Sterling Aberdeen Standard CPI+2.0% Portfolio

Quarterly Review

March 2022

I. Quarterly commentary summary

1. Macro and market commentaries

Amid a volatile market environment, global equities and bonds both made negative returns in aggregate.

Global equities suffered a difficult quarter, falling materially in January and to a lesser extent in February before erasing some losses in March. Worries over escalating inflation in many developed economies and the prospect of rising interest rates accounted for the sell-off in the early weeks of 2022. Further market volatility followed, as Russia invaded Ukraine on 24 February: energy and food costs surged in response, oil prices hit multi-year highs and natural gas prices soared. European and US stock markets were particularly weak, but Asian and emerging markets also dropped, especially in China, which was affected by Covid-19 lockdowns.

In fixed income, global government bonds experienced a dismal quarter, with US Treasuries suffering their worst quarter in decades. Despite the asset class being regarded as a haven, bond yields rose sharply (and bond prices fell). Investors reacted negatively to the pronounced shift by the US Federal Reserve (Fed) to a more hawkish stance on monetary policy. Faced with inflation at a 40-year high and a strong jobs market, the central bank increased its key interest rate by 25 basis points and signalled as many as six more rate increases in 2022. Elsewhere, the Bank of England increased its base rate. Bucking the trend, the Bank of Japan and People's Bank of China kept monetary policy loose, amid long-term deflation worries and slowing growth concerns, respectively. Corporate bonds also suffered a poor quarter. Investment-grade and high-yield debt performed weakly, as investors worried about multi-decade high inflation levels in the US and Europe leading to higher interest rates.

2. Performance review

The portfolio returned -5.09% over the quarter, with most assets contributed negatively. The allocation to absolute return strategies and our equity positioning both dragged on performance, although this was marginally offset by our listed alternative (infrastructure and special opportunity) exposure.

3. Macro and market outlook

The major risks faced by financial markets are, firstly, the withdrawal of central-bank policy at a time of heightened macroeconomic uncertainty and secondly, high-asset valuation and rising stagflation risk that is exacerbated by the Russia-Ukraine war.

For the former, the market has already priced in nine to ten hikes from the Fed within the next year. On the other hand, we believe Chinese policymakers will continue with their easing measures to stabilise growth but measures will be domestically focused and unlikely to create strong tailwinds to the global economy.

For the latter, we understand from history that equities on average correct 5–7% and take about three weeks to bottom during geopolitical events. This time, however, high inflation and hawkish central banks make the situation trickier. We think the market has priced in the present level of conflict but not the downside scenario of sustained disruption to commodity supply and further escalation of Western sanctions/Russian retaliation. In the near term, we are likely to see a range-bound equity market. We will stay on our course of rotating opportunistically between broad market and late-cycle exposures such as commodity producers, and gradually adding to long-end government bonds as a hedge for a recessionary outcome down the road.

4. Hgh level portfolio positioning

The portfolio is well balanced. We have exposure to defensive assets such as Australian investment grade bonds and Australian inflation-linked bonds as a layer of cushion. We also hold growth assets that offer sector, thematic and geographical tilts to capture opportunities across different themes (structural growth, high inflation and high rates, supply side recovery). We have diversifying strategies in place, such as absolute return strategies that are macro-investment ideas, as well as our long-term allocation to listed alternatives that tap into idiosyncratic price drivers. We keep a close watch on any market developments and manage the portfolio actively.

During the quarter, we dynamically adjusted our equity position, given the volatile market. We bought VIX calls to provide cost-efficient protection in light of potential spikes in equity market volatility. We rotated part of the international exposure to Australian equities as we believe the Australian economy is set to benefit from the exports in commodities and improving terms of trade. We also rotated from international equities to commodity basket equities (gold miners, energy companies, copper miner) to benefit from the high inflation environment.

Within fixed income, we reduced exposure to global high yield and emerging market debt, then added to Australian inflation linked-bonds and Australian government bonds to gain more downside protection.

Key information[1]

This portfolio aims to achieve a real return equivalent to 2% per annum above inflation (before fees) over a rolling 3-year period.

- **Benchmark:** CPI plus 2.0% p.a.
- **Investment Time Horizon:** 3+ Years
- **Portfolio launch date:** 31 August 2020

[1]Source: abrdn, 31 March 2022

II. Asset class review

Listed equities:

Following a strong end to 2021, volatility returned to equity markets in the first quarter with global equities delivering a mid-single digit negative return over the quarter. The initial impetus for this was hawkish comments from the Fed and the expectation of more rates hikes from central banks in other developed markets. This was exacerbated by concerns over the war in Ukraine and by early March global equities had fallen by more than 12%. However, sentiment improved during the reminder of March and markets recovered over half of their losses.

