EPOCHONOMICS

SUMMER 2017

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WEALTH MANAGEMENT

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INTRODUCTION

Welcome to the Summer 2017 issue of Epochonomics, our take on the financial markets and the financial planning opportunities (and threats) they may present.

Following feedback from clients, we've decided to make Epochonomics a six-monthly publication. It's proved hard to please all clients on this as some like a quarterly newsletter and others don't. However, on balance, due to several factors, we've decided it's right to move to less frequent distribution. The next issue will therefore arrive in January or early February 2018.

In this issue, Epoch's Managing Partner, Barry Newbury, completes the series we've run over previous issues on the tax, legal and corporate finance issues an entrepreneur needs to consider when thinking of selling their business.

We also have an interview with one of the fund managers that's represented within our portfolios. This time, it's the turn of Fidelity's Emerging Markets fund. James Barber, our Head of Investments, also gives us the Investment Team's take on the wider economy.

Finally, we have an update on Epoch news and we introduce you to a member of the team here. This time round, it's the turn of Helen Cameron, who's Markas' assistant.

As ever, if you have any comments about the content, please let me know. If we aren't giving you information on something you'd like to see us cover, or if we aren't doing things in a way you can engage with, I'd love to hear from you! Email me at tom@epochwm.co.uk or call me on 01225 487261.

Tom Annear
Head of Business Development and Marketing

EPOCH NEWS

Richard Barrington
Chief Operating Officer

This quarter has seen Epoch shortlisted for two more awards – Money Marketing's Adviser Firm of the Year and the UK Platform Awards' Leading Adviser firm. This marks the second time of being shortlisted for each. We were Highly Commended in the Money Marketing Awards this time round and hope to go one better in the UK Platform Awards in September.

Although some awards are barely worth the effort, these are two which really are. To be highly commended by an industry leading judging panel of a well-respected award effectively says we're the second-best firm out there (we think we're better than that, naturally!).

The quarter was rounded off by being classed as one of the top 100 fastest growing companies in the South West by Insider Magazine, another respected financial publication.

Away from the awards, we've recruited another paraplanner to help with our growing client bank. Gemma Statham has worked in Financial Services for a number of years and her appointment marks the start of another exciting chapter of our growth. We've also re-launched our website. Please take a look and let us know what you think; we've focused much more on client stories this time round.

Finally, Mel Gogarty recently scaled the Lares Trail to reach Machu Picchu in aid of CLIC Sargent. A higher and harder route than the Inca Trail to arrive at the same destination, Mel slugged it out and got to the destination in one piece. She raised more than £600 for the charity which is a strong effort!

Mel Gogarty

THE EPOCH INTERVIEW

THE FINANCIAL PLANNING ASPECTS OF SELLING A BUSINESS

Barry Newbury
Managing Partner

Rounding off our series on the various elements entrepreneurs should consider when selling a business is our own take on the matter. Epoch's Managing Partner, Barry Newbury, explains what the firm believes entrepreneurs need to consider from a financial planning perspective when thinking about a potential business sale.

Q1 Hi Barry, can you explain what Epoch does for entrepreneurs considering an exit?

The actual selling of a business is only a part of what is often a seismic change in a client's life. It can take years of planning prior to the sale event and often takes some considerable time after the sale to acclimatise to the changed circumstances.

When we first sit down with a client who's considering selling a business, our key questions to them are not at all financial. We ask them about what they want out of life. We ask them to visualise what life looks like post exit. We ask them to imagine a life with no income and someone else in control of their business. How do they feel about that and are they prepared for it?

Do they want to go again? Do they want to sit on a beach / golf course from then on? Do they want something in between? Knowing these key drivers allows us to help with the next stage – the financial considerations of a potential sale.

Q2 So, what discussions happen next?

Once clients are clear on what they want their life to look like post-exit, we can start getting more forensic. Clients will often have an aspirational 'magic number' in their mind as to what they want to sell the business for. However, this may have no real link to the real value of the business or, importantly, the sum of money they need to tick all the items on their 'bucket list'.

Many of these things are not immediately obvious to our clients and it's only through asking a series of probing questions that we manage to tease this information out. In fact, much of the value clients derive from the process comes from us drilling down on the subconscious targets they have set themselves and challenging them. Often, this is the first time many clients have been forced to really think about these things rather than just focussing on a sale value.

For example, we ask them what their current 'burn rate' on cash is. We challenge how accurate that is and then ask them how that burn rate could change post-sale. More holidays? More property or other assets? More / less expenditure on the core costs of living?

Let's not forget, this is one of the biggest decisions a client will ever make and to think it is often done without any real analysis of the numbers and data is incredible.

Q3 When do these conversations take place and what are the next steps?

Even if a sale is just an idea in a client's head, they should have a chat with a financial planner and a Corporate Financier as early as possible. Armed with the information we'll have collected, a Corporate Financier can then explain the likelihood of structuring a deal in the way they want. From there, and in conjunction with their lawyers and tax advisers, a plan can then be put together to get the business into the strongest possible shape and achieve the best possible result.

