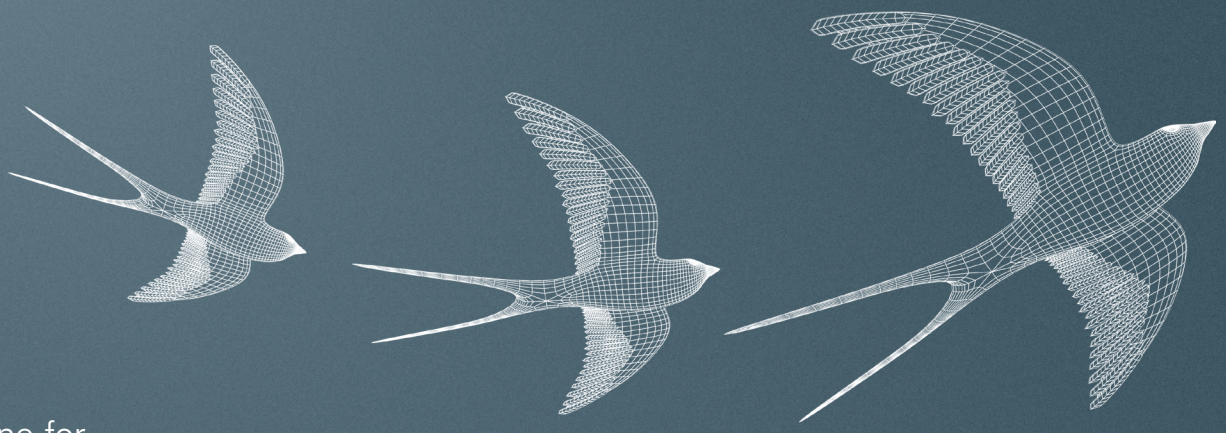
INVESTMENT FOCUS

Janus Henderson
INVESTORS



The magazine for investors with Janus Henderson

Issue 18
Winter 2017/18

Inside: Technology – continual change offers a source of opportunity

For promotional purposes

Simon Hillenbrand
Head of UK Retail

WELCOME

It might not be until March before swallows are sighted on our shores but the birds are a useful symbol. They concurrently represent change and continuity: the shift towards spring yet the regularity of the seasons.

We see something of this duality in the investment world where commentators often have a habit of exaggerating near term changes yet underestimating longer-term shifts. Our feature on pages 12-13 explains how our technology fund managers look beyond market hype at the underlying resilience of the themes that are shaping changes within our world. Similarly, within the article on commercial property, Ainslie McLennan, co-fund manager of the Janus Henderson UK Property PAIF, explains how alternative property sectors have grown over time from a fringe area to be sought-after investments.

A common phrase in the financial industry is "This time it's different", often used to justify high valuations and the triumph of hope over experience. In the article on page 10, seasoned investor John Bennett questions whether US stocks can continue to outperform and considers whether the migration towards US stocks in recent years is set to reverse as investors rediscover more attractively valued European stocks.

Remaining aloft

2018 could prove to be an interesting year as the supportive prop of central bank purchases of assets is heavily reduced, and Brexit negotiations enter a critical stage. Countering this is synchronous economic growth among all the leading economies, together with the progress that the US made on tax reform, which is expected to provide a generous boost to corporate profitability. In his outlook on page 5, Paul O'Connor, Head of Multi-Asset, suggests 2018 will favour equities, yet our feature on pages 6-7 explains why structural shifts in the economy may yet keep a lid on growth and inflation, which could offer support to bonds.

Other areas covered in this issue include China where fund manager Charlie Awdry sees opportunities within the banking sector and we interview Dean Cheeseman, the new manager within the Multi-Asset Team, who shares his views on risk, among other things.

It remains for me to say that I hope that you find this edition of Investment Focus interesting. I would also like to thank our readers for choosing to invest with us and hope that 2018 proves a happy and prosperous year for you all.

Simon Hillenbrand
Head of UK Retail
Janus Henderson Investors

Does the change of year herald a change in market direction or can assets continue to make progress?

NEWS IN BRIEF

Name changes

Please be reminded that all Henderson funds now begin with the pre-fix Janus Henderson; these changes have been incorporated into literature and the website.

Responsible citizens

Janus Henderson Investors is committed to playing an active role in improving society and the environment. In July 2017, we re-signed the HM Treasury Women in Finance Charter, which seeks to promote gender equality in the workplace. Towards the end of 2017, we also signed a new investor initiative on climate change known as Climate Action 100. Participants aim to engage with the top 100+ companies that contribute the most to global emissions, seeking action to reduce emissions and calling for enhanced corporate disclosure.

Past performance is not a guide to future performance.
The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested.

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MARKETS

WILL THE BULL KEEP CHARGING IN 2018?

The second half of 2017 concluded a remarkable year for financial markets. Despite adverse political developments in some parts of the world and the looming end of the 'great monetary easing', it was one of the most tranquil years historically for equity and bond market volatility (price fluctuations) and equity markets continued to charge ahead.

One significant feature was the number of positive global growth surprises – a welcome development after six years of disappointments. While political developments were a distraction for investors on many occasions, they were never big enough to overwhelm encouraging macroeconomic trends. For most of the time, at least, economic fundamentals continued to outdo politics in driving market direction.

