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Portfolio funds update
January 2023

KEY MESSAGES

- The absolute performance last year primarily reflects an historically rare combination of bonds falling more than equities
- The relative underperformance against peers primarily results from the previous structure of the funds' currency hedging policy, compounded by stock selection during the calendar year
- We have fundamentally altered the funds' currency hedging policy and believe the new approach will ultimately lead to a superior risk/reward outcome for clients
- We remain convinced that any underperformance from stock selection is a short-term issue – the funds have a very strong track record of successful stock selection and have a full pipeline of ideas awaiting attractive entry points
- Our macro framework, which was effective last year, suggests that a recessionary backdrop will still need to be negotiated. The funds are positioned accordingly and we believe they are very well placed to navigate and evolve with the changing economic environment. We are excited by the long term opportunities beginning to emerge and fully believe that these should reward clients in the coming years

2022 MARKET OVERVIEW

2022 was a particularly challenging one for investors and fund performance struggled as a result. Broad asset classes were almost exclusively negative in 2022, with the traditionally safer-haven bond market selling off even more significantly than global equities. This meant that investors were faced with the very unusual occurrence of the two most significant components of multi-asset portfolios falling heavily in tandem.

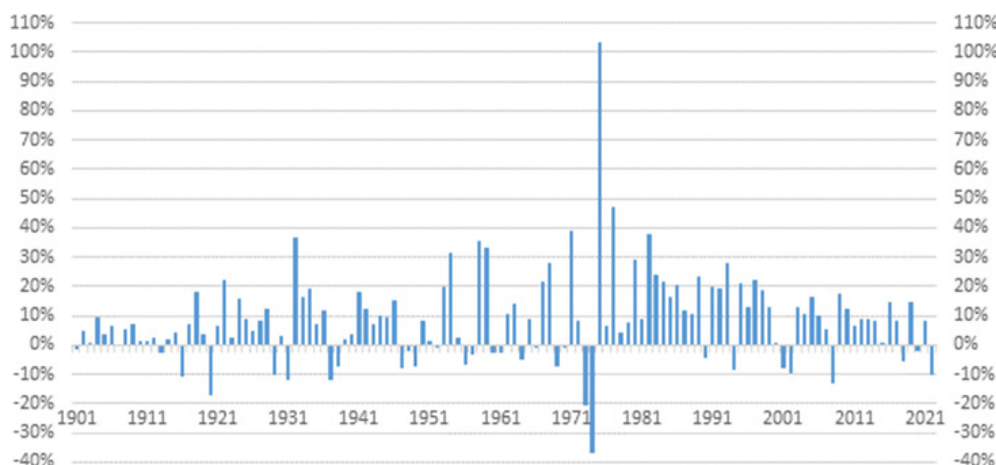
The decline experienced by equities last year is not in itself that remarkable. Looking at data since 1900 (and excluding 2022), equities have experienced negative total returns in 33 calendar years (27%). We expect equities to be volatile whilst producing good returns over the long run. However, the behaviour of bonds in this backdrop was uncommon. Bonds have unusually lagged a falling equity market, rather than cushioning the portfolio as normally occurs. Of these equity down years, returns from bonds have only been worse than stocks on six occasions in the last 121 years (5%).

There have been 29 instances when a hypothetical 60/40 equity/bond portfolio (which can be used as a proxy for a 'Balanced'/'Moderate' risk multi-asset portfolio) has experienced negative returns since 1900 (24% of all years excluding 2022) but only 7 with double-digit losses – 2022 will now be the eighth. This past year has therefore been the worst investor experience since the Global Financial Crisis in 2008, and before that, the worst since the 1970s.

GLOBAL EQUITIES (MSCI ALL COUNTRIES WORLD INDEX) AND STERLING BONDS (ICE BOFA STERLING BROAD MARKET INDEX) CALENDAR YEAR 2022 PERFORMANCE

SOURCE: BLOOMBERG

HYPOTHETICAL '60/40' PORTFOLIO ANNUAL RETURNS SINCE 1900



SOURCE: BARCLAYS EQUITY GILT STUDY 2022, BLOOMBERG, CBAM ANALYSIS

WHY HAVE WE WITNESSED SUCH A DIFFICULT BACKDROP?

