Q | THREE

COUTTS INVESTMENT OUTLOOK 2019 | Q3

# THE POWER OF INFLUENCE


Coutts

*At Coutts, we take our responsibility to our clients seriously. It's one thing to invest in a way that preserves and grows your wealth for the future; it's something else to make sure we're all proudly contributing to a future worth living in. This means making sure the investment decisions we make on your behalf always also look through a sustainability lens.*

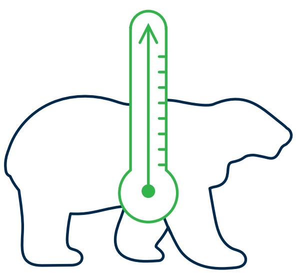
PETER FLAVEL
*Chief Executive Officer, Coutts*

# CONTENTS

# INTRODUCTION

## HOW DO YOU WANT TO SPEND THE FUTURE?

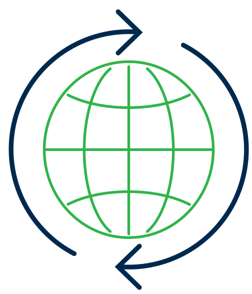
Investing for the long term means looking beyond the surface of investment data. In this quarter's outlook we take a look at sustainability in its different forms and the different ways it applies to investment. To us it means not only giving our clients sustainable investment returns, but making sure our world offers coming generations the same opportunities and potential for achievement that previous generations have enjoyed.



### Investing with purpose

Debate over appropriate action in the face of climate change has been rising in volume as the issue becomes more urgent. In this context we have to consider not just the investment opportunities presented, but also the broader implications for our investment strategy.

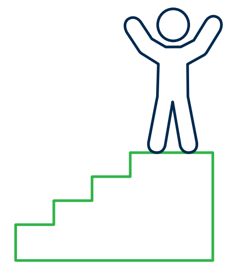
Similarly, we are endeavouring to encourage diversity among the companies we invest in and in the investment teams of the funds we invest with. We believe that more diverse pools of talent make better decisions by including a broader range of perspectives. And more than this, the drive to provide more opportunities for more people is a force of history that we believe is worth supporting.



### The world keeps turning

If the first quarter was characterised by relief for investors following a bumpy end to 2018, the second quarter was a reminder that short-term noise never completely fades away. Politics was largely responsible for market jitters in May, from Brexit to the China-US conflict over trade.

But if things are never quite as good as some of the more exuberant commentators may suggest, it is equally true that things are never quite as bad as the naysayers would have you believe.
The discipline to stick with your convictions when market sentiment goes in the opposite direction is the defining characteristic of a successful investor.



### Achieving your goals

Whatever your goals and aspirations, the right financial plan is an invaluable tool for achieving them. Finding an investment manager who you can trust to deliver consistent and sustainable returns is just one part of the decision.

Partnering with an adviser who really understands you is just as important. We know that the financial affairs of our clients can be complex – complex problems require ingenious solutions. When it comes to building a clear financial strategy, that takes account of both your long-term goals and day-to-day needs, our knowledgeable and experienced team can help you shape your future.

As ever, if you would like to discuss any of the issues raised in this Outlook, I urge you to contact your wealth manager or private banker or email us on investmentqueries@coutts.com.

MOHAMMAD KAMAL SYED
*Head of asset management, Coutts*

# THE INVESTMENT VIEW

## CHANGE BRINGS OPPORTUNITY

The economic environment continues to move quickly and we have made changes to our positioning in response. Overall we're slightly more cautious than we were three months ago, but changes bring opportunities to be grasped as well as dangers to be avoided.

# OUR CONVICTIONS

## EMERGING MARKET DEBT

*Attractive valuations and high yields make emerging market government bonds more attractive than low-yielding developed market credit.*

## US GOVERNMENT BONDS

*We've diversified our developed government bond exposure rather than rely only on gilts, which are vulnerable to the outcome of Brexit negotiations.*

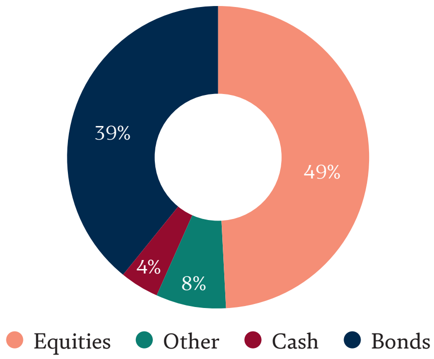
## FALLING US INTEREST RATES

*The economic environment is likely to see the US Federal Reserve lower interest rates, which will favour short-dated US government bonds over longer-dated debt.*

# CURRENT POSITIONING

Indicative positioning based on the average sterling balanced portfolio as at 30 June 2019. Other strategies and products may vary.

**Sterling Balanced**




Source: Coutts & Co

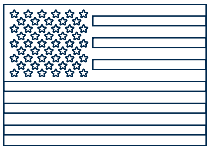
# TACTICAL MOVES

Changes to holdings over
the last 12 months.

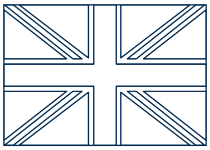
| | | |
|---|---|---|
| **Increased over the last 12 months** | **Reduced over the last 12 months** | **No change over the last 12 months** |

## EQUITY

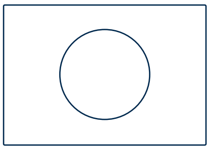
After a significant rally in the first half of the year, the outlook for equities looks less attractive than six months ago.



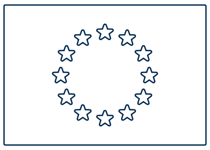
**US**



**UK**



**Japan**

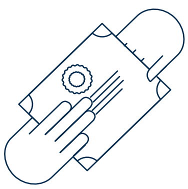


**Europe**

**Emerging markets**

# BONDS

While the long-term outlook for bonds remains unattractive, the current environment of lower inflation and looser central bank monetary policy - combined with equity volatility - has seen us increase exposure recently.



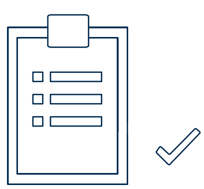
**Developed market government bonds**

**Investment grade**

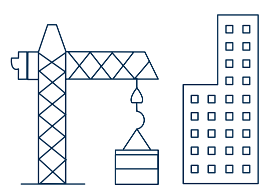
**Emerging market debt**

# OTHER

Many alternative investment strategies continue to struggle in the current financial environment, although we have recently made small additions in specific markets where there is a strong rationale.



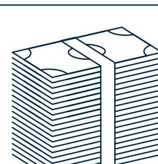
**Absolute return strategies**



**Commercial property**

# CASH

We have recently used cash to invest in assets that reflect the changes in the outlook of central bank policy and bond markets.



**Cash**

# INVESTMENT UPDATE

## POLITICS, ECONOMICS AND THE WISDOM OF THE MARKETS

The second quarter of 2019 has demonstrated that the concerns investors had at the end of 2018 hadn't been eliminated by the market recovery since the start of the year. In the third quarter, we're looking carefully at how global politics can influence investment performance.

*Since late last year we have reduced our exposure to equities, added to US government bonds and moved some equity exposure from emerging markets.*

While 2018 was marked by a slowing global economy, we saw some tentative signs of economic rebound during Q1, followed by a slower Q2. Much of the current slowdown is concentrated in traditional manufacturing sectors but there is also some weakness in service sectors. During the first half of 2019 the US economy, which proved resilient in 2018, has started to show signs of weakness. This is most likely a delayed response to the continued uncertainty about trade tariffs and its impact on global supply chains.

However, financial market performance this year looks remarkably more positive than last year's. This is partly because of the rebound in economic growth during Q1 but is mostly because of the  dramatic shift in central bank interest rate policy. While 12 months ago it was consensus among investors that central banks would increase interest rates in 2019, they have now started the countdown for interest rate cuts, with the first one coming at end of July from the US Federal Reserve (Fed). This supported riskier assets such as equities in the first half of the year.

So the scene is set for the two main actors of the second half of 2019: central banks and geopolitics, with trade tariff negotiations at the core.

Without a resolution to the US/China trade dispute and with global growth remaining under pressure, any new episode of US-Sino trade tensions comes at a delicate time. Up to now the combined efforts of the main western central banks and Chinese stimulus has allowed financial assets to deliver strong returns as they expect a positive outcome of the recent slowdown rather than a slide into a recession. A new round of trade tensions poses a risk for corporate and investor confidence and raises general economic uncertainty.

## Think politically

*It's probably fair to say that politics will remain an influence on markets as and when tensions rise. Campaigning for the 2020 US Presidential election is ramping up and the never-ending Brexit uncertainty continues to put pressure on the UK's parliamentary system. Interestingly, as the global economy has generally slowed, politics has started to influence economics and both now seem to increasingly feed each other.*

While the current US administration is taking a hard stance on tariffs – the recent episode with Mexico was a good reminder – it nevertheless seems reasonable to expect that the closer we get to the Presidential election in November 2020 the more domestic economic factors like unemployment or wage growth will move to the foreground. Surely, President Trump will want to be seen as a president who promotes jobs and employment and not simply as a "tariffman". Therefore he will likely consider very carefully before escalating trade tensions further given the recent softness in the US manufacturing data.

