Active MPS
2023 Review

January 2024

For Professional Advisers Only

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Introduction

The aim of this review is to consider how we performed during 2023, our thoughts on where the Active MPS is currently positioned and how we view the year ahead. Both bonds and equities rallied as the global economy escaped the worst scenario of a sharp downturn after the biggest inflation and interest rate shock for 40 years and 2023 can aptly be described as 'The Great Escape'. Despite the end result for most investors being positive, the year was undoubtedly a bumpy ride as uncertainty around the future paths for inflation, interest rates and growth led to considerable market volatility.

As a reminder, our philosophy since launch has been to provide a series of risk targeted portfolios that result in a service similar to that which our firm's private clients receive. We do this by adopting a 'whole of market' approach that includes investment companies and passives alongside open ended funds to gain access to as many asset classes as possible through the most appropriate structure.

Reflecting on 2023

We entered the year with the portfolios positioned to benefit from the recovery in risk assets that started in the fourth quarter of 2022. Overall, we were pretty fully invested with an underweight allocation to cash, overweight equities, overweight alternatives and underweight bonds. Within the equity allocation we were overweight in the UK where we believed the valuation relative to other developed markets looked compelling despite strong outperformance in 2022. We were also overweight in North America although this was slightly skewed by the holding in BlackRock Gold & General which does not provide mainstream exposure. Taking away this exposure left us moderately underweight. Japan was a small underweight, whilst we were overweight in Asia and Emerging Markets in the lower risk models and underweight in the higher risk ones.

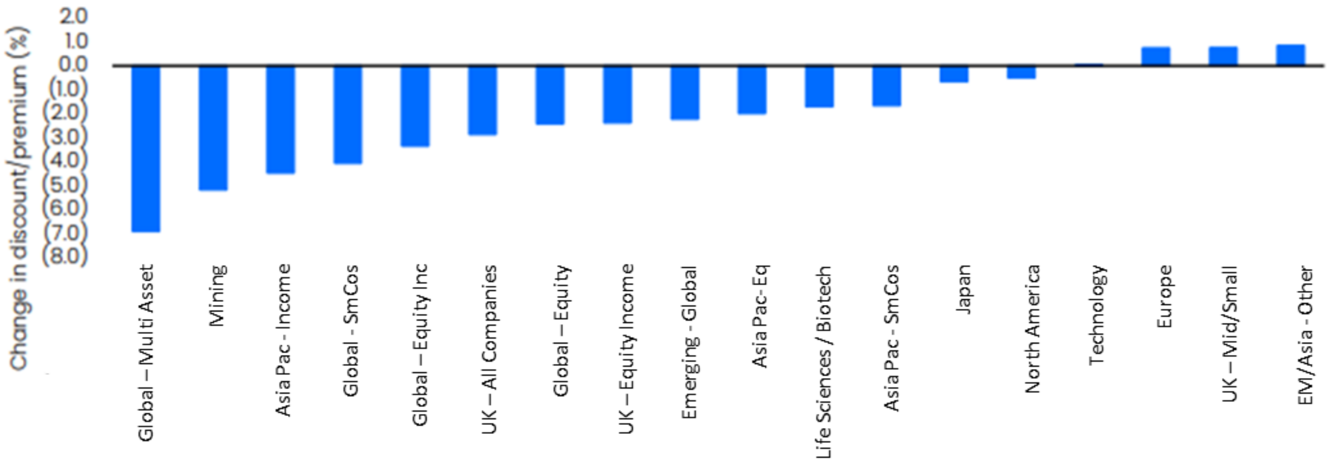
The year started well with inflation expectations falling and investors beginning to anticipate interest rates in the US peaking before the start of gradual cuts towards the end of the year. In Europe, the outlook for the area improved as it avoided an energy crisis over the winter which, along with encouraging economic and company earnings data, helped improve investor sentiment. The Chinese government's rapid policy change on Covid going into the year also helped drive the performance of the region's stock markets. Of note was the FTSE 100 breaching the 8,000 mark for the first time in its history in February.

