Sterling abrdn CPI+5.0% Portfolio

Quarterly Review

September 2023

I. Quarterly commentary summary

1. Macro and market commentaries

Global stock markets ended the third quarter of 2023 lower, with the MSCI AC World Index returning -0.43% (total return in Australian dollars, AUD). Despite continued volatility over the review period, investor appetite for equities remained strong. Australian equities declined slightly over the third quarter, with the ASX 200 Total Return Index returning -0.27% (in AUD terms). Shares fluctuated over the period with brief rebounds in late July and early September. In August, the company reporting season demonstrated corporate resilience, especially from the financials and mining sectors, but many outlook commentaries reflected an increasing sense of uncertainty.

Data released in July showed that Australia's inflation rate declined to 6% in the second quarter, but still remained above the central bank's target range of 2-3%. Yet the Reserve Bank of Australia (RBA) maintained the cash rate at 4.1% during the third quarter. The RBA was still assessing the impact of the previous rate hikes on the economy as the data regarding this is still mixed. The interest-rate-sensitive household sector was facing a period of uncertainty and a slowing in Chinese growth was being closely monitored as well. In September, the Melbourne Institute's Monthly Inflation Gauge remained flat, following a 0.8% and a 0.2% rise in July and August, respectively. The Judo Bank Australia Composite PMI increased from 48 to 50.2, signaling private sector expansion, driven primarily by the service industry, while the manufacturing sector faced a faster decline due to economic challenges and higher interest rates. Elsewhere, the jobs market painted a mixed picture as well, with 32,600 jobs added in June, keeping the unemployment rate at historic lows of 3.5%. Yet in September, unemployment ticked up to 3.7%.

In fixed income, the Australian 10-year government bond yield surged over the three-month period, and especially in September, to end the third quarter above 4.47%, its highest level since October 2011.This was driven by global expectations of prolonged higher interest rates to combat inflation. Within Australia, corporate bonds have had a mixed quarterly performance, but outperformed government bonds. Meanwhile, over the third quarter, the Australian dollar weakened from 0.66 against the US dollar to around 0.64 as investors remained cautious ahead of the RBA's October policy meeting.

Elsewhere, equities declined in the US. Most major European markets also fell in local-currency terms as shrinking business activity in Germany dampened investors' risk appetite. Japanese equities rose in yen terms, while the currency depreciated over the quarter. Although Asia Pacific ex-Japan equities ended lower in local-currency terms, small-caps in the region rose. Chinese equities ended lower, along with stocks in Taiwan and South Korea. Despite fresh stimulus measures announced by the authorities, Chinese investors worried about the country's economy, particularly its property sector. More positively, shares in India had a robust quarter as second-quarter GDP rose by 7.8% year-on-year and the central bank kept its benchmark rate at 6.5%.

Global government bonds fell in local-currency terms with 10-year government bond yields in the US, Germany and Japan all rising over the quarter. Major central banks continued to raise interest rates to combat still-elevated inflation. Although price pressures have been easing in most major economies, core inflation has stayed stubbornly high. Corporate bonds had a lacklustre quarter. Riskier high-yield (HY) corporate bonds slightly outperformed their investment-grade (IG) counterparts in the US as investors were attracted by the former's relatively high starting yields.

2. Performance review

The portfolio returned -0.28% over the quarter. The biggest detractor was our multi-asset strategy exposure. Our exposure to equities, as well as Australian government bonds also detracted from performance. However, holding Australian IG bonds and cash helped cushion some of the drawdown.

3. Macro and Market outlook

Expectations that central banks will keep interest rates higher for longer, as well as a significant increase in term premia, are sending bond yields higher. While we wouldn't necessarily take central bankers at their word about keeping interest rates elevated should the economy weaken as we expect, we think that the drivers of higher term premia are structural and long lasting.

Financial markets have been volatile, amid the significant sell-off in developed market (DM) government bonds and a partial recovery as geopolitical uncertainty has spiked. Our policy rate forecasts envisage a period of rates remaining at or around current levels until the middle of next year to squeeze out remaining inflationary pressures, but then followed by an easing cycle from the second half of 2024 onwards.

