

ROSSIE HOUSE INVESTMENT MANAGEMENT

December 2018

Rossie House Investment Management has had a busy year. It is now ten years since the great financial crisis. As we move into the winter months security markets are having to deal with a somewhat different environment from that which has prevailed for the past decade. Ever since Lehman's bankruptcy, governments and central banks have been widely supporting markets. This has been through sustained, historically low interest rates combined with unusual monetary measures. Both have now started to reverse.

We start with the usual market commentary. The outlook is not a pea souper but we think the fog is particularly thick over the English Channel. Despite changing conditions, client portfolios have long been positioned with one eye on the downside risks.

The newspapers this year have been full of Russian espionage and cyber sabotage. Regulations introduced in May (GDPR) have also caused everyone to look at their data. We are aware of the precious nature of the data we hold on your behalf. A number of years ago, we decided we needed to take outside advice on security from our technology adviser, Netopa. We include an edited article about some of the protections we have in place. Over the coming months, we intend to carry out a simulated "cyber attack" to test our 'firewalls' and nerves. We continue to invest to ensure the highest levels of data integrity.

Two centuries after the birth of Karl Marx and in the year that China gifted a statue of the great man to Germany (where he was born) it seems a timely moment to review his Communist Manifesto. The uncertain political environment, not just in Britain as a result of Brexit but also in other European countries, brings this previously unimaginable prospect closer than it has been for many years. Although the manifesto is dated, we felt it might interest readers to remind them what was in it.

In "Family Matters" we pay tribute to Irene Goodall as well as note in passing that several of our younger fund managers have been expanding their families.

<u>CONTENTS</u>	<u>PAGE</u>
Introduction	1
Market Thoughts	3 - 4
Cyber Defence	5
Karl Marx – The Communist Manifesto	6 - 7
Family Matters	7

MARKET THOUGHTS

It feels as if markets are currently making their way through fog in choppy seas. The fog is quite dense in the English Channel, so to speak, given the uncertainty around Brexit. Two key landmarks have been visible through it: the dry land of the thriving, productive US economy and markets, and the rocky hazards of weak Emerging and Asian markets.

Markets fell quite sharply in October, driven by a coalescence of worries over rising US interest rates, trade friction and turbulence related to politics in Europe. Brexit has been joined as an anxiety by the challenge to European budgetary oversight from the populist Italian coalition government. President Trump has lost control of the lower house and retained control of the Senate in the US mid-term elections. Whilst this is not unusual in US electoral cycles it adds further uncertainty to muddled world politics. The MSCI WMA Private Investor Index is down slightly so far this year, at the time of writing.

The US economy continues to produce strong growth in GDP and employment. Corporate tax cuts have been a boost to the profits of US companies and profits (measured by earnings per share) are forecast to rise by 23% over 2018. Fiscal stimulus in the form of government borrowing and spending has added another layer of icing to the cake. The US is also home to some of the world's most innovative and productive companies. Many of these technology-related shares have lost ground in recent weeks leaving the equity market broadly flat so far this year. A strengthening dollar - 5% against sterling - responding to the strong economic climate and interest rate rises, has brightened the picture.

In the strength of the US can be seen the seeds of weakness in Emerging Markets. Dollar borrowing has been an Achilles heel for Emerging Market and Asian countries. Turkey and Argentina, countries with high levels of external debt (and trade deficits), have seen their currencies weaken, inflation rise and growth slow. Another US export – President Trump's 'Trade War' rhetoric and tariffs on China – has also had a negative effect on equities in these regions. Investors have been quick to 'read across' from structurally challenged to ostensibly healthy markets. Asian and Emerging Markets have been the weakest areas of world equity markets.

Whilst Emerging and Asian stock markets have borne the brunt of US 'Trade War' talk, there has been some contagion among other world markets with Japanese and Continental European equities posting losses for sterling investors this year.

The uncertainty over Brexit, a phrase which has become tediously familiar, is affecting confidence in the UK. Businesses are somewhat reluctant to spend on new productive capacity, and consumers show hesitation to spend on both necessities and frivolities such as restaurants. UK GDP growth is pedestrian at 1.5% and inflation is stubbornly higher. The threat of a redistributive left-wing government remains. On a more positive note, UK employment

remains at high levels with the unemployment rate a mere 4%. Against this confusing backdrop, the UK stock market has struggled to make progress this year.

