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Strategic Asset Allocation 2020

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Dear investor,

As we enter a new decade, our annual strategic allocation process is an important opportunity to step back from immediate political and economic concerns to focus on long-term trends.

The global economy closed the decade in a far healthier position than it began it in. 2019 was a positive ending to a decade which saw global equity markets more than double in value. The 2010s were by no means an economic panacea for the traumas of the previous decade but, in the context of political upheaval globally, the world economy had a relatively calm ride.

From a macroeconomic point of view, 2020 looks to repeat the pattern of the past few years – low inflation, moderate growth and expansionary monetary policy. It could be tempting, then, to see financial markets as stable, at least in the short to medium term. This could well be a mistake; if recent history has taught us anything, it is to expect the unexpected and be ready to respond to rapidly changing political and environmental landscapes. These will, inevitably, be reflected in financial markets.

This report focuses on the expected returns of the asset classes that make up our investment portfolios. For long-term returns, keeping equity components as a key part of your portfolio is still the best solution. Fixed income securities, by contrast, will struggle to generate positive real returns to protect capital against inflation.

Therefore, it remains as important as ever for asset allocation to reflect the risk and return expectations of our investors. This report will detail Moneyfarm's assessment of the asset classes that make up our different investment portfolios, giving our investors an important insight into our decision-making process for the medium and long term.

Ultimately, we remain firm in our belief that a balanced approach to investment is the best way to protect and grow capital for the future. As we look ahead to the coming 10 years, our job is to justify that belief on behalf of our investors – we believe our strategy puts us in a very good position to do so.

Yours sincerely,

Richard Flax
Chief Investment Officer

The strategic asset allocation process

Each year, the strategic asset allocation process is our opportunity to evaluate the outlook of the markets to compose our investment portfolios. We start by analysing the inputs: the economic context and the risk-return profile of each asset class (equities, bonds, etc.). A series of checks are then put in place, both quantitative and qualitative. It is a sophisticated process, made up of a number of different phases which are designed to make optimum use of our experience. This helps us find the ideal strategy for each of the Moneyfarm investment portfolios.

Correlations

These measure the likelihood of an asset to move in a coordination (or opposing direction) to other assets. Correlation is the basis of diversification: asset classes likely to move in opposite directions decrease the risk in a portfolio.

Volatility estimation

Risk analysis is an integral part of the SAA process. Volatility is estimated for each asset class based on historical data from periods which we believe to most accurately reflect the current landscape.

Expected returns

By assessing the economic context and the price of the various asset classes, we estimate the potential long-term yield of all the tools that make up portfolios.

Risk return profile for each asset class

Provisional portfolios

Limitations

Qualitative review

Our investment committee checks the outputs from the quantitative process and corrects them if necessary.

Robust optimisation

We carry out numerical simulations aimed at analysing the behavior of portfolios in different scenarios. This allows us to stress test our models and our assumptions and to obtain robust portfolios that are also ready for adverse scenarios.

Limitations

Each asset class in the portfolio cannot exceed the limits set by the portfolio managers. The allocations are corrected according to the limits established to guarantee effective diversification.

QUANTITATIVE INPUTS

STRATEGIC WALLETS

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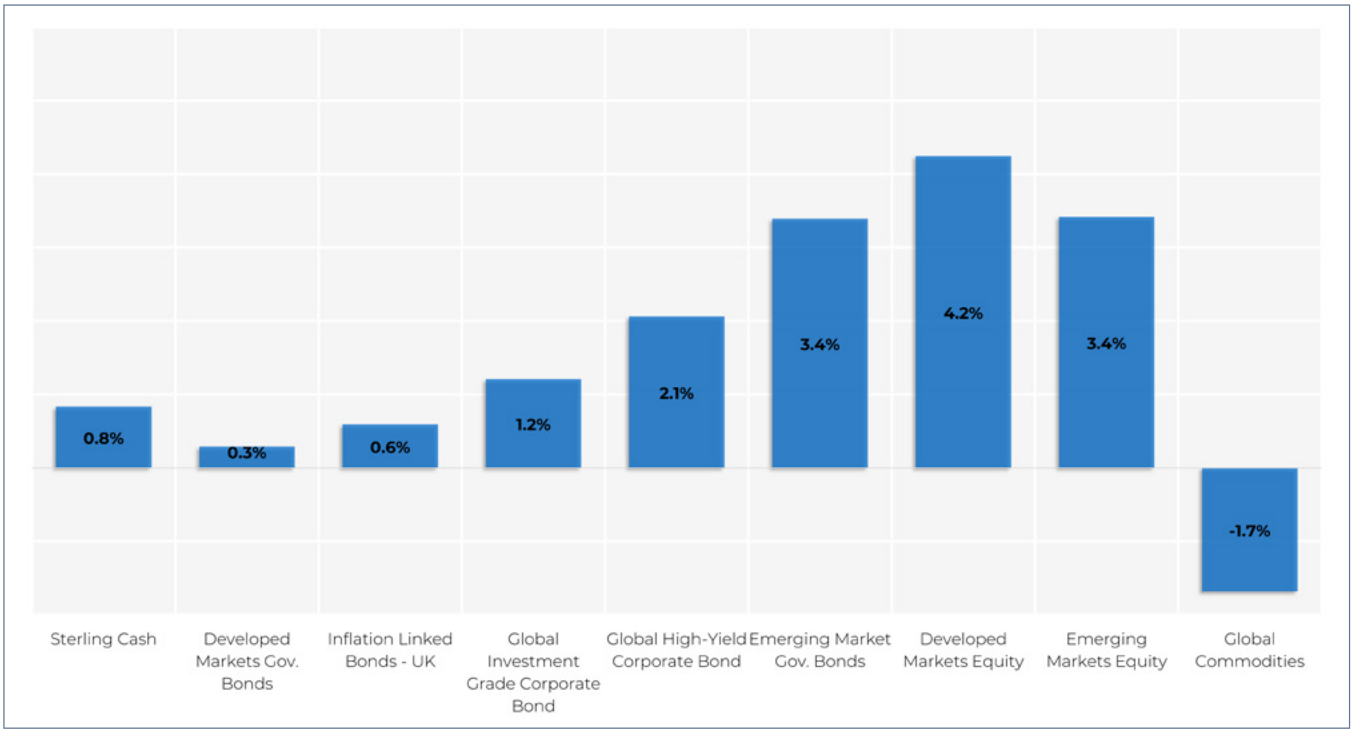
A look at the 2020s

Expected returns and the macroeconomic landscape

Expected returns 2020-2030

The chart below shows the estimated yearly returns for the next 10 years. As you can see, the expected returns are positive for almost all asset classes. Given the extremely low level of interest rates, fixed income securities in general start at a disadvantage, while more volatile investments like equities, we expect to show positive returns and a marginal premium for risk. Rates on government securities reflect an already expansionary monetary policy, thus not offering particularly attractive returns.



Strategic asset allocation 2020: expected returns
The estimated annual returns of the principal asset classes for the next 10 years.

In such a scenario, our role as asset managers is to make a considered selection of asset classes in order to make the most of the opportunities present in global markets.

We aim to provide a mix of instruments that, in the current landscape, are able to offer the best risk-return profile to all investors. In particular, this year our attention was captured by emerging government and corporate bonds which, beginning with their higher coupons, should be able to offer positive returns also in growing interest rates scenarios. This asset class provides the extra benefit of adding a source of diversification to our portfolios.

Despite low interest rates, we believe it is important to continue investing in low-risk asset classes such as government bonds. While offering limited expected returns (but still higher than deposit rates and current accounts), they serve to mitigate the volatility of the portfolio.