**Where to focus in the coming months**

In the second half of this year our analysis is likely to centre on three key areas:

- **changing global economic activity**
- **the interplay between trade tensions and central bank actions**
- **investor activity and sentiment**

On the first point, our own research provides an objective, data-driven assessment of global economic direction, which correctly anticipated the economic slowdown last year. Currently, this points to signs of stabilisation in China and some European countries, but also shows that the global business cycle remains in slowdown for now.

Since late last year, when we first spotted this slowing trend, we have made gradual shifts to our funds and portfolios accordingly. These include reducing our exposure to equities and adding to US government bonds, and moving some equity exposure from emerging markets to a steadier home in developed economies.

## Peace in our time?

*Our base case on the US/China trade dispute is that the two sides will eventually come to an agreement, as it is in the best economic interests of both parties to normalise trade as soon as possible. When this will happen, though, isn't clear as any solution is dependant as much on political considerations as economic ones.*

The risk to this view is that President Trump may see tariffs as a winning tool for his re-election. As mentioned, his view may change if the economy gets weaker as continued disruption and added expense to industry – likely to be passed on to consumers – have the potential to exacerbate weaker economic activity and act as a drag on growth as business investment and consumer confidence slow. Central bank policies and economic stimulus by the Chinese government remain the main mitigating response to any adverse developments. China has already put a significant amount of monetary and fiscal stimulus in place, and looks ready to deploy more if needed, as economic stability remains the main Chinese objective.

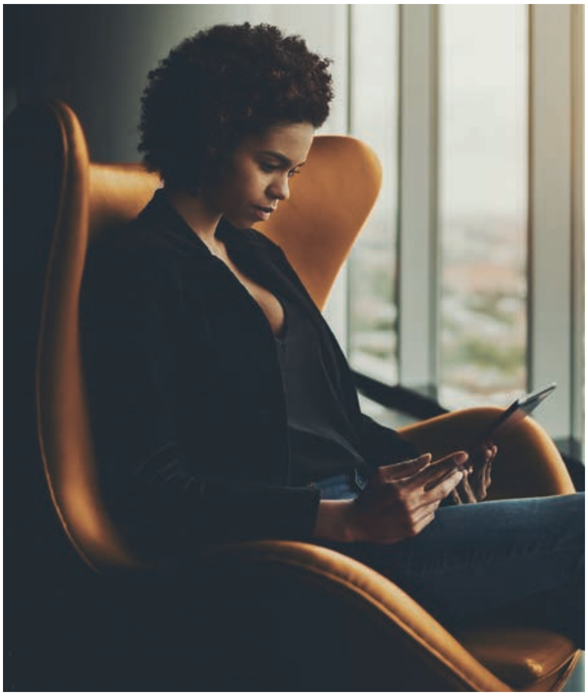
The US Fed also appears determined to remain supportive and other central banks are likely to follow the Fed's lead in time.

## Stick with the plan

*Against this complex backdrop we are considering a number of factors such as valuations, business cycle sensitivity and technical measures to guide our investment decisions. These continue to suggest a balanced approach to risk assets like equities or credit on the one side, and government bonds – which tend to perform well when the business cycle slows – on the other.*

In line with our contrarian approach we see negative investor sentiment as an opportunity, while equally viewing any investor exuberance as a risk. For example, we hold a low and selective exposure to emerging market equity and debt in part because it has rapidly become a consensus investment since the start of the year.

There are imminent risks on both the upside and the downside. Resolution of trade tensions and further economic expansion would be positive for markets, while further renewed slowdown in economic activity under the impact of renewed uncertainty would see some asset classes struggle. As the year unfolds, we will continue to monitor markets with an eye to the longer term and make adjustments as necessary. ☐



# WITH AN EYE ON THE FUTURE

# YOU HAVE THE POWER FOR CHANGE

Investing isn't only about protecting your financial future.
It can also be a way to influence the world around you and create a better future for everyone.

# THE ENVIRONMENT

## WEATHERING THE CHANGING CLIMATE

The choices we make about our environment today have the potential not just to affect investment returns but to severely limit the choices open to future generations. To help protect our freedoms, and to ensure the long-term future of our investments, we have to think differently.

As long-term investors, we're used to looking years and even decades ahead to consider the implications of our decisions. The emergence of responsible investing – which puts the environmental impact, social benefits and corporate governance of companies (often abbreviated to ESG) on an equal footing with traditional investment measures – is a crucial tool. As well as highlighting non-financial corporate risks it is a way for us to ensure that our clients' investments support the evolution of a world that they will be comfortable living in.

Around the world, scientific voices are increasingly united in the conclusion that changes to the planet's climate could have grave consequences for humanity. In less than a generation, many of the privileges we enjoy today could be severely limited, or disappear altogether.

But it doesn't have to be this way. At Coutts, we recognise our responsibility to current and future generations of our clients to help preserve – and even increase – the choices we have today.

*The emergence of responsible investing – which puts the environmental impact, social benefits and corporate governance of companies (often abbreviated to ESG) on an equal footing with traditional investment measures – is a crucial tool.*

## The changing investment landscape

*Climate change is a financial risk for all investors, and a fiduciary responsibility for professional investors such as Coutts, but it is also an opportunity.*

Demonstrating how mainstream the idea has become, no less an establishment figure than the governor of the Bank of England, Mark Carney, speaking to the European Commission conference 'A Global Approach to Sustainable Finance' in March this year, said, "Advances in reporting and risk analysis are paving the way for investors to realise the opportunities in climate-friendly investment by re-orienting their focus to broader, more sustainable long-term value creation."

Emissions and energy efficiency data will be an increasingly important focus for investors, as will investment in green technologies. Oil and gas companies will need to consider their reserves, a proportion of which may become stranded and no longer economically viable or environmentally desirable to continue to extract.

In the meantime, the urgent need to transition to a low-carbon economy has seen industry respond with new green technology solutions. Oil and gas producers like BP have huge financial resources to transition their business models from fossil fuel extraction to renewable technology. While the transition is likely to be a medium to long-term process, it has implications for today's decisions on capital expenditure on new projects. Technological innovation always creates opportunities for companies to develop new markets and income streams, and investors who support them stand to benefit.

## Good intentions into action

*As a large investor, Coutts is in a strong position to influence the companies we invest in on our clients' behalf.*

We incorporate research and data from a specialist research provider Sustainalytics in the selection process for our direct equity portfolio. This includes a company's greenhouse gas emissions, effluents and waste, its energy efficiency and how efficiently it uses its inputs. Sustainalytics also gathers information on how well a company manages its impact on land, ecosystems and wildlife.

This data feeds into our equity selection process. Companies with a high level of environmental risk or which have been involved in recent environmental controversies receive a lower investment score in our selection framework and so are less likely to be included in client portfolios.

Some activists are urging investors to drop all investment in companies contributing to harmful climate change. Our approach is to tilt our selection away from harmful companies while putting pressure on the companies we do invest in to make positive changes.

Working with third-party engagement specialist Hermes EOS, we can coordinate efforts with other shareholders to bring significant influence to bear. Around 30% of Hermes EOS engagements on our behalf are in relation to environmental issues. Hermes EOS is a leading player of the Climate Action 100+ coalition which aims to engage with the 160 systematically most important greenhouse gas emitters to help achieve the goals of the Paris Agreement.

Hermes has engaged with five of the companies we invest in directly. In December, for example, Shell reached an agreement with the coalition to adopt new emission targets and link these to executive remuneration following collaborative engagement with the company. But engagement isn't limited to energy companies.

On our behalf, Hermes has also engaged with companies whose supply chain has an impact on greenhouse gas emissions, water usage and deforestation. We vote on environmental issues at shareholder meetings, which has given us the opportunity to challenge companies to ensure that their strategies are aligned with the goals of the Paris Agreement to limit global warming to below 2°C. Recently, we voted in favour of a resolution at BP for the company to follow a strategy consistent with the goals.

*On our behalf, Hermes has also engaged with companies whose supply chain has an impact on greenhouse gas emissions, water usage and deforestation.*

## What's next

*The Task Force on Climate-related Financial Disclosures (TCFD) was established by the Financial Stability Board in 2016. It encourages companies to publish consistent information on climate-related financial risk for investors, lenders, insurers, and other stakeholders. Asset managers, for example, are encouraged to explore how climate-related risks and opportunities are managed within each of their portfolios, with scenario-based assessments a recent and evolving tool.*

From 2020, the Principles for Responsible Investment (PRI), to which Coutts is a signatory, will require all signatories to report on TCFD-aligned indictors. This will increase awareness of how critical considerations of climate risk and opportunities are to investing for the long term.

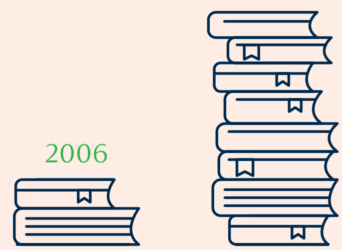
Engagement and assessment remain the most powerful tools in our arsenal to reduce the negative effects of climate change. As we become more aware of what action can be taken to minimise the harm potentially caused by climate change, we'll be looking to support these steps through our investments. □

# WHAT ARE THE RISKS?

Climate change presents several specific risks that investors need to address in their portfolios.

