

Tactical Passive

Quarterly Update, Q1 2024



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The big picture: Macro and Markets

In a nutshell

- **Equities outperform bonds in a very strong first quarter**

Risk of a recession is put to one side by markets as they focus on the positives.

- **Bond yields trend back up**

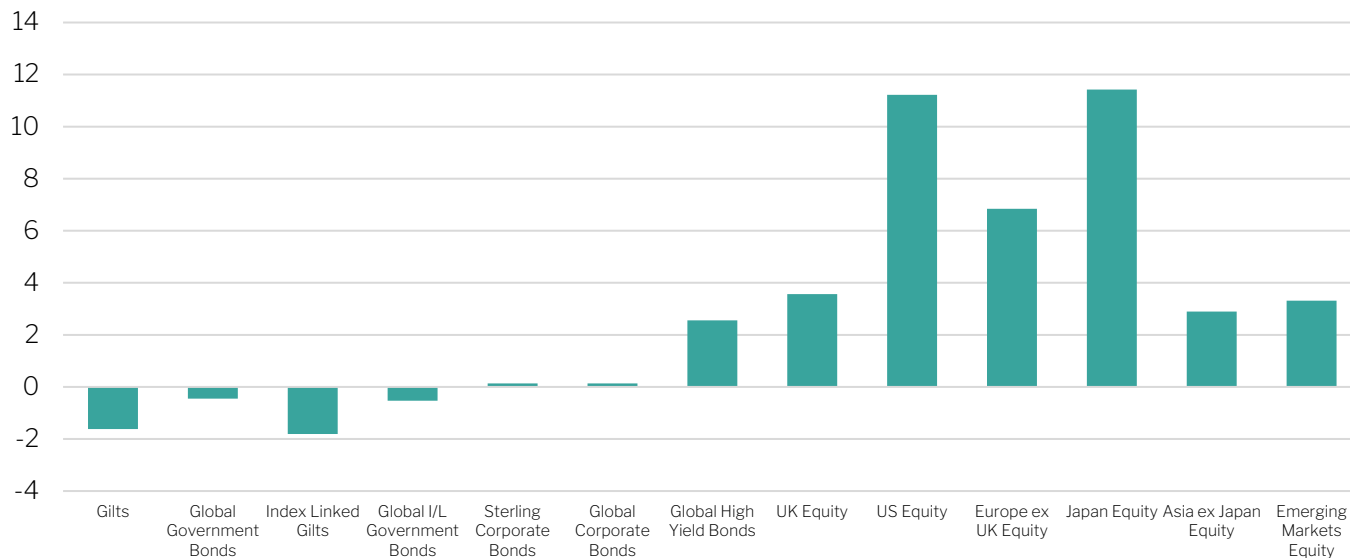
After the sharp rally in Q4 last year, Government Bond yields move back to the 4% range as rate cuts are reevaluated.

- **“Magnificent Seven” are not all magnificent**

As AI excitement continues, those stocks with more to benefit are being rewarded.

What's been happening in Q1?

Asset class returns (Q1 2024)



Risk assets led the way in Q1. With the prospect of a deep recession seemingly reduced, equity markets rewarded investors that avoided the allure of high interest rates.

Q4 last year captured the excitement around possible rate cuts, with yields coming in sharply following talk of lots (and lots) of cuts this year from the Fed. The market then spent Q1 digesting the overreaction and priced in something closer to reality. This saw yields move back up and 10yr government bonds settle at around 4%, creating a sort of 'V' shape over the last 6 months. This meant losses for bond holders, with the negative impact on capital values more than offsetting the income earned.

For credit investors, the picture was slightly different. The positive sentiment that pushed equities higher also meant credit spreads (a measure of how much you need to be paid to take on the risk of lending to a company) reduced, boosting returns. This offset rising yields, flattening returns for corporate bonds overall, and returning over 2% for high yield bonds.

