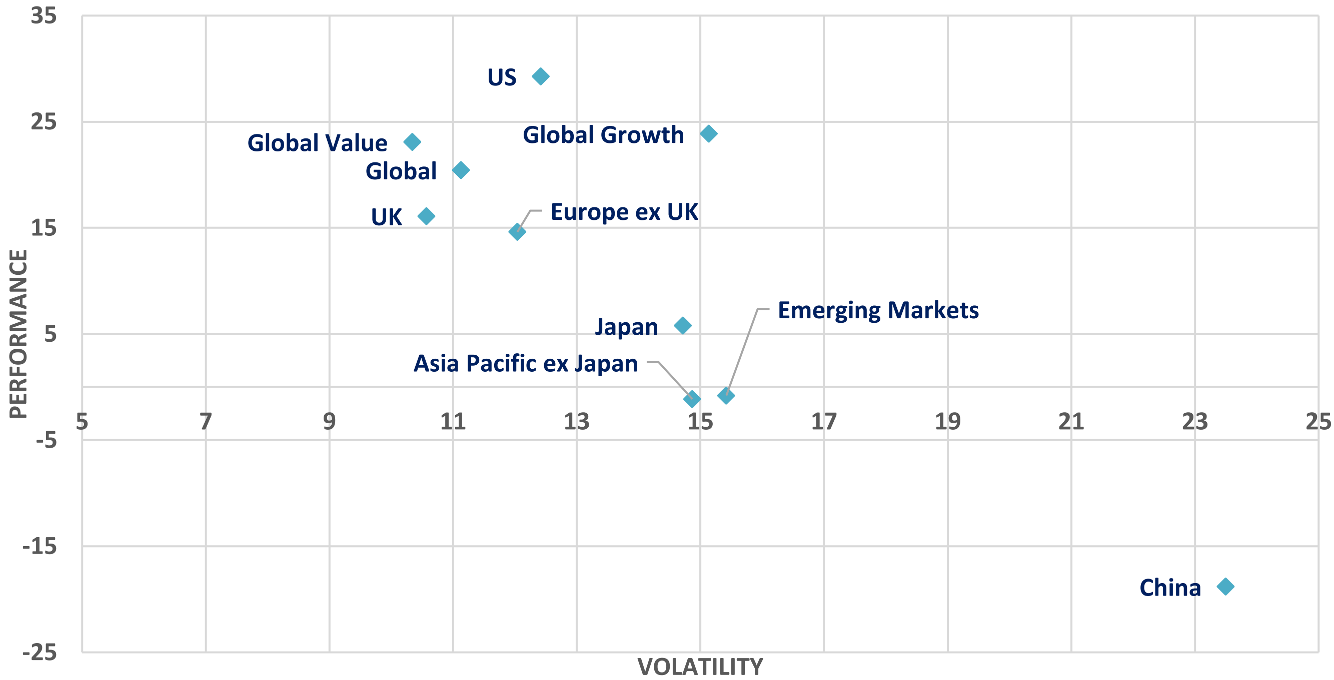
A year in review

If 2020 was all about COVID-19, then 2021 has been all about the emergence from lockdown and the increasing threat of inflation. What a curious year it has been. Who would have thought a year ago, as effective vaccines were launched, that 12 months later countries would be reintroducing various lockdown measures and about to enter year three of the pandemic? At the turn of the year, no one expected it to be easy but, despite the abundance of headwinds, the MSCI World Index is up nearly 24% at the time of writing (Source: Bloomberg). We have had the ending of lockdowns, the vaccine rollout, value versus growth gyrations, 'meme stock' euphoria and various ongoings in China.

LGT Vestra's main investment themes have evolved throughout the year, but a few commonalities include active management over passive, small cap over large cap, being active with our bond exposure, positive on Asia and positioning to take advantage of sustainability themes. Not all of these have borne fruit, but it is imperative as money managers to reflect on the good and the not so good – more on these later.

Risk vs Return for selected equity markets in 2021



Source: FE Analytics (15/12/2021). Asia Pacific ex Japan: MSCI AC Asia Pacific ex Japan; China: MSCI China; Emerging Markets: MSCI Emerging Markets: Europe ex UK: MSCI Europe ex UK; Global: MSCI All-Country World Index (includes developed and emerging markets); Global Growth: MSCI The World Growth; Global Value: MSCI World Value; Japan: MSCI Japan; UK: MSCI United Kingdom; US: MSCI USA.

