SAUNDERSON
HOUSE

Special Briefing

September 2021

Our Asset Allocation Journey through the Coronavirus pandemic

In February we presented our 'Asset Allocation Journey' over the past three years, which detailed some of the key changes made over that period, and their impact on portfolio profile and performance. This note will take a closer look at our investment decisions made over broadly the last year and a half, assessing the period in which the Coronavirus pandemic has impacted markets. We will not only review the impact of our top-down asset allocation changes, but also the changes we have made within asset class positioning that have added diversification and resilience to portfolios over the period.

Before reviewing our asset allocation journey over the past year and a half in detail, it is worth revisiting the scale and speed of the market moves driven by the Coronavirus pandemic, and putting these in a historical context against other significant market events of the past few decades. Although we discussed these characteristics a numbers of times last year and at the start of 2021, they are worth reviewing to remind ourselves of the unprecedented nature of the market moves in reaction to the Coronavirus pandemic.

Figure 1 on the next page shows the performance of global equity markets from their high point to their low point (peak to trough) and the time they took to recover, through the last seven major 'bear markets' which were accompanied by recessionary environments. It also shows the length of time, in months, between the peak and trough for each event.

David Morcher
Investment Analyst, Saunderson House

E: david.morcher@saundersonhouse.co.uk
T: 020 7315 6575

Authorised and Regulated by the Financial Conduct Authority

Figure 1: Equity 'bear market' performance and duration of market falls and subsequent recovery: significant recessionary periods between 1968 - 2021

Recessionary period	Stock market return peak to trough (%)	Length between market peak and trough (months)	Length of time for market to recover to prior peak (months)	'Bear market' dates
US fiscal tightening and the Vietnam War**	-33	20	23	Nov' 1968 - Jun' 1970
Nifty fifty stock bubble burst & the oil crisis of the early 1970's	-28	18	40	Apr' 1973 - Sep' 1974
Iranian oil crisis of the early 1980's	-17	21	4	Dec' 1980 - Aug'1982
US recession driven by excessive monetary policy tightening	-18	5	5	Jun' 1990 - Oct' 1990
Tech bubble crash	-48	31	39	Apr' 2000 - Oct' 2002
Global financial crisis	-55	18	49	Oct' 2007 - Mar' 2009
Coronavirus pandemic	-33	1.5	5	Jan' 2020 - Mar' 2020

Source: Thomson Reuters Datastream; MSCI; S&P
Returns represented are the MSCI World Total Return Index in USD, other than ** which shows the S&P500 price return;

It is notable that the Coronavirus pandemic market sell-off happened over a far shorter period than all of the other events. This is particularly remarkable, given the market falls witnessed due to the pandemic were in the top three most severe of all above periods. In addition, equally remarkable was the speed of recovery of markets post their drawdown, with equity markets only taking five months to recover to their 'pre-Covid' level.

Undoubtedly a reason for the brevity of the market drawdown was the incredible speed at which central banks and governments reacted to facilitate support for locked-down economies. This support was provided in multiple forms, including:

- Monetary stimulus, in the form of interest rate cuts and injections of money into the economy through quantitative easing programmes; and
- Fiscal stimulus, through furlough schemes for example, and later, spending programmes on infrastructure and other public projects.

This extensive support resulted in markets stabilising quickly and being primed to recover, whilst the underlying backdrop remained one of vast economic shutdowns and a severe slowdown in global growth.

This created a unique environment through which to make asset allocation decisions, with short term fundamentals clouded, medium term fundamentals contingent on successful containment of the virus, but with financial markets appearing well supported by policy response in the short and medium term. Timely decision making was important over the period, as the speed of the market fall and subsequent recovery left little time to react to the market sell-off.

Changes to the equity allocation in models through the initial market volatility

Against this backdrop, and having entered 2020 with our lowest aggregate equity weighting ever (41% in Wealth Management Balanced portfolios), we took advantage of the market falls in the first quarter of the year. Despite the uncertain short-term outlook, our decision making was largely predicated on valuations which became more appealing as equity markets fell, with the long-term return outlook for equities quickly becoming more compelling. This was exacerbated through March where we saw signs of panic and desperation from investors, and ever more appealing valuations.

