FUSION ASSET MANAGEMENT

Fusion DFM
Rebalancing Update and Market Comments

26 April 2021

Global equity markets climbed to new highs in the first quarter of 2021. Robust income growth, record household net worth and high private savings point to significant support for consumer spending as the pandemic constraints subside. The continued strength of the stock market is not surprising given the optimism surrounding an economic recovery this year. Instead, what is most interesting about the continued push higher in stocks is the rotation of the top performing stocks and sectors. Last year's losers have become this year's winners; energy and financials are the prime examples. These two sectors were among the worst performers in 2020. This year energy stocks are up 30.6% and financials 15.9%. A stark contrast to technology up 2.1%.

With inflation concerns escalating, many investors are becoming increasingly concerned about how much further rates could rise. Although the US Federal Reserve believes inflation concerns are temporary, investors' fears could put further pressure on bond prices, causing some to question the role of bonds in a portfolio.

At the start of the year, we wrote that we expected a good pace of recovery in the UK, and we are happy to confirm that it has outpaced previous expectations. After suffering its worst recession in over 300 years, the UK economy is projected to grow by 7.25% in 2021, up from the previous forecast of 5%. The Bank of England has kept interest rates on hold as it forecasted the fastest annual pace of growth for the British economy since early on during World War II, largely as a result of the rapid rollout of coronavirus vaccines.

Emerging markets equities lagged behind developed markets despite their impressive start to the year. EM vaccine programs lagged developed markets. A pick-up in daily new cases of Covid-19 led to renewed activity restrictions in some countries. Meanwhile, a marked increase in US Treasury bond yields pressured higher growth areas of the equity markets and accompanying US dollar strength was also a headwind for EM.

After strong outperformance of Fusion portfolios in the previous calendar year, portfolios underperformed their benchmarks by 4% on average in Active portfolios and by 2% in Optima. This underperformance comes from a sharp growth of inflation expectations, that hit hard the performance of bonds and growth equities which were overweighted in comparison to the benchmark.

Performance overview

Active Range

Year-on-year return ranges from 10.1% for the Active 1 portfolio to 21.6% for Active 5 across all of the risk levels. The underperformance of Active portfolios against the benchmarks is between 1% and 4%. This underperformance comes from a low base effect of the benchmark in April of the previous year, as well as an underperformance of Fusion portfolios in the last quarter.

Since the last quarterly re-balancing, the Active portfolios delivered slightly negative returns ranging between -1.9% for low risk to -0.6% for high-risk portfolios.

Optima Range

Year-on-year performance is strongly positive for all programs, with the Optima range delivering from 8.6% return for the Defensive portfolio to 22.4% for Generation. The average underperformance against the benchmark is the same as for the Active range.

Fusion Optima portfolios showed moderately positive results since the last quarterly re-balancing, with portfolio returns between -0.2% for the Defensive portfolio to almost 2.6% for the Generation portfolio.

Market Commentary

Global equity markets have been volatile, partially due to the volatility in bond markets. But this headwind should ease later in Q2, once inflation readings start to stabilize. On the growth and earnings front, investors look forward to a more complete reopening of the global economy. Additionally, as the buyback 'blackout period' ends (when programs can kick in) there will be the next inflow of corporate funds into the equity markets – further lifting risk and pulling equity liquidity out of the markets.

Markets' positive view on the cycle also naturally puts some upward pressure on bond yields. In part, this is because bullish equity markets imply less "safe haven" demand for government bonds. But the move is principally driven by fears that stronger activity and higher fiscal spending will lead to higher inflation. On this point, Fusion only partially agrees with markets: we think inflation will rise, but only mildly and temporarily. Contrary to markets' fears, we think inflation remains structurally low. Fusion manages this short-term volatility by diversifying bond portfolios, keeping bond duration in check, and by incorporating some positions in Commodities in low-risk portfolios.

The firm's outlook for emerging markets equities overall remains positive in anticipation of a stronger rebound in global growth over 2021. Interest rates remain a factor to watch closely, however. The yield on the 10-year US Treasury bond has risen steadily since August last year, from 0.5% to 1.7% by the end of March. During this time, emerging markets equities continued to push higher. When yields are gradually rising due to a strong recovery in economic growth, emerging markets can outperform, particularly the economically sensitive, traditional value securities, such as materials, energy, and financials. However, should the increase in yields become too sharp and sudden, the asset class may weaken.

The quarterly and yearly performance figures are shown in relation to the Fusion quarterly rebalance dates: 20Apr2020, 21Jul2020, 16Oct2020 , 26Jan2021

Re-Balancing Portfolios

Looking forward, we continue to combine strategic allocations through models with tactical adjustments, based on our current view of global markets.

On the asset allocation side, there are number of changes to the portfolios reflecting the main themes highlighted in the market overview:

- Increase the weights allocated to developed market equities, especially UK, due to a high vaccination rate. It should speed up recovery of the economy which suffered from corona-crisis more than other developed countries.

- Increase the weights of commodities in low-risk programs.

- Decrease the weights of fixed income.

Asset selection

Optima Range

While Chinese equities suffered during the previous quarter, Chinese bonds have done well and we continue to diversify fixed income exposure. This time it concerns risky portfolios to which we have extended to the changes that we previously made to other portfolios during the last rebalance. Some weights were reallocated from SPDR Bloomberg Barclays UK Gilt UCITS ETF to iShares China CNY Bond ETF in the Generation portfolio and SPDR Bloomberg Barclays Global Aggregate Bond UCITS ETF to iShares China CNY Bond ETF in the Growth portfolio.

Also, Avi Global Trust PLC has been replaced by Baillie Gifford UK Growth Fund due to a greater allocation to the UK region. A small weight was transferred from iShares Core GBP Corp Bond UCITS ETF to Baillie Gifford UK Growth Fund due to our positive view on equity and the UK especially. This change only applies to the Generation portfolio.

Active Range

As a result of our constructive view on UK equities, allocation to UK Equity increased at the expense of bond weights. This was done by changing weights of funds which are already in the portfolios. The weights were moved from developed government bonds proportionally to Royal London Sustainable Leaders Trust for portfolios from Active 1 to Active 3 and from UK IG funds to DME UK funds proportionally in the Active 5 portfolio.

In the Active 5 portfolio, a new UK fund has been added to diversify allocation - ASI UK Mid-Cap Equity Fund. The weight allocated to UK equity has been distributed between the existing fund, Royal London Sustainable Leaders Trust, and ASI UK Mid-Cap Equity Fund, with a split of 2/3 and 1/3 respectively.

Following our asset selection process, Jupiter European Fund has been fully replaced and now European equity exposure is distributed between Premier Miton European Opportunities Fund and Baillie Gifford European Fund equally. This change concerns only Active 5 portfolio.