However, comments from the Federal Reserve Chair, Jerome Powell at the beginning of March, citing strong economic numbers, suggested the possibility of higher interest rates for longer. This occurred ahead of rumblings in the US banking sector where the rapid collapse of Silicon Valley Bank (SVB) and several other regional banks took investors by surprise. Perhaps even more shocking was Credit Suisse being taken over by UBS in an emergency deal that was only made possible by extensive government guarantees. These episodes were an unwelcome reminder of the 2008 banking crisis and resulted in markets falling sharply. It soon became clear that falling inflation expectations at the beginning of the year had been far too optimistic and this hung over markets going into the fourth quarter. The one bright spark was the Artificial Intelligence related theme of the so-called 'Magnificent Seven' stocks of Alphabet (formerly Google), Apple, Amazon, Microsoft, Meta (formerly Facebook), chip-producer Nvidia and Tesla. These companies dominated markets in 2023, delivering returns of 107%[1] to investors, with the only downside being that at the index level they masked generally uninspiring performance from almost every other US company for most of the year.

However, the year's fortunes turned sharply in November and December when investors took the run of softer economic data as confirmation that the Federal Reserve's interest rate hiking cycle had reached its conclusion. This change in market sentiment was supported by dovish communication from the Federal Open Market Committee (FOMC), the group responsible for setting interest rates in the US, as it changed its forward guidance to signal it expected to cut rates three times next year. This marked a considerable change in tone from the September meeting when the committee did not expect to cut interest rates at all in 2024. As a result, bond yields were driven lower and equities bounced as valuations increased.

Since the launch of the Active MPS in September 2012 we have extolled the virtues of investment companies and their use in diversified portfolios. However, the past two years have been an incredibly frustrating period for investors in these vehicles, such as ourselves, as they have struggled due to their discounts to NAV, for various reasons, widening out. During 2023 discounts widened in almost all equity sectors:

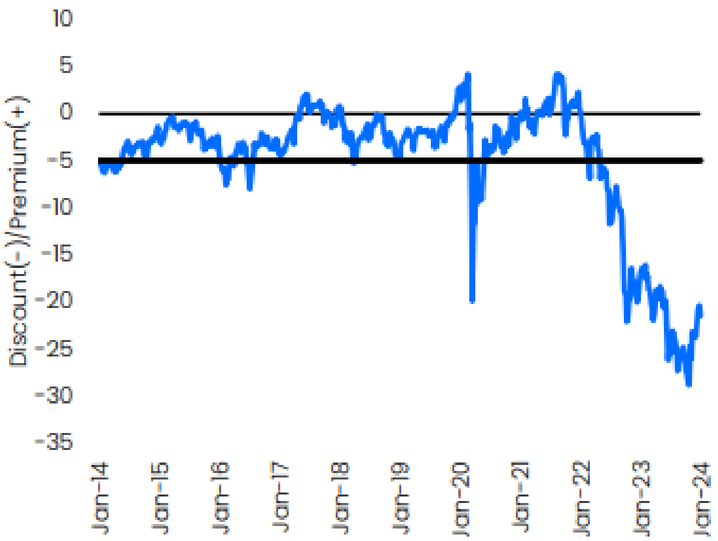
Figure 1: Equity ICs – change in discount since December 2022



Life Sciences excludes BB Biotech Source: Morningstar, Datastream & Numis

And saw a huge widening in alternative assets such as Infrastructure and Property:

Figure 2: Alternative ICs – discounts versus 10 year average



Excludes 3i Group Source: Numis, Morningstar & Datastream

This has unsurprisingly been a significant headwind for our portfolios, However, our enthusiasm for these vehicles remains undimmed and they will continue to feature significantly. We strongly believe that our list of names has the ability to enhance the return profile of each portfolio over the longer term and that we will be rewarded in due course.

In terms of overall performance, all six portfolios made positive ground, ranging from 4.4% for Defensive and 7.7% for Growth[2].

[1] Bloomberg
[2] Factset

What did the team get up to in 2023?