A prospective buyer will want to get under the bonnet of the business and if you have all the data ready for them in advance, it's a massive tick in the box. That means a proper handle on all the facts and figures, a succession plan ready and so on.

Preparation is everything to a deal. The more time your professionals have to get your business to the point you can extricate yourself with minimal loss of value, the better.

Q4 What other considerations are there?

The shape of any potential deal could have a massive bearing on your final "magic number" and it's crucial to have fully explored the emotional aspects of the deal – will you be able to work for someone if there's an earnout period, for example – to again ensure you make the most of the opportunity.

Q5 Finally, are there any financial planning solutions in advance of a sale a client should be aware of?

In short, yes. As a result of working with clients in this situation over many years, we are aware of a number of planning opportunities that can help business owners that sell their business down the line.

These planning opportunities are largely centred around tax but can make a significant difference to their personal financial position if executed correctly. Some of these things are relatively obvious but some are almost always missed and can be very expensive in the wrong circumstances.

For more information, please contact your adviser or email Tom: tom@epochwm.co.uk. We will be looking to bring the four articles together into a white paper in the near future. If you'd like a copy, let Tom know by emailing him.

ECONOMIC UPDATE

MACRO-ECONOMIC OVERVIEW AND OUTLOOK

James Barber
Head of Investments

The main political event during the second quarter was the General Election. Prime Minister May had called the election in the hope of consolidating the Conservative party's majority and push forward her view of an orderly hard Brexit. Ultimately her hopes were dashed as the 318 seats they won was just short of an outright majority, and left the Conservatives requiring support. This was achieved by way of a confidence and supply agreement from Northern Ireland's Democratic Unionist Party.

We will never know the exact reason for May's sharp fall in the opinion polls, but the poorly run Conservative campaign clearly cost votes. In particular, the decision to put forward the unpopular "dementia tax" into their manifesto, only to then do a very public U-turn was a factor. Also, the decision to aggressively target Labour held seats, rather than focus more time on those marginal Conservative seats will have contributed. It was a sign of the over-confidence within the Conservative camp. But there was also strength from within the Labour campaign, in terms of running with a populist manifesto that particularly struck a chord with younger voters (turnout for the youth vote was up significantly from the 2015 election).
The implications of the election result is that there has already been a tangible shift towards a softer Brexit as the nation did not back the 'hard Brexit' mandate Prime Minister May had sought. From an economic perspective, this is expected to be a better outcome in the short-term (long-term remains unclear), but it also increases the risk of a 'no deal' outcome, that would be a negative outcome from an investment perspective. The shift towards a 'soft Brexit' outcome has led to a slight reversal in Sterling, recovering some of the falls seen in the second half of 2016, following the Brexit vote.

THE UK – AN ECONOMY ON THE EDGE?

Looking at the UK economy, we have seen concerning signs developing in the data. With the sharp increase in UK inflation – brought about by a combination of Sterling depreciation and the rebound in the oil price – wage growth has now turned negative in inflation adjusted terms (Figure 1 opposite). This feeds into consumer confidence and spending habits, where we have already seen a sharp fall in retail sales figures.

The prolonged period of abnormally low interest rates has punished savers. In response, over the past 7 years, the UK household savings rate has fallen dramatically and is currently at multi-decade lows. Indeed, low interest rates have also incentivised households to borrow more, which has helped drive up property prices. Also, unsecured borrowing has helped drive retail sales volumes higher over that period. Naturally, from an investment perspective, this is a concern to those companies most sensitive to the domestic economy, although much of these risks are already priced in. As

