ST. JAMES'S PLACE
WEALTH MANAGEMENT

THE ANNUAL REPORT OF THE ST. JAMES'S PLACE INVESTMENT COMMITTEE 2018

PARTNERS IN MANAGING YOUR WEALTH

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Welcome to The Annual Report of the St. James's Place Investment Committee 2018.

CHAIRMAN'S STATEMENT

The past year has been dominated by significant uncertainty around Brexit, weakening political stability across a number of EU countries, and a rise in trade tensions driven by an intensifying tariffs war between the US and China. Against this backdrop, and despite a strong first half to the year, markets ended the year lower, impacted by increased volatility and weakness in the final quarter.

This is despite continuing US economic expansion which, having begun in 2009, is now the second-longest in its history. It will become the longest should it stretch out until the summer. Given the influence of both American growth and the level of the dollar on the global economy, the US provided an important bedrock for investment returns, before leading markets lower as fears of a slowdown in China and rising interest rates undermined investor confidence.

Of course, market movements reflect human decision-making, with all its attendant intellectual limitations and emotional biases. However, it is during times of rising market volatility that we like to remind investors of the benefits of being able to look beyond such short-term market volatility and avoid the temptation to try to time the market. Time and again this approach, taken together with a balanced portfolio of investments, has proved to be a sound and sensible way to accumulate positive returns over the long term.

"The volatility experienced during the year serves as a reminder of the importance of our Investment Management Approach..."

The volatility experienced during the year serves as a reminder of the importance of our Investment Management Approach and the work of the Investment Committee, which remains dedicated to finding the best managers to look after our clients' funds through all market cycles. Above all, it seeks out managers whose approach and abilities enable them to achieve a sensible balance between investment returns and the amount of risk taken over the medium to long term, irrespective of short-term market shocks, be they political or economic.

I wanted to take this opportunity to inform our clients of the appointment of Rob Gardner, who joins St. James's Place as Investment Director. Rob joins us from Redington and will bring valuable experience to the investment function, leading the investment team in Cirencester.

I will continue to chair the Investment Committee and retain responsibility for the ongoing monitoring of our fund managers, making changes to the roster of managers and introducing new investment opportunities for our clients.

Coming back to this year's report, Chris Ralph, our Chief Investment Officer, describes in more detail how events in the major markets unfolded over the past 12 months and what it means for investors.

I have asked Danni Brotherston, Head of Investment Solutions, to discuss the challenges investors face upon reaching retirement and drawing an income from their savings – a process known as 'decumulation', which will be a key area of focus for us in 2019. Danni explores some of the investment strategies clients could consider to mitigate the key risks at this stage of life, as well as how taking the right advice can help design a sustainable income portfolio.

Recognising the increasing importance of responsible investing as a fundamental aspect of our investment approach, Sue Meech, Chair of our Responsible Investment Committee, reports on some recent developments in this area.

Finally, I am pleased to introduce you to Saleena Goel and Aidan T. Corcoran of KKR, managers of the new Diversified Assets fund, who provide insight into the characteristics of private market assets. KKR is a world leader in this field and, in this article, they explain how private markets can offer different sources of return than traditional equities and fixed income assets.

I hope you find the content in this year's report helpful, informative, and a useful update on the work undertaken by the Investment Committee. The continued innovation and evolution of our fund range is crucial to ensuring we deliver the investment outcomes our clients want and expect, as well as making sure our Investment Management Approach is robust as we enter 2019 – a year in which it may be wise, once again, to expect the unexpected.

