SARANAC PARTNERS

Investment Committee Update

April 2021

AT A GLANCE

- In this month's update we focus on two of our core themes for the year: economic growth versus elevated valuations and the rotation from growth to value.
- Our outlook on potential economic scenarios has improved, with the likelihood of negative outcomes receding. We are currently at 6/10 in terms of risk appetite.
- In conducting a detailed analysis of equity market valuations we also concluded that expectations are rational and indeed there is scope for earnings to outperform expectations.
- We continue to believe this regime favours value and cyclical businesses, despite the outperformance of growth factors in the last month.
- In addition, we believe financial stocks represent an interesting opportunity with depressed valuations and positive earnings revisions. We will therefore be looking for opportunities in this area.
- We believe our current portfolios are well positioned for improvements in the economic environment and have made no changes this month.
- Our current equity allocation is at 50% including a European equity call option. Our equity holdings are balanced between long-term growth stocks and well-priced value and cyclical exposures positioned to benefit from an uptick in economic growth.

In this month's update we focus on two of our three key trends for the year: economic growth versus elevated valuations and the rotation from growth to value.

1. ECONOMIC GROWTH VERSUS ELEVATED VALUATIONS

Over recent months our views on the economic outlook have been trending in a positive direction and this month is no different. Our risk appetite, on average, has moved from 5.5 to 6/10 driven by in particular by the receding risk of negative scenarios. Recession risk has fallen away to near zero probability over the next 12 months and we continue to support the consensus view of a booming economy.

Valuations haven't changed and remain expensive, however in our view valuations have not separated from reality. This month we have undertaken an extensive analysis of equity valuations across sectors and regions relative to different levels of forecast growth for those sectors. We then compared these metrics with prior post-recession periods to see if expectations and/or valuations were unusually high. We concluded that markets seem to be relatively rational in their expectations now, in particular when considering the relative growth rates of differing sectors and their experience through the pandemic to date. If anything, there is scope for revisions to continue to surprise to the upside and for forecast earnings this year and next to move higher than currently predicted.

Bond market volatility has also eased over the past month and we have seen government bond yields stabilise, yield curves have flattened out and higher risk credit has generally outperformed. This has helped risk assets overall. Inflation fears have been the main cause of concern recently and there has been no data to suggest that it is moving higher yet, let alone running out of control. In addition, the Federal Reserve and other central banks have been at pains to assure markets that they are not going to raise interest rates sooner than planned and that they are willing to tolerate inflation above their 2% target for some time if that means the economic recovery is on a more solid footing and unemployment falls to pre-pandemic levels. As a result market angst about an earlier and more aggressive monetary tightening has eased for the time being.

2. ROTATION FROM GROWTH TO VALUE

Equity markets enjoyed strong returns in March but it was interesting to see a pause in the recent outperformance of value over growth. A stable bond market and flatter yield curve may have been relevant in seeing a weaker performance in financials (the most important value sector), while energy had something of a correction after some very strong returns, in line with the weakening in the oil price. The more traditional growth areas of technology and consumer discretionary performed best, with semiconductors in particular enjoying a very strong month on highly publicised supply shortages.

Despite this month's reversal, however, we continue to believe that the equity regime remains one that favours value sectors. Cyclical sectors within markets have re-rated to higher valuations than their defensive counterparts, but that is to be expected as their earnings growth is going to be much faster coming out of a recession. When looking at

The anticipated economic boom over the coming 12 months has seen expectations for earnings growth rise across the market, and now value stocks look attractively priced relative to growth for a given unit of growth.

the P/E to growth rate (the PEG ratio), then cyclical sectors look relatively well placed compared to the more quality growth areas of the market.

This has not always been the case. One interesting change has been the improvement in growth prospects for value stocks – in aggregate the PEG ratio of value stocks is now lower than that of growth stocks, a reversal of the position that has held for most of the past decade (figure 1). Earnings growth has been so weak for value over the last 10 years that despite their cheap valuation, their PEG ratio has been worse than that of growth stocks. The anticipated economic boom over the coming 12 months has seen expectations for earnings growth rise across the market, and now value stocks look attractively priced relative to growth for a given unit of growth.

Figure 1: S&P 500 growth and value
For much of the past 15 years, the P/E to growth (PEG) ratio of value stocks has been higher than that of growth stocks. However, recent improving growth prospects and still lower valuations has seen the PEG ratio of value fall below that of growth, suggesting a more attractive valuation for value per unit of growth.

Source: Yardeni Research Inc.

Another sector that also attracted attention was financials. This sector has performed well over the past six months, leading the recovery in value, but it is clear that valuations remain very depressed on both an absolute and relative basis (figure 2). Despite this, positive earnings revisions are some of the best in the market.