We executed three significant rebalances during the course of the year, with one very minor one just before Christmas. The themes across each one were similar, namely reducing equities and adding to bonds.

The February rebalance was primarily driven by the annual update made to the Dynamic Planner asset allocation framework. At the headline level we reduced equities and hedge funds and increased the overall allocation to fixed income as the yields available on both government and corporate bonds looked attractive. We introduced exposure to US government bonds hedged back to sterling across the range as well as adding to shorter duration corporate bonds in the lower and medium risk models. The reduction in equities reflected a prudent move following the strong recovery in markets in the fourth quarter of 2022 combined with the more uncertain outlook as to what terminal interest rate levels might be. We reduced the allocation to the US and to a lesser extent the UK. Although the bulk of these proceeds were used to fund the increased bond allocation, we did selectively add to the overseas exposure in most models.

In July we further reduced our overweight to equities and again increased the allocation to both government and corporate bonds. Most significantly, the exposure to US government bonds hedged back to sterling was generally increased across the range as we believed that the US was close to the peak in its interest rate cycle and we would expect these bonds to provide good risk-off protection for the portfolios should the macro-economic picture deteriorate. The reduction in equities varied across the range with the only consistent theme being a reduction in the UK exposure. Three new names were introduced to the range at this point. GQG US Equity is a large cap, high conviction strategy with a benchmark agnostic approach and a strong long term track record. It complements our other US holdings well and was added to all but the lowest risk model. INPP is a listed infrastructure investment trust that, due to the movements in bond markets, had seen its discount to net asset value widen significantly. The dividend yield on offer looked compelling and it was added to the two lowest risk models. Finally, Federated Hermes Asia Pacific ex-Japan was brought into the highest risk model to replace two incumbents (Asia Dragon Trust and Fidelity Emerging markets) in whom our conviction had waned.

In November we increased the allocation to cash and government bonds at the expense of equities and corporate bonds in all but two of the portfolios; no changes were made to Growth and Dynamic Growth. Corporate bonds had become less attractive as credit spreads had tightened to levels that made their protection characteristics in a portfolio less obvious. We therefore reduced exposure to longer dated corporate bonds but retained significant exposure to shorter-dated ones that should fare relatively well in the event of any downturn. Government bonds were added to once again.

Finally, in December we rebalanced Defensive and Defensive Income due to AXA's decision to close their Sterling Index-Linked Bond fund. We made a straight swap into the Vanguard UK Inflation Linked Gilt Index fund where we have access to the institutional plus share class that attracts an OCF of just 0.06%.

What investments were the team most pleased to hold and what didn't work so well during the year?

In last year's update the list of funds that had performed well over the year was pretty limited. 2023 saw far better news, with the vast majority of positions providing positive returns.

Within the UK the undoubted star was Artemis UK Select (+19.4%). This was a welcome return to form for its manager, Ed Legget, and demonstrates that after a very tough few years, we may be in a more suitable environment for active managers in the UK to reassert themselves. Further evidence of this can be seen in the gains made from NinetyOne UK Alpha (+12.0%) and Redwheel UK Equity Income (+10.1%). The only disappointment was Premier Miton UK Multi Cap Income (-4.2%) that continued to be held back by its significant allocation to smaller companies. We are happy to retain this position as UK small caps are trading at incredibly cheap levels and even a minor change in sentiment could see a significant rebound in the fund's fortunes.

