SAUNDERSON HOUSE

Special Briefing

February 2021

Asset Allocation Journey: 2018-2020

In previous editions of our 'Asset Allocation Journey' we have discussed how our top-down asset allocation, that is our exposure to equities, bonds, commercial property and cash, has changed over the longer term, and how we have taken an active, research-driven approach to selecting appropriate weightings of these asset classes over a complete business cycle.

Given the extraordinary events witnessed through 2020 and the extreme price moves in reaction to the onset and subsequent recovery from the Covid-19 pandemic, this latest account of the Asset Allocation Journey will cover a much shorter period by firstly explaining briefly what we did in 2018 and 2019. We will then discuss how we reacted to the pandemic and developments in the macroeconomic environment including major changes in the political landscape in 2020 and how we altered exposure to those four asset classes (Figure 1).

In summary these included:

1. Increasing the defensiveness of portfolios in 2018 and 2019;
2. Allocating to Asian and emerging markets and UK equities as markets fell sharply in Q1 2020;
3. Increasing US equities as equity markets strengthened in Q2 2020;
4. Making portfolios more resilient in Q4 2020.

Ben Williams
Head of Fund Research, Saunderson House

E: ben.williams@saundersonhouse.co.uk
T: 020 7315 6533

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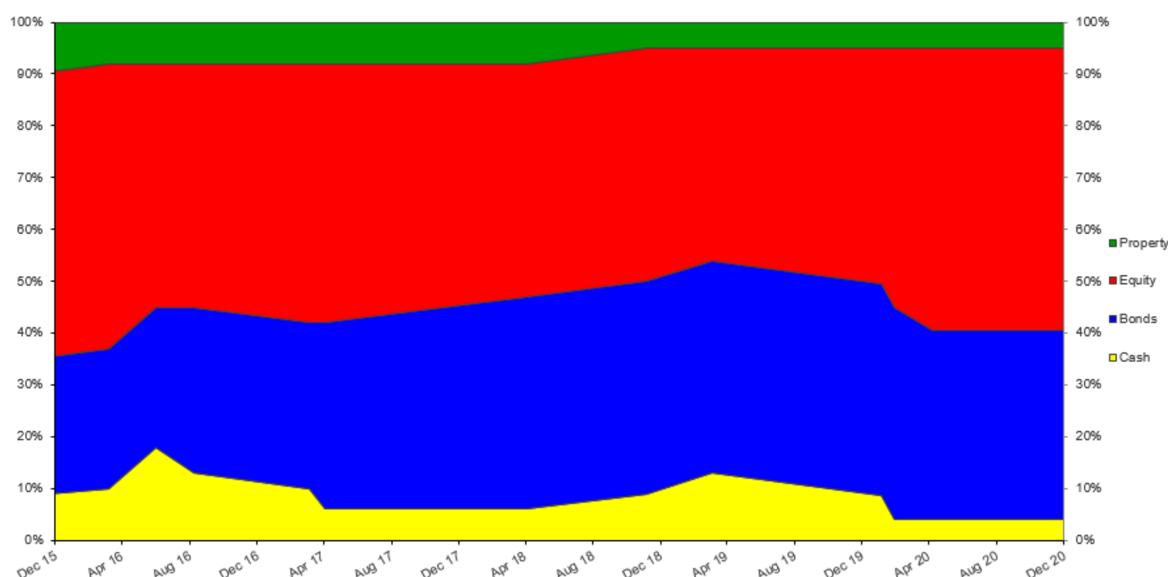
Figure 1: The Changing Shape of Recommended Asset Allocations 2015-2020



Source: Saunderson House Ltd, Asset Risk Consultants, FE Consultants

The chart above shows asset allocation changes made to the SHL Wealth Management Balanced Model portfolio. Equivalent shifts were made to other model portfolios, though the magnitude of these will have varied with risk profile and investment time horizon.