Looking ahead, we expect monetary policy tightening to weigh on growth in the next 12 months, but major DM economies are likely to avoid a recession this year before a more challenging 2024 starts. Global growth remains supported in the near term, making inflation re-acceleration and continued policy tightening a plausible scenario. In such an environment, we expect the US dollar (USD) to stay strong against other currencies. Equities will be supported by the growth backdrop. However, we favour defensive equities such as moat-based equity and global quality equity. Chinese equity's current cheap valuations are difficult to ignore, but its near-term direction will likely be determined by the forcefulness of policy stimulus and

Key information[1]

This portfolio aims to achieve a real return equivalent to 5.0% per annum above inflation (before fees) over a rolling 7-year period.

- **Benchmark:** CPI plus 5.0% p.a.
- **Investment Time Horizon:** 7+ Years
- **Portfolio launch date:** 31 August 2020

[1]Source: abrdn, 30 September 2023

geopolitical development. DM government bonds are under pressure from a macro and supply-demand perspective but the rapid rise in yields and increasingly appealing valuation levels could lead to a short-term reversal. Across credit, we prefer IG over HY given the rising default rate in the lower quality space.

4. High level portfolio positioning

The portfolio is relatively defensively positioned. We have exposure to defensive assets – such as Australian IG bonds, Australian government bonds, Australian inflation-linked bonds, a money market ETF and cash – as a layer of cushion. While we are underweight equities, we focus on markets that are expected to provide more resilience such as MinVol, moat-based, and quality equity. We also have positions in Chinese equities as the current cheap valuation is difficult to ignore, but its near-term direction will be determined by the forcefulness of policy stimulus and geopolitical development.

Our long-term allocation to listed alternatives that tap into idiosyncratic price drivers, with some of the investments with direct or indirect linkage to inflation, provide diversification. We keep a close watch on any market developments and manage the portfolio actively.

II. Asset class review

Listed equities:
Over the review period, global equity markets ended the third quarter lower. Investors mainly focused on the extent to which the world's major central banks would have to tighten monetary policy to combat still above-target inflation levels. While economic data has generally been more robust, the risk of a global recession remains. Meanwhile, investor appetite for technology stocks linked to generative artificial intelligence platforms started to decrease, especially in the latter part of the quarter, leading to declines worldwide.

Australian equities also experienced a negative quarter as the inflation data showed mixed signals and the RBA reaffirmed its statement that further tightening of monetary policy may be required in the September meeting.

Fixed Income:
Australian government bonds delivered a negative return over the quarter given rising inflation expectations and policy uncertainty. Australian IG bonds, on the other hand, delivered positive returns as credit spreads tightened slightly on the back of robust investor appetite.

Infrastructure:
Our infrastructure allocation produced a negative return over the quarter. This primarily came through discounts to net asset value (NAV) increasing. Investor concerns were focused on the impact of rising interest rates globally and the impact this may have on asset values as well as the relative attractiveness of infrastructure yields versus other asset classes. Lastly, declining short-term power prices affected sentiment towards certain renewable infrastructure investments.

We continue to assess the impact of these factors on long-term expected returns. While higher bond yields may result in higher discount rates used to value assets, most investments continue to benefit from long-term, stable, inflation-linked revenues. In addition, we have also seen certain infrastructure companies sell assets selectively. These transactions have been in line or above valuations, helping to validate NAVs. Combined with the current discount to NAVs, we continue to see compelling long-term return opportunities across many areas of infrastructure.

Some of our renewable infrastructure companies reported second-quarter results with NAV total returns ranging from -4% to +2%. We saw headwinds from higher discount rates and falling near-term power prices largely offset from higher short-term inflation assumptions and high levels of excess cash generation.

Within our social infrastructure allocation, International Public Partnerships released half-year results to end-June. Performance was flat over the period, with robust operational performance and higher inflation offset by higher discount rates. HICL Infrastructure announced the disposal of five assets during the quarter for £204 million – a small premium to the reported holding value. This takes total accretive disposals this year to £310 million with proceeds used to reduce the company's revolving credit facility.

