Fusion DFM
Rebalancing Update and Market Comments
1 November 2021

Recovery is heading in the right direction but at a slower pace than was expected as the global economic recovery hit some speed bumps in Q3. The Delta variant delayed some economic activity from Q3 into Q4 and 2022, while supply chain bottlenecks and higher prices dampened real growth. Fusion's portfolios delivered positive returns from 1.5% to 5.6% over all series and risk grades.

For this quarter, Developed markets equity indices show slightly positive returns despite turbulence caused by the intensification of the Delta variant during September and the end of October.

Bond prices were down, though not as much as could be expected given the level of inflation that central bankers are claiming to be transitory. Many countries remain completely locked down, while most governments continue to impose mobility restrictions over people and goods (think tariffs and red tape). This lack of movement leads to imbalances that translate into price increases and slower delivery times.

Emerging market equities declined in Q3, which saw a sell-off in Chinese stocks, concern over continued supply chain disruptions, and worries over the implications of higher food and energy prices for some markets. US bond yields rose towards the end of the quarter. Regulatory actions in China were the initial trigger for market weakness. These were compounded by the re-imposition of some Covid-19 restrictions and supply chain disruption in August, worries about possible systemic financial system risks stemming from the potential collapse of Evergrande, and power shortages.

At the last rebalance in July, we noted that the relationship between bonds and equity has significantly changed. At the end of September, correlation between the two gave us positive confirmation of what we had previously noticed. Moreover, we see close to historically low spreads in corporate bonds, which makes them twice as exposed to drawdowns. Due to the same reasons, yield in corporate bonds is low and as such income is also not attractive.

Active Range

Since the last quarterly re-balancing the Active portfolios delivered moderate positive returns ranging between 1.5% for low-risk to 3.6% for high-risk portfolios. The portfolios slightly underperformed their respective benchmarks. This underperformance comes from diversification in emerging markets, which were affected by the continuation of China's policy response and the Evergrande situation.

Year-to-date return is ranging from 2.4% for the Active 1 portfolio to 8.3% 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 2.2% to 4.2%. The portfolios also marginally underperformed the benchmarks, similar to the Active Range.

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.

ProActive Range

Fusion ProActive portfolios performed positively since the last quarterly re-balancing, with portfolio returns between 2.1% to 5.6%. The portfolios performed inline with benchmarks, except for the most and least risky portfolios which were behind the benchmark by 0.8%.

Year-to-date performance is positive for all programs, with the ProActive range delivering from 1.9% return for the ProActive 1 portfolio to 4.9% for ProActive 5.

Market Commentary

Overview

The economic recovery is expected to remain solid over the coming quarters, especially in the developed economies, with normalising labour markets and still very accommodating monetary financial conditions. However, growth is likely to remain heterogeneous amongst world regions and its strength may be affected by a number of different risks. These risks include: how countries manage the covid crisis (especially the lower vaccination rates in the United States), persistent friction in production and supply chains, a sharper slowdown in China (zero-Covid policy, “common prosperity” policies and Evergrande crisis), as well as budget uncertainties in the United States.

While it is clear that we have transitioned to the mid-cycle stage following the sharp V-shaped recovery this year, and equity returns are steadying, it is less likely that the going will be smooth. Vaccinations allow economies to reopen, but the path can be volatile due to the Delta variant. Similarly, supply chain bottlenecks should be resolved over time, but reports of shortages can lead to market nervousness. And while we expect inflation to fall in the coming quarters, the risk is that this could be delayed, causing bond yields to remain “low but volatile”.

Fixed income

Following up our previous view on bonds, Fusion continues to reduce our positions in fixed income instruments in favor of equity, especially high-quality ones, and cash as an instrument of capital preservation. This time we’ve reviewed corporate bonds.

The economic recovery has played in favour of corporate spreads this year, which saw earnings improving amid the reopening of the economy. However, things can change quickly if inflationary pressures become persistent and central banks need to taper more aggressively than the market forecasts. Currently the market isn’t pricing aggressive monetary policies at all, providing ample support to all corporates, including those with weak balance sheets (also known as zombies). But credit spreads at **record tight levels** represents a threat because they are highly dependent on accommodative monetary policies. As soon as central banks become aggressive, we can expect spreads to widen substantially and defaults to rise.

There is not much space for spreads to move tighter and we assume that rates will go up, so corporate bonds have limited upside and two potential risks underway. That’s why a significant part of corporate bonds have been replaced by high quality equity as an instrument of income in the Fusion portfolios.

Emerging Markets

Emerging markets is a risky asset class, as evidenced by periods of elevated volatility. This being so, pricing risk effectively is critical to being successful. Therefore, after a period of substantial absolute and relative weakness, we have assessed the price of Chinese assets today relative to the risk of investing there, and also how that compares to other emerging markets.

In our opinion, many Chinese assets look attractively valued on a long term risk-adjusted basis. But at the same time, Fusion see opportunities in other Emerging Markets and have decided to redistribute some weight out of Asia to markets with a higher proportion of commodity exposure such as Middle East, Russia and Africa.