Our response to these market moves was to increase allocations to Asian and Emerging market equities in February 2020, and add further to these regions in March, alongside a top up in UK equities. As we wrote in our recent Asset Allocation Journey: 2018 – 2020 update, we made a third top up to equity allocations in May as markets swiftly moved into the recovery phase. This increase was made through an increased allocation to the US equity market. Whilst valuations here were arguably not as compelling as in other regions, we believed that the level of policy response in the US provided a significant foundation to the nation's equity market, and a reason for a positive outlook on economic recovery over the following years.

Notably, all the above increases in equity exposure were funded through reductions in either corporate bonds or cash. This was due to the much-improved return outlook from equity markets following their valuation falls, and the far more muted return outlook for both cash and bonds. This was particularly the case following the sharp falls in interest rates which accompanied the pandemic-induced market volatility.

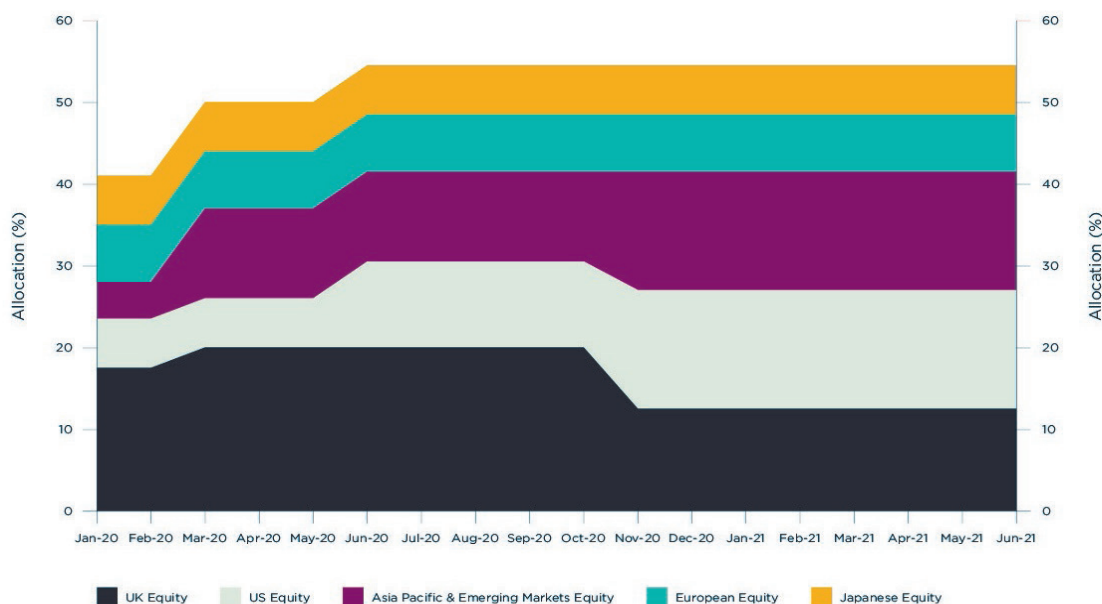
Changes to the equity allocation in models later in 2020

Our final change in equity allocations over 2020 came in October. At this point, most markets had recovered significantly from the volatility of the first few months of the year, and we believed that the rebound in equity markets from the first wave of the Coronavirus pandemic was largely complete. Consequently we did not feel a further increase in aggregate equity weightings was appropriate. Instead, we recommended adjusting the blend of equity allocations within models, to give portfolios more balance, and exposure to a wider set of growth drivers.

To do this we reduced UK equity allocations, having seen them generate reasonably strong returns since their low point in March, reinvesting the proceeds into North America, Asia and emerging market equities. Importantly, despite the reduction, we retained a significant exposure to the UK equity market in portfolios, as it remained one of the more compelling markets in our view, particularly from a valuation perspective. However, we believed a more balanced exposure to both US and emerging market equities would allow portfolios to benefit both from the wide range of durable, long term structural growth trends impacting these markets, as well as from a recovery in the UK equity market.