UK equities gained ground as investors took heart from an improving domestic economy and encouraging company earnings (FTSE All-Share Index +7.2%). The UK economy grew 0.4% quarter-on-quarter in the third quarter of 2017 and consumer prices inflation crept higher, climbing to 3.1% year-on-year in November. Responding to the higher inflation rate, Bank of England policymakers raised interest rates from 0.25% to 0.5% – the first rise in 10 years. On the political front, Brexit negotiations remained in focus as the European Union and the UK government grappled with two sticking points: the 'divorce' bill and the future of the Irish border.

European equities shook off political uncertainty to end the six-month period in positive territory (FTSE World Europe ex-UK Index +4.0%). The German federal elections ended in no clear majority, meaning Chancellor Merkel's Christian Democrats (CDU) had to seek new coalition partners; talks were ongoing to the end of the period. Elsewhere, the region of Catalonia declared independence from Spain, causing weakness in the Spanish equity markets. Meanwhile, European Central Bank policymakers announced plans to scale back the bank's asset purchase programme.

US equity markets advanced as investors hoped that the Trump administration would enact pro-business tax cuts (S&P 500 Index +7.0%). President Trump signed the reforms into law just in time for Christmas after a frantic passage through Congress. It is expected that much of the benefit will be felt in corporate earnings through lower tax rates and therefore better equity market performance. The US economy continued to grow, increasing at an annualised rate of 3.2% in the third quarter – its fastest pace for two years. The Federal Reserve raised interest rates for the third time in 2017, to a range of 1.25-1.5%.

Japanese markets moved higher in sterling terms (FTSE Japan Index +8.8%). Prime Minister Abe secured a decisive election victory, sparking hopes of further monetary and fiscal stimulus measures and sending equities higher. As expected, the Bank of Japan kept interest rates on hold throughout the period. Inflation continued well below the central bank's target, sliding to 0.2% in October.

Asian equity markets also fared well, despite ongoing tensions stemming from North Korea's nuclear missile tests. In India, the corporate sector showed signs of strength, with more than 150 companies launching new stock on the market in 2017. The Chinese authorities made more efforts to entice foreign investors by lifting restrictions on foreign investment in some financial companies, but larger listed Chinese companies suffered their biggest one-day falls in November for 17 months owing to fears about tougher borrowing regulations (FTSE World Asia Pacific ex-Japan Index +7.2%).

Paul O'Connor
Head of the UK-based Multi-Asset Team

Within emerging markets, Brazilian markets shook off political woes to make gains, despite President Temer facing a fresh wave of corruption allegations. In August, the US Senate approved sanctions against Russia, a rebuke for alleged Russian interference in the 2016 presidential election and also its military operations in eastern Ukraine (MSCI Emerging Markets Index +11.5%).

In fixed income, government bond yields within the 'core' markets of the UK and the US nudged higher (prices fell). Improving economic data and the prospect of higher rates offset bouts of risk aversion. However, German government bond yields slipped (prices rose), as European political uncertainties supported 'safe-haven' buying. In corporate bond markets, companies rushed to take advantage of low borrowing rates; 2017 looked set to be a record year for new issues of non-financial bonds (JPM Global Government Bond Index -1.4%; Barclays Global Aggregate Corporate Bond Index +1.1%).

Commodity markets moved higher in aggregate. Despite some fluctuations, the price of Brent Crude oil ended the period significantly higher, at almost US$67 a barrel, on news that producers planned to extend output cuts into 2018. Within precious metals, gold also finished the period slightly higher on geopolitical concerns and US dollar weakness (London Gold Bullion +0.7%; Brent Crude Oil +33.8% in sterling terms).

Source for all index performance: Thomson Reuters Datastream, 30 June 2017 to 31 December 2017, total return indices in sterling unless otherwise stated.

Past performance is not a guide to future performance.

Outlook

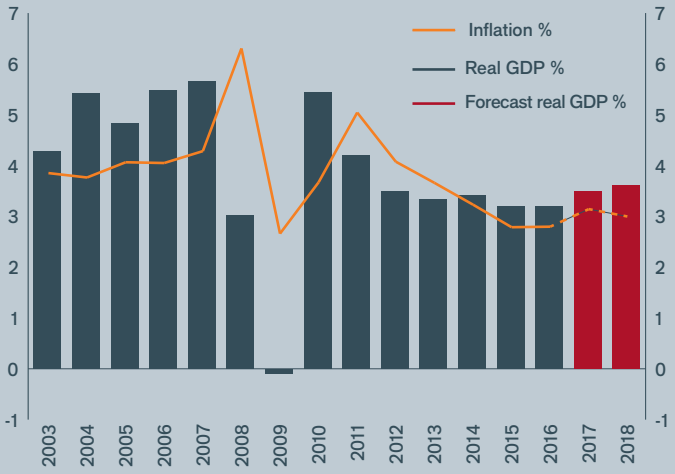
We see good reason to expect positive economic momentum to continue well into 2018. The global expansion is geographically broader than at any time since 2007 and is also now broadening across sectors, with capital spending turning up after years of decline. In the absence of any major surprises, it is quite plausible that the moderate pace of this recovery will give it an unusual longevity, compared to the faster upswings of previous cycles.