In the US, the AI momentum continued which, alongside robust economic data, led the FTSE USA to double digit returns so far this year. There's also been a broadening of returns, and large differences in performance of the 'Magnificent Seven', which collectively contributed so much to returns last year.

Japan was the other standout performer. If it weren't for a weakening Yen, returns would've been higher still. The irony is that the Bank of Japan finally ended their negative interest rate policy, moving to a 0-0.1% window, slightly reducing their interest rate differential with other regions.

After a tough start to the year, several support measures and a change of tone from China gave the emerging markets a boost. Still lagging developed markets, but positive nonetheless. Whether there'll be more significant intervention to strengthen markets remains to be seen. Economic data has been steady recently, and sentiment appears to be turning. However, issues with the property sector will likely continue to be a strong headwind.

What does that mean for performance?

Cumulative Performance (%)

This table outlines the cumulative investment performance of this solution across various risk grades, versus their IA benchmark.

| | Q1 | YTD | 1 Year | 3 Year | 5 Year |
|--|-------------|-------------|--------------|--------------|--------------|
| Risk Grade 1 | 0.75 | 0.75 | 3.68 | 0.98 | 2.54 |
| IA Standard Money Market | 1.29 | 1.29 | 5.18 | 7.42 | 8.43 |
| Risk Grade 2 | 1.36 | 1.36 | 4.62 | 3.31 | 8.72 |
| Risk Grade 3 | 2.07 | 2.07 | 6.05 | 6.60 | 14.41 |
| Risk Grade 4 | 2.85 | 2.85 | 7.57 | 10.57 | 17.86 |
| IA Mixed Investment 0-35% Shares | 1.50 | 1.50 | 5.85 | -0.64 | 7.48 |
| Risk Grade 5 | 3.27 | 3.27 | 8.18 | 12.14 | 22.39 |
| Risk Grade 6 | 3.97 | 3.97 | 9.38 | 14.77 | 26.69 |
| IA Mixed Investment 20-60% Shares | 2.49 | 2.49 | 7.71 | 5.34 | 17.16 |
| Risk Grade 7 | 4.31 | 4.31 | 9.85 | 15.50 | 28.18 |
| Risk Grade 8 | 4.75 | 4.75 | 10.48 | 16.73 | 32.68 |
| IA Mixed Investment 40-85% Shares | 4.17 | 4.17 | 10.16 | 10.65 | 28.73 |
| Risk Grade 9 | 5.34 | 5.34 | 11.54 | 18.89 | 38.84 |
| Risk Grade 10 | 5.99 | 5.99 | 12.92 | 19.34 | 46.42 |
| IA Flexible Investment | 4.48 | 4.48 | 10.08 | 10.88 | 31.49 |

Discrete Annual Performance (%)

This table outlines the discrete annual performance of this across various risk grades, versus their IA benchmark.

| | 2023 | 2022 | 2021 | 2020 | 2019 |
|--|-------------|---------------|--------------|-------------|--------------|
| Risk Grade 1 | 4.12 | -5.33 | -0.90 | 2.23 | 4.16 |
| IA Standard Money Market | 4.74 | 1.28 | -0.05 | 0.43 | 0.73 |
| Risk Grade 2 | 5.12 | -8.16 | 3.83 | 3.80 | 6.42 |
| Risk Grade 3 | 6.06 | -8.05 | 6.41 | 3.84 | 8.46 |
| Risk Grade 4 | 7.00 | -7.61 | 9.11 | 0.99 | 10.47 |
| IA Mixed Investment 0-35% Shares | 5.97 | -10.87 | 2.84 | 3.90 | 8.70 |
| Risk Grade 5 | 7.15 | -7.10 | 10.30 | 1.39 | 13.50 |
| Risk Grade 6 | 7.68 | -6.25 | 11.52 | 0.97 | 15.16 |
| IA Mixed Investment 20-60% Shares | 6.81 | -9.47 | 7.20 | 3.51 | 11.84 |
| Risk Grade 7 | 7.78 | -6.23 | 12.31 | 0.81 | 15.50 |
| Risk Grade 8 | 8.01 | -6.03 | 13.20 | 2.33 | 16.11 |
| IA Mixed Investment 40-85% Shares | 8.08 | -10.04 | 10.94 | 5.32 | 15.78 |
| Risk Grade 9 | 8.55 | -5.63 | 14.02 | 4.56 | 16.45 |
| Risk Grade 10 | 9.35 | -6.37 | 13.78 | 7.72 | 19.57 |
| IA Flexible Investment | 7.08 | -8.98 | 11.30 | 6.70 | 15.66 |