Reflecting on 2021

Q1: vaccines and restriction reversal

Thinking back to Q1 of 2021, we had successful vaccine rollouts from the majority of developed nations and the reversal of many COVID-19 restrictions. This spurred a reflation or reopening trade which led to a period where value stocks outperformed versus growth. We saw a continued shift out of safe havens and stocks that had held up well through the worst of the pandemic, into some of the areas hardest hit in 2020. Equity markets were generally positive, but with a huge dispersion of returns.

Q2: supply chain woes
That being said, in Q2 of 2021, the rotation out of technology and growth stocks into pandemic recovery plays and value stocks partially reversed. This trend of markets gyrating between value and growth continued throughout the year and signified how rapidly the swings between differing investment styles can take place.

Hedge funds appeared to be a target of retail investors when chat on the social media platform, Reddit, caused more than a tenfold rise in the price of GameStop. A bricks and mortar retailer in the middle of an online shopping boom, GameStop had been heavily shorted by hedge funds and retail investors took Wall Street head on. For a brief period, we had ‘meme stock’ euphoria, giving investors pause for thought. Retail investor bullishness has continued throughout the year and we have had big swings in Bitcoin and Tesla, for example. This has largely been driven by the ‘wall of money’, with individuals experiencing a huge increase in savings and net worth. The fact that equity funds have taken in more cash this year than in the previous two decades combined is proof of this sentiment (Source: BofA Global Investment Strategy, EPFR).

The blockage of the Suez Canal in March uprooted supply chains and for the first-time alarm bells were ringing about the fragility of global supply chains. These have not abated. The pandemic made it harder for the world to produce and transport goods amid shutdowns to contain the spread of COVID-19. Meanwhile, governments shored up incomes in the crisis like never before, so households remained eager to spend and initially this was focused on goods instead of services. This increase in demand created a ‘bullwhip effect’ where small fluctuations in demand at the retail level can cause progressively larger fluctuations in demand at the wholesale, distributor, manufacturer and raw material levels. It eventually led to congestion at ports and longer delivery times, as well as dramatically higher freight costs. These inflationary pressures should subside as new supply comes on-line, and services reopen. Indeed, it could even potentially lead to a glut of supply in 2022.

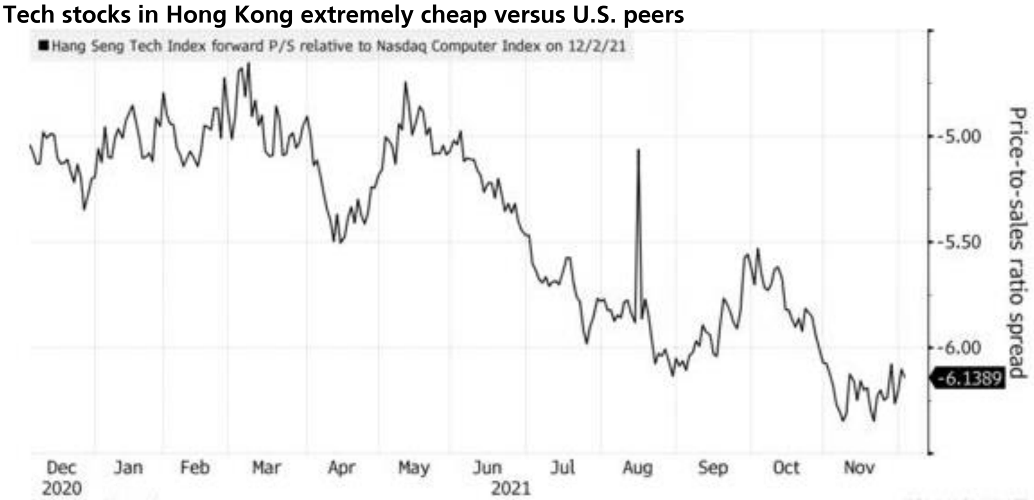
The pandemic caused large scale damage to the global economy, but massive fiscal and monetary support was forthcoming, and helped to prevent a much greater economic disaster and permanent destruction of capital. However, this enormous stimulus has led to inflation fears dominating much of the discussion around the outlook for investors this year. Central bankers on both sides of the Atlantic were sanguine in their response, sticking to their view that a rise in inflation would be temporary and rates would not rise for some time. Even though the word of the year ‘transitory’ has since been “retired” by the Federal Reserve (Fed), the word has been hard to escape this year.