David Lamb
Chairman
December 2018

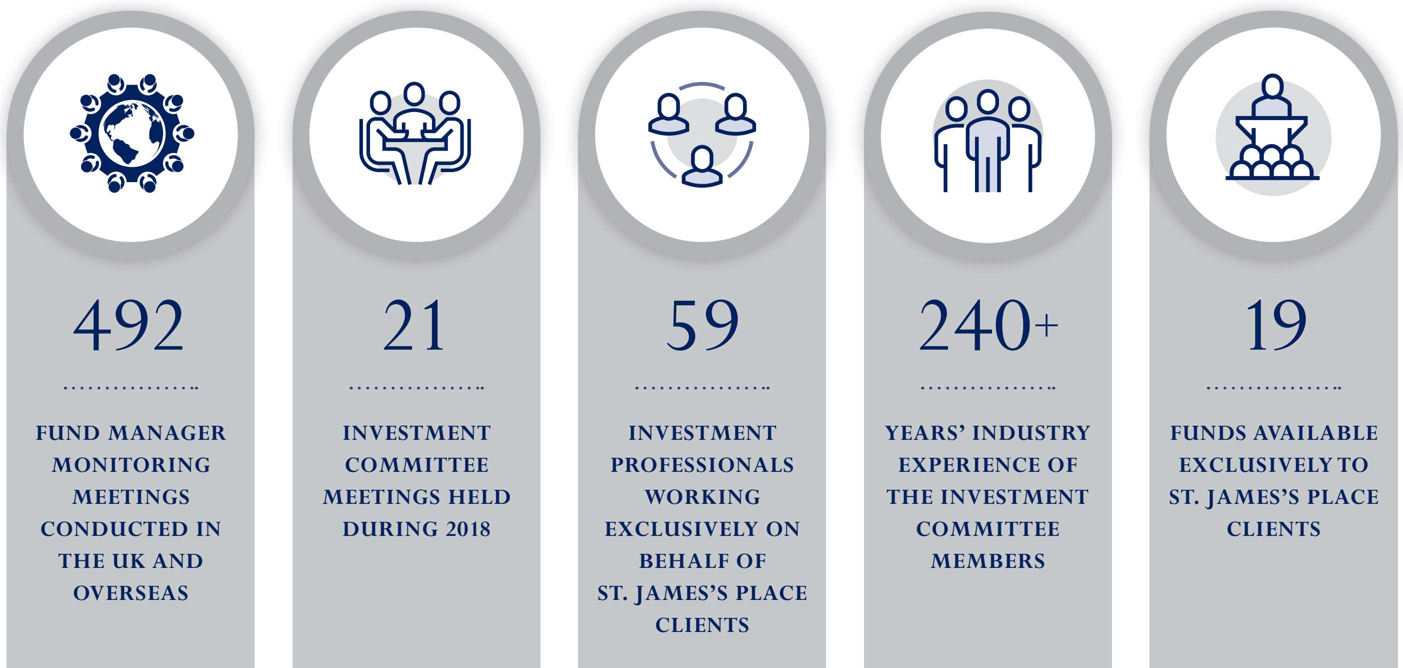
OUR INVESTMENT MANAGEMENT APPROACH IN NUMBERS – 2018

The cornerstone of the St. James's Place approach to investment management is the Investment Committee. The Committee's role is to 'manage the fund managers' on behalf of our clients.

As always, the aim is to generate superior investment results over the medium to long term. Having selected the best managers, the key to achieving this objective is to monitor both the individuals and the company they work for to ensure that they remain the right choice for the fund they are managing.

It is vital that the monitoring process underpinning our investment approach and, in particular, the work of our independent investment consultants, continues to meet the requirements of our expanding fund range and the increasing scale of wealth entrusted to us by our clients.

The data below provides a snapshot of the research, analysis and monitoring conducted during 2018 by the various functions that support the Investment Committee, which include the teams at Stamford Associates, Redington and at our head office in Cirencester.



CHIEF INVESTMENT OFFICER'S REPORT

"quantitative easing turned to quantitative tightening"

It was a difficult year for global markets, as major bond and equity indices reflected increasing concern among investors of lower growth in 2019 and an end to a long economic upturn.

