WILSONS

A Challenging Start to the Year for Multi Asset Portfolios

Our quarterly managed funds report outlines the pathway best-suited to deliver on our current asset allocation strategy.

26 April 2022

Q1 Review and Q2 Outlook

The 1st quarter has been a challenging one for investors. Global equities came under pressure through much of January as the market began to price a more aggressive tightening cycle from the US Federal Reserve.

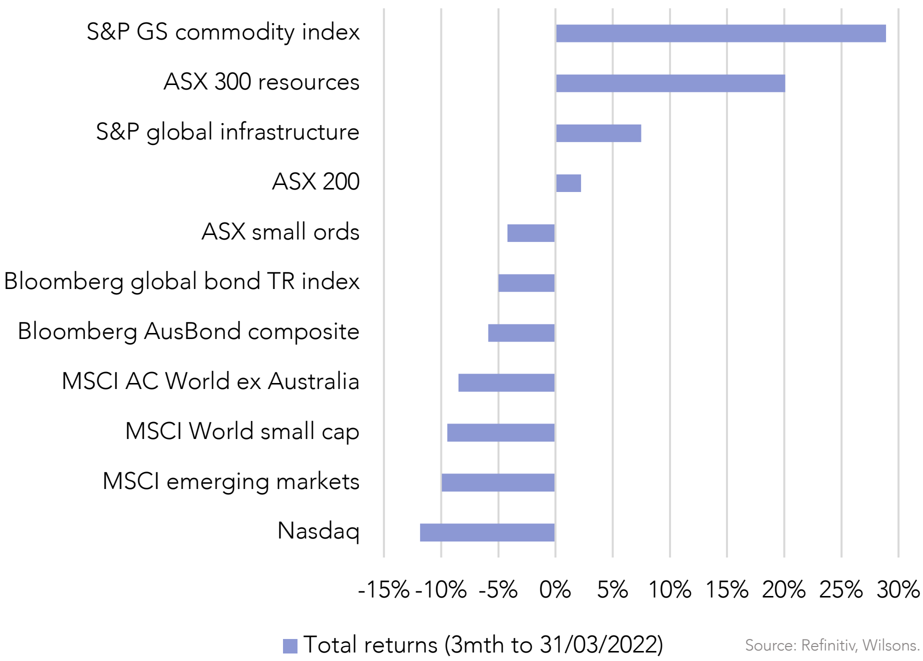
After clawing back some territory in February, Russia's invasion of Ukraine caused another spike in risk aversion late in the month. Equities once again managed to stage a decent rally through much of March, but global stocks still finished down ~9% (in A$ terms) for the quarter. A strengthening A$ added to the performance drag for unhedged global equity funds in Q1.

In comparison, Australian equities have been a solid relative outperformer so far this year, with the Australian equity accumulation index posting a 2% gain in Q1. Outperformance has continued so far in April. This has been due primarily to Australia's high resource weighting and partly due to our higher weighting in banks. Our overweight to Australian equities has been beneficial, albeit we trimmed the overweight (in hindsight prematurely) in April.

In contrast, neither domestic nor global bonds have been a safe haven this year as rising inflation, more hawkish central bank expectations and the prospect of quantitative tightening conspired to push global and domestic bond yields significantly higher.
This has driven significant capital losses ~6% in fixed interest in Q1, though our tilt to "non-traditional" managers has mitigated losses (see exhibit 3 for more detail).

While the performance from our alternative managers has been somewhat mixed, our overweight to alternatives - largely in preference to fixed interest - has been beneficial. The majority of our managers have managed to grind out positive returns for the quarter, while the 12-month return for our alternatives allocation has been in the order of 6% vs close to zero for cash and -6% for the Australian fixed interest benchmark. We remain overweight a range of alternative strategies, including private equity, private debt, real assets (infrastructure and commodities) and hedge funds.

Figure 1: Asset class returns have diverged so far this year



Source: Refinitiv, Wilsons.

2022 Investment Outlook – Cautious but Backdrop Should Improve

While uncertainty is undoubtedly higher than average, we still see the 12-month outlook for equities as being supported by a reasonably robust global growth backdrop and what are still relatively low interest rates in a historical context.

We believe global recession risk over the coming 12 months is relatively low. Our base case is that the world (led by the US) continues to grow at an above-average pace, supporting an ongoing corporate earnings expansion.

US inflation is undoubtedly proving more problematic than first thought, and the Fed is becoming more and more hawkish in response. This does raise risks for the investment outlook particularly in the near term; however, we think US inflation is likely to be at or very close to its cycle peak.

The interest rate market has aggressively repriced the near-term path of interest rates; however, long-term bond yields and the market's peak cash rate projections are still not at levels we would consider "restrictive".

Hence, 12-month recession risks remain low for both the US and Australian economies in our view. Long-term inflation expectations (as embedded in the bond market) also remain relatively contained despite the current inflation spike.