Within our economic infrastructure allocation, Pantheon Infrastructure released half-year results to end-June, revealing a NAV total return of 3%. 3i Infrastructure revealed good earnings growth across the portfolio, with most assets performing in line or ahead of expectations.

Lastly, battery storage investor Gresham House Energy Storage announce a small single-digit negative NAV total return over the first half of 2023, largely driven by lower third-party revenue forecasts. There was a drop in revenues over the first half of the year driven by lower power price volatility affecting trading strategies; and the current low utilisation of battery capacity in the balancing mechanism, the primary tool used to balance the supply and demand on the UK grid.

Special Opportunities:
Special opportunities include allocations to a diverse range of exposures with differing return drivers and risk characteristics.

Round Hill Music, our music royalties investment, received a cash offer from Alchemy Copyrights (which trades as Concord) at a 67% premium to the closing price of the share prior to announcement. This development crystallises a significant amount of value for shareholders, with the shares having traded at a significant discount to the reported NAV in recent months.

Burford Capital, our litigation finance investment, released half-year results, revealing higher revenues as a result of good business momentum but conversely higher discount rates were used to value assets. There was also an increase in operating expenses.

III. Outlook and positioning

At the top level, we rotated from Australian equities to global equities given the growing recessionary pressure in the domestic market in July. Also, given that a US recession has been pushed out, we increased our exposure to global equities, value and quality by adding to the moat-based equity ETF and Quality ETF while reducing Min Vol. In August, we reduced the Australian Money Market ETF to bring cash back to target level.

Within the multi-asset strategy, the portfolio invests in the abrdn Multi-Asset Real Return Fund, which was dynamically managed throughout the quarter.

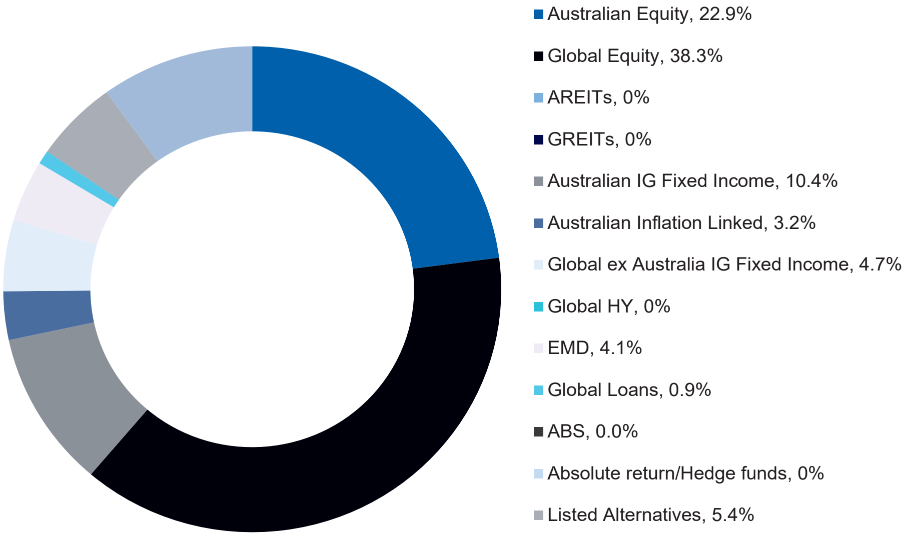
In July, we increased global equities exposures towards the new Strategic Asset Allocation (SAA) target, funded out of cash. We also added to our USD exposures against AUD given the more dovish RBA versus Fed positioning, and indirectly reduced China risk associated with the Australian dollar. Lastly, with the US market looking stretched, we rolled the existing SPX Put spread and bought VIX call to protect the portfolio from a near-term technical pull back.