What worked and what didn't?

Higher risk grades outperformed lower risk grades over the quarter, as equity markets rose strongly, and bonds were impacted by rising yields.

All risk grades outperformed their IA sector benchmarks over the first three months of the year, except for risk grade 2 (which had a much lower risk profile than the Mixed 0-35% Shares sector) and risk grade 1 (which is benchmarked to a cash peer group). Performance over all time periods shown is sequential, with clients being rewarded for taking on additional risk. Bar risk grades 1, 2 and 7, all portfolios are ahead of benchmark over 1,3 and 5 years.

Asset classes

Equities broadly added value for clients, with the US and Japan in particular performing well with double digit returns. Given the size of the allocation to the US, this had the most meaningful impact on portfolios.

We currently have an overweight position to Japan, which helped to boost the strong returns further. Elsewhere we are underweight to Global Index-Linked Bonds, which had a negative return for the quarter.

The UK and Emerging Markets asset classes produced positive returns for Q1 but lagged those of other Developed Market regions.

There is still a fair amount of negative sentiment around the UK market, with UK investors consistently preferring to allocate to Global and US equities instead.

Earnings growth within Emerging Markets is expected to outstrip that of Developed. Couple this with sentiment towards China changing, and there's scope for stronger performance ahead.

We remain underweight to the UK and overweight to Emerging Markets.

Apart from High Yield Bonds, Fixed Interest detracted performance over the quarter. The market began to unwind its view on the number of interest rate cuts this year and so yields began to move back up. This hurt capital values and the more rate sensitive areas such as UK Government Bonds, fell by the most.

After such a strong Q4 last year, it isn't overly surprising to see some of the gain given back.

In terms of tactical positioning, we're underweight to US equity, which hurt performance. We have offset this to a degree with an overweight in US small cap (within the Global Smaller Companies asset class), where valuations are much more appealing.

How are we positioned as a result?

Portfolios retain a defensive tilt, but this has reduced slightly through the changes made over the quarter.

At an aggregate level, risk grades are circa 3% overweight defensive assets versus growth assets. This has brought us closer to our long term, strategic asset allocation, and reflects the breadth of potential outcomes for markets over the medium term. Whilst reduced from a double to a single overweight, we see Government Bonds as a very attractive way to hedge a risk off market event given a current income yield of circa 4% for 10-year Gilts and Treasury's. With inflation trending down and supply side issues seemingly more under control, we also see reduced risk of yields rising much from here.

Adding money into Global Smaller Companies allowed us to close the underweight to riskier assets, whilst also avoiding richly valued US Large Cap stocks. If the US does manage to avoid a serious recession, Small Cap stocks should be positioned well through a recovery/expansion phase of the cycle, particularly from a lower valuation point.

As economies begin the likely unwinding of interest rate hikes over the coming year, there is scope for continued regional divergences in performance. A nimble and dynamic approach to portfolio management is needed to capture to opportunities ahead.