Shocks aside, a more orthodox threat to the longevity of the recovery would be a sustained upswing in inflation expectations, reviving prospects of 'old-school' boom, bust and recession scenarios. Given that inflation has consistently undershot expectations throughout the post-crisis recovery, this might seem a remote possibility. However, underlying inflation is creeping higher globally. Core inflation increased in 72% of developed economies during the past year – the highest percentage since 2011. At this stage, we expect the recovery in wages and prices to remain gradual, but note that any big rethink on this front could well have a significant impact on our view on the market outlook.

Market sensitivities to the inflation outlook are of course linked to the outlook for monetary policy and the speed at which normalisation proceeds. It is encouraging that markets have reacted so calmly to interest rate hikes and the ending of quantitative easing (QE; asset purchases) in the US, so far.

Still, the challenges ahead are formidable. The major central banks purchased more than US$2 trillion of assets in 2017 and that flow will gradually come to a halt by the middle of 2018. Given the unprecedented nature of these changes, it is difficult to be confident about how markets will adjust to the withdrawal of such a huge monetary stimulus. We take comfort from the fact that central banks will proceed cautiously and policy should remain accommodative, but we must recognise that central banks are heading into unknown territory.

Consensus world GDP growth and inflation



Source: Janus Henderson Investors, Bloomberg, as at December 2017.
Notes: Red bars and dotted line represent current median consensus forecasts (which combine forecasts from different analysts). Real GDP = gross domestic product adjusted for inflation. Inflation is year-on-year % change.

What is priced into markets?

On balance, our core view for 2018 is a constructive one, featuring a synchronised global recovery, a modest pick-up in inflation, and a gradual normalisation of central bank monetary policy. Still, with few assets looking particularly attractive from a valuation perspective, we have to question the extent to which many of the positive features of our view are already priced into financial markets. Our enthusiasm is also tempered by the fact that bull markets in many assets are already very long by historical standards. In US equities, for example, the current bull market is now the second biggest and the second longest since the 1920s.

Once again, we enter the year with equities our preferred asset class. While the ending of QE will be a challenge for all asset classes, equities at least offer solid earnings growth as an offset. Relative valuations remain attractive, compared to cash, government bonds, and corporate debt. However, given the maturity of the bull market, absolute valuations that are far from cheap, and emerging evidence of investor complacency, we do not think that this is the time to be 'all-in'. Looking ahead we expect lower returns and higher volatility compared to 2017, a year with barely a market fall. We think it is sensible that we start the year keeping some firepower in reserve, so that we have some cash to put to work if any dips do materialise.

Bull market: a financial market in which the prices of securities are rising, especially over a long time. The opposite of a bear market.

Commodity: a physical good such as oil, gold or wheat.

Macroeconomic: refers to the performance and behaviour of an economy at the regional or national level. Macroeconomic factors such as economic output, unemployment, inflation and investment are key indicators of economic performance.

These are the manager's views at the time of writing on 31 December 2017 and should not be construed as investment advice. The opinions expressed do not necessarily reflect the views of others at Janus Henderson.

SQUARE ROOT RECOVERY

John Pattullo, Co-Head of Strategic Fixed Income, takes a look at how the different parts of the world economy have grown since the Global Financial Crisis.

Remember 2009, when a year and a half after the worst financial crisis to hit the globe since the 1930s finally looked to be over, and economists had begun speculating over the likely shape of the recovery? The discussions turned emphatically alphabetical with various letters V, U, W and L thrown into the debate, and when they ran out of suitable letters, squiggly mathematical symbols (notably George Soros' inverted square root sign) would do nicely.

Over eight years on, disappointingly, economic recovery has turned out to be both one of the weakest, and the longest, in modern history with many bumps along the way.

In the US, where economic recovery began earlier than the rest of the developed world, growth has been uneven, both geographically and through the years, and at levels only modest at best. Reaching its eighth year and 99th month on 30 September, this has been one of the longest economic cycles (growth, boom, recession and recovery) in the US, behind only two others — the 1960s (106 months) and the 1990s (120 months).

Nevertheless, there has been some positive news recently that the fairly tepid growth may have begun to accelerate. In October, the International Monetary Fund upgraded its forecasts for 2017 and 2018, stating that the world economy is gaining momentum, enjoying its most widespread growth since the temporary bounce back from the global recession in 2010.

However, many remain concerned that despite this benign short-term outlook, the underlying growth dynamics in many advanced economies remain weak. This is based on low levels of investment, sluggish productivity and protectionist policies, among other structural factors.

Today's alphabet soup of economic recovery

Since the downturn, monetary policy efforts, such as lower interest rates aimed at propelling economic growth, have successfully brought about considerable asset price inflation, but very little wages or goods inflation. Did central bankers target the wrong sort of inflation?

The current economic expansion is a most unusual one. Different parts of the economy have displayed different shapes of recovery. Asset prices have had a V shaped recovery, falling sharply but bouncing back even faster and continuing to rise. In fact, equities seem to be reaching a new peak every day (widely referred to as "the most hated bull market ever"). The result has been more inequality in society, with the rich getting richer and the poor getting poorer; a situation exacerbated by new structural forces (shifts or changes) in the economy. One example is change in the work force reflected in a rapidly expanding new class of workers — the precariat — defined by the instability and insecurity of their jobs.

Productivity and real wages, which fell and failed to recover, exhibited a classic L shape. Economic growth (as in gross domestic product, GDP), however, has taken on a square root shape.