Figure 2 on the next page shows how regional equity allocations in portfolios changed over 2020 (in a representative balanced portfolio), showing the aggregate overall exposure to equities as an asset class, and allocations to the different regional components. Following the changes made in October 2020, we believe that portfolios are more resiliently positioned, with greater diversification across regions apparent, with core allocations to each of the UK, the US and Asia and emerging market equities.

Figure 2: Aggregate equity allocation and regional equity allocation: 2020 - 2021



Source: Saunderson House Ltd

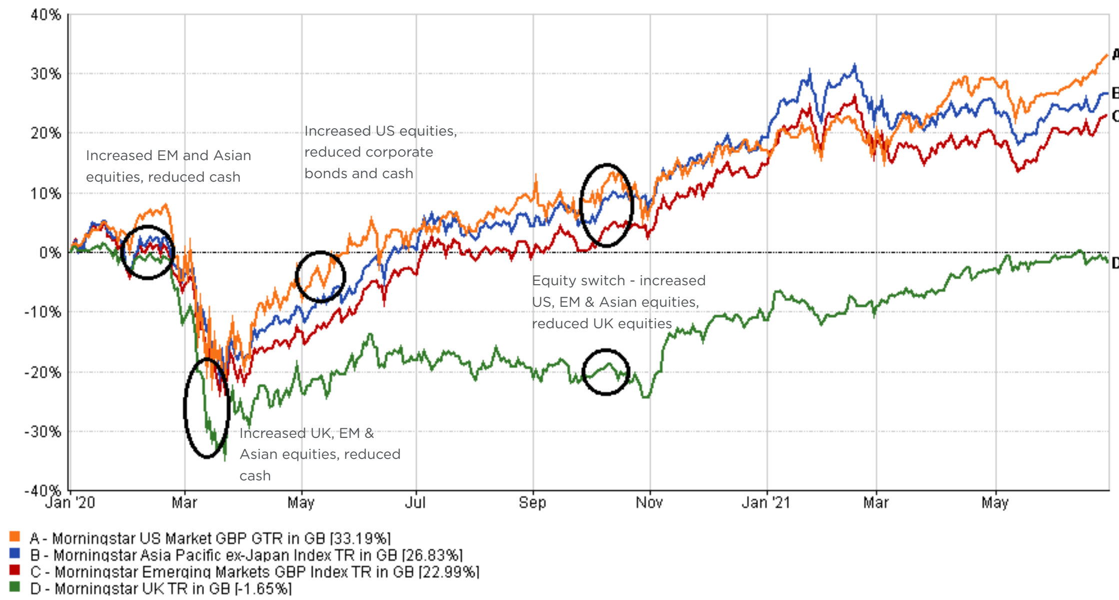
Reviewing equity market performance since the Coronavirus pandemic

Figure 3 on the next page details the performance of the equity markets discussed above over the year and a half to the middle of 2021. Reviewing the impact of the changes to portfolios to the mid-point of 2021, with the benefit of hindsight, the early additions to equities in 2020 were well timed in the context of the recovery we have seen in markets.

In particular, despite markets only beginning to fall materially in value in February 2020, the additions we made to equity allocations in March were around the low point in market levels. This was due to the remarkable speed of the market decline and subsequent recovery from the Coronavirus sell-off. As we noted earlier, this was unprecedented in a historical context and meant that without prompt asset allocation decisions in the first quarter of 2020, the opportunity to add equity exposure at significantly reduced entry points would have been missed. A lot of investors who ‘sat on their hands’ and were not decisive with investment decisions during this period, gave up the opportunity to add significant value to portfolios.

The addition to US equities in May has also been beneficial, with the country’s economy and financial markets continuing to recover strongly from the Coronavirus pandemic (albeit with recent concerns over rising Coronavirus case numbers). With all the above allocations to equities made at the expense of bonds or cash, which have generated far more modest returns over the period, the money put to work has been very additive to overall portfolio performance.

