SEI Strategic Portfolios:
Q1 2018 Quarterly Commentary

STABILITY-FOCUSED

SEI New ways. New answers.®

Following a quarter of increased volatility and meaningful drawdowns, global markets end lower; while not immune to losses, the Stability-Focused Strategic Portfolios achieved risk reduction over the period.

Executive Summary

- US tax reform and fiscal spending, a strengthening outlook for rising interest rates, as well as the imposition of trade tariffs by the US, thereby kicking off the rumblings of a global trade war, combined to provide markedly increased levels of global equity market volatility and drawdowns during the first quarter. Correspondingly, global fixed income markets also experienced notable sell-offs over the period.
- For the Stability-Focused Strategic Portfolios, dedicated short duration allocations as well as short duration positioning, both providing relatively lower interest rate sensitivity, cushioned the impact of rising yields in many fixed income markets. The global managed volatility equity asset class did not provide the expected protection in February, however meaningful risk reduction was achieved in March. Despite this, SEI's view is that the asset class has not been tested in an environment in which it may provide more meaningful capital preservation benefits. Strengthening of sterling over the period also provided a headwind to unhedged, non-UK positions, relevant because the SEI strategic portfolios structurally are global in nature.
- The Stability-Focused Strategic Portfolios (the Defensive, Conservative, and Moderate Funds, collectively "the Funds", Sterling Wealth A share class, in GBP, net of all fees) returns ranged between -0.67% and -2.31% in Q1 2018, compared to the -0.21% return of BofA Merrill Lynch Sterling Broad Market index over the same time period, which can be seen as a representation of the UK fixed income market. UK equities meanwhile declined by -6.87% over the same period, as measured by the FTSE All-Share Index. Crucially, each of the funds continued to achieve their longer-term returns with a higher level of risk-adjusted return than the above-mentioned benchmark, consistent with their unique asset allocation design.
- Consistent with their Goals-based investment design, SEI manages the Stability-Focused Strategic Portfolios to specific maximum drawdown targets which tend to result in an asset allocation structure that seeks to deliver a smoother investment journey for investors. Evidence of the success of this approach can be found in the 5-years to 31 March 2018 volatility data of the Stability Focused Strategic Portfolios, with respective values of 1.71%, 2.86%, 4.10% for the Defensive, Conservative, and Moderate Funds, comparing favourably against the fixed-income only BofA Merrill Lynch Sterling Broad Market index volatility number of 6.59%.

Market Overview

Equities tumbled around the globe during the first quarter after climbing to record highs in late January. Several partial rebounds had varying degrees of success and staying power, depending on the country and region; the US and China fared better than Europe, the UK and Japan. Most stock markets ended March near the low end of their quarterly range. Government bond yields rose across all maturities in the US and generally declined in Japan. UK and euro-area yields mostly increased, although longer-term yields declined. Oil prices fell with the initial stock sell-off, but recovered to finish the first quarter higher than where they began.

The Bank of England's Monetary Policy Committee did not make policy changes during the first quarter. Retail sales in the UK appeared set to disappoint in March, based on a preliminary distributor's survey, while February was a modestly strong sales month following a decline in January. Unemployment for the November-to-January period came down to 4.3%. The final reading for overall fourth quarter economic growth held at 0.4% (just below the third quarter pace) and 1.4% year-over-year.

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The ECB took no new actions at their respective January and March meetings, but removed some dovish language from its forward guidance during the latter meeting. Eurozone manufacturing and services growth moderated during the first quarter after nearing red-hot levels in the prior three-month period; economic sentiment also declined, as optimism waned on both the industrial and consumer fronts. The unemployment rate edged down to 8.5% in February after remaining unchanged in January. Total economic growth in the fourth quarter of 2017 was unchanged at 0.6% for the three-month period and 2.7% year-over-year.

US President Donald Trump volleyed a series of tariffs as the quarter progressed, beginning with specific consumer products, then moving to industrial metals, and concluding with a round dedicated to China. These invited a range of proposed retaliation measures (as well as a concrete response from China at the beginning of April). Several countries received exemptions as an incentive to hammer out trade deals with the US.

With the new Fed Chair Jerome Powell freshly sworn in, the Fed increased its funds rate in March. It maintained its outlook for two additional rate hikes this year, but boosted the number of expected rate hikes for 2019. US manufacturing conditions remained vibrant throughout the first quarter. The unemployment rate held at 4.1% throughout the quarter. Personal income strength held at 0.4% through February, outpacing consumer spending, while personal consumption expenditure prices edged upward. The US economy expanded at a 2.9% annualised rate in the fourth quarter, based on the final reading of gross domestic product for the period.

Selected Asset Class Commentary

Global Short Duration Asset Class: Benign market conditions at the beginning of 2018 gave way to a significant pick-up in volatility at the start of February. Central banks continue to remove liquidity, either through interest rates hikes or signalling their intention to reduce and remove asset purchases, actions that should be generally supportive of shorter duration allocations and biases. For the quarter, the main contributors to asset class excess returns were the overweight to local currency emerging debt and underweight to US duration. Off-benchmark exposure to spread sectors had a muted impact. Colchester Global Investors, the top contributing manager, benefited from an underweight to US duration and overweight positions to Mexico and Brazil bonds.

