ROSSIE HOUSE
INVESTMENT MANAGEMENT

February 2018

We start with a review of what happened last year – encouraging returns. Until recently optimism had been high and volatility at very low levels. However, equity markets experienced quite a setback in the last few weeks. We share our thoughts.

In our last periodical we wrote about Blockchain Technology, what it is, how it works and how it is disrupting an established industry. Since then we have seen Bitcoin, which uses this technology, dramatically rise (and subsequently fall) in value although many fear that it is highly speculative. We now turn our attention to other themes which are already disrupting a number of other industries.

We wrote to you last year about our new link with HIML Holdings Ltd. They are the parent company for the manager of Herald Investment Trust which is held by a number of our clients. It was an excellent performer last year, rising over 30%. The manager, Katie Potts, has very kindly written a short piece about the trust.

All of us in the fund management industry have been weighed down with a huge new piece of regulation. The legislation known as MiFID II (Markets in Financial Instruments Directive) follows a previous version implemented some years ago. It is designed to offer investors enhanced protection and is all explained in over a million paragraphs. We try to shed some light on how it affects you.

Some portfolios have invested into a gold exchange traded fund. This is a somewhat untypical investment for Rossie House. A well-known gold stockbroker, Julian Baring, was once questioned as to why gold had any worth at all because it yielded nothing. He produced a piece of gravel and a small bar of gold, then asked which the person would rather have. The attraction was obvious. We feel the subject warrants a bit of additional explanation.

The Rossie House Portfolio Fund had a reasonable year. A short update comes next. We continue to feel it is a useful vehicle for investing small sums (e.g. JISAs) as well as big investors who wish to benefit from the freedom from capital gains tax (within the fund). It continues to grow steadily and we are pleased with progress.

Occasionally we get asked to have interns for a period of time. It is our normal practice to ask them to write about a particular topic and occasionally one of their own choice. We share the result of one stint concerning whether happiness may be a better way of measuring economic progress than conventional methods. We thought it quite interesting and topical. It is increasingly obvious that all investment is being forced to take more notice of social and ethical considerations. There can be mutual advantage in having young minds to explore new trends and challenge old norms.

Regarding "family matters" we are very pleased to report that Scott Baikie joined us shortly before Christmas. Scott studied law at university, after which he did a post-graduate degree in economics. More recently, he has previously been with Adam & Company's investment team and latterly Speirs & Jeffrey. He has long experience of managing private client portfolios as well as charity funds. He has already contributed greatly to our investment thoughts and some of you will no doubt be meeting him over the coming months.

As always, we would welcome any feedback.

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MARKET THOUGHTS

At Rossie House we like to keep things simple. There is a rather charming parable[1] that delivers this point far more eloquently than we could hope to –

An American investment banker was at the pier of a small coastal Mexican village when a small boat with just one fisherman docked. Inside the small boat were several large yellowfin tuna. The American complimented the Mexican on the quality of his fish and asked how long it took to catch them.

"Only a little while," the Mexican replied in surprisingly good English.

"Why don't you stay out longer and catch more fish?" the American then asked.

"I have enough to support my family and give a few to friends," said the Mexican.

The American then asked, "but ...what do you do with the rest of your time?"

The Mexican fisherman smiled and said, "I sleep late, fish a little, play with my children, take siestas with my wife, Maria, and stroll into the village each evening where I sip wine, and play guitar with my amigos. I have a full and busy life."

The American scoffed and stood tall. "Sir, I have an M.B.A. from Harvard, and can help you," he said. "You should spend more time fishing, and with the proceeds, buy a bigger boat. With the proceeds from the bigger boat, you could buy several boats, and eventually you would have a fleet of fishing boats. Instead of selling your catch to a middle-man, you could sell directly to the processor, eventually opening up your own cannery. You could control the product, processing, and distribution," he said. "Of course, you would need to leave this small coastal fishing village and move to Mexico City, then Los Angeles, and eventually to New York City, where you will run your expanding enterprise."

The Mexican fisherman asked, "But, how long will this all take?"

To which the American replied, "Oh, 15 to 20 years. 25 tops."

"But what then?" asked the Mexican.

The American laughed and said, "That's the best part. When the time was right, you would announce an IPO, and sell your company stock to the public and become very rich. You would make millions!"

"Millions – then what?"

The American said, "Then you could retire. Move to a small coastal fishing village where you could sleep late, fish a little, play with your kids, take siestas with your wife, and stroll to the village in the evenings where you could sip wine and play guitar with your amigos."

[1] Sadly its author remains anonymous. Our apologies to those readers with an MBA from Harvard, of which we are certain there are some within the ranks.

Second guessing the UK's rate of economic growth for 2018; where US interest rates are heading or whether the pound will continue to appreciate against the dollar is not our bag. We are, alas, not clever enough to know. Importantly however, we know that we do not know. Rather like our Mexican fisherman, trying to fathom such matters is akin to his building a commercial fishing operation – lots of time and effort with no real tangible reward.