We trimmed our overall equity position marginally in early April but remain moderately overweight in Australian equities. The Australian economy is in good shape, inflation is picking up but is less of a problem than overseas and commodity prices are booming.

Australia's market composition, being overweight resources and financials and underweight IT, is still a superior setup for the current environment. A resolution in respect of Russia and Ukraine could see Australia lag a risk rally, but we still see a superior risk-return tradeoff for Australia over the next 12 months. Australia is looking a bit overbought near-term, but our relative outperformance is only small in a longer-term context.

We have begun to edge up our fixed interest exposure. Australian yields (3% for 10-year bonds), in particular, are now looking reasonable value, and we have started to edge back into (domestic) fixed interest from a very underweight position.

We still expect higher 10-year US yields in this cycle (potentially moving local yields slightly higher), so our initial move back toward fixed interest is relatively small. In spite of their poor recent performance, we believe bonds still have a portfolio insurance role. They do have the capacity to rally if one or more of our risk case scenarios (e.g. a Russia-Ukraine escalation) comes to pass.

Key Signposts to Turn

We are watching the following key signposts to move more cautiously or positively on risk assets.

1. **Is the peak in US inflation close at hand or will it prove more stubborn?** Our base case is a March CPI reading (delivered April 12) will be the peak for US inflation. This should help calm markets.

2. **US reporting season – more upside surprise or margin pressure?** It is still early days at the time of writing but our central case is another decent US reporting season.

3. **Escalation in Russia-Ukraine hostilities or a negotiated truce?** We see a settlement in coming months as a logical outcome, but this is far from assured, and tail risks remain significant.

4. **European economic data – rolling over or resilient?** Europe looks resilient at present, but this resilience has its limits. A Russian energy embargo into Europe is unlikely but cannot be completely discounted.

5. **Will the Fed be more or less hawkish than priced at its May 3 meeting?** The Fed's guidance come the May meeting is hard to call, though we expect some inflation relief to ultimately calm the Fed and the front end of the curve over the balance of 2022.

6. **Will COVID derail Chinese growth?** The Omicron variant has spread to multiple regions across China in March, leading to tightened mobility restrictions, mass testing and lockdowns in multiple cities. China's strict COVID policy is likely to stay in force for some time. The negative impact on growth is likely to be offset somewhat by more policy support, but near-term growth has downside risk. At the same time, these recurrent outbreaks represent another challenge for the global supply chain.

So there is plenty to digest over the next few months. While we have edged down our risk allocation a little, we continue to stay cautiously constructive.

Read our Q2 Asset Allocation Outlook

Figure 2: Asset allocation comments

Asset Class	Tactical Tilt	Movement	Wilsons View
Cash	Neutral	no change	Neutral weighting reflects residual risk that recent correction extends, balanced by relatively positive 6-12 month central case view on risk assets.
Fixed income (Domestic & Global)	Underweight -7%	1	We retain a significant underweight in fixed interest due to what are still low yields and our view of a continued global and domestic recovery over the coming year. Australian bond yields are now looking reasonably attractive so we begin to add some exposure. Credit preferred over government debt given solid growth outlook.
Equities - Domestic	Overweight +2%	-2%	Australia still preferred on 12 month view given strong economy and commodity skew but edging down exposure after the recent strong rebound
Equities - International	Neutral	no change	While we are still constructive on global equities we see better relative upside in Australian equities while (long duration) US equities may need to digest a further rise in bond yields. UK (value) and EM at overweight (China easing). We retain our 40% hedge back to the A$ as we still believe it has medium-term upside, particularly against the US$.
Alternatives	Overweight +5%	1	We retain our signifcant tactical overweight given a) above average economic and policy uncertainty b) unattractive valuations in govt. bonds. A range of growth and defensive alternative strategies appeal i.e. private equity, infrastructure, real property, long short global hedge funds and private credit (adding). Gold still appeals as a portfolio hedge against worse than expected inflation outcomes and heightened geopolitcal tensions but could be cyclically vulnerable to a rise in global real interest rates.

*Our tactical tilts represent our view over the next 6-12 months, though active tilts could be held for shorter or longer periods depending on both asset class performance and fundamental developments.

Source: Refinitiv, Wilsons

Manager Focus List

Performance update as at March 31 (selected managers)

Fixed Interest

CC JCB Dynamic Alpha Fund

The CC JCB Dynamic Alpha Fund returned -0.65% in the quarter to March, underperforming the RBA Cash Rate Total Return Index by -0.66%. For the year to March 2022, the fund returned -0.21%, underperforming the fund cash benchmark by -0.25% but finishing well ahead of the -5.9% return delivered by the Australian composite bond index.

The main performance detractor in the period was exposure to Australian short-end bonds, which suffered from the heightened hawkishness of the central bankers and selling from Japanese investors into their financial year-end.