If we turn away from geographies and consider what type of investments have done well, it is clear that investors still prize growth highly. The MSCI AC World Growth Index, which tracks the faster growing companies in the MSCI AC World global equities index, is up over 50% more than the equivalent 'Value' index (tracking the cheaper but typically slower growing companies) over the last two years.

There is unfortunately no premium on hindsight. Trying to shine a searchlight through the fog gives no clear answers. There are certain conclusions we can draw. Investment markets have become expensive in certain areas, particularly in the US and among growth companies. We had suspected the US market could slow as profits revert to a more 'normal' level after the one-off boost from corporate tax cuts and as interest rate rises begin to pinch. Global debt levels remain high, among governments, consumers and corporates, but the banking system is in better shape to withstand any heavier economic weather. Certainly more so than it was at the time of the 2007/8 financial crisis. Some vigilance seems justified, but we do not yet see an end to the current lengthy but slow economic expansion.

We will continue to concentrate on good fund managers investing in profitable, growing companies. That is what we do best. We believe that this is exactly the type of market where discriminating, active managers should do better than robots.

CYBER DEFENCE

So in war, the way is to avoid what is strong and to strike at what is weak.¹ Sun Tzu

Cyber-attacks, for both individuals and businesses, have risen sharply in recent years. They are becoming more sophisticated and disruptive in nature.

Rossie House use industry best practice across their Information Technology. This ensures a well-balanced approach to cyber defence and the protection of their (and your) data. The Netopa team, IT consultants for Rossie House, proactively install tools and equipment to monitor and protect the firm's network. For those of a geekish persuasion, we have outlined below the steps taken:

- Hardware firewall - security appliance which monitors incoming and outgoing network 'traffic'.
- Modern, anti-virus software suite.
- Email filtering - third party product which screens for viruses, junk mail and corruptive software.
- Microsoft Desktop / Server updates - fixing security loopholes in the operating systems at the earliest opportunity.
- Data back-ups - regular 'cold' back-ups taken in Edinburgh and Forgandenny which are physically disconnected from the network to prevent malware² encryption.
- File permissions - secure file access only for authorised users.

These represent the core layers of protection and are necessary but sadly not sufficient.

Having installed an alarm and fitted locks on all the proverbial doors and windows, Netopa has found that perhaps the biggest threat to companies such as Rossie House comes from those with the keys – the employees. Hackers can use social engineering techniques by way of emails and phone calls that are crafted to fool staff into providing snippets of information. These can expose logins and ultimately allow full computer access. The best defence against these softer methods of attack is for staff to have an up to date awareness of the techniques used and to be given regular training. Testing, by employing the services of a confederate or ethical hacker, is another practice encouraged by Netopa to protect against such risks.

The majority of attacks we hear about in the news can be traced back to servers simply not updated with the latest security patches. This allows hackers access to an organisation's network where they can then attack individual computers. An example is "ransomware" which encrypts all data and then demands a ransom for its unlocking. The menacingly named "WannaCry", which hit the NHS and others in May last year, was of this variety.

The strength of Rossie House's cyber defence lies in its balance. The projection of strength through the hardware and software it uses (heeding the advice of Sun Tzu) combined with the softer skills of common sense and knowing their clients well.

¹ Quote by Sun Tzu from the Art of War

² Malware is software intentionally designed to cause damage to a computer

KARL MARX – THE COMMUNIST MANIFESTO

“They openly declare that their views and aims can only be attained by the forcible overthrow of all existing social conditions. Let the ruling classes tremble at a Communistic revolution. The proletarians have nothing to lose but their chains. They have a world to win.”

Many of us working in financial markets today have little empathy with and limited understanding of Communism. It may seem strange to think that until the 1960s Communism was identified with an image of ruthless and energetic modernity. Later, the Reagan / Thatcherite reforms at the end of the twentieth century swept aside most lingering Communists, at least for a while. However, the recent momentum for Corbynism provokes more serious reflection on this subject. The year 2018 also marks two centuries since the birth of Karl Marx in Trier, Rhineland.