John Pattullo
Co-Head of Strategic Fixed Income

As the chart shows, after the financial crisis the world economy collapsed, rebounded and has since almost plateaued. This has resulted in a dilemma for central banks. Numerous quantitative easing (QE) policies (asset purchase programmes) in the ten years since the financial crisis have failed to produce the desired inflation and growth environment. Lack of investment and productivity have contributed to the low growth pattern, while deteriorating demographics, the deflationary effects of technology and behavioural changes in consumers have all contributed to the slow growth and low inflation world that we now live in. These factors are unlikely to disappear any time soon.

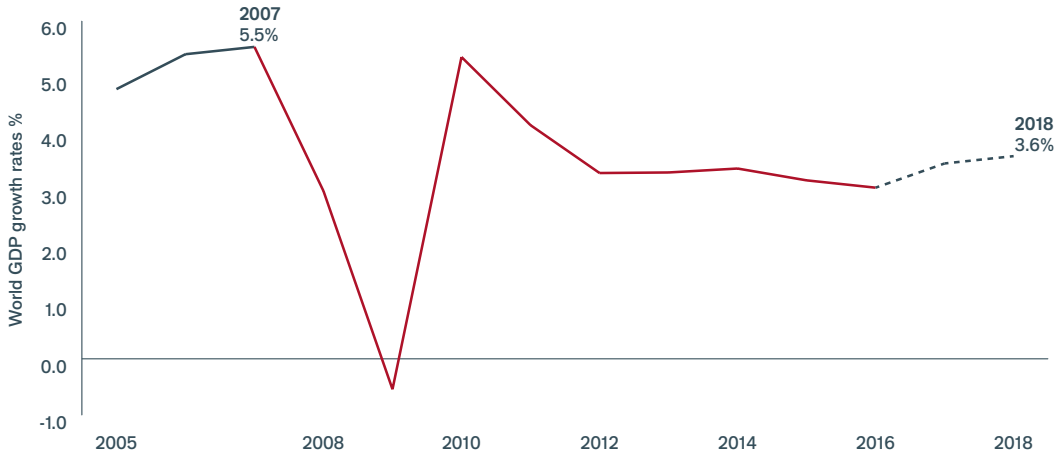
As a result, many tools used by central banks in gauging the economy and setting policy now look flawed, and with interest rates at such low levels, central bankers are facing the lobster pot problem, where they cannot get out of QE as easily as they assumed. The US Federal Reserve has announced a very gradual tapering (reduction) of its balance sheet while emphasising that rate hikes will be slow, gradual and data dependent, while the European Central Bank has also indicated a gradual tapering of its asset purchases. The emphasis is very much on the 'gradual'.

Going out with a big bang or a whimper?

Despite the recent optimism on higher economic growth rates, given the fundamental picture of both short and long-term structural factors that impede growth and inflation in today's world, we believe that we are likely to stay in the square root for a long time.

We also do not think that the economy will go out with a bang, but a whimper, and will continue to limp along for the foreseeable future. However, if there is another downturn, the underlying causes could be geopolitical, China-induced or from an asset price bubble, which could trigger a correction, but not, in our view, from an inflationary economic boom.

A square root recovery



Source: OECD (2017), "OECD Economic Outlook No. 101 (Edition 2017/1)", OECD Economic Outlook: Statistics and Projections (database). Dotted line represents forecasts for 2017 and 2018.

Quantitative easing: a measure whereby a central bank creates large sums of money to purchase government bonds or other securities, in order to stimulate the economy.

Past performance is not a guide to future performance.

BEHIND THE MONEY

The newest recruit to Janus Henderson's UK-based Multi-Asset Team, Dean Cheeseman, has his sights set on risk management and asset growth, writes Jennifer Hill.

In a world of high asset prices and the withdrawal of the monetary stimulus that has fuelled them, managing risk is more important than ever. It is something that Dean Cheeseman, the latest addition to Janus Henderson's Multi-Asset Team, is particularly cognisant of.

"One of the things I'm most excited about is the opportunity to bring institutional discipline and rigour into the retail space," says the portfolio manager, who has notched up more than 20 years' industry experience and joined Janus Henderson in September from Mercer where he was responsible for $5.8 billion (£4.4 billion) of active institutional strategies.

When it comes to managing risk, Dean says that Janus Henderson is industry-leading. "There's some really strong infrastructure at Janus Henderson; for example, we have a risk manager who produces a daily report on expected volatility for our risk-targeted funds," he says. He believes that "the granularity and level of detail" that is expected for the institutional world is something that the retail space should further embrace.

Unique selling points

Cheeseman and Paul O'Connor, Head of Janus Henderson's £5.1 billion UK-based Multi-Asset Team, worked together for two years at Mercer and one of the main attractions for Cheeseman was the strength of O'Connor's strategy.

"Paul is a fabulous strategist," says Cheeseman. "Not only is his perception of what's happening in an increasingly difficult world absolutely first class, his ability to communicate difficult matters in layman's terms – whether the nuances of Brexit or the breakdown in correlations (asset class relationships) – is exemplary."

Janus Henderson's multi-asset proposition starts with an understanding of the macroeconomic picture. O'Connor leads this top-down analysis, assisted by Nick Harper, who joined the 12-strong team in July as a portfolio manager and asset allocation specialist, and Oliver Blackbourn, who joined in August as an analyst.

