

# STABILITY-FOCUSED

**The final quarter of 2018 hosted precipitous declines in stock markets around the globe, exceeding the corrections of the first quarter and erasing the recoveries that followed**



## Executive Summary

- › The US equity market finally succumbed to risk-off sentiment and rolled over in the fourth quarter of the year, leading global markets lower. Government bonds led fixed-income performance, while riskier segments like high-yield bonds had the sharpest losses, consistent with a flight-to-safety environment.
- › Considering 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), an overweight to credit and higher yielding fixed income in our global investment-grade building blocks detracted. The environment was positive for the Global Managed Volatility Equities Building Block, which by design seeks to reduce risk.
- › The Stability-Focused Strategic Portfolios returns ranged between -0.83% and -3.61% in Q4 2018, compared to the 1.41% 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, while the Bloomberg Barclays Global Aggregate GBP-Hedged index delivered 1.26%. Crucially, with the exception of the ultra-conservative Defensive fund, 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. (Source: SEI)
- › Despite a challenging year, SEI's outlook for valuation-based strategies has further improved. Valuation dispersions in the US show the strongest reading, only slightly below the all-time high of the Tech Bubble, while exceeding those of 2008. This is especially relevant to the positioning of the Global Equities Building Block.
- › While challenging to returns in 2018, in SEI's view this presents a strong opportunity on a forward-looking basis. Many cyclical and consumer-oriented names trade at below 5x of earnings multiple and below their book values. Even a moderate US recession, which SEI believes to be unlikely, does not justify such a degree of de-rating.
- › 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 December 2018 volatility data of the Stability Focused Strategic Portfolios, with respective values of 1.58%, 2.73%, 4.01% for the Defensive, Conservative, and Moderate Funds, comparing favourably against the fixed-income only BofA Merrill Lynch Sterling Broad Market index volatility number of 6.36%. (Source: SEI)



## Market Overview

The last quarter of the year began with swift and sharp selloffs in the global equity market, followed by a comparatively flat November overall in most regions; the final month of the quarter saw many markets hit with losses that were more severe than those experienced in October.

Sovereign yields fell in the UK and Europe during the fourth quarter, while the US Treasury yield curve continued to flatten as US short-term rates increased and longer-term rates fell; intermediate-term segments of the US yield curve inverted at the beginning of December and broadened through the end of the year. Commodity prices generally tumbled during the fourth quarter, with West-Texas Intermediate crude-oil prices falling by 38%.

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The Bank of England and Bank of Japan's respective monetary policy groups each convened twice during the quarter, and neither introduced new policy actions. Prime Minister May's survival of a no-confidence vote brought about by a subset of her Conservative colleagues and a growing chorus of politicians calling for a second referendum. Details of no-deal Brexit contingency plans also began to trickle out on both sides of the English Channel near year-end. UK services growth re-accelerated slightly in December after coming perilously close to contractionary conditions in November; manufacturing activity followed a similar pattern, but at relatively healthier levels.

The European Central Bank (ECB) unsurprisingly announced and issued the final net purchase of bonds as part of its quantitative-easing programme in mid-December. EU leaders agreed to terms of the UK's divorce in November, establishing a set of domestic challenges for Prime Minister Theresa May. France was stricken by anti-establishment riots during most of the fourth quarter that were seemingly triggered by the perceived injustice of President Emmanuel Macron's tax policy, while the Italian coalition government passed a budget at the end of December that retained some promised working-class relief after initial drafts were rejected by the EU. Eurozone business activity softened into year-end, with the services sector slowing towards no-growth territory in December and slow-growth manufacturing conditions holding firm.

The US Federal Open Market Committee increased the federal-funds rate in mid-December—the fourth time in 2018—while softening its projections for future rate increases. US elections in early November produced a partial shift in power away from Republicans and towards Democrats in Congress and statehouses across the country. The US–China trade relationship began the fourth-quarter downbeat, with President Trump threatening to expand tariffs to essentially all of China's imports. The situation improved after the countries' leaders conducted a trade-focused meeting on the sidelines of the early-December G20 summit, agreeing to delay punitive actions and producing a three-month roadmap towards more substantive progress. US manufacturing growth eased considerably yet still ended 2018 at solid levels. Services sector growth was unchanged, remaining in expansion territory at the end of the year.