We do however have a duty as your investment manager to make a judgement on where we think we are in the market cycle. Our response to the obvious follow-on question of 'where are we now?' is closer to the end than the beginning. This rather glib response is the best we can muster ... timing is devilishly hard.

With the benefit of hindsight, we were too cautious for clients last year. An allocation of around 30% in 'defensive' securities for Balanced and Growth mandates has undoubtedly stymied returns. 2017 was a bumper year for risk assets with most stock markets showing double digit Sterling returns. Contrary to predictions at the start of the year, the pound provided a gentle tailwind for most portfolios – appreciating 9% against the US dollar in 2017. Our congratulations to those who had tucked away Bitcoin in their digital wallets and then sold them at the year end. The cryptocurrency rose a staggering 1,300%[2] last year, though has since fallen sharply.

Amidst a most extraordinary year for politics globally one wonders where it will all end. The shocking disaster at Grenfell Tower characterises the current fractious mood in Britain. Such events coupled with central banks' lifting of interest rates in America, the UK and Canada are not the benign backdrop one might expect for such buoyant markets. Perhaps most surprising has been the timidity of bond markets as interest rates and inflation have risen. Although the interest rate on the UK's ten-year government bond has moved up in the past month, its current level of 1.6% remains significantly below the rate of inflation. Where are the bond vigilantes of old?

We have often thought that we are fortunate, at least in terms of our temperaments, to work in an industry where the news flow is generally of unerring optimism (FT exempted!). This sits in stark contrast to the incessant negativity spewed forth by mainstream media. There are some worthy factors though that may justify continued optimism for investors, at least for the year ahead. 2017 was the first year in the last three where company earnings on average met or beat analysts' expectations at the start of the year. Matching and beating earnings expectations is vital if equity markets are to make further headway. Secondly, Trump's tax cuts will have a warming effect on corporate and personal finances in the US for 2018 and beyond. There are some big numbers involved with the expected cost of this largesse estimated at $1.5 trillion over the next ten years.

It has been a challenge to reach this stage of our commentary without mentioning Brexit. We feel once again this is one of those times where we should follow the example of our Mexican fisherman. Not sleep late and sip wine, but keep things uncomplicated and focus on where we

[2] 1,331% to be precise - US$ 968.23 on 31st December 2016 to US$ 13,860.14 on 31st December 2017 – source Coindesk.com

can add most value for you. We do not wish to belittle the potential impact the negotiations (or lack thereof) could have. Our point is that much has been debated and written on this topic with potential outcomes, and the probabilities of those outcomes, unfeasibly complicated. We continue to carry a significant allocation in portfolios to overseas assets as a hedge to any unwelcome result. We are also confident in the abilities of the underlying fund managers we have selected to navigate these testing times. Selecting them is where our greatest efforts are trained.

Pulling this all together, we felt one of our funds' investment advisers hit the nail on the head with their recent comment on markets – "And so, we climb the wall of worry."[3] We view the correction and volatility spike in February as a shot across the bow of a complacent market. Whilst we can envisage further upside to this market cycle, our inclination is to edge closer to the proverbial door.

[3] Gemsstock Fund – November 2017 Factsheet

DISRUPTIVE INDUSTRIES

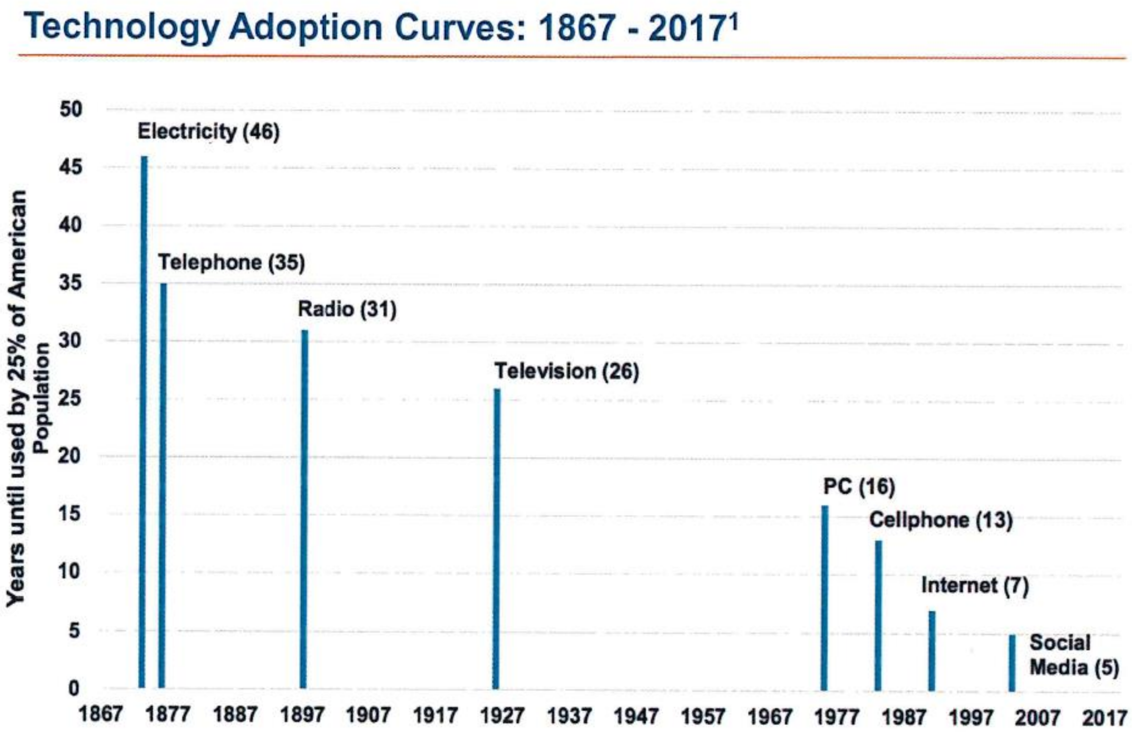
Disruption may be an obvious cause for concern for some companies but it also provides a plethora of opportunities for investing. The tricky part is to deduce which companies will most likely come out on top and, for us, choosing the funds that correctly hold these companies. As ever, we believe that diversification is key and that it is important to focus on broad thematic shifts as this reduces the pressure should one individual company not perform as well as was expected. Here are some themes we have been considering.

