

Diversification is key as risks remain

14th September 2022

In summary

- The continued concern over the impact of high inflation, and the central bank response to it, has been a key driver of the drawdowns of major indices
- Bonds have been vulnerable to an interest rate rising environment
- Absolute Return funds have provided ballast in the lower risk model portfolios

So far, 2022 has been a challenging year for investors in both bonds and equities. The below table outlines the year-to-date performance of indices across both asset classes.

Index	Performance (YTD)
Bonds	
Barclays Global Aggregate Bond Index	-16.54%
IA UK Index Linked Gilts Index	-27.85%
FTSE Actuaries UK Conventional Gilts	-21.22%
Equities	
S&P 500 (USD)	-14.31%
Nasdaq 100	-24.06%
FTSE 100	+2.62%

Source: FE Analytics as at 13/09/2022

Whilst the FTSE 100 is up +2.62%, this has done little to change the fortunes of the globally diversified MSCI ACWI, which is also down -14.19% (USD)^[1].

As central banks are aggressively raising interest rates in response to high inflation, we have seen sharp drawdowns across major indices. While government bonds have in recent decades provided protection relative to equities during periods of market turmoil, inflation has a detrimental impact on both asset classes. As such, multi-asset investors have had to search harder for effective ways to allocate client capital. Since the start of the year, it has been crucial to be strategic and tactical with fixed income exposure, avoiding those areas most vulnerable to extreme drawdowns, but also remaining active, in order to capitalise from the higher yields now on offer.

Absolute Return providing ballast

For some time now, in the lower risk model portfolios, we have utilised absolute return funds in place of a portion of the bond exposure. This is due to being cognisant of the fact that bonds were vulnerable to an interest rate rising environment. In preparation for this eventuality, we started allocating to multi-asset funds such as Troy Trojan and CG Absolute Return as well as Ruffer Diversified Return upon the launch of their daily dealing strategy. Since the start of this year, the Ruffer strategy is flat, CG Absolute Return is down 0.30% and Troy Trojan is down less than 2%. Given the moves we have seen in the wider market, the diversified and low risk return profile of these funds has provided important defensive characteristics within the overall portfolio. The lowest risk model portfolio, the Defensive portfolio, has 20% allocated to absolute return strategies, around one third of the allocation that would ordinarily be made to bonds. In our Balanced (medium risk) portfolio, there is a 14% allocation to the absolute return funds mentioned above.

Looking forward

This year, both bonds and equities have been hurt by stubbornly high inflation and a dramatic change in the expected path of interest rates. However, when looking at monthly data going back to 1976, according to analysis carried out by Vanguard^[2], the nominal returns of stocks (S&P 500) and bonds (Barclays Global Aggregate Index) have both been negative 15% of the time. Looking at the same data set, investors have never experienced bonds and equities (same proxy indices) being down for three years, and only 0.4% of the time have bonds and equities been negative over a one-year time period.

Importantly, the LGT WM Model Portfolios do not just invest in single indices, and as demonstrated above, we are actively utilising alternative asset classes such as absolute return to provide ballast in the current market environment. We are also tactically holding cash across the portfolio range on a short-term basis, as we see both heightened volatility of individual holdings, but also higher correlations between bonds and equities. We expect to deploy this cash in the coming months, as we see opportunities and perhaps approach peak bearishness in markets.

Important information

This communication is provided for information purposes only and is intended for the exclusive use of the recipient to whom it has been directly delivered by LGT Wealth Management UK LLP and is not to be reproduced, copied or made available to others. The information presented herein provides a general update on market conditions and is not intended and should not be construed as an offer, invitation, solicitation or recommendation to buy or sell any specific investment or participate in any investment (or other) strategy. Past performance is not an indication of future performance and the value of investments and the income derived from them may fluctuate and you may not receive back the amount you originally invest. Although this document has been prepared on the basis of information we believe to be reliable, LGT Wealth Management UK LLP gives no representation or warranty in relation to the accuracy or completeness of the information presented herein. **The information presented herein does not provide sufficient information on which to make an informed investment decision.** No liability is accepted whatsoever by LGT Wealth Management UK LLP, employees and associated companies for any direct or consequential loss arising from this document. LGT Wealth Management UK LLP is authorised and regulated by the Financial Conduct Authority.