Investors were sensitive to a number of factors: the Federal Reserve moving to a more cautious stance on interest rate plans; the Trump tax-cuts boost potentially petering out; an emerging Sino – US trade war; worries that growth in the US had peaked; ongoing Brexit uncertainty; and a spate of debt and growth challenges in some emerging markets. As a result, volatility returned after an extended hiatus, albeit only to historically normal levels.

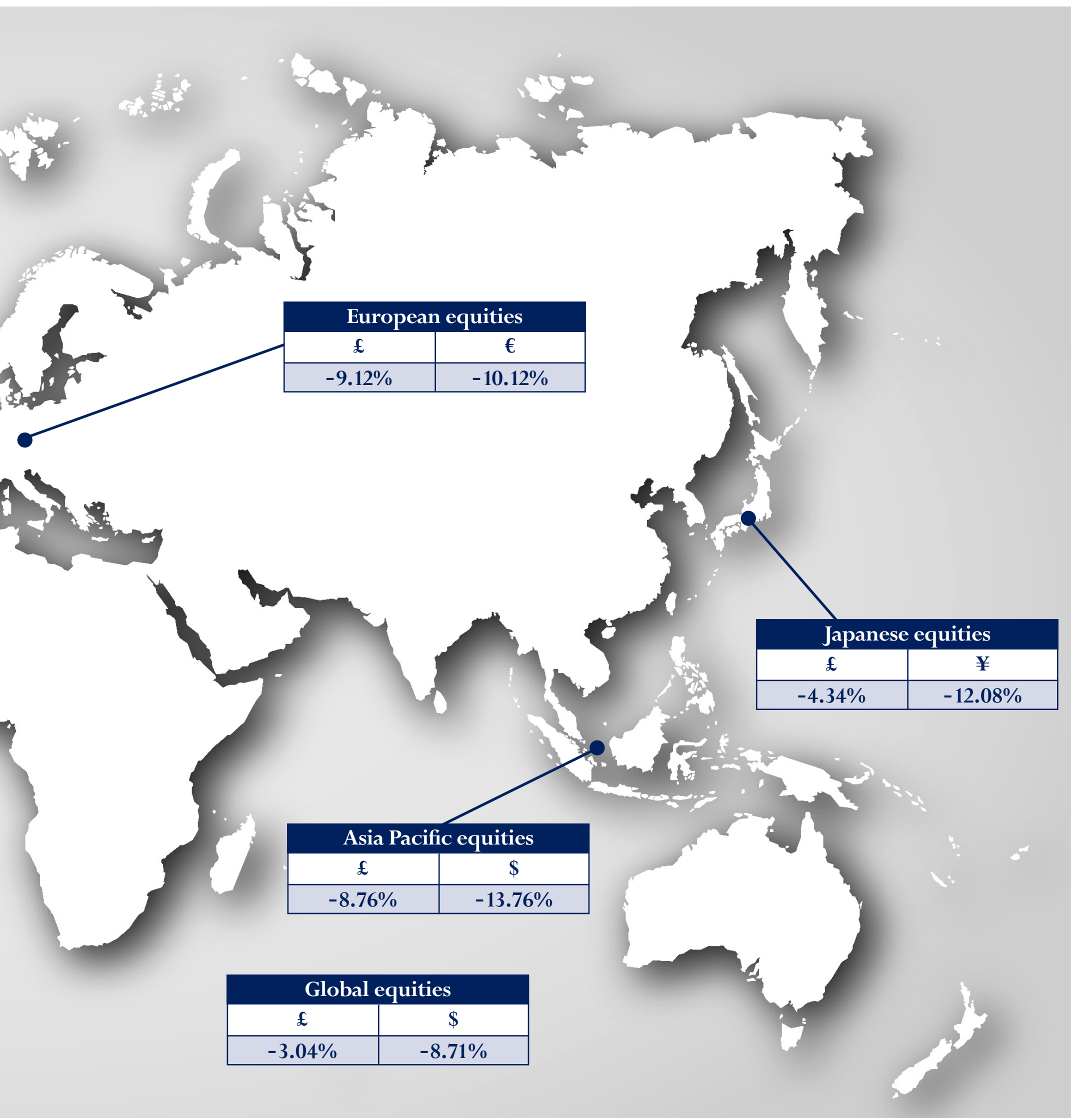
Yet despite the return of volatility, many of the global economic indicators were in fact quite strong. Growth in the US is set to exceed 3%, while US corporate earnings growth struck multi-year highs in both the second and third quarters. The FTSE 100, despite a disappointing performance in the second half of the year, delivered a third quarter dividend growth record for UK stocks.

