors are becoming cheaper, connectivity ubiquitous and, as we better map the cellular and molecular pathways of disease, we can better assess what to monitor, how to monitor it and how this relates to disease. These technologies can be incredibly empowering for patients and prompt better lifestyle choices. They are also easy to roll out to a large market.

In essence, we are moving to a more real-time, joined-up, intelligent and hopefully more decentralised healthcare system. Dexcom makes a sensor that attaches to your skin and monitors blood-glucose levels in real time, sending the information to your mobile. Insulin-taking diabetics dosing directly off this information have improved compliance, are hospitalised less and hopefully have much better long-term outcomes. Currently, it is mainly used for type 1 diabetes but the much larger opportunity is for type 2 diabetes.

Despite the challenges, I believe we are on the cusp of a golden era in innovation. Over the coming years we anticipate that more companies will use technology to unlock novel ways to prevent, diagnose and treat disease. If we are right, the

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implications are profound. The lives of billions of people from every continent will be improved and the economic benefits will run into the trillions of pounds.

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WINNERS: TODAY AND TOMORROW

While 2016 was a year of upheaval, from the EU referendum to the election of Donald Trump as US president, 2017 saw a return to stability. Fears over the rise in populism in Europe abated and markets shrugged off the unwinding of quantitative easing and modest hikes to interest rates on both sides of the Atlantic.

Many world stock markets continued their upward trajectory, with most poised to post double-digit returns.

We recount this year's winners – from the investment sectors and individual trusts that have performed the best to those that met most demand from investors, either enjoying the strongest re-rating in their share prices or raising the most capital.

With numerous risks on the horizon and the valuations of many assets looking lofty, we also look ahead to prospects for 2018.

We hear from investment trust managers on what lies ahead for investors in the UK, US, Europe, Japan and emerging markets and ask wealth managers and analysts for their recommendations in each of the five markets.

Among developed markets, the common view is that next year will prove an ideal environment for bargain-hunting – rooting out the opportunities that investor nervousness creates. Valuations remain more compelling among emerging markets, with experts highlighting Japan as in a sweet spot.

Valuations remain more compelling among emerging markets, with experts highlighting Japan as in a sweet spot

It has long been a favourite of conservative investment trust Ruffer, which has added to Japanese banks this year. Prime minister Shinzō Abe's resounding victory in the snap election in October should bode well for economic reform.

However, it has also put in place protections against a severe market correction in the western world. Co-manager Hamish Baillie sees parallels between now and just before the financial crisis: 'It feels like our patience is going to be rewarded.'

Jennifer Hill, **Editor**

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Europe in 2017: ‘The’ Investment

EUROPE BECOMES THE FLAVOUR DU JOUR

As global economies emerged from a searing financial crisis at the turn of the decade the US and UK seemed to pull ahead of their European cousins. Earnings there lagged; growth tinkered on the edge of deflation; its misaligned cadre of politicians toiled with Grexit and Brexit and much in between.

2017 has switched fortunes – Europe has become the poster-child for its cousins and the catch-up trade. GDP growth is strong. We believe margins are improving. It has the biggest earnings upgrades in developed markets. Where the US and UK have become victim to populism, Europe has rejected it.

Indeed the strength has not gone unnoticed by the European Central Bank (ECB) with its president Mario Draghi beginning to the prepare the market for a withdrawal of their unprecedented quantitative easing (QE) program, most likely in the latter part of 2018.

The euro has also strengthened, which is now at levels last seen before European QE started in spring 2015. It has meant larger European companies, whose earnings tend to be harvested from across the globe leaving them at the behest of currency swings, have performed less well in recent months. Smaller companies, where we are invested, tend to have more of a domestic focus and so have performed better.

SMALL IS MIGHTY

TR European Growth Trust is a truly small company trust, with a large slice of the portfolio – over 50% - invested in firms under a £1bn market capitalisation. As investors in larger companies in Europe have struggled to find value amid renewed enthusiasm for European shares, they’ve reset their sights further down the scale and targeted mid-sized businesses, which in-turn have become more expensive. We believe it means the smaller end of the market is one of the last remaining places to find relative value, and it’s an area that we have a long history of seeking exciting growth opportunities for our investors.

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We're cognisant of the risks that come with investing in much smaller firms: they are more susceptible to market swings than bigger businesses and can be difficult to trade in large amounts, but to offset this and diversify the risk we run a longer stock list than most funds, at around 140 holdings.

WHAT TO BUY

So how do we find the sorts of investments that have the potential for strong capital growth?

We look for businesses with management teams that will continue to take the right decisions to either fix what is broken internally or continue growing their earnings strongly, regardless of geopolitical uncertainties or potential adverse market reactions to more hawkish central banks. It broadly translates into three areas of investment.

'Value' is one – companies that we believe the market is pricing below their intrinsic value. The next is growth-at-the-right-price (GARP): firms whose earnings are perceived to be growing more vigorously than their peers or the wider market, but the trajectory of which is being undervalued by the market. The final is turnaround stories, or 'self-help' as we call it – businesses that have been underperforming and are unloved by the market but striving to change their destinies. Below are some portfolio examples.

SELF-HELP

Van Lanschot - Dutch banking

Van Lanschot is the oldest independent bank in the Netherlands, dating back to 1737. It's in the business of private banking, asset management and merchant banking, and in the process of running off a loan portfolio it serves to corporate clients.

Back in April 2016 it presented a new strategy designed to reinvigorate the private banking arm – at the time the division earned around half of VL's

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revenues yet accounted for only 7% of total profits, indicating poor efficiency and enormous scope for self-improvement. Looking forward, it is attempting to be more asset-light and build up its capital ratios, returning cash to shareholders wherever possible. As it stands, its return on equity – a measure of profitability – is poor at around 7%; this we believe should be much higher.

VALUE

Alma Media

The Trust has taken a number of positions in Finland as we are finding undervalued businesses there which we think will perform well amid an improving economy.

