News from the Investment Committee

Q4 2022

News from the Investment Committee – End October 2022

The Investment Committee (IC) met on Thursday 20th October, ironically the day the former prime minister Liz Truss announced her resignation following her truly tumultuous six weeks in office.

The IC initially focused on the unprecedented shockwaves suffered by UK assets and currency following the September mini-budget's proposed scale of unfunded spending and tax cuts. In expectation of a return to some form of fiscal normality in the UK, the IC then considered the wider global perspective. The downstream implications of years of excessive financial stimulus, supply chain disruption and rising inflation look to have manifested into a "rolling recession" that started in the US and which now appears to have been exported globally. With US real GDP growth hovering around zero and inflation stubbornly high, being mired in a stagflationary cycle puts growing pressure on corporate earnings. Unlike the Great Financial Crisis however, this should not be considered a Credit Crunch, but rather having the makings of a growing government debt crisis, as global economies face the difficult challenges of simultaneously bring down their ballooning fiscal deficits, quantitative tightening and further aggressive hikes in interest rates in prospect.

As central banks play catch-up to quench ingrained inflationary pressures, less globally co-ordinated policy responses appear likely, which could further increase bouts of currency and economic volatility, suggesting that asset allocation decisions on country and currency still matter.

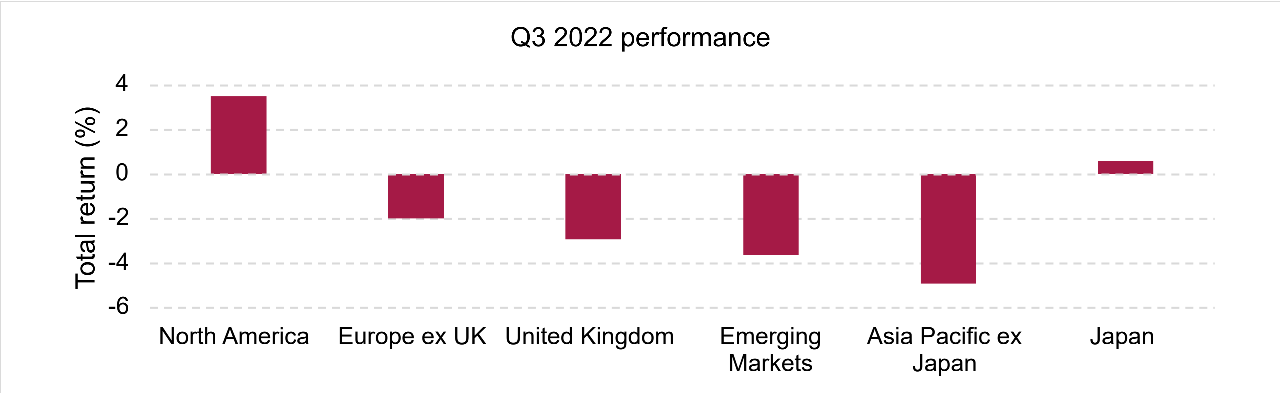
The IC considered the potential risks facing the lower risk benchmark portfolios, other than rising energy bills, inflation and UK political uncertainty. The main systemic risks highlighted were the extent of leverage and derivatives being used via Liability Driven Investment (LDI) and risk parity strategies. In particular, how any simultaneous unwinding of derivative positions in the light of more attractive gilt yield levels could steepen the yield curve even further and potentially create liquidity pressures for UK and government bond markets. The increasing balance sheet risks for those major insurance companies who are active in providing LDI strategies were also a concern.

The IC discussed the importance of maintaining bond holdings in the lower risk benchmarks and also the option of introducing a more defensive short-dated bond exposure for added diversification purposes. However, maintaining the discipline of the strategic framework was agreed as more appropriate, and also given the sheer scale of UK gilt yield swings over recent weeks, the timing challenges the latter introduction would create.

