Current Focus

September 2017

A monthly market comment from Rivers Capital Management. Views expressed here are subject to change and for professional advisors only.

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Summary

- Sterling devaluation boosts returns for all UK investors
- Currency has contributed to returns for UK investors for 10 years
- Currency risk management is needed to contol risk and add return
- 'Enhancer' and 'Diversifier' assets will benefit from active currency overlay

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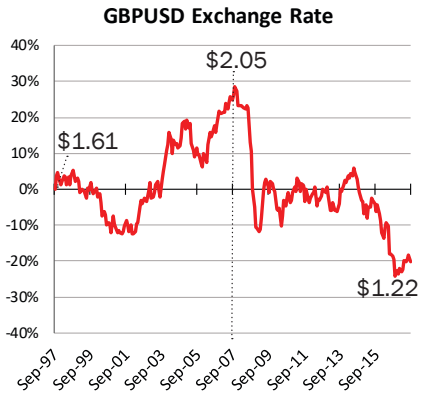
Market Commentary

August, as usual, saw low volume and increased volatility across many asset classes. That said, and thanks mainly to a strong rally in the final week, most asset classes ended the month in positive territory, at least in Sterling terms, as did all the Rivers Portfolios. A fall in the value of sterling during the month supported returns for non-sterling assets and a moderation in interest rate expectations led UK Gilts to reverse recent losses. This month we want to focus on currency and the way we think it should be managed within portfolios. We look at how we think currency can be used to add return and, more importantly, control risk in the future. We don't want to make currency predictions and, for the record, we are not planning on re-allocating all non-sterling funds to currency hedged share classes just yet, but we retain the option to do so.

Despite the defensive risk positioning across our models, last month's 2.3% decline in the value of sterling materially contributed to return. In the recent past, market moves like those in August have not been unusual; Sterling and its value have become headline news but, whatever the media say, this is not simply a 'Brexit' issue. 'In sterling terms' has been a significant performance contributor for UK investors for a long while. The effect, on average, has been positive for the last ten years but it has not been one way traffic. Currency may be the most difficult asset class to predict but it clearly matters as it affects both risk and return.

Some background statistics: Next month marks the ten year anniversary of the 'pre financial crisis' high for both the FTSE 100 and the S&P 500 equity indices. No reader will need reminding that both markets subsequently lost around 50% of their value during 2008/9 as the world experienced the worst recession since the 1930s. It is not news either that both markets have recovered strongly and, in time, exceeded their respective index highs. On a total return basis, the FTSE 100 reached its pre-crisis high in January 2011 and the S&P 500 in September that year. None of this will surprise anyone, except perhaps that the total return for the UK market beat the total return for the US. Over the full ten years the S&P 500 total return index has outperformed returning 85% while the FTSE 100 total



Source: Financial Express Limited.

return has managed a not insignificant 61%. Bearing in mind that this return is from the 'market high' level of October 11th 2007, the performance has been remarkable. However, before we all turn into 100% equity investors overnight it's worth noting that the UK Gilt market has returned 88% over the same period – at less than half the risk.

The returns mentioned above are all in local terms. For our purposes it is more relevant to consider the difference in return not in local terms but from the perspective of an investor. To do that we must translate the returns to share currency. In US dollars, 85% for the S&P 500 and a paltry 2% for the FTSE 100, or into sterling; 61% for the FTSE and a not at all paltry 192% for the S&P 500. This enormous difference is due to the 58% depreciation in the value of sterling over the same period. It cannot, and should not, be ignored, even for long-term investors. The problem is that it is not one way. The chart this month shows the 20-year value of sterling against the US Dollar. It doesn't show a trend, a regression would at best be mildly negative. The reality is that the last ten years proceeded a period where, at least against the US dollar, sterling appreciated to levels not seen since 1981. Today, even after recent falls it remains above the low level seen in 1984.

Generally, with the portfolios we manage, we hold low-risk or 'Anchor' assets in either sterling or in currency hedged share classes. These are low-risk by definition and introducing the risk of currency is likely to remove that characteristic. We won't do that. For 'Enhancer' and 'Diversifier' assets however (those chosen specifically to add return to the portfolio, or to diversify risk) currency does need to be managed dynamically. The strategic

argument of not managing currency risk either because equity has a 'natural hedge' built into it or simply that currency risk doesn't change the characteristic of the asset class, needs to be reviewed. It is worth noting that for the last ten years the FTSE has been pretty much the worst performing equity market for sterling investors, so long as no currency hedging was in place: the Japanese (90%), European (62%) and Global (127%) equity markets have all been very positive; at least in 'Sterling Terms'. Is the benefit gained by sterling investors purely down to luck or judgement? We'd prefer it to be at least partially judgement.