## LITIGATION

Individuals and organisations are increasingly going to court seeking damages in relation to companies' actions regarding climate risk.

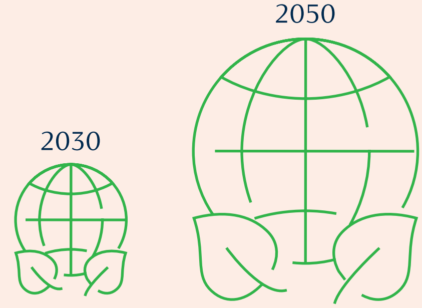



**Number of climate change-related cases under litigation**
One big successful challenge could pave the way for a large number of claims seeking reparations based on historical emissions and activity, leading to costly payouts.

Source: Carbon-Delta

## REGULATION

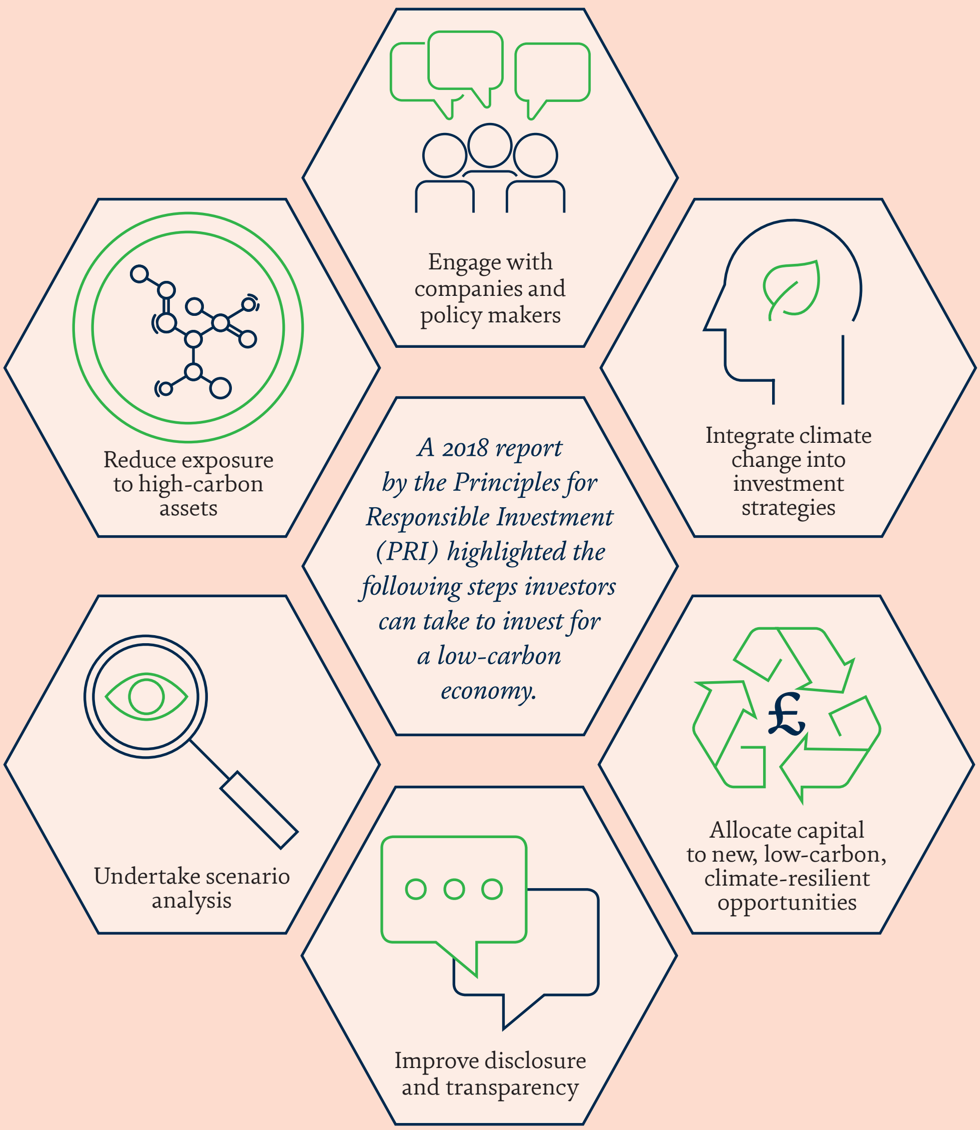
National governments and international regulators are setting tough targets for reducing greenhouse gas emissions. The cost of meeting these targets will be met largely by companies.

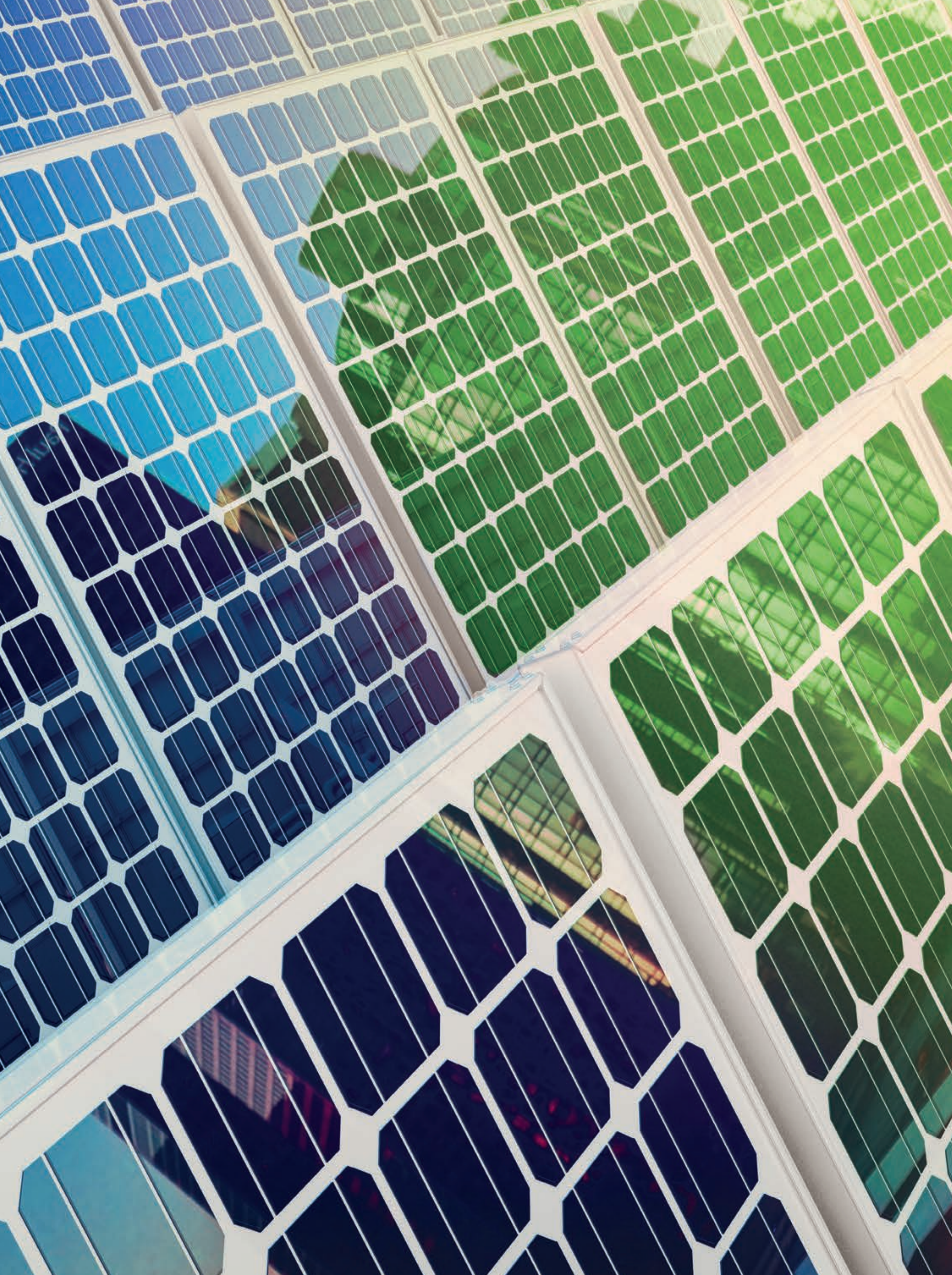



Reduction of carbon emissions pledged by EU nations (relative to 1990 levels)

Reduction in emissions targeted in the UK Climate Change Act (2008), in line with the Kyoto Protocols

# HOW TO INVEST FOR A LOW-CARBON ECONOMY





# DIVERSITY

## DIVERSE DECISIONS ARE GOOD DECISIONS

Diversity delivers. Companies with a range of voices at the top make better decisions, while making the most of a deeper pool of talent. But not only can it have a material benefit, we believe it's the right thing to do.