## Selected Asset Class Commentary

**Global Short Duration Asset Class:** The building block underperformed for the quarter. An overweight to global inflation linked bonds (US, Japan, UK, Germany and Brazil) detracted as they underperformed nominal bonds; most of the underperformance was from exposure to US Treasury Inflation Protected Securities (TIPS). An overweight to Australia, one of the best performing government bond markets, enhanced returns. Schroder Investment Management struggled due to an underweight to duration in Canada, the US and the UK, as well as off-benchmark US corporate bond exposure. Alliance Bernstein detracted due to underweights to duration in Japan, the US and the core eurozone, as well as off-benchmark exposure to US TIPS and corporate bonds.

**US High Yield Fixed Asset Class:** The high yield bond market was in negative territory in the quarter and for 2018, the first negative calendar year since 2015. The energy sector was in negative territory for the quarter and year, underperforming the broad market's return. J.P. Morgan Investment Management, the top contributing manager, benefited from an underweight to and selection within energy, and overweight to and selection within leisure. Brigade Capital Management detracted due to selection within services and energy. Benefit Street Partners' overweight to and selection within energy and selection within media hurt returns.

**Global Managed Volatility Equities Asset Class:** The building block performed better than the market and delivered meaningful risk reduction. Analytic Investors performed best as they are the manager with the lowest correlation to the market among the three managers. Acadian Asset Management performed worst due to their momentum flavour. The building block is designed to provide downside protection in stressful market environment with a cost of not rising as much when the market rallies. By design, the most important return driver this quarter was still the building block's constant focusing on risk reduction through allocations to low volatility securities.

**Global Equities Asset Class:** The building block underperformed its benchmark primarily due to poor stock selection, as well as biases towards higher risk and smaller capitalisation investment, most notably among the regional value managers, as investors chased expensive large cap and technology stocks. Dynamic changes in alpha source allocations, specifically an increase to stability-focused strategies (LSV GMV) funded by a reduction to trend-following strategies (INTECH), partially mitigated the losses. Towle's losses partially stemmed from their cyclical (and higher risk) small cap holdings, but also from poor stock selection. Poplar results mimicked Towle, with higher risk holdings and poor stock selection driving most of the losses. Momentum extended its selloff, hurting both Lazard and INTECH. Both managers also suffered from smaller cap bias.

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## Manager Changes

**Colchester Global Investors Limited (Colchester)** was added to the Emerging Markets Fixed Income building block in October 2018.

**Marathon Asset Management, L.P. (Marathon)** has been added to the Emerging Markets Fixed Income building block in October 2018.

**Poplar Forest Capital, LLC (Poplar)** has been added as a sub-advisor for the Global Equities building block in October 2018.

**AQR Capital Management, LLC's (AQR)** has been removed from the US Large Companies Equities building block in December 2018.

**Fiera Capital Corporation (Fiera)** has been removed from the US Large Companies Equities building block in November 2018.

**Fred Alger Management, Inc. (Alger)** has been added to the US Large Companies Equities building block in December 2018.

**Schafer Cullen Capital Management (Schafer Cullen)** has been added to the US Large Companies Equities building block in December 2018.

**AQR Capital Management, LLC (AQR)** has been removed from the US Small Companies Equities building block in December 2018.

**CastleArk Management LLC (CastleArk)** has been removed from the US Small Companies Equities building block in December 2018.

**Hillsdale Investment Management Inc. (Hillsdale)** has been added to the US Small Companies Equities building block in December 2018.

**PanAgora Asset Management Inc. (PanAgora)** has been removed from the Emerging Markets Equities building block in December 2018.

