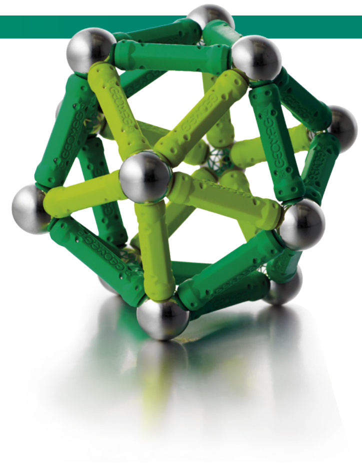

Q1 2017
QUARTERLY REVIEW
OLD MUTUAL GENERATION PORTFOLIOS

PORTFOLIO MANAGER'S MARKET VIEWS AND IMPACT

MARKET REVIEW

Economic data, business and consumer confidence brightened during the first quarter of 2017, building on improvements last year – and in contrast to the weak start to 2016.

Consumer spending did much to drive the economies of the US and Europe; although in Japan it was more subdued, Japanese exporters were helped by a weaker yen. China's industrial production beat forecasts, and Latin America seemed to be pulling out of recession. However, the global improvement was from a weak base, and world economic growth remains below its long-term average.

Global company shares, or equities, performed strongly during the quarter, in line with the bright tone set by economic data: the MSCI All-Country World index rose 5.4% in sterling terms over the period. Technology stocks topped the leader board on the index, as shares in companies like Apple and Facebook surged, while energy firms were among biggest decliners amid a drop in oil prices.

Emerging-market equities, such as those in Mexico, Brazil, South Korea, India and China – but with the exception of Russia – outperformed those in developed markets, which were generally also strong. Shares in emerging markets were supported by a lessening of investor concerns about possible trade wars, and by weakness in the US dollar during the quarter, which eases the burden of loans taken out in the currency.

In the US, the main index of company shares, the S&P 500, reached an all-time high in early March, thanks to a strong February: shares softened during March on concerns that US President Donald Trump's economic stimulus plans might become mired in delays. Euro-area shares also performed strongly, as economic data improved, as worries over political risk waned somewhat and valuations appeared more attractive than in the US.

Elsewhere, the UK stock market advanced even as the prime minister, Theresa May, formally communicated to the European Council the UK's intention to leave the European Union in two years, and the government prepared for what could be tough negotiations.

Global debt markets rose as investor expectations for inflation – which eats away at the value of the fixed payments on bonds – stabilised, and the US Federal Reserve (Fed) carried out a widely anticipated interest-rate increase. Rate hikes typically weigh on debt markets as they raise the appeal of cash versus bonds.

Company bonds (debt issued by companies) generally outperformed government debt, lifted by confidence about economic growth; higher-yielding corporate bonds performed especially well, as they did last year.

Gold rose by 8.9% in US dollar terms during the quarter, on geopolitical fears and as the US currency weakened. The oil price was tugged back and forth, dipping during early March on fears about mounting stockpiles, but recovering at the end of the month as production cuts by Opec member nations seemed to be having an effect.

PERFORMANCE REVIEW

The portfolios generated positive returns over the quarter, with stronger equity markets driving performance. As such, higher returns were achieved in higher-risk portfolios. In general, our selection of managers had a positive impact in alternatives – broadly, non-traditional assets other than bonds, equities and cash – but had a mixed effect in company shares and debt markets. The overall impact of our asset allocation was negative, due to our cautious stance on equity markets.

Within equities, we held an underweight position in order to mitigate possible losses. While we were cautious most of the quarter, we took opportunity of gentle levels of market fluctuations to add to our exposure to a cheap strategy via options, or financial contracts, which gave us the right – but not obligation – to trade shares at a specified price and within a specified time.

The portfolios also benefited from our emerging-market equities position, which we topped up over the quarter. Happily, manager performance in emerging markets was also positive. In other parts of the portfolios, manager returns were more difficult, with notable underperformance from UK managers. Directly held stock allocations were positive overall, with underperformance from the UK offset by US and continental European exposures.

As noted above, allocations within bond markets was positive for the funds – we have maintained our underweight position in developed market government debt, given our preference for holding company-debt assets. This worked well over the first quarter. While manager performance was mainly positive, the key detractor was within our higher-yielding bond holdings. Elsewhere, returns from investment grade and emerging-market debt were strong, as were those from our absolute-return holdings – which seek to generate positive returns regardless of the market environment.

Alternatives exposures were positive over the month, with good returns from macroeconomic managers IPM and a recent addition, the Old Mutual Systematic Positive Skew Fund. Alternative income strategies also delivered a good performance.

ACTIVITY REVIEW

Over the quarter, we increased our exposure to emerging-market equities as economic data and various short-term factors stabilised.

Overall allocations to equities have remained near maximum underweight: we view the market as expensive, with a number of potential catalysts for retreat from current levels. Nevertheless, we opportunistically added to equity positions through options, as described above, when such strategies were cheap (primarily through January and late March).

In bond markets, we increased our emerging-market debt exposure via a small Mexican government bond position. Valuations, given the quality of the country's macroeconomic situation, appeared very attractive.

The sensitivity of our bond holdings to moves in interest rates has been relatively flat since the start of the quarter; it remains relatively low even though we did increase it somewhat when yields were higher (and prices lower).

FUND POSITIONING AND MANAGER'S OUTLOOK

After a tumultuous 2016, the first quarter of 2017 was relatively quiet, by contrast. Markets have remained calm, with the widely followed VIX index – regarded as Wall Street's main barometer of investor fear – staying particularly low over the period. We have previously noted that 2017 would be a year of delivery – it is possible that this environment reflects the uncertainty clouding the outlook. After all, the first quarter saw a failed attempt by the Trump administration to repeal and reform US healthcare legislation, the triggering of Article 50 for the UK to leave the EU and the first Fed rate hike of the year. Investors are closely watching each of these areas for progress or resolution.

This is evident from equity markets, where valuations are often high. At the same time, economic data are looking more positive (although some of this is 'soft' survey data) while company earnings appear to have troughed. Given this dichotomy, our strategy of trying to find cheap upside will remain – at least while market fluctuations remain low. But we still believe that opportunities will remain across sectors and regions, and our balanced blend of active managers will attempt to capture these. Equally we will tactically shift positions – as we have done in emerging markets – to seek to extract some of that value.

Within bond markets, the direction of travel still seems to be for higher interest rates. The market is still considering the path and nature of this normalisation of policy from the emergency levels of rates and other stimulus set during the financial crisis; however, it is remarkable that investor reactions have so far been rather sanguine. Our sensitivity to moves in interest rates will probably remain light, or underweight benchmarks, until reasonable valuations have re-asserted themselves in government bond markets. While company debt-related assets look less interesting than previously – largely as valuations are stretched – we believe exposure is still warranted given the attractive yield pickups over government debt.

Alternatives remain good source of diversification in light of these valuation challenges, in our view. Having a broader and diversified set of strategies, across asset class and regions, is an important part of seeking to generate returns.

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