Figure 3: Selected equity market performance since January 2020



Source: FE Analytics

The equity switch made in October with an increase to US, Asia and emerging markets, funded by a reduction to the UK has been relatively neutral to this point in performance terms. Despite strong performance from the US and emerging markets from October to the mid-point of 2021, the UK equity market has also performed strongly, particularly following the vaccine announcements in November. With that said, as figure 4 shows, our UK allocation has outperformed the UK equity benchmark markedly since October 2020. Consequently, despite a slightly lower allocation to the region, this part of portfolios has still contributed very meaningfully to positive model performance. This was discussed further in our recent quarterly update.

Figure 4: UK equity model performance versus benchmark since October 2020

Source: FE Analytics

Post the mid-year point in 2021 we have seen some considerable short-term volatility in emerging market equities, due principally to concerns over the behaviour of the Chinese government with respect to capital markets. This is something we are monitoring closely when assessing our current positioning and further discussion on this topic will feature in the next review of our performance.

Changes to fixed income allocations over 2020

In the fourth quarter of last year, our Investment Committee considered it a good time to take stock and rethink wider portfolio positioning, particularly given the continued strength in equity markets. As well as some changes in the composition of our equity holdings noted above, this led to a change in the fixed income holdings within models. These changes were designed, firstly to increase the resilience of portfolios, through introducing additional diversification within the fixed income allocation. Secondly, a key goal was to take specific advantage of what we considered to be relatively attractive valuations in parts of the corporate credit market, notably high yield.

To achieve the primary goal of increasing portfolio diversification, we added a new sub-asset class allocation into models in October 2020; an allocation to a basket of global developed market government bonds. We were acutely aware that the timing of this move was not hugely compelling from a valuation standpoint, with bond yields (which move inversely to price) not far from historic lows. However, we were of the opinion that this allocation would give us something different in portfolios to protect clients in the next period of market stress, as these bonds typically perform as 'safe haven' assets in periods of strong market drawdowns.

The timing of the addition, at a point when valuations were not a key driver of the change, meant this was not a typical Saunderson House investment decision. However, we believed that when making such an allocation, were an investor to wait until the point these assets are needed (i.e. the point at which the market falls), it is inevitably too late to add them into portfolios, as prices have already rallied. Furthermore, with the outlook still relatively clouded at that point, and the path back to economic normality far from certain, we valued the resilience that this allocation to safe haven assets could bring to portfolios. This was particularly the case given we had increased the level of risk elsewhere in portfolios during the year by increasing equity weightings.

The second key change made to fixed income allocations in October 2020, was to add a direct allocation to the high yield corporate bond market across most model portfolios. This was a far more typical 'Saunderson House move', with the high yield market having trailed the investment grade bond market to that point in the year, due to its sharp fall during the Coronavirus driven sell-off. We felt that this valuation dynamic, alongside the clear potential for fundamental improvements in high yield corporate debt issuers as economies opened up, offered a double benefit which would serve those portfolios with a more aggressive risk appetite well.

Both these changes were funded by a reduction, and complete sale in many portfolios, of short dated corporate bond funds. We felt that these funds had served their purpose during the pandemic as they protected against the larger capital value declines of other assets. Further, looking forward at that point in time, they were a less compelling long-term investment option in most balanced portfolios, when viewed alongside the other changes we were making to fixed income positioning.