Against this backdrop, our equity allocation performed broadly in line with global equity markets. However, there are a few areas that outshined the overall equity market. The Australian equity position performed strongly as the market rose on the back of the expectation that the Australian economy is set to benefit from the exports in commodities and improving terms of trade. Our granular sector tilt in commodities basket equity also added to the performance.

Infrastructure :

Infrastructure delivered a positive return over the quarter with contributions coming from a number of different holdings.

A number of renewable infrastructure companies announced strong fourth-quarter net-asset value (NAV) returns, continuing the trend witnessed in recent quarters. These were typically driven by increasing short-term power price forecasts and higher-than-expected inflation, with the latter positively affecting revenues derived from inflation-linked subsidies.

Gresham House Energy Storage produced a trading update that highlighted the strong trading environment for battery storage assets over recent months, largely as a result of the volatility in power prices. The company highlighted strong revenue generation in 2021, with revenues comfortably ahead of expectations and earnings before interest, taxes, depreciation and amortisation more than twice that of 2020. The full-year 2021 and full-year 2022 dividends are expected to be fully covered and management expects NAV growth in 2022 to be ‘towards the upper end of the target range of 8% to 15%”.

A number of social and diversified infrastructure companies released results or market updates. International Public Partnerships released full-year results with a NAV total return of 6% over 2021. HICL Infrastructure and 3i Infrastructure both released trading updates that highlighted strong operational performance from the underlying portfolios.

Asset Backed Securities:

Asset-backed securities (ABS) returns were slightly negative over the quarter. Spreads across ABS experienced only limited volatility in the first half of the quarter, resulting in relatively stable performance versus other areas of fixed income. There was some spread widening later in the quarter but this was largely offset by income.

Special Opportunities:

Special opportunities produced a small positive performance over the quarter.

Burford Capital, the litigation finance investor, announced its annual results for 2021. These revealed record commitments and deployments to new investments but slow progress on the existing investment portfolio, reflecting delays in litigation caused by Covid-19. More positively, delays have not resulted in losses but rather cases taking longer to reach conclusion.

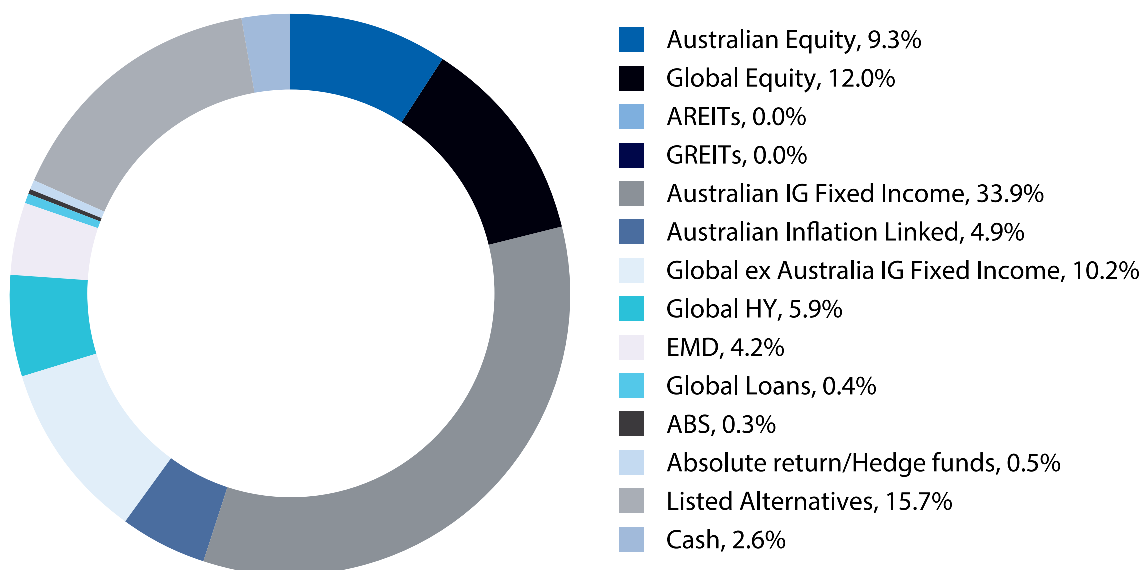
Property:

Property produced a broadly flat performance over the quarter.

Our logistics center holding Tritax BigBox REIT provided updates for the fourth quarter, pointing to strong industrial data in 2021 with very low vacancy rates, increased occupier take-up and strong uplifts to passing rents. Positive performance in this sector is expected to continue into 2022. Tritax BigBox REIT development pipeline is accelerating, reflecting occupier demand.