We believe that, as the economy continues to emerge from global lockdowns and issues in supply chains iron themselves out, inflation will be higher in the short-term. Elements of inflation will be stickier – namely wage pressures and the cost of moving to a greener, cleaner world. However, we are sceptical that we have entered a new era of runaway inflation. Let us not forget that the disinflationary themes of ageing demographics and technological advances are still very much with us – and, if anything, have been hastened by the pandemic. The debt burden has also grown, and the structure of the economy is very different to the last time we saw consistently high inflation.

There are already seismic shifts under way in technological innovation as companies continue to reconfigure how they organise themselves as they recover from the shock of the pandemic. Productivity is key to global businesses and, whilst a volatile measure, is critical to gauge how labour and capital combines to produce more. With a deepening use of technology across a range of businesses, scaling up without much added cost could, therefore, alleviate inflation.

Q3: Chinese crackdown on Tech
Q3 of 2021 saw supply chains heating up, authorities in China flexing their muscles and the prospect of a withdrawal of pandemic relief measures, which all weighed on markets. Communism and billionaires are not natural partners, and throughout the year the Chinese Communist Party (CCP) acted to crackdown on large Chinese technology companies and advance its own ‘Common Prosperity’ agenda by restricting the activities of Chinese companies providing private tuition, at a profit, outside the state system. Further actions to contain the rising property market contributed to the gradual collapse of the Evergrande Real Estate developer after it found itself on the wrong side of China’s ‘three red line’ policy. Even though Asian equities have taken a hit, they are now trading at a sizeable discount to their US peers.

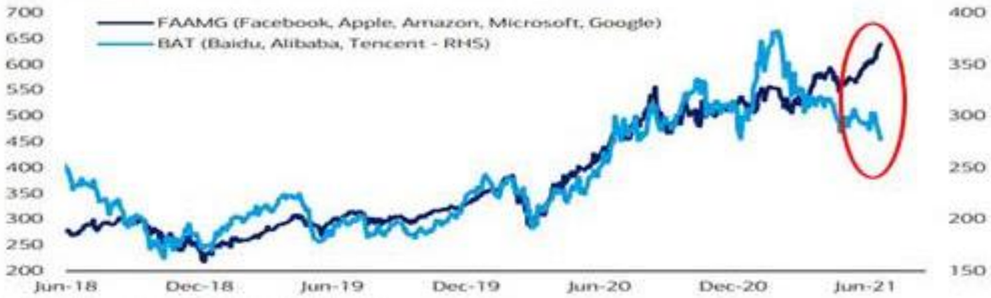
Tech stocks in Hong Kong extremely cheap versus U.S. peers