Figure 2: MSCI Financials vs MSCI World
The relative valuation of the financials sector remains at very depressed levels compared with global equities.

Source: Saranac Partners.

In aggregate, we concluded that the changes we have made to our equity portfolios since last summer have put us in the right position, balancing our core long term growth stocks with more cyclical and cheaper equities poised to benefit from an acceleration in economic growth. However, we are intrigued by the value financial stocks still show and are looking for opportunities in that area.

Within our hedge fund allocation it has been noticeable that the equity long/short managers have been able to take advantage of equity market volatility this year.

PORTFOLIOS

Asset allocation

Despite the improvement in our assessment of the economic outlook, prior changes to portfolios and the inevitable moves in asset allocation caused by performance (aka drift) mean that we do not feel the need to make further changes to portfolios to reflect this more positive view.

Equity performance, notably from the call option we hold, means that the allocation to equity in balanced portfolios has risen to close to 50%. Given our range is 20–60% in this asset class, this position adequately reflects our market views right now.

Fixed income

Following the sharp rise in inflation expectations and the rise in longer dated bond yields through February and early March, the more recent period has been relatively benign. Credit has continued to outperform, especially short-duration high-yield areas of the market.

Our fixed income portfolios have been protected from some of the losses caused by rising yields through their limited allocation to government bonds and a relatively short duration, leading to a lower sensitivity to higher bond yields than the market. In addition, our emphasis on high yield credit has also helped, having outperformed other areas of the global bond market year-to-date.

Our typical fixed income allocation currently offers a yield of 2.8% on a 4.2-year duration, which we view as an attractive risk/return proposition in the current environment. In the context of extraordinary monetary and fiscal accommodation, we do not rule out further pain on long-duration fixed income. Hence, we decided to leave our fixed income positioning unchanged.

Equities

We hold a European equity call option in most portfolios and this has performed well for us since we bought the position, such that the exposure has more than doubled. This option is the second such derivative we have held in portfolios this year. The first option we sold in February, having doubled our money, and we invested the profit into the current option as an efficient means to capture potential further upside in markets. As the option approaches maturity in May, it’s sensitivity to market movements rises and we calculate that the option is currently giving us the equivalent of 7–8% additional equity exposure. We are comfortable maintaining this additional exposure, given that it is based on the European equity market, which has a higher cyclical and value bias to it than the US.

Alternatives

We reduced our position in gold to 3% last month and the metal has stabilised towards $1,700 for the time being. Inflation expectations have also levelled off and this has eased some of the pressure on gold, real interest rates remained the same over the past month.

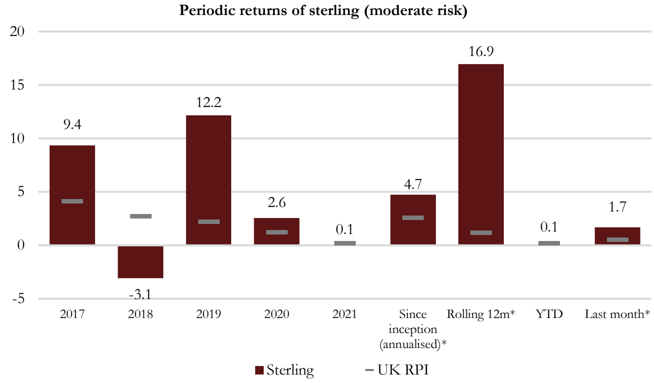
The proceeds from the sale of the gold have been reinvested into a commodity fund which gives us exposure to many other areas of the commodity market, such as industrial metals and rare earths, as well as gold. Much of this exposure is through mining companies, rather than the underlying commodity itself, and the manager actively tilts the emphasis of the fund towards the sub-sectors of the commodity market he believes are most attractive. In this way we have broadened and diversified the commodity exposure in portfolios.

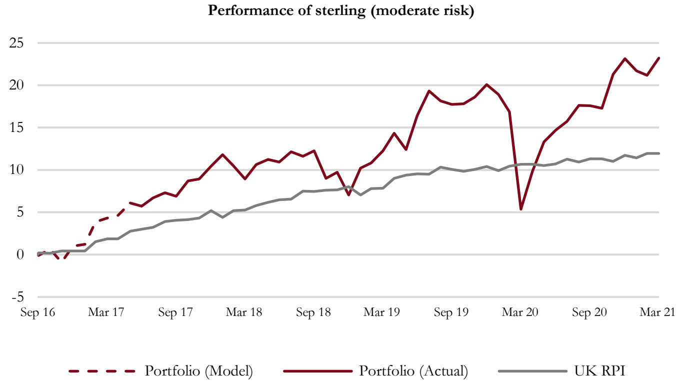
Within our hedge fund allocation it has been noticeable that the equity long/short managers have been able to take advantage of equity market volatility this year. Whilst they follow very different strategies, one being tech focused and the other a value manager, they have both generated strong returns so far in 2021.