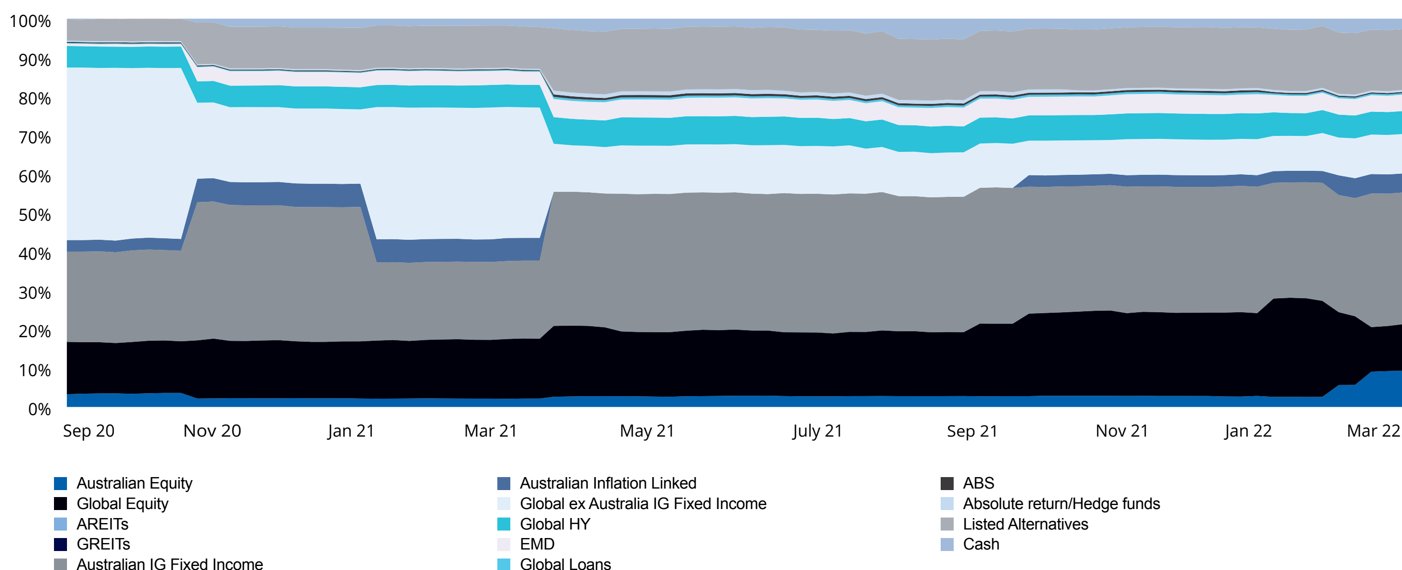
The student housing exposure Unite Group published its full-year results to end-December and reported a NAV total return of 10.2%. The company has recorded 94% occupancy and 2.3% rental growth for the 2021/22 academic year as well as a record development pipeline of roughly 6,000 beds (£1.3 billion) for delivery by 2026. The fundamentals of the student accommodation sector are strong and full recovery from the next academic year is expected. The company is guiding towards full occupancy and rental growth of 3-3.5%.

Chart 01: Current asset allocation



Source: abrdn, 31 March 2022

Chart 02: Historic asset allocation evolution



III. Outlook and positioning

We still think there are three major risks faced by global financial markets, namely hawkish central banks, particularly the Fed, multi-decade high inflation exacerbated by the Russia-Ukraine war and a growth slowdown, amid tightening financial conditions and corporate margin pressure.

The Federal Open Market Committee meeting in March delivered the first rate hike in the US, which eliminated some uncertainty; however, investors are still nervous about the pace of tightening over the rest of the year. The market has now priced nearly 10 rate hikes in 2022 and a balance sheet rundown at US$95 billion per month. Meanwhile, inflation expectations have eased somewhat, thanks to moderating energy prices and the possibility of a ceasefire in Ukraine, but the likelihood of a peaceful resolution remains very low. Finally, growth data in the US still looks robust for now, but the risk in the eurozone and Asia has risen materially and first-quarter earnings results can surprise on the downside.

We are positioned near the midpoint of our risk range as we believe some but not all of the risks are discounted in asset prices, as reflected by around a 10% price-to-earnings de-rating of global equities and a 120 basis point rise in the 10-year US Treasury yield over the year to date. We are marginally overweight equities compared with our strategic weights, with tilts towards financial and commodity exposures that are likely to do well in the late cycle. We have also shifted duration to the long end, as we believe plus 20-year US Treasuries will reach fair value soon and should provide protection to the portfolio once the market starts to price in more slowdown risk induced by Fed tightening.