A study by McKinsey & Company, titled 'Why Diversity Matters' and published in 2015, provided clear evidence that diversity can improve the performance of companies. Companies in the top quartile for racial and ethnic diversity were found to be 30% more likely to have financial returns above their national industry medians. Similarly, companies in the top quartile for gender diversity are 15% more likely to have financial returns above their national industry medians.

In the meantime, companies in the bottom quartile for both gender and ethnic diversity were shown to be less likely to achieve above-average financial returns. So, not only are more diverse companies more likely to do better than the average, less diverse companies are less likely to outperform.

Of course, correlation is not causation, and the relationship between greater diversity and commercial success is not entirely clear. But the authors of the McKinsey report suggest that diverse organisations are more in tune with the preferences of their customers. They also saw higher scores in employee satisfaction, giving diverse companies an advantage in their ability to attract and retain talent.

## The effect on investment

*Diversity, both in gender and ethnicity terms, is very low in the investment industry. A 2017 study by the Harvard Business School focusing on the US asset management industry (Diversifying Investments: A Study of Ownership Diversity and Performance in the Asset Management Industry) found that investment firms with at least 25% women or minority ownership represented just 1.3% of the industry's total number of firms, and only 0.9% of the industry's assets under management.*

The European fund management industry appears to be doing slightly better than the US, but diversity is still at a low level. A recent analysis conducted by research firm Refinitiv found that about 14% of 329 European equity funds (managed by 156 different asset managers) had at least one female fund manager. Of those 14%, only one-third were managed by one female portfolio manager or by an entirely female portfolio management team.

The impact of diversity on the performance of investment funds is still under-researched. The Harvard Business School study concluded that the average investment returns generated by mutual funds owned by women or ethnic minorities (where 'owned' refers to at least 25% ownership by women or minorities) were not materially different from those generated by non-diverse fund management firms.

However, 26% of women-owned and 29% of minority-owned funds found themselves in the top quartile (that is the top 25%) of performers in both 2016 and 2017, according to the Harvard study. The fact that more diverse investment teams are proportionately over-represented among the top performers implies that they are generating returns that are, at the very least, somewhat more stable and consistent than those generated by less diverse teams.

The Coutts investment team has also been looking into what behavioural economics can tell us about the investment decision-making process. Behavioural economics studies the effects of in-built biases on decision-making. We've been trying to get a better understanding of some of the biases that can lead to bad decisions with the aim of mitigating their effects in our portfolios. Our research has revealed that overconfidence can have a materially negative impact on investment decisions.

One of the best ways to avoid this is to ensure investment managers challenge their own investment conclusions and always seek out conflicting views. On this basis, we believe that more diverse teams are better able to provide this important challenge and avoid myopic decision-making.

## Things can only get better

*While we take heart from this evidence, there is more at stake than just a few basis points in fund performance. As well as the potential to improve investment returns, we believe that increasing the diversity in our own field improves life opportunities for everyone in the communities we live and work in.*

For this reason, we've built diversity into our environmental, social and governance (ESG) assessment of fund managers and companies:

- Where we are directly investing in shares, we are bundling our shareholder powers with like-minded investors to push for diversity within these organisations and on their executive boards
- Where we are investing in third-party investment funds, we do not settle for just finding the best investment talent – we are also seeking to actively 'nudge' them to improve the diversity of their investment team

And we think that efforts like this by ourselves and the investment industry at large are making a real difference. When we started integrating ESG elements into our fund selection process we noticed stark differences between fund management firms, both in terms of resources dedicated to ESG research and how well and thoughtfully it was integrated in the overall investment process.

Our 'nudging' has led to improvements. One prominent fund management firm with whom we have sizeable (and well-performing) client assets has created a dedicated ESG function and hired a specialist researcher. It's changes like this that give us hope that our efforts are working and drive us to achieve more.

We believe that this has the potential not just to improve outcomes for our investment clients, but to make the world a fairer place for generations to come. □

*This has the potential not just to improve outcomes for our investment clients, but to make the world a fairer place for generations to come.*

# TAKING ACTION

At Coutts, we're addressing diversity in two ways – engagement and assessment

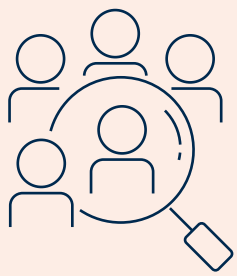
## ENGAGEMENT IN ACTION

*With support from Hermes EOS, we actively engage and vote to encourage companies we invest in directly to improve the diversity of their organisations and executive boards. This is not just a social issue but it is also good for governance and risk management.*

For a number of years, Hermes EOS has been pressuring Anglo-Australian mining company Rio Tinto regarding the lack of diversity on its Board. They recommended voting against the appointment of three male non-executive directors (NEDs) in early 2017 as this would have resulted in only two female directors out of 12. Following continued engagement, a new female NED was appointed in February 2018.

The company has a target of 33% female representation by 2020 which it will fill as vacancies become available. These might feel like small steps but if we can help improve board diversity in an industry like mining, we can do it anywhere.

## ASSESSMENT IN ACTION



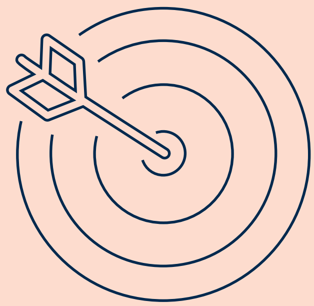
*Environmental, Social and Governance ('ESG') considerations have already been part and parcel of our fund selection process for several years and deepened continuously.*

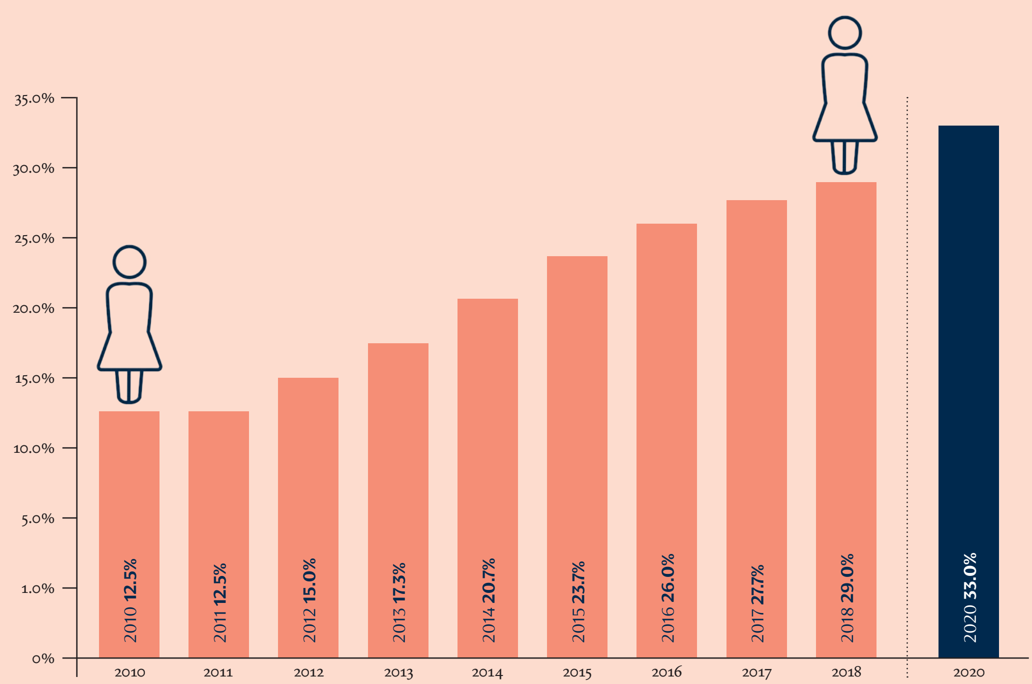
As the latest step, with a specific focus on diversity, we have now started to assess the diversity of the investment team of funds that we are analysing and investing in. We will assess the male-female ratio of investment teams at the start of our analysis and then track changes to this ratio as part of our monitoring and review process.

Our hope and expectation is that, by merely asking the question, repeatedly and persistently (and conveying the Coutts view on the benefits of diversity), we will do our bit to trigger change in the fund management industry.

# GETTING DIVERSITY RIGHT

In 2010, the government set a target for 25% of board members of FTSE 100 companies to be women by 2015. In 2015, the target was moved on to 33% by 2020.






Source: Improving the Gender Balance in British Boards, Davies Review, 2015;
The Female FTSE Board Report 2018, Cranfield University.

# SUSTAINABLE RETURNS

## LOOKING BEHIND THE LONG TERM

An understanding of valuations is an important driver of long-term returns, but it's not enough to deliver the returns our clients are seeking. We can add considerably to returns – and deliver a smoother ride – if we capture opportunities thrown up by volatility.

At Coutts, we manage our multi-asset portfolios with the long term in mind. We aim to deliver clients above-market returns over five years or more, and recommend that they keep this time horizon in mind when investing and reviewing monthly or annual performance; one bad month, quarter or even a year doesn't necessarily mean that they'll be looking at a long-term loss.

But containing volatility is important. Evidence shows that too much volatility, especially on the downside, can lead investors to make bad decisions, usually that of selling up and crystallising a loss. If we can minimise these sudden drawdowns clients will be more likely to stay invested. Research shows that some of the best periods of performance come after a significant drawdown, and so encouraging investors to hold on can be in their best interests.