Increasing the defensiveness of portfolios in 2018 and 2019

We start our journey at the end of 2018 with a brief review of our allocation to UK commercial property. Having already cut exposure from 14% to 8%[1] in 2016 in response to Brexit-related uncertainty, the sector's correlation with prospects for the UK economy and some impressive returns over the preceding two years, we once again reduced our weighting in December 2018. Proceeds were moved to cash, thereby continuing a de-risking of portfolios that had begun earlier in the year with a switch from Asian and emerging markets equities into corporate bonds. We concluded that a continuation of Brexit, slowing returns from industrial assets and a worsening outlook for the retail sector, together with some elevated valuations, posed increased risks for the sector and lowered potential future returns. The additional yield offered by the commercial property sector over other assets, such as cash and corporate bonds, in our view, didn't adequately compensate for such risks. Hence, we reduced property weightings to 5%, our lowest since June 2009.

Moving through 2019, our focus was on how equity and bond markets were faring given a plethora of market and non-market risks. These included, but were certainly not limited to, the pace of monetary policy normalisation by the Federal Reserve (Fed), the trade war between the US and China, political impasse in the former and issues with the shadow banking system in the latter, the rise of populism around the globe and, closer to home, continuing Brexit challenges. Given these risks, and with equity valuations not offering enough of a cushion against either a deterioration in economic news or the Fed further tightening financial conditions, we took profits from Asia and emerging markets, and once again, allocated the proceeds to cash. This took the model's cash weighting to 13%, its highest level for nearly three years, together with a healthy allocation towards short-dated corporate bonds and our lowest aggregate equity weighting (41%) ever. This 'dry powder', was on hand to be rapidly deployed for when we saw a more conducive financial environment, primarily looking to take advantage of weaker equity markets.

[1]For the SHL Wealth Management Balanced Model portfolio

Allocating to Asian, emerging markets and UK equities as markets fell sharply in Q1 2020

Coming into 2020, as investors reacted to the spread of Covid-19 from China to other parts of the world, despite extraordinary fiscal and monetary support packages from governments and central banks, equity markets fell sharply in February. Whilst our proactive reduction of equity and commercial property allocations protected portfolios from the full force of market falls as the panic exploded, it proved to be less defensive than we would have hoped. However, one benefit of having positioned portfolios more conservatively over the previous two years was that we now could use our considerable dry powder to take advantage of weaker equity prices by redeploying cash and bonds that had been built up in portfolios. Initially, in February, with Asian economies being the epicentre of the crisis and seeing the first major correction, this represented what we saw as a good tactical opportunity to use some of that cash to reweight towards those markets. At this point, having seen the largest price falls, we believed they offered greater potential for long-term returns than most other markets. Hence, we added 4.5% to Asian and emerging markets from cash.

At the beginning of March, we recommended a further increase in equities, again from cash, taking advantage of further price falls by adding to Asia and emerging markets once again, and to the UK, which had sold off more aggressively than other developed regions. In our view, guided by our proprietary 'fear and greed' indicators we were witnessing signs of panic and desperation from investors. As we wrote in our client bulletin "You make most of your money in a bear market, you just don't realise it at the time" on the 26th of March, for the long-term investor who has no need to sell assets to create liquidity, the extreme volatility in share prices provided an opportunity to be taken advantage of. Despite saying that "no-one rings a bell at the bottom", and urging clients not to adopt a 'flight to safety at any price' investment approach, our timing proved fairly spot on, with the UK equity market bottoming on 23rd March as the country went into lockdown.

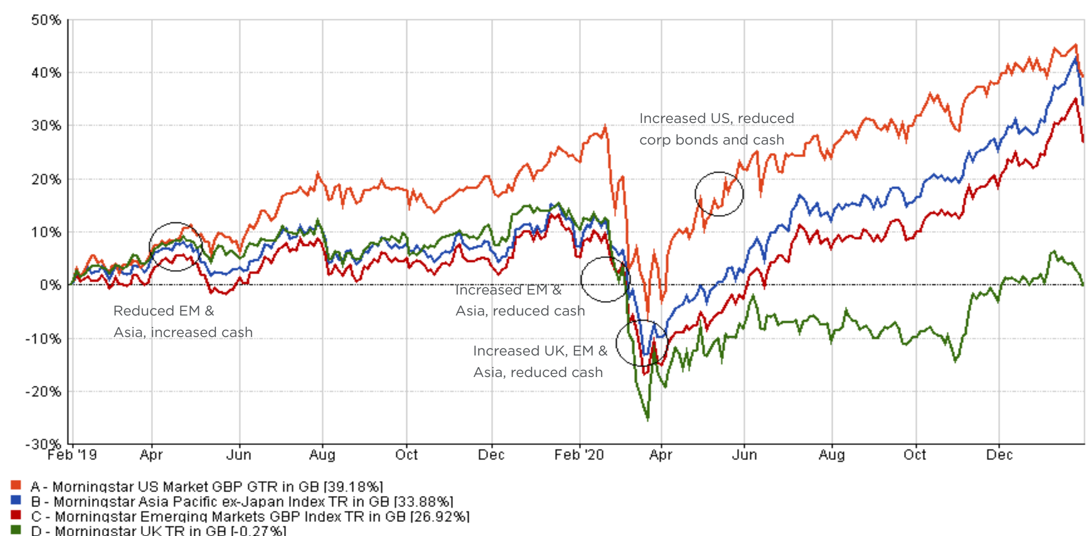
Increasing US equities as equity markets strengthened in Q2 2020