Alma Media purports as a media owner of regional, local and free circulation newspapers for print and online, and the market is pricing it as such. But what it should be focusing on is what the business is really about: online classifieds - websites that deal in used cars, used equipment and in real estate – of which it is a market leader. Axel Springer, a similar outfit in Norway, provides guidance in this respect, with the market placing significantly more value on its operations. In our opinion other investors will catch-up with this thinking.

GROWTH (AT THE RIGHT PRICE)

Zur Rose

Founded in 1993, the group is in the businesses of online drugs, operating a prescription mail order business under its DocMorris brand in Germany, and a market leading online pharmacy business in Switzerland under its Zur Rose brand.

Pharmacy is a market ripe for disruption in Europe: small, relatively high value non-

perishable packages are extremely well-suited to e-commerce, which remains a very under-penetrated market considering the 125 thousand bricks and mortar pharmacies across Europe which have operated as such for 500 years.

What is more, the German market has recently been prised open by a European Court of Justice ruling and we believe market leader DocMorris will be a key beneficiary.

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All-in-all it has been a good year for European equities, and in particular small-caps. But we think they have much further to go: profitability languishes as the earnings of European firms have yet to catch-up to those of their developed market counterparts. In the portfolio we will continue to seek out those businesses that have the potential for superior capital growth over the longer term.

Deflation – a decrease in the price of goods and services across an economy.

Quantitative easing – when a central bank print money to buy assets and stimulate the economy.

Market capitalisation – the total value of a company's issued shares.

Hawkish – policy stance by the central bank aimed at cooling the economy

Capital ratios – the amount of liquid assets a financial institution holds against its risk operations.

Return on equity – the amount of net income relative to the shareholders invested equity.

The above stock examples are intended for illustrative purposes only and are not indicative of the historical or future performance of the strategy or the chances of success of any particular strategy.

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The best from our website

Check out our website – citywire.co.uk/investment-trust-insider – for your daily dose of news, interviews and comment on your favourite investment funds.

VIDEO

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Winner of our UK All Companies Performance Award reflects on a blockbuster 2017.

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An equally rare interview with veteran winner of our UK Smaller Companies award.

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Jennifer Hill

Ruffer:
for when the house of cards falls

RUFFER: FOR WHEN THE HOUSE OF CARDS FALLS

KEY POINTS

Ruffer, a multi-asset investment trust that aims to protect investors from big price crashes, has struggled to deliver much of a return this year. Its capital preservation mandate means it has a third of its assets in index-linked gilts, which have fallen 3-5%.

However, its managers are sticking with their knitting. The western world's 'house of cards' – high levels of debt, record share and corporate bond valuations, and an end to loose monetary policy – is poised to come crashing down.

As 2017 draws to a close, we speak to Hamish Baillie, one of the trust's managers since its inception, on the protection it aims to afford investors in a world of no riskless assets.

The performance of **Ruffer Investment Company (RICA)** has flatlined this year – a stark contrast to last year's double-digit return, despite its holdings being broadly similar.

It has eked out a share price return of 1.4% in the year to date – far lower than an average of 9% for its global defensive peer group and a gain of 14.7% for the FTSE All-Share index – and a significant drop on last year's return of 12.5%.

Hamish Baillie, co-manager of the multi-asset trust, which prioritises capital protection over capital growth, is disappointed but unapologetic: 'This year has been a bit frustrating. What we feel we did well last year, and what we always want to do for our shareholders, is to protect them from bad things happening, while giving them some •••

Hamish Baillie

sort of return; we're cognisant we can't expect them to stick with us while earning them no return or even losing them money while the party [for risk assets like equities] continues.

'The cost of our protection has been high, and while we might have made returns on our equity book, they haven't been enough to offset the cost of protection,' he concedes, referring to a small option book and 32% allocation to index-linked government bonds.

The portfolio of shares, index-linked bonds and gold benefited last year from the stellar performance of index-linked bonds, as well as stronger returns than this year from its significant weighting to Japanese equities.

Its index linkers, which shelter investors from rising inflation, had a phenomenal run during 2016, up 55%, not because investors were necessarily worried about rising inflation (although the weakness of the pound did push up consumer prices), but because a drop in yields on conventional bonds meant many offered a very low or even negative real return after inflation. By contrast, linkers offered a positive return over inflation and looked attractive – a reminder of the double-headed nature of these investments.

Despite a common misconception, currency movements contributed little to performance. 'Some people think we made money last year because sterling was weak, but we took the view going into Brexit that in the event of a remain vote sterling would strengthen sharply; we felt that was an unnecessary risk to take, so our overseas currency exposure was almost fully hedged •••

Ruffer's overseas currency exposure was almost fully hedged going into the EU referendum

'We don't know what it is that's going to bring the house down, but we do know that houses of cards are very fragile'

backed to sterling (80%) going into the referendum,' explains Baillie.

'We didn't get the tailwind [of the pound's depreciation], but when sterling is weak inflation expectations pick up, so we got some of that benefit through our index linkers.'

Faced with the same set of circumstances again, Baillie and his co-managers, Steve Russell and Duncan MacInnes, would 'absolutely' make the same currency call: 'Our main objective is to keep our investors safe.'

HOUSE OF CARDS

Baillie sees parallels between now and just before the financial crisis. Back then, Ruffer was defensively positioned – holding Swiss francs, Japanese yen and short-dated government paper. Its performance was flat between 2006 and 2007 – at a time when it was easy to make money from financial markets.

Shares in the trust, which typically trade at a small premium to net asset value (NAV), moved to their widest-ever discount of 7.6% and the board offered shareholders the opportunity to exit at NAV through a tender offer: 16% of them took it up.

At the height of the financial crisis in 2008, it was one of only a handful of funds to make a positive return for investors – something it has achieved every year since it was launched in July 2004 with the exception of a small 1.1% fall in 2015.

'When the storm hit, the protections we'd put in place served us really well,' says Baillie, who sees the trust as a balance to less conservative holdings in an investor's portfolio.