While the long term remains important to our promise to clients, we think that the best route to delivering clients a smoother ride is through focusing on the medium-term. In our view, we are most able to manage the balance between upside potential and volatility over a 12-18 month horizon.

## Understanding short-term drivers

*There are two reasons that short-term returns are harder to gauge. Firstly, while valuation has empirically been shown to be a good guide for long-term returns, evidence shows that it's less reliable over shorter time periods. If you purchase something below its fair value today, there is a high probability that the price will rise back to fair value after several years. These probabilities decrease, however, as the time period gets shorter because short-term price dynamics are less predictable.*

Similarly, expected earnings growth can be inferred reasonably well over the long run. There's a relationship between how much corporate profits can grow and GDP growth, and so if you have a grasp of the economic picture you can judge the potential for growing earnings. But earnings can be very volatile over shorter-term periods, which are dominated by the business cycle.

# WHAT DRIVES LONG-TERM RETURNS

What drives the performance of asset classes over time is a combination of income and capital gain or loss. This is true for a property, for example, that you buy and then rent out – the total return will be the income from rent plus any gain you make when you come to sell the property, and the same is true for equities, bonds and any other asset class.

## FOR EQUITIES, THE RETURN IS MADE UP OF:

**Income from dividend payments and share repurchases**

This represents the portion of a company's earnings paid out directly to shareholders.

**Capital gains due to earnings growth**

Earnings generated but not distributed by the company– they could be invested, for example, in new plant or property – increase the value of the holding represented by a share, and should lead to a higher share price.

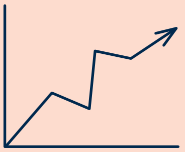
**Changes in share price based on changes in the price/earnings ratio**

Companies with a lower price/earnings ratio are considered undervalued and should attract investors, and share prices should rise based on the law of supply and demand.

## FOR INVESTORS THIS TRANSLATES INTO THREE QUESTIONS WHEN ASSESSING A SHARE:


**What income can I expect from owning the asset?**

**Am I paying the right price or not, compared to the asset's intrinsic value?**



**How will my share of the profits grow over the years?**

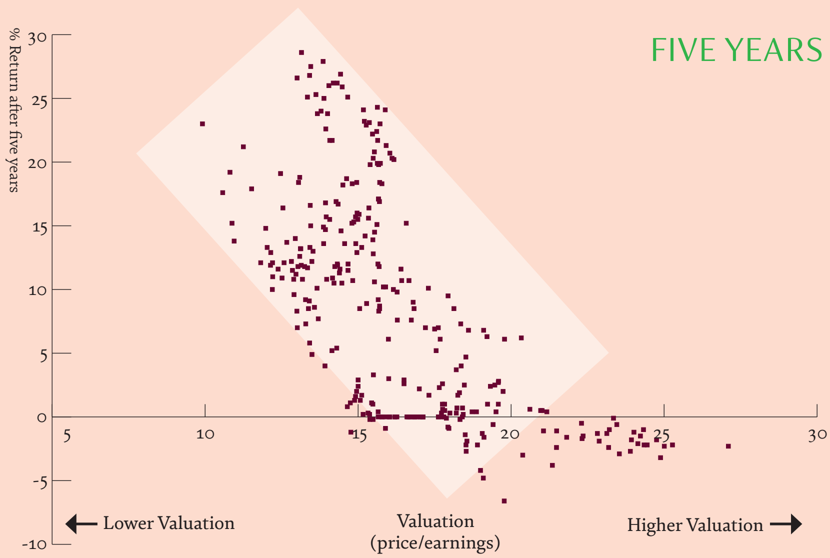
These essential questions set out a fairly clear framework that we can use to determine a likely range of return over the long run. However, they provide little guide as to what to expect over shorter time periods, say 12 months or so.

# VALUATIONS

Helpful in the long-term, less so in the short term

## OVER FIVE YEARS, A LOWER P/E RATIO IS STRONGLY ASSOCIATED WITH GOOD RETURNS

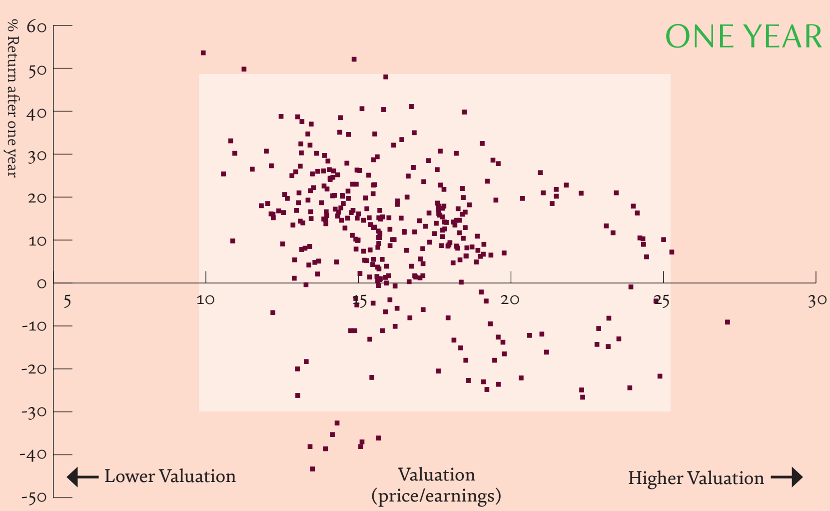
A low valuation can mean that the market has underestimated a company's potential – in time, the share price increases in line with the company's intrinsic value.
In addition, you are usually paying less for income, in the form of dividends, than a company with a higher P/E ratio.




Each dot represents five-year performance of S&P 500 relative to price/earnings ratio at purchase.
Past performance should not be taken as a guide to future performance.
Source: Coutts & Co, Bloomberg.

## OVER ONE YEAR, A LOW P/E RATIO IS NOT A GOOD INDICATOR OF RETURNS

Not only does it take time for share prices to realign with intrinsic value, but short-term limitations on a company's ability to make profits could also take time to shift.




Each dot represents one-year performance of S&P 500 relative to price/earnings ratio at purchase.
Past performance should not be taken as a guide to future performance.
Source: Coutts & Co, Bloomberg.

## HOW DO WE JUDGE VALUE?

One way to compare companies is consider the price/earnings ratio, or P/E. This tells an investor how much they are paying for a company's earning potential. A low P/E ratio indicates that a company is good value, while a higher P/E means it's not good value.

It's calculated by dividing the share price by the earnings per share. A company priced at £100 per share with annual earnings of £10 per share would have a P/E ratio of 10x.

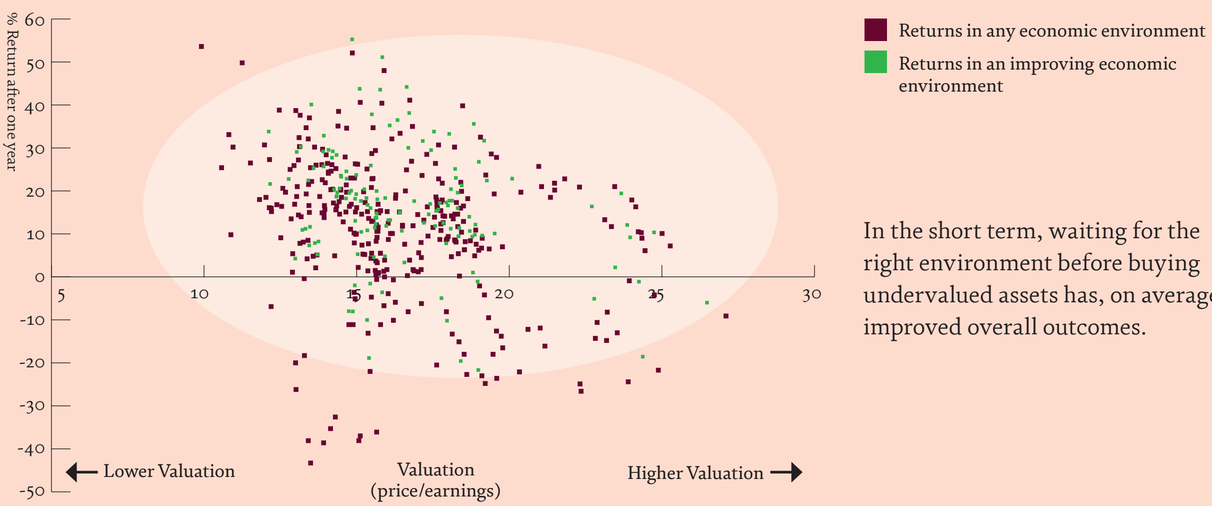
Conversely, a company priced at £10 per share but with annual earnings per share of £0.10 would have a P/E ratio of 100x. Even though the share price is lower than the £100 share it would represent much poorer value.

It's worth remembering, however, that there are other ways to value companies and can be good reasons to buy assets with a high P/E ratio.

## IN THE SHORT TERM, THE ECONOMIC ENVIRONMENT IS KEY

Economic fortunes drift up and down following a pattern that's often referred to as the economic cycle. It can last from five to ten years, and include boom times at the peak and descend into recession at the trough.