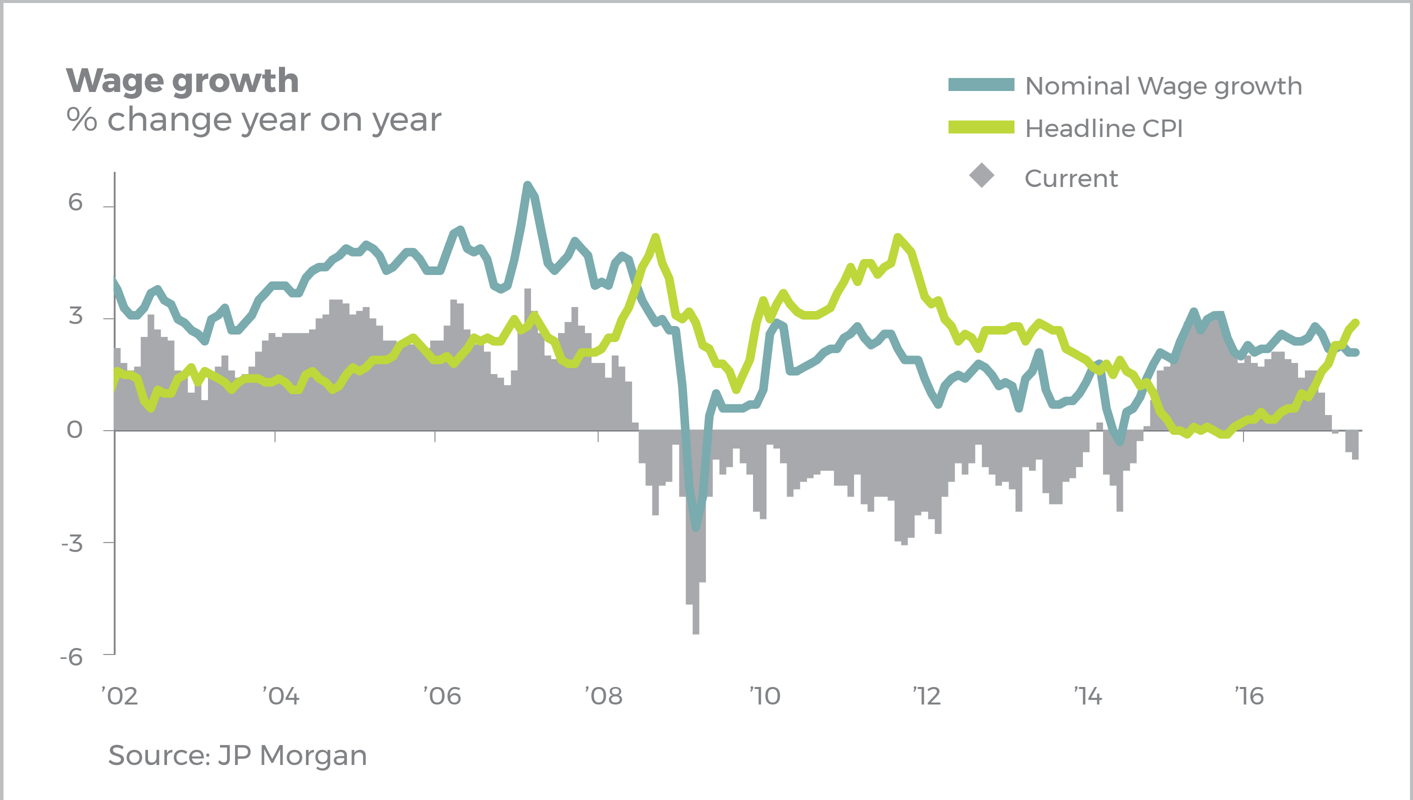


Figure 1 UK wage growth compared to inflation

such, it is not simply a case of ignoring such companies, e.g. UK retailers, as share prices may have fallen sufficiently to represent interesting investment opportunities. This is the focus of Epoch's Investment team discussions at the current time and we'll report more when we have clarity and consensus.

THE GLOBAL ECONOMY – IT CONTINUES TO LOOK ROBUST... BUT IS A RECESSION COMING?

Outside the UK, the global economy continues to grow steadily. As Figure 2 shows, economic growth since the Credit Crisis has been much lower than in previous economic expansions (RHS) although in terms of duration (LHS), at 96 months, this represents the third longest period of economic expansion in over 100 years.

While we see evidence that the duration of expansions has increased in recent decades, investors are questioning at what point the next recession will hit. With the U.S. that much further ahead in terms of an economic recovery, it is natural to look at U.S. data for signs of a recession. Not least as a recession in the U.S. will impact on investment markets globally.

Neither unemployment data (which continues to trend downward), nor consumer confidence data signals an imminent U.S. recession. From our perspective, the main area of concern relates to corporate profitability. With U.S. unemployment running at 4.4% (June 2017), and an expectation that this figure will

ECONOMIC UPDATE (CONTINUED)