UK Core Fixed Income Asset Class: While the Bank of England was interpreted as being more hawkish, the central bank kept rates on hold in its last meeting, in-line with market expectations. Markets are pricing one to two more rate hikes this year with May and August both presenting opportunities for policy change. The asset class bias toward short duration and long credit assets was beneficial at the beginning of the quarter, but detracted toward quarter end. Schroder Investment Management, the top contributing manager, short rate exposure in US and Germany. PIMCO Europe detracted as exposure to spread sectors, primarily bank, hurt performance.

Global Managed Volatility Equities Asset Class: Low volatility was unable to deliver much downside protection in February, due to strong performance of IT and a bond sell-off. However, in the March equity market sell-off low volatility performed well, as IT struggled. The asset class did deliver meaningful risk reduction for the quarter, 19% as measured by standard deviation weekly returns. LSV Asset Management performed best, as the manager's valuation focus worked well in March. Analytic Investors underperformed the other managers significantly in January and February due to low volatility exposure and an overweight to non-US equities; however performance improved in March.

Global Equities Asset Class: In spite of substantial spike in volatility, underlying equity market dynamics remained broadly unchanged over the quarter. The asset class benefited from an overweight to momentum, underweight to low volatility and strong stock selection from valuation-focused managers which partially mitigated their alpha source drag. Global managers contributed the bulk of the building block's performance, predominantly on the back of momentum tail-winds. On top of alpha source tailwinds, INTECH investment Management also realised strong stock selection. Lazard Asset Management detracted due to poor stock selection, which fully negated momentum outperformance.

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Manager Changes

There were no manager changes in Q1 2018.

Outlook

Despite a recent softening in the economic data, the overall global economic picture is one of continued synchronised growth, improving (tightening) labour markets and slighter firmer (albeit still muted) inflation. Nevertheless, the fundamental, technical and psychological factors driving equity-market performance appear consistent with the latter stages of an up cycle. This particular phase can last a few years if all goes well, but the ride will likely be bumpier than in recent years.

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Although equity markets underwent their first real correction in some 20 months during February and March, the pullback does not look like the start of a more serious decline. At SEI, we see two fundamental drivers behind the correction in equities and the return to more-volatile price action. The first is the upward shift in investors' interest rate expectations as the global economy kicks into a higher gear. The second is concern that the Trump administration's recent actions on the trade front will lead to a broader trade war that could hurt global growth and push inflation higher sooner.

The long bull market in equities and other risk-oriented assets has been sustained by the extraordinarily expansive monetary policies of the world's most important central banks. And the subsequent decline in yields across the maturity spectrum reached levels never seen before. However, the US treasury yield curve remains upward sloping and can narrow further without causing too many problems. High yield bonds, in particular, should be considered the canary in the coal mine. Spreads tend to widen well before the stock market tops out. Even during the recent turbulence in the stock market, the option-adjusted spread on high yield bonds held surprisingly steady.

The US equity market has historically managed to withstand the depressive impact of rising interest rates until the 10-year US treasury reaches a level of 4% to 5%. Owing to the structural decline in bond yields and the elevated equity valuations that have resulted, SEI now think it prudent to assume that the stock market will begin to struggle if the 10-year treasury rate approaches 4%, the lower end of the traditional "danger zone". SEI is in watchful-waiting mode when it comes to trade, but we think it premature to expect a catastrophe. Our preference is to see what trade sanctions are actually levied, and how target countries respond, instead of assuming the worst from the get-go.

Like many investors, SEI has been disappointed by the poor relative performance of eurozone equities since the middle of last year. The eurozone economy has been gaining traction since early 2016; we judged the potential for future growth to be much greater in the eurozone than in the US given their respective points in the economic cycle. SEI also looked for a jump in earnings, as European companies have a high degree of operational leverage, while valuation considerations also provided support to our bullish rationale. Meanwhile, the ECB is moving away from the asset purchases that have supported the eurozone's economic recovery and credit markets. Patience and vigilance is clearly required.

The past nine years have been full of challenges and uncertainties. The years ahead don't seem to promise anything different in that regard. Yet, the bull market has managed through it all. SEI will likely give it the benefit of the doubt for a while longer. Although the ride has turned bumpier, SEI believes that economic fundamentals justify further gains in US and global equity prices. The synchronised global expansion is still alive and well. Earnings continue to climb briskly around the world. US companies' cash flows and earnings, meanwhile, are benefiting mightily from tax reform. There really are few signs that a recession will rear its ugly head anytime in the next 12 to 18 months. As a result, SEI's cautious 'risk-on' positioning will remain in evidence through the Strategic Portfolios.

Important Information on Performance

Past Performance is not an indicator of future performance. Standardised performance is available upon request. All data is as at 31 March 2018.

Asset class performance discussed is based on the majority SEI fund underlying the asset class. This does not include analysis of the manager pools, hedged share class investments within SEI Funds, additional SEI funds or any third-party funds within the Strategic Portfolios. As a result, performance for the total asset class allocation may vary. Not all asset classes discussed are included in all Strategic Portfolios. All asset class comparative performance is relative to the benchmark of the specific SEI fund representing the majority of the asset class investment.

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- Fixed-income securities are subject to credit risk and may also be subject to price volatility and may be sensitive to interest rate fluctuations.
- Absolute return investments utilise aggressive investment techniques which may increase the volatility of returns. If the correlation between absolute return investments and other asset classes within the fund increases, absolute return investments' expected diversification benefits may be decreased.
- International investments may involve risk of capital loss from unfavourable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations.

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SEI sources data directly from FactSet, Lipper, and BlackRock, unless otherwise stated.

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