Managed Portfolio Service

Quarterly report – Q1 2022

BREWIN DOLPHIN

Introduction

Welcome to the Brewin Dolphin Managed Portfolio Service investment review. In this report we will be covering information and events that influenced performance during the first quarter of 2022.

The first quarter began with a focus on the Omicron outbreak, rising inflation and the threat of interest rate hikes, but these issues were soon dwarfed by Russia's invasion of Ukraine on 24 February. After two months of heightened volatility, the invasion led to a sharp sell off in global equities and a decline in bond prices. Sanctions on Russia led to a surge in commodity prices, contributing to a further increase in inflation and concerns about supply chain disruption.

In the US, the economy began to show signs of overheating as unemployment fell and the annual inflation rate surged to a 40-year high of 7.9% in February. The Federal Reserve voted to lift interest rates by a quarter percentage point in March – the first rate increase since 2018 – and pencilled in six more increases by the end of the year.

Here in the UK, the Bank of England raised rates at three consecutive meetings for the first time since 1997, taking the base interest rate to 0.75%, amid warnings inflation could peak at close to 9% this year. The Office for Budget Responsibility warned that soaring prices, an increase in the national insurance rate and the freezing of income tax thresholds meant households were on course for "the biggest fall in living standards in any single financial year since ONS records began in 1956/57."

Surging inflation is not a supportive environment for equities, but it is worth noting that price rises are being partly driven by the reopening of economies as countries learn to live with the presence of Covid-19. It is quite common for stocks to continue to rise alongside interest rates, as both reflect strong economic activity. Investors hold stocks knowing that, at some stage, the economic cycle may take a turn for the worst, while remembering that stocks offer the greatest scope to protect wealth against the ravages of inflation over the long term.

The big picture in Q1 2022

- The first quarter was dominated by Russia's invasion of Ukraine in late February. The unfolding human tragedy fed through into global financial markets, resulting in a steep sell off in global equities and a decline in bond prices.
- The conflict is adding to inflationary pressures in Europe and the US, but we do not believe the war, on its own, will be enough to derail global economic expansion. The key uncertainty is the continued free flow of commodities out of Russia, particularly oil and natural gas.
- The rally in energy prices will weigh on economic growth, but absent any major supply shocks or renewed price surges, it is unlikely to send the economy or markets into a tailspin. Considering oil's historical relationship with global growth and the US dollar, it would be a surprise to see the oil price continue to accelerate beyond the second quarter.
- Although stock market sentiment has largely recovered, it is still on balance slightly bearish. Nevertheless, equity valuations are reasonable in absolute terms and still attractive relative to bonds.
- The US yield curve inverted towards the end of the quarter. Part of the reason for this inversion is the low 'term premium' – i.e. the compensation that fixed income investors receive to compensate for uncertainty around central bank policy and inflation. This may suggest the economy is not as late in the cycle as it had been in the past when the curve inverted.
- US unemployment fell to 3.6% in March, its lowest level since the pandemic struck. While this seemingly increases pressure on the Federal Reserve to hike interest rates, it appears the labour force participation rate might rise, which has positive implications for growth. This would mean more jobs can be created before true full employment is reached and, in turn, reduce the pressure on the Fed to tighten monetary policy.
- The Fed and the European Central Bank (ECB) downgraded their expectations for economic growth and revised up their expectations for inflation. They also moved toward a more hawkish stance to reining in inflation, which has triggered an upward movement in bond yields. But with slack in the economy remaining and the widening in periphery spreads, it is likely the ECB will tighten policy at a slower pace than other central banks.

Market overview Q1 2022

- Global equities fell -1.7% over the first quarter as the war in Ukraine, surging energy prices and rising inflation weighed on investor sentiment.
- UK and emerging market equities were the only regions in positive territory, with a return of +0.5% and +2.8%, respectively.
- The extremely negative impact of the Ukraine war on Russian equities was offset by strength from the rest of EM ex Asia as commodity prices soared.
- Chinese equities were negatively affected by renewed Covid-19 outbreaks, which led to further lockdowns in some major cities.
- Bonds retraced their previous quarter gain and fell by -6% as central banks began tightening their monetary policy and increasing interest rates.
- Gold rose by over +10% and may continue to rally further. However, given the upside potential in real bond yields, this may be limited.
- Absolute return rose by +3.8%, whereas global real estate investment trusts (REITs) fell by -2.4%.