Source: Bloomberg

Baidu + Alibaba + Tencent vs Facebook + Amazon + Apple + Microsoft + Google

US FAAMG at all-time highs, China BAT at 12-month lows

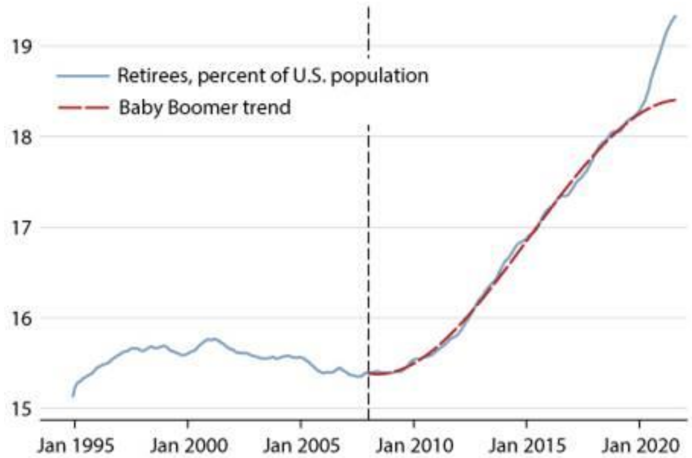


Source: BofA Global Investment Strategy, Bloomberg

China, and the actions of the CCP, has been one of the big talking points this year. From a geopolitical point of view, the next steps taken by the CCP will be crucial, particularly surrounding their relationship with the US. Recent actions by China in Taiwan also point to future geopolitical issues, along with the conflict between Russia and Ukraine intensifying. Elsewhere, we have seen the Taliban regain control of Afghanistan, the Singapore Prime Minister resign after losing the confidence of parliament and a coup in Guinea with the resulting arrest of the country's President. Political uncertainty remains in South Africa following violent civil unrest in the summer. Social unrest during the summer of 2021 was also seen in Cuba, Colombia, Nigeria and Haiti, with the latter culminating in the assassination of the President. These countries all have extremely complex social, economic and political backdrops but these have only been inflamed by the fallout of the pandemic and food inflation is often the precursor to riots and regime overthrows.

On top of the supply chain constraints highlighted above, we have seen disruptions in the labour market. People have been stepping out of the workforce to avoid infection, recover from illness, or cope with school closures. A big factor has also been the swathe of early retirements brought about by the pandemic – a sharp reversal of the pre-pandemic trend that saw people working for longer. The thought of returning to the office and the daily commute may seem unpalatable for many individuals, and with surging equity markets having boosted pension plans, early retirement seems a very attractive option. These effects have added a shock to the labour pool and are likely to continue into next year.

Percentage of retirees in the US and the Baby Boomer retirement trend



Left hand side axis: percentage of US population

Source: Federal Reserve Bank of St. Louis (15/10/2021)

Q4: Omicron and Central Banks' action

During the final quarter of 2021, Central Banks' actions and the emergence of the Omicron variant have been the main headwinds for markets. Nevertheless, the Model Portfolios have come through the numerous variants with positive returns and whilst the Omicron variant adds one more level of uncertainty, we do not see it as a reason to change our investment positioning as it stands. We have generally favoured quality companies with growing earnings that weathered the pandemic well and, in some instances, they have even improved their market dominance. We will continue to monitor the short-term news flow closely for longer term implications, should they arise.

The Bank of England (BoE) hiked rates in December and the Fed have said they will quicken the scaling back of their tapering, whilst the European Central Bank (ECB) have left rates on hold. Given quantitative easing and ultra-low interest rates have dominated the investment backdrop for all asset classes for more than a decade since the Global Financial Crisis, it is a delicate balancing act given increased debt levels. Markets are currently pricing that the Fed will hike interest rates twice in 2022 and a further three times in 2023. However, interest rates will remain very low by historical standards – they are not expected to rise above 2% at any point in the next 10 years. The same will be similar for the BoE and the ECB – there will be rate rises, but whilst there is take off, they will not be going to the moon.

Themes of 2021

Our Investment Managers have been active with their decisions this year, making changes to adapt to the ever-changing macroeconomic backdrop. The more significant changes are discussed below, but include active management over passive, moving down the market cap spectrum, reducing duration and favouring high quality companies.

Active management

Looking at historic bear markets, the first 12 months after the market low has seen strong performance in stock markets. During this period, it is easier for companies to surprise on the upside, as demand surges as the economy gets back on its feet, monetary and fiscal policy are loose, and expectations are overly cautious. During the second year, however, because expectations are higher, monetary conditions often tighter and new demand for new goods and services levels out, companies find it increasingly difficult to surprise investors on the upside. This often results in greater volatility and the market index trading sideways for a period, in spite of the macroeconomic data also being very strong. We continue to believe that this environment creates ample opportunity for active managers who are willing to take advantage of market dislocations and have high conviction. To this end, we switched the remainder of our passive exposure in the US and the UK into active managers this year.

Active, high conviction managers are able to seek out companies with pricing power whilst simultaneously avoiding those with less favourable characteristics. A company that has substantial pricing power is one that provides a rare or unique product/service with little competition and can raise prices without significantly reducing demand. In fact, businesses with strong pricing power can take advantage of the sharp demand recovery to raise prices to improve profitability. These types of companies include luxury companies, which thrive on brand power, exclusivity, and scarcity; consumer goods like Nestlé; online entertainment like Netflix; and payment networks like Visa or Mastercard can typically pass on rising costs to the consumer. Morgan Stanley Global Brands, Fundsmith Equity and Lindsell Train UK stand out as the three funds in the Model Portfolios that hold companies with the greatest pricing power.