The drivers of economic cycles can be complex, and the peaks and troughs can vary. But careful analysis of economic data means we can usually have a good idea of which way the economy is heading.




In the short term, waiting for the right environment before buying undervalued assets has, on average, improved overall outcomes.

Each dot represents one-year performance of S&P 500 relative to price/earnings ratio at purchase.
Past performance should not be taken as a guide to future performance.
Source: Coutts & Co, Bloomberg.

## THINKING BEYOND VALUATION

Combining an understanding of the economic environment with value measures can lead to a smoother investment journey without sacrificing performance in the longer term. In an improving economic environment, returns are less dispersed and there is less risk on the downside.

This could be for various reasons, for example higher consumer fueling profits or increased investor confidence supporting share prices.

## The long term versus the short term

*If you wait at least five years, you see that buying undervalued assets would have historically delivered a positive and above-average return: valuation works over the long term.*

So, while they're a good way to assess potential long-term gains, there are risks in putting too much emphasis on valuations. Short-term volatility and potential underperformance can act as a drag on performance while you wait for the fundamentals to kick in, and assets that are undervalued can remain undervalued for some time. Outside of idiosyncratic reasons, an asset class typically becomes undervalued when it falls out of favour. One reason this happens is when the economic environment acts as a headwind – cyclical stocks, for example, are so named because their revenue and profits are highly dependent on business activity.

Automobile companies are a prime example. Given the high proportion of fixed costs and the discretionary nature of the products they sell, their profit will benefit disproportionally from a rise in sales that can come when the economy is doing well, while suffer in a slowdown or recession. This means that when you see the economy beginning to slow, it is a signal to review – and potentially divest – your holdings in the automotive sector.

## Making good decisions across all time frames

*Taking all these factors into account, there are two main considerations, among others, for us when we're assessing different asset classes, based on long-term and short-term considerations:*

**Long term: Valuation**
This is our anchor and a very good discipline when investigating assets. All else being equal, we will always prefer investing in assets that are cheap based on their fundamentals.

**Short term: The economic environment**
The business cycle is the driver of corporate growth and inflation, and short-term changes in asset prices hinge on these. Stronger growth should lead to higher profits and higher inflation. This tends to be good for equities and negative for fixed income. At Coutts, we have developed in-house indicators to track the business cycle and understand whether economic activity is going to expand or slow down. This helps us position our portfolio between risk-seeking and defensive assets.

When making investment decisions on attractively valued assets we consider the state of the economic environment and the likely impact this may have on shorter-term returns. While we may miss out on some positive outcomes, we see a better risk-adjusted return, with a reduced dispersion in returns. This is exactly what our investment process is about. It is about delivering a better path, a more palatable journey without compromising on the return potential.

So when we look at what is attractive, we look at the valuation but we are always aware of the economic environment. We want to buy assets that are undervalued, yes, but only if we have enough conviction that the environment will justify a re-rating.

Essentially, our role is to consider valuation in the context of the macro-economic background. We examine a range of data – for example, leading economic indicators – to form a view of how valuations might change for particular assets, and these will have a bigger impact on the changes we make to our tactical allocation than valuation.

For example, while on some measures bond markets look expensive, we have increased our position based on our assessment of the direction of the global economy. This, rather than bonds' high valuation, is likely to have a bigger effect on returns in the short term, a view that's been borne out by returns over the last 12 months. And it's worth making it clear that there are other factors we consider. In particular, there are quantitative and qualitative elements specific to particular assets that we examine in detail before investing.

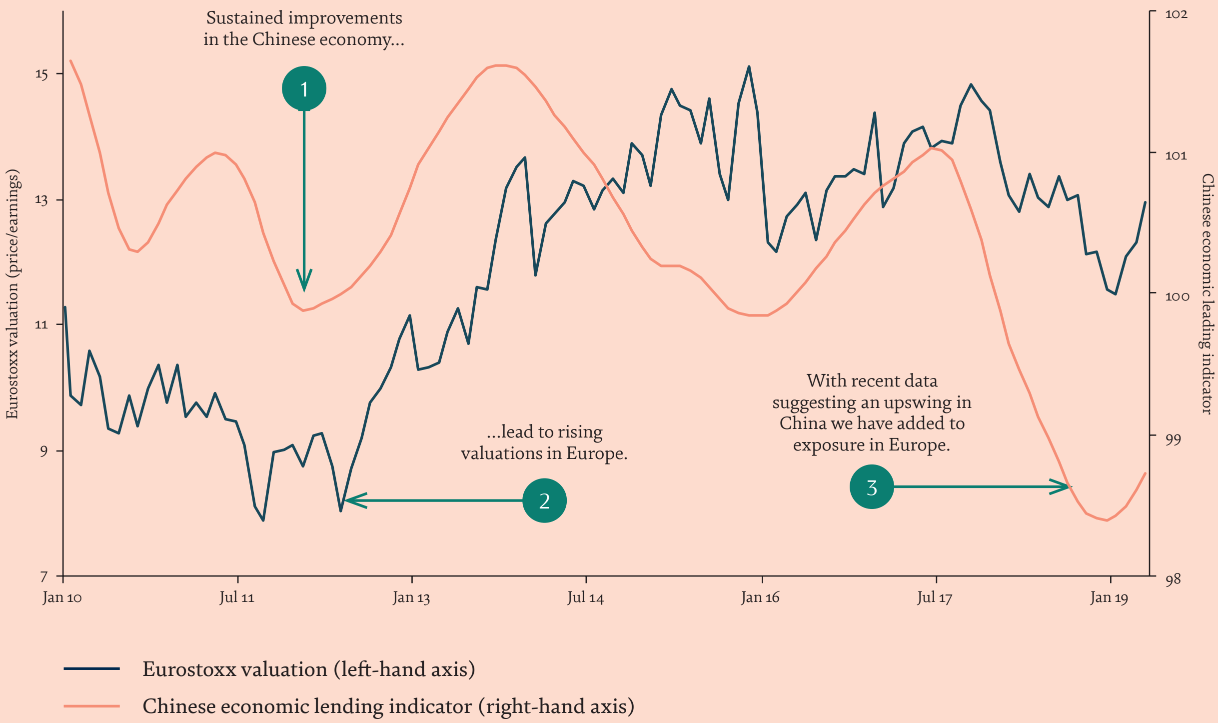
Relying solely on valuation works in the long run but it involves a higher level of volatility. Combining these considerations will give our clients a smoother short-term return without substantially reducing the potential for long-term gains, which we believe provides a better experience for clients. □

# The economic cycle in action

**Waiting to strike in Europe**

Europe is a very cyclical market, largely dependent on the Chinese economy. The graph below shows how positive turns in China's leading economic indicator – which signals improvement in the Chinese economy – provides a strong confirmation signal that cheap valuations in European stocks are on the mend. If you looked at valuations only, you would have looked to buy European equities in 2010-2011. But the re-rating only occurred from 2012 onwards, on the back of a recovering Chinese economy. Up until then you would have been sitting on flat returns. When improving economics meet attractive valuation - that's when you want to strike. You might miss some of the upside but, you skew the odds in your favour and avoid the long wait where capital isn't generating a return.

WHERE CHINA GOES, EUROPE FOLLOWS



# PERFORMANCE

## WELL-POSITIONED FOR UPBEAT MARKETS

Investors can take comfort from a bold first half of the year for markets. Despite a wobble of confidence in May, investment returns over the last six months have rewarded investors who held their nerve at the end of 2018.

After a positive first quarter, the second quarter has once again seen positive returns for Coutts investors. The CMAF UK Balanced fund was up 3.3% over the quarter, bringing returns since the beginning of the year to 10.4%.

Over the year-to-date, our funds and portfolios have been well positioned for rising equity markets over the quarter, with our positions in Russian equities and technology being particularly beneficial. Preferring equities over bonds in general has helped, as bonds have been out of favour since equity markets picked up at the start of the year.

We're happy with these short-term results, but for us the real test is the long term. Over five years, CMAF UK Balanced has delivered 28.8%, compared with inflation of 7.7%. Even our most cautious strategy, CMAF UK Defensive, has delivered an inflation-busting five-year return of 22.8%. This demonstrates how investing has the potential to not only preserve the buying power of your wealth, but could grow the real value of the capital you invest.

It's worth remembering that all investment comes with risk. Past performance is not a guarantee of future returns - markets can go down as well as up and you may not get back the capital you invested.

## Making good decisions across all time frames

*Money in low-interest deposit accounts will have seen its buying power decrease over both the short and long term. While there are good reasons to have a reserve of cash on hand – to fund short-term purchases, for example – cash held in the bank can be severely undermined by the effect of inflation.*

And if the effect is this stark over five years, consider how it might be over 25, 50 or even a hundred years. Wealth that grows can help you achieve your goals, whether that is to support your family or achieve a broader purpose or legacy. You can set your wealth to work in the world to serve the causes that are closest to your heart.This is exactly what our investment process is about. It is about delivering a better path, a more palatable journey without compromising on the return potential.