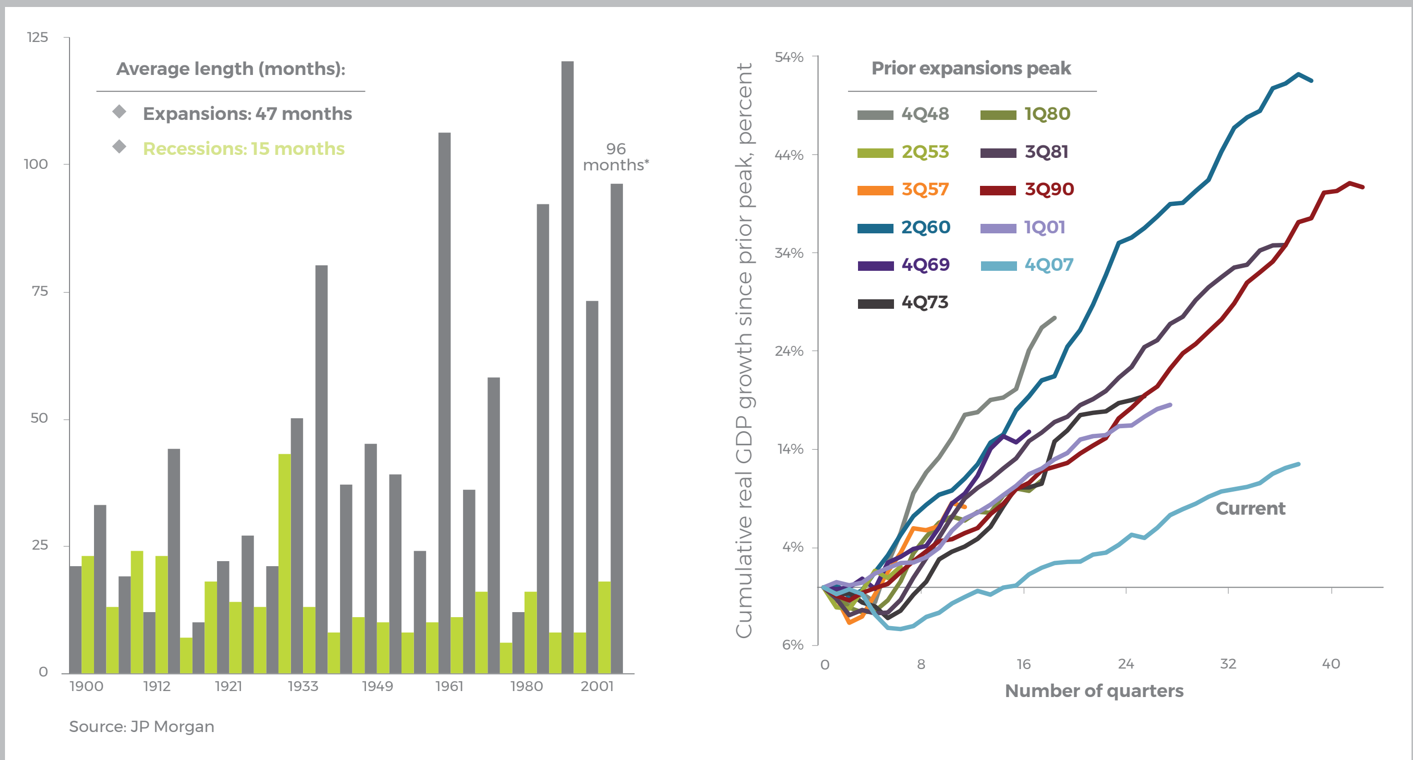


Figure 2 Economic expansions, magnitude and duration

continue to move down through the rest of 2017, coupled to data such as the ratio of new hires to job openings or the ratio of vacancies to unemployed, there is a clear indication that we are moving to an environment where there is a scarcity of skilled workers. Not only could the shortage of labour act as a brake on the economy, but also the supply / demand imbalance should lead to increased pressure on wages. Coming at a time when the Fed is raising interest rates, this could put pressure on two meaningful costs business faces i.e. labour and debt servicing costs. The concern is that if profits continue to be squeezed (noting the corporate share in percentage terms of overall GDP has already fallen from c. 66% to c. 63% in the past couple of years), companies will have to react to maintain profit levels through cost cutting programs. These would have the potential to act as the catalyst to a self-fulfilling economic slowdown.

Ultimately, we believe that when considering the balance of risks, it is unlikely that a U.S. recession will manifest this year, although we continue to be prudent with our equity allocation within portfolios. We continue to favour equities relative to both cash and fixed interest securities, but feel that given the potential absolute risks that we should moderate our equity allocation towards neutral positioning and utilise alternative sources of investment return, to supplement the allocations to the more traditional asset classes.

VALUE VS GROWTH – IS THERE AN OBVIOUS WINNER?

Another reason for moderating our equity allocation is valuation. This is something we have discussed in previous editions of Epochonomics.