MPS performance

MPS PERFORMANCE (%)												
	Q1	2022 YTD	1yr	2yr	3yr	4yr	5yr	2021	2020	2019	2018	2017
Cautious Portfolio	-4.3	-4.3	0.0	14.4	11.6	17.2	18.4	3.7	6.7	11.2	-2.7	5.9
Cautious Higher Equity Portfolio	-4.4	-4.4	0.9	17.7	13.6	19.0	20.2	5.5	6.6	11.2	-2.7	5.9
Income Portfolio	-4.3	-4.3	1.6	23.1	17.1	24.3	25.4	6.8	6.8	14.5	-4.2	8.1
Income Higher Equity Portfolio	-4.1	-4.1	2.6	27.1	19.4	26.5	27.6	8.4	6.9	14.5	-4.2	8.1
Balanced Portfolio	-4.5	-4.5	3.2	33.1	23.6	32.7	34.2	10.6	7.8	16.6	-3.9	8.8
Growth Portfolio	-4.8	-4.8	4.3	43.4	30.7	41.1	46.1	13.5	10.3	18.4	-4.0	11.8
Global Equity Portfolio	-4.8	-4.8	5.6	52.3	35.4	47.9	52.6	16.0	10.0	22.1	-4.8	12.8

All figures shown above are calculated to 31 March 2022.

Performance Calculation: All income is reinvested. Performance is shown inclusive of underlying fund charges but gross of Brewin Dolphin's investment management charge. Deduction of this charge will have the result of reducing the illustrated performance. Neither simulated nor actual past performance are reliable indicators of future performance.

MPS performance highlights Q1 2022

Asset Allocation

What worked and why?

As central banks tightened policy in the face of rising inflation, bonds which generally pay fixed amounts to investors, lost value. The portfolios' underweight to bonds was therefore helpful.

Oil and gas stocks rose over the quarter and the UK equity market has more of these than the wider global equity market.

Being overweight to UK and emerging market equities and underweight to bonds were the key positive contributors to performance this quarter.

What didn't work and why?

Alternatives fell but were more resilient in the face of falls in the value of bonds and equities.

Fund Selection

What worked and why?

BNY Mellon and JPM US Equity Income delivered positive returns thanks to their exposure to financial stocks. The more defensive strategy of Newton Asian Income contributed positively, as did Man GLG Japan Core Alpha.

The DWS US TIPS strategy also performed well.

What didn't work and why?

Baillie Gifford American, Ninety One UK Equity Income and Jupiter UK Mid & Large Cap Crossover struggled due to their focus on growth stocks.

MPS portfolio changes Q1 2022

Asset Allocation

On a tactical basis, the Asset Allocation Committee agreed in February to reduce the equity overweight and allocate the proceeds to absolute return. The equity overweight has been allocated to reflect each region's benchmark weight and our desire to have a balanced regional equity positioning.

In March, the committee increased the allocation to gold by 1%, bringing it in line with the strategic asset allocation benchmark. Corporate bonds were reduced by 1%, with half taken equally from UK and global bonds where appropriate.

Fund Selection

The MI Select Managers Alternatives fund has been included in MPS. The fund invests in property, commodities and absolute return strategies in order to give diversification to clients' portfolios.

MI Select Manager fund weights

MISM FUND WEIGHTS			
Date	**MISM Fund**	**Mandate**	**Weight (%)**
31/03/2022	MI Select Managers Bond Instl Inc	Robeco Global Credits	29
		PIMCO UK Corporate Bond	24
		Insight UK Government Bond	16
		Colchester Global Bond	17
		Allianz Strategic bond	4
		DWS US TIPS 10yr+	10
31/03/2022	MI Select Managers NA Equity Instl Inc	JPM US Equity Income	28
		Baillie Gifford American	14
		BNY Mellon US Equity Income	28
		Artemis US Select	30
31/03/2022	MI Select Managers UK Eq Inc Instl Inc	Ninety One UK Equity Income	33
		Man GLG UK Equity Income	34
		Threadneedle UK Equity Income	33
31/03/2022	MI Select Managers UK Equity Instl Inc	JPM UK Equity Core	31
		RWC UK Equity Income	27
		Lindsell Train UK Equity	25
		Jupiter UK Mid & Large Cap Crossover	9
		Teviot UK Smaller Companies	8
31/03/2022	MI Select Managers Alternatives Fund	Schroder Global Cities	9
		Muzinich and Co	30
		Commodities and other alternatives	46
		Absolute Return Funds	15

The value of investments, and any income from them, can fall and you may get back less than you invested. Neither simulated nor actual past performance are reliable indicators of future performance. Investment values may increase or decrease as a result of currency fluctuations. Information is provided only as an example and is not a recommendation to pursue a particular strategy.

Asset Allocation Committee investment outlook

These views are implemented across our portfolios but there may be deviations where asset classes or suitable investments are unavailable or excluded.

Cash

We have boosted our cash overweight. Cash has become a relatively attractive asset class at a time when it appears too early to boost bond exposure and the risk/reward backdrop for equities is deteriorating. Moreover, the Bank of England base rate is now at 0.75% and is likely moving higher.