Multi-asset strategies

Performance as of 1 April 2021

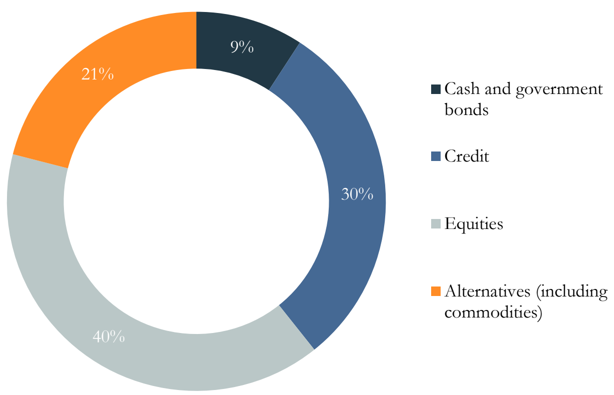
Returns (%)

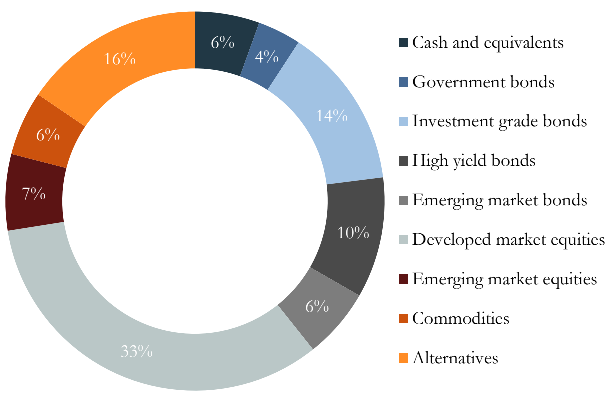




*End March 2021 for Sterling. End February 2021 for RPI (March data not available yet).

Asset allocation (average across all portfolios, %)

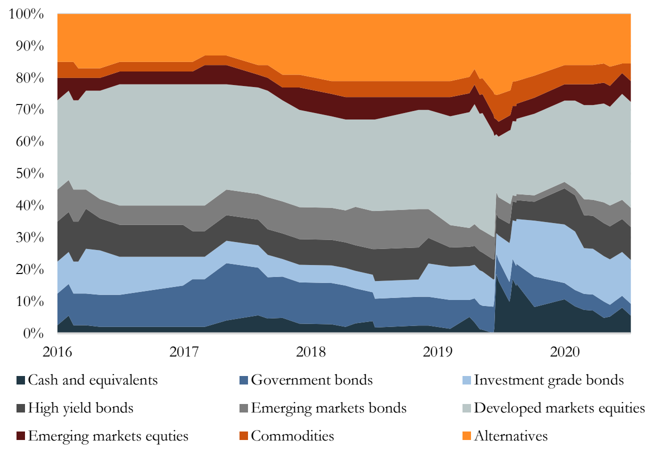




Changes over the past month (%)

	Sterling	Change
Cash and government bonds	**9.2**	**0.3**
Cash and equivalents	5.5	0.3
Government bonds	3.7	0.0
Credit	**30.1**	**-1.0**
Investment grade bonds	13.8	-0.5
High yield bonds	10.3	0.0
Emerging market bonds	6.0	-0.5
Equities	**39.7**	**2.2**
Developed market equities	33.2	2.2
Emerging market equities	6.5	0.0
Alternatives	**21.0**	**-1.5**
Commodities	5.5	-0.5
Alternatives	15.5	-1.0

Changes over time (%)

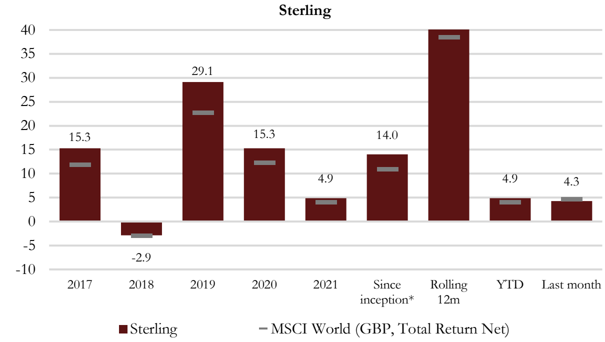


Performance figures from inception (28 September 2016) to end May 2017 are based on model portfolios, simulated from a full record of trading decisions and execution levels are readily available for review. Performance figures from June 2017 onwards are based on an aggregation of actual client portfolios whose mandate most closely follow the Moderate Risk model. Dividends have been included on an accruals basis in both cases. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance.