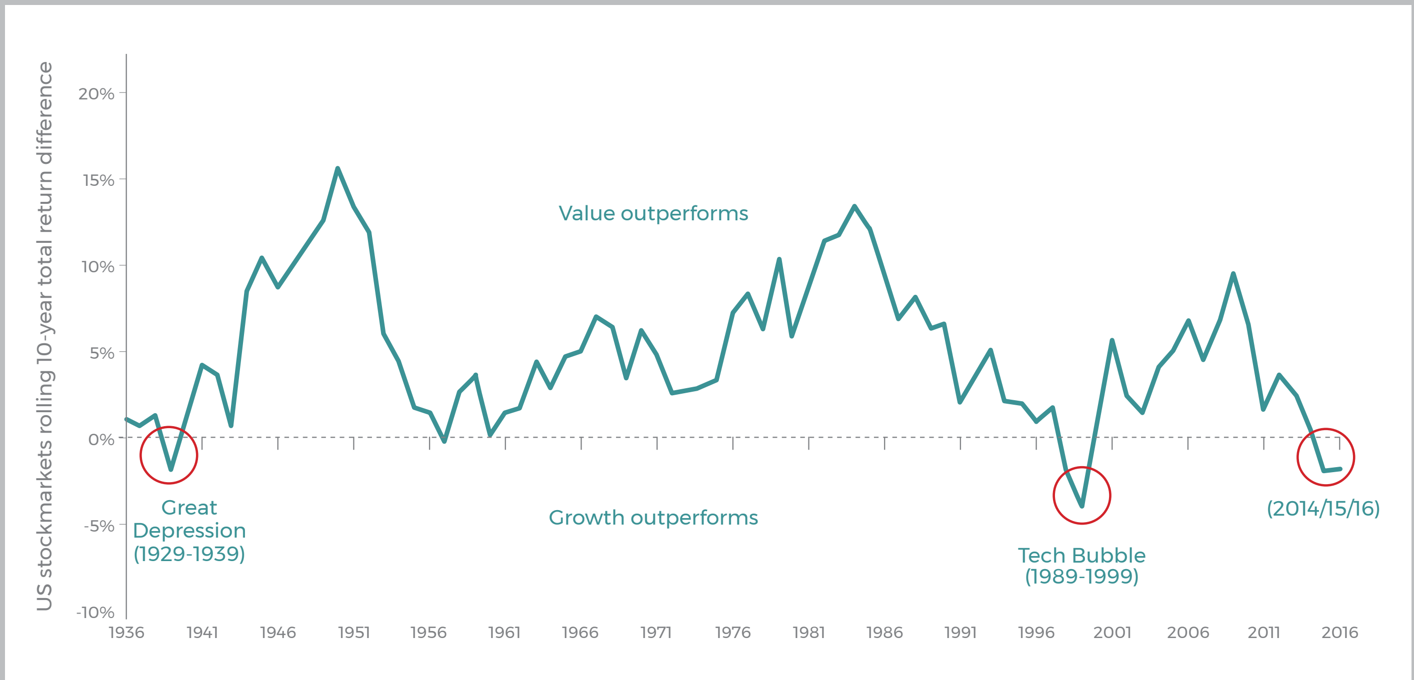


Figure 3 Value Vs Growth: Rolling 10 Year total return difference (U.S Stock Market)

With most asset classes having performed very strongly since 2009, many investments look either at fair value or expensive. Naturally, it is the latter that we are most concerned with, as over-paying for an asset has a logical negative impact on the future potential returns.

One of the most discussed investment strategy decisions at the moment is that of 'Value' versus 'Growth'. To try and explain the difference, "Value" investors generally look to buy stocks that are cheap, often on the premise that either the share price will revert to mean or that there is some positive change within a business that has not been recognised by the market. This style of investing often leads investors into uncomfortable investments, since in order for a company to be cheap, there will be one or more negative factors weighing on the stock price.

"Growth" on the over hand, is more about investing in businesses where earnings are growing, and will hopefully compound over time. The type of growth can range from steady and predictable, such as in the case of consumer staple businesses, through to growth that is uncertain but potentially massive, as would be the case with many internet / disruptive technology stocks. Logically, a company that is expected to grow meaningfully over time will be more expensive on current valuation metrics versus a Value stock; however, the critical question is how much more should an investor be willing to pay for growth (and indeed the certainty around that growth)?

As can be seen from Figure 3, which shows the rolling 10-year relative return from the two styles, value as a style has rarely underperformed over a longer time period. One of the key reasons for the recent relative underperformance has been the strength in performance in "quality growth", i.e.

ECONOMIC UPDATE (CONTINUED)

companies that have predictable revenue streams that are able to consistently grow profits over time. In simple terms, investors have been willing to pay a large premium for the visibility of earnings growth and perceived safety of such companies. In addition, as interest rates have fallen, stocks that are negatively correlated to longer dated bond yields have risen.

Value as a strategy tends to outperform in periods where inflation (and therefore interest rates) is rising. For example, banks are able to earn higher net interest margins. Similarly, insurance companies are beneficiaries of higher interest rates as they can achieve a higher investment return on their assets. This could be a useful characteristic in an environment where central banks globally move towards normalisation of interest rates. From where we stand today, 'quality growth' stocks face a headwind simply on valuation grounds, caused by a prolonged period of outperformance, where investors have been willing to pay ever higher multiples for safe and predictable earnings streams.

Over a twelve-month period, starting towards the end of 2015 through to October 2016, we gradually shifted portfolios from a balance between the two styles, towards a notable value bias. This was a contributing factor to the strong returns seen in the last quarter of 2016, although value as a style has struggled again in 2017. On a longer term outlook, we feel comfortable with the current value tilt within the portfolio, noting we still retain exposure to growth managers. Clearly, we want to retain exposure to companies that are growing, just favouring managers who would be described more as "growth at a reasonable price".