Economic developments across Europe more broadly were less encouraging. While the eurozone economy began the year on a strong footing, growth slowed sharply through 2018. In Germany, growth had slipped into negative territory by the third quarter, with lagging

trade clearly a leading cause. France fared somewhat better; but the eurozone as a whole saw a significant fall in its growth rate across the year. Politics loomed large throughout: both Angela Merkel and Emmanuel Macron saw their popularity decline through the year, while the new Italian government faced off with Brussels over its budget plans.

One of the less trumpeted themes of the year was the shift in central bank support for the global economy. Among the major central banks, only the Federal Reserve and Bank of England raised interest rates. However, 2018 saw a still more significant shift, as quantitative easing turned to quantitative tightening. This was one of the reasons behind the rise in the yield on 10-year US government debt.

A rise in yields tends to push up the value of the dollar and a rising dollar was a major headwind on emerging markets (EM) throughout the year. Since listed EM companies tend to borrow in dollars, the currency shift pushed up the size of their debt in local currency terms. This contributed to slower growth in China, which has also been buffeted by US trade wars and domestic debt fears. However, the Chinese economy still expanded by over 6% and continues to be a catalyst for global growth, which may continue in 2019 as President Xi Jinping unveils a raft of economic stimuli.



Source: FE; performance figures to 31 December 2018, on a total return basis and expressed in sterling and local currency terms (US dollar terms for Asia Pacific, Emerging Market and Global equities).

The value of an investment with St. James's Place will be directly linked to the performance of the funds selected and may fall as well as rise. You may get back less than the amount invested. An investment in equities will not provide the security of capital associated with a deposit account with a Bank or Building Society.

Political uncertainty was especially high in the UK, where the government agreed an EU withdrawal deal and political declaration with the 27 EU member states, only for the prime minister to postpone the scheduled vote in the Commons at the eleventh hour as support for the deal in Parliament fell away. Subsequent talks in Brussels yielded no further breakthrough, however, and sterling fell to an 18-month low. At the time of writing, we are still no clearer as to what shape any Brexit deal will take, or indeed, whether a second referendum and a no-deal Brexit are more likely.

These developments did not deter our fund managers from investing in companies that offer good growth opportunities over the long term, whether focused on the UK or overseas markets. Moreover, as the value of assets under management continued to rise, the Investment Committee further expanded its work of monitoring our funds, recommended enhancements to existing funds and introduced new strategies.

"we continue to develop the processes and proposition that underpin our investment approach."

As mentioned in the Chairman's Report, during the year we introduced a broad programme of changes to our fund range, appointing new managers to the Balanced Managed, Continental European, Greater European and Alternative Assets funds.

Towards the end of the year, the Committee announced two new and important developments that highlight our commitment to the continued extension of our Investment Management Approach, with the aim of producing additional opportunities for growth over a long-term investment horizon to help investors achieve their financial goals.

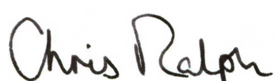
The launch of the Diversified Assets Fund of Alternative Investment funds offers our clients the opportunity to access private market assets that are typically only available to institutional investors. This fund is unique in the wealth management marketplace and further differentiates the St. James's Place investment proposition.

