ROSSIE HOUSE
INVESTMENT MANAGEMENT

September 2015

Investment themes rarely change markedly from one quarter to the next. Now that we report to you quarterly, we thought it would be more helpful to send you a periodic commentary rather than summarising the key issues driving our investment policy each quarter. We intend to focus on topical issues, as well as giving a flavour of our longer term investment thinking and style. This is the first such periodical.

We start with some views on the outlook for economies and markets setting out why we remain of the view that all clients should hold some assets which are designed to be more defensive. We live in a difficult world and it is somewhat surprising that the bull run which began in 2009 has been extended.

Here at Rossie House we don’t have a large marketing department. In fact we don’t have one at all and we rely – grateful thanks to you all – on the many client referrals we get for new business. Last year we set up a new fund which mimics the typical Rossie House investment portfolios that we run. We hope this will be of interest to clients and others and have high hopes that it will grow steadily with the right client base over coming years. It may well be suitable for smaller sums of money (as well as large amounts) and we wanted to bring it to your attention.

Our aim will be to shed some light on individual funds that are widely held by our clients. In this edition Charles Heenan of Kennox Asset Management has been generous enough to write a piece for us. His fund is typical of what we look for in the funds we select. He is bristling with experience and after working with the well regarded Asian team at Stewart Ivory (which was absorbed by First State) he left to set up his own firm and manages his own capital alongside our clients in the Strategic Value Fund. The managers of Kennox have material personal investments in the Fund, so aligning their interests with those of outside investors – something we strongly favour.

In Lord Lovat’s autobiography he advised members of the Stockbridge Angling Club to skip to the next chapter as he went on to describe how he used foul methods to catch salmon in the Beauly River. For those of you who find economics dull, you may wish to skip our nerdy piece on Quantitative Easing. However, it has determined asset prices for the last six years and is a subject we have been asked about frequently. We have endeavoured to shed a bit of light on why it occurred and how it works.

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All of our clients know about Rossie House Investment Management but some will know little or nothing about Rossie House itself after which the business is named. We have therefore included a bit about the place and some pictures of its remarkable garden for those who have never visited – we hope you all will one day. And for those of you who skip the piece on QE (quite understandably!) you may find this more to your taste.

In short we hope you enjoy reading this. It is intended to keep clients up to date with our thinking and a bit about what is going on here at Rossie House Investment Management (RHIM). Any comments (good or bad) are welcome and we shall try to reflect what is popular. However, above all, we would like to stress that we aim to provide a personal service and so would encourage telephone calls, meetings and regular updates. Please don't be shy to contact us.

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Market Thoughts

At Rossie House we attempt to steer a course between two types of excess. We seek to avoid the type of blind optimism which led to the TMT (technology, media and telecom) crash in 2000. However, equally importantly, we must not succumb to an excess of pessimism. This path leads towards holding assets which produce little or no return as against inflation – and as anyone who has found old paper currency in a drawer at home knows, this is a very poor way to look after your money. Our balancing act has involved a tilt towards equities in portfolios, with a good level of diversification in the type of strategy and companies each of our chosen managers follows, and also in the geography and industry in which these companies operate. Companies can benefit from growth (via increased sales and / or prices) in a way that bonds with a fixed coupon do not, in fact the latter's value is eroded by excessive growth and inflation. Or so ran the conventional logic, in the world before the debt crisis and the emergence of Quantitative Easing (QE).

We cover the subject of QE in more detail later in this memo. A critical point about QE is that the process of governments creating new money has driven up asset prices, whilst it has not generally pushed up inflation to very high levels. This has led to a state of affairs which overturns conventional wisdom – both shares and bonds (and for that matter other assets) have all risen in value. It is hard to argue that stockmarkets look cheap, based on conventional measures such as the Price / Earnings ratio. These valuation measures are typically at or above their long term averages in almost all equity markets. Bonds also look an expensive asset. You can be quite confident you will be paid the 1.9% per annum of yield on a 10 year UK government bond but you may well not beat inflation (estimates suggest a figure approaching 2% in the UK is likely in 2016). Our defensive holdings have tended to include some allocation to inflation-linked bonds, which are linked to the RPI (retail price index) and so gain some benefit from inflation – albeit they are also expensively priced.