"There's a big difference between undertaking granular, proprietary top-down work and grabbing a quick sound bite on macroeconomics and throwing it out there; separating the wheat from the chaff in terms of who is genuinely top-down is one of the big challenges for advisers and investors," says Cheeseman.

"One of our great selling points is the clarity that the top-down perspective gives us when it comes to my job – translating that into bottom-up manager and security selection."

Monetary stimulus: a central bank increasing the supply of money and lowering borrowing costs.

Volatility: the rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. It is used as a measure of the riskiness of an investment.

Risk targeted funds: these funds are designed to stay invested within specific risk parameters, usually measured by volatility – the tendency of returns to fall or rise over a defined period of time. Janus Henderson's risk-targeted funds, the Core Income range, are only available through your financial adviser because they require an assessment of investor goals.

When constructing portfolios the team invests with conviction to avoid falling into the trap of building expensive index trackers (portfolios that replicate an index).

"In the retail world, there can be a propensity to overpopulate portfolios with too many components: if you diversify too much you end up building expensive indices," says Cheeseman.

"We have a blend, but we also want biases towards the areas that stand to do well depending on where we are in the economic cycle; in a recession you want high quality assets, whereas in an expansion you want value-orientated cyclicals – typically banks, industrials and retailers. If you don't have a top-down view, how can you know where to tilt (adjust) the money?"

Long term, the team is optimistic about the economic outlook. Shorter term, it sees risks on the horizon as quantitative easing (central bank asset purchases) slows and eventually ceases. That is being reflected in more cautious portfolios, which hold proportionally more cash and fewer investment-grade corporate bonds. The team's high yield bond exposure is to those bonds that are short-dated, while government bond exposure has been increased as an offset against a correction in asset markets. The team has also taken profits in European and emerging market equities, while retaining an overall preference for equities over bonds.

"If central banks' asset purchase programmes are going to slow, we should start to see a more traditional supply/demand dynamic and a possible rerating (repricing) in investment grade debt," says Cheeseman. "To paraphrase [Warren] Buffett, we'll see who's 'swimming naked' having chased riskier assets when the tide of support from central banks has retreated."

QUICK FIRE Q&A

Q The first piece of business advice I received was...

Always first consider the proposed solution from the perspective of the client

Q My ideal job, other than this one, would be...

Grass roots development coach for rugby or athletics

Q My favourite holiday destination is...

North Norfolk coast – Brancaster/Holkham beaches

Q Favourite film...

The Sting (1973)

Q Favourite app...

Beanhunter (helps users find great coffee)

Q The historical or fictional character I most revere is...

General Sir Peter de la Billière – he never asked his troops to do anything that he wasn't willing to do himself

Q The charity closest to my heart is...

Cancer research: everyone's directly or indirectly affected

Q The finance-related headline I'd most like to see is...

'Bitcoin crashes after Chinese government finally stops mass cash exodus'

Jennifer Hill is a freelance financial journalist and Citywire editor, who was previously deputy money editor of The Sunday Times, personal finance correspondent of Reuters and personal finance editor of The Scotsman.

Top-down investing: analysing the 'bigger picture'. This approach considers economies and industry forecasts to ascertain which investment areas might generate the best returns.

Bottom-up investing: seeking individual companies, assets, or funds that are expected to perform well over time, based on eg, the management team, and expectations for growth, yield or earnings.

Value investing: a type of style investing. Value investors search for companies that they believe are undervalued by the market, and therefore expect their share prices to increase.

Index: represents a particular market or a portion of it, serving as a performance indicator for that market.

Portfolio positions are correct as at 31 December 2017 and may be subject to change. These are the manager's views at the time of publication and should not be construed as investment advice. The opinions expressed do not necessarily reflect the views of others at Janus Henderson.

John Bennett
Head of the Pan European Equities Team

FOCUSING ON STOCKS, NOT MARKETS, IN 2018

John Bennett, Head of the Pan European Equities Team at Janus Henderson, outlines his expectations for a change in market leadership in 2018.

For the past decade, with the exception of a brief interlude in 2009, investors have favoured companies they expected to grow their earnings at an above-average rate, so-called 'growth' companies. This has favoured the US, where markets tend to be more of a 'growth' construct than in Europe. We felt, at the beginning of 2017, that with valuations at elevated levels, the time was right for investors to shift their attention to companies that appeared to be trading at an undervalued price – 'value' companies. Europe did not look great value, but such was the length of US equity market outperformance, we sensed that we might finally see a rebalancing.

As it turned out, we were wrong. 2017 was another year for growth stocks, and US equity markets remained at the fore. Valuations moved higher and growth stocks remained in demand. But moving into 2018 we still think that is going to change. I am a firm believer in the 'iron law' of mean reversion in investing. This explains that everything, from stock prices to the growth rates of countries, has a tendency to revert to the mean over the long term. Things tend to overshoot in many aspects of life, and nowhere is that more true, in my view, than the stock market.

My sense is that 2018 will bring a challenge to both market direction and market leadership.

A challenge to market leadership?

My sense is that 2018 will bring a challenge to both market direction and market leadership. 2017 brought few challenges, with very rare falls and little volatility in equity markets. I expect this to change, with potential catalysts coming in the form of a more urgent need for central banks to raise interest rates, or some growth or momentum stocks starting to wilt under the weight of their own elevated valuations.