The biggest detractor of relative performance across the range was the allocation to developed market equities. As mentioned earlier, the US market was driven by the 'Magnificent Seven' tech stocks, making it almost impossible for any active manager to outperform. Our best performing holding here was Vanguard US Equity Index (+18.7%), although even this lagged the benchmark's 19.5% rise. GQG US Equity, although not held for the entire year rose by 13.1% and Monks rose by 12.6%. Perhaps unsurprisingly the biggest laggards were JPMorgan US Equity income (-1.7%) and BlackRock Gold & General (+1.9%) which have minimal or zero exposure to technology names, Interestingly, BlackRock outperformed over the last three months of the year as the conflict in the Middle East ensured the gold price remained firm. The geopolitical uncertainty here is unlikely to go away any time soon and explains the likelihood that this position will be retained for some time to come. Our Japan holdings were also a source of disappointment as the market was buoyed by a rally in value style names of which we have minimal exposure to. Jupiter Japan Income (+10.6%) led the way ahead of the growth focused names of JPMorgan Japan (+9.5%) and Baillie Gifford Japan (-5.6%). Baillie Gifford's poor performance was exacerbated by its discount to NAV widening out considerably. Our European exposure was a significant positive driver with both of our core names, Janus Henderson European Focus (+20.4%) and BlackRock European Dynamic (+17.5%), outperforming significantly.

Within Asia and Emerging Markets relative performance was predicated on one factor- how much China exposure a fund had, with those with a significant weight generally struggling. India has been the biggest beneficiary of investor wariness of China's macro and governance outlook and it once again turned in a leading role, with our holding in Goldman Sachs India (+19.6%) being a direct beneficiary. However, for the second year in a row, the fund that led the way was BlackRock Emerging Markets Equity Strategies (+20.6%), driven by its managers' high conviction and contrarian bets. Three of our investment companies, BlackRock Frontiers (+15.7%), Utilico Emerging Markets (+14.0%) and Asian Total Return Investment Company (+10.3%) also outperformed significantly. The only holdings that disappointed were, unsurprisingly, Fidelity China Special Situations (-9.3%), Fidelity Asia (-3.6%) and Hermes Global Emerging Markets (-2.1%). Overall, our allocations to developing markets contributed positively to performance.

The bond allocation was also a positive driver of performance. Artemis Corporate Bond (+10.4%) led the way although there were also significant contributions from AXA US Short Duration High Yield (+8.6%), M&G Emerging Market Bond (+7.8%) and Sequoia Economic Infrastructure Income (+5.8%), the latter despite its discount to NAV widening out over the year. The returns from government bonds were slightly more muted with iShares 0-5 Year Gilts (+4.2%) and Sanlam International Inflation Linked Bond (+3.3%) both making positive ground.

Alternatives were the star of the range in 2022, but were a significant relative drag in 2023, primarily driven by the allocation to hedge funds. Both NB Uncorrelated Strategies (-9.0%) and BH Macro (-18.3%) were unable to take advantage of the rally in risk assets. BH Macro's NAV performance was respectable (-2.0%) but its discount to NAV blew out following a merger of two of the UK's leading wealth management firms that resulted in the combined entity owning more than 30% of the company. Normally such a stake would require a bid to be made but this was waived by the market regulator. However, the business is a known forced seller of the shares and until the overhang is cleared the discount will persist. Having significantly reduced the holding across the range in 2021 we may look to take advantage of the share price weakness at some point as this holding has demonstrated excellent disaster insurance qualities over the years. Within the property names, Empiric Student Property (+12.6%) did well but this was offset by the more generalist Picton Property Income falling by 13.4%.

Source: Morningstar, Factset as at 31.12.23.

How is the MPS currently positioned as we begin a new year?

The portfolios remain fully invested, with an underweight allocation to cash but overweight all other asset classes, namely equities, bonds and alternatives. The overweight to bonds is almost entirely explained by a maximum overweight to government bonds that was built up throughout 2023. The alternatives overweight can be explained by the portfolios having a range of exposures to property, hedge funds and infrastructure, all of which we believe provide portfolio diversification.

Within the equity allocation we are fractionally underweight the UK and Japan but overweight Europe and North America. The North America position remains skewed by the holding in BlackRock Gold & General which does not provide mainstream exposure. Taking away this exposure leaves us moderately underweight. Finally, we are overweight Asia and Emerging Markets in the lower risk models and underweight in the higher risk ones.

What is the outlook for markets in 2024?

We see five key themes for this year:

1. Equities to outperform bonds: Solid top-line sales growth and resilient corporate pricing power can keep profit margins elevated, which can in turn support company earnings and share prices. The backdrop for bonds is also positive, as central banks are expected to cut interest rates and that should lead to higher bond prices. Nevertheless, given the balance of risks, equities probably look a better option at current valuations.