If bonds and equities have both risen because of QE, and both look expensive why favour equities over bonds? The answer lies in the large level of debt across the world, estimated recently at somewhat above £200 trillion. Contrary to the rhetoric of some politicians who oppose 'austerity', debt has been rising rather than falling for governments and companies in the main. Creating inflation is a way to decrease the value of this debt. If inflation is allowed to exceed interest rates over a period, a government 'magically' pays down debt. It is unclear that governments will be able to achieve this end without losing control, but it seems likely they will try. QE seems a first step in attempting to create inflation and others could follow. We therefore continue to favour equities which will benefit potentially from the early stages of inflation (uncontrolled inflation is destructive to all assets), rather than bonds which will suffer if inflation rises, as we feel this is where government policy will tend.

Equity market returns in the first half of the year ranged from the astounding (Chinese equities), via the good (Japan and Europe) to the not very exciting (UK and US). The US economy led the recovery, and this saw very good returns from both the US stockmarket and currency. Since the start of this year, both the dollar and the US stockmarket have been flagging. The US market looks expensive and earnings have plateaued – in part because of that same dollar strength. This may be a template for where other equity markets could end up. Since mid-June, the Chinese market has been in reverse but still remains above the level at the start of the year, at the time of writing. The difference now is that it has begun to affect other Asian markets, particularly since the Chinese authorities initiated a strategy to devalue the Yuan and therefore make their exports more competitive.

We believe that there are signs that earnings growth could improve in many areas including Europe, notwithstanding recent problems in Greece, where consumer and business confidence surveys are improving, and Japan where corporate and wider societal change continues apace.

High debt levels and the risk that the bond markets could react badly to rising interest rates – likely to start in the US, but probably only on a small scale – create the risk of dislocation which could spread beyond fixed income markets. There is also the potential for equities to benefit ultimately from a more solidly rising global GDP growth trend in developed markets. Our balancing act continues, and we expect any interest rate rises to cause some market weakness. In our view, it is sensible to have a predominance of equities in our clients' portfolios, but with an element of defensive exposure to dampen the anticipated market volatility.

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Rossie House Portfolio Fund

The Rossie House Portfolio Fund (RHPF) is a new vehicle that we launched on 1st May 2014. It is particularly suitable for smaller pots of money which can now be managed in exactly the same way as a typical Rossie House portfolio. We are especially grateful to a client who agreed to seed it with £5,000,000. The partners of RHIM committed 5% of the initial capital and intend to increase their commitments over time. At the time of writing, the Fund has grown steadily to £7.0m in size.

Over the past few years the burden of regulation has made managing smaller sums of money uncommercial. However, we have always wished to look after clients of all sizes and especially children, charities, JISAs and ISAs, etc. of existing clients. We hope that if you have small sums of cash needing professional management at a reasonable cost which you want to “tuck away”, this might be an ideal product.

At Rossie House, we don’t really like the word “product” and the stigma attached to it. We would like to feel that investors in RHPF can get some sort of service as well. We intend to publish a quarterly fact sheet on our website - it will also have an annual and interim shareholder report and we will endeavour to provide further information to those interested through their normal Rossie House contacts.

The RHPF itself is like a unit trust but is technically a NURS (Non UCITS Regulated Scheme). This has all the same characteristics as an open ended unit trust but allows us slightly greater investment freedom over the size of holdings and also to select funds from a wider pool. We intend to replicate the type of portfolio we would run for an average client with a long term objective of capital growth whilst receiving a modest level of income. The indicative yield is about 1.5% but this will vary. In regulatory parlance the fund has a “*Balanced*” mandate and is “*Medium*” risk. For clients who wish to concentrate more on capital growth we suggest they reinvest the dividend and we have launched an accumulation unit for this purpose.