We are not suggesting we can predict currency values. Many investors, much smarter than us, have tried and failed but we do think a currency risk management approach needs to be adopted. Relative value and fundamental factors, combined with trend analysis must be considered. This gives us scope to introduce investments with specific hedged, un-hedged or partially hedged share classes. We've been doing this for many years and while hedging, from a sterling perspective, has rarely added to return since 2007 (the exception being Japanese equities since 2012) it has controlled risk. The devaluation of sterling will not go on forever in any case, whatever the general view on Brexit may be.

Currency risk management, the dynamic allocation between active and passive solutions, as well as the tactical management of asset exposure, are all tools essential to the successful management of client portfolios. The devaluation of sterling continues to boost UK investor returns but should not be taken for granted. If anything it highlights the danger of not managing this risk intelligently.

Benchmark Returns - 31st Aug 2017	1 Month	3 Month	6 Month	YTD	1 Year	S/I*
Anchors						
Cash + 1%	0.1%	0.3%	0.7%	0.9%	1.4%	1.6%
Inflation Linked UK Bonds	4.0%	2.2%	1.5%	2.0%	2.4%	7.7%
Gilts	2.1%	0.2%	1.3%	2.5%	-3.5%	1.4%
Global Government Bonds (hedged)	0.9%	0.5%	1.3%	1.3%	-1.7%	-1.8%
Enhancers						
Global Corporate Bonds (hedged)	0.7%	1.2%	2.8%	4.0%	1.3%	3.3%
Global High Yield (hedged)	0.5%	1.2%	3.2%	6.1%	7.6%	12.5%
Emerging Market Bonds (hedged)	3.9%	5.5%	6.3%	10.9%	13.5%	16.6%
FTSE 350 TR Index	1.4%	0.0%	5.1%	8.0%	14.1%	20.8%
FTSE UK All-Small Cap	0.6%	2.0%	9.8%	13.5%	20.5%	32.6%
Global Equity (MSCI)	2.5%	3.1%	4.1%	8.8%	18.1%	25.7%
European Equity (MSCI)	2.6%	2.4%	11.2%	13.9%	21.7%	29.8%
US Equity (S&P)	2.6%	3.0%	1.7%	6.9%	17.4%	24.3%
Japan Equity (Topix)	2.7%	4.0%	4.6%	9.5%	18.7%	28.3%
Pacific Ex Japan Equity (MSCI)	3.9%	9.0%	15.7%	26.0%	27.8%	41.6%
Emerging Market Equity (MSCI)	4.6%	9.6%	14.0%	23.0%	26.6%	39.1%
Chinese Equity (Hang Sang)	5.2%	11.2%	16.2%	24.8%	27.6%	44.4%
Indian Equity (Nifty)	1.1%	4.2%	12.6%	23.4%	20.2%	31.1%
Diversifiers						
Commodity Index	0.3%	2.1%	-3.6%	-3.4%	2.0%	-5.1%
Gold	6.3%	3.5%	1.2%	9.2%	1.5%	2.3%
Silver	6.7%	0.5%	-8.9%	4.2%	-6.1%	-4.3%
Brent Oil	2.0%	4.8%	-9.7%	-11.6%	12.0%	9.4%
UK Property	0.4%	1.7%	3.6%	4.7%	8.4%	5.7%
Global Property Shares	-0.2%	-0.7%	3.6%	5.5%	4.2%	11.4%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*1.2%*	*1.1%*	*1.5%*	*2.7%*	*4.4%*	8.3%
Rivers Cautious Portfolio	*1.4%*	*1.2%*	*2.4%*	*4.6%*	*7.6%*	13.4%
Rivers Balanced Portfolio	*1.6%*	*1.3%*	*2.8%*	*5.8%*	*9.3%*	16.4%
Rivers Adventurous Portfolio	*1.4%*	*1.0%*	*3.0%*	*6.6%*	*10.6%*	18.6%
Rivers Aggressive Portfolio	*1.7%*	*1.7%*	*4.5%*	*9.3%*	*14.5%*	23.5%
Rivers Cautious Income Portfolio	*0.7%*	*0.2%*	*1.6%*	*3.7%*	*4.6%*	8.0%
Rivers Balanced Income Portfolio	*0.4%*	*0.3%*	*2.4%*	*5.3%*	*7.7%*	12.9%

Source: Financial Express in GBP (unhedged unless stated) as at 31st August 2017. *Rivers Portfolios since launch June 30th 2016.

Model performance is indicative only and is net of Rivers Capital Management charge and underlying fund charge but not advisor or platform costs.