There are few people who have not heard about the success of Amazon and the increase in online shopping as a percentage of total retail sales. While the impact on traditional retailers may be obvious to some, another more disruptive effect is taking place. Traditionally, choice in the shops would be between an inexpensive, own brand product which probably performed adequately and a more expensive, branded product which might have performed better but in some cases did not. This choice is being picked apart by the likes of Amazon, who are able to produce a third alternative. This alternative is cheaper than both of the first options and yet likely to perform better than either of them. This is already the case with batteries and nappies, where Amazon's products now have 32% and 17% market share respectively. This is one driver of Amazon's success. As e-commerce accounted for approximately 9% of total retail sales in the US in 2016, there is still plenty of room to grow.

The collapse in computing costs and advances in computational power have allowed artificial intelligence technologies to flourish. There has also been exponential growth in data and information. Already Wikipedia in the UK is 100 times the size of the Encyclopaedia Britannica and there are over 2,000 billion Google searches per year, with 15% of these having never been searched for before. Very soon, artificial intelligence will be able to solve problems that no one has even encountered and its pattern recognition will grow exponentially as the quantum of submitted data increases. This may well be a threat to the entire legal profession, for example, once the data is input, and the benefits will be applicable to a vast number of industries.

One company, Illumina, has been involved in reducing the cost of sequencing a human genome from $3bn (when it was first performed) to around $400 today. The implications of this are huge. The current process within healthcare is to make an appointment to see a GP when you are unwell, describe your symptoms, send off blood tests and then be forwarded to a specialist or simply put on a broad spectrum of antibiotics, depending on the results. With sequencing, you can send off a tissue sample when (or even before) you are unwell and your exome can be sequenced to show which genes are activated at the current time. This will give a precise diagnosis of the issue and either specific medicine can be posted to you or you will be able to see a specialist at a much earlier stage, more likely resulting in a positive prognosis. This could transform our health service and even disrupt industries such as pharmaceuticals and insurance.

Even the concept of ownership and responsibility is being challenged by some forms of technology. One could see that the possible introduction of self-driving cars into mainstream use, twinned with big data and artificial intelligence could render car ownership as less important. Cars could simply be booked to turn up when you need them without the need to pay for a driver. They wouldn't need to be parked outside your house and, like some robot lawnmowers currently on the market, could recharge themselves at a recharging station overnight or when not in use. This will be revolutionary as well as sensible, bearing in mind that the average car is in use just 4% of the time. In turn, this could remove the responsibility from the driver in the instance of an accident, which would certainly affect the insurance industry. Any dramatic decrease in injury resulting from traffic collisions would also have a positive effect on our healthcare system.



A theme running through a number of these subjects is technology. It took 35 years for a quarter of the population of America to adopt the telephone and 26 years for the same number to adopt the television. Yet it took just 7 and 5 years to adopt the internet and social media respectively. It would seem that the rate of change is increasing. It is important for us to keep abreast of these thematic shifts within industries and the causes of the disruption. Some of our investments such as Scottish Mortgage, Herald Investment Trust, Edinburgh Worldwide and Polar Capital Technology specialise in companies that aim to capitalise on these trends.

HERALD INVESTMENT TRUST PLC

It seems rational to be apprehensive. Apprehensive because the British Government deficit is still expected to be around £50bn this financial year, in spite of nearly a decade of belt tightening, and the trade deficit is even worse. This combined with greater political uncertainty than we have experienced for many years, and bond yields passing their low-point makes wealth preservation a key focus for us all.