'When you look at what's happening today – growth in debt in the western world over the past 20, 30, 40 years has far outstripped economic growth – we have a house of cards. We don't know what it
is that's going to bring the house down, but we do know that houses of cards are very fragile. We are sticking with our knitting; it feels like our patience is going to be rewarded.' •••

Ruffer takes a barbell approach to its fixed income exposure, holding both ultra-long UK index-linked gilts (dated 2068) and short-dated paper (2022). Its US Treasury inflation-protected securities (TIPS) are even shorter duration (2021) amid expectations of interest rates rising faster in the States.

'If we've reached the stage of more fiscal stimulus coming through, we should see bond yields starting to rise,' says Baillie. 'This would hurt our linkers in the short term and so we have tried to hedge out some of the interest rate risk through options and financials (banks and life assurers).

'It's a classic Ruffer trade: we hold these linkers for an event that has not yet unfolded, they face a short-term risk and so we have tried to find offsetting investments to protect them.'

'We think index-linked bonds will be one of the only ports in the storm'

Despite the propensity for them to be 'knocked about a bit' in the short term, they stand to be the most valuable part of Ruffer's portfolio.

'The solution to the western world's debt addiction will not be growth or austerity; it will be a continuation and exaggeration of the financial repression that is already in place,' says Baillie.

'If the authorities can keep interest rates below the rate of inflation then there is a natural clearing mechanism, which spreads the burden of that debt between borrower and saver. The borrower eventually repays the debt, but in devalued currency.

'This scenario is terrible for savers and asset prices – think about the UK in the 1970s – and there are very few ways to protect savings. We think index-linked bonds will be one of the only ports in the storm; after all, they were initially issued by governments in the early 1980s to regain credibility in the aftermath of the inflation debacle of the 1970s by offering protection against the event that had just passed.'

BATTLE GROUND

With less than half the portfolio in equities (44%), competition for inclusion is fierce.

'The battle ground is probably on the •••

equity side; our analysts are trying to find where we can maximise returns from our equity book,' says Baillie.

'This part of the portfolio has got to fight pretty hard for us if the party continues and markets keep going up.'

The battle tends to be more stock specific than thematic, but the managers sold out of 'bond proxies' – the pharmaceuticals, utilities and telcos that tend to pay decent dividends and are traditionally considered the safer end of the stock market – over the second half of last year amid lofty valuations that left little scope for growth.

Valuation is a key metric for Ruffer, with the managers favouring free cash flow yield – which measures the amount of money flowing into a business – as a more transparent metric than dividend yield. Boeing, the US aircraft manufacturer, is a case in point. It did not look particularly cheap on a range of valuations, but its high free cash flow yield and the long pipeline of its order book spanning several years made it attractive.

Baillie sees the potential to find value among UK grocers, having picked up Tesco in April, and media companies, having bought France's Vivendi in June and America's Walt Disney Corp in the first quarter.

'Media stocks have been hit quite hard by so-called cable cutting – people moving from having a monthly TV bill to watching online – but Vivendi has another string to its bow in its ownership of Universal Music Group, which stands to benefit from the pickup in music streaming. A spin-off could equal the full market cap of Vivendi. •••

Ruffer has been adding UK grocers to its portfolio on valuation grounds

'Disney owns ESPN, a live sports channel, which is arguably less at risk than other forms of pay TV, but also has the strength of its studios business, parks and consumer products. Over the years it has proved remarkably adept at engaging its customers in these areas – watch the film, buy the toys, visit the park.

'Disney's a really interesting business that we followed for ten years before we bought it; we liked it, but considered it too expensive until recently.'

This year, Baillie has picked up a couple of cyber security stocks – an unequivocal 'growth area' – and added to Japanese banks, which he likes on the grounds of the 'wonderful inverse correlation' they have to bond prices. 'We want them to be going up when bond yields are going up [yields rise as prices fall],' he says.

Ruffer first bought into the Japanese stock market back in 2003 and has a 19% weighting today – buoyed by prime minister Shinzō Abe's resounding victory in the snap election in October, which drove the Nikkei to a 22-year high.

Abe looks set to become the country's longest serving prime minister after clinching a super-majority that will allow him to push through his program of economic reform, potentially with greater ease given that the opposition proposed more extreme versions of Abenomics – economic liberalism, sales of state-owned assets and ultra-loose monetary policy.

'Japan stands in stark contrast to western economies,' says Baillie. 'It shares the characteristic of improving economic growth and business confidence, but is a country with political stability, a relatively cheap equity market and ultra-loose monetary policy with no indication of a change of tack from the Bank of Japan. There's a lot of value in the Japanese stock market; we just need a catalyst to unlock it and we think that is now in place.'

INCOME PURSUIT

Income has never been a big part of the Ruffer proposition and the market has shrugged off a recent dividend cut.

The board was forced to cut the trust's total dividends for the year to 30 June – to 2.6p from 3.4p – due to dwindling income from its near zero-yielding, defensive investments.

'We did a lot of work consulting with shareholders and we [the share price] didn't miss a beat,' says Baillie.

The trust, which currently yields •••

Ruffer refuses to pay dividends from its reserves of capital gains in the belief that this would undermine its capital preservation mandate

0.8%, has previously supplemented dividend payouts from its income reserves, but unlike a growing number of investment trusts, Ruffer refuses to pay dividends from its reserves of capital gains, believing that to do so would undermine its goal of preserving shareholder capital.

'What it really shows to people is that we're not going to take excessive risk in the pursuit of income,' says Baillie.

Given its conservative approach, risk management is paramount to Ruffer and Baillie believes many investors are taking 'excessive' risk just now in the pursuit of income.

'There's a lot of that going on right now and not just in equity markets; there's a lot of issuance in high yield markets that has found its way into funds promising daily or weekly liquidity, but that liquidity is not found in the underlying investments.'