The purpose of the strategic benchmark asset allocations is to differentiate between risk/reward expectations over the longer-term, reflecting the average outcomes for investors buying and selling at different times over the cycle. The asset & risk model already has an extensive range of Capital Market Assumptions (CMA's) covering various bond maturities and equity capitalisations. This provides the necessary flexibility for both advice firms and asset manager clients, should they wish, to assess the investor risk implications relative to the benchmarks, when constructing new client portfolios or making shorter term tactical decisions with existing ones. Following the benchmark allocations to the letter has never been or should be viewed as mandatory when using Dynamic Planner to assess the suitability of portfolios.

The Previous Quarter's Market Overview

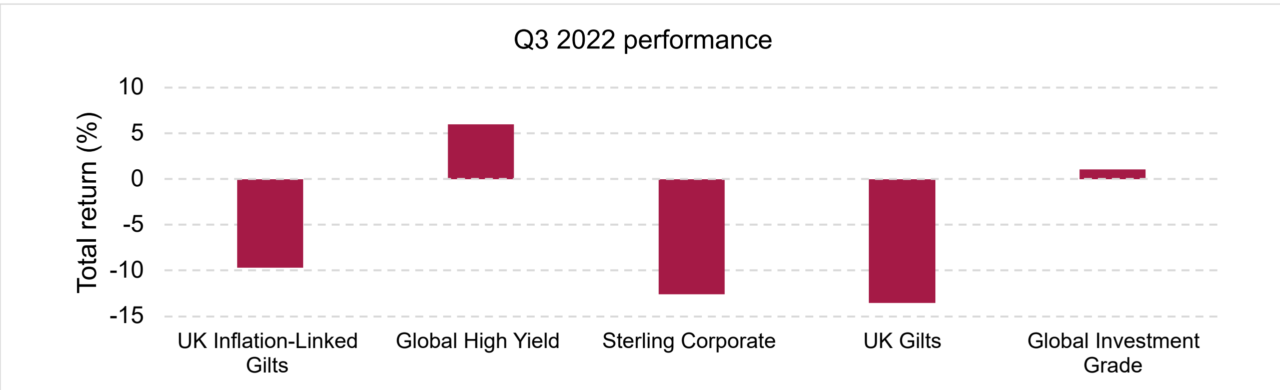
Equities



The ongoing energy crisis, rising inflation, and consequent fears about the outlook for global economic growth took another heavy toll on equity markets over the quarter, but the ongoing strength of the US Dollar against Sterling (and other currencies) managed to provide some insulation for those with North American asset exposures. Fears of further lockdowns in China as it continues to pursue a policy of zero-Covid and resultant economic worries in the growth-sensitive Asian markets, saw their weakest relative performance over the period.

The US Fed raised the federal funds rate by 75 basis points (bps) to 3.25% in September; the third consecutive 75bps increase, whilst the European Central Bank raised interest rates in July and September, taking the deposit rate to 0.75%. The Bank of England increased the Base Rate by 50bps, to 1.75% in August and a further 50bps in September to 2.25%.

Bonds



The UK gilt market suffered eye-watering losses as global bond investors lost confidence in the credibility of the government's fiscal framework, leading the Bank of England to intervene by temporarily buying long dated gilts.