Central bank action has been instrumental. They typically have two mandates – a strong economy and low inflation – and act by raising interest rates to tame inflation and cutting them to protect employment. The fiscal stimulus from politicians responding to the Covid pandemic caused demand to overwhelm supply for many goods and services as economies emerged from recessions following lockdown measures, sending prices higher. Last year central banks, most notably the Federal Reserve in America (Fed), prioritised taming inflation over maintaining a strong economy. Higher interest rates sent bond yields higher (and therefore prices lower), putting pressure on both equity and bond valuations as the cost of capital soared.

WHAT'S OUR VIEW?

We believe we are in the midst of a global growth slowdown. In the US, aggregate coincident measures of economic activity, such as data on industrial production, jobs, retail sales, and personal incomes underscore this view. Leading indicators such as housing activity and manufacturing orders are consistent with recessionary conditions. We believe the Fed is fully committed to keeping interest rates high until inflation is back to lower levels on a sustainable basis, irrespective of the economic consequences. As a recession unfolds corporate profits will fall, likely putting further downward pressure on equities and potentially hurting corporate bonds as the risk of default rises.

WHAT DID WE DO IN PORTFOLIOS?

At the asset allocation level we have been cautious. We:

- Reduced our allocation to equities for each fund, moving underweight relative to peer groups in March, ahead of the most significant market declines in the second quarter, and remained so throughout the rest of the year
- Held less in corporate bonds than we typically do and less than our peer group average, with a higher credit rating (as corporate debt bears a degree of equity-like risk from the risk of default)
- Held bonds which are less interest rate sensitive, and more cash than our peer group average to protect against rising interest rates
- Within alternatives, we had already sold out of industrial metal holdings before the year began in view of their vulnerability to economic slowdown and recession risks, only buying into gold later in 2022 once we believed interest rates had peaked

WHERE HAS THE DISAPPOINTING PERFORMANCE COME FROM?

The asset allocation outlined above – most notably the low interest rate sensitivity of our bonds and cash resulting in our fixed income holdings declining around half that experienced by peers, we believe – helped to protect portfolios last year. Unfortunately, two factors resulted in overall underperformance compared to our peer group:

Equity stock selection.
The Portfolio Funds had a strong period of peer group outperformance in the fourth quarter of 2021 from equity stock selection dominated by the core top ten featuring the longstanding, strongest-performing holdings over previous years. In hindsight, this was pulling returns forward, which the market unwound abruptly in the first quarter of 2022 by punishing most of what had just performed best.

	4Q21	1Q22
Close Conservative	3.46%	-6.15%
IA 20-60	1.81%	-3.32%
Quartile	1	4
Close Balanced	5.35%	-7.86%
IA 40-85	2.74%	-3.59%
Quartile	1	4
Close Growth	7.62%	-9.53%
IA Flexible	2.26%	-3.54%
Quartile	1	4

The team evaluated these holdings, re-affirming the investment case in five (Microsoft, Alphabet, Applied Materials, 3i, Visa) whilst selling the others, four of which went on to underperform subsequently (Partners Group, Accenture, Zoetis, Hoya) with only one recovering (Admiral). Returns outside the top ten were mixed, with some notable gainers (AIA, UnitedHealth) being offset by notable detractors (Ally Financial, Avantor) where conviction was maintained.

The team introduced fifteen new stocks to portfolios last year which have added value in aggregate, exhibiting a high 'hit rate' of successful ideas and positive 'skew' of relative return contribution: eleven of the fifteen have been positive against four negative, with the average relative return of the contributors 1.3x that of the detractors. Put simply, on these investments the team have been right far more frequently than when they have been wrong, and they added more value when they have been correct than detracted when they have been wrong – but an insufficient amount to offset the overall detraction from equity stock selection over the course of the calendar year.

