Stonehouse Core Value Portfolio

Monthly Update – September 2018

stonehouse

September Performance Overview

The Stonehouse Core Value Portfolio (CVP) returned -0.20% in September as volatility returned to equity markets. The Australian equity market posted a negative return (-1.60%) while the MSCI World Index posted a modest gain (+0.60%) led by the Japanese equity market (+5.5% in local terms).

Within the domestic equity component of the Portfolio, Allan Gray Australian Equity was the standout performer (+1.8%) positing a positive return while the local market was negative, indicative of its contrarian characteristics. The remaining managers posted negative returns led by the beta exposure held in Macquarie Australia Shares True Index (-1.2%), IML Equity Income (-0.9%) and the small cap exposure SGH ICE (-0.2%).

Performance of the global component of the Portfolio's equity investments was mixed. The top performing strategy was the Blackrock iShares Japan High Dividend Yield ETF* (+4.7%), which posted a strong return as Japanese equities rallied. This was closely followed by Lansdowne European Equity* (+4.6%) which had a solid quarter (+8.2%). Wingate Global Equity Income (+0.3%) also posted a positive return. The worst performer within global equities was the small cap exposure Lazard Global Small Caps (-2.0%), followed by Northcape Emerging Markets (-1.9%), Platinum International (-0.3%) and Old Mutual World Equity* (-0.2%).

Within Alternatives the top performing strategy was the GMO SGM Major Markets Trust (+0.7%). The remaining managers detracted from returns led by the Bennelong Long Short Equity Fund (-3.9%) which reversed some of the previous months' strong gains. This was followed by Ellerston Australian Market Neutral (-0.8%), Invesco GTR (-0.3%) and Watermark Market Neutral (-0.2%).

The Property and Infrastructure sector posted mix results with the top performing strategy being Resolution Global Property (+4.1%), benefitting again from the decline in the $A and following its strong return in August with another excellent month. The remaining two managers detracted from returns led by Cromwell Phoenix Property Securities (-0.9%) and Lazard Global Infrastructure (-0.2%).

Performance of the domestic and global bond managers contributed positively to the returns of the portfolio. The top performing manager was the largest exposure via T Rowe Dynamic Global Bond (+0.7%) which reversed some of the previous months' lacklustre performance. This was followed by CQS Credit Multi Asset (+0.5%), Ardea Real Outcome (+0.2%), YBR Smarter Money Active (+0.2%) and Payden & Rygel Global Income Opportunities (+0.1%).

Trades were implemented during the month in an effort to position the equities holdings in the Portfolio more defensively. The J O Hambro Asia ex Japan fund was redeemed as was the Lazard Global Small Cap Fund. The funds were partly rotated into the diversified managers Platinum, Old Mutual and Wingate and partly to boost cash reserves. These adjustments reflect the Investment Committee's commitment to minimising losses as well as ensuring the Portfolio is able to take advantage of opportunities during expected heightened volatility.

*In local currency terms.

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Portfolio Summary

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Unit Price at 30 September 2018		$1.1094
Asset Class Ranges & Current Allocations		**Current Exposure**
Cash & Fixed Interest	15% - 60%	31.4%
Property	0% - 25%	4.6%
Equities	25% - 65%	45.1%
Alternatives	5% - 35%	18.9%

Top 10 Investment Holdings (ex cash)	
1.	Old Mutual World Equity
2.	Wingate Global Equity Income
3.	Macquarie Australian Shares True Index
4.	Northcape Emerging Markets
5.	T Rowe Dynamic Global Bond
6.	Platinum International
7.	Invesco GTR
8.	Payden & Rygel Global Income Opportunities
9.	Ardea Real Outcome
10.	SGH ICE

Market Performance and Outlook

September was a mixed month for world financial markets, with falls in a number of equity markets, including Australia. Bond-sensitive equities such as REIT's performed particularly poorly as the US 10 ten-year bond yield rose through 3.0%. The divergence between US monetary policy and that of other developed countries continued in September. In particular, while the US Federal Reserve lifted its cash rate by another 0.25% and flagged its intention to continue doing so into 2020, other countries left their cash rates steady. This included Australia, where the Reserve Bank once more left the cash rate at 1.5%, and the ECB which left the cash rate at 0% and said it has no plans to change this until well into 2019. An important consequence of this divergence is that the A$/US$ has continued to decline. The A$ finished August at US$0.726 and fell to US$0.71 by mid-September before recovering to finish the month that US$ 0.72. Geopolitical developments in the US, UK and Italy contributed to market nervousness and volatility.

Global liquidity conditions will continue to tighten as we move into 2019. Not only will the US Federal Reserve continue its program of adjusting monetary policy, but the ECB has said it will start its quantitative tightening program in coming months. The ongoing strength of the US economy has surprised many commentators. Strong growth is exacerbating capacity constraints and increasing the likelihood that our forecasts of higher inflation will be realised. That in turn increases the risk of the Fed tightening more than the markets currently expect, which would push bond yields and the US dollar up, leading to further pressure on the emerging market economies which are struggling at the moment. At some point the odds are that all this spills over into a more significant correction in global equities across the board.

The strategy of managing equity market risk by lowering outright allocations to equities, combined with selected hedges, including foreign currency, is seemingly sound. Another facet of risk hedging, alternative strategies, have been less effective because of the distortions within markets driven by the final stages of "risk-on". If our expectations of higher US bond yields triggering further volatility in global markets come to pass then this would be a better environment for alternatives strategies to add value and fulfil their role in the portfolio.