At present RHPF holds 26% in assets that are intended to preserve capital in the event of a fall in equity markets. The rest is invested in equity funds, run by talented managers, with exposure to all global markets. Since inception to the time of writing the capital return of the fund is up 7.3%, which compares to a loss of 0.3% in the UK equity market and a rise of 3.6% in the FTSE WMA Balanced Index, which is the benchmark. It has typically participated slightly less on the upside when equity markets have been rising but fallen rather less when they have been weaker. This reflects our current positioning where we anticipate some more upside from shares but acknowledge there are lots of risks around. Shares have had a good run since the crash of 2008/09 and they are now rated quite expensively.

Please contact us for further information if you would like to know more.

Kennox Asset Management – Strategic Value Fund

Kennox was established to focus exclusively on running one portfolio – the Kennox Strategic Value Fund, our value-driven global equities portfolio – for a limited number of risk-conscious investors who identify with our long term, capital preservation focused approach. Based in Edinburgh, wholly independent and manager owned, Kennox, has considerable experience managing investments for some of the world's most well-regarded investment institutions. Approximately 90% of the Fund is held by leading wealth managers including private banks, family offices, multi-family offices and charities.

We are fully aligned with our investors. The Kennox management team has a significant investment in the Fund and both our fund managers have their entire equity holdings in the Fund. Our approach is inclusive and we see all clients as co-investors.

We have a clear performance objective – to deliver attractive, risked adjusted long-term returns. Since UK launch in 2009, the portfolio has achieved an annualised return of 9% which has been delivered through a consistent adherence to our focus and patient style: buying quality companies only when they become available at excellent valuations.

Unconstrained by sector, industry or market cap, our theoretical investment universe is over 60,000 companies. However, very few meet our demanding criteria. Our research process, driven by proprietary tools, enables us to quickly eliminate unsuitable companies, thus maximising the time available to our investment team to focus on genuine opportunities. As high conviction investors, the very few companies that we buy, we hold for the long term – turnover is typically less than 15% annually.

The result is a concentrated, well diversified portfolio (currently 29 stocks) which looks like no other – all high quality companies at compelling valuations. We are extremely risk aware, always focusing on the downside, conscious that with good stock selection the upside should take care of itself. We believe that excessive diversification is a poor surrogate for real knowledge. In order to be added to the portfolio, a stock must complement existing holdings and not merely add to a concentration of risk.

Importantly, we have the ability to hold up to 20% in cash. This is rare amongst portfolio managers and is essential to our strategy. It enables us to sell when we see a stock as being fully valued and allows us to be patient when extended bull markets stretch equity valuations and offer few opportunities. Our current cash level is 17%, indicative of the fact that following a six year bull market quality companies at good valuations become available extremely rarely. Our cash holding is dry powder, providing us with the ability to take full advantage of the more volatile markets investors are currently experiencing.

More information on Kennox and our approach to investment can be found on the Kennox website www.kennox.co.uk.

The above article was contributed by Kennox Asset Management – July 2015

Quantitative Easing

Background

In the autumn of 2008 the economy was crashing and stock markets were in a tailspin. Alistair Darling ordered the banks to raise capital and a government spending package amounting to £20 billion was announced. However, the economy continued to shrink. On 29 January 2009 the Chancellor wrote to the Bank of England (BoE) instructing it to set up a new fund – the Asset Purchase Facility. By 17 February the Governor warned of a "materially worse outlook" and the Monetary Policy Committee (MPC) lowered interest rates to 1%. Still the economy failed to respond.

Why it was needed

So, on 5 March 2009 the MPC decided to reduce interest rates again to 0.5%. Commentators reflected that this indicated the exhaustion of monetary policy – it had reached the "Zero Bound". Paul Krugman[1], who had continually pushed for more government spending to boost economies, ventured that the economy was in a "liquidity trap"[2]. The normal way for the MPC to conduct monetary policy was to alter the Bank Rate to encourage lending and spending. In Bernanke's[3] 1998 Paper – he called it "creditist" policy. However, interest rates could hardly go lower, growth was still absent and investors began to worry about deflation. A new approach was required.