Later in August, with yields rising, we decided to add further to our Australian government bond position while liquidating our global HY exposure given the turn in the US credit cycle with the number of downgrades increasing. We also reduced our exposure to China given continued headwinds and rotated into India on the back of strong Indian macro and earnings growth momentum. Additionally, we took some profit on the NASDAQ Composite Index exposure, reducing the position but adding to the MSCI World Index to maintain the Fund's overall equity exposure.

Finally in September, we increased our USD exposure after, potentially, the last rate hike by the European Central Bank and eurozone's relatively weaker growth outlook. We also closed out the September VIX call option before expiry given the subdued volatility levels.

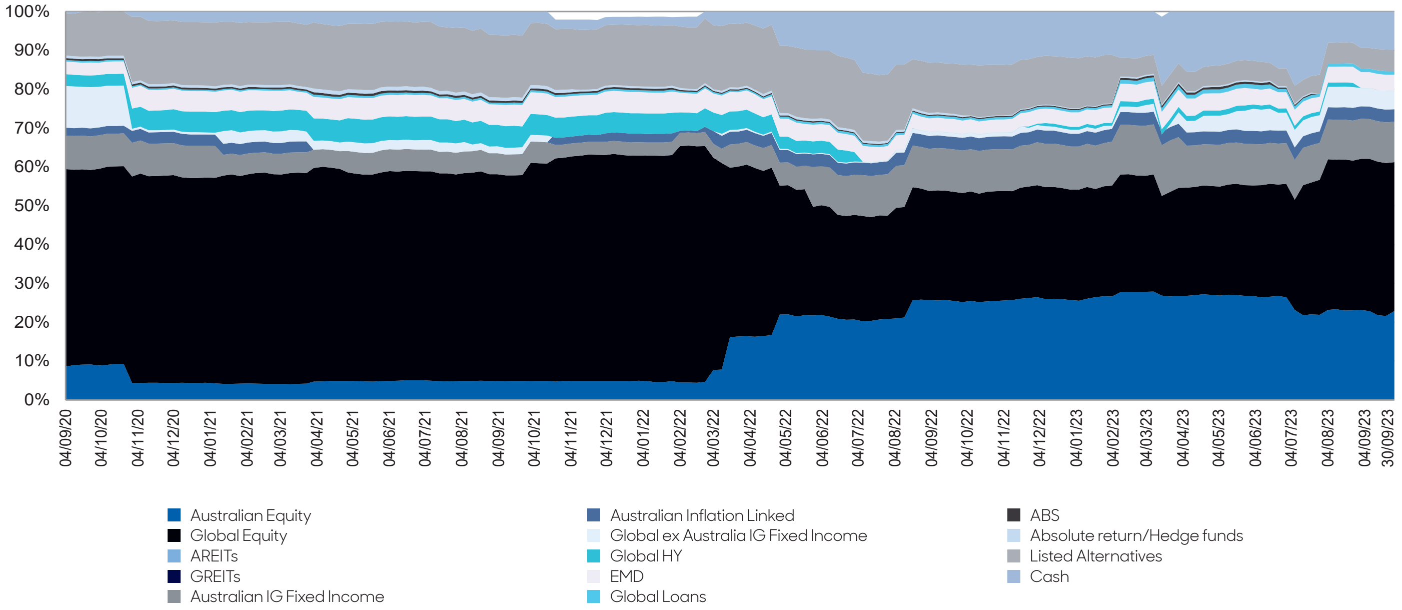
With the uncertainties in the market, we take a cautious approach to the impending risks, and the portfolio remains tilted toward more defensive equities.

Chart 01: Current asset allocation



Source: abrdn, 30 September 2023

Chart 02: Historic asset allocation evolution



IV. Performance and risk contribution

1. Performance table

The Portfolio returned -0.28% over the quarter. Since inception the Portfolio has delivered a return of 0.96%.