Reviewing fixed income market performance since the Coronavirus pandemic

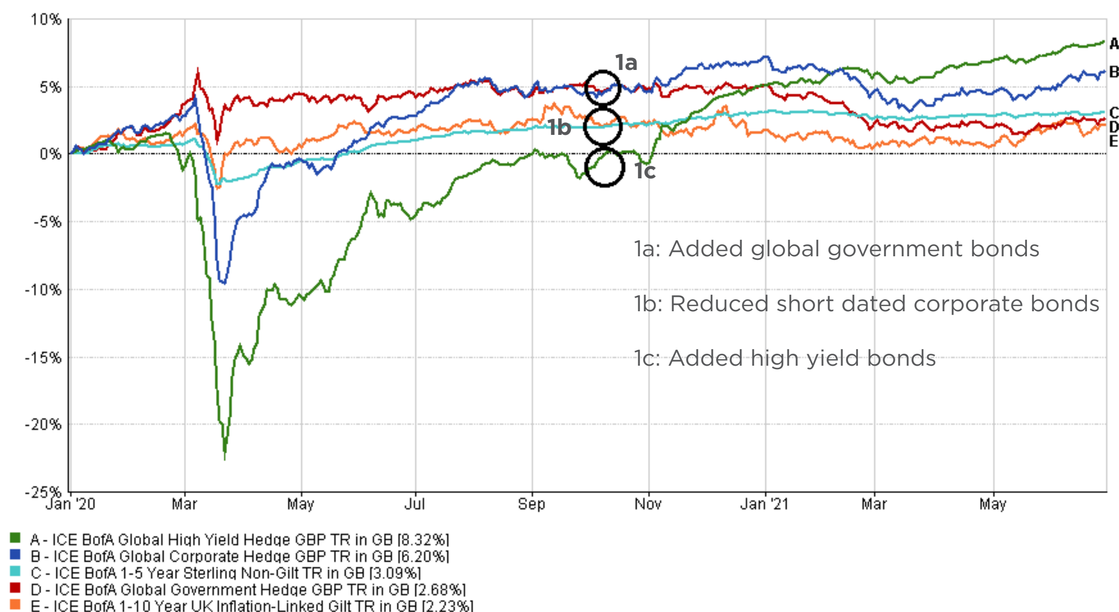
Figure 5 on the next page details the performance of the core fixed income markets to which we allocate in client portfolios, over the year and a half to the middle of 2021. Although we would caution reviewing any portfolio performance metrics over too short a time horizon, reviewing the impact of the changes made to portfolios in October 2020 does allow us to verify that our models are performing as we expected when implementing these changes.

Authorised and Regulated by the Financial Conduct Authority

On review, the addition of a direct high yield allocation to many portfolios has been beneficial, as the asset class rallied strongly when the vaccine rollout began in the fourth quarter of 2020. In addition, the high yield market has been the strongest performing fixed income sector by a considerable margin through 2021 to date. Conversely, our reservations over valuations in the government bond sector were indeed validated in the short-term, as this market has seen modest price falls since its addition to portfolios in October last year.

However, given the blend of assets held within our fixed income mix, crucially, the underperformance from the government bond portion of models has not led to underperformance from client fixed income models (or indeed wider models) as a whole. Indeed, our balanced fixed income blend is still comfortably ahead of a broad global bond benchmark over the period since the changes were made. This is a key aim when we look to build a diversified portfolio that is resilient to many different environments. In addition, with many equity markets continuing to hit new highs as we move through 2021, having an asset that can rally in a flight to safety is something that we continue to value.

Figure 5: Selected fixed income market performance since January 2020



Source: FE Analytics

Conclusion

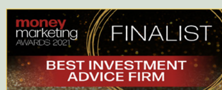
On balance, when 'marking our scorecard' to this point following the Coronavirus pandemic, we believe that the highly active approach we took to managing portfolios through the volatility in 2020 has been of considerable benefit to client portfolios, both in generating some short-term performance gains, but also in adding resilience to portfolios through increased diversification. These changes helped drive models to deliver performance comfortably in excess of ARC comparators through the second half of 2020, and over 2021 to date.

Looking forwards, the investment landscape remains as challenging as ever, with equity markets continuing to hit record highs in some regions, whilst uncertainty over the persisting impact of Covid, government behaviour in China and the looming spectre of inflation, continue to provide balance to the outlook. With much uncertainty remaining, and valuations across many markets seemingly elevated, we believe that added resilience should be of continued benefit to client portfolios in the long-term and in the meantime are watching markets closely for the next turning point.

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

The value of investments and any income therefrom can go down as well as up and you may not get back the full amount you invested. This note is for general guidance only and does not constitute and should not be construed as, investment advice or a recommendation to buy, sell, or otherwise transact in any investments. Detailed advice should be taken before entering into any investment activity, any specific recommendations are based on your individual stated objectives and defined risk profile.

INVESTORS IN PEOPLE



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
Authorised and Regulated by the Financial

Saunderson House Limited is authorised and regulated by the Financial Conduct Authority. Levels and bases of, and reliefs from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor. We cannot assume legal liability for any errors or omissions.