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, we have made the following changes:

1. Reallocation from Investment Grade Bonds to Cash and Quality Equity across all portfolios and series, 10% has been taken from Bonds and equally distributed between Cash and Equity so overall risk should stay at the same level.
2. To follow our updated Emerging Markets view, part of the investments from the Asia Equity allocation were reallocated to Chinese government bonds, Alternatives and equities of non-Asia emerging countries. On average, 5.5% has been removed from Emerging markets across all portfolios.

Asset selection

Optima Range

Some new funds have been added to implement the asset allocation updates:

1. ***Invesco FTSE RAFI Emerging Markets UCITS ETF*** has been added as a fund with less allocation to Asian equity. As a result, the allocation to Asia inside Emerging Markets equity has been reduced by 10%.
2. Half of the weight from Corporate bonds (5%) has been moved to ***Xtrackers MSCI World Quality Factor UCITS ETF***, which tracks stocks with a high-quality factor from developed countries.
3. On average, 2% has been moved from Emerging Markets Funds equity to ***Rize Sustainable Future of Food UCITS ETF.*** This fund seeks to invest in companies that potentially stand to benefit from the accelerating transition to more sustainable food production systems. This trend was highly supported at **COP26,** the most recent annual UN climate change conference.
4. The same reallocation as above was performed with ***L&G Ecommerce Logistics UCITS ETF***, which is comprised of companies that provide "logistics" services (i.e. the warehousing of goods or the fulfilment and delivery of goods), including software solutions to companies that provide logistic services related to "ecommerce".

We have also made some changes to the weights of existing funds:

- Weights inside Investment Grade bonds were redistributed to reduce the concentration, so *iShares Core GBP Corp Bond UCITS ETF* (*SPDR Bloomberg Barclays 0-5 Year Sterling Corporate Bond UCITS ETF* for Defensive portfolio), *UBS Bloomberg Barclays MSCI US Liquid Corporates Sustainable UCITS ETF* and *iShares GBP Corp Bond ex-Financials UCITS ETF* have the same weight.

Active Range

As in the Optima range, some new funds were added to implement our updated asset allocation views:

- ***Fidelity Emerging Europe Middle East and Africa Fund*** was added as part of the allocation to non-Asia emerging markets.
- ***Ninety One Global Quality Equity Income Fund*** is a quality equity fund which received its weight at the expense of investment grade bonds.
- Around 2% was transferred from Emerging markets to ***Sarasin Food and Agricultural Opportunities***. The fund provides exposure to the food and agricultural sectors which should helps to hedge the impact of inflation on portfolios.

Weights of investment grade funds have been also rebalanced. HSBC Sterling Corporate Bond Index Fund, Royal London Corporate Bond Fund and Vanguard US Investment Grade Credit Index Fund now have same weights following the rebalance.

Re-Balancing Portfolios

ProActive Planet Range

Changes in the sustainable portfolios are inline with Fusion's other series:

- The allocation of corporate bonds has been lowered by 10% and moved to ***Vanguard ESG Developed World All Cap Equity Index*** and Cash in equal parts. This fund seeks to track the performance of the FTSE Developed All Cap Choice Index. The fund also promotes environmental and social characteristics by excluding companies from its portfolio based on the impact of their conduct or products on society and/or the environment.
- The Emerging markets allocation was lowered by around 2% and weight was reallocated to ***Sarasin Food and Agricultural Opportunities.*** Participants of COP 26 recognize the need for sustainable food systems to ensure global food security. This fund aims to take advantage of these opportunities, as it invests in companies across the food and agricultural spectrum – 'from field to fork'.

In addition to the new allocations, during this rebalance Fusion has updated funds to minimize OCFs across all portfolios with new products entering the market and becoming available on platforms. As a result, fees have been **lowered by 8.6 bps o**n average across the ProActive Planet portfolios.

Guinness Sustainable Energy Fund has been added as a cheaper option to provide exposure to the energy sector. The fund invests in companies involved in the generation, storage, efficiency and consumption of sustainable energy sources (such as solar, wind, hydro, geothermal, biofuels and biomass).

M&G European Sustain Paris Aligned Fund, Royal London Sustainable Leaders and Stewart Investors Global Emerging Markets Sustainability Fund were added to diversify exposure across some funds and different providers in the corresponding asset classes - Europe, UK and Emerging markets equities. The above funds are highly ESG rated and have reasonable fees, which help to reach our main diversification targets without excessive costs.

- ***M&G European Sustain Paris Aligned Fund*** invests in companies that contribute towards the Paris Agreement climate change goal of keeping a global temperature rise this century well below two degrees Celsius above pre-industrial levels.

- ***Royal London Sustainable Leaders*** invests predominantly in the shares of UK companies listed on the London Stock Exchange that are deemed to make a positive contribution to society.

- ***Stewart Investors Global Emerging Markets Sustainability Fund*** invests in shares of high-quality companies which are positioned to benefit from, and contribute to, the sustainable development of the countries in which they operate. Sustainability is a key part of the approach. Also, the fund has a limited allocation to Chinese equities which stays inline with Fusion's decision to reduce allocation to Asian equities.