Current Focus

March 2018

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

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INTELLIGENT INTUITIVE INVESTING

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Summary

- Market volatility affected most asset classes during February
- Diversifiers are important with both equity and fixed income valuations still high
- Diversifiers will improve long term portfolio efficiency
- Sustained volatility will increase opportunity for tactical adjustment

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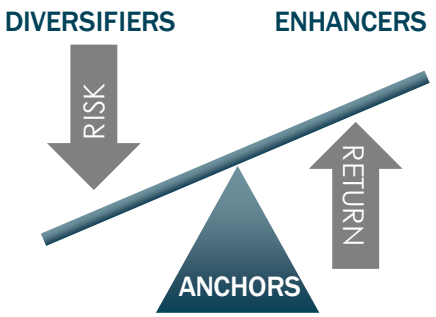
Market Comment

February proved to be the most challenging month for investors since January 2016. Most major equity indices saw material corrections in the second week of the month and a marked increase in volatility. Expected interest rate increases in the US appeared to change investor confidence that the longstanding market momentum could be maintained. The recovery from the lows in early February has been positive but most indices remain lower and we expect increased volatility to be sustained. The current valuation of equities remains high, and with interest rate increases the likely catalyst for volatility, it is unlikely fixed income will offer much refuge in the event of a further correction. Given these combined risks it is more important than ever to maximise diversification across investment portfolios; the problem is how best to achieve that desired diversification. Our Focus this month is, therefore, on Diversifiers.

We define Diversifier assets as investments with an underlying long-term correlation of less than 0.7 to both global equity and interest rate risk. While short term market sentiment may influence their pricing, the primary drivers for returns must be identifiable and distinct from the factors driving equity beta or interest rate. A positive return expectation is desirable for these assets, but this is not to be the primary reason for their inclusion in an investment portfolio. These assets include Commodities, Property, Gold and other absolute return and hedging strategies. The purpose of allocating to these assets is to increase diversification thereby lowering overall portfolio volatility. It is true that many Diversifying asset classes are unavailable through open ended fund solutions, especially daily traded ones on platforms, but these can be implemented through listed equity proxies. This adds a further dimension to the allocation decision, as shown in the recent divergence between Gold and Gold miners but it does not negate the benefits of diversification. In fact these anomalies can increase the opportunity to provide enhanced risk adjusted long term returns.



Source: Rivers Capital Management

Considering the very recent past it is easy to demonstrate both the limitations of Diversifiers and the benefits. Considered in local currency terms, of the 32 broad asset classes we monitor only 5 had a positive return during February. These were Cash, Short term and Long term UK Gilts, Inflation linked Bonds and a proxy to the UK Property index. Of these, only UK Property would be classified as a diversifier given our definition. Other diversifying asset classes actually underperformed equity indices. In the event, it appeared that diversification provided little short-term protection as nearly all assets moved in the same direction during the month. The only assets that protected value at the exact time of this selloff were government fixed income and cash, as investors appeared to sell any risk related asset and hold only cash. This is not uncommon during periods of sharply rising volatility but correlations, in the medium term, can be expected to revert to trend. If we do look very slightly further back at the 13 asset classes that had positive local returns for the last three months, including the sell off, five were diversifiers. Once the noise, led by short term sentiment in the market, abated, the fundamental correlations between asset classes revert to normal and the combined volatility of an investment portfolio containing all 32 assets declines.

Regarding using equity listed proxies to gain exposure to diversifiers, the effect of additional factors and overriding market sentiment do need to be considered more closely. In the case of Gold, for example, we would normally prefer an allocation to be implemented through physical Gold, either through an ETF or directly, but we would consider an equity proxy (such as

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Gold Miners) if that was the only available vehicle, or indeed if that was preferable. The lack of consistency between the price of Gold Mining equities and the price of Gold itself has been significant in the last 12 months. Gold has appreciated around 5% over this period (on the back of USD weakness) while the index of listed Gold Miner equities has lost around 20% of value. Explaining this difference is complex and may be related to USD weakness but given that the gold price is undeniably the underlying driver to listed miners the disparity is hard to ignore, and potentially offers opportunity. Currently Gold Miners offer exposure to Gold, a diversifying asset class, while at the same time being more attractive on a valuation basis. The underlying equity market exposure this brings needs to be considered but provided it is the underlying diversifying benefits of Gold will likely play out over time.