Equity strategies

Performance as of 1 April 2021

Returns (%)



Euros and US dollar

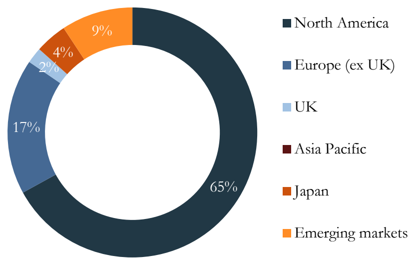
	2017	2018	2019	2020	2021	Since inception*	Rolling 12m	YTD	Last month
Euros	10.9	-4.0	36.7	9.1	10.3	57.4	57.4	10.3	6.3
MSCI World (EUR, Total Return Net)	7.5	-4.1	30.0	6.3	9.2	43.8	43.8	9.2	6.7
US dollar	26.2	-8.6	34.2	19.0	5.9	17.0	68.6	5.9	3.0
MSCI World (USD, Total Return Net)	22.4	-8.7	27.7	15.9	4.9	13.8	54.0	4.9	3.3

*Since inception figures are annualised.

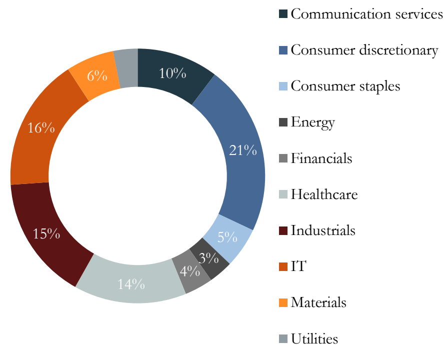
Top 10 holdings (%)

Holding	Weight (%)
FANUC	4.2
Alphabet	4.0
Microsoft	3.8
United Health Group	3.6
Home Depot	3.6
Facebook	3.5
Discover Financial Services	3.5
LVMH	3.5
Visa	3.4
United Rentals	3.4

Regional exposure



Sector exposure

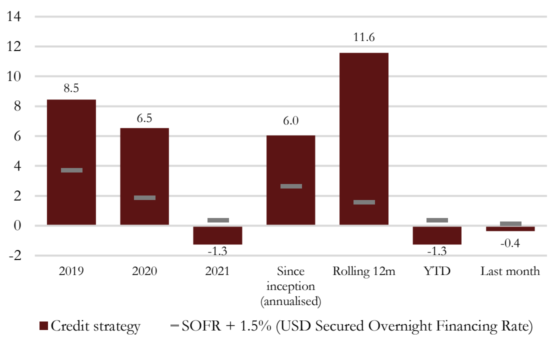


Performance figures from inception (1 January 2017) are based on a model portfolio, simulated from a full record of trading decisions and execution levels are readily available for review. Dividends have been included on an accruals basis. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance. Actual fe.es paid by the client portfolios excluded. Fees may vary.

Credit strategy

Performance as of 1 April 2021

Returns (%)



	Credit strategy			Benchmark		
	USD	GBP (hedged)	EUR (hedged)	USD	GBP (hedged)	EUR (hedged)
Last month	-0.4	-0.4	-0.4	0.1	0.1	0.1
Rolling 12m	11.6	11.2	10.6	1.6	1.3	0.7
2020	6.5	6.0	5.2	1.9	1.4	0.6
2019	8.5	6.6	5.3	3.7	1.9	0.6
Since inception	14.1	11.5	9.1	6.0	3.6	1.4
Since inception (annualised)	6.0	5.0	4.0	2.6	1.6	0.6

Asset allocation and performance measures

Issuer type	Weight (%)	Yield to maturity (bps)	Modified duration	Composite rating
Core IG allocation	**73.0**	**232**	**4.7**	**BBB**
Developed markets	52.0	219	4.7	BBB
Emerging markets	18.0	258	4.9	BBB+
Asset backed securities	3.0	310	2.2	A-
High yield satellite	**27.0**	**474**	**3.2**	**BB**
Developed markets high yield	12.0	396	1.9	B+
Emerging markets high yield	2.0	780	7.0	BB-
Corporate hybrids	5.0	478	3.0	BB+
Financial subordinated	8.0	512	4.7	BB+
Total portfolio	**100.0**	**298**	**4.3**	**BBB-**

Performance figures from inception 31/12/18 are based on an actual client portfolio whose mandate most closely follows the Diversified Credit Strategy. All performance is shown inclusive of fees. Since inception, the portfolio has experienced zero defaults. Your capital is at risk and past performance is not a reliable indicator of future performance.

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