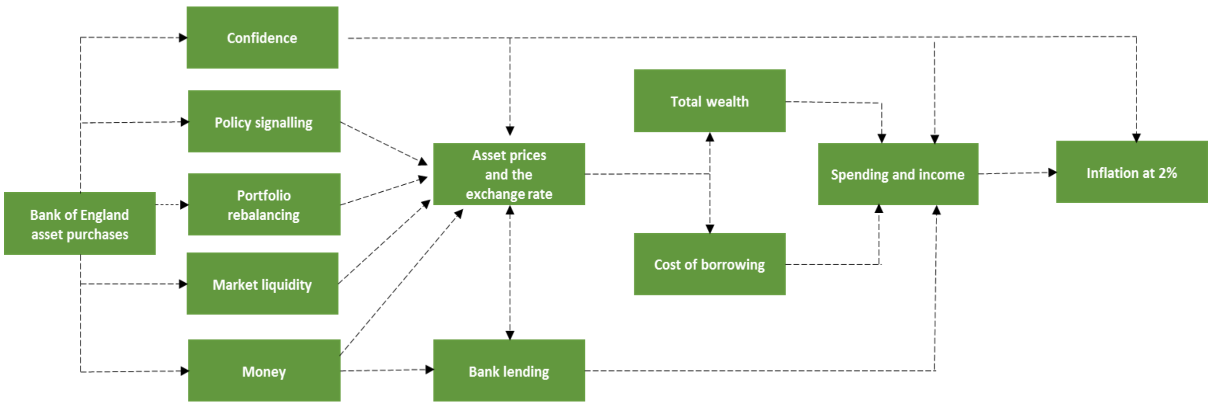
Theory

The BoE turned to history. In Irving Fisher's "The Debt Deflation Theory of Great Depressions"[4] he set out the relationship between money and the price level[5]. Friedman[6] developed these theories further in the 60s and 70s emphasising the superiority of monetary aggregates over interest rates. He suggested spending and asset prices respond to the **quantity of money**. The MPC announced it would undertake "quantitative easing" (QE) amounting initially to £150 billion. This "shifted the focus of monetary policy towards the quantity of money as well as the price of money …. [to] provide an additional stimulus to nominal spending and so help meet the inflation target [of 2%]"[7]. The BoE began purchasing public and private sector assets (mainly Gilts) from the *non bank* sector using central bank money, created electronically.

How it works

A useful chart[8] explaining how QE is intended to work is shown below. Initially, money created by the BoE would end up in the bank accounts of pension funds, insurance companies etc. from whom it bought the Gilts. These institutions would not wish to have "excess" cash balances so would purchase other assets (including equities) until their cash balances were rebalanced to the desired levels. Equity and other asset prices would rise, as would the bank balances of those from whom they were purchased. They in turn would use the cash to purchase other assets, pushing up their prices. Cash would soon pass from strong companies to weaker ones, eliminating strains in the economy, asset prices would recover along with demand, output and employment. A key point is that this extra expenditure would come about even if banks did not increase lending. It is the **increase in the money supply** (which consists of deposits – not loans) that is the key part of the transmission mechanism for QE.

QE transmission channels



Source: Bank of England Quarterly Bulletin 2011, Q3, p.201

Success or not

By the spring of 2010 the UK economy had stabilised. Note that this was despite many banks radically reducing their balance sheets in response to the authorities requiring banks to increase their capital. The two policies were contradictory and reveal how misunderstood QE was. Many still doubt whether QE works. Japan is often quoted as a country which has tried QE (indeed the name QE was coined to describe Bank of Japan policies between 2001 and 2006) yet its economy has been in a long period of deflation. Tim Congdon[9], a leading advocate of QE, suggests Japan was (and still is) mistaken to target the "monetary base" using money market operations. Although beyond the scope of this article, he argues it is necessary to operate *debt market operations* where the monetary authorities buy assets from the *non bank* sector for QE to be effective in increasing **money supply**. It has also been widely argued that QE will eventually lead to inflation. Another topical complaint is that it has widened inequality because existing owners of assets have benefited at the expense of borrowers and the poor. Final judgement as to whether QE is effective will likely need more time.