Bonds

We believe that inflationary pressures are set to move lower as the year progresses. However, inflation may stay stronger for longer than most investors believe. Against this backdrop, and with central banks turning more hawkish and given the underlying strength in the economy, safe-haven bond yields probably have additional scope to move higher. This justifies a continued underweight position in bonds. Within a bond portfolio, we continue to favour inflation-linked over their corporate and nominal government bond counterparts.

Global Equities

Over the past month, the inflation/growth mix has deteriorated. Central banks have become more hawkish, and bond yields have backed up sharply. All this has fast forwarded us to a later stage of the economic cycle. Sentiment is not as bearish as it was several weeks ago, and there has been a decent rally to sell into. Against this backdrop, we have cut our global equity exposure. Nevertheless, we believe it is still appropriate to maintain a small equity overweight. While the war in Ukraine is bad for both growth and inflation, it probably won't be enough to derail the global economic expansion. The yield curve inversion is an ominous signal. However, part of the reason why the yield curve has already inverted is that the 'term premium' is so low. This may suggest the economy is not currently as late cycle as it has been in the past when the curve inverted. Although sentiment has recovered as the market has rallied, it is still on balance slightly bearish. Equity valuations are reasonable in absolute terms, and still attractive relative to bonds.

Alternatives

We hold a neutral position in gold. The potential for real bond yields to rise anew (a headwind for gold) is offset by the potential for a further rise in geopolitical risk. We retain our underweight in property. Because our property benchmark is comprised of listed stocks (developed world REITs), we evaluate property against the broad global equity market. REITs' dividend yield spread versus the broad global market has dropped sharply. If history is a good guide, this points to REIT underperformance this year. On the back of our equity downgrade, we have boosted our overweight to absolute return. This is a relatively attractive asset class at a time when the risk/reward backdrop for equities is deteriorating and when it appears too early to boost bond exposure.

UK Equities

UK equities remain cheap. To the extent that global government bond yields have scope to rise further over the medium term, this should support the relative performance of the cheaper, value-style exposed areas of the market like the UK. Nonetheless, we are not banking on a sustained, large outperformance of value in the months ahead. We therefore hold a UK position that is consistent with return expectations that are broadly in line with the global equity market over the medium term.

US Equities

With its large weightings in technology and other tech-like names, the US is heavily exposed to the growth style. To the extent that global government bond yields continue to rise on the back of continued economic growth and tightening monetary policy, the relatively expensive US market should suffer periodic bouts of underperformance. Nevertheless, we remain structurally bullish on the US, and believe any underperformance will prove fleeting.

Europe ex-UK Equities

Europe ex UK relative performance is typically inversely related to the fortunes of the global tech sector, given that Europe ex UK has very low weightings in new economy stocks. Tech has underperformed this year, which makes Europe ex UK's underperformance look out of place. If bond yields continue rise as we expect, that should ultimately hold back tech relative performance. That said, the war in Ukraine and high natural gas prices are a headwind for Europe. Against this backdrop and with the region trading on undemanding valuation multiples, we maintain an allocation versus benchmark that is consistent with our expectations of a total return broadly in line with that of the global equity market.

Japan

With the plunging population and birth rate, Japanese equities are confronting major demographic headwinds. This backdrop acts as a strong disincentive for Japanese businesses to invest and is a structural deterrent to equity market outperformance. More immediately, Japanese equities have underperformed sharply in common currency terms given the very weak yen. Although there are few catalysts on the horizon that would support Japanese equity outperformance, Japan looks near-term oversold. As such, we judge near-term relative performance prospects as balanced.

Asia ex-Japan Equities

Chinese and Hong Kong equities have sharply underperformed other countries in Asia ex Japan over the past year, so their weight in the index has dropped. But they both still account for about 42% of the market cap of Asia ex Japan, so what happens in China will be instrumental in terms of regional relative performance. The main questions confronting Chinese equity investors relate to policy. These include big tech regulation, real estate policy, the outlook for its zero-Covid policy approach, and the potential for pro-growth policy support. The bad news is that China is currently battling its biggest Covid wave since the pandemic began. The good news is that the authorities are taking steps to stabilise growth.

Emerging markets ex-Asia

Russian-listed stocks dragged down the EM ex Asia index following its invasion of Ukraine. Last month, index providers MSCI and FTSE Russell removed Russian equities from their indices, so they no longer impact performance. However, with Brazil, Saudi Arabia, South Africa, Mexico and the UAE as the countries with the highest market cap weightings in EM ex Asia, it is still a very commodity exposed index. Looking ahead, there are crosscurrents confronting the region. On the one hand, EM ex Asia remains very cheaply valued and there is scope for the economies in this index to bounce back as the Covid crisis subsides. On the other hand, our base case expectation is that the oil price moderates somewhat in the second half of this year. Against this backdrop, we believe only modest exposure to this pro-cyclical region is appropriate.

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