REGIONAL ALLOCATION: EUROPEAN EQUITY REMAINS OUR LARGEST REGIONAL OVERWEIGHT

As we highlighted in last quarter's Epochonomics, our portfolios are generally

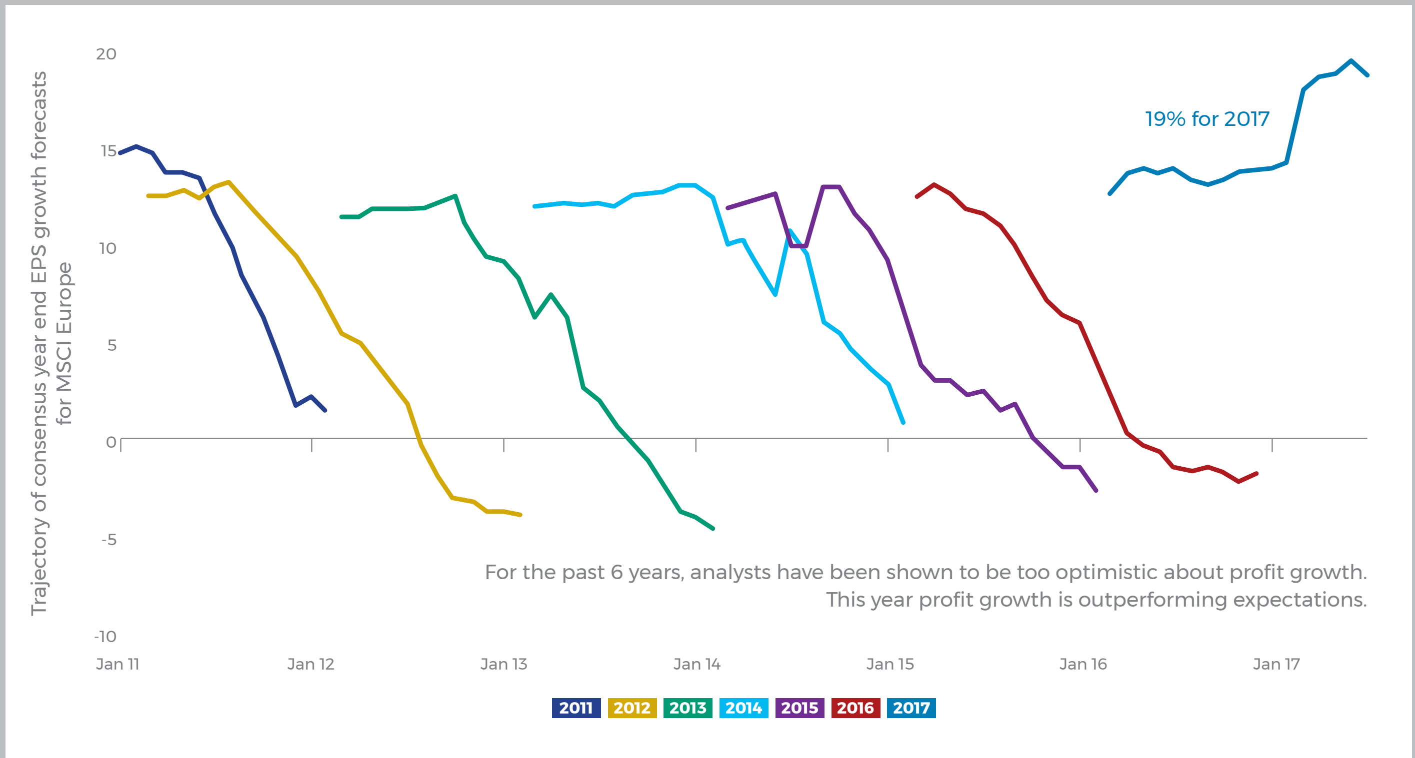


Figure 4 European equity analyst's earnings expectations over time

overweight non-U.S. equities (specifically European and Asia/Emerging Markets). These are positions we have held for some time, so it would be wrong to suggest we have perfectly timed the strength in these markets; however, the rationale for taking the positions is what is driving current outperformance, and indeed we have seen our European equity overweight shift from being quite a lonely position, to one of the most talked about active allocations this year.

The primary reason for this is that earnings forecasts have been extremely resilient in 2017. As Figure 4 shows, analysts usually start the year very optimistic with expected profit growth around 15%, and then each year these expectations are gradually marked down to end the year with final growth numbers at or below zero. 2017 has been very different, as not only have earnings growth forecasts not fallen, they have actually been revised upwards.

While European equities currently look like other regions on simple valuation metrics, if earnings can maintain these growth rates, then European equities could start to look much more attractive further out. The point we observed last quarter was that while U.S. earnings have risen to all-time highs, Europe (and indeed other regions such as Emerging Markets) have yet to pass the pre- Crisis peaks, and potentially could benefit from a degree of catch-up in earnings versus the U.S. As discussed above, it is essential to be aware of data coming out of the U.S., as even if underweight the region, U.S economic strength is critical to the success of both European and Emerging Market equities.