Having witnessed equity markets rally strongly from those March lows and economic data appearing to have troughed, we proposed a third increase in equity weightings in May, this time recommending a 4.5% increase in North American equity allocations. In our view, the combination of liquidity injected by the Federal Reserve and fiscal stimulus from the US government, totalling close to 40% of US GDP, was likely to benefit the US economy and hence its stock market over the next 2-3 years. As part of a recent review of our investment approach, we are now more willing to take some positions in what we would view as shorter-term investment opportunities, alongside other longer-term, valuation-driven positions. This is particularly the case if these shorter-term positions provide balance to our portfolios. This asset allocation move was one such opportunity, which was less value-driven than previous recommendations, but reflected what we believed was an underappreciation of the speed and duration of the US economic recovery from the Covid-19 pandemic. The increase was funded by selling short-dated corporate bond funds, which no longer offered attractive prospective risk-adjusted returns.

From having had a fairly defensive portfolio in April 2019 with 41% allocated to both equities and bonds and 13% in cash, these gradual moves through the first half of last year had made some very significant changes to the asset allocation, resulting in a portfolio with 55% in equities, as high as they have ever been, and a 4% weighting to cash, its lowest ever weighting.

Figure 2 shows how those markets to which we increased allocations in the first half of 2020 have performed over the past two years.

Figure 2: US, UK, Asian and emerging markets returns over two years



Making portfolios more resilient in Q4 2020

Finally, in the fourth quarter of last year, our Investment Committee considered it a good time to take stock and rethink our positioning, particularly given the strength in equity markets. We concluded that the rebound in equity markets from the first wave of the Covid-19 pandemic was largely complete and that we would need a slightly different asset allocation for the more volatile expansionary growth phase of the economic cycle. We were also well aware that if we were to suffer another bout of coronavirus-induced weakness, having more exposure to 'safe haven' assets would make portfolios more resilient. Hence, while keeping aggregate equity weightings the same, we reduced UK equity allocations, having seen them generate strong returns since March, reinvesting the proceeds in North America, Asia and emerging market equities to benefit from more durable, long term structural growth trends in these regions. At the same time, we adjusted bond allocations, introducing a 'barbell' of safe haven global government bonds at one end, and attractively valued high yield bonds at the other, alongside a core set of strategic bond funds. This came at the expense of short-dated corporate bond funds, which we believed had served their purpose and were now less compellingly valued.

Conclusion

As you can see, we have been highly active in making asset allocation decisions over the last few years, both from a long-term valuation view and a shorter-term tactical perspective. We believe that the changes should add resilience to portfolios and give clients a smoother investment journey. A colleague described the increased allocations to equities during the pandemic as 'classic' Saunderson House moves, based on contrarian, valuation-driven decisions, and those made in the second half of the year as 'contemporary', pragmatic moves, designed for when we believe valuations may not be the key driver of returns. They have so far added value to portfolios and we think both are key to our investment framework as we negotiate an extraordinarily challenging investment environment in 2021.

If you have any questions regarding the information covered in this bulletin, please contact your Saunderson House adviser.

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Saunderson House Limited
1 Long Lane, London EC1A 9HF

T: 020 7315 6500
F: 020 7315 6650
E: shl@saundersonhouse.co.uk
www.saundersonhouse.co.uk

Registered in England. Address as above.
Number 940473
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