LOWES
INVESTMENT MANAGEMENT

Defensive Growth

Quarterly Report to 30 September 2024

Objective

To protect capital values against the effects of inflation over the medium to long term, whilst minimising the effects of market downturns.

Strategy

The portfolio is constructed so that at least sixty percent will be allocated to Targeted Absolute Return funds which seek to generate positive returns in all market conditions with significantly less volatility than equities. This means that these strategies can include a greater use of derivative based strategies by the underlying fund managers. The remainder of the portfolio will include an allocation to funds from other Investment Association (IA) sectors where it is believed that they contribute to the overall portfolio objective.

Market Commentary

From an economic perspective concern clearly shifted from inflation to economic growth. For now, inflation appears to be behaving itself. In the euro area the rate has fallen below 2%. In the UK, consumer price inflation has now held steady at 2.2% for two consecutive months. In the US, meanwhile, we have also seen a move down towards target, falling most recently to 2.5%. Whilst there are still some components of the inflation basket which remain sticky, such as housing rents, concerns are dissipating.

Narrative is now more closely focussed on economic growth and how central banks protect it. Whilst the most recent forecast from the Organisation for Economic Co-operation and Development (OECD) remains relatively positive, investors are keen to understand how western central banks will navigate from the current higher interest rate environment to one more commensurate with lower inflation. There was concern that the US Federal Reserve (Fed) had left it too long after a weak August jobs report. This triggered them into action, with their first move being a 0.5% reduction. The market also priced in a number of subsequent cuts in quick fashion. It has not been uncommon for the market to get ahead if itself, a point in case being the fourth quarter of last year. It may have done so again this time too, following a stronger than expected employment report for September which appears to have reinforced the soft landing thesis.

The Fed, European Central Bank (ECB) and Bank of England are all expected to continue their path of cutting moving forward. The exception to the rule is the Bank of Japan who appear to be in hiking mode. They caught the market off guard with their most recent hike at the end of July, which sent equity markets into a downward spiral. Whilst the hike was only a small 0.15%, it was enough to unsettle investors.

With US interest rates moving one way and Japanese in the other, we saw what appears to be a partial unwinding of the carry trade in early August, the carry trade being where investors borrow in a lower yielding currency, i.e. the Japanese yen, to invest in higher yielding currencies/assets. No one is quite sure exactly how large the positioning in the carry trade is, with some wide ranging estimates. The general consensus is that positions in the carry trade still exist and therefore a keen eye will likely be kept on the Bank of Japan.

The weakness in markets was met this time with investors keen to get back into the market at lower valuations. Liquidity is certainly abundant, with the Investment Company Institute reporting $6.46 trillion in money market funds in the US. The question is, is this money likely to make its way into investment markets or stay parked where it is. Plenty to monitor as we enter the final quarter of 2024.

Performance

The portfolio posted a return for the period of 2.45%, ahead of the IA Targeted Absolute Return sector average of 1.57%. All but one of the underlying holdings outperformed this sector average.

After being one of the weaker performers in the portfolio in the second quarter, the strongest performing fund during the period was the Ninety One Diversified Income fund. This highlights the true benefit of diversification within a portfolio. The fund performed well during the period thanks to its weighting to fixed income. This asset class performed well following interest rate cuts and on the expectation that there are more to come. Long duration assets such as HICL Infrastructure, also held in the fund, also performed well.

A further fund to benefit from the performance of the fixed income asset class was M&G Episode Allocation. This fund held a meaningful exposure to government and corporate bonds. Naturally those funds investing in only this asset class, including Artemis Short Duration Strategic Bond and TwentyFour Absolute Return Credit were also beneficiaries. The returns posted by the long/short equity funds allocated to were all positive but to different degrees, being very much driven by stock selection.

Source: FE Analytics, Bid-Bid, Total Return

Portfolio Activity and Positioning

During the quarter the allocation to the BlackRock UK Absolute Alpha fund increased at the expense of the Ninety One Diversified Income fund. We chose to reduce the allocation to the Ninety One fund due to its greater focus on fixed income compared to other multi-asset funds allocated to within the portfolio. Whilst falling interest rates will be a positive for the asset class, this is now being priced into the market. Although bond yields at the shorter end of the yield curve will come down as interest rates do, we are not convinced that longer dated yields will to the same extent, especially if we were to see the soft economic landing play out. This will see the yield curve steepen. Should it become apparent that a harder economic landing is more likely then we re-assess this decision. An allocation is still maintained in this fund.

The beneficiary of this reduction was the BlackRock UK Absolute Alpha fund. This fund is already allocated to within the portfolio. It is a long/short equity fund and therefore has the ability to benefit from share prices rising or falling. A greater dispersion of returns within UK equities across the market cap spectrum should hopefully provide rich pickings for a fund such as this. Following this reallocation, the portfolio was rebalanced. It remains diversified across long/short equity funds, fixed income funds managed with an absolute return mindset, along with multi-asset funds looking to achieve the same. This diversification should help to achieve the desired outcome for this portfolio over the medium to longer term.