MEET THE MANAGER

FIDELITY EMERGING MARKETS

Nick Price
Fund Manager

Q1 Could you give our investors an overview of the Fidelity Emerging Markets fund, particularly in terms of what you see as the key elements of your investment style and strategy?

Emerging market investing is as much about what you don't own as what you own. In this context, our index-agnostic approach and focus on high quality stocks with earnings potential through the cycle is designed to offer investors a less volatile play on emerging markets with attractive total return potential.

We invest in companies with low levels of debt and structural competitive advantages that enable them to generate superior and sustainable returns on assets. These characteristics permit them to withstand competitive pressures, fund the growth of their business and achieve attractive returns for minority shareholders. This long-applied investment philosophy forms the basis for a disciplined emerging markets investment process that has delivered consistent outperformance for investors over time.

Q2 What do you see as the current opportunities for investors who are allocating to Emerging Market equities?

Over the first half of the year, emerging markets outperformed developed markets by 7.5% in GBP terms. This is the largest margin of outperformance in the first half of the year since 2009; June was the sixth straight month in which emerging markets outperformed developed markets, only the fourth such streak in the last 20 years. In short, emerging markets are attracting investor attention.

The rally this year has largely been driven by internet and technology-related stocks, some of which are classified in the consumer discretionary sector where we have a large overweight within our fund.

In China, for example, the overall focus remains firmly on moving the economy's move towards domestic consumption, rather than fixed asset investment. One of the key pillars that this is being built on is the growth of e-commerce. For example, not so long ago, expectant Chinese couples would head to Hong Kong to buy the leading infant milk formula. Now they can buy it online. Likewise, the luxury goods they used to buy in places like Paris or Milan can now be bought online too. Online retail sales make up 33.4% of total sales in China .

The development and penetration of e-commerce in China and other emerging market countries is outstripping even developed markets and is one of the key opportunities we play in our fund.

India is one of our favourite countries to invest in. Lower oil and food prices are putting a lot more money in Indian consumers' pockets,

which will help drive demand for consumer goods and services such as banking. That, in conjunction with the ongoing economic reforms in the country, makes investing in India an attractive proposition.

Q3 Following on from question two, what do you see as the immediate risks or threats facing investors who are allocating to Emerging Market equities?

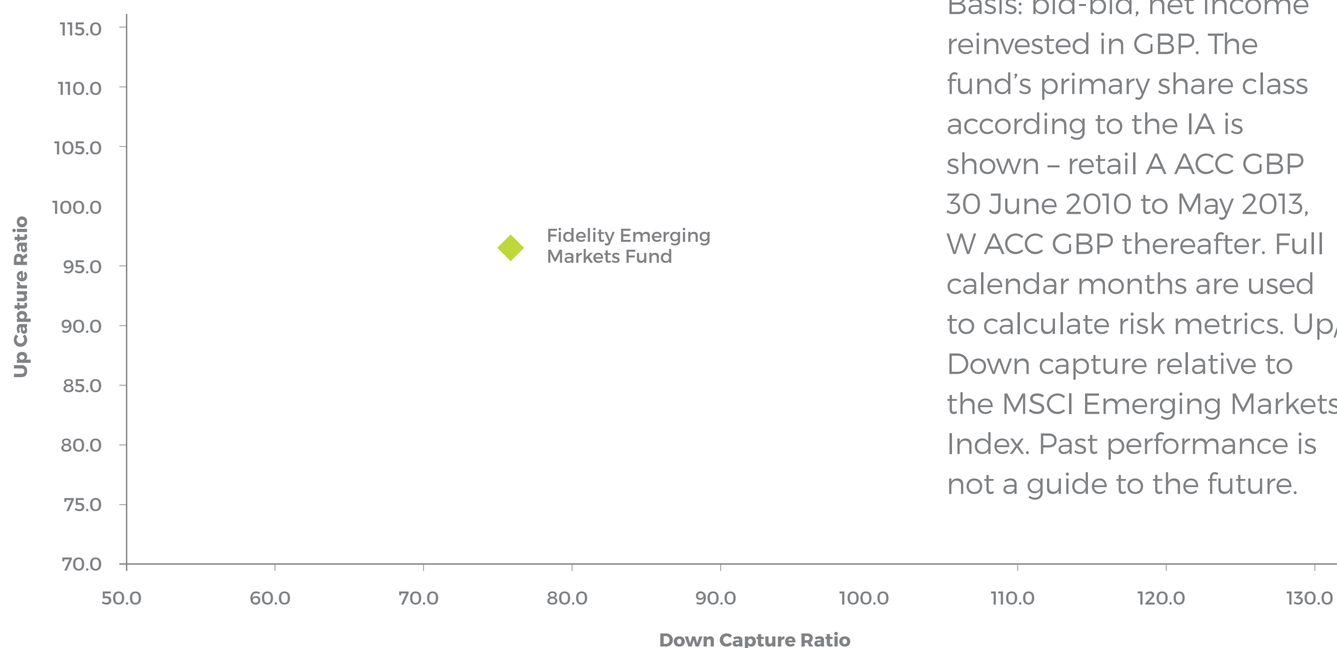
Emerging market investing is a broad category; encompassing countries as divergent as South Africa, India, China and Turkey, all with their own unique issues and economies. The next political crisis is never far away, with the news flow surrounding Turkey's Erdogan and South Africa's Zuma prime recent examples.

