Charles Stanley Monthly High Income Fund

Annual Review of 2017

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Last year was a perfect environment for positive returns across almost all asset classes because of low levels of volatility. This was caused by a breakout of global growth from its recent range, subdued inflation and helpful policies from global central banks. Importantly, there was also an impressive delivery of corporate earnings from companies both large and small.

Things have now changed and there will be some significant differences in markets in 2018 and beyond. Developed market central banks are likely to change their policies over the next 12 to 18 months, ending the era of easy money that has been seen since the financial crisis. The US central bank, the Federal Reserve, has already starting increasing interest rates and is reducing the other unconventional measures it has used to support markets over the last few years, such as bond purchases. The European Central Bank has also begun to cut its purchases of government and corporate bonds. This means investors will need to choose assets much more carefully, with different asset classes no longer moving in step. Volatility is likely to increase.

This change is very much welcomed at Charles Stanley, as it gives managers something which is coveted when running funds like the MHI – an increased dispersion of returns. A slow and gradual increase in interest rates should not prove a disaster for assets such as equities and bonds if it reflects an improving economic backdrop and an improvement in profits at companies. Indeed, central bankers know this. The biggest risk would be a sharp rise in rates, on the back of a spike higher in inflation, but we do not expect this to happen and we expect that both bond and equity markets will avoid any dramatic falls as central banks tread very carefully to unwind their quantitative easing programmes. Bond markets are, however, likely to see yields edge higher over the course of the year.

It is a healthy exercise to review how we have performed over the year to see where we added value and where we can refine our investment processes even further. We monitor all aspects of the fund on a daily basis, but also take the time to step back to look at the bigger picture at regular intervals. Some of the highlights of this review process are discussed in this piece as we try to critique what is a very established investment process. Over the calendar year of 2017 we returned 5.6% on a total return basis, of which roughly 4.3% was gross income. This compared favourably to our IA Mixed Investment 0-35% Shares peer group, which returned 4.8%.

Our priority remains the generation of an attractive and sustainable level of income whilst offering the potential for capital growth. We would therefore consider this to have been a successful year for the fund, with our targets met. (Source: Financial Express Analytics at 31/12/17. Total return, sterling, net income reinvested for the C Inc share class.)

Preference Shares: These represent a legacy and forgotten asset class by many, with companies now preferring other methods of issuing debt. This means there is limited liquidity available, but there are very attractive returns to be earned if you can build a position on a selective basis. Over the calendar year our preference share allocation posted an impressive 16.0% total return. These instruments are senior to common shares and offer a fixed dividend and generally a perpetual maturity. Even with the price appreciation that we have seen over the year many of these still offer 5-6% yields.

Intermediate Capital Group is an alternative asset manager which has developed its fund management business in recent years to shift the focus away from investing its own capital and towards generating sustainable investment management fees. We have been long term holders of both the equity and two of their retail bonds but the last year has been quite transformational for the firm as the business model progresses. The shares generated a total return of 69.0% whilst the two retail bonds (6.25% maturing: 2020 and 5% maturing: 2023) posted 7.4% and 8.9% total returns respectively. We have rotated our holdings over the years between these securities depending on the best relative value and are currently looking at what offers the best returns given the moves this year.

Provident Financial is an example of an investment that failed to meet our expectations in a somewhat dramatic manner. The company's woes were well published as a botched restructuring within the home credit division was then compounded by an FCA review of their Vanquis Bank division. The CEO departed and the dividend was cancelled. As profit warnings and corporate management issues go this is about as bad as they come, so the shares reacted accordingly and ended the year down 67.5% on a total return basis. As long-term holders of both the equity and a number of retail bonds this was a very disappointing result for us but our strict diversification policy (our self-imposed no non-sovereign/supranational exposure greater than 3% of the funds total net asset value) led to the fund's loss on these position being a tolerable 0.6% for the year.

Performance (%)

Share Class	Dec 16 - Dec 17	Dec 15 - Dec 16	Dec 14 - Dec 15	Dec 13 - Dec 14	Dec 12 - Dec 13	3 Years	5 Years	10 Years	Since Inception
MI Charles Stanley Monthly High Income	5.6	4.5	2.3	4.7	5.9	12.9	25.2	65.8	67.4
IA Mixed Investment 0 - 35% Shares	4.8	8.5	0.4	4.8	4.2	14.2	24.7	44.4	49.8
Quartile	1	4	1	3	2	3	2	1	1

Source: Financial Express Analytics at 31/12/2017 Total Return, Sterling, net income reinvested. Returns are based on the C share class and have been extended, at FE's discretion, to give a sense of a longer track record of the fund as a whole. C shares launches 10th December 2012. A Shares launched 13th March 2006. Past performance is not a reliable indicator of future results.