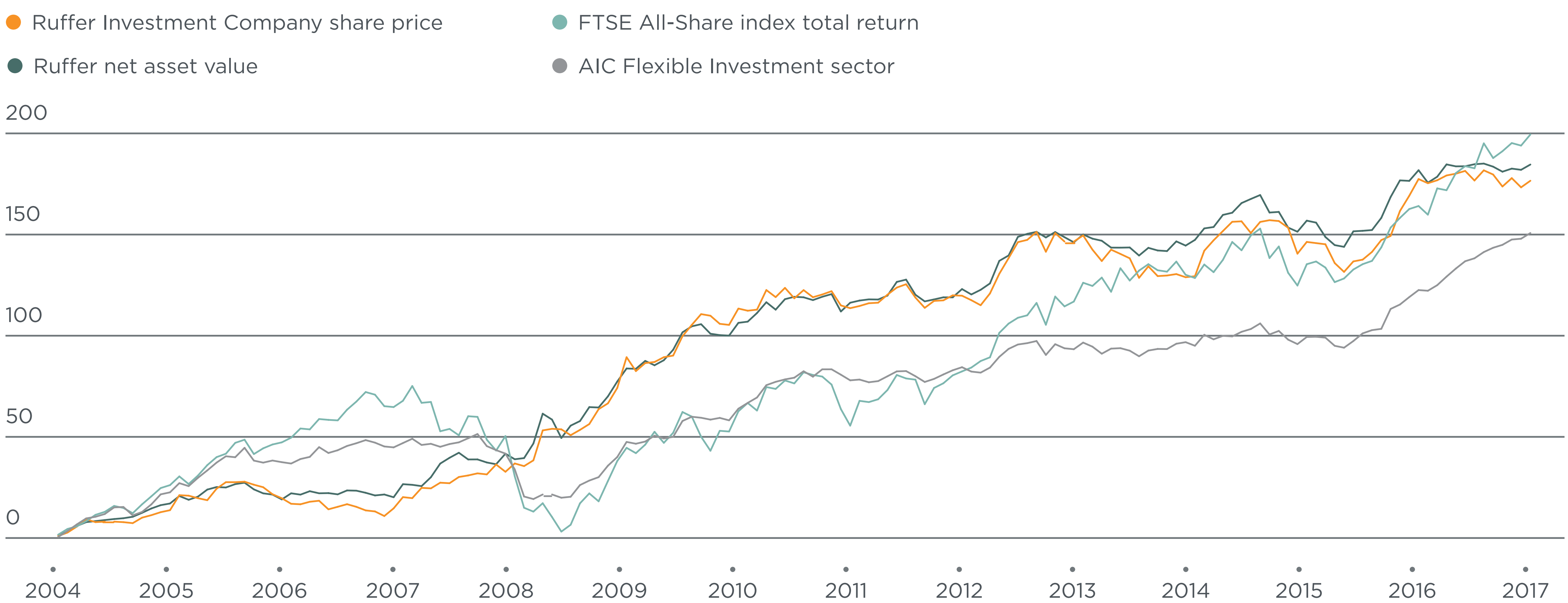
Stronger economic growth poses the greatest risk for these investors: rising bond yields could result in a rush for the exit from corporate bond markets, particularly high yield, and could cause a liquidity crisis: 'That could become a vicious circle, with yields going up faster because people are forced sellers.'

The alternatives, it seems are few and far between. 'We've described the [2008] financial crisis as "optional", because if you were in cash you were fine, as long as you were with the right bank,' says Baillie.

'Today, there are very few places to hide. There is no riskless default option, which is a pretty uncomfortable place to be. Choose your poison.' •

RUFFER OUTPERFORMS WHILE PROTECTING CAPITAL

Ruffer has outperformed its peer group since inception, while protecting investors' capital and giving a smoother investment ride



SOURCE: MORNINGSTAR 2017. TOTAL RETURNS IN STERLING.

Rob St George

2017's big winner: the status quo

2017'S BIG WINNER: THE STATUS QUO

KEY POINTS

While 2016 was a year of upheaval on the political front, 2017 saw fears over the rise in populism in Europe abate.

Markets appreciated the stability with European, Japanese, and Chinese equity sectors producing the highest average returns in the investment trust world.

As 2017 draws to a close, we reveal this year's success stories: which investment trusts have performed the best, which have had the strongest re-ratings and which have raised the most capital?

2016 was a year of upheaval, from the Brexit vote to the election of Donald Trump. Given that turmoil, it seemed appropriate that the year's best-performing investment trust sectors were some of the riskiest ones: commodities and Brazilian and Russian equities.

It was perhaps inevitable, then, that 2017 would see the status quo reassert itself. In politics, centrist candidate Emmanuel Macron fought off populist challengers to become the French president, Shinzo Abe was re-elected prime minister of Japan, and Xi Jinping further consolidated power in China.

This year, markets appreciated the stability: European, Japanese, and Chinese equity sectors produced the highest average returns in the closed-ended space. •••

BEST PERFORMING INVESTMENT TRUST SECTORS

By share price total return	
Asia Pacific – China	**45.9%**
Japan – Smaller Company	**41%**
Europe – Smaller Company	**40.1%**
By net asset value	
Asia Pacific – China	**46.2%**
Technology	**35.4%**
Japan – Smaller Company	**32.7%**

Source: Numis Securities, asset-weighted sector average, performance to 20 November 2017

The technology trusts also deserve to be mentioned: propelled by the 'FANG' grouping of Facebook, Amazon, Netflix, and Google, these portfolios saw their net asset values soar. Their share price performance of 36.9% was even better, but fell just outside the top three, reflecting lower starting points for valuations in Chinese, Japanese and European equity markets.

FINE CHINA

Beneath these broader trends, several individual trusts have recorded even more exceptional numbers in 2017.

The two China specialists have both stormed ahead, with **JPMorgan Chinese (JMC)** outshining **Fidelity China Special Situations (FCSS)** despite its lower gearing – or borrowing – of 9% to the latter's 25%. The JPMorgan fund offers more mainstream exposure to Chinese equities than its Fidelity counterpart, which has a larger weighting to mid and small-cap stocks, including some unquoted holdings.

BEST PERFORMING INVESTMENT TRUSTS (BY NET ASSET VALUE)

JPMorgan Chinese	**58.6%**
Pacific Horizon	**55.5%**
Allianz Technology	**46.8%**
Independent Investment Trust	**45.1%**
Fidelity China Special Situations	**44.3%**

Source: Numis Securities, performance to 20 November 2017

Baillie Gifford's **Pacific Horizon (PHI)** shares with them an interest in China and technology, with its top holdings like theirs being Alibaba and Tencent. It is not restricted to China though, and also has large investments in Korea and India.