A further change, reflecting evolving attitudes from investors, saw a change of strategy and subsequent renaming of the Ethical fund. Kirsteen Morrison and David Winborne of Impax Asset Management were appointed as the managers of the Sustainable & Responsible Equity fund.

The Ethical fund had historically employed a traditional 'negative screening' process, whereby strict criteria were used to exclude, or limit, exposure to specific sectors or industries. However, ethical investing has developed significantly in recent years. Where emphasis was previously laid on disengaging from certain sectors or industries, today, investors are increasingly focused on positive engagement instead.

In this, as across our range of investment strategies, the Investment Committee remains focused on ensuring that we continue to develop the processes and proposition that underpin our investment approach.

By remaining loyal to this approach, and flexible in how we adapt to change, we will continue to provide the investment solutions you need to achieve your long-term goals, in 2019 and beyond.



Chris Ralph
Chief Investment Officer
December 2018

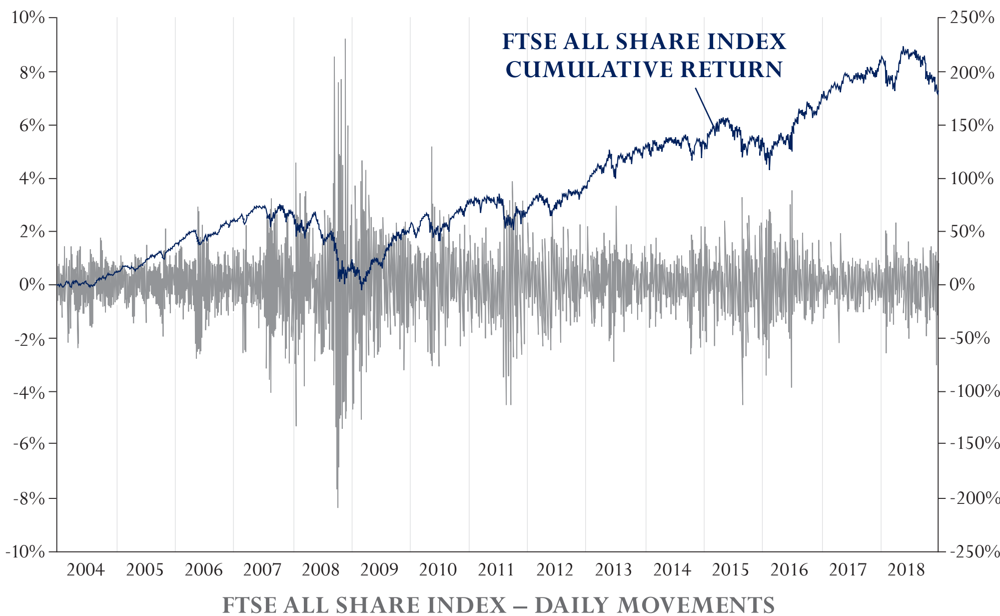
TUNING OUT TO THE NOISE

Investors need little reminding of the political turmoil and trade tensions that drove market sentiment last year.

The twists and turns in Brexit negotiations, slower global growth, and the trade war between the US and China were just some of the challenges that had the potential to unnerve investors on a daily basis. Ultimately, they played a big part in why global equity markets suffered their worst year in a decade. Regrettably, those issues look set to dominate the agenda for some time to come.

But a look back over the past shows that, while the reasons for it vary, short-term market volatility is normal. The chart below shows the daily movements in the FTSE All Share Index over the last 15 years as well as the cumulative market return over the period. The clear pattern that emerges is that investors cannot know what will happen from one day to the next, but they can have more confidence in the longer term picture.

FTSE All Share – cumulative and daily returns over 15 years



Source: Financial Express. Data to 31/12/2018.

Please be aware that past performance is not indicative of future performance.

The lesson for investors is simple to state, but not always easy to implement; ignore the short-term noise.

