Fusion DFM
Rebalancing Update and Market Comments
20 July 2021

The second quarter brought a flow of good news despite a sizable drawdown related to the peak of inflation fear in the middle of May. Overall, portfolios achieved positive returns close to 1.7% across all series and risk levels. Most of the asset classes, including developed market equities and bonds, showed positive returns upon declining rates and increased vaccinations around the world.

Major stock indices further built on their already impressive first quarter results. This, however, excluded emerging markets (EM) equities which suffered from the tightening of policy in China against their leading technology companies. China's technology companies have been largely unencumbered by regulation as they grew into some of the world's largest corporations. This has changed in the past year as regulators have started to pay more attention, especially to those companies which operate in the financial sector. Beijing's tightening regulations have hit a number of sectors, including micro lending and what it viewed as monopolistic practices on internet platforms. The government's long-term objectives focus on technology, consumption and efficiency. Therefore, we conclude that Beijing does not intend to destroy these sectors and innovative companies will continue to be the growth drivers. We maintain portfolios' EM exposure.

Another story of this quarter is a pause of equity rotation. The previous year's winners *Growth** stocks delivered same return, as did the losers - *Value** stocks. *Value* won back a significant part of the COVID drawdown from the previous quarter. The rotation started last autumn with the approval of COVID-19 vaccines and in anticipation of an economic reopening. Another negative factor for *Growth* was a rise in US Treasury yields which are more sensitive to rising interest rates. This quarter, *Value*'s outperformance stalled as yields peaked in the middle of May and then pulled back, allowing growth stocks to comeback.

In the last rebalance notes we concluded that developed government bonds have limited downside as the inflation story was most likely to be transitory. This left us with a conviction that there was a potential for bonds prices to come back. This indeed has realized this quarter as bonds prices returned to their Q1 levels.

Active Range

Since the last quarterly re-balancing the Active portfolios delivered moderate positive returns ranging between 1.7% for low-risk to 2.1% for high-risk portfolios. The portfolios slightly underperformed their respective benchmarks by 0.5% on average. A significant part of this underperformance comes from emerging markets which were affected by China's policy response.

Year-to-date return is ranging from 0.9% for the Active 1 portfolio to 4.3% for Active 5 across all of the risk levels.

Optima Range

Fusion Optima portfolios performed positively since the last quarterly re-balancing, with portfolio returns between 1.5% to 1.9%. The portfolios also slightly underperformed the benchmark by 0.6% on average. A significant part of this underperformance also comes from emerging markets which were affected by China's policy response.

Year-to-date performance is positive for all programs, with the Optima range delivering from 1.9% return for the Defensive portfolio to 4.9% for Generation.

Growth stocks are those companies that are considered to have the potential to outperform the overall market over time because of their future potential.
Value stocks are classified as companies that are currently trading below what they are really worth and will thus provide a superior return.

Overall situation

The powerful economic restart is broadening as more and more people get vaccinated, with Europe and other major economies catching up with the US. Despite new COVID variants, we see that cases are an order of magnitude less lethal and severe in the UK compared with the previous wave in January, and its the same situation in other countries with high a percentage of vaccination. We expect that we will witness the same dynamics in other countries who are lagging behind in vaccination but are going to catch up soon.

With positive signals of economic recovery, we have slightly increased the proportion of equities in all Fusion portfolio series. We maintain the current proportion of equity styles in our portfolios with a balance between ***Growth*** and ***Value*** stocks as the world changes and new technologies (mostly to ***Growth)*** will stay with us while the former losers, ***Value*** stocks, still have a room to run.

Recharging Emerging Markets Growth

Economy of region leader - China's continues to recover from the COVID-19 pandemic. Its GDP increased by **12.7%** through the first half of 2021, high comparing with US GDP which increased by **5.8%.** This is particularly impressive because of the fact that in 2020 China **gained 2.3%** while the US **lost 3.5%.** This obvious economic growth has not yet revealed itself in equity prices, with Chinese equity losing around **10%,** while the US equity market has risen nearly **17%** since the start of the year.

We have a strongly positive view on Emerging markets and China especially:

- China's equities' correction looks **overdone**;
- Policy that oriented to ***quality of growth***, which limits current returns but should be positive news in the longer run and in the case of stress;
- The Asia **Green transition** stocks are aligned with the long-term policy agenda which follows the current trend to sustainability;
- Significant **gap** between emerging and developed markets fundamentals which expanded in the current year.

Despite reduced enthusiasm for the region at the moment due to worries over policy tightening, vaccine progress and regulation in China, we see a great opportunity for Emerging markets, not only the case of a bright future but also in the case of a limited global market correction.

Fusion portfolios overweight Emerging markets across all of our portfolio series at the expense of the allocation to **Alternatives.** Part of Alternatives contains **Infrastructure** on which we have a slightly negative view in the short term in the context of growing inflation. Another part incudes **Convertibles** which in turn consist of high-yield bonds skewed to Growth companies which would suffer twice in the case of growing rates.

Equity and Bonds relationship

Currently we don't see bonds as a valuable diversifier for mixed asset portfolios, as rates remain low and have limited space to go much lower in times of market stress. Developed countries sooner or later will have to raise rates as inflation is becoming real. This, however, does not concern emerging markets debt, especially China. Therefore, Fusion has reduced the allocation to Developed Government Bonds in the programs with medium-risk by transferring that weight to Cash and, a small part, to Chinese Government Bonds.

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 the following changes:

1. Reallocation from Alternatives to Emerging Markets Equity across all portfolios and both series, from 3% in Defensive programs to 7% in Generation.
2. In low-risk programs, we have replaced some part of developed government bonds with cash and Chinese government bonds. From Developed Government bonds, 5% was taken to Cash in Defensive portfolios and 2.5% in Cautious. Additionally, from 3% in Defensive to 1% in Balanced portfolios was transferred to Chinese Government bonds.
3. Minor changes include reallocations from Investment Grade to Developed Market Equities of around 0.5%, except for the riskiest portfolio.

Asset selection

Optima Range

The only new fund is HSBC MSCI Emerging Markets UCITS ETF through which the new allocation to Emerging Markets Equities has been added. It is a low-cost tracker fund which additionally should diversify our position in Emerging Markets.

The following rebalancing has been done with existing funds:

- Weight from Alternatives has been taken from each fund in equal parts. As such, the weights of Renewables Infrastructure Group Ltd, iShares Global Infrastructure UCITS ETF, SPDR Morningstar Multi-Asset Global Infrastructure UCITS ETF and SPDR Refinitiv Global Convertible Bond UCITS ETF have been lowered.
- In the case of bonds, equal weight was taken from SPDR Bloomberg Barclays Global Aggregate Bond UCITS ETF and iShares Global Govt Bond UCITS ETF.

Active Range

The only new fund is iShares Emerging Markets Equity Index Fund through which the new allocation to Emerging Markets Equities has been added. It mirrored the asset selection choice in the Optima range as a low-cost tracker fund.

As in Optima, further portfolio rebalancing has been performed with existing funds:

- Alternatives with reduced weight: Polar Capital Funds plc - Global Convertible Fund, FP Foresight Oeic-FP Foresight Global Real Infrastructure Fund and Fidelity Investment Funds ICVC - Global Property Fund. Weight has been reduced in equal parts across all alternatives funds available in each specific portfolio.
- For bonds to cash reallocation, the funds selected were Vanguard Investment Series PLC - Global Bond Index Fund and PIMCO GIS Global Bond Fund. There are no suitable funds to allocate money to Chinese debt, so this part remained unrealized for the Active range.