Continuing the theme is **Allianz Technology (ATT)**, which has comfortably outperformed the Dow Jones World Technology index's return of 32.8% this year. This has occurred despite manager Walter Price cutting all his exposure to China following Trump's election, missing out on some of the rally in Chinese internet businesses, although he has now built that back up to around 6.5% of the portfolio via the likes of Alibaba and Tencent.

The anomaly among these stars then, is the **Independent Investment Trust (IIT)**, which sits in the Global sector even though it invests almost exclusively in the UK. Manager Max Ward •••

typically eschews all publicity, but collected his trophy for the UK All Companies category at the inaugural Citywire Investment Trust Awards in November, admitting he 'never imagined it would be as strong a recovery as this' after his portfolio struggled following the European Union referendum last June. He has been particularly well served by holdings like Blue Prism, an automation specialist that has gained more than 1,200% since floating in 2016.

UP THE CREEK

Of course, a sparkling portfolio is not always rewarded by a vertiginous rise in a trust's valuation, in the same way that a trust's share price can surge without anything spectacular happening to its net asset value.

That is the case with the **Alternative Liquidity Fund (ALF)**, whose 3.4% gain in its net asset value belies its 96.5% total return. What is spectacular though, is not only that this follows a similar performance in 2016 when it appreciated by 112%, but that it nearly repeated that feat this year despite switching managers.

Alternative Liquidity only came to the market in September 2015, acquiring a portfolio of hedge funds' discarded scraps – bundles of illiquid assets separated from their former hedge fund owners into special-purpose vehicles and now managed for liquidation – and being run by Morgan Creek Capital Management.

Morgan Creek resigned in July to focus on its activities in the US, although portfolio manager Tim Gardner also left that firm to join Warana Capital, an experienced investor in illiquid fund holdings that has been appointed as Alternative Liquidity's new adviser. Anyone doubting that the £82 million fund can make it a hat trick of sensational years should note that it still trades at a 71% discount, compared to 81% last year. •••

BEST PERFORMING INVESTMENT TRUSTS (BY SHARE PRICE)

Alternative Liquidity	**96.5%**
Dunedin Enterprise	**67.7%**
Independent Investment Trust	**67.6%**
JPMorgan Chinese	**63.1%**
Manchester & London	**61.9%**

Source: Numis Securities, performance to 20 November 2017

> **'A different way of identifying the trusts that have enjoyed the strongest reratings this year is to look at their Z-scores'**

Private equity trust **Dunedin Enterprise (DNE)** has had a better year in its portfolio, with its net asset value up by 17%, but has re-rated even faster with the discount closing from 39% in January to 14% now.

That is attributable to a series of high profile sales as it winds down, including the initial public offering of Alpha Financial Markets Consulting at a premium of 86% to its carrying value. Dunedin still has more assets to divest, such as courier CitySprint.

The other trust that has significantly outperformed its own portfolio, which itself returned a commendable 34.6% this year, is the £104 million global equity fund **Manchester & London (MNL)**.

The fund received a boost in March when the Telegraph's Questor column highlighted it as 'an easy way for British investors to buy Amazon shares'.

Having significantly underperformed its peer group for several years until 2015, Manchester & London quietly reinvented itself as a concentrated growth strategy, with 12% of its portfolio now in Amazon and large stakes in Google, Facebook, Apple, and Alibaba and Tencent too.

CATCHING SOME Zs

A different way of identifying the trusts that have enjoyed the strongest re-ratings this year is to look at their Z-scores. These are a measure of how a fund's discount or premium has changed relative to its historic trading range; a Z-score above two implies that a trust has become significantly more highly •••

HIGHEST ONE-YEAR Z-SCORES (BY SECTOR)

Environmental/ Alternative Energy	3.0
Emerging Europe	1.8
UK Mid Cap & Small Cap	1.6

Source: Numis Securities, performance to 20 November 2017 valued; below -2 it is viewed as getting cheap. (If you are interested in this data the 'Investment Trust Watch' column on our website looks at Z-scores every Friday to highlight potential buying and selling opportunities.)

The theme from these Z-scores is evidently relief: that a Trump administration is not unduly disadvantaging environmental businesses, that Russia is not proving more aggressive on Europe's eastern periphery, and that Brexit has not yet done too much damage to the domestic UK economy.

This is again clear when looking at the individual funds with the highest Z-scores over the past year. **Impax Environmental Markets (IEM)**, for example, has seen its discount narrow from 11% in January to 7% now as it has come to be known for investing in businesses that benefit from the long-term trend towards resource efficiency and tighter environmental regulations rather than being regarded as a simple 'green' play. The trust also cut its tiered management charges in October, with Numis Securities estimating that the effective fee will decrease from 0.91% to 0.89%.

HIGHEST ONE-YEAR Z-SCORES (BY TRUST)

Impax Environmental Markets	3.4
Henderson Smaller Companies	3.3
Dunedin Enterprise	3.3
Standard Life UK Smaller Companies	3.2
Hansa Trust	3.1

Source: Numis Securities, performance to 20 November 2017

The discount on **Hansa Trust (HANA)**, meanwhile, has tightened from 34% in January to 23% today as it has continued to transition away from being predominantly a UK equity portfolio to transforming into more of a defensive multi-asset fund since Alec Letchfield became manager in 2013.

BIOTECH BOUNCES BACK

Shares in biotechnology and life sciences trusts also enjoyed a positive re-rating as it became clear that president Trump did not have the political clout to make good his election threat to tackle alleged 'price gouging' by US drugs companies.

Having started the year on an average discount of 7%, the sector moved to •••

a 5.5% premium as investors renewed their faith in the long-term growth prospects of companies seeking scientific cures to the range of ills suffered by the world's ageing populations.