What matters is the long-term trend for stockmarket returns. In spite of the ups and downs each day, week or month, investors who have continued to focus on their long-term objectives have been rewarded.

THE DECUMULATION DILEMMA

"Attempting to avoid the risk of outliving resources… creates the so-called decumulation dilemma."

It can be difficult, against the background noise of geopolitical and market uncertainty, for an investor to reflect on a key question: "What is the right investment strategy for me?"

For those seeking to grow the value of their assets, in what is described as the 'accumulation phase', the best strategy is typically defined by the ability to ride out temporary shocks and focus instead on the long-term view, whilst taking a reasonable degree of investment risk.

Retaining sight of their objectives is especially important as an investor enters a stage of life at which they need to draw a regular income from their savings. This is known as 'decumulation', essentially the opposite of accumulation, whereupon attempting to avoid the risk of outliving resources, or being unable to leave a legacy, creates the so-called 'decumulation dilemma' for many.

Decumulation is increasingly relevant today as life expectancy has increased and traditional sources of income, such as the State Pension and annuities, have become less attractive, with the latter impacted by low interest rates. Indeed, during decumulation, investment strategies need to be flexible because capital preservation, rather than capital growth, is likely to be an important additional goal for many investors.

Investors who try to preserve their investment pot will have less margin for error, as market movements or inflation can have a pronounced impact and alter a retiree's accessible income. This means retirees must be proactive and be prepared to frequently reassess their investment strategy to ensure it still meets their aims.

Designing an investment solution which is sustainable in the decumulation period is far from simple, as it needs to address several complex risks:

- **The need to plan for essentials** – Some assets are illiquid. This means it may not be possible to access money required for essential needs such as paying bills. Investors should ensure they have readily available cash for necessities.
- **Maintaining a sustainable withdrawal rate, especially in times of volatility** – This becomes even more important if an investor enters decumulation during a falling stock market as withdrawals, coupled with assets losing their value, can inflict irrecoverable damage on an investment portfolio.
- **Compromising desired standard of living** – Products such as an annuity deliver guaranteed income, but might not provide a level of income sufficient to enable the standard of living a retiree desires. In contrast, an investment portfolio may have a better chance of delivering such returns, but the levels of investment risk required to achieve this may not be palatable.
- **Meeting different income needs at different stages of retirement** – Our needs change over time. For example, retirees are likely to want more money in early retirement for travel or holidays, but may also need to preserve money in late retirement for long-term care requirements.
- **The danger of outliving assets** – Increasing life expectancy heightens the risk of the retiree running out of money, perhaps due to a long-term care requirement.

SO, IN LIGHT OF THE RISKS, WHAT ARE THE CHOICES FOR INVESTORS IN RETIREMENT?

- **Cash** – Investors may be able to take some of their retirement pot in the form of a tax-free lump sum. A cash portfolio provides accessible money for essential needs but investors would be reliant on interest rates delivering stronger returns than the drag of inflation to maintain their spending power in real terms.
- **Annuities** – A form of insurance which pays out a guaranteed and fixed income stream of payments until death. However, the lack of flexibility in the income they generate means that, in isolation, they may be unsuitable for some investors with fluctuating income needs.
- **Investment income** – Some clients with sizeable wealth may have sufficient assets to live off the investment return. However, there is a risk that stock market performance could reduce the value of the portfolio, necessitating a change in strategy.
- **Investment drawdown** – This is the most common strategy and one in which clients withdraw from their accrued pot to help meet regular outgoings in retirement. Clients must manage the threat of poor market performance diminishing the portfolio whilst taking some investment risk to try and help meet their needs.

"A bespoke plan will also take into consideration a client's capacity for loss..."

Investors should also consider that solutions which have served them well in recent years may not be as effective in a more challenging market environment. Diversification is crucial: this is why the St. James's Place offering extends beyond traditional equities and bonds to include alternative funds. These combine various asset types to deliver differentiated sources of return and spread investment risk. Investors often have multiple objectives and it is important to explore assets and solutions which can deliver a range of investment outcomes.