2. US stock market rally to broaden out: If the US avoids a recession, then we could see the market broaden out beyond AI-led stocks to unloved areas of the market, like energy and small caps. Even so, core quality stocks that typically have strong balance sheets, stable sales, attractive margins and generate cashflow still have a place in portfolios over the business cycle, including the AI-related stocks.

3. Favour UK internationals: The UK large cap equity market can, broadly speaking, be split into domestics and internationals. Domestics earn a higher share of their revenue in the UK and internationals earn a higher share overseas. While both types of company can play an important role in portfolios, in 2024 we favour internationals over domestics for two reasons. First, internationals are more exposed to the global economy, which we expect to perform better than the UK economy. Second, internationals offer better relative value given their more favourable earnings outlook. The risk to this view is that domestics could receive a sizeable relative boost if we see a stronger pound this year. There is also the looming spectre of takeover activity which, having paused for much of last year, appears likely to become a factor again this year. The UK market looks cheap on many metrics, particularly for overseas buyers, and we expect this to result in significant dealflow as the year progresses.

4.Tailwinds to support government bonds: For most of last year, it looked like government bonds were on course to post two consecutive years of negative returns. But bond investors were saved in the final quarter of the year when government bonds rallied strongly. In 2024, we expect a more favourable environment as growth slows, inflation continues to decelerate and central banks start cutting interest rates. With the UK's growth outlook looking weaker than its peers, we like exposure to the gilt market.

5. US dollar depreciation and gold appreciation: Expect the US dollar to depreciate as reviving risk appetite and the overvaluation of the greenback against other major currencies unwinds. Gold should benefit given its role as a portfolio diversifier and an alternative to the fiat currency debasement associated with rising government debt. This was particularly notable during the bond and equity sell-off in 2022 when the gold bullion price was largely flat.

Conclusion

In summary, the inflation shock of 2022 did not morph into a growth shock in 2023, reducing hard landing fears. As interest rates start to come down this could release liquidity into the financial system: Goldman Sachs, an investment bank, estimates that investors poured US$1.4tn into US money market funds (i.e. quasi-cash instruments) and just US$95bn into US equities in 2023[3]. A potential release of this liquidity creates opportunities across equity markets, in UK internationals, gilts and gold in 2024, with the US dollar set to be the big loser.

We thank you all for your support over what has been a testing couple of years and we look forward to staying in regular communication with you throughout the year.

[3] Goldman Sachs, US weekly kickstart, 15 December 2023

Cumulative performance to 31 December 2023

	1 year	5 years	Since Launch
Active MPS Defensive Portfolio	**4.36%**	**16.18%**	**70.45%**
IA 0-35% Shares	6.06%	10.50%	38.42%
Active MPS Defensive Income Portfolio	**5.66%**	**24.38%**	**99.06%**
IA 20-60% Shares	6.86%	19.02%	59.21%
Active MPS Balanced Income Portfolio	**6.61%**	**35.33%**	**124.54%**
IA 40-85% Shares	8.09%	32.08%	96.42%
Active MPS Balanced Growth Portfolio	**7.49%**	**39.77%**	**147.44%**
IA 40-85% Shares	8.09%	32.08%	96.42%
Active MPS Growth Portfolio	**7.67%**	**40.83%**	**158.29%**
IA Flexible	7.30%	34.39%	100.42%
Active MPS Dynamic Growth Portfolio	**7.49%**	**36.02%**	**149.35%**
IA Global	12.65%	64.48%	199.74%

Past performance is not a guide to future performance. Capital at Risk. The value of investments and the income from them can fall as well as rise and you may not receive back the original amount invested. The portfolio's performance is shown above after the effects of all charges made by the underlying holdings but before accounting for Evelyn Partner's investment management charge, and any platform fees and adviser charges. The effect of these additional fees and charges would be to reduce the returns shown. IA = Investment Association. Source: Factset as at 31.12.23.

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