LF BENTLEY
STERLING INCOME FUND

31ST DECEMBER 2018

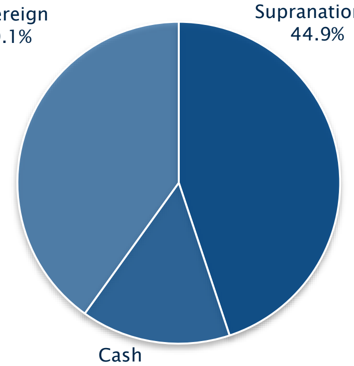
BENTLEY REID

INVESTMENT OBJECTIVE

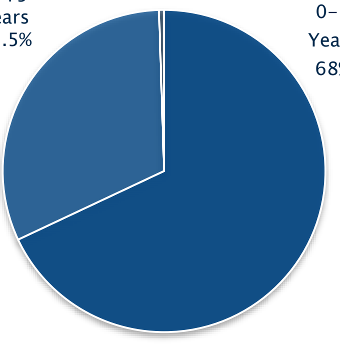
The Income fund invests in a diversified portfolio of high quality fixed interest investments. The aim of the fund is to achieve a return in excess of sterling cash rates over any three year period. The fund seeks to achieve this goal with low volatility and limited downside. To limit the currency risk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

SUPRANATIONAL BONDS	**44.9%**
EIB 1.5% 01/02/2019	11.3%
EIB 5.375% 07/06/2021	15.6%
KFW 0.375% 15/12/2020	10.9%
KFW 5.55% 07/06/2021	7.1%
SOVEREIGN BONDS	**5.6%**
Vanguard US Govt Bond £ Hedged	5.6%
SOVEREIGN INDEX-LINKED BONDS	**34.5%**
UK Index-Linked Gilt 1.875% 22/11/2022	12.9%
UK Index-Linked Gilt 0.125% 22/03/2024	12.1%
UK Index-Linked Gilt 2.5% 17/07/2024	9.1%
UK Index-Linked Gilt 0.125% 22/03/2068	0.4%
CASH	**15.0%**

ASSET ALLOCATION



BOND MATURITY BREAKDOWN



QUARTERLY INVESTMENT REPORT

The fund produced a 0.6% gain last quarter, leaving it with a 0.3% total return for 2018. The majority of the portfolio remains invested in relatively short-dated paper and there are three distinct bond sub-allocations.

A total of 45% is held in £ supranational debt with maturities of no more than 2 ½ years, 35% is invested in UK government index-linkers and 6% is allocated to the US Treasury market on a currency-hedged basis. The residual balance is held in £ cash deposits and money market funds. All three bond sub-allocations generated solid gains last quarter amidst a strong performance for global bond markets.

UK gilt yields have declined across the curve over the past quarter (meaning prices have risen) as investors sought safe-haven assets in response to falling equity and credit markets. Heightened concerns over Brexit amplified the demand for UK government paper with the 2-year gilt yield falling from an early October peak of 0.9% to a December low of 0.7%. This resulted in the fund's short-dated supranational bonds posting a modest capital gain to complement the income component of the return.

continued overleaf

PERFORMANCE (NET OF FEES)*

Cumulative	3 Months	YTD	1 Year	3 Year (Ann.)	5 Year (Ann.)
Fund	0.6%	0.3%	0.3%	0.5%	0.2%
Benchmark	n/a	n/a	0.5%	3.7%	4.4%

12 Months to	31 Dec 18	31 Dec 17	31 Dec 16	31 Dec 15	31 Dec 14
Fund	0.3%	-1.1%	2.3%	-1.6%	1.3%

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

At face value the rally in UK bonds is inconsistent with the economic backdrop. Falling petrol prices have caused headline CPI inflation to drift lower in recent months, from 3% y/y at the start of 2018 to 2.3% y/y in November, but inflation-adjusted (real) yields remain firmly in negative territory. The 10-year gilt yield finished the year at 1.3% p.a. in nominal terms so around -1% p.a. on an inflation adjusted basis. If this were to revert to its historical "fair value" around +2%, the 10-year gilt price would need to fall by approximately 25% from its current level. We do not envisage such a scenario unfolding, but these figures should help to explain why we continue to avoid investing in longer-dated gilts. Note the prices of the shorter-dated issues are much less sensitive to any change in interest rates.

Recent backward-looking economic data also suggests that gilt yields should be trading at higher levels. GDP growth rebounded to +0.6% q/q in Q3, buoyed by the heatwave and the football World Cup, which combined to induce a debt-funded consumer spending binge over the summer months. The UK unemployment rate remains close to a multi-decade low of 4.1%.

So why then does the market believe that the Bank of England will maintain such a loose monetary policy? Firstly, the corporate sector is showing signs of strain with business investment grinding to a halt; many firms have warned they will not raise capital spending until there is some form of Brexit clarity. Secondly, last quarter's 33% sterling-based slump in the Brent crude oil price has alleviated some of the near-term inflation pressures.

Whilst UK inflation appears to have peaked for the time being we retain a high conviction in the fund's index-linked gilt positions. Indeed, we note that the UK has bucked the broader trend in recent months with longer-term inflation expectations rising despite the global disinflation scare; the UK 5yr/5yr forward breakeven rate (a flagship gauge of expectations for future inflation) rose from 3.3% to a peak of 3.6% during the quarter, which boosted the price of the index-linkers.

The Brexit impasse has been another driver of the recent gains in inflation-linked debt, particularly during the first week of December when Parliament entered gridlock over Prime Minister May's proposed deal with the EU. Over that 7-day period, nominal yields fell whilst inflation expectations spiked because of renewed sterling weakness. This saw real yields fall sharply and triggered a 17% gain in the price of the index-linked bond that matures in 2068. Its price has since fallen back and such volatility explains why it is only a 0.4% weighting, but with Brexit uncertainty set to intensify in early 2019 we are comfortable holding over a third of the fund's assets in index-linked bonds.

It was also a good quarter for the 6% position in US government bonds as investors bid up safe-haven assets and began to price in the end of the Federal Reserve's rate hike cycle. The Vanguard Government Bond tracker rose by 2% in sterling terms. We expect US recession risks to build over the coming months so Treasury prices look set to remain well supported.

Finally, please note that we have made a minor alteration to the composite benchmark, which has historically been comprised of a 75% allocation to the Citigroup UK government bond index and 25% Citigroup 1-month cash deposit return. Due to corporate activity at the index provider we have changed the benchmark constituents to 75% Bloomberg Barclays UK Govt All Bonds Total Return Index and 25% HSBC GBP Deposit Index. This does not materially affect the benchmark's historic reporting figures.

PORTFOLIO ACTIVITY

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KEY FACTS

Price	£0.9181	NISA	Yes
Fund Size	£13.9m	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		

CONTACTS

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