Moving down the market cap spectrum

The standout trade this year has been taking profits in the Morgan Stanley US Advantage fund and redistributing capital to the T. Rowe US Smaller Companies and Alliance Bernstein US Sustainable funds. The Morgan Stanley fund had a fantastic run in 2020, gaining a whopping 68.63%, contributing over 3.5% of returns for the Balanced portfolio. This meant the fund was becoming an increasingly large component across all of our portfolios and given the toppy looking valuations for some of the holdings, we felt it was a prudent time to take profits on a portion of the position across all the risk levels. Moving into the T. Rowe and Alliance Bernstein funds added exposure to a certain amount of cyclicality via the T Rowe fund, and also to the green infrastructure theme via Alliance Bernstein – both increasing our exposure to small/mid cap names.

Moving down the market cap spectrum also grants us access to ‘next generation’ companies: seeking out the next Apple or Amazon, for example. We already have good exposure to next generation companies throughout the growth funds in our portfolios: Morgan Stanley US Advantage, Impax Asian Environmental Markets, Baillie Gifford Japanese Smaller Companies, Jupiter UK Smaller Companies, Schroder Asian Total Return, Morgan Stanley Asia Opportunities, T Rowe US Smaller Companies and even Polar Capital Global Insurance (insurance companies are increasingly adopting automation and robotics). However, for a deeper dive into some of our exposure, please refer to the Next Generation documents produced by the MPS team this year (Asia, UK, US and Europe).

Reducing duration

In November 2020 we switched some of our conventional US treasuries into inflation protection via the CG Dollar fund. At this point in time US 10-year break-evens remained low (around 1.7%) as inflation expectations were well below current levels and economies looked set to reopen in 2021. As such, we decided to add to the asset class which has consistently proven to provide protection in time of market distress and provides cash flows linked to inflation levels.

We maintained this inflation protection exposure up until August 2021 where we decided to take some profits. At this point, break-evens were far higher (around 2.4%) and yields, despite breaking out to higher levels earlier this year, had moved back to historic lows. Coupled with the threat of the Fed tapering for a market that is highly supported, we felt that it was an opportune time to take profits on the position and move in to lower duration bonds that will be less effected by a rise in yields and are not linked to inflation expectations.

High quality

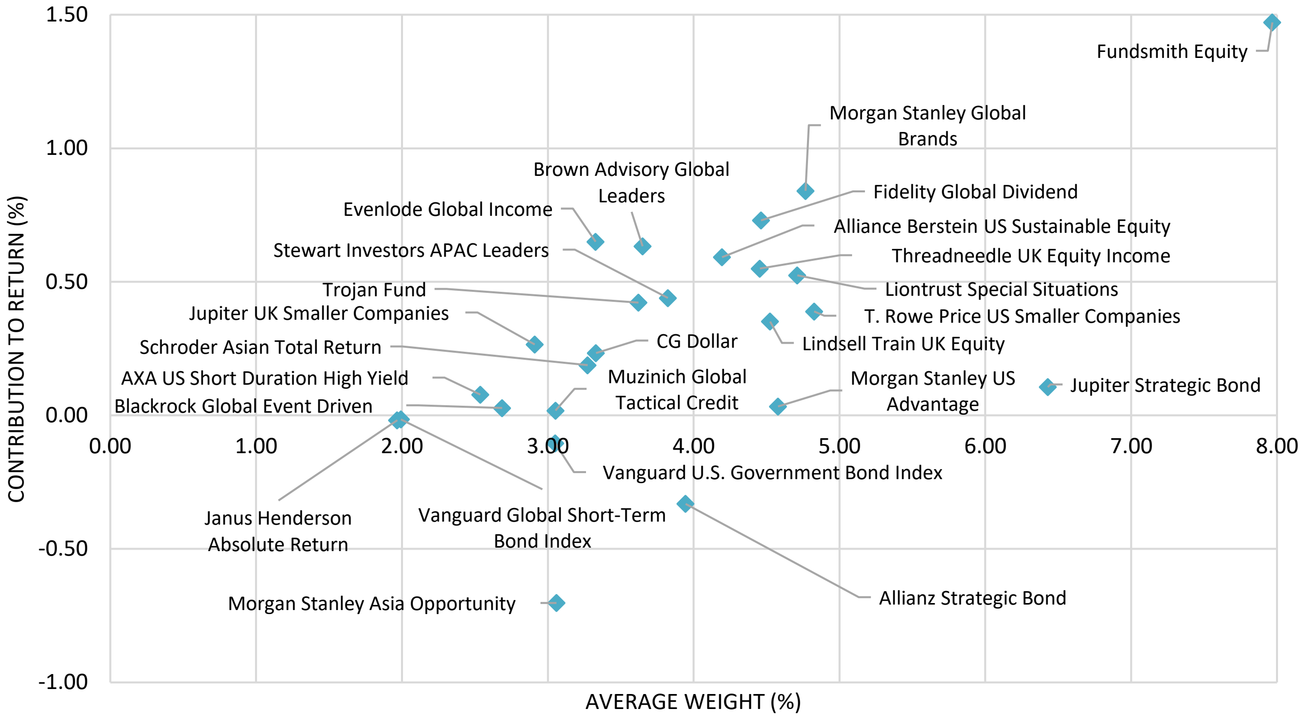
A high inflationary environment and heightened volatility means companies with strong balance sheets, healthy margins and pricing power from a wide economic moat become the most attractive investments. These types of companies are deemed 'high quality' and the Model Portfolios have a bias to quality – from both our equity and bond managers alike. This is a well-established bias within our portfolios and something we have been championing for a while now. Whether inflation subsides in 2022 or remains elevated, and whether it causes an economic slowdown or not, high quality equities should be resilient at worst, and produce attractive returns at best.