Asset Allocation

| Asset Class | (--) Double underweight | (-) Underweight | (=) Neutral | (+) Overweight | (++) Double overweight |
|---|-------------------------------|--------------------|----------------|-------------------|------------------------------|
| Managed Liquidity | ● | ● | ● ← | ● | ● |
| Global Government Bonds | ● | ● | ● | ● ← | ● |
| Global Index Linked Government Bonds | ● | ● | ● | ● | ● |
| UK Corporate Bonds | ● | ● | ● | ● | ● |
| Global Strategic Bonds | ● | ● | ● | ● | ● |
| Diversified Alternatives | ● | ● | ● → | ● | ● |
| UK Equity | ● | ● | ● | ● | ● |
| US Equity | ● | ● | ● | ● | ● |
| Europe ex UK Equity | ● | ● | ● | ● | ● |
| Japan Equity | ● | ● | ● | ● | ● |
| Global Smaller Companies | ● | ● | ● → | ● | ● |
| Asia Pacific ex Japan Equity | ● | ● | ● | ● | ● |
| Emerging Markets | ● | ● | ● | ● | ● |

Changes

Annual Strategic Asset Allocation Amendments

To increase diversification and capture attractive long term valuation opportunities, we've introduced a new Global Smaller Companies asset class from the middle risk grades upwards. We've reduced exposure to Asia Pacific ex Japan Equity and Emerging Markets to accommodate this. We remain positive on the long-term prospects for these markets, these changes simply help improve the balance in the higher risk grades.

We've also combined the UK Equity Growth and the UK Equity Income asset classes, now called UK Equity. This change will make it easier to blend our selected UK fund managers.

Tactical Asset Allocation Amendments

Several changes were made by the Tactical committee over the quarter.

| Reduce | Increase |
|--------------------------------|--|
| Global Government Bonds | UK Equity & Uncorrelated Strategies |

Global Government Bonds are now looking less attractive following a fall in yields in the previous quarter, so we've reduced the weighting. The proceeds were reinvested into UK Equities and the uncorrelated strategies part of Diversified Alternatives.

| Reduce | Increase |
|--------------------------|---------------------------------|
| Managed Liquidity | Global Smaller Companies |

With a soft landing looking more likely, we also removed the overweight to cash. The proceeds were used to bring Global Smaller Companies overweight. This asset class offers exposure to the US market, without the high multiples, and the potential to outperform through the recovery phase of the economic cycle.

Asset allocation (%)

| Risk Grade | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|--------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Managed Liquidity | 63.00 | 27.50 | 17.50 | 10.00 | 5.00 | 2.50 | 0.00 | 0.00 | 0.00 | 0.00 |
| Global Government Bonds | 13.50 | 22.00 | 19.50 | 16.25 | 13.50 | 10.00 | 8.25 | 6.00 | 4.00 | 0.00 |
| Global Index Linked Government Bonds | 4.50 | 7.50 | 6.00 | 4.25 | 2.50 | 1.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| UK Corporate Bonds | 4.50 | 7.75 | 8.50 | 8.50 | 8.25 | 7.00 | 6.00 | 4.00 | 1.75 | 0.00 |
| Global Strategic Bonds | 4.50 | 7.75 | 8.50 | 8.50 | 8.25 | 7.00 | 6.00 | 4.00 | 1.75 | 0.00 |
| Diversified Alternatives | 10.00 | 11.50 | 11.50 | 11.50 | 11.50 | 11.50 | 11.25 | 7.50 | 5.00 | 0.00 |
| UK Equity | 0.00 | 5.50 | 10.50 | 16.00 | 17.00 | 17.00 | 18.00 | 19.00 | 16.00 | 14.00 |
| US Equity | 0.00 | 3.50 | 7.25 | 11.75 | 13.00 | 16.75 | 18.00 | 19.50 | 23.00 | 27.00 |
| Europe ex UK Equity | 0.00 | 0.00 | 0.00 | 0.50 | 0.75 | 2.00 | 2.50 | 3.00 | 4.25 | 5.50 |
| Japan Equity | 0.00 | 4.00 | 5.50 | 6.75 | 6.75 | 6.75 | 6.50 | 6.00 | 5.50 | 5.00 |
| Global Smaller Companies | 0.00 | 3.00 | 3.00 | 3.00 | 4.50 | 5.50 | 6.50 | 8.00 | 9.50 | 11.00 |
| Asia Pacific ex Japan Equity | 0.00 | 0.00 | 0.00 | 0.00 | 1.50 | 2.50 | 3.50 | 5.00 | 6.50 | 8.00 |
| Emerging Markets | 0.00 | 0.00 | 2.25 | 3.00 | 7.50 | 10.50 | 13.50 | 18.00 | 22.75 | 27.00 |