As for UK inflation linked bonds, they remain fairly expensive, since they are still pricing the Brexit risk.

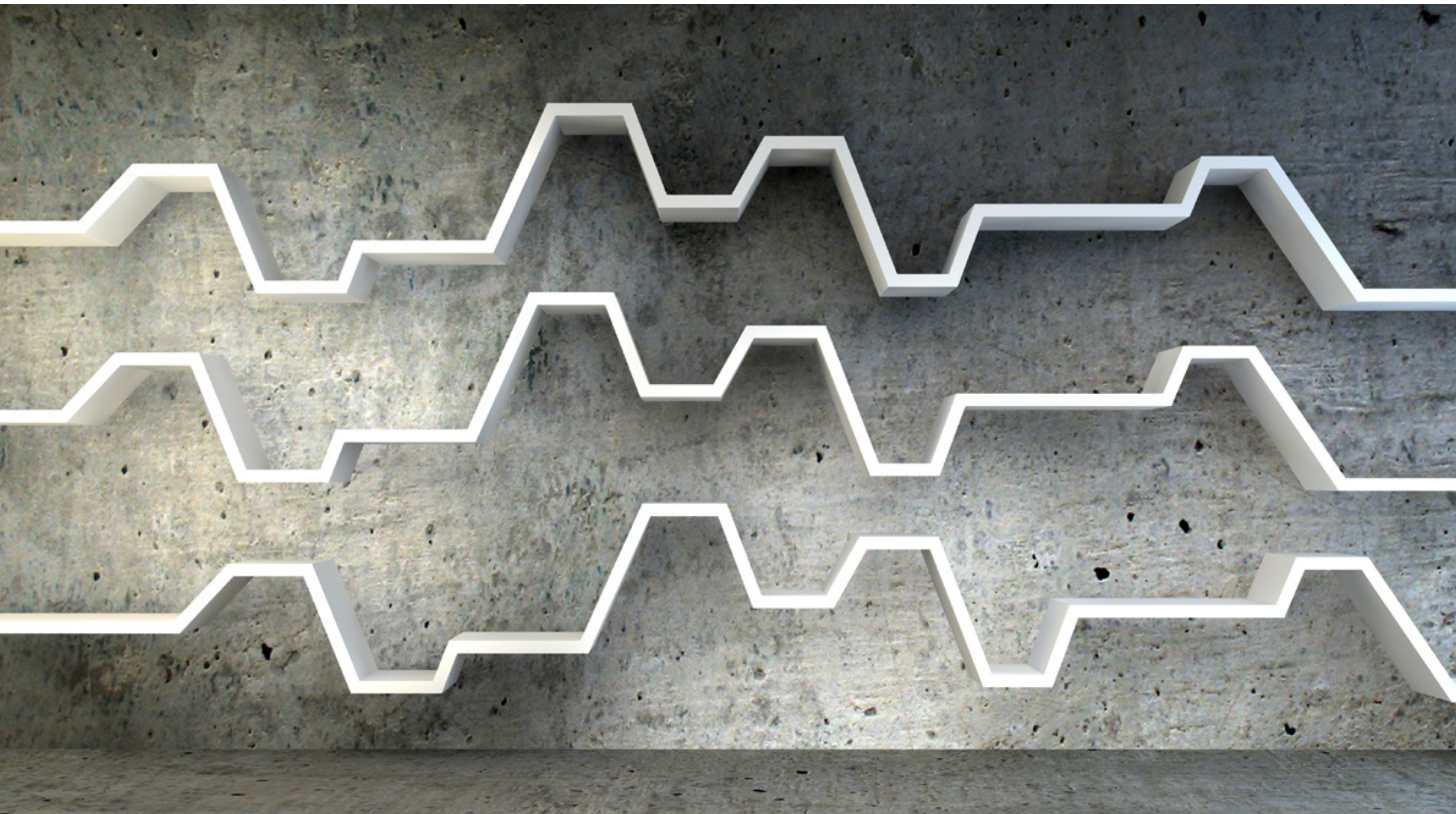
What are the expected returns?

Expected returns are the calculated estimates of future returns of each asset class within a given period (10 years in our case). The annual return of an asset class is calculated using the average return over the observation period. The expected return is based on the probability of future return, taking into account the starting point and the historical data. It, therefore, is not a guaranteed return. Estimating the expected returns helps us, together with predicted volatility and correlations, to put together effective strategic portfolios.

More attentive investors will have noticed the decrease in expected returns when compared to last year. This is inevitable given the growth in valuations that we saw in 2019. This was caused, among other things, by monetary policy that further reduced interest rates.

If we consider inflation, over the past 10 years, negative real rates have affected the pockets of those who have their savings in current or savings accounts. In the context of low but positive inflation (the Bank of England, for example, is targeting a 2% rate for the foreseeable future), it is important to invest in assets capable of generating positive real returns, accepting a certain degree of risk and building a portfolio appropriate for your risk profile.

Even with returns expected to be lower than in the past, having an investment plan – while opening yourself up to the possibility of better returns in the future – remains the best way to protect your savings from devaluation. This golden rule will still apply in the 2020s.



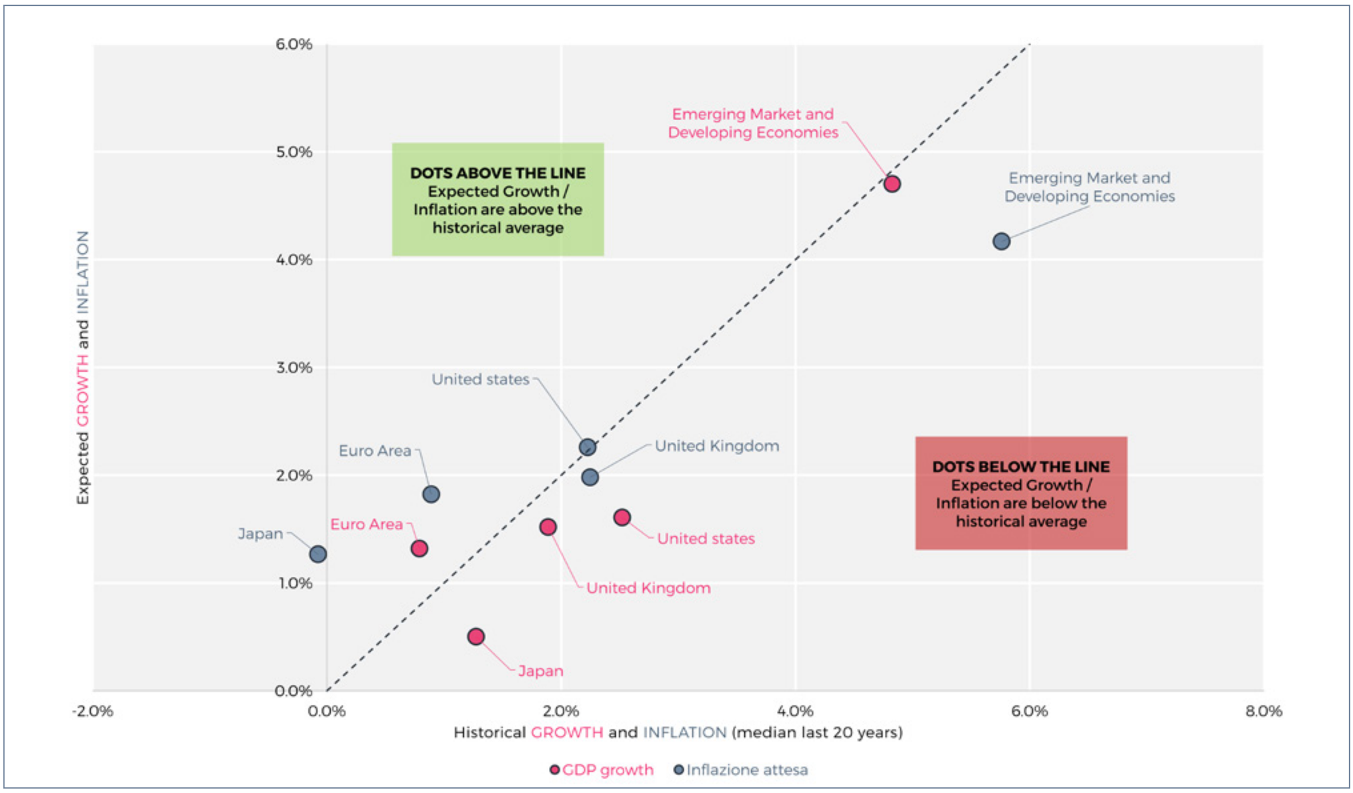
The macroeconomic context, inflation and correlation