PLANNING AND REVIEWING YOUR STRATEGY IS VITAL

Ultimately, the implementation of a suitable investment solution is likely to benefit considerably from receiving tailored advice. This will help an individual assess their income and spending needs and plan for a smooth transition from working life into retirement. A bespoke plan will also take into consideration a client's capacity for loss and how their age and health could influence their retirement journey.

Due to the range of risks and considerations, there is no silver bullet that guarantees successfully meeting all of your goals during decumulation. As inflation and interest rates fluctuate, and as your needs in retirement change, regularly rebalancing your portfolio is increasingly important. This will help ensure there are sufficient growth-generating assets to meet ongoing investment objectives whilst remaining within an acceptable band of risk.

Danni Brotherston

Head of Investment Solutions
December 2018

RESPONSIBLE INVESTMENT COMMITTEE'S REPORT

"working with our peers to further promote sustainable investing within the industry"

The growth in responsible investing strategies – those which include the integration of environmental, social and governance (ESG) factors into investment processes and decision-making – has been one of the most important recent trends in the investment industry and now accounts for $20 trillion – around a quarter of all professionally-managed assets.

This approach makes for sound investment analysis, as the way in which corporations respond to risks (such as climate change), create sustainable business models, or ensure that all shareholders are fairly treated, are all instructive means of assessing the likelihood of continued performance. Incorporating these factors can also lead to a better experience for clients, enabling them to understand how the company's investment strategies may impact the environment, society and economy around them.

The Responsible Investment Committee is committed to delivering client outcomes in line with their financial objectives and works to promote the principles of responsible investing through discussions with our range of external fund managers and investment consultants. This is evidenced by the annual Responsible Investing & ESG due diligence questionnaire which provides a rating to all our fund managers and, this year, became a mandatory requirement for any newly-appointed fund manager.

Another key step this year has been our active engagement with industry bodies. In February 2018, St. James's Place became signatories to both the United Nations Principles for Responsible Investment and the Financial Reporting Council's UK Stewardship Code. We were awarded the highest assessment ratings by both organisations based on the quality of our disclosure and activities. In addition to this, we have become members of the Investment Association's Sustainability and Responsible Investing Committee, which involves working with our peers to further promote sustainable investing within the industry.

A tangible example of how responsible investing considerations are reflected in our fund range is the appointment of Impax Asset Management to run our newly renamed Sustainable & Responsible Equity fund. This strategy will explicitly incorporate ESG factors into its investment process as it looks to invest in a portfolio of around 50 companies which are well-positioned for the transition to a globalised sustainable economy.

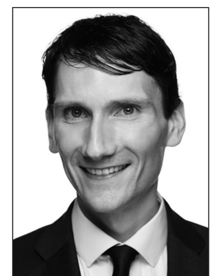
Kirsteen Morrison, co-manager of the fund, describes how their approach can provide "an insight into the 'character' of a company and a flavour of how their business model can manage ESG risks and plan for the future". A thorough analysis of a company's ability to combat emergent threats and establish well-formulated competitive advantages can help make reasoned assessments about the opportunities it presents for sustainable growth.

Whilst we have made progress over the past 12 months, our activities in this area will continue to expand as we add resources and experience to the team. Further success as a company will only be achieved with the principles of responsible investing at the core of our investment approach. We firmly believe that this will be a key contributor to ensuring the best possible outcomes for clients.

Sue Meech

Chair of the Responsible Investment Committee
December 2018

THE CASE FOR PRIVATE MARKET ASSETS



"Private equity could be an option in the investor's toolbox."

In recent years we have seen increasing interest in alternative investments and private markets. Why is this?