Against the gloom there is one area of the economy conspicuously growing. The technology sector has been strong globally in 2017, but it has been remarkable how much growth there has been in London. In part this reflects a bubble in San Francisco and Silicon Valley, which has led to the big internet companies expanding elsewhere, and London has emerged as a hub that has attracted leading edge talent, and in consequence companies. Google for example has received planning permission for a new 1m square foot office at Kings Cross following a submission in June 2017, and Facebook are allegedly negotiating to take a further 400,000 square feet nearby. These have followed announcements from Apple, who are building a new 500,000 square foot UK HQ in Battersea, and Amazon have taken 514,000 square feet in Shoreditch. In addition London has become an important technical centre for the traditional financial sector, and is a hub for start-ups.

Herald Investment Trust was established in 1994 to invest in smaller quoted technology, media and telecom companies. Although the mandate globalised in 1996 the manager has surprisingly maintained the majority of the portfolio in the UK with the exception of a brief period in the 2000 internet bubble. There is a significant, if under-appreciated, entrepreneurial spirit in the UK, technical expertise and a paucity of capital. These factors combine to offer sensible investment opportunities on AIM. Katie Potts, who established Herald and remains the team leader, finds it fulfilling to provide development capital, and often survival capital to emerging companies on a regular basis. When the Trust was launched £65m was raised, and a further £30m two years later, since when there has been no new outside capital. This capital has been recycled, and over £400m has now been invested in primary capital for businesses. Investments are also made in the secondary market. The UK economy has been successful in creating jobs in the last few years, but unfortunately this job creation significantly reflects low paid workers who have been subsidised through working tax credits, housing benefits, healthcare and so on. Technology companies in contrast are creating high added value and high paid jobs. There are only about 350,000 top rate tax payers in the UK, and a not immaterial proportion will be employed by companies in part funded by Herald. Even better the original Herald investors have seen a capital return of nearly 14x in terms of net assets per share and more in terms of total return.

The fund was originally launched to provide a lower risk way of gaining exposure to emerging companies with a high stock specific risk and limited liquidity, but risk reduction through diversification. The winners can appreciate more than 10x, which more than compensates for the occasional loser. The returns have been well spread with over 90 companies yielding profits to the Trust of at least £4m, and total profits are now nearly £1bn since inception. This mandate seems as valid now as it was in 1994. Herald is struck by the chasm between the depressing picture gleaned daily from the media, and the cheery excitement of so many companies that the team meet on a daily basis.

MiFID II

What is MiFID II?

MiFID II came into force on January 3rd 2018. The need for an acronym suggests an attempt to bring order to a complex subject – this certainly applies to MiFID II. MiFID stands for Markets in Financial Instruments Directive. MiFID II is an effort to build on the original EU Markets in Financial Instruments Directive of 2007. This latter EU initiative was intended to help make a single European financial market reality. It aimed to improve European financial market practices in three areas; the conduct of business with clients, the way organisations are managed and licensed and the transparency of business in equity markets. Notwithstanding the UK's impending departure from the EU, the country is committed to fully adopting the regulatory changes of MiFID II.

What are the main themes behind the new regulations of MiFID II?

The principal efforts are directed to offering greater consumer protection, improved market competition and greater transparency on dealing in equities, fixed income, exchange traded funds and foreign exchange transactions. MiFID II has been seven years in the creation, having been conceived following the financial crisis of 2007-8 in order both to try and update gaps in the original MiFID (which was very focussed on equities) and to help restore investor confidence in financial markets generally. The full MiFID II Directive contains – perhaps rather alarmingly – 1.7m paragraphs of rules. MiFID II should also be viewed in the context of other global regulatory initiatives which aim to track any unpaid taxes and proceeds associated with illegal activity (US FATCA and the European Common Reporting Standard, for example), as part of a general tightening up of markets and effort to make them more transparent.

What are the main practical impacts of MiFID II?

One of the main areas where there has been a significant change is that asset managers must now pay directly for research they use in making investment decisions. This was formerly often bundled with trading fees, resulting in poor transparency for the asset managers' underlying investors. The second notable impact has been in the amount of detail required to be reported on financial market trades. This now includes information on the identity of buyers and sellers. It is important to note that the impact of these rule changes goes well beyond European States and will, for example, affect US based institutions which are buying European shares.

It is a belief dear to our national heart that we have tended to be over-zealous in our adoption of European regulations. Other European states are certainly less well-prepared for MiFID II than the UK and a number of specific last-minute exemptions have been given to futures and metals exchanges (including in the UK). Of the 28 European states, so far only 11 have fully transposed the MiFID II regulations into their national laws.

What impact has MiFID II had on our clients and on Rossie House Investment Management itself?