The macroeconomic context of 2019 was one of weak, uncertain growth and moderate inflation, so much so that the main central banks have implemented expansionary monetary policies in order to stimulate the economy.

The decline in economic fundamentals is due to the maturity of the economic cycle (growth has been continuous for more than ten years in many countries), as well as external factors such as the trade war between the United States and China and the lack of structural reforms in many economies.

However, the tail end of the year saw improvements in the outlook for some of the global economy's most critical issues. The manufacturing sector, particularly in the Eurozone, seems to be climbing out of its negative trend. Global trade, too, is enjoying a more stable outlook thanks to a reduction in uncertainty related to international disputes.

In the medium to long term, the basic assumption is a return to normal economic growth. Some of the emerging economies that have struggled in recent years, particularly in Latin America and Europe, will return to driving global economic growth. For countries that have recorded significantly higher growth rates than others in past years - the US and Germany, for example – we estimate a more gentle climb.



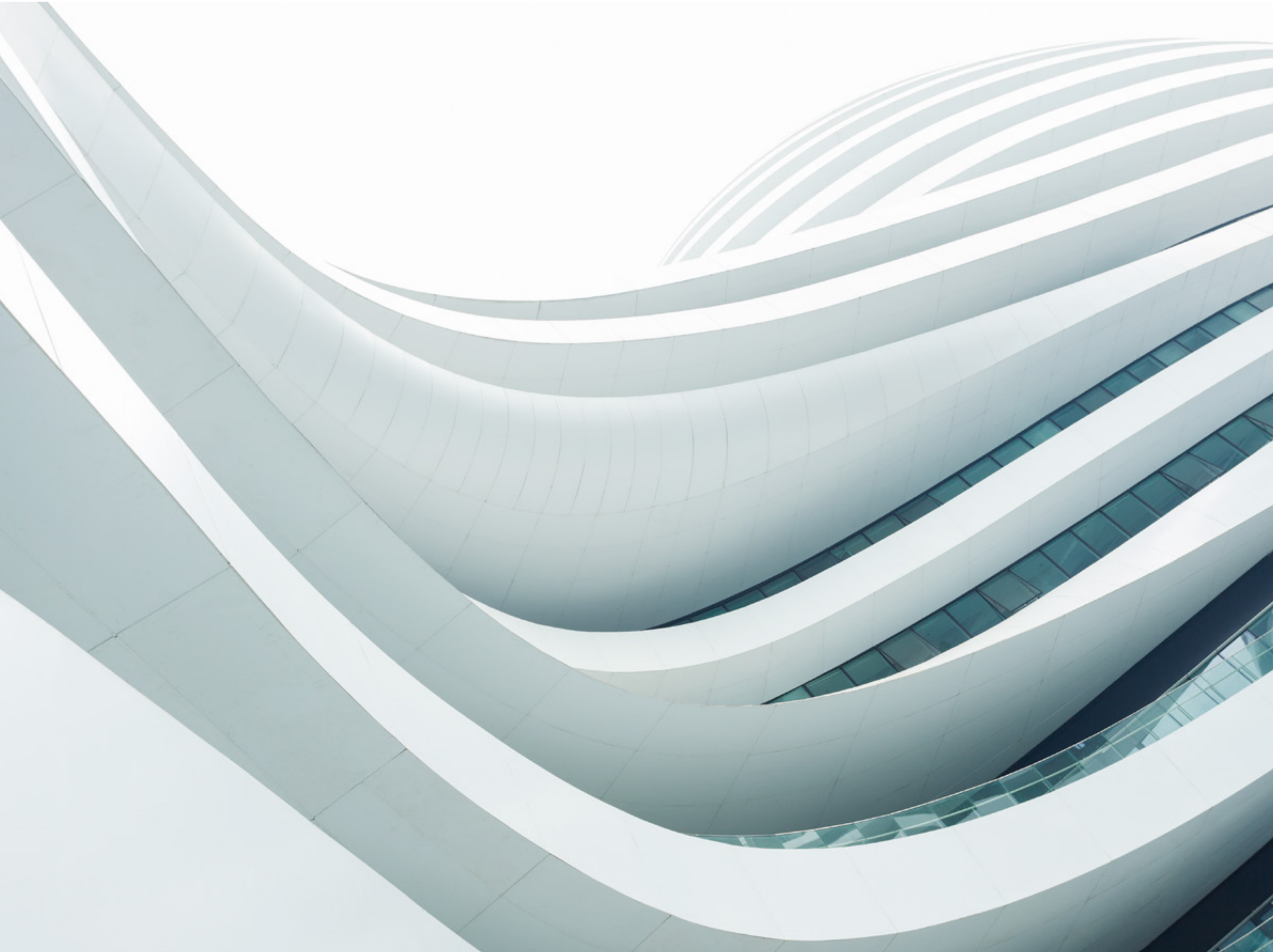
The relationship between stocks and bonds compared with the relationship between economic growth and inflation
This graph shows the expectations of real growth and inflation against historical growth and inflation. While inflation is expected to recover in Japan, stabilisation towards lower values is expected in emerging markets.