There was an income dimension to this revival. **International Biotechnology Trust (IBT)**, winner of the first Citywire Specialist Equities Performance Award, shed its 13% discount and currently trades close to par, or net asset value, after investors approved of its decision to start paying a 4% dividend from capital.

The sector's newest entrant, **BB Healthcare (BBH)**, avoided falling to a wide discount after its launch last December, as improved sentiment to the sector and its 3% dividend yield enabled the shares to trade in a relatively narrow valuation range, currently trading at a 3% premium over NAV.

Syncona (SYNC) was the most spectacular performer. The merger of the former Battle Against Cancer investment trust with the investment arm of the Wellcome Trust at the end of last year forged the UK's largest life sciences investor. Investors liked the story, chasing the stock from a 5% discount to a 20% premium with the result that the total shareholder return for the year so far of 41% is nearly double the underlying growth in NAV.

MONEY MAKERS

A final way to review the success stories of 2017 is to look at the funds that raised the most money in the year. It was again a difficult time for launching trusts, with one of the highest profile casualties of this environment being Daniel Godfrey's proposed People's Trust. Despite plenty of publicity, Godfrey had to abandon the flotation after being unable to attract the target £125 million.

Indeed, no new conventional equity fund managed to pull in more than £100 million in 2017. The largest debuts came from the £90 million **Jupiter Emerging & Frontier Income (JEFI)** trust, the £56 million **Downing Strategic Micro-Cap (DSM)** trust, and the £50 million **ScotGems (SGEM)** from Stewart Investors. They had originally aimed for £200 million, £100 million, and £100 million respectively.

There were nevertheless some blockbuster listings, dominated for yet another year by the search for alternative income sources.

Biopharma Credit (BPCR) differs from the older healthcare and biotech •••

trusts by investing in debt rather than equities, spanning bonds and loans as well as royalties whereby the fund has claims on the revenue streams from specified drugs.

The infrastructure trusts **HICL (HICL)** and **International Public Partnerships (INPP)** will have been glad to raise money before the Labour party spooked the market by threatening to nationalise private finance initiative contracts in September.

Finally, the proliferation of new specialist property mandates – from warehouses to private rental and social housing – has significantly broadened investors' range of options from the previous mainstays of retail, healthcare and student accommodation. •

LARGEST FUNDRAISINGS

Biopharma Credit	**£606 million**	Flotation
HICL Infrastructure	**£528 million**	Additional issuance
Tritax Big Box REIT	**£350 million**	Additional issuance
Greencoat UK Wind	**£340 million**	Additional issuance
International Public Partnerships	**£330 million**	Additional issuance
PRS REIT	**£250 million**	Flotation
Greencoat Renewables	**£242 million**	Flotation
Triple Point Social Housing REIT	**£200 million**	Flotation
Warehouse REIT	**£191 million**	Flotation
Residential Secure Income REIT	**£180 million**	Flotation

Source: Association of Investment Companies, data to 1 November 2017

Michelle McGagh and Danielle Levy

Prospects and tips for 2018

KEY POINTS

From ongoing negotiations for Britain to leave the European Union to the withdrawal of monetary stimulus packages and the prospects of further increases to interest rates on both sides of the Atlantic, investors have got much to consider in 2018, so just what are the prospects for next year?

We hear from investment trust managers on what lies ahead for investors in the UK, US, Europe, Japan and emerging markets.

And we ask wealth managers and analysts for their favourite trust in each of the five markets.

USA: TAX JITTERS

The US stock market, as measured by the S&P 500 index, has had another good year, gaining 16% in dollar terms. With the total return in sterling to UK investors having hit nearly 147% over past five years – helped in part by the dollar appreciating 20% against the pound – attention has inevitably focused on valuation.

Fran Radano (pictured, above centre), manager of the **Aberdeen North American Income Trust (NAIT)**, is anxious to see President Trump (above right) secure some of his corporate tax reforms, believing they are vital to foster the economic growth needed to support a highly-priced stock market.

'We are going to need earnings growth; it has bubbled up in the last couple •••

of quarters. A certain level of earnings growth is fairly priced in, but if there is pro-tax policy there is scope for continued earnings and visibility. Without that policy in place we are at risk of a fall-back where companies have billions trapped offshore that they cannot get to and the highest tax rates in the world,' he said.

One area where valuations are not demanding is financials, where Radano has nearly a quarter of his £427 million fund invested. He has moved 'overweight' to financial companies compared to the index in the past 18 months, mostly in the hope that Trump would reverse some of the new regulations covering the sector.

'Financials and banks were under-regulated going into the crisis and now they are over-regulated. Regulation is being fine-tuned at the moment,' he said. 'That has been good.'

The manager avoids the big US mega-banks, however, focusing on the smaller regional banks he believes will benefit most from less red tape. 'They are better positioned and less complex and not exposed to capital markets in the way that brings an extra level of risk to the big banks,' he said.

TRUST TIP: JAM TODAY

Consistently beating the S&P 500 is notoriously difficult for active stock pickers and fund managers to do, which is why there are only six investment trusts covering the world's biggest stock market and why so many investors have plumped for index-tracking exchange traded funds for their US exposure.

Gavin Haynes, managing director at Whitechurch Securities in Bristol, likes **JPMorgan American (JAM)**. The £914 million trust – the biggest in the North America sector – has broadly only matched the US index return with an average annual gain return over 10 years of 13.7%, just ahead of the 13.2% annual gain in the S&P 500, according to Morningstar figures.

However, its value-hunting fund managers Garrett Fish and Eytan Shapiro are under pressure from the board to do better by putting more money behind the stocks they like the best and cutting their losers more aggressively. With the shares trading on a modest 4% discount and the trust's ongoing charges of 0.62% the cheapest in its sector, Haynes believes the trust is worth holding.

'I think it is a good, solid core choice for US exposure,' he said. •••

PROSPECTS AND TIPS FOR 2018

UK: CHEAP IF NOT CHEERFUL



The Brexit cloud hanging over the UK economy is a big reason its stock market has mounted a relatively muted 9% advance so far this year.