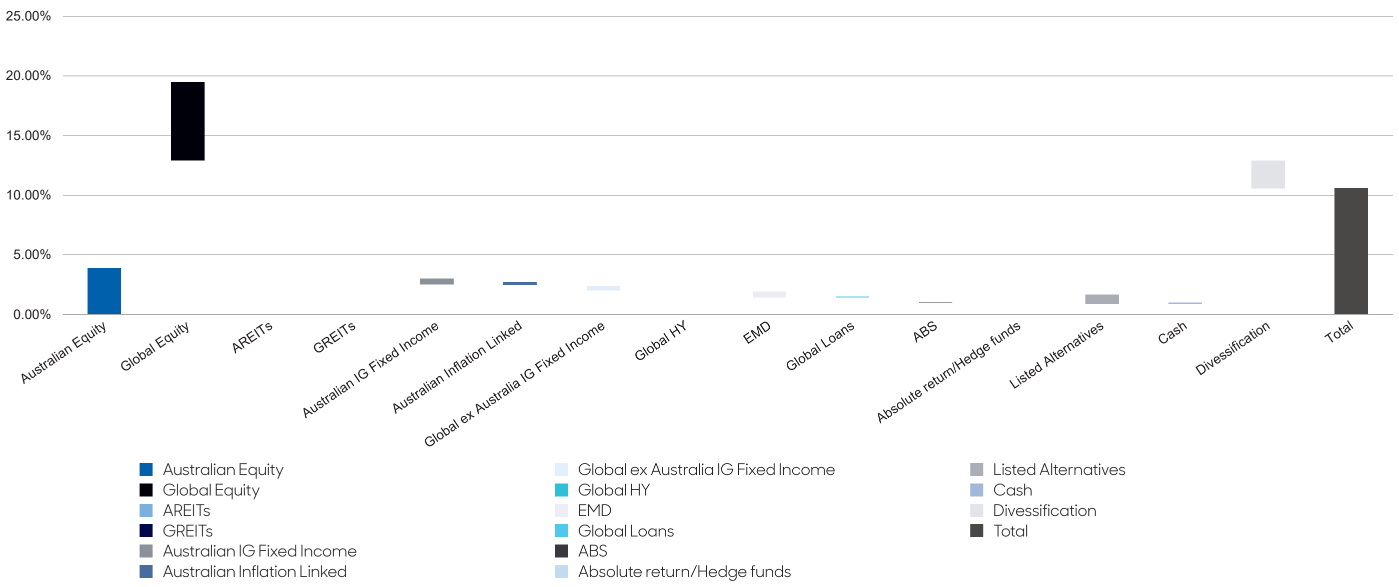
Sterling abrdn CPI+5.0% Portfolio	1 Month %	3 Months %	6 Months %	YTD %	1 Year %	Inception (p.a)%
Portfolio	-2.63	-0.28	0.98	3.04	7.49	0.96
Benchmark: CPI plus 5.0%p.a.	0.84	2.62	5.49	8.51	11.39	8.58

Portfolio performance is provided net of fees on underlying investments but gross of Advisory/Platform fees.
Source: abrdn Lipper, 30 September 2023
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 slightly below that of equity at 10.6%.

Chart 03: Risk Contribution



Source: abrdn 30 September 2023

Important Information

Financial commentary contained within this document is provided by abrdn Oceania Pty Ltd ABN 35 666 571 268, the portfolio manager responsible for designing and managing the composition of this managed portfolio to meet the investment objectives and investment strategy detailed in the model portfolio sub-advisory agreement. abrdn Oceania Pty Ltd (ABN 35 666 571 268) is a Corporate Authorised Representative (CAR No. 001304153) of AFSL Holder MSC Advisory Pty Ltd, ACN 607 459 441, AFSL No. 480649 and CAR No. 001304154 of AFSL Holder Melbourne Securities Corporation Limited, ACN 160 326 545, AFSL No. 428289.

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Model Portfolio performance is based on the theoretical performance of the model portfolio, and does not take into account any fees applicable to the model portfolio. Actual portfolios may not perform in the same manner as the model portfolios, depending on customisations and timing issues. Accordingly, the actual after tax returns you receive are likely to be different from the model portfolio returns and those of other investors. Rounding used in the presentation of data may result in minor variations.

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