OCF & Yield

| Risk Grade | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|------------|------|------|------|------|------|------|------|------|------|------|
| OCF (%) | 0.15 | 0.16 | 0.16 | 0.16 | 0.17 | 0.17 | 0.17 | 0.16 | 0.15 | 0.12 |
| Yield (%) | 4.10 | 3.11 | 2.90 | 2.75 | 2.61 | 2.49 | 2.40 | 2.40 | 2.30 | 2.33 |

A view on risk

| | Volatility (%) | | | Max Drawdown (%) | | |
|---|----------------|-------------|--------------|------------------|---------------|---------------|
| | 1 Year | 3 Year | 5 Year | 1 Year | 3 Year | 5 Year |
| Risk Grade 1 | 2.01 | 2.90 | 2.53 | -0.65 | -7.18 | -7.35 |
| IA Standard Money Market | 0.18 | 0.67 | 0.59 | 0.00 | -0.08 | -0.10 |
| Risk Grade 2 | 4.03 | 5.15 | 4.75 | -1.91 | -10.01 | -10.01 |
| Risk Grade 3 | 4.80 | 6.01 | 5.75 | -2.10 | -10.40 | -10.40 |
| Risk Grade 4 | 5.54 | 6.81 | 7.30 | -2.40 | -10.48 | -10.48 |
| IA Mixed Investment 0-35 Shares | 5.55 | 6.10 | 6.47 | -2.69 | -13.28 | -13.28 |
| Risk Grade 5 | 6.10 | 7.27 | 8.51 | -2.90 | -10.14 | -12.62 |
| Risk Grade 6 | 6.50 | 7.68 | 9.44 | -3.27 | -9.50 | -14.63 |
| IA Mixed Investment 20-60 Shares | 6.34 | 6.97 | 8.42 | -3.30 | -12.14 | -12.89 |
| Risk Grade 7 | 6.93 | 8.15 | 9.91 | -3.61 | -9.55 | -15.61 |
| Risk Grade 8 | 7.41 | 8.67 | 10.78 | -4.00 | -9.15 | -17.34 |
| IA Mixed Investment 40-85 Shares | 7.30 | 8.36 | 10.25 | -4.39 | -12.54 | -15.41 |
| Risk Grade 9 | 7.86 | 9.20 | 11.21 | -4.38 | -8.91 | -17.72 |
| Risk Grade 10 | 8.41 | 9.81 | 11.97 | -4.76 | -9.86 | -18.66 |
| IA Flexible Investment | 7.03 | 8.04 | 10.13 | -4.31 | -11.20 | -15.53 |

What's the outlook?

After such a strong start to the year, it's easy to get carried away. The narrative of a shallow (or avoided) recession and gradually reducing interest rates is a favourable one. So, whilst its likelihood has certainly increased - it isn't without risk.

Holding government bonds at a 4% yield offers an attractive way to hedge against this. If there's an equity market sell-off, we believe they'll provide positive performance to support client portfolios.

Inflation continues to fall in line with expectations, boosting both real wages across developed markets and the chances of rate cuts from around the middle of the year. The Bank of England have given the clearest guidance that they won't be waiting for inflation to hit 2% before making their move.

Small cap and emerging market equities offer investors access to strong potential returns at an attractive entry point. The same is true for UK equities, with many companies buying back shares in a sign that current price levels appear too low.

Time in the market continues to be a strong mantra to follow. The potential outcomes are wide, from avoiding a recession to a rate hike induced, delayed but deep recession (or anything in between). Predicting the near-term direction of markets is particularly hard in this environment, but backing the market over the long term is never in question.

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