## A plan for all reasons

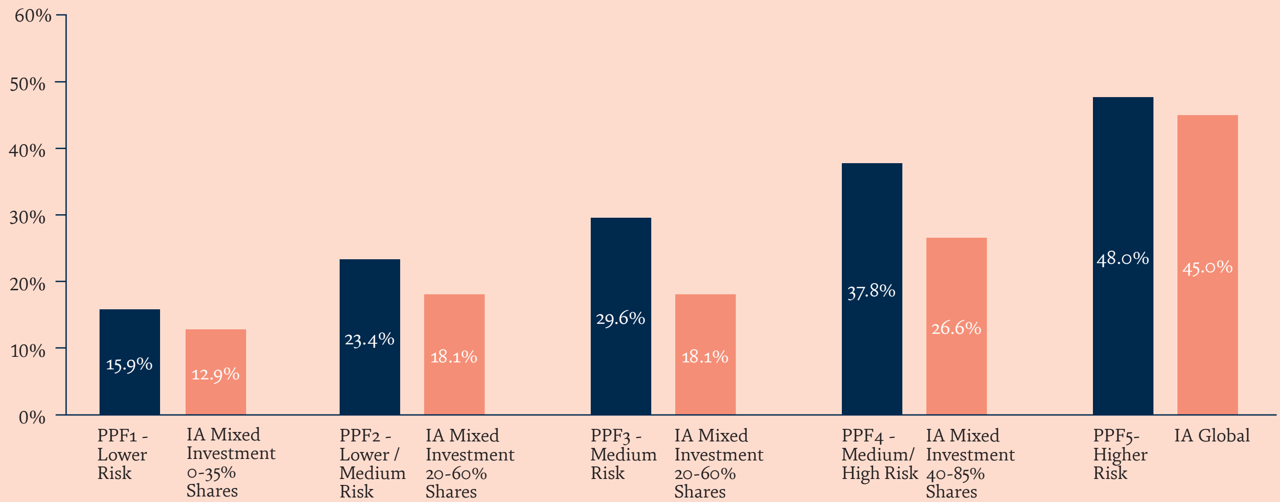
*Investment is not an end in itself. We are proud of our investment expertise and success but we recognise that it is only one part of how our clients achieve their goals. It's important to consider its place in your broader financial plan:*

Your wealth manager can work with you to take a holistic view of your financial health. At its most basic level this could include the banking services you use with Coutts, how to borrow flexibly when needed, putting appropriate levels of insurance in place and making sure you are investing efficiently. Beyond the day-to-day, we can help you consider the possibilities that your wealth can bring. Whether it's indulging a passion for art and culture, finding and financing a unique property or supporting the causes that are close to your heart, we are here to help.

Past performance should not be taken as a guide to future performance. The value of investments, and the income from them, can go down as well as up and you may not recover the amount of your original investment.

## PERSONAL PORTFOLIO FUNDS - PERFORMANCE SINCE INCEPTION (JUNE 2016)

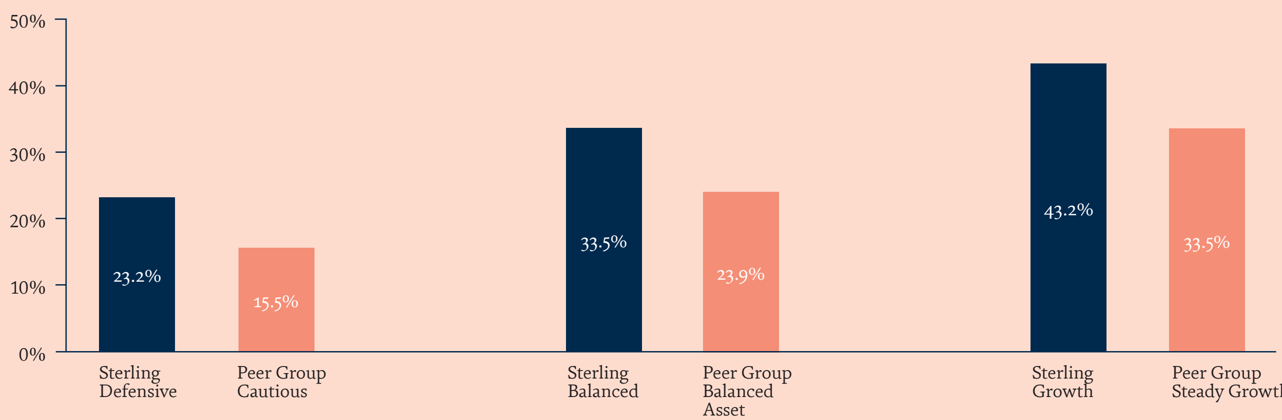
Five diversified multi-asset funds designed to match different risk appetites. These funds invest in the Coutts asset allocation through passive index funds, providing a simple exposure to our investment expertise.




Cumulative returns since inception (June 2016 to June 2019), calculated on sterling basis, including income compared to relevant Investment Association peer group sector. This graph shows a very isolated period of past performance. For further context of historic performance, please refer to the rolling 12-month performance presented overleaf. Source: Eikon/Datastream, Investment Association, Coutts & Co.

## STERLING PORTFOLIOS - FIVE-YEAR PERFORMANCE

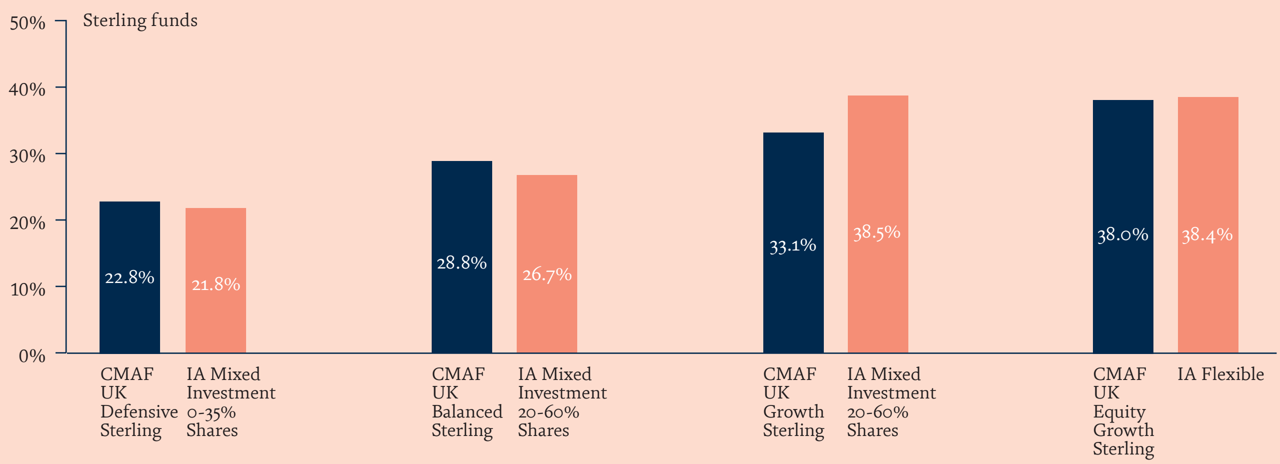
Our portfolio service aims to deliver attractive long-term returns through investing in a broad range of assets including bonds, active and passive funds, direct equities and alternative assets.

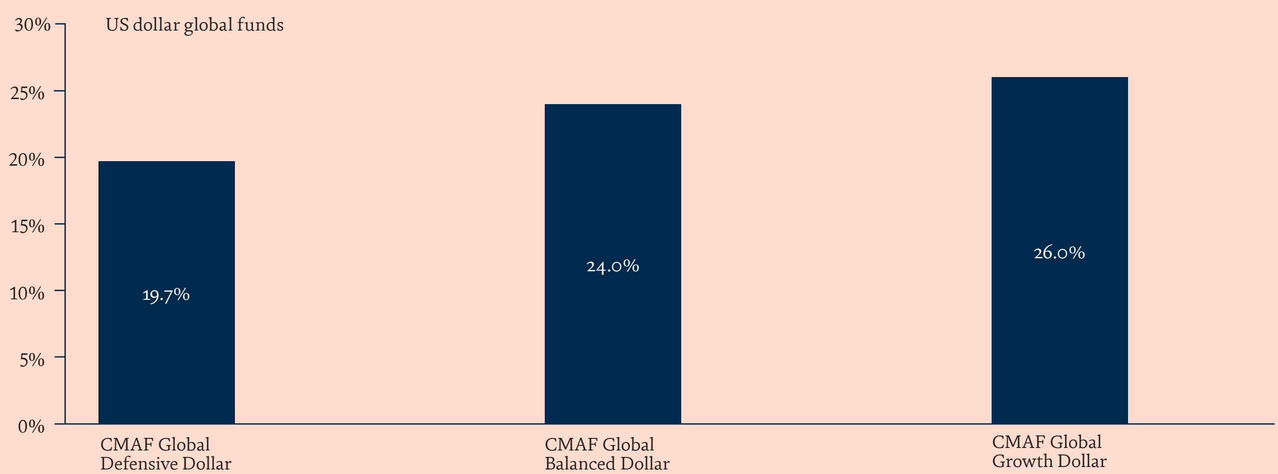



Cumulative returns over five years to end of June 2019, calculated on sterling basis, including fees and income. Performance figures are composite returns from the actual portfolios of all clients. For the composite performance calculation, individual portfolio monthly returns are asset-weighted based on their respective asset values at the beginning of the month. ARC peer group data represents consolidated performance of similar investment strategies sourced from over 50 discretionary private client portfolio managers. This graph shows a very isolated period of past performance. For further context of historic performance over the last five years, please refer to the rolling 12-month performance presented overleaf. Source: Asset Risk Consultants, Coutts & Co.