Given the volatility in equities, especially in the middle of the quarter, we rotated from global equities to a commodity equity basket, which included gold miners, energy companies and copper miners, as geopolitical tensions have exacerbated the already very tight commodity supply/demand imbalance. We also rotated from other developed markets to Australian equities. Australian equities are more resilient because the economy is more insulated from the war in Ukraine, the terms of trade will improve due to commodity exports and there is relatively more subdued inflation pressure compared with other developed markets, which should allow for the Reserve Bank of Australia to be more patient in policy normalisation. On level one equity exposures, we reduced our MSCI World Equity Index exposures, given rising geopolitical and stagflation risk, and replaced part of the exposure, with US equity call options and exchange-traded funds, given the US is more insulated from war-induced growth risk and domestic growth remains resilient.

In fixed income, we added incrementally to Australian government bonds and inflation-linked bonds in light of tightening financial conditions and lingering geopolitical concerns, as the duration factor has incrementally evolved to be a diversifier for risk assets and overall interest rates have risen from the cycle lows.

On foreign exchange, we added to the Australian dollar versus Japanese yen position on the back of Australia's improving terms of trade. Finally, we added to our short euro position in light of Europe's weakening economic outlook due to the Russian invasion of Ukraine.

IV. Performance and risk contribution

1. Performance table

The Portfolio returned -5.09% over the quarter. Since inception the Portfolio has delivered a return of -0.34%.

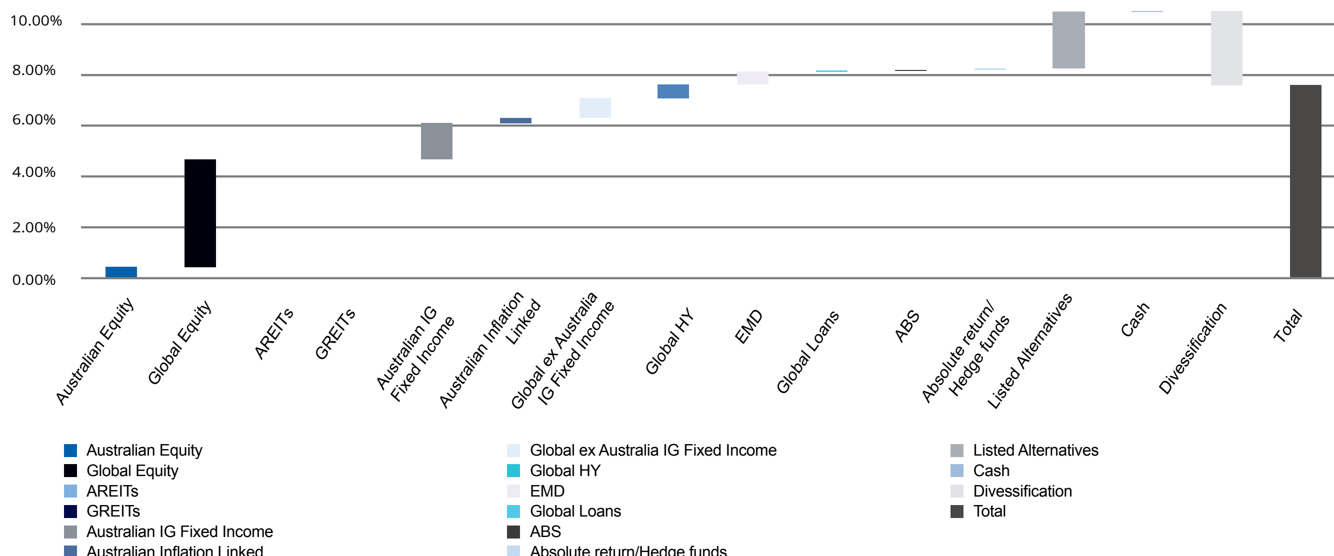
Sterling Aberdeen Standard CPI +2.0%Portfolio	1 Month %	3 Months %	6 Months %	YTD %	1 Year %	Inception %
Portfolio	-0.63	-5.09	-4.24	-5.09	-2.54	-0.34
Benchmark: CPI plus 2.0%p.a.	0.39	1.12	2.15	1.12	3.85	1.74

Portfolio performance is provided net of fees on underlying investments but gross of Advisory/Platform fees.
Source: abrdn Lipper, 31 March 2022
Past performance is not a guide to future results

2. Risk Contribution

Our long term proprietary estimations of risk and correlation continue to suggest a high degree of diversification across the various asset classes that compose the portfolio. The portfolio's long-term expected volatility remains well below that of equity at 7.6% per annum.

Chart 03: Risk Contribution



Source: abrdn 31 March 2022

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