The thrust of the regulatory changes is certainly intended to benefit clients. We suspect the immediate impact for clients will be limited. It has so far been confined more to the realm of administration. Within Rossie House, we have been dealing with quite a number of upgrades to systems for reporting, in conjunction with our Custodian, as well as other changes behind the scenes which have been driven by MiFID II. You will have noted that we sent you some updates to our terms and conditions in the final quarter of the year. The main direct impacts of MiFID II for you as a client of Rossie House Investment Management are as follows:

1. Costs and Charges. We will provide you with a statement once a year giving a summary of all the costs and charges you pay on your investments through Rossie House. This will include the costs and charges you pay us for our investment management service as well as the underlying charges of the holdings in which you are invested.

2. Research. We conduct a considerable amount of research work ourselves. We also subscribe to various economic and market analysis services and have signed up to pay for research from a number of brokers whose input we value. Rossie House pays these research costs itself, rather than passing on the charge to you.

3. Legal Entity Identifiers. Those of you involved with Trusts will be aware that we have had to ensure that every Trust has a Legal Entity Identifier (LEI) number for use in reporting transactions.

4. Best execution. We strive to achieve an excellent outcome for our clients on dealing. We wrote to you with further details of the updated policy with our recent terms and conditions update letter. We will also be reporting our top 5 execution venues on our website.

5. Valuations. In the event a portfolio falls by 10% from its previous quarterly value we are required under MiFID II to inform you within 24 hours.

6. Telephone recording. We will be recording telephone calls and retaining the records for 5 years, as required by MiFID II.

It is our firm hope that you, our clients, will gain some positive benefits from MiFID II. The intentions as regards consumer protection and improving market operation are good, but the immense quantity of new rules may take some time to bed in. It will probably, as with all major changes, be too early to say what the ultimate effects will be for some time.

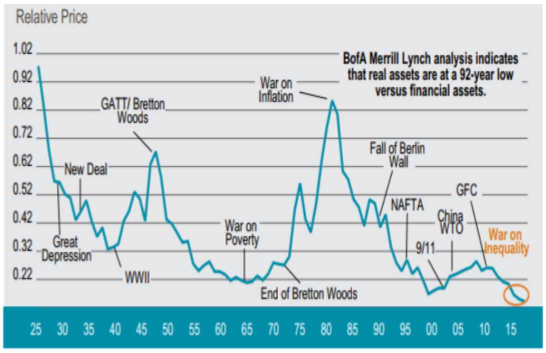
GOLD

At our investment meetings over the last ten years we have regularly discussed the idea of buying gold as a potential "defensive" investment. We have considered both an exchange traded fund (ETF) as well as gold mining companies. However, despite good performance we never quite had the confidence to invest.

As an asset class it lacked yield. We certainly were not experts in the precious metals sector. It has also seemed overly fashionable at times. However, recently we have decided to include a gold ETF (Gold Bullion Securities) in some portfolios. We believe gold is a justifiable asset for investors to own in a portfolio. The physical attraction means it is widely used for jewellery, especially in Asia[1]. It is also used in industry due to special physical properties.

Back in 2011 gold was highly fashionable and rose to over $1,800 an ounce. Since then it has fallen about 30% in dollar terms and is generally out of favour. In our view this provides an interesting opportunity. At present, gold looks good value relative to financial assets and the S&P 500 – see charts below:

Real Assets vs. Financial Assets



At October 16, 2016. Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg, USDA, Savills, Shiller, ONS, Spaenjers, Historic Auto Group.

S&P 500 to Gold Ratio

Being scarce the supply of gold is constrained. It is this latter point which means it has backed currencies for centuries and gives it the characteristics of a financial asset. In recent times governments have found it too difficult to sustain gold backing for their currencies. Often as a result of financing wars, linkages to gold were suspended or broken - Switzerland being the last country to do so in 2000 (previously 40% backed by gold). The fact that many central banks continue to hold large quantities of gold validates that it is a sensible long term store of value.

One commentator recently described the UK as a "defibrillator economy". This is because central banks have been running very unconventional monetary policies, including QE (Quantitative Easing). These policies have never before been tested. We are now at the moment

[1] Emerging economies are particularly big buyers of gold, especially the Hindus in India at the festival times of Diwali (Oct/Nov) and Akshaya (Apr/May).

when QE is being reduced (in Europe) or reversed (in the US). This comes at a time when over a quarter of total US government debt needs to be rolled over in 2018. No one can be quite sure how things will work out.

We have felt the most likely outcome is inflation – hence our index-linked bond holdings. However, debts are very high and the possibility of deflation cannot be entirely discounted especially if there is some form of unexpected shock. The "defensive assets" held in most portfolios (such as index-linked bonds) are expensive by historic standards. In this highly unusual environment we think gold provides valuable diversification.

An interesting analyst, Diego Parrilla, recently wrote a book suggesting that gold was an "anti bubble". His thesis is that in an environment where almost all assets are overinflated gold is an asset which provides a defence mechanism against bubbles. He suggests "gold has a few hundred dollars of downside and a few thousand dollars of upside".

We also take encouragement from Roy Jastram, an economics professor at the University of California, who carried out extensive research into gold in 1977 and found some surprising conclusions[2] - see the table below.