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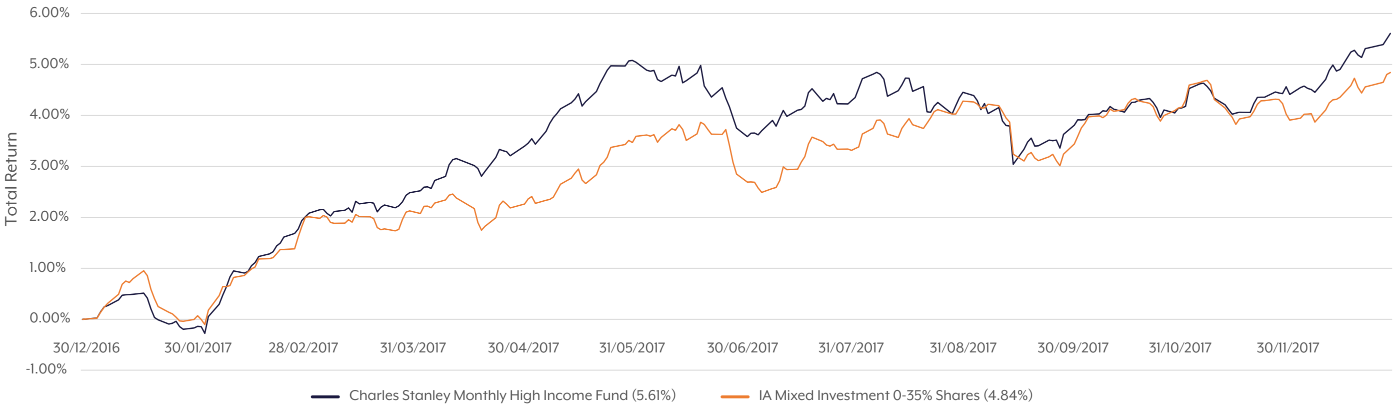
With hindsight, the issues faced in restructuring the self-employed collection agents, involved in the very personal relationship focused home credit division, were always present but we had faith in the long standing management team to execute these changes. Regulatory risk is always extremely difficult to anticipate, as the internal operations and policies are very difficult to gain any real granularity on, so this was always going to catch the market offside. Non-standard finance is a contentious business sector at the best of times and we have completely exited our holding in Provident Financial due to the huge uncertainty that will persist. Our investment rationale was based on the transition towards being a Vanquis Bank led offering, rather than the legacy home credit business but we misread this one and were swift to take the remedial action required.

As touched on above, diversification is key, but it is worth re-iterating its importance in delivering attractive returns with a low level of volatility. We ended the year with around 120 holdings within the fund, or around 90 different issuers if we account for multiple securities from the same issuer. This provides excellent levels of diversification and also adds to our liquidity profile when we are considering executing trades.

We are conscious of both the size of our positions as a proportion of the fund and our holding as a proportion of the securities market capitalisation. As one of the smaller funds in the peer group we see no near or medium term concerns around our liquidity profile, barring a market wide systemic shock.

There were a number of administrative changes to the fund during the year, with the notable ones being the name change and income distribution frequency. At the same time that we moved the Authorised Corporate Director (ACD) to Maitland Institutional Services Ltd we decided to change the name of the fund to MI Charles Stanley Monthly High Income Fund. This reflects both the rationalisation of brands at Charles Stanley and the move to monthly income distributions going forwards rather than the previous quarterly schedule. We hope that this monthly income distribution is an attractive feature for our clients in an investment environment starved of yield. As we enter 2018 we are cautiously optimistic on the investment outlook and continue to position the fund to provide our clients with a conservatively managed fund which generates an attractive level of income.

Performance for 2017



Source: Financial Express Analytics at 31/12/17. Past performance is not reliable indicator of future results.

Find out more:

0207 149 6437

asset.management@charles-stanley.co.uk

www.charles-stanley.co.uk

Charles Stanley & Co. Limited
55 Bishopsgate
London
EC2N 3AS

Fund Managers:

Chris Ainscough -
chris.ainscough@charles-stanley.co.uk

Jeremy Spain -
jeremy.spain@charles-stanley.co.uk

Fund Ratings:

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