It is also worth reiterating that our approach to equity stock selection will largely dictate the geographical allocation of the equity component of the funds. The Portfolio Funds achieve their exposure primarily through direct securities, with the equity portfolio assembled on a bottom-up basis with a top-down sense check in conjunction with appropriate fixed income and alternative investments. As such, the regional allocation of the equity component can deviate from peers who construct portfolios differently. In 2022, the UK FTSE All-Share rose marginally, while most other developed market indices fell substantially. The UK market was, however, heavily buoyed by the significant presence of energy and mining stocks in the index. In 2022, the Portfolio Funds obtained exposure to the energy sector through ownership of Canadian Oil Sands companies, which shows up as a positive contribution to stock selection, whereas from the perspective of peers who had a more significant allocation to the UK, the return can be seen as positive regional asset allocation decision: but they are essentially the same trade.

Currency movements
The non-sterling holdings in the portfolios were 50%-hedged into sterling intended to reduce currency risk for sterling-denominated investors. However, as many equities are denominated in US dollars, this also had the effect of creating a sizeable bet against the US dollar in favour of sterling. As sterling weakened considerably against the US dollar last year (the US dollar is generally perceived as a safer currency in 'risk-off' market environments) unitholders did not benefit from dollar exposure to the extent that they would have done in an unhedged fund. This contributed to a performance lag relative to unhedged peers, felt most acutely in the second and third quarters.

After careful consideration, we took the decision to reform the funds' currency hedging policy. Rather than hedging 50% of all non-sterling assets, we have introduced a more dynamic approach whereby we will hedge (up to) 100% of direct fixed-income assets only. Going forward, we believe portfolios should benefit from a reduced performance headwind, lower volatility, and a fixed income investment universe expanded beyond traditional sterling bond markets.

Both these adverse effects were most pronounced in the higher risk Growth fund, which maintains a larger weighting to equities and, hence, experienced a greater impact from the adverse stock selection, while it effectively carried a larger bet against the US dollar, and with less invested in fixed income received less of the benefit from our asset allocation. Currency movements were more impactful than equity stock selection.

HOW IS THE PORTFOLIO POSITIONED TODAY?

At the asset allocation level we remain cautious. We:

- Continue to hold less in equities than we typically do and less than our peer group average
- Continue to hold less in corporate bonds than we typically do and less than our peer group average (as corporate debt bears a degree of equity-like risk)
- This is also reflected in security selection. We:
- Own equity in companies that we believe are less economically-sensitive than the market average (to protect against cyclical earnings declines)
- Own corporate bonds with strong investment grade credit ratings (to protect against any rising risk of default)
- However, with growing confidence that the Fed is approaching the end of their interest rate increases – and will have to start cutting rates again within a year or two as inflation falls and the economy weakens in recession – We:
- Have been buying gold (which does not carry earnings risk like equities do and should benefit if bond yields fall)
- Have been buying long duration US Treasury bonds (which will also benefit if yields fall)
- Started to buy into cyclical companies which have already experienced earnings downgrades (as the stocks will recover with their earnings)
- We are looking ahead to deploying the remaining cash held in the portfolio, and that which we believe will ultimately be generated by these defensive investments, further into equities and corporate bonds for the eventual recovery
- The economic backdrop of rising recession risks will present opportunities, and we continue to work to identify new stock ideas with a full idea pipeline awaiting attractive entry points as the cycle plays out. Some themes the equity portfolio holdings are exposed to include: China reopening: Asian insurance demand, AIA and Prudential; luxury goods spending, LVMH and Moncler; step-up in oil demand, Canadian Natural Resources, Cenovus Energy, Suncor
- Economic defensiveness: professional services businesses Relx and Wolters Kluwer; insurance brokerage Brown & Brown, Marsh McLennan and AJ Gallagher; branded consumer goods, Nestle; automobile maintenance O'Reilly Autoparts and Valvoline; medical devices and life sciences Olympus, Cooper Companies and Avantor; discount retailing Costco and 3i Group
- Early cycle cyclicals: companies that have already experienced their "earnings recession", First Republic bank and Taiwan Semiconductor Manufacturing Corporation

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