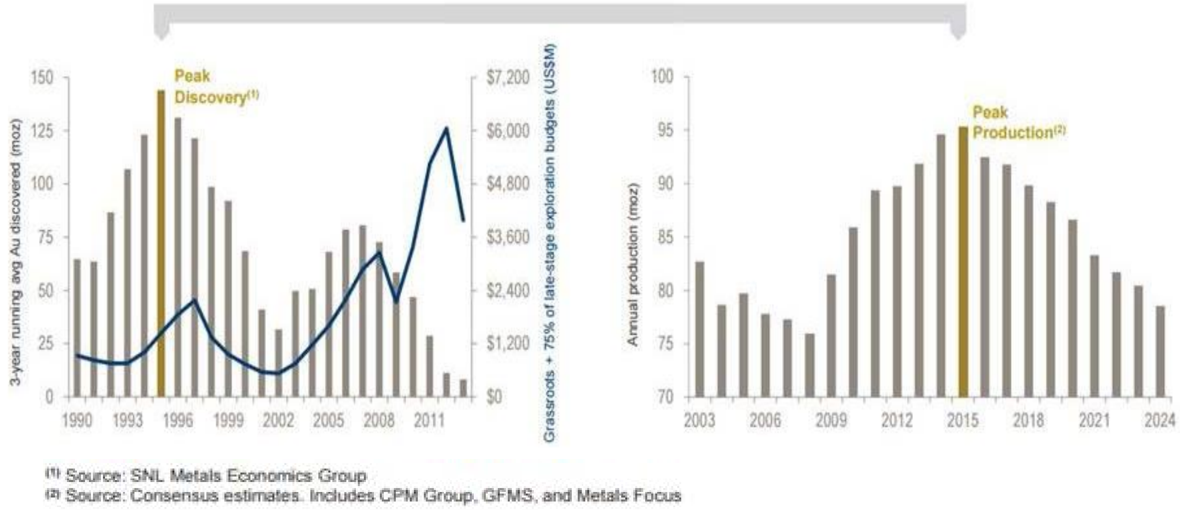
Years	1808 - 1814	1814 - 1830	1843 - 1857	1861 - 1864	1864 - 1897	1897 - 1920	1929 - 1933	1933 - 1951	1951 - 1976
Inflation / Deflation									
Prices (%)	+58	-50	+48	+117	-65	+232	-31	+168	+101
Purchasing Power of Gold (%)	-37	+100	-33	-6	+40	-70	+44	-37	+80

Perhaps the biggest surprise was that he concluded gold proved a very effective store of value in deflationary periods. Counterintuitively, his research showed that in major inflationary periods the purchasing power of gold was not a great hedge. For example, between 1933 and 1976, an inflationary era, gold lost about 25% of its purchasing power. However, as prices had risen enormously over that same period, gold had certainly protected wealth to a very considerable degree. In the 1970s, a generation of investors witnessed rampant inflation, tumbling equity indices and the gold price rising from $35 in 1971 to $850 by the end of the decade, proving to be a wonderful store of value**. *Jastram passed judgement that over long periods of time gold does maintain its purchasing power.*** He also described the "Attila Effect" where gold has served as a financial refuge in political, economic, and personal catastrophes.

The supply / demand situation is also interesting at the moment. A chart from a Goldcorp (a large gold miner) presentation pointed out how discovery and production is falling sharply. If nothing else this gives a basic level of support to the price of gold – see chart overleaf.

[2] The Golden Constant: The English and American Experience, 1560 – 1976. Roy Jastram 1977 He used "England {as} a country for which data are available over unusually long spans of time. …. For about 700 years, there was no break between the money of one year to the next."

Global mine supply peaked in 2015; significant supply constraints ahead



Goldcorp – August 2016

One of the detractions of gold has been the "opportunity cost" of holding it. When interest rates are high this is undeniably true but interest rates, even if forecast to rise, are near historic lows at present. Over $10 trillion of global bonds were trading with negative yields at one stage in 2017. The European Central Bank has a bank deposit rate of negative 0.4% and Sweden, Denmark, Switzerland and Japan all have negative interest rates. This makes the lack of income much less of an issue today.

In summary, what has prodded us to consider investing in gold having stood on the sidelines in the past? Well, it seems a better time to buy. There is little enthusiasm for gold at present. It feels very unloved as the price has fallen – almost like a "Giffen Good". It is an asset that has stood the test of time and we think it provides some diversification in portfolios. We considered gold mining stocks (and gold funds) which have been even more harshly sold off than bullion but felt that they brought an extra degree of uncertainty.

Gold Bullion Securities (GBS), our chosen ETF, is a liquid stock and traded on the London Stock Exchange. It is backed by physical gold that is "allocated". It cannot be lent and holds only gold that conforms to the London Bullion Market Association standards. Each bar is segregated, individually identified, and has particular weight, dimensions, fineness and serial marks. It is held at a vault with HSBC and is inspected twice per year with the inspection / audit reports available online. The Trustee is Law Debenture. GBS also partners with the Royal Mint and offers investors the right to redeem their gold for bullion[3].