## COUTTS MULTI ASSET FUNDS - FIVE-YEAR PERFORMANCE

A range of unitised funds that invest in the Coutts investment view through a mix of passive and actively managed third-party funds and individual securities.




Cumulative returns over five years to end of June 2019, including income. Sterling CMAF compared to relevant Investment Association peer group sector. This graph shows a very isolated period of past performance. For further context of historic performance over the last five years, please refer to the rolling 12-month performance presented opposite. Source: Eikon/Datastream, Investment Association, Coutts & Co.

| Values in percentage | June 2014 to 2015 | June 2015 to 2016 | June 2016 to 2017 | June 2017 to 2018 | June 2018 to 2019 |
|---|---|---|---|---|---|
| **Personal Portfolio Funds** | | | | | |
| 1 - Lower Risk | n/a | n/a | 5.7% | 1.8% | 3.9% |
| 2 - Lower / Medium Risk | n/a | n/a | 9.3% | 3.4% | 4.6% |
| 3 - Medium Risk | n/a | n/a | 12.8% | 4.8% | 4.8% |
| 4 - Medium / Higher Risk | n/a | n/a | 17.5% | 6.2% | 5.3% |
| 5 - Higher Risk | n/a | n/a | 22.4% | 8.2% | 5.5% |
| **Sterling portfolios** | | | | | |
| Defensive Strategy Composite | 4.8% | 4.0% | 7.7% | 1.7% | 3.1% |
| Balanced Strategy Composite | 6.1% | 3.1% | 13.2% | 4.2% | 3.6% |
| Growth Strategy Composite | 6.3% | 2.8% | 18.3% | 6.5% | 3.9% |
| **Global portfolios (US$)** | | | | | |
| Balanced Strategy Composite | 1.1% | -5.2% | 12.7% | 5.1% | 4.2% |
| Growth Strategy Composite | 1.3% | -7.2% | 17.4% | 8.3% | 3.8% |
| **Euro portfolios** | | | | | |
| Balanced Strategy Composite | 13.1% | -6.4% | 10.3% | 1.1% | 3.2% |
| Growth Strategy Composite | 19.7% | -7.6% | 15.3% | 3.3% | 4.1% |

Note: Performance figures are composite returns from the actual portfolios of all clients shown on a total return basis and quoted net of all fees. For the composite performance calculation, individual portfolio monthly returns are asset-weighted based on their respective asset values at the beginning of the month.

| **Coutts UK Multi Asset Funds** | | | | | |
|---|---|---|---|---|---|
| Defensive | 5.5% | 2.2% | 9.8% | 0.5% | 3.2% |
| Balanced | 5.7% | -1.0% | 15.0% | 3.9% | 3.1% |
| Growth | 6.1% | -2.9% | 19.0% | 6.2% | 2.2% |
| Equity Growth | 5.7% | -2.9% | 21.8% | 8.0% | 2.2% |
| **Coutts Global $ Multi Asset Funds** | | | | | |
| Defensive | 1.9% | 0.3% | 8.0% | 1.9% | 6.5% |
| Balanced | 2.5% | -5.3% | 15.1% | 4.8% | 6.0% |
| Growth | 2.5% | -8.3% | 18.3% | 7.3% | 5.5% |

Note: All returns are net of fees and charges
Source: Coutts & Co., Thomson Datastream

Past performance should not be taken as a guide to future performance. The value of investments, and the income from them, can go down as well as up and you may not recover the amount of your original investment.

# MARKET DATA

| Equity markets as of : **30 June 2019** | Performance (%tr*, local) | | | | 12 month performance to end June | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Current | -1M | -3M | YTD | 2019 | 2018 | 2017 | 2016 | 2015 |
| Developed Equity (MSCI) | 1,662.5 | 5.9 | 3.8 | 29.9 | 7.3 | 10.5 | 17.9 | -4.0 | 14.6 |
| MSCI UK | 2,139 | 4.0 | 3.3 | 15.3 | 7.6 | -0.2 | 23.6 | -5.8 | 6.2 |
| MSCI UK Large-Cap | 1,058 | 3.8 | 3.0 | 16.2 | 9.4 | -0.4 | 26.7 | -6.7 | 4.9 |
| S&P 500 | 2,942 | 7.1 | 4.3 | 38.1 | 9.5 | 14.0 | 17.2 | 1.8 | 12.7 |
| Nasdaq Composite | 8,006 | 7.5 | 3.9 | 52.8 | 10.6 | 20.8 | 22.9 | 0.6 | 18.1 |
| DJ EuroStoxx | 375.8 | 5.3 | 4.8 | 17.3 | 1.4 | 3.0 | 20.5 | -12.4 | 20.6 |
| Nikkei 225 | 21,276 | 3.5 | 0.6 | 17.0 | 0.9 | 15.7 | 15.0 | -11.1 | 31.6 |
| Hang Seng | 28,543 | 6.7 | -0.1 | 42.5 | 0.0 | 29.5 | 20.6 | -13.6 | 17.1 |
| Emerging Equity (MSCI) | 58,072 | 4.7 | 0.3 | 30.4 | -1.6 | 22.4 | 15.5 | -7.4 | 11.3 |

Source: Datastream, all returns in local currency; *tr=total return, including reinvested dividends.

| Bond markets as of : **30 June 2019** | Performance (%, local) | | | | 12 month performance to end June | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 10 yr yield* | -1M | -3M | YTD | 2019 | 2018 | 2017 | 2016 | 2015 |
| US Treasury index | 2.00 | 0.7 | 2.4 | 2.9 | 2.1 | -1.8 | -3.8 | -0.1 | 2.9 |
| UK gilts index | 0.84 | -0.2 | 0.3 | -0.1 | 1.4 | -2.6 | 3.7 | 0.3 | 11.5 |
| Eurozone govt bond index | -0.32 | 4.1 | 4.4 | -2.0 | -4.6 | -3.4 | -1.5 | 4.7 | -2.0 |
| US investment grade index | 3.16 | 2.2 | 3.5 | 2.7 | 1.0 | -1.8 | -1.5 | -3.3 | 1.5 |
| US high yield index | 5.87 | 1.8 | 1.6 | -0.3 | -0.8 | -2.2 | 10.6 | -8.9 | -4.4 |
| Emerging market index | 14.09 | 6.8 | -2.7 | -21.1 | -21.5 | 4.9 | 8.0 | 10.5 | 0.9 |

Source: Barclays indices; Datastream; *current yield on benchmark 10-year Treasury, gilt and bund respectively

| Commodity markets as of : **30 June 2019** | Performance (%, dollar) | | | | 12 month performance to end June | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Current | -1M | -3M | YTD | 2019 | 2018 | 2017 | 2016 | 2015 |
| Commodity index (TR) | 167.8 | 2.7 | -1.2 | -5.2 | -5.3 | 3.7 | 8.7 | -19.6 | -27.0 |
| Brent oil price (spot) | 67.5 | 1.6 | -0.6 | 22.3 | -1.6 | 32.6 | 33.8 | -27.9 | -49.1 |
| Gold bullion (spot, per ounce) | 1,412 | 8.6 | 9.0 | 22.0 | -2.1 | 6.1 | 1.0 | 3.9 | -7.9 |
| Industrial metals (TR) | 238.4 | 2.0 | -7.2 | 9.0 | -3.1 | 12.7 | 26.2 | -21.0 | -7.6 |

Source: Datastream

# THE COUTTS INVESTMENT TEAM

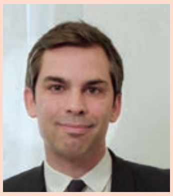
Our investment team brings a wealth of experience and expertise to managing our clients' funds and portfolios.

**Mohammad Kamal Syed**
Head of asset management

**Monique Wong**
Executive director, portfolio management

**Vinod Nehra**
Executive director, investment strategy

**Alan Higgins**
Head of multi-asset management



**Lilian Chovin**
Director, investment strategy

**Mathilde Helaine**
Head of analytics

**Sven Balzer**
Head of investment strategy

**Leslie Gent**
Head of responsible investment

**Hans Prottey**
Head of strategic solutions

## Invest with Coutts

Building lasting, intelligent and trusting partnerships with our clients is at the heart of the Coutts service. For over 300 years, clients have valued our discretion, professionalism and dedication to providing high-quality advice and wealth management.

Our primary aim is to deliver long-term returns that allow our clients to grow and maintain the future purchasing power of their wealth. We work closely with them to understand their specific needs and aspirations and create financial plans that meet their unique requirements.

Our investment process combines quantitative research with qualitative and economic analysis of markets to make considered investment decisions focused on the long term.

To find out more about investing with Coutts visit
**www.coutts.com/wealth-management/investment-services.html**

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