An area we have been focusing on this year is the so called ‘middle ground’, i.e. not growth nor value but those high-quality-yet-fairly-priced core investments that sit somewhere in the middle. Two funds we have favoured to play this theme are Fidelity Global Dividend and Evenlode Global Income. Reliable income-generating assets such as the dividend growers held in these funds should benefit if interest rates do not rise much, the economic boom moderates and the inflation scare retreats in 2022. Both funds own a number of 'quality' names whilst screening attractively from a valuation perspective.

Portfolio performance

Our performance this year has been strong, and we have remained within, or exceeded, our target matrix assumptions for all risk profiles.

Performance Attribution – LGT Vestra Balanced



Data by Morningstar (15/12/2021)

Top performing funds

Fund	Year to date return (%)
Evenlode Global Income	21.36
Alliance Bernstein US Sustainable	20.56
Fundsmith Equity	20.18
Brown Advisory Global Leaders	19.38
Morgan Stanley Global Brands	19.07

Data by Morningstar (15/12/2021) – net of fund charges

Our high conviction approach can be split into two components:

1. We are happy to hold large position sizes in individual funds (8% in Fundsmith Equity in the Balanced) or happy to exclude a geography (0% direct Europe and Japan in the Balanced) or sector in its entirety if we don’t feel it adds value to the portfolio. In general, our conviction in these high-quality managers such as Fundsmith has added long-term value to our clients.
2. Secondly, we invest into fund managers that are high conviction themselves, often concentrated and different from their benchmark. By actively positioning away from the crowd, this can sometimes lead of periods of outperformance but also some periods of underperformance. It should be noted that taking active positions (i.e. away from the benchmark) does not necessarily mean that the fund is higher risk, it can also result in a lower risk fund than the benchmark. We do, however, expect some variance from the benchmark if we are going to pay fees for active management, and unfortunately in spite of all the research and due diligence that we undertake, occasionally this can sometimes go against us, as it has for a couple of funds this year.

In a strong year for most asset classes, unfortunately there are two trades that have detracted just under 1% from the performance of the Balanced portfolio this year:

Allianz Strategic Bond: The Allianz fund was included as a diversifier with a low correlation to our other fixed income and equity holdings. We knew the fund was a complex, highly active strategy and had various different levers that it could use to generate alpha but we felt that it was worthy of inclusion given our continued cautionary stance towards passive fixed income funds. One particular trade they are employing at the moment, a bet that UK break-evens will decrease, has caused returns to bleed significantly. We have been monitoring the fund and their trades extensively but we believe that this trade should eventually reverse course and result in profits for the fund. In effect, they have the same viewpoint as LGT Vestra regarding UK breakevens but their expression of this trade has been rather more aggressive. When this trade does start to reverse it could quite quickly result in a change of fortunes for the fund. The fund is down nearly 9% since inclusion to the time of writing and this trade has taken -0.33% from the overall performance of the Balanced portfolio.