[3] This is something that an investment trust well known to us, Personal Assets Trust, tested successfully by swapping the value of their considerable gold holding into bullion in 2011.

ROSSIE HOUSE PORTFOLIO FUND

The Rossie House Portfolio Fund B Income shares[1] rose 12.0% in the 2017 calendar year. In comparison the benchmark MSCI WMA Balanced Index rose 9.9%. Overall the Fund made good progress last year. With the help of market gains and some inflows the Fund stood at over £11m at the end of the year. It is worth noting that partners and staff of Rossie House Investment Management (RHIM) own significant holdings in the Fund.

The year saw very differing performances between value and growth investment strategies. Those investing for growth made excellent gains whilst value investors have had a less successful year. Technology stocks in particular, especially the largest well-known names in the US, have all performed spectacularly well. Herald Investment Trust (+32%), a technology specialist but not invested in larger companies, appreciated sharply. Similarly, Monks Investment Trust (+34%), which has a growth bias, also made good progress. In contrast, value investors such as Kennox Strategic (no change) and Overstone Global Equities (+6%) performed less well. The Fund benefited from Odey Allegra Developed Markets Fund (+22%) due to good stock picking rather than any particular investment style.

The UK exposure had a difficult year in 2016 so it was a relief that this reversed in 2017. As the economy continued to grow the worries about a Brexit recession dissipated and the market made decent gains, especially smaller companies. Standard Life UK Smaller Companies Trust (+35%) has a growth bias and performed better than Miton UK Microcap Trust (+16%) and Aberforth Smaller Companies Trust (+20%), both of which still made decent gains even with their value oriented styles. The bigger company trusts we own were dull, especially JO Hambro UK Opportunities Fund which has built up a very defensive cash position and was sold to fund a redemption after the year end.

Overseas equity markets generally assisted returns. Findlay Park American Fund (+12%) proved reliable. The Japanese exposure was also helpful with MW Japan Fund (+16%) – a value investor – performing well and Baillie Gifford Japan Trust (+46%) shooting the lights out. As the trust had moved to a significant premium to assets this was sold at the end of the year. Asian and emerging market exposure was also strong. Edinburgh Dragon Trust (+24%), Somerset Emerging Markets Smaller Companies Fund (+20%) and Utilico Emerging Markets Investment Trust (+16%) all contributed handsomely as well. Finally, the relatively small holding of Hansa Trust (+26%), which stands at a discount that we believe is too large, started to show some form.

As one would expect, the defensive part of the portfolio did not really participate in the strong market gains. However, Trojan Fund (+4%), Ruffer Investments (no change) and Capital Gearing Trust (+5%) all performed satisfactorily. The overseas index linked bonds exposure, gained through CG Real Return Fund (-6%), was affected by the strength of Sterling against the US Dollar because the fund largely consists of US TIPS (Treasury Inflation Protected Securities). We continue to feel there is a role for this holding especially with the US

[1] With distributions added back

Dollar trading at a fairly depressed level. A holding in Gold Bullion Securities (-3%) was added towards the end of the year. It too was affected by Dollar weakness but this is held as an alternative to cash with potential for non-correlated[2] returns when other securities markets are falling.

The consensus outlook for 2018 expects synchronised growth in all major economies. This bodes well for profits growth. The downside to this good news is that it looks like central banks will, for the first time in a long period, start to increase interest rates (UK and US) as well as reverse or reduce (US / Europe respectively) their QE programmes. This comes at a time when many equity markets are quite highly rated and, until recently, there had been an uneasy period of extreme low volatility.

At the time of writing we have just experienced some quite severe equity market falls. After a period of strength this can be seen as a healthy correction which may allow further gains as the year progresses. However, we know debt levels are very stretched in many places and no one quite understands how these can all be repaid. We certainly feel that we are nearer the end of an economic cycle than the beginning but, as the growth over the past ten years has been so anaemic, it is possible that we have a much extended economic cycle.

Our approach to this conundrum is to retain a balanced portfolio. We resolve to continue holding at least a quarter of the Fund in defensive assets that we expect to perform better than equities if stock markets fall. With the balance, the portfolio is positioned to take advantage of any further equity gains. It holds some outstanding funds, managed by exceptionally talented managers, with contrasting styles so we are not too dependent on any one outcome. We will not therefore expect to be the best performing Fund at any particular time but we do expect all our funds to produce satisfactory (absolute) returns over the long term.

[2] will change in value independent of how bond and equity markets are performing

HAS GDP HAD ITS TIME?