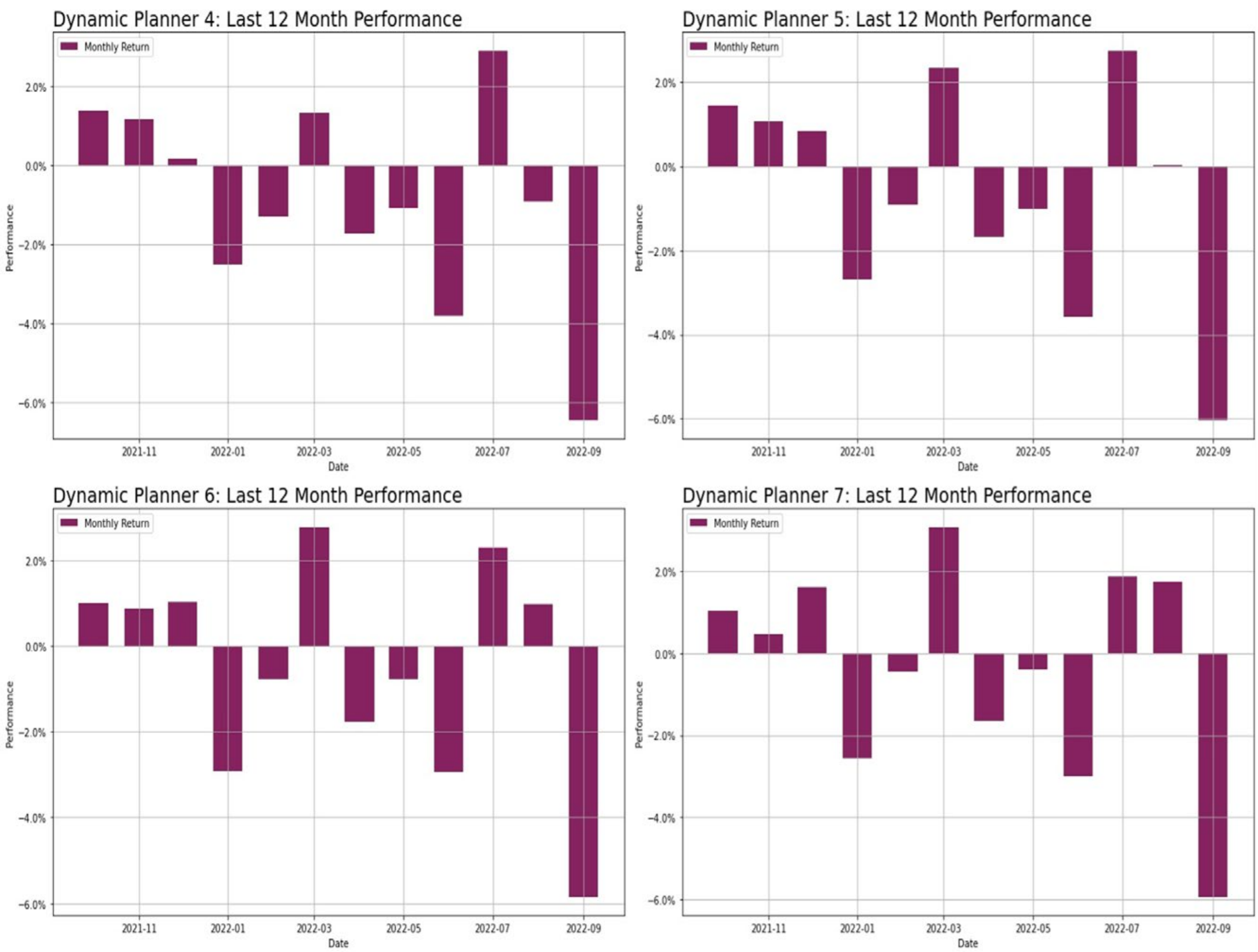
Global government bond yields were generally higher and investment grade credit spreads widened amid fears that tighter monetary policy will undermine economic growth prospects and lead to recession.

With Sterling hitting an all-time low of $1.03 in the closing days of September before recouping some of its losses, interest earned in overseas currencies delivered some welcome relief for holders of diversified global bonds.

Review of the benchmark allocation performance

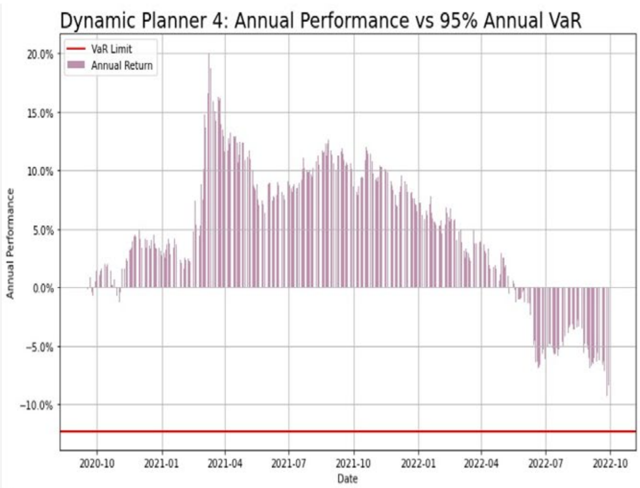
The very unusual stand-out were the September falls being of a similar scale across the lower and medium risk benchmarks. This was attributed to the greater weighting in UK gilts and lower levels of diversification in global assets and currency exposures with the former benchmarks.