[1] Krugman, Professor of Economics at Princeton and Nobel prize winner; [2] Keynes invented the liquidity trap in *The General Theory*; [3] US Federal Reserve Chairman 2006-14; [4] One of the US's most influential economists, writing in a 1933 academic article in *Econometrica*, set out how individuals and companies would repay bank debt by selling assets. This would in itself depress assets further, resulting in further forced liquidations; [5] *The Purchasing Power of Money* - 1911; [6] Taught at Chicago University, Nobel prize winner and author of *A monetary History of the United States, 1867-1960*; [7] *Bank of England Quarterly Bulletin* Q2 2009; [8] *Quantitative Easing – House of Commons Library*, Economic Policy and Statistics Section 28 Oct 2014; [9] *Money in a Free Society* – Tim Congdon, Essay 4.

Rossie House and Gardens – David Nichol

There have been a number of technology companies which started life in garages in California but I can't think of any investment management companies which had a former coal shed in Perthshire as their birthplace. That is nevertheless how Rossie House Investment Management began and it was only after Charlie Cox and Jean Matterson joined me that we moved to the comparative luxury of a converted potato shed in the old farmyard at Rossie House.

Rossie House dates back to 1657 when it was built by Robert Oliphant for his son William and his new wife, Isabella Drummond. It remained in Oliphant family ownership until the last family member migrated to Canada at the end of the nineteenth century. There have been a number of alterations to the house over the years; the most significant being in the 1950's when it was dramatically reduced in size to adapt to post war social changes.

The gardens, too, have changed over the years. Originally, the walled garden was where all the vegetables and flowers were grown, the house itself being surrounded by parkland and trees. Along with the post war house alterations came the creation of a new woodland garden amongst the ancient trees and alongside the stream. New borders were made around the house, thus creating the foundation of the gardens you can see today.

When Judy and I moved to Rossie 37 years ago we found a garden that was overwhelming in size and sheer volume of work. It is, however, wonderfully sheltered and the framework of mature oak, beech, chestnut, cedar and wellingtonia, some over two hundred years old, had been supplemented with inspired under planting of shrubs and other ornamental trees. It was a magical place but we had a lot to learn.

To the west of the house was a swimming pool which we transformed into a private garden with roses and smaller shrubs under the south facing wall. On the north side was an abandoned area used as a hen run. A *rosa rugosa* hedge has replaced the chicken wire and it now surrounds the tennis court and small areas of herbaceous planting alongside agapanthus and lavender.

The main challenge in the early years was the woodland garden which had become overgrown. Judy was keen to keep it less formal whilst fighting back the brambles and rejuvenating the planting. It was always a difficult decision to fell old trees. To begin with when a tree fell down we were horrified but a week later Judy would say, "that is a good spot for *euchryphia*". Eventually a number were removed, notably a line of limes which bounded the main lawn, instantly softening the outlook and improving the view of the Ochil hills. The sunken garden which has a delightful old summer house draped in *vitis ciognetiae* was cleared

of ponticum and the pond drained, cleared of mud and made shallower to avoid drowning the children. There are now pockets of *trillium*, bog loving plants such as *rodgersia*, irises, *hostas* and primula against a backdrop of azaleas, *sorbus*, *parrotia persica* and *davidia* waving its comical handkerchiefs in the early summer. New planting is intended to be as maintenance free as possible and much of Judy's later ideas have extended the season so it is no longer just a spring garden.

In 1986 there were terrific gales in Perthshire solving the quandry about which trees to keep. Judy took advantage of the spaces planting unusual oaks, *magnolias*, *cercidiphyllum* for its autumn colour and bright red *acer palmatum*. The outside of the walled garden is lined with rows of purple *allium* and swan wing tulips, whilst inside a restaurant is growing specialist vegetables and herbs for its guests. We have become less nostalgic about trees, particularly if they are left to season and made into furniture; which is how it should be. There is a heron statue by David Annand in the pond and seats carved out of oak by Nigel Ross.

The gardens are open for charity from time to time and by appointment. If you are visiting the office and bored with economics and the state of your portfolio come and see for yourself; you will be most welcome.

Rossie Gardens are open for charity under Scotlands Gardens on Sunday 29th May 2016. Garden Societies and groups are also welcome by prior arrangement with Judy through e-mail: judynichol@rossiehouse.co.uk.

Further pictures are available on the "News" section of the Rossie House Investment Management website: www.rossiehouse.com

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

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