Many overseas investors are shunning the FTSE All Share, nervous that a further slide in the pound could damage the value of their investments while an economic slowdown makes life difficult for British businesses.

However, for Alex Wright (pictured), manager of **Fidelity Special Values (FSV)** investment trust, this is an ideal environment for bargain-hunting. Although he is not optimistic about the UK economy, he is keen to exploit the opportunities that investors' negative sentiment creates, believing the stock market is comparatively cheap.

'People are generally concerned about the UK and global investors are shying away from investing in the asset class,' he said.

Wright's search for undervalued companies he believes will re-rate when investors discover they are doing better than expected has led him to invest nearly 40% of the £773 million fund in financials, such as Lloyds Banking Group.

'The UK is generally cheaper – Lloyds is a very good bank in terms of return and market shares but it is trading on 9x price/earnings and HSBC [a global bank] is on 14x,' he said.

'Price to book, HSBC is also more expensive. It's not that I have a positive view on the UK but the market is •••

'Having started 2017 with the discount to net asset value close to par it [Fidelity Special Values] has widened out to 8%, which I would hope provides a more attractive entry point'
Alistair Hodgson, Pilling & Co

taking a negative view, and I'm a contrarian investor, so that interests me.'

Wright isn't going overboard on UK domestic stocks, though. Recently he has added to Pearson, the educational publisher whose core US market has struggled with a move online, taking it from a 0.6% position to a top 10 holding in the fund.

'It has been a troubled stock over the last five years and lost 70% of its market value, and the perception of it is very negative,' said Wright.

'That's incorrect, it's a cyclical business and it has had a tough time because of its inability to call what will happen in the market but there is nothing structurally wrong and it has a 40% share in the world's largest education market.'

TRUST TIP: WRIGHT IS RIGHT

Alistair Hodgson, a wealth manager at Pilling & Co, likes Wright's high conviction approach and willingness to run his winners which is why he chooses Fidelity Special Values as his choice for the UK.

'Having started 2017 with the discount to net asset value (NAV) close to par it has widened out to 8%, which I would hope provides a more attractive entry point - notwithstanding concerns investors may rightly have about the outlook for the UK equity sector,' Hodgson explained.•••

Fidelity Special Values has added Pearson, the educational publisher, which has lost 70% of its market value

EUROPE: GLOBAL GROWTH



UK investors have piled into Europe as the region's recovery has strengthened and the euro's gains over the pound have amplified their returns. The MSCI Europe ex UK index has risen nearly 18% in sterling terms this year.

Stephen Macklow-Smith (pictured, above centre), manager of **JPMorgan European Growth (JETG)**, expects this to continue: 'The European recovery started 18 quarters ago now and we had been underwhelmed by the size of the growth but now unemployment is falling significantly and continues to fall and quality job creation is high, consumer confidence is high, and credit supply is good,' he said.

Europe is also exposed to global economic growth and in particular the recovery in emerging markets – for example, Macklow-Smith said Spain had benefited from Latin America pulling through the commodities downturn of recent years.

The political fears that weighed on Europe at the start of this year have passed with far-right nationalists not making the electoral gains that had been forecast in Austria, the Netherlands and France.

'We have the Italian elections [next year] and we will have to keep an eye on the opinion polls but even the populist parties have backed away from criticising the EU and the euro,' he said.Macklow-Smith said a bad Brexit with the UK crashing out of the EU with no deal' •••

'He [John Bennett of Henderson European Focus Trust] has a pragmatic style and is prepared to adapt, based on the underlying backdrop'
Gavin Haynes, Whitechurch Securities

was still a risk and would cause problems although he believed the two sides would ultimately reach a deal.

TRUST TIP: HEFT IS STRONG

Whitechurch's Haynes selected **Henderson European Focus Trust (HEFT)**, pointing to fund manager John Bennett's track record which has seen the fund beat the market in five out of the seven years he has been in charge of the £301 million trust.

At the present time, Bennett has the greatest exposure to Germany, followed by the Netherlands and Italy. 'He has a pragmatic style and is prepared to adapt, based on the underlying backdrop,' said Haynes.

He likes that Bennett has shifted the £295 million portfolio away from quality growth companies in favour of cheaper value stocks over the past 12 to 15 months.

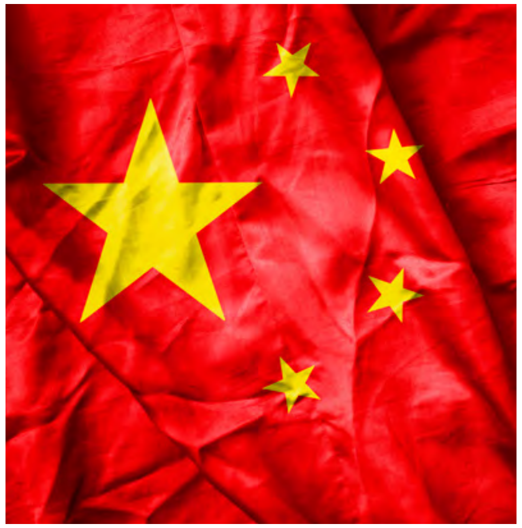
The resulting 37% gain over the past year has left it with the best five-year return in its sector of 156%.

The shares are fully priced though, standing just below their net asset value having started the year on a 9% discount to NAV. •••

Henderson European Focus Trust has beaten the market in five of the past seven years

PROSPECTS AND TIPS FOR 2018

EMERGING MARKETS: ROOM FOR GROWTH



After a 26% rally this year emerging markets are definitely not the bargains they were in January. Ross Teverson (pictured, right), manager of the new **Jupiter Emerging & Frontier Income (JEFI)** trust, said there was still room for growth, particularly in the smaller and medium-sized stocks he focused on.

'This time last year we were talking about emerging market valuations being cheap in a historical context and now we're saying emerging market valuations are reasonable in that context,' he said.

'Overall, valuation levels are supportive of strong medium and long-term returns,' he added. Key to prospects was the level of earnings growth that could be sustained in 2018, Teverson said.

'Most companies we have been meeting over the last few months, the message from management has been supportive for earnings growth and that bodes well for the asset class,' he said.