Conventional economic thinking has long equated money with happiness. There is an unshakeable belief amongst policymakers that if they achieve GDP growth, incomes will rise, and the happiness of their citizens will follow suit. However, research put forward shows that this might not necessarily hold true. There is a paradox. As western societies have become richer, their people have become no happier. This was first observed by Richard Easterlin in 1974 and became popularly known as the 'Easterlin Paradox'. In his book, 'Does Economic Growth Improve the Human Lot', he concluded that raising the incomes of all does not increase the happiness of all, finding that despite substantial increases in income, US citizens are no happier today than they were in the 1940s and 1950s; with a similar story seen in both the UK and Japan. Many scholars have since put forward evidence supporting his findings. Economies have grown, but people have become no happier.

One reason for this apparent paradox is that the key underlying indicator of economic growth, Gross Domestic Product (GDP)[1], is in itself inherently flawed. GDP is a measure of a country's economic activity, taking precedent over all other metrics. It is king. It was first developed for a very good reason – to provide policymakers with information to intervene effectively in the US economy after the Great Depression. Soon after, GDP was used as a broader measure of a country's overall social and economic progress, taking on deeper connotations of success and wellbeing.

To quote Robert F. Kennedy:

"It counts special locks for our doors and the jails for the people who break them. It counts the destruction of the redwood and the loss of our natural wonder in chaotic sprawl… Yet the gross national product does not allow for the health of our children, the quality of their education or the joy of their play" (Kennedy, 1968)

Kennedy's critique succinctly identifies a major criticism of GDP, in that it is unable to distinguish between that which makes us truly happy and that which adversely affects our wellbeing. The depletion of finite resources are seen as a positive in the eyes of GDP, as is environmental degradation and the clean-up costs associated with pollution. There is also no consideration for sustainability in GDP figures. It includes the costs associated with rising crime rates, the spending on healthcare to cure illness, and the legal fees associated with divorce – to name but a few. On top of this, much of what is considered great in life is excluded from the indicator. Nature, something many consider is essential for happiness has no impact on GDP figures. Nor does marriage, exercise, volunteering and quality adjustment – again to name but a few. Arguably though the most significant omission is friendship; its importance to individual wellbeing cannot be underestimated. Epicurus believed that friendship should be prioritised above all else:

"Of all the things that wisdom provides to help one's life in happiness, the greatest by far is friendship"

[1] It started life as Gross National Product (GNP) in the 1930s. GNP was then superseded by GDP as the key economic indicator in 1991.

Some political scientists even go as far as to equate the health effects of social isolation to that of smoking. Despite its significance, no consideration is made for social connection in GDP. How then can an economic indicator which excludes much of what makes us happy, be used as a true gauge of prosperity and societal wellbeing? It can't. But then it was never intended to. However, continued GDP growth still remains an established part of a nation's economic orthodoxy. What was once a means to an end, has become an end in itself. And in becoming an end in itself, it has diverted us away from what we should really be pursuing in life; the things that truly make us happy. There are many sources of happiness, sources that bring deep and long-lasting happiness, but GDP makes no consideration for these.

There are hopeful signs. Many world leaders have called for alternatives to GDP; measures with a much greater focus on true societal wellbeing, as opposed to economic production and consumption. David Cameron has famously spoken out against GDP and its limitations in the past:

"It's time we admitted that there's more to life than money and it's time we focussed not just on GDP but on GWB – General Wellbeing."

In 2010, he even called upon the Office for National Statistics to measure wellbeing alongside GDP, asking them to look not just at how an economy is growing, but how citizens' quality of life is improving. Like Cameron, Ban Ki-moon, the former UN Secretary General, has been critical of the measure believing that for too long GDP has wrongly been the "yardstick" by which economies and politicians have been measured. And that as a measure it fails to take into account the social and environmental costs of so-called progress. Nicolas Sarkozy has also advocated for alternative measures, having described GDP as "obsolete" in the past. During his time in office Sarkozy commissioned economist Joseph Stiglitz to chair the 'Commission on the Measurement of Economic Performance and Social Progress', with the aim of identifying the limitations of GDP and to outline new alternative measures. Stiglitz spoke of the problem being that "what is measured affects what we do". And that "if we have the wrong metrics, we will strive for the wrong things". In the pursuit of GDP growth, countries may take actions which in the future will actually lower societal wellbeing. He focuses on sustainability, and that current consumption may put in jeopardy future living standards. The depletion of resources and degradation of the environment today are "robbing" future generations of a high standard of living.

Many point to the small country of Bhutan and its big idea of Gross National Happiness (GNH) as a possible alternative to GDP. The country rejected the idea that GDP was the only way to measure prosperity. GNH puts more emphasis on the spiritual, physical, social and environmental health of its citizens and natural environment, much of which is ignored by the conventional measure.

Human wellbeing is not best served by conventional economic approaches centred on GDP growth. Much of what is considered important in life is given no consideration by the measure. And in the eternal quest of GDP growth, the wellbeing of future generations may ultimately suffer. However, GDP is unlikely to be dethroned anytime in the near future. Perhaps what is more realistic is that alternative measures are brought in alongside it, measures which focus more on what really matters in life.

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

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