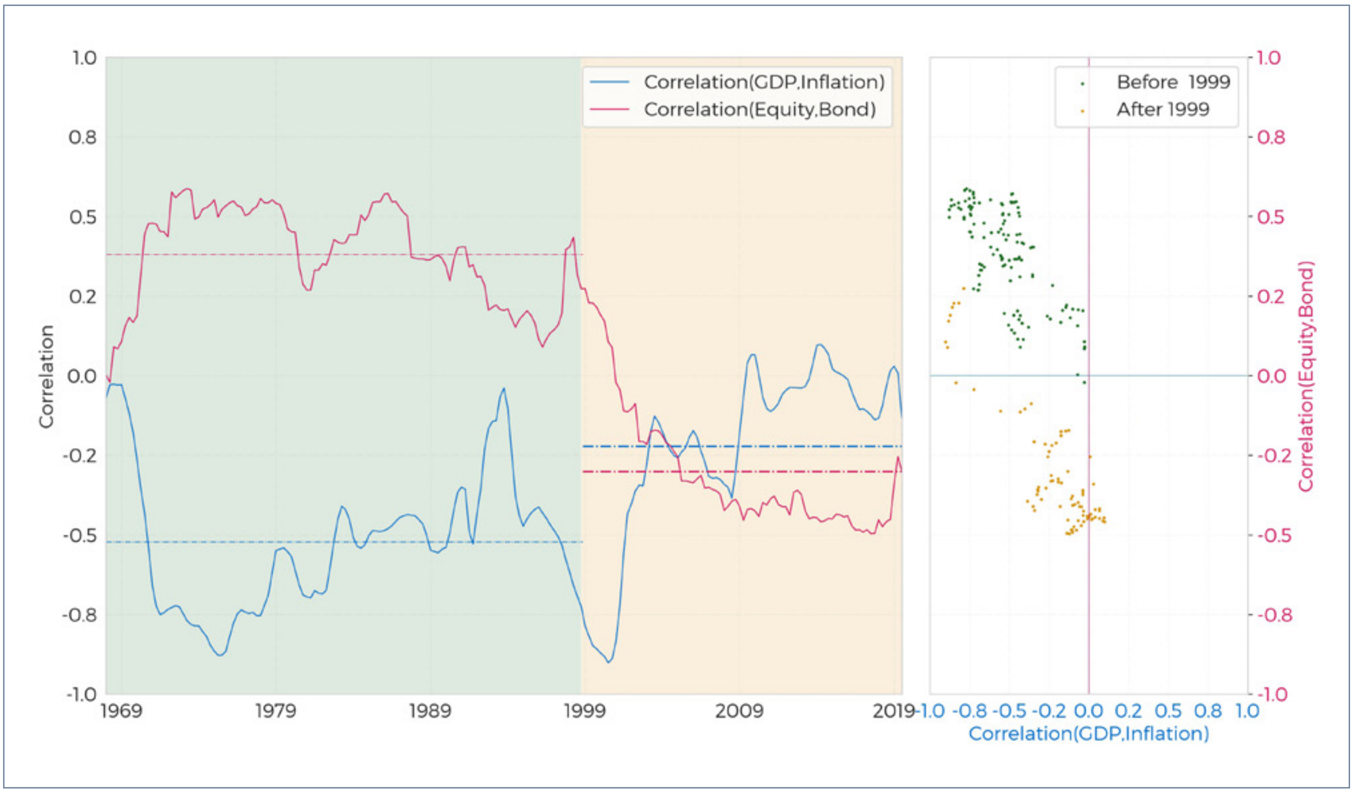
Inflation rates will remain contained in emerging countries, while in developed countries we expect an upward normalisation of prices, which should benefit from the expansionary monetary policies implemented in the last decade.

In this context, a crucial variable for understanding the price trends of the asset classes will be monetary policy, with its ability to influence the price level of the assets. It is also important to consider the correlation between the various asset classes.

Assumptions around both GDP growth and inflation are crucial in sustaining the current market condition. Current equity evaluations incorporate the view that corporate earnings will accelerate after a relatively mild year.

As such, any factor with the potential to cast a shadow over global growth also has the potential to bring about volatility in the market. Saying that, the general consensus is that the probability of a recession over the next 12 months is moderate and we generally agree with this view. Exogenous risk factors, though, such coronavirus and Brexit, deserve careful consideration.





The relationship between stocks and bonds compared with the relationship between economic growth and inflation
In the 2000s, the negative relationship between the movement of prices and economic growth weakened. Inflation has ceased to act as a counter-cyclical force, no longer penalising equity performance and reducing the negative correlation between equities and bonds.

As for inflation, it's important to consider where we are coming from with a bit of perspective: over the past few years, we have seen some extraordinary measures from central banks. Those measures, at odds with expectations, failed to create substantial inflation. There are a number of reasons for that - some are relative to the current market situation (the inability of the banking system to inject liquidity into the economy) while others are more structural, such as changes affecting global value chains and technological developments.

Whatever the reason, over the past 10 years we have enjoyed accommodating monetary policy with moderate inflation. This is an ideal position for owners of equity and shareholders to be in.

The question is: will this equilibrium continue or are we going to see a spike in inflation? We believe that, despite an uptick in inflation, monetary policy will remain supportive, at least in the medium term.

This is one of the key assumptions of our strategy. Inflation is one of the main factors affecting correlations between bonds and equities. We believe that this correlation will remain negative over the coming years.

Expected returns

Focus on the main asset classes

The construction of the strategic portfolios is based on the projected returns for each asset class, and the estimate of expected volatility. In this next section, we will go into the details of the valuations of the main asset classes that make up the expected returns.

Developed markets government bonds

To evaluate the return of government bonds, we have to consider both the coupon payments and the relative value of the securities when compared to bonds that will be issued in the future. When rates are low, as they are at the moment, both of these components are at risk. In fact, low rates are not only reflected in minimum coupon yields. When the probability that more bonds with a higher coupon will be issued in the medium term is high (i.e. when rates go up), the value of previously issued bonds is negatively impacted.

Monetary policy remains the fundamental factor influencing the yield on developed markets government bonds. In this sense, 2019 was an eventful year. Late in 2018, the divergence of markets' and central banks' expectations around global growth led to a stock market crash that was averted by the sudden decision of the Fed to turn back on itself and cut rates. This policy reversal precipitated the market rebound witnessed in 2019.

In the space of a few weeks, we moved from interest rates aimed at 3% to a path of reduction that manifested as three cuts in the rate of return on deposits in the United States over the year (with a cumulative value of 0.75%). In Europe, too, the Central Bank has entirely changed course regarding policy. At the beginning of the year, there were plans to hike rates before the summer, but September saw Mario Draghi end his mandate with a set of policies that reopened the liquidity taps. And in the UK, we saw rates down due to their global correlation.

Looking to 2020, there is still a disparity between the Fed's expectations and those of the markets. Jerome Powell has announced that the base scenario for 2020 is the maintenance of current rates, with a reduction only if the macroeconomic scenario worsens. FOMC members seem to be aiming unanimously for a revised upward rate to 2021, but the markets have a different view.

The events of 2019 negatively affected the expected returns of the next decade. Unless unforeseeable inflationary shocks happen, we expect a slow and gradual rate normalisation. We expect to see central bank intervention in the medium term, but less so than in the past. We, therefore, believe that 10-year rates can reach average values of 3% in the UK, 2% in Europe and 4% in the US in the long term.