Focusing on individual stock stories

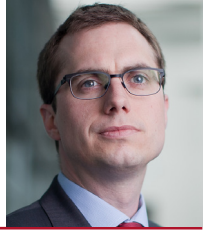
Over the past 30 years, I have always sought to blend sector themes, where identified, with individual stock ideas. Sector themes do not come along every year, and as we stand today it is difficult to have any strong convictions. Instead, the best opportunities as I see them are very much company specific.

We are in an environment that to my mind signals an end to the bull market. We have unicorns (start-up companies with a valuation of over US$1 billion) and we have had the frenzy around bitcoin. These are good examples of what you tend to get when markets are close to their peak.

Of course, we are mindful that it is impossible to make calls on turning points in markets. However, in the current environment, I believe that investors will be best served by finding the right ideas at a stock level, and it is here we are focusing our attention.

Momentum stock: a stock or other security that has delivered strong performance in the recent past.

Charlie Awdry
Co-Manager of the Janus Henderson China Opportunities Fund



BANKING ON CHINA

Janus Henderson China Opportunities Fund Co-Manager, Charlie Awdry, shares his thoughts on what might move Chinese markets over the course of 2018.

A key theme for China in 2018 is President Xi's increasing power and clout. Xi sets the agenda for the Chinese economy and for businesses, and so we maintain a laser-like focus on Chinese policy.

Recently, there has been a raft of announcements regarding financial regulation and changes to China's banking sector, with stronger emphasis on the reduction of debt, one of the three competing forces for China along with growth and reforms. These efforts are aimed at addressing the off-balance sheet lending economy within China, such as wealth management products and shadow financing (lending by non-bank entities), as well as the rapidly-growing areas of small-scale lending by small businesses and individuals, and internet financing. We are seeing more guidelines about how these products are sold to the customer, and the liability of the banks that offer them.

We are heartened by these developments as they lend support to our decision to reintroduce bank shares into the fund since the second quarter of 2017. The Chinese economy has performed better than many expected; non-performing loans ('bad loans') appear to have peaked and we think the valuations of bank shares appear attractive, although we are being very selective. We really want to be invested in the largest banks with the strongest retail deposit franchises, that are well capitalised and have adequate cash to fund their operations.

Another meaningful event is the inclusion of mainland A shares – those renminbi-denominated Chinese shares listed in the Shanghai and Shenzhen markets – into the MSCI All Countries' World and Emerging Markets indices in June 2018. This is a market that we have been investing in for a long time. Foreign investors will be exploring A shares more and we believe they will be pleasantly surprised by the high quality of some of these companies as the perception is that these markets are extremely volatile and very immature.

The final theme that could play out in 2018 is the 'old chestnut' of growth investing versus value investing. 2017 was a good year for Chinese growth stocks and consequently they have become quite expensive. We have, therefore, been moving the portfolio more towards value or a more neutral stance.

In terms of compelling opportunities in the market, the foundation of the China investment case remains the consumer and the rise of consumption. We are seeing some really interesting recovery stories, such as Chinese sports brands, and other unloved value sectors of the market that appear to be more attractively valued at the moment. We truly think these areas have the strongest potential to deliver meaningful long-term returns for our investors.

Growth investing: growth investors search for companies they believe have strong growth potential. Their earnings are expected to grow at an above-average rate compared to the rest of the market, and therefore there is an expectation that their share prices will increase in value.

The foundation of the China investment case remains the consumer and the rise of consumption.

INNOVATION AND DISRUPTION

Alison Porter, Graeme Clark and Richard Clode, portfolio managers in Janus Henderson's Global Technology Team, explain why they believe technology stocks have the potential to continue to outperform global equities in the long term.

Reflections on a strong year

2017 proved to be one of the strongest years for technology stocks as the MSCI ACWI Technology Total Return Index rose 30% in sterling terms, outpacing the 14.8% rise in the broad sector MSCI All Countries World Index.* There was a broad-based acceleration across many of the key investment themes running through the Janus Henderson Global Technology Fund. Internet transformation and 'winner takes most' was very evident globally, the migration to cloud computing continued apace and artificial intelligence (AI) became more prevalent, enabling a wide array of new technologies from voice-activated virtual assistants in the living room to autonomous driving. These are not one-off themes but structural forces that we expect to drive technology stocks through 2018 and beyond.

*Source: Thomson Reuters Datastream, 31 December 2016 to 31 December 2017.

Market drivers in 2018...

Monetary policy changes, tax reform and the US mid-term elections are likely to affect the macroeconomic backdrop for equity markets in 2018. We have already seen the shift from monetary policy and quantitative easing to a focus on fiscal easing through tax cuts and increasing government spending.

In the US, the tax reform changes that were voted through at the end of 2017 are likely to support the US economy. The reduction in corporation tax from 35% to 21% this year should boost earnings while repatriated US corporate profits (seeking to take advantage of a one-off levy of 15.5%) also have the potential to unlock billions of dollars of cash that has been sitting offshore. The technology sector has the strongest balance sheet among the main sectors and large cap technology companies are set to benefit most from this ability to repatriate cash at attractive rates. This could drive increased merger and acquisition activity and also could drive shareholder returns through increased share buybacks and/or dividends.