Marx, along with his friend and financial backer, Engels, jointly authored the Communist Manifesto. In 1844 he began his collaboration with Engels and developed a new theory of communism to be brought into being by a proletarian revolution. Expelled from Paris and unable to publish in Brussels he later moved to England. By 1848 The Communist Manifesto was ready to publish though it was not until 1888, after Marx’s death, that the first English edition¹ was produced.

Their dream was for the proletariat to overthrow the bourgeoisie and capitalist society. Overtly a class struggle, the movement was an expression of “the revolt of modern productive forces against modern conditions of production, against the property relations that are the conditions for the existence of the bourgeoisie and of its rule”.

To remind our clients of what Marx (and Engels) proposed the Manifesto¹ went as follows:

“Nevertheless, in the most advanced countries, the following will be pretty generally applicable:

- 1. Abolition of property in land and application of all rents of land to public purposes.*
- 2. A heavy progressive or graduated income tax.*
- 3. Abolition of all rights of inheritance.*
- 4. Confiscation of the property of all emigrants and rebels.*
- 5. Centralization of credit in the hands of the State, by means of a national bank with State capital and an exclusive monopoly.*
- 6. Centralization of the means of communication and transport in the hands of the State.*
- 7. Extension of factories and instruments of production owned by the State; the bringing into cultivation of wastelands, and the improvement of the soil generally in accordance with a common plan.*
- 8. Equal liability of all labour. Establishment of industrial armies, especially for agriculture.*

¹ translated by Samuel Moore

9. *Combination of agriculture with manufacturing industries; gradual abolition of the distinction between town and country, by a more equable distribution of the population over the country.*
10. *Free education for all children in public schools. Abolition of children's factory labour in its present form. Combination of education with industrial production, etc, etc "*

Communism, or as Marx called it, the "spectre haunting Europe" is somewhat alive today. Venezuela, commended by Corbyn, is a timely reminder of how ruinous the general "principles" of Communism can be. That said, we should not underestimate the feeling that exists today; revolutionary parties in many European countries remind us all that the verities of capitalist markets that have prevailed over the past 40 years cannot be taken for granted. Highly regarded economic commentators whisper to us that we should think about and possibly prepare for capital controls, confiscation and much higher tax rates. We should all take note.

Working men of all countries unite!

FAMILY MATTERS

When Rossie House started in 1993, David Nichol needed some assistance to help run the firm. He turned to Irene Goodall who he poached from the Scotch Whisky trade. Irene lived locally, was highly efficient and prepared to move. Twenty five years later the rest is history. If anyone upheld the high standards we aim for, it was Irene. If a report was wrong at 5pm on a Friday night she would stay behind to ensure it was sent out correctly. Regular tasks were carried out with precise diligence, her accuracy and dependability were exceptional. The telephone was answered with that care and knowledge of our clients that made it a personal service, a client's call to Rossie House likened to that of speaking with a friendly aunt. Many of our clients became her friends.

It was typical that she chose to glide into a well-deserved retirement without too much fuss. A personal email warned some of you that she was off. She has already been back to help us with a project and we very much hope she will continue to pop back in, we will miss her. I know she will be embarrassed by these words but they are essential!

We communicate frequently with our new partners at Herald and we already benefit from their undoubted expertise. Our London office is now set up and working and we hope that some of our clients based in the South may be able to meet us in Charterhouse Square.

In the case of Mike Elliot and Scott Baikie, they (with essential help from their wives!) have been producing the next generation of fund managers. Mia and Oscar arrived in September and January this year.

Rossie House Investment Management LLP is authorised and regulated by the Financial Conduct Authority and as such is required to state that:

- (i) the value of investments and income derived from investments can fall as well as increase and the investor may not get back the amount invested,
- (ii) past performance is no guide to the future, and
- (iii) the levels and bases of, and reliefs from, taxation can change.

As the issuer, Rossie House Investment Management LLP has approved the contents of this publication.

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