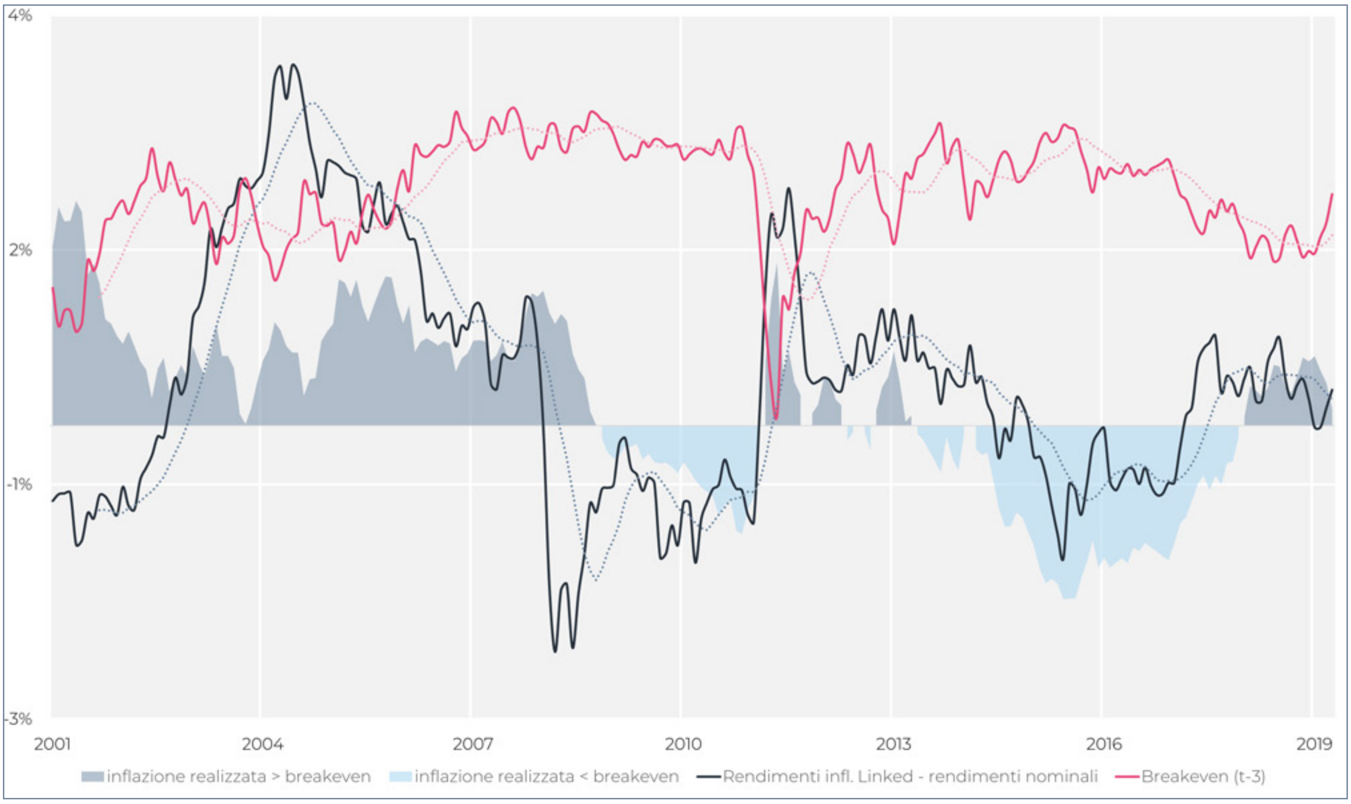
The gradual growth in interest rates will breathe life into the coupon rates, but will negatively affect the price return on bonds. Bond coupons will only partially compensate for the depreciation as a result of interest rate growth. Only the government bonds of the United States and Italy have positive expected returns, thanks to lower starting valuations.

Government bonds linked to inflation

Inflation-linked bonds are bonds issued by the governments of economically developed countries, with their yield tied to a price index. Inflation has been the sleeping giant of the past decade for most Western countries. This allowed central banks to stimulate economic growth without worrying too much about inflation getting out of control.

There are two key parameters for evaluating an inflation-linked bond. From the point of view of relative return, it is necessary to consider the efficacy of these inflation-linked securities compared to corresponding, non-indexed options. From the point of view of risk management, it is necessary to consider the ability of these investments/ assets to offer protection from sudden price increases; giving up some of the return for greater protection could be a justifiable choice.

Relative attractiveness can be estimated through the so-called break-even rate, i.e. the level of inflation which makes the nominal bond yields equal to the real ones. If the inflation achieved is higher than the break-even level, the yield of the index bond will be higher than that of the respective nominal bond.



Inflation-linked bonds versus ordinary bonds
If the inflation realised is greater than the breakeven level indicated in the purchase price, the returns of inflation-linked bonds are higher than that of ordinary bonds. When the breakeven is lower, the probability that the return of inflation-linked bonds grows is higher.

Considering our forecasted levels of interest rates, inflation and break-even, the expected returns are positive for almost all countries.

In Europe, inflation-linked bonds continue to be an interesting option. Less so in the United Kingdom, where securities continue to include Brexit risk and the impact that possible trade tensions and currency fluctuations may have on prices.

With this in mind, the expected return on inflation-linked bonds is higher than that of non-indexed bonds.

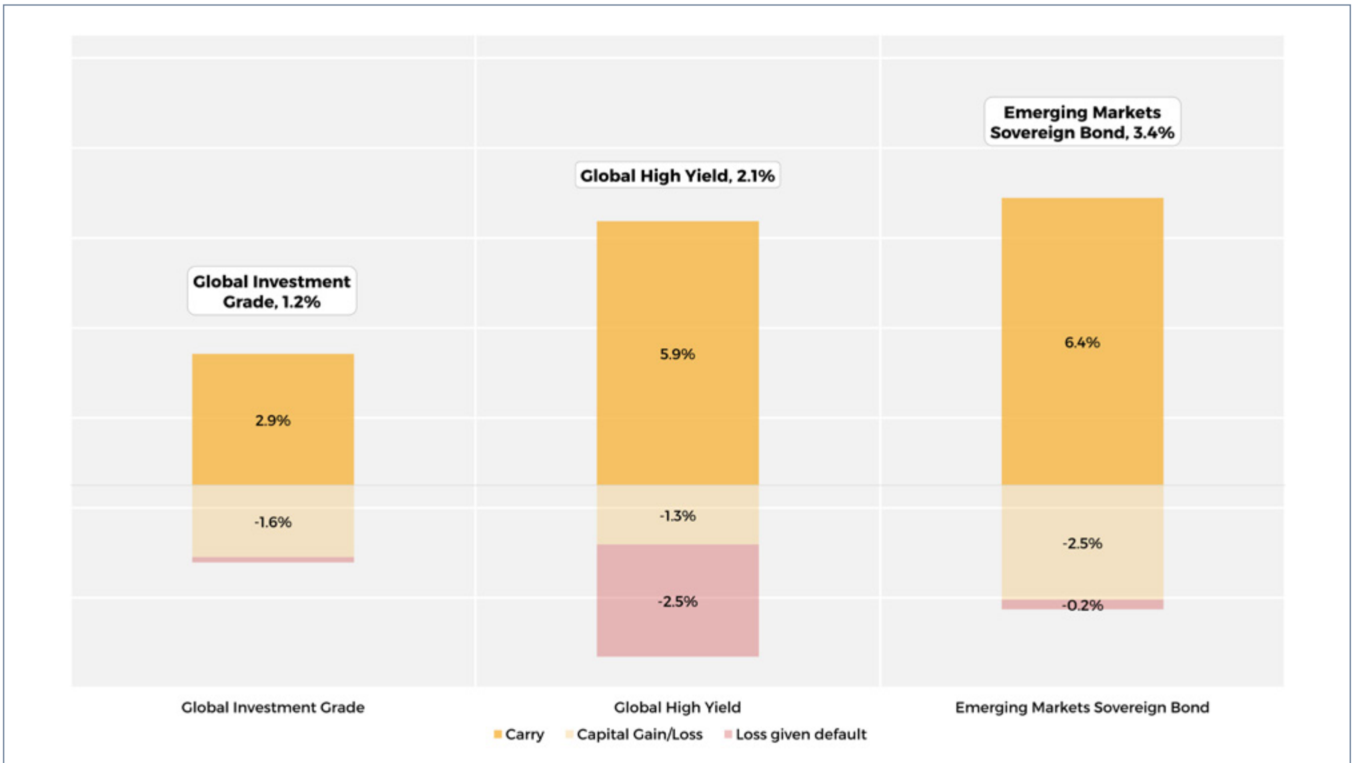
HY Credit & Emerging Market Gov Bonds

HY Credit & Emerging Market Gov Bonds represent a particularly interesting asset class this year. Although the spreads (the coupon premium against the risk free rate have narrowed over time and are at their lowest levels since 2008, this asset class is still able to offer a positive coupon component, and offers a return even in the event of defaults in some of the underlying securities.