...and challenges

Large tech platforms have built wide competitive moats through their scale, network effect of users, dominant market share and high levels of spending on research and development and investment. Their impressive scale has, however, raised concerns about market competition and data privacy, particularly in the European Union (EU). We expect further regulation and scrutiny in 2018, on privacy and data (General Data Protection Regulation), on competition (notably the EU case against Alphabet on Android), and on tax. This is a continuation of the pattern we have seen over the last 10 years as governments and regulators adapt to an ever-evolving technology landscape. We view increased regulation as an inevitable but manageable risk for the sector given the resources these companies have available and their experience of managing through change.

Long-term themes dominate

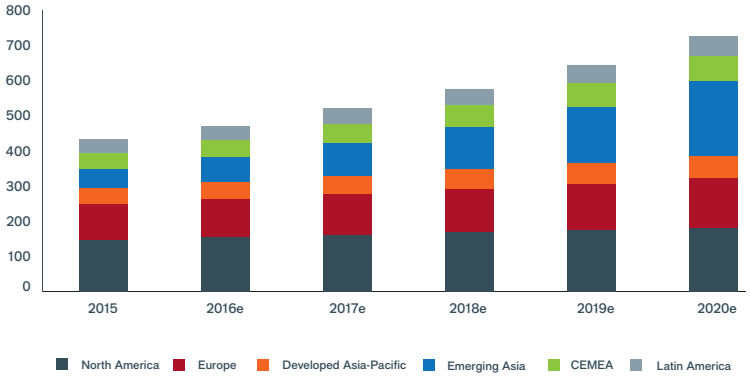
In terms of the long-term case for investing in the sector, we believe that demographic trends remain a powerful driver of technology usage – as millennials (people born after 1980) grow in economic power, we see technology continuing to take a greater share of both time and spending. Technology continues to be a deflationary force, driving productivity by allowing us to do many tasks more cheaply and with better performance.

These core drivers of demographics and innovation provide the fuel for the powerful secular themes that we believe will drive long-term performance of the sector. AI is more than just a theme; we view it as the fourth technological wave (following from the earlier mainframe, PC, and mobile internet waves).

We see investment opportunities within AI with machine learning software and through the way in which we interact with technology (from type and touch to voice and vision) and in the revolution occurring in transportation. To facilitate this move to AI – the fourth wave – we require next generation infrastructure, another investment theme, focused on cloud computing and the move to 5G.

Other long-running themes in the portfolio include finding the winners in global internet transformation and payment digitisation. In terms of the latter, the increasing use of mobile phones is helping drive the move away from cash transactions to digital payments. This trend is particularly evident in emerging markets where digital payments are being rapidly adopted and could outpace developed markets (see chart).

Number of worldwide non-cash transactions is rising (billions)



Source: World Payments Report 2017, Capgemini and BNP Paribas, e = estimated.
Note: CEMEA is Central Europe, Middle East and Africa.

While these themes are powerful and drive attractive growth potential, we remain driven by bottom-up stock picking. We navigate the hype cycle around new technologies by focusing on sustainable barriers to entry and valuation discipline.

Internet winner takes most: there are strong network effects on the internet – the more users use a product or service the more additional value it gains, creating a gravitational pull on both customers and revenue.

Cloud computing: managing IT services remotely over the internet instead of on a computer's hard drive or on-site servers.

Artificial intelligence: the ability of machines to simulate human intelligence processes, such as learning and reasoning.

5G: the fifth generation of wireless communication providing seamless high speed data connection at all times

Hype cycle: the expectations (and share price) cycle common to many a new technology where there is an initial trigger of innovation, followed by a rapid rise in expectations, followed by a trough of disillusionment and then a more enlightened view of its potential. The actual outcome of the new technology may exceed the early expectations but it typically takes longer than the market had anticipated.

Past performance is not a guide to future performance. Portfolio positions are correct as at 31 December 2017 and may be subject to change. These are the managers' views at the time of publication and should not be construed as investment advice.

ALTERNATIVE LIFESTYLE

Ainslie McLennan, co-manager of the Janus Henderson UK Property PAIF, explains how many areas of the alternative commercial property sector, such as cinemas, student accommodation and hotels, are in tune with trends shaping the modern world and are becoming sought-after income-producing assets.

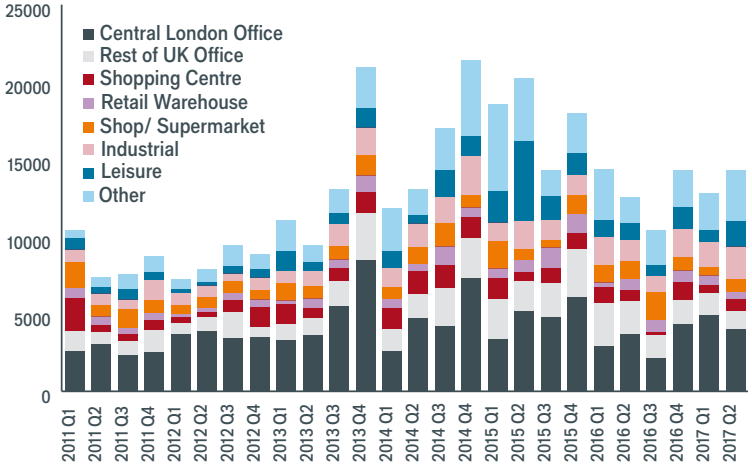
Offices, retail and industrial represent the principal commercial property sectors, yet there is a whole range of properties classed as alternatives that have a valuable role to play in bringing diversification to a property portfolio. The specific property requirements from tenants within the alternatives sector mean that lease lengths can be long, often offering 20 years or more of income. In addition, these specialist assets have historically provided higher yields – the level of rental income expressed as a percentage of the property's capital value – compared to higher-quality assets within the office, retail and industrial sectors.