Currently, the markets are pricing in more than double the team's estimated tightening amount from the RBA, which Jamieson Coote believe is a significant overstep. The expected RBA implied policy rate in 2 years is above 3.52%, more than 50 basis points higher than that of the U.S Federal Reserve – suggesting the RBA can raise rates faster than the U.S Fed, which Jamieson Coote believe is a clear mispricing.

Australia Equities

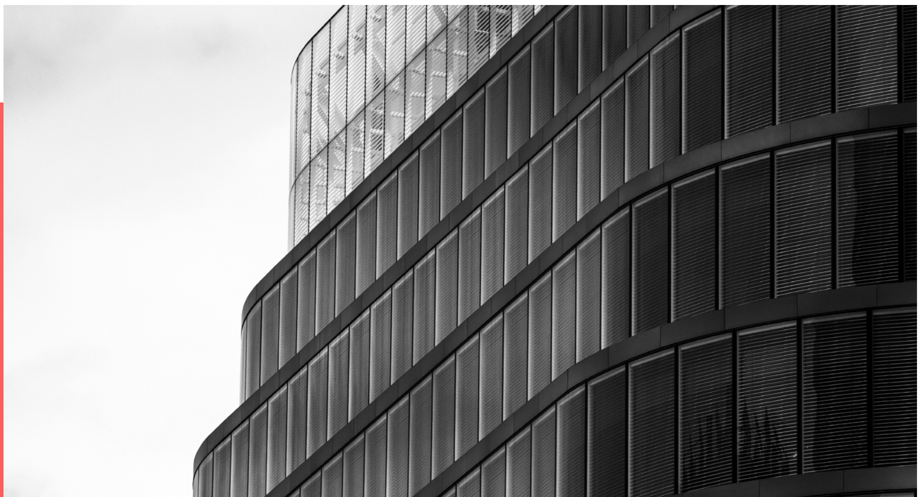
AB Managed Volatility Equities Fund

The AB Managed Volatility Fund declined 2.5% in the March quarter, underperforming its benchmark. the S&P / ASX 300 Accumulation Index, by 4.58%. For the year to March, the strategy returned 10.3% compared to 15.2% for the benchmark.

Despite global inflation fears and the Ukraine invasion, cyclical stocks rallied in Australia. Accordingly, the fund lagged the benchmark due to its defensive positioning and underweight to banks and resources.

In contrast, the fund's selected exposure to technology offset some of this negative performance. Not holding BHP detracted the most during the period, as the miner outperformed when several of its key commodities—iron ore, metallurgical coal and oil rallied in Q1. In addition, BHP's shares experienced higher demand due to the higher domestic market weight as the company delisted from the UK to list exclusively in Australia.

Core holdings in medical laboratory business Sonic Healthcare and healthcare service provider Healius both underperformed despite a lack of material news about either company.



Both companies' core pathology operations are delivering robust growth and cash flows, and while their temporary surge in profits derived from PCR coronavirus testing should peak this year, both companies are using the surplus to buy back shares and invest in future growth. The team believes the high quality of their pathology services makes both companies attractive investments, and they continue to hold both stocks in the fund.

Acorn Capital NextGen Resources Fund

The NextGen Resources Fund returned 10.1% for the quarter to March, slightly behind its benchmark, the S&P ASX Small Resources Index, which rose 14.5%. Interestingly, the quarterly underperformance can be attributed to a number of thermal-coal producers the fund does not invest in. For the year to March, the fund returned an impressive 62.2%, outperforming the small resources benchmark by 10.2% after fees.

Over the quarter the fund's top contributors came from a mix of battery metals, energy and gold commodity exposed companies.

The rising nickel price along with drilling results aided developer Ardea Resources (up 254% in the quarter to March 22). Ionic Rare Earths was up on a significant acquisition (rare-earth developer, up 89% in the March quarter). Stanmore Resources (coking coal producer, up 83%) lifted on the back of the completion of its coking coal acquisition. Comet Ridge (gas developer, up 56%) increased on flow testing progress while Allkem (lithium producer, up 9.9%) increased due to improved lithium prices and expansion projects.

Negative performers included Sandfire Resources (copper producer, down 13.6%) due to operating cost increases in Europe. Australian Rare Earths fell on limited news (explorer, down 12.3%). Neo Performance Materials (rare-earth producer, down 24%), continued to soften on exposure of its Estonia plant to the war in Ukraine.

The portfolio held 41 stocks at the end of March. EV metals, copper and uranium, continue to represent about half of funds under management.