Corporate bonds and emerging market debt offer higher coupon rates than government bonds in developed countries as they carry additional risks (such as the possibility, for example, that one of the companies we lend money to will fail and not pay its debts). The "spread" is that additional premium that investors require from issuers to obtain a return for these additional risks.

For corporate securities, the aim is primarily to benefit from credit risk and liquidity risk. As for emerging bonds, the spread instead compensates the risk linked to the instability of the issuer which can result in inflation peaks (and therefore rate hikes by central banks) and in credit risk. The estimate of expected returns for these asset classes is aimed at targeting whether the spread component is able to remunerate the underlying risks.

As with government bonds, the yield on corporate bonds can be summarised into three components. The first is the loss (or gain) in price return, which depends on the movement of interest rates and the widening and narrowing of spreads. The second is the coupon component, which is generally more attractive than that of government bonds. And finally, we must bear in mind that in a diversified corporate bond allocation, particularly when we are in the High Yields space, a number of companies can be expected to default each year.



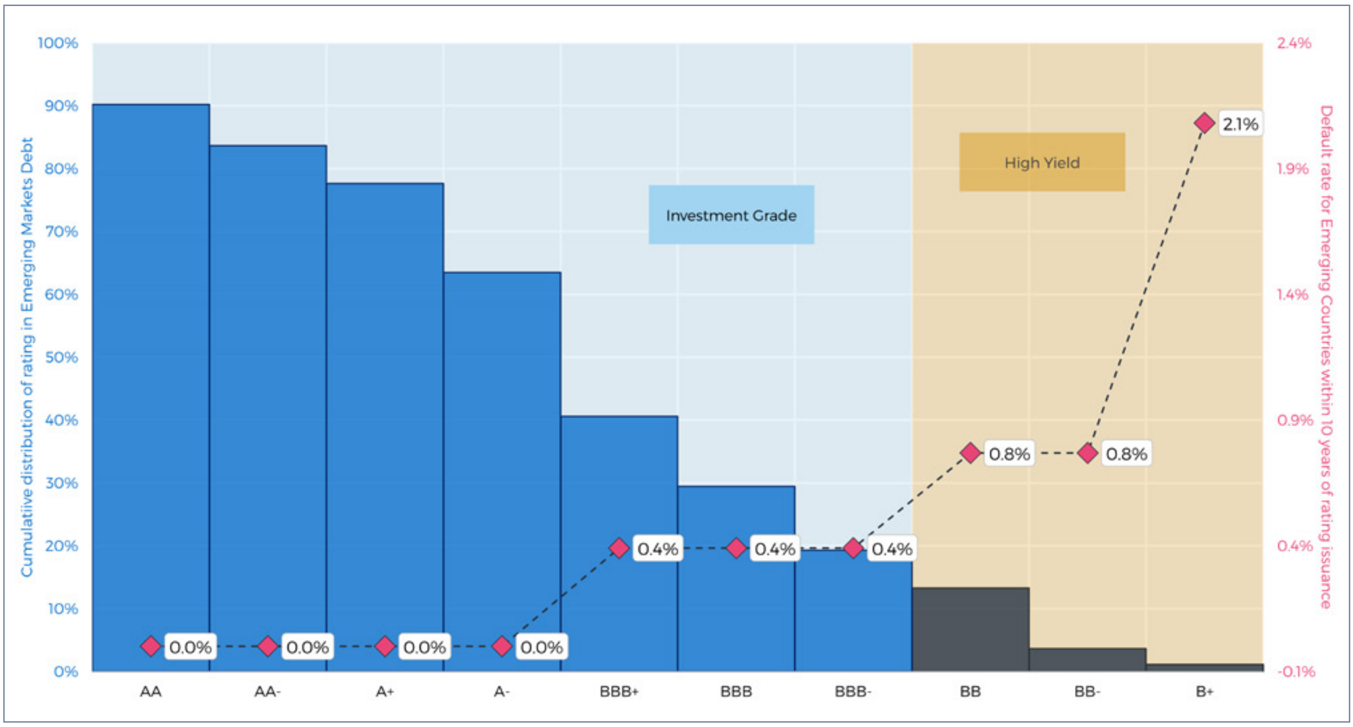
Emerging market corporate and government bonds
Although the probability of a capital loss is relatively high, we still expect the coupon component to deliver a positive general return.

Debt securities are also currently seeing high valuations compared to historical levels which, in terms of long-term normalisation, reduces their expected return. This applies mainly to high yield corporate bonds and government bonds from emerging economies. However, we believe the coupon component is sufficient to counteract both the capital losses and the expected defaults in the coming years.

Turning to corporate debt, the US Investment Grade sector has the most attractive risk-return profile. As the valuations are relatively low, we expect to see lower spread widening in comparison to High Yield. Given the current spread, equal to about 1%, we have also estimated a coupon component capable of compensating the price return losses deriving from the normalisation of rates and the potential defaults.

Last but not least, if we exclude anomalies like the 2008 financial crisis, Investment Grade securities tend to see a tight correlation with government bonds, offering a source of diversification within the equity component of the portfolio.

Emerging Markets Government bonds also have characteristics that are halfway between risky and conservative assets. We believe that the gradual hiking of rates that we expect in developed economies will also affect emerging economies. Among the latter, some are more developed than others. South Korea and Israel, for example, in addition to having a high rating, also have greater stability in their inflation rates and consequently in monetary policy. For other countries, however, we believe that the risk of a higher than expected rate hike is greater, but is largely offset by expected returns, which are not far off from those offered by equities.



Credit ratings of emerging economies whose bonds are included in Moneyfarm portfolios
The blue bars indicate the spread of Moneyfarm's emerging market bond exposure among different credit ratings.

Equities

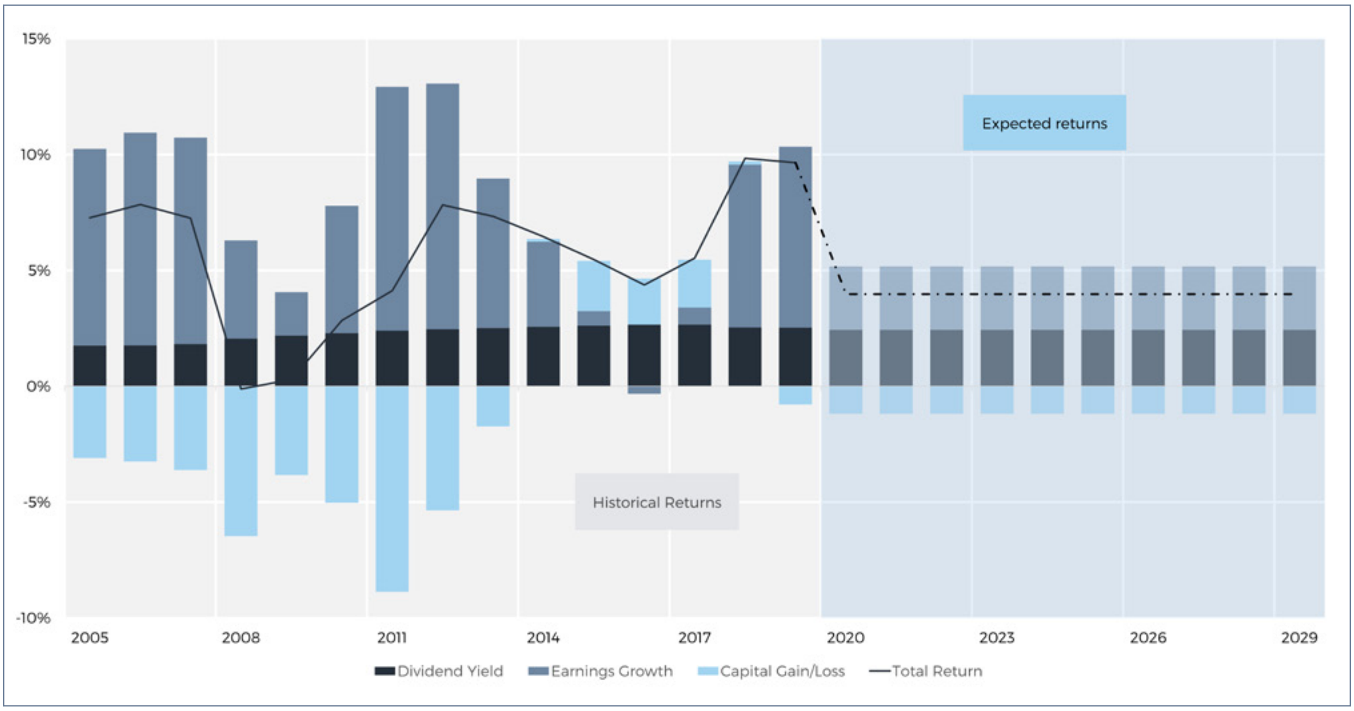
2019 was a year of extremely positive returns for equities, which benefited both from the expansionary monetary policy and the reduction in trade tensions between the US and China towards the end of the year.