The chart shows how alternatives – indicated in blue shades – have become an increasingly large component of market activity as investors seek out a more diverse tenant base. This demand has pushed up property prices and lowered yields* across the market for high-quality and well-located alternative assets.

The Janus Henderson UK Property PAIF has been invested in the alternatives sector for a number of years. Aside from income and diversification, a key part of the attraction of alternative properties also lies in their relevance to the modern world as illustrated in the following sector comments.

*Yields have an inverse relationship to prices, for example, as prices rise yields fall.

UK investor volumes and key sectors (£ million)



Source: PropertyData.com, 31 August 2017

Leisure – mixing it up

People never lose the desire to be entertained and commercial property has an essential role to play in delivering the built amenities. The increasing urbanisation of the UK population means that people want gyms, cinemas and retail to be in convenient locations. Shopping areas gain from a mixed use proposition that incorporates leisure facilities, such as restaurants and cinemas that mutually drive consumer traffic to one another.

Mixed-use schemes maximise convenience, offer a place where people can socialise and increase footfall. Muswell Hill is an example of the mixed-use property we like to hold within the London High Street sector of the market. The overall asset comprises a multi-let retail parade, a cinema and some residential space on the upper floors. A short video on the asset features at **hgi.co/muswellhill-video**.

There is a whole range of properties classed as alternatives that have a valuable role to play in bringing diversification to a property portfolio.

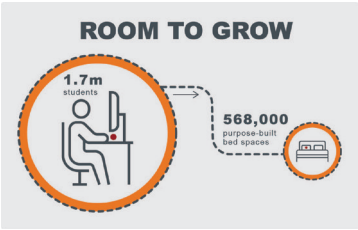
Everyman cinema, Muswell Hill, London

Source: TH Real Estate

Ainslie McLennan
Co-Manager of the Janus Henderson UK Property PAIF

Student accommodation – professional development

One way that students can control their expenditure and ensure a decent living environment is through purpose-built student accommodation. This has the advantage of being surrounded by like-minded peers, offering a guaranteed level of amenities and providing better security. For landlords of student accommodation, the advantages are a relatively captive market with a reliable income. The PAIF recently completed development of an 89-bed student accommodation block on campus in Kingston-upon-Thames, South West London. A 25-year lease was signed by Kingston University in advance of completion, with annual uplifts linked to the retail prices index measure of inflation.



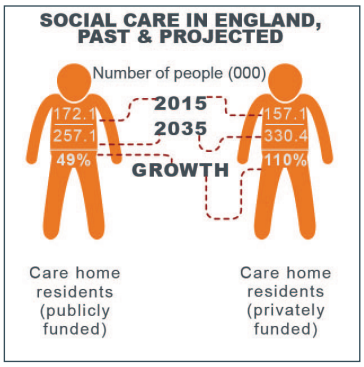
Source: Cushman & Wakefield, UK Student Accommodation Report 2016/2017

Data centres – monetising noughts and ones

The creation of more and more data demands additional storage facilities. Beyond simply finding space to store data, organisations need to keep digital information safe, private and secure, in order to protect intellectual property rights. In 2015 we acquired a data centre with a 28-year lease in Romford, Essex, which is an excellent location with strong demand due to its proximity to Central London. The PAIF also owns a data centre development in London Docklands, which offers 140,000 square feet of space.

Care homes – comfort in old age

We live in an ageing society. According to UK Government figures the population of those aged 75 or more in the UK is expected to grow from 5.2 million in 2014 to 7 million by 2024 and more than 8.7 million by 2034. As a result, demand for privately funded care homes is expected to more than double in the next twenty years.



Source: Personal Social Services Research Unit, Future of an ageing population, Government Office for Science, 2016

The PAIF owns care homes in Edinburgh, Orpington in London, and Hailsham in Sussex, which are well located close to dense population centres.

Hospitals – patient capital

Private hospitals fulfil a useful role in supporting the UK's healthcare system by treating patients privately and additionally providing outsourced treatment for NHS patients. This is particularly true of the PAIF's hospital let to BMI in Poole. It sits opposite the town's main NHS hospital and has a constant flow of referrals, particularly for eye operations. The UK's growing and ageing population means that demands on the hospital sector are only set to increase. The Poole asset has more than 15 years remaining on its lease.

Hotels – a room with a view

Well-located hotels will always attract travellers and the hotel industry continues to see rising demand for bed space. Growing supply of beds also means that location, quality and value for money will remain key determinants of the success of a hotel.

The PAIF has a long lease on a Travelodge in Hackney, London and a Hub hotel in Edinburgh. The latter was a conversion of a vacant office building into a 145 bedroom hotel for Hub by Premier Inn, which appeals to the cost-conscious traveller. It is a smart hotel, where everything from room entry to check in is electronic, in tune with today's modern lifestyles. The hotel comes with a 30-year lease on upward-only rent reviews.

'Hub' Premier Inn hotel, Edinburgh

Source: TH Real Estate

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