LF BENTLEY
STERLING INCOME FUND

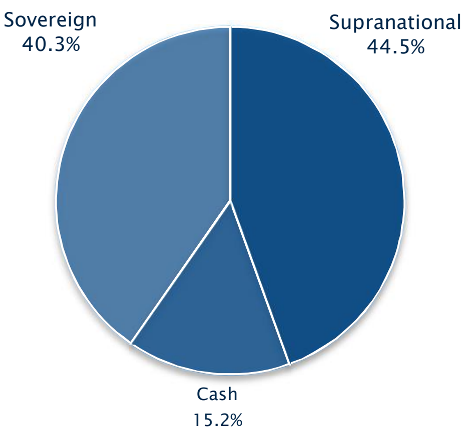
30TH SEPTEMBER 2018

BENTLEY REID

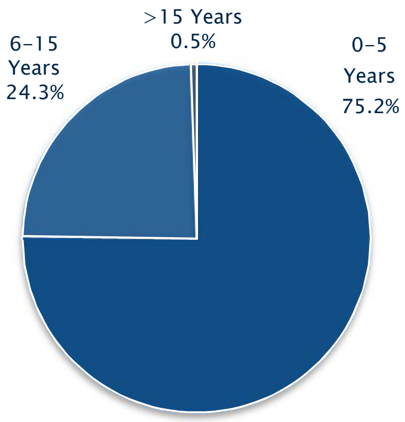
INVESTMENT OBJECTIVE

The Income fund invests in a diversified portfolio of high quality fixed interest investments. The aim of the fund is to achieve a return in excess of sterling cash rates over any three year period. The fund seeks to achieve this goal with low volatility and limited downside. To limit the currency risk the fund may only invest in sterling assets.

ASSET ALLOCATION



BOND MATURITY BREAKDOWN



SUPRANATIONAL BONDS	**44.5%**
EIB 1.5% 01/02/2019	11.2%
EIB 5.375% 07/06/2021	15.5%
KFW 0.375% 15/12/2020	10.7%
KFW 5.55% 07/06/2021	7.1%
SOVEREIGN BONDS	**5.5%**
Vanguard US Govt Bond £ Hedged	5.5%
SOVEREIGN INDEX-LINKED BONDS	**34.8%**
UK Index-Linked Gilt 1.875% 22/11/2022	13.8%
UK Index-Linked Gilt 0.125% 22/03/2024	11.7%
UK Index-Linked Gilt 2.5% 17/07/2024	8.9%
UK Index-Linked Gilt 0.125% 22/03/2068	0.4%
CASH	**15.2%**

QUARTERLY INVESTMENT REPORT

The fund declared a dividend in August that equates to a net annualised yield of 1.1% (source Bloomberg). Its total return was flat over the quarter.

Global bond markets weakened further over the summer. After many years of yields falling/prices rising, fixed income assets have been selling off this year in the face of lingering inflation and mounting debt concerns. The latter has been caused by numerous governments resorting to debt-funded stimulus in a bid to reflate economic activity and, in turn, appease disenchanted voters. Government spending is generally on the rise, but with tax revenues under pressure, borrowing levels continue to rise. In return, bond investors are demanding a higher yield to compensate them for lending to governments with deteriorating public finances.

Global inflationary pressures are borne mainly of rising commodity costs. The price of Brent crude oil is up 53% in sterling terms over the past 12 months; a trend that is encouraging Central Banks to hike borrowing costs despite subdued economic growth. This is another factor underpinning the global increase in bond yields.

continued overleaf

PERFORMANCE (NET OF FEES)*

Cumulative	3 Months	YTD	1 Year	3 Year (Ann.)	5 Year (Ann.)
Fund	-0.1%	-0.3%	-0.5%	0.0%	0.0%
Benchmark	n/a	n/a	0.6%	2.5%	3.8%

12 Months to	30 Sep 18	30 Sep 17	30 Sep 16	30 Sep 15	30 Sep 14
Fund	-0.5%	-2.4%	2.9%	0.2%	-0.3%

** the 3 and 5-yr figures for the fund and benchmark return are annualised averages.*

The UK is one of the more acute expressions a low growth/rising inflation economy. Nominal GDP is growing at just 0.4% q/q (less than 2% annualised), but CPI inflation has ticked back up to 2.4% y/y, above the Bank of England's 2% target. This is nothing like the "stagflation" of the 1970s, that saw inflation surge into the double-digits, but it is an unfavourable environment for bonds. It also presents a challenge to the monetary authorities; do they raise rates to quell price pressures or accept higher inflation in the hope it is accompanied by stronger economic growth?

For now, the Bank of England seems to be erring on the side of caution by raising rates at a glacial pace. In August the target rate was increased from 0.5% to 0.75%, only the second rate hike in the post-crisis era and it came with guidance that another increase is unlikely until well into 2019. This was enough to spark a sell-off in gilt prices last quarter, resulting in yields rising across the curve. The benchmark 10-year issue saw its yield increase from 1.3% to 1.6%. A further increase in government bond yields would be a positive development for the fund as it would provide us with the opportunity to deploy some of the cash back into "safe" assets at a more attractive yield. But whilst gilt yields have already risen markedly from their 2016 record lows (when the 10-year yield fell to just 0.5% p.a.) we believe they are not yet high enough to compensate investors for rising economic and political risks.

UK politics looks set to have a huge influence on the gilt market over the next 6-12 months. A lot of Brexit-related news is already priced in and whilst a "Hard" outcome could boost prices (amidst a bid for safe-haven assets), the prospect of Prime Minister Corbyn would be an offsetting negative. This is not our core scenario, but political events of recent years suggest we should plan for the unexpected; we struggle to see how a Corbyn victory would be anything but negative for UK gilts. Sterling would likely slump, amplifying the threat of improved inflation, and the putative surge in unfunded government spending would add further to the country's excessive debt pile. Both domestic and foreign creditors would likely demand a much higher gilt yield.

As a result, the fund does not own any longer-dated UK conventional bonds; this lack of "duration" materially reduces the risk of a significant capital loss. Instead we continue to own 6% in sterling-hedged US Treasury bonds, where dollar yields have already risen to 3%+ p.a. and we retain a sizeable allocation to UK index-linkers, which speak to our likely short and long-term economic forecasts.

These inflation-linked bonds provide protection against cyclical price pressures trending higher over the coming months and also offer insurance against a more extreme bout of inflation that would cause UK real (inflation-adjusted) yields to become strongly negative. This could result from the Bank of England keeping its target rate artificially low and letting inflation accelerate further. This is why we added to the ultra-long dated UKTI 2068 linker position last quarter, doubling it to a 0.4% position. The exceptionally long time to maturity makes it a volatile asset (hence the small position size), but one that could generate huge gains if we are correct and UK real yields continue to fall.

PORTFOLIO ACTIVITY

INCREASE SOVEREIGN INDEX LINKED EXPOSURE:
Buy UK Index-Linked Gilt 0.125% 2068 (+0.2%)

KEY FACTS

Price	£0.9125	NISA	Yes
Fund Size	£14.1m	Launch Date	06/02/2007
Distribution Yield	0.62%	Bloomberg Code	CFSTIIN LN
Benchmark	Composite*	ISIN	GB00B1LHH164
Initial Fee	0%	ACD	Link Funds Solutions Limited
Fees	0.5% AMC	Depositary	BNY Mellon Trust & Depositary (UK) Ltd
Ongoing Charge Figure	0.91%	Prices Published	www.bentleyreid.com
Minimum Investment	£5,000		

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