Although the forecasts for corporate profits have not drastically changed, the implications of the aforementioned factors have alleviated the implicit risk in valuations (i.e. the relationship between the cost of securities and the economic activity of companies), leading to an increase in the price of equities. This has negatively impacted the expected returns of our 2020 strategic asset allocation. However, expected returns remain positive and keep offering a premium for risk which is invaluable for those investors who need to protect their portfolio from inflation in the long term.

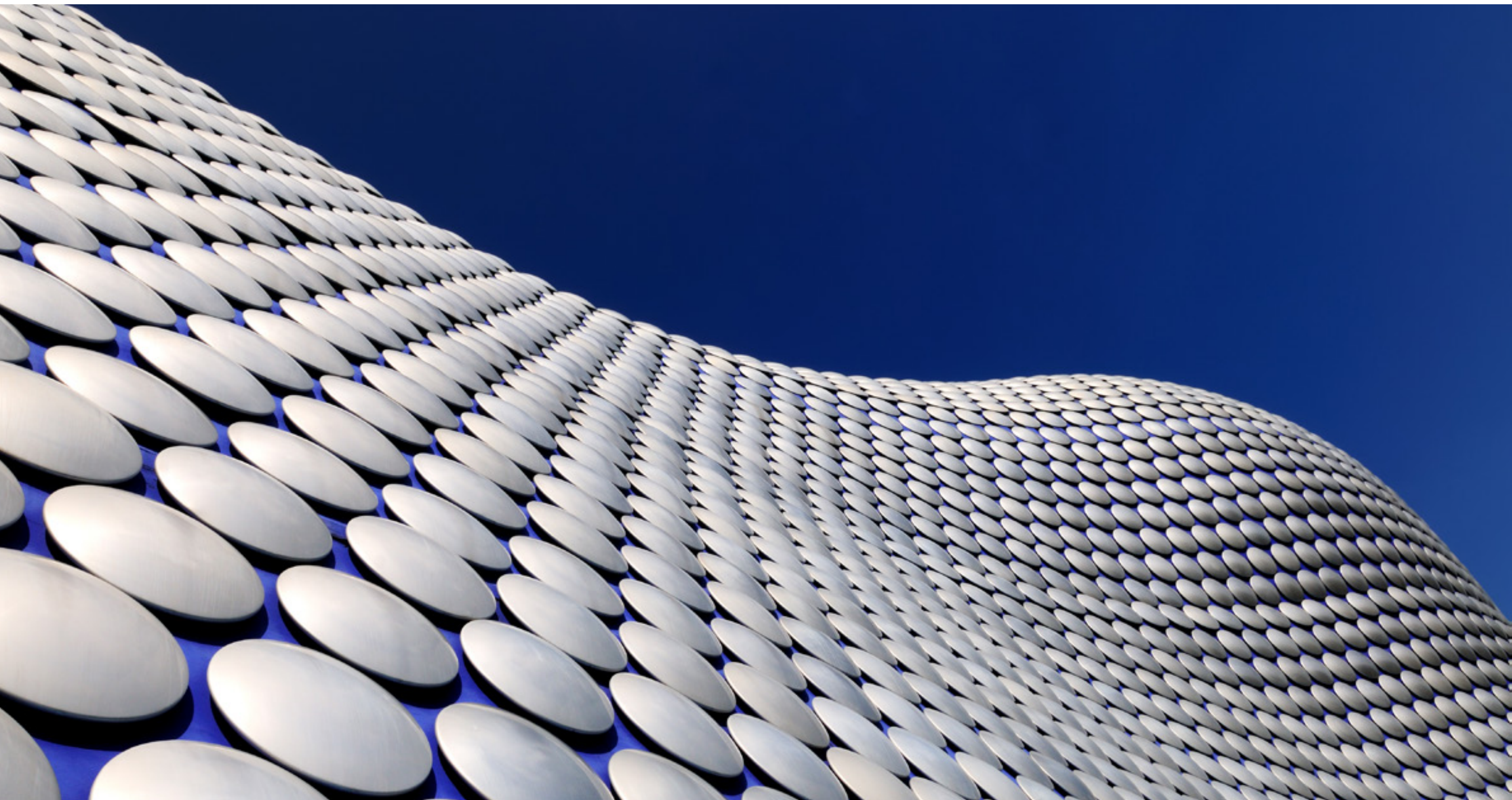
By analysing different geographies, we estimate higher returns for developed economies than for emerging markets. The growth in corporate profits for the latter is closely linked to the growth in global exports, the forecasts for which are positive for the coming decade, though they have been revised downwards.

Determinants of developed market equity expected returns
Although high valuations can limit future returns, earnings growth and dividends still render this asset class the key contributor to long-term growth.

Among the developed economies, the United Kingdom and the United States are preferred to other geographical areas. If overseas equity benefits from significant dividends, the United States enjoys cheaper valuations.



Contributing factors to the last 10 years of equity returns
Over the last 10 years, the above chart shows that valuations have negatively contributed to equity returns, while dividends and earnings growth had a positive impact.