Private markets, by their nature, are somewhat opaque. But the essence of these markets is actually pretty simple. In private markets, investors typically forego initial liquidity. In return, they gain the opportunity to reposition a company, improving its finances and, potentially, its environmental, social and governance metrics. Through this process, they should earn a differentiated return – this is known as the 'illiquidity premium'.

The recipe for driving these returns is also no great mystery. It may include helping a company to break into new regions or market segments, streamlining procurement, repositioning a brand, driving management and employee motivation through appropriate incentives, or all of the above. In our view, it really comes down to hard work, experience and partnership. It is not a fancy recipe; but investors can add value in a private investment where they have a degree of influence in a way not possible in public markets.

So, what can this add up to in returns? Let's take private equity, as one example of a private investment. Over the last 30 years, private equity has returned significantly above public equity, and with lower volatility.[1] So, while not suitable for everyone, private equity could be an option in the investor's toolbox.

To be clear, we are not advocating a high concentration in private markets. After all, these are illiquid assets with volatility almost as high as that of public equity. However, within a broadly diversified portfolio, an allocation to private equity, private debt, infrastructure or, indeed, high-yield bonds or tradeable bank loans, can add an additional layer of diversification.

So just how meaningful is the diversification benefit? It would be great if private markets always went up when public markets go down; but unfortunately, they do not. However, over the last 30 years, the periods when private equity has most notably outperformed public equities have been during periods of public equity market weakness[2]. Conversely, when public equity markets are performing strongly, private equity tends to lag, which has been particularly seen during aggressive public market rallies (returns above 20%). Private equity will generally not fully participate in such periods of exuberance. Taken together, over the long-term, private equity has been the more stable choice.

What explains this pattern of outperformance in bad times and underperformance in exceptionally good times? Part of it is down to management. Public companies report their results regularly (often quarterly) and, in many cases, this drives management to optimize performance over the short term, instead of through an entire market cycle. On the other hand, private equity managers usually assume a holding period of at least five years, giving company management the confidence and flexibility to adapt their strategy for different market environments.

Another way to think about the diversification benefit of private markets is in terms of sectors. As one example, in Europe, there are many companies with excellent technological expertise. The issue is that they are almost all private: it is hard to get exposure to the technology sector in public markets. In fact, technology makes up just 5% of the STOXX Europe 600 Index (source: Bloomberg, 11 December 2018). So, having some exposure to private markets allows investors to target sectors that are growing their share of the economy, regardless of their representation in public markets.

Diversification can also come from investing in company debt – that is corporate bonds issued by a company or loans – in order to balance an investor's equity exposure. Often, debt can be a good choice, given it should have less risk compared to equity, as the value of an equity investment is the residual of a company's value after all the company's creditors have been fully repaid. This kind of surety can provide ballast to a portfolio, whether the debt investment is in the private or public markets. The key difference between private and public investments on the debt side is the same as on the equity side: liquidity. An investor in private debt can secure a higher return in exchange for giving up liquidity, but the investor must be willing to hold that investment to maturity.

In conclusion, while diversification is seen as the investor's best friend, we believe that it becomes even more critical late in the market cycle. That includes diversification by region, sector, equity versus debt, and, last but not least, public versus private markets. In addition, we believe private markets are attractive for long-term investors, due to the ability to pick up an illiquidity premium and, in many cases, to pro-actively reposition a business through partnership with its management.

Saleena Goel

Member, Head of Customized Portfolio Solutions
KKR
December 2018

Aidan T. Corcoran

Director, Global Macro & Asset Allocation
KKR
December 2018

[1] KKR Insights Publication: Rethinking Asset Allocation, October 2018. Source: Cambridge Associates, Bloomberg.
[2] & [3] KKR Insights Publication: Rethinking Asset Allocation, October 2018. Source: Cambridge Associates, Bloomberg, KKR Global Macro & Asset Allocation.

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ST. JAMES'S PLACE
WEALTH MANAGEMENT

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