We remain cautious on companies with large state ownership, where capex is potentially misdirected by the government and results in a permanent destruction of capital.

At the individual company level, we would be wary of businesses like Petrobras where the debt burden subsumes all equity value. In 2016 many stocks like this were bid up as a function of being large constituents in the index or seemingly cheap. As the market has refocused on results, this trend is reversing itself and a number of the portfolio's holdings are showing strong upside.

Q4 Are there particular economic conditions where the Fidelity strategy should outperform on a relative basis, and conversely what are the conditions where the strategy would be expected to underperform?

Through its focus on strong sustainable returns on assets for shareholders, the Fidelity Emerging Markets Fund has historically offered very good downside protection during market declines which is highly beneficial to long-term performance in a volatile asset class.



Source: Morningstar Direct. Basis: bid-bid, net income reinvested in GBP. The fund's primary share class according to the IA is shown – retail A ACC GBP 30 June 2010 to May 2013, W ACC GBP thereafter. Full calendar months are used to calculate risk metrics. Up/Down capture relative to the MSCI Emerging Markets Index. Past performance is not a guide to the future.

Figure 1 Protecting on the downside

The chart shows the proportion of market upturns and downturns that is captured within the fund. The ideal position is top left, where you capture most upside and least downside. Our ability to protect from nearly 25% of market falls, whilst sacrificing only about 5% of the market upturn in return has helped performance.

The only period through which the fund might underperform the market is when sentiment is driving the market and the prices of certain stocks are bid up purely as a function of being large constituents of the index. This occurred in 2016, when large and heavily debt-burdened companies such as Petrobras performed well despite poor underlying fundamentals.

Q5 Can you provide an example of a key active position in your portfolio and the investment rationale behind it?

An example of a company well-placed to benefit from the consumer growth story in emerging markets is HDFC bank. As India's leading private bank, HDFC is a company which is ideally placed to take advantage of the country's low credit to GDP ratio and gain market share from public banks.

The demonetisation that was imposed towards the end of last year is another example of the bold reforms implemented by the government. HDFC was well placed to benefit thanks to its forward-looking approach to digitising its back office and it is also growing its loan book at a rate of 20% per year.

This strong foundation was further validated by encouraging earnings announcements. HDFC currently services 37m customers in a country of 1.2bn people, providing a long-term growth opportunity that simply does not exist for comparable businesses across the developed world.

STAFF PROFILE

HELEN CAMERON

Helen Cameron
Markas' assistant

We try to be as transparent as possible with our clients and contacts. That said, it's possible that you may only have regular contact with a few Epoch staff. To help you better understand the depth of talent we have here, this final section introduces you to a member of staff you may not have dealt with before. This time, we meet Helen Cameron who is Markas' assistant.

Q1 When did you join Epoch?
In January 2016, I came for an interview just to find out what Epoch was about and after my first interview I knew it was a place I wanted to work.

Q2 What does your day to day job entail?
It is incredibly varied position and it keeps me out of mischief! I coordinate Markas' work life and prepare him for all his client meetings.

Q3 What's the best thing about working here?
The family feel, socialising, the company culture and banter. I love the variety of work and the constant learning; you could never get bored at Epoch! Markas' clients are particularly lovely and I really enjoy my contact with them.

Q4 And the worst?
It's busy place to work and discipline is sometimes needed to go home. The clients are so lovely you want to do the very best for them.

Q5 What might someone be surprised to learn about you?
Every year I try something new or visit a place I've never been to before, I love an adventure and will try most enjoyable challenges, it's all about the fun times! I have a special family anniversary set a side when my son and I do whatever we like – no holds barred.

Q6 When you're away from the office, what do you enjoy doing?
Relaxing with friends and family. More than anything I love to dream of my next adventure. I recently took my son to Cape Verde where we took some diving lessons, jumped off the cliffs into the sea, saw a mirage for the first time, watched turtles laying their egg, did a bit of snorkelling and stand up paddle boarding. I spend a lot of effort supporting my son's endeavours and this year I've had the pleasure of seeing him finish the Ten Tors Challenge and his School's Centurion Challenge; 100 miles in 48 hours!

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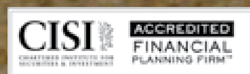

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Please note the content of the Meet the Manager article is from Fidelity's emerging markets team rather than specifically in Nick's name.

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