Morgan Stanley Asia Opportunity: The MS Asia fund was included as a high beta, high octane exposure to Asia and China in the hope that it could be a big beneficiary of some of the key themes and trends that we believe will emerge in the region over the next 5-10 years. We have been positive on Asia for a while now and the inclusion of this fund was an expression of this view, with the fund expected to be a direct beneficiary of the region's continued economic growth. We were well aware that the fund is noticeably more directional or high conviction than some of our other Asian holdings, such as Stewart Asia Pacific Leaders, but were happy to hold the fund as part of a larger diversified basket of Asian holdings. Following the quite extreme and unexpected moves by the CCP earlier this year, the fund has suffered significantly and has reversed some of the impressive gains that it made 2020. The fund is down -17.45% at the time of writing, leading to a -0.70% detraction to returns. It is worth mentioning that the Schroder Asian Total Return (ATR) fund was able to provide some protection via its derivatives as it held some Chinese puts and the more defensive Stewart APAC Leaders fund only fell -1.14% in a turbulent July. On aggregate our Asian equity holdings produced a similar return to the index in July, vindicating the combination of holding Stewart APAC, Schroder ATR and MS Asia together.

Outlook for 2022

What's important is to focus on the long-term outlook and not get too drawn into the short-term dramatic headlines – although, we do have to be aware of the current macroeconomic backdrop and factors influencing short-term price movements. We have a strong emphasis on owning good quality companies that can compound over time, regardless of the macroeconomic news around them. Owning these high-quality companies gives us optionality as their strong balance sheets and experienced management teams will protect us if markets waiver, but also the quality of their brands and strong product suites should mean that they should also be relatively insulated. For example, some of the top underlying holdings in our Balanced portfolio are very established companies and have navigated many economic cycles and weathered various storms. Some of our themes for 2022 are outlined briefly below.

Volatility to remain
After a good year for a lot of asset classes, the case for significantly increased volatility is easy to make, whether this is due to the new COVID-19 variant, Central Banks intervention, inflation not receding as expected, or geopolitical risks stemming from Russia and China. Heightened volatility should lead to greater market inefficiencies. Our, 'active' approach to portfolio management should enable us to take advantage of these inefficiencies.

Market volatility is why it is so important to maintain a diversified asset allocation, including fixed income and absolute return, and to focus on the long-term. It is worth noting that downside protection is something we pride ourselves on, and this can be seen in our historic drawdown and volatility figures.

Value/growth gyrations to continue
Throughout 2021 markets have continued swinging between value and growth styles, largely driven by inflation and inflation expectations. This, in our view, is likely to continue. However, the speed at which these rotations happen means the trades are tricky to time and getting involved risks being whipsawed. In this economic climate, we continue to favour companies with high margins, strong balance sheets, relatively low labour and capital intensity, with recurring revenues and growing earnings.

Watch out for bond yields
We will continue to monitor Central Banks actions, as this has a direct impact on the bond market. Over the past year, with inflation rising across the developed world, the Fed and the BoE have had to pare back their accommodative stance at a faster pace than previously envisaged. Further action cannot be ruled out. This will result in heightened bond volatility, providing us with opportunities through our active approach.

COVID-19
The world now understands its enemy far more clearly than it did back in March 2020, but the virus will continue to evolve and impact lives in 2022. Fundamentally, however, vaccines work and whilst the virus is getting more virulent, it is hopefully becoming less deadly and will eventually become endemic. Vaccine uptake and the emergence of new strains will drive short-term sentiment and we will likely experience higher volatility in reaction to the data as a result.

To summarise, the LGT Vestra Model Portfolios continue to own a collection of wonderful companies that are market leaders, robust and adaptive. This point can be illustrated by looking at the top five underlying holdings in our Balanced portfolio: Microsoft, Unilever, RELX, Visa and Diageo. These forward-thinking companies, but also our high-quality fixed income and absolute return funds should prove us well as we roll into 2022 with elevated volatility.

Finally, from all the MPS team, we wish you a happy (and healthy) Christmas and look forward to seeing you in 2022!

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