Although China might be considered the driving force for emerging markets, Teverson is underweight at 11% compared to the 30% weighting in the MSCI Emerging Markets index.

'The picture in China is high overall indebtedness and at the same time, China does not enjoy the same structural tailwinds that other areas do,' he said. 'The demographic picture is also more supportive in other emerging markets than China.' •••

'The fund [Genesis Emerging Markets] has a good team and is trading on a wide discount. They are active managers who do not follow the benchmark'
Daniel Lockyer, Hawksmoor Investment Management

Teverson said he was excited 'about a number of frontier markets' and he owns banks in Nigeria, Kenya and Georgia that have 'strong deposit functions and high returns on equity with low levels of risk'.

He also invests in 'supply chain' companies that operate in areas of strong growth, including Taiwanese company Bizlink which supplies wire harnesses that connect the cells in the batteries used by electric car manufacturer Tesla.

TRUST TIP: GO GENESIS

Daniel Lockyer, chief investment officer at Hawksmoor Investment Management, picked **Genesis Emerging Markets (GSS)**. Although its performance has not been quite as strong as rivals, its shares traded more than 13% below net asset value. Lockyer liked the fact that its manager, Genesis Investment Management, focused solely on emerging markets.

'The fund has a good team and is trading on a wide discount. They are active managers who do not follow the benchmark,' he added. •••

Genesis Emerging Markets has not kept up with rivals which is why its shares look cheap

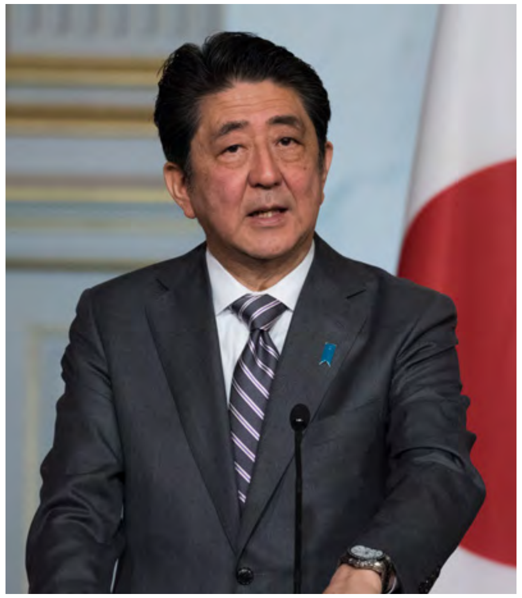
JAPAN: SWEET SPOT

The nagging worry for investors in Japan is the wild card of North Korea and the risk that its erratic despot Kim Jong-un stokes up tensions in the region and the US with its nuclear missile programme.

That aside, the picture is positive with Japan's stock market still looking cheap despite a 16% sterling rise this year, as the country attempts to pull out of a long era of deflation under prime minister Shinzō Abe (above right).

Abe's re-election in October pushed the Nikkei 225 index to its longest-ever winning streak of 16 days as investors looked forward to more business- and growth-friendly policies.

Richard Aston (pictured, above centre), manager of **Coupland Cardiff Japan Income & Growth (CCJI)**, says he is optimistic for 2018 as Japan's companies are in a 'sweet spot', with the economy growing and a tight labour market helping to revive long dormant inflation. Meanwhile, the Bank of Japan continues to hold interest rates at ultra-low levels and to print money in a bid to drive down the value of the yen and help exporters.



Aston has moved the £159 million fund into the machinery sector to leverage the demand for Japan's skills from a growing global economy. 'It's a sector we've not looked at before but now we like machinery,' he said. 'Japan lost its technical prowess but there are areas where it continues to maintain competitiveness and leadership, and that's in machinery.' •••

The performance of JPMorgan Japanese is improving, yet the shares can still be bought on a wide discount

'Normally it would be Baillie Gifford Japan, but the fact that it is trading ona massive premium to everything else and the manager Sarah Whitley is retiring means I would probably go with JPMorgan Japanese'
James Burns, Smith & Williamson

Japan is adding consumer services to its list of exports, where traditionally it has only exported products, and is also expanding its cosmetic and chemical businesses 'beyond Japan to other Asia regions', he said. 'Telecoms, which has been a poor performer, is looking appealing in terms of value and growth,' Aston added.

TRUST TIP:

Top performing **Baillie Gifford Japan (BGFD)** would historically have been the choice of James Burns of wealth manager Smith & Williamson.

However, on an 8% premium above net asset value, he views the shares as expensive, particularly as its long-standing manager, Sarah Whitley, is about to retire.

By contrast, **JPMorgan Japanese (JFJ)** makes a good alternative with its performance improving under Nicholas Weindling and Shoichi Mizusawa and its shares trading on a wide 11% discount to NAV.

'Normally it would be Baillie Gifford Japan, but the fact that it is trading on a massive premium to everything else and the manager Sarah Whitley is retiring means I would probably go with JPMorgan Japanese,' Burns said. •

NEXT ISSUE:

Season's Greetings to all of our readers! We'll be back with more investment trust news and views in February 2018.

THE TEAM	EMAIL	TELEPHONE
Editor Jennifer Hill	jen@media-hill.co.uk	07968 560643
Editor in Chief Gavin Lumsden	glumsden@citywire.co.uk	020 7840 2256
Senior Graphic Designer Deepti Miller	dmiller@citywire.co.uk	020 7840 5150
Junior Graphic Designer Paolo Gritti	pgritti@citywire.co.uk	020 7840 5183
Head of Creative Robert McColgan	rmccolgan@citywire.co.uk	020 7840 2461
Production Isabel Godfrey	igodfrey@citywire.co.uk	020 7840 5163
Picture Desk Coordinator Kathryn Richardson	krichardson@citywire.co.uk	020 7840 5156
UK Business Development Manager Charlie Rosier	crosier@citywire.co.uk	020 7840 2479
Digital Sales Director Dominic Ward	dward@citywire.co.uk	020 7840 2265
Product Development Director Nick Collard	ncollard@citywire.co.uk	020 7840 2168

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