Diversifiers have not done well relatively (to Enhancers) on a 1 or 3 year basis but they will improve risk efficiency over time. Looking forward, with both equity and interest rate risk elevated, maintaining or increasing exposure to assets which in the long run have demonstrated low correlation to both these risks will improve overall performance.

Diversifiers appeared to provide little short term protection in the selloff during February but they remain an important component to any portfolio if, as we believe, volatility remains high and tactical asset allocation becomes increasingly important. As market volatility is expected to increase over the next year, holding uncorrelated assets will protect value and increase the opportunity to increase overall risk at more attractive valuations in the coming months.

Market Returns (£) - 28th Feb 2018	1 Month	3 Month	6 Month	YTD	1 Year	S/I*
Anchors						
Cash + 1%	0.1%	0.4%	0.7%	0.3%	1.4%	2.3%
Inflation Linked UK Bonds	1.4%	-1.2%	-5.0%	-2.4%	-3.6%	2.3%
Gilts	0.3%	-0.4%	-2.5%	-2.0%	-1.2%	-1.2%
Global Government Bonds (hedged)	0.0%	-0.8%	-1.0%	-0.7%	0.3%	-2.7%
Enhancers						
Global Corporate Bonds (hedged)	-1.1%	-1.4%	-1.3%	-1.8%	1.4%	1.9%
Global High Yield (hedged)	-1.1%	-0.4%	0.3%	-0.7%	3.4%	12.8%
Emerging Market Bonds (hedged)	2.1%	3.4%	-3.3%	1.8%	2.7%	12.7%
FTSE 350 TR Index	-3.3%	-0.6%	-0.9%	-5.2%	4.2%	19.7%
FTSE UK All-Small Cap	-3.0%	-0.5%	1.3%	-3.0%	11.2%	34.3%
Global Equity (MSCI)	-1.1%	0.5%	1.8%	-0.9%	6.0%	28.0%
European Equity (MSCI)	-2.7%	-0.7%	-1.8%	-2.3%	9.2%	27.4%
US Equity (S&P)	-0.7%	1.0%	3.4%	-0.1%	5.1%	28.5%
Japan Equity (Topix)	1.7%	1.9%	6.5%	0.9%	11.4%	36.7%
Pacific Ex Japan Equity (MSCI)	-1.7%	3.5%	4.0%	1.0%	20.4%	47.3%
Emerging Market Equity (MSCI)	-1.6%	5.2%	3.4%	1.5%	17.9%	43.8%
Chinese Equity (Hang Sang)	-3.0%	3.9%	4.0%	1.3%	20.8%	50.1%
Indian Equity (Nifty)	-4.8%	0.0%	-2.6%	-4.0%	10.8%	29.8%
Diversifiers						
Commodity Index	-1.9%	2.7%	4.0%	-0.1%	0.3%	-1.3%
Gold	1.4%	1.4%	-6.8%	-1.3%	-5.8%	-4.7%
Silver	-2.2%	-2.3%	-13.1%	-6.3%	-20.8%	-16.8%
Brent Oil	-1.9%	1.2%	17.5%	-3.2%	7.5%	28.5%
UK Property	0.2%	1.6%	3.5%	0.8%	7.2%	9.4%
Global Property Shares	-5.1%	-0.2%	-1.5%	-7.8%	2.1%	9.7%
Rivers Model Portfolios						
Rivers Preservation Portfolio	*-0.2%*	*0.1%*	*0.4%*	*-0.3%*	*2.0%*	8.9%
Rivers Cautious Portfolio	*-0.7%*	*0.0%*	*0.7%*	*-0.7%*	*3.2%*	14.3%
Rivers Balanced Portfolio	*-1.0%*	*0.0%*	*0.9%*	*-1.0%*	*3.8%*	17.6%
Rivers Adventurous Portfolio	*-1.1%*	*0.0%*	*0.6%*	*-1.3%*	*3.7%*	19.4%
Rivers Aggressive Portfolio	*-1.6%*	*-0.1%*	*1.0%*	*-1.6%*	*5.5%*	24.7%
Rivers Cautious Income Portfolio	*-1.1%*	*-1.0%*	*-1.5%*	*-1.6%*	*0.1%*	6.5%
Rivers Balanced Income Portfolio	*-1.3%*	*-0.9%*	*-0.8%*	*-1.7%*	*1.6%*	12.0%

Source: Financial Express in GBP (unhedged unless stated) as at 31st January 2018. *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.