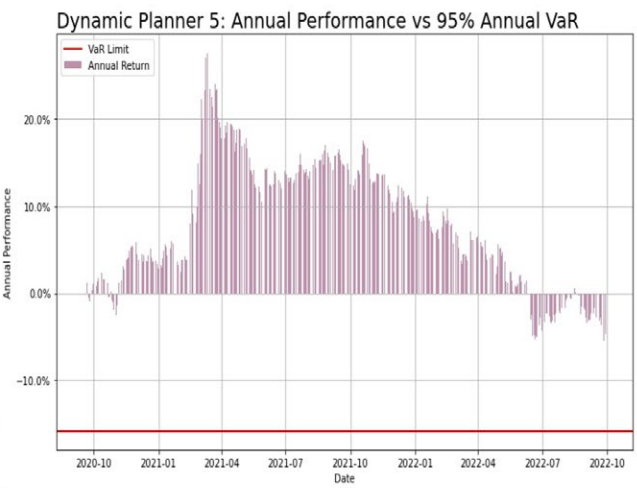
Monthly observed returns over last 12 months

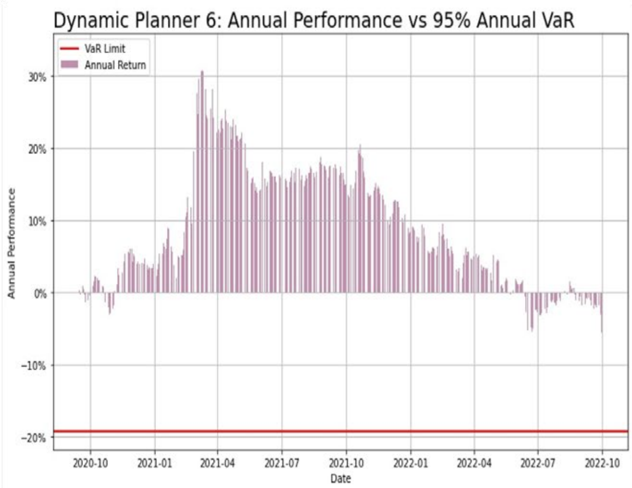


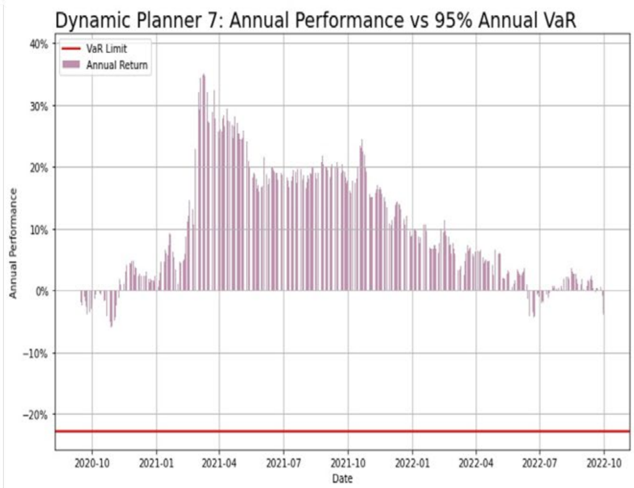
Annual Value-at-Risk analysis

The charts below show the rolling annual returns calculated each day over the last two-year period versus their 95% VaR limit (the red horizontal lines). Importantly, there were no VaR breaches with the benchmarks when viewed over annual periods, however they were evident for the monthly VaR expectations in September, reflecting the extreme level of volatility endured in both Sterling and Sterling denominated debt.









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