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Volatility and correlations

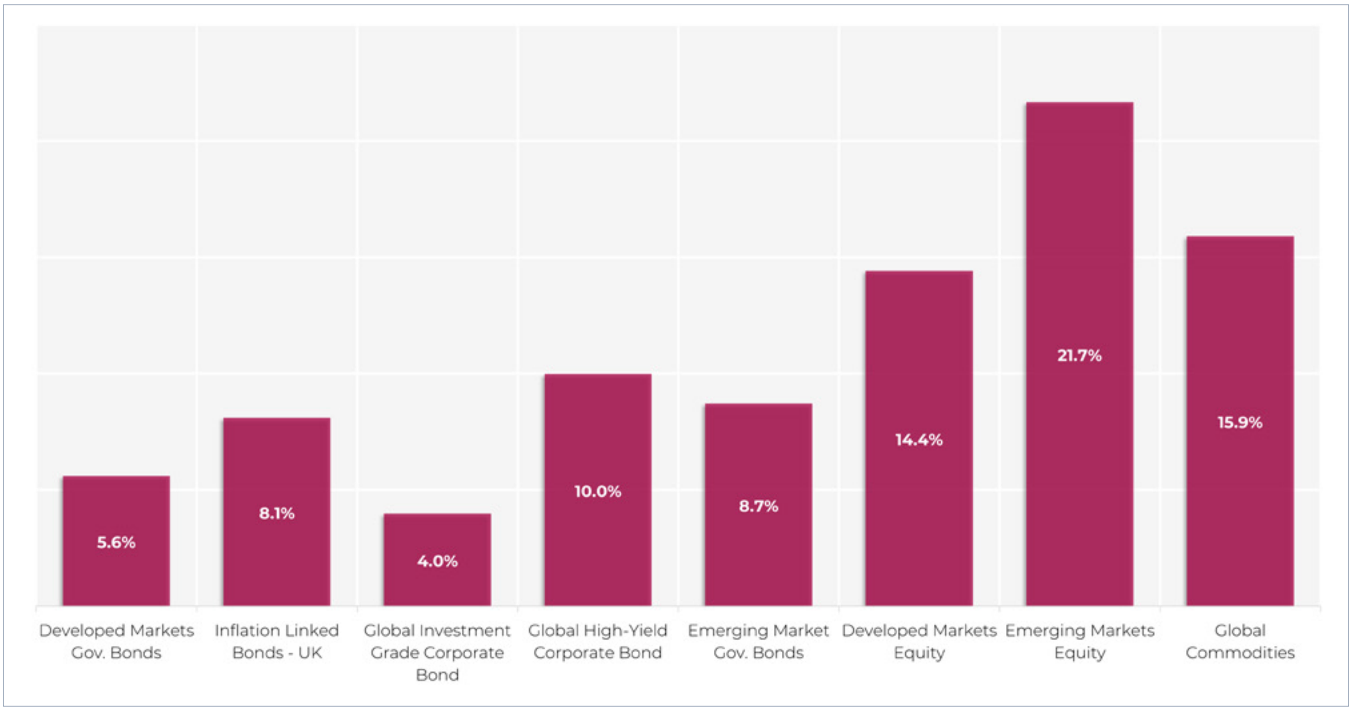
Risk estimate

Our Strategic Asset Allocation works on a long-term time horizon. Therefore, to estimate volatility and correlations, we look at historical data, on a sample long enough to guarantee coverage of a full economic cycle.

For this year, we have chosen the last 20 years as the historical reference sample for the estimate of volatility and correlations. Despite the availability of older historical data, we have focused on the last 20 years for two reasons:

- The financial landscape that has characterised the last two decades will continue to define the markets in the medium term. We believe that the monetary policy and inflation trends of the past decade will remain prominent in the coming years.
- The market structure, important for defining asset class volatility, was notably different before the past two decades.

Therefore, we expect to see slightly higher volatility than what we saw in 2019, but ultimately in line with our Strategic Asset Allocation of last year. The same goes for correlations. This means a higher correlation between risky asset classes, but also a greater capacity for fixed income markets to diversify portfolios.



Strategic asset allocation 2020: expected volatility

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The 2020 Strategic Portfolio

Finalising our strategic asset allocation portfolios

The final stage of the strategic asset allocation process is the creation of seven portfolios that maximise the expected utility for each investor. Once we have identified the spectrum of risk levels, we select the combination of assets that maximises the expected return for each portfolio.

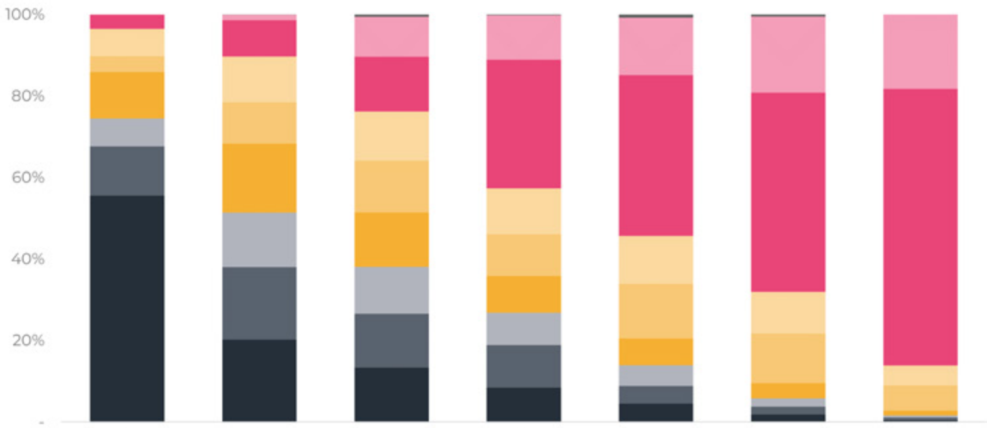
Finding the optimal composition means simultaneously considering the income component, the risk component and the interdependencies between the different asset classes. To consider these three elements at the same time, we use quantitative tools, created with safeguards against the underestimation of risk. Quality checks are then performed at both input and output stages. Each assumption – from the risk level of the asset classes to the estimate of expected returns and the expected benefits of diversification – is subject to verification by the members of the Asset Allocation team, as well as the Investment Committee.

Robust optimisation

In addition to placing constraints on each asset class, in the process of creating portfolios we carry out numerical simulations to analyse the behaviour of portfolios in different scenarios. Although the expected return on equities in emerging economies is lower than that of developed markets, for example, we also consider scenarios in which the former outperforms the latter. This allows us to stress-test our models and our assumptions to obtain robust portfolios that are ready for adverse conditions.

In almost all portfolios, we note the presence of the corporate bond component within high yield, investment grade and with Emerging Market Government bonds, whose exposure reaches a maximum of 12%.

The exposure to the developed market equities remains predominant, being the asset class offering the highest expected return, while the lower anticipated returns from emerging market equities penalises their weight even in the riskiest portfolios.



	p1	p2	p3	p4	p5	p6	p7
Global Commodities	0%	0%	1%	0%	1%	1%	0%
Emerging Markets Equity	0%	1%	10%	11%	14%	19%	19%
Developed Markets Equity	3%	9%	13%	32%	39%	49%	68%
Emerging Market Gov. Bonds	7%	11%	12%	11%	12%	10%	5%
Global High-Yield Corporate Bond	4%	10%	13%	10%	13%	12%	6%
Global Investment Grade Corporate Bond	11%	17%	13%	9%	7%	4%	1%
Inflation Linked Bonds - UK	7%	13%	12%	8%	5%	2%	1%
Developed Markets Gov. Bonds	12%	18%	13%	10%	4%	2%	1%
Sterling Cash	56%	20%	13%	8%	5%	2%	0%

Strategic asset allocation 2020: our strategic portfolios

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Summary

Main takeaways

- Expected returns remain positive for most asset classes over the long term.
- Expected returns are down on last year.
- The level of the rates has forced us to look for yield in the equity component of the portfolio.
- The last 10 years have been characterised by moderate growth, low inflation and accommodative monetary policy: we believe that this balance will continue into the coming years, during which we will see a gradual normalisation of the picture.
- Government bonds from developed countries have comparably low yield prospects. Government bonds linked to inflation are preferred, which also helps guarantee coverage in the event of unforeseen price acceleration.
- Despite high valuations, corporate bonds and emerging debt offer the best risk-return profile in the bond sector.
- Finally, this year the expected returns for developed countries are better than those of emerging countries.

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Additional information

As with all investing, your capital is at risk. The value of your investment can fall as well as rise and you may get back less than you invest. Eligibility to invest in a pension depends upon your circumstances. Tax rules may change in the future. If you need help with pensions, seek independent financial advice. Note that you cannot withdraw money from a personal pension until you are 55.

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