

Strategic 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.

	Q4	YTD	1 Year	3 Year	5 Year
Risk Grade 1	0.68	0.68	3.97	-0.04	0.53
IA Standard Money Market	1.29	1.29	5.18	7.42	8.43
Risk Grade 2	1.40	1.40	5.45	2.40	6.48
Risk Grade 3	2.20	2.20	7.06	6.20	12.26
Risk Grade 4	3.02	3.02	8.68	10.59	16.07
IA Mixed Investment 0-35% Shares	1.50	1.50	5.85	-0.64	7.48
Risk Grade 5	3.45	3.45	9.29	12.29	20.65
Risk Grade 6	4.14	4.14	10.50	15.32	25.47
IA Mixed Investment 20-60% Shares	2.49	2.49	7.71	5.34	17.16
Risk Grade 7	4.49	4.49	11.00	16.47	26.99
Risk Grade 8	4.94	4.94	11.63	18.33	33.48
IA Mixed Investment 40-85% Shares	4.17	4.17	10.16	10.65	28.73
Risk Grade 9	5.57	5.57	12.69	20.59	40.24
Risk Grade 10	6.21	6.21	13.88	22.33	48.35
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	4.69	-6.73	-0.81	1.87	2.14
IA Standard Money Market	4.74	1.28	-0.05	0.43	0.73
Risk Grade 2	6.21	-9.73	3.51	2.68	6.36
Risk Grade 3	7.26	-9.40	6.01	2.53	8.33
Risk Grade 4	8.26	-8.56	8.57	-0.29	10.74
IA Mixed Investment 0-35% Shares	5.97	-10.87	2.84	3.90	8.70
Risk Grade 5	8.37	-7.98	9.69	0.13	13.47
Risk Grade 6	8.87	-6.86	10.88	-0.10	15.15
IA Mixed Investment 20-60% Shares	6.81	-9.47	7.20	3.51	11.84
Risk Grade 7	8.96	-6.51	11.60	-0.30	15.09
Risk Grade 8	9.12	-5.83	12.62	1.68	16.62
IA Mixed Investment 40-85% Shares	8.08	-10.04	10.94	5.32	15.78
Risk Grade 9	9.52	-5.31	13.71	3.98	17.01
Risk Grade 10	10.12	-5.23	14.44	7.15	18.54
IA Flexible Investment	7.08	-8.98	11.30	6.70	15.66

What worked and what didn't?

Positive returns from all sub equity asset classes versus negative or flat returns from fixed income asset classes has led to higher risk models outperforming over the quarter.

A strong start to the year for equities has led to more standardised sequential alignment of performance in line with risk within the solution. All models except risk grades 1 and 2 outperformed their sector benchmarks over the quarter. All risk grades also continue to comfortably outperform over longer time periods, except risk grade 1. Risk grade 1 is benchmarked versus cash, so the fixed interest within the model has hurt relative returns due to deeply negative absolute returns through 2022 especially.

Asset classes

Equity markets rallied in Q1, as indicated by the asset class performance chart on page 2. Both US and Japan led the way, providing double digit returns over the quarter and both hitting new highs within their respective indices.

Europe also performed well despite ongoing economic concerns in the region. Global smaller companies, which were added to our strategic asset allocation in February to diversify our higher risk equity allocations, provided strong returns of over 5% through the quarter, buoyed by the prospect of interest rates falling sometime this year.

All other equity asset classes provided positive absolute returns; they just didn't reach the highs of the above-mentioned asset classes. Between 3 and 4% returns over a single quarter are still very strong from the UK, Asia ex Japan and Emerging Markets.

Within Emerging Markets, China continued to lag, despite a strong rally in February. India continued to perform well, and Taiwan led the way.

The only fixed interest asset class to perform well was high yield. Given the generally lower duration profile versus other sub asset classes the rise in yields was less impactful. However, strong global growth led to positive price returns. We're just beginning to see a few single company issues, so defaults will be one to watch moving forward.

After the euphoria of Q4 2023 where we saw positive returns across every asset class and very positive returns from fixed interest assets, it's no surprise to see a slight pull back in Q1. Markets tend to overreact to news and that has played out again.

Markets priced in 6+ rate cuts in Q4 for 2024, post central bank comments, which led to that strong rally. Central banks have always said that was unrealistic and markets now seem to be on the same page, pricing in 2 or 3. The fall in expected rate cuts from 6 to 3 meant bond yields rose which led to capital falls. The higher yield, however, means the income helps to offset the capital falls and provide a flat return across most fixed income asset classes.

Fund 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.

Asset allocation (%)

Risk Grade	1	2	3	4	5	6	7	8	9	10
Managed Liquidity	60.00	27.50	17.50	10.00	5.00	2.50	0.00	0.00	0.00	0.00
Global Government Bonds	13.50	19.00	16.50	13.25	10.50	7.00	5.25	3.00	1.00	0.00
Global Index Linked Government Bonds	7.50	10.50	9.00	7.25	5.50	4.00	2.75	1.50	0.50	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	10.00	10.00	10.00	10.00	10.00	10.00	7.50	5.00	0.00
UK Equity	0.00	8.00	13.50	19.00	20.00	20.00	21.00	22.00	20.00	18.00
US Equity	0.00	5.50	10.25	14.75	16.00	19.75	21.00	22.50	26.00	30.00
Europe ex UK Equity	0.00	2.00	3.25	5.00	5.25	6.50	7.00	7.50	8.75	10.00
Japan Equity	0.00	2.00	3.00	3.75	3.75	3.75	3.50	3.00	2.50	2.00
Global Smaller Companies	0.00	0.00	0.00	0.00	1.50	2.50	3.50	5.00	6.50	8.00
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	0.00	0.00	4.50	7.50	10.50	15.00	19.75	24.00

OCF & Yield

Risk Grade	1	2	3	4	5	6	7	8	9	10
OCF (%)	0.15	0.14	0.14	0.14	0.14	0.15	0.15	0.14	0.13	0.11
Yield (%)	4.08	3.33	3.13	2.99	2.85	2.73	2.64	2.62	2.51	2.41

A view on risk

	Volatility (%)			Max Drawdown (%)		
	1 Year	3 Year	5 Year	1 Year	3 Year	5 Year
Risk Grade 1	2.15	3.24	2.74	-0.49	-8.38	-8.38
IA Standard Money Market	0.18	0.67	0.59	0.00	-0.08	-0.10
Risk Grade 2	4.25	5.50	4.88	-1.59	-11.54	-11.54
Risk Grade 3	5.07	6.27	5.78	-1.97	-11.44	-11.44
Risk Grade 4	5.83	6.96	7.28	-2.44	-11.17	-11.17
IA Mixed Investment 0-35 Shares	5.55	6.10	6.47	-2.69	-13.28	-13.28
Risk Grade 5	6.38	7.33	8.46	-2.93	-10.77	-12.41
Risk Grade 6	6.78	7.66	9.35	-3.31	-9.89	-14.45
IA Mixed Investment 20-60 Shares	6.34	6.97	8.42	-3.30	-12.14	-12.89
Risk Grade 7	7.20	8.03	9.79	-3.64	-9.63	-15.53
Risk Grade 8	7.68	8.49	10.85	-4.02	-8.90	-17.67
IA Mixed Investment 40-85 Shares	7.30	8.36	10.25	-4.39	-12.54	-15.41
Risk Grade 9	8.14	9.03	11.27	-4.42	-8.54	-18.01
Risk Grade 10	8.68	9.70	12.12	-4.83	-8.79	-18.97
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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