International Equities

Pzena Global Focused Value Fund

The Pzena Global Focused Value Fund returned -2.2% after fees for the quarter to March 31, 2022. In comparison, the MSCI World AC Index declined by 8.6%. For the year to March, the strategy returned 7.3% compared to 8.7% for the Index. Global markets ended Q1 in negative territory as Russia's invasion of Ukraine, combined with rising interest rates drove down sentiment, especially in Europe and the emerging markets. Despite incessant recession and stagflation fears, value indices outperformed growth and our portfolio handily outperformed the benchmark, led by our energy names. The remaining sectors outside of healthcare and information technology were either flat or negative.

The top contributors were Halliburton, Baker Hughes, and Shell plc. US oil servicers Halliburton and Baker Hughes were particularly strong as the attractiveness of energy independence reasserted itself in the minds of US consumers and the government. Integrated oil and gas major Shell was higher on surging crude prices, which had been rising for months on a general supply–demand imbalance, then spiked on the developments in Eastern Europe.

Fidelity Global Emerging Markets Fund

The Fidelity Global Emerging Markets Fund returned -13.5% for the quarter to March, underperforming the MSCI Emerging Markets Index by 3.55%. For the year to March 2022, the fund returned -6.79%, outperforming the benchmark by 3.31%.

The strategy's underperformance in the quarter was against a backdrop of extreme uncertainty: the war in Ukraine, spiralling global inflation and China's regulatory overhang were among the factors that contributed to volatile conditions.

At the country level, stock picking in China hampered relative returns. The holding in clothing manufacturer Shenzhou International Group declined as investors remained wary of the near-term COVID-19 impact on its operations and the slow production capacity recovery in Vietnam.

Stock picking in financials was the top detractor from relative performance. Here much of the underperformance came from Russian holding TCS Group. The stock was impacted by the sell-off but has not been sanctioned; its London listing provided a means to reduce Russia risk, and the fund fully exited the position.

Not holding many of the cheaper, lower quality banks in EM was also a detractor to performance as the growth to value rotation continued. The fund's copper holdings First Quantum Minerals and Southern Copper were among the positive key contributors. Copper will likely benefit given the accelerated move to electric vehicle/alternative energy in case of persistent higher oil prices. Fidelity remains biased towards copper producers as their view on copper is underpinned by supply constraints and the move towards a greener economy.

Munro Global Growth Fund

The Munro Global Growth Fund returned -12.2% in the March quarter. The fund's long positions and currencies were the key detractors to performance, while shorts and put option hedging were relatively flat as the team recycled hedging gains into additional risk management positions to help minimise volatility.

1Q22 has been difficult for global financial markets and the Munro Global Growth Strategy. What began as a growth equity correction escalated through February with the Russian invasion of Ukraine and concluded in March with a vicious bond market sell-off on the back of an increasingly hawkish Federal Reserve.

At various points through the quarter, the S&P was down 13%, the Nasdaq was down 20% and the Eurostoxx 600 was down 15% for the year before a market rebound in the past two weeks. This has been a difficult period for investing, and one where taking too much drastic action could ultimately have led to a significant loss of capital.

Having been caught offside during the first two weeks of the year, the fund quickly followed its stop-loss disciplines and reduced exposure to equity markets.

The focus on lowering volatility through the difficult February / early March period saw hedging gains given back as markets rallied to close the quarter. While hedging tools were useful in lowering volatility through the most difficult period, they negatively contributed to returns for the quarter as Munro elected to keep rolling over the downside protection positions to guard against a possible worsening market environment.

The team remains confident in the ability of the portfolio investments to grow earnings through this uncertainty and ultimately deliver returns for investors.

From a stock attribution perspective, positive contributors came from more recent names in Food Revolution, Nutrien and Deere & Co as the issues in Eastern Europe have highlighted the need for greater food security and the importance of farm management to improve efficiency. Longer-term, they are expected to benefit from resource scarcity and the shift to sustainable agriculture. The main detractors were High-Performance Compute names, Advanced Micro Devices and ASML, as markets became concerned about a shorter-term hit to consumer electronics given the worsening macro landscape and the possible impact on consumers.

EFTS Physical Gold ETF

The ETFS Physical Gold ETF provides a low cost and efficient exposure to physical gold. For the quarter to March the ETF returned 2.4%. For the year to March 2022 it returned 15.8%.

The rise in the gold commodity price was driven by gold's appeal as both a safe haven and an inflation hedge. Russia's attack on Ukraine pushed gold to an intraday price of US$2,070 per ounce on March 8, just shy of its August 2020 all-time high of US$2,075.

Fuelling uncertainty and volatility in the markets and coinciding with gold's 19-month high, on March 8 the London Metal Exchange (LME) was forced to halt trading in nickel after a short squeeze drove the nickel price up over 100% in one trading session.

On March 16, as widely expected, the Federal Open Market Committee (FOMC) raised the federal fund's target rate by 25 basis points. Gold rallied again post the announcement and showed resilience in the second half of March, despite a steady US$ and significantly higher US treasury rates.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

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