**Qtron Investments, LLC (Qtron)** has been added to the Emerging Markets Equities building block in December 2018.

Further information regarding the rationale for the manager changes can be found in SEI's manager change communications.



## Outlook

As painful as 2018 was for risk assets, their gyrations were not outside the norm. Rather, given SEI's view that the global economy will continue to grow and that market participants are overreacting to the concerns of the day, SEI sees another important risk-on opportunity developing in equities and other risk assets. SEI believes a rebalancing of assets back towards undervalued equity classes is an appropriate and timely response.

SEI still views the US economic position as solid. Points of strength include the improving economic position of US households as labour markets tighten and real wage growth accelerates, while increased government spending has also helped. With Democrats controlling the House of Representatives and Republicans holding power in Senate, any fiscal-policy agreement made during a period of political gridlock will likely mean slightly more federal-government spending, not less.

The decline in energy prices is especially good news for the broader economy since it reduces concerns about inflation accelerating beyond the US Fed's comfort zone anytime soon. It can lower costs for consumers and businesses on a broad range of petroleum-based products.

Some Fed officials, including Chairman Jerome Powell himself, explicitly acknowledge that the federal-funds rate now is near a 'neutral' level. SEI predicts just one rate increase in 2019, and perhaps one in 2020. The important thing to remember is that the central bank is adopting a wait-and-see approach to monetary policy and has ended the nearly automatic quarterly rate increases of 2017 and 2018.

SEI thinks the odds favour a strong rebound in US equity prices for the following reasons:

- The US economy should continue to grow and corporate earnings are expected to post mid-to-high single-digit gains in 2019.
- Valuations for the S&P 500 Index have declined from almost 19 times one-year forward earnings per share to an attractive level of almost 14 times following the decline in share prices.
- US bond yields remain rather low and have moved down again in late 2018, bolstering the case for riskier assets.
- Investor risk aversion has increased, and SEI think much of the bad news of recent months is reflected in current stock prices, creating space for potential upside surprises on trade wars, the Fed's policy path, Brexit, corporate profits and elsewhere.
- SEI believes fiscal policy will not be the strong catalyst for growth in the US that it was in 2018, but the impact of political gridlock should still be mildly expansionary.

Regarding Brexit, SEI believes it's unlikely that the UK will fall out of the EU without some sort of deal in place. In SEI's view, the real choice now is between Prime Minister May's Brexit deal, or no Brexit at all. Although the European banking system is in better shape than it was in the immediate aftermath of the global financial crisis, it is still vulnerable at a time when the ECB is in a holding pattern, policy-wise, and possesses only a few options in the event of a financial emergency.

SEI leans on the optimistic side for emerging markets in 2019. The valuation piece is already in place, in our opinion, with the price-to-forward-earnings ratio collapsing from 13 times at the end of January to 10.5 by year-end. But what could be the catalyst for a turnaround? Big debt expansions in China typically lead to big gains in emerging-market equities. The question is whether the Chinese government has the will to go back to the debt well one more time. Furthermore, recent dialogue regarding trade relationships has taken a more positive turn, but this will continue to drive market sentiment as it ebbs and flows.

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Commodity prices and the earnings of emerging-market companies are closely correlated in inverse fashion with the movements of the US dollar. For most of 2018, the dollar gained against other currencies, putting downward pressure on commodity prices and the earnings of energy and materials companies that are a large part of the MSCI Emerging Markets Index.

SEI is looking for a change in the dollar's trend in 2019. In our view, US economic and corporate-earnings performance will move towards that of other developed countries. If there are positive developments in some of the pressure-point issues that have roiled markets, investment capital could flow away from the US and back into the world, thereby removing an important source of support for the US currency and a big headwind from the rest of the world. This potential for a reversal in investment flows could accelerate if Fed policy becomes more dovish than currently projected by the central bank.

The risk to equities at the start of the 2019 would seem lower than it was at the start of 2018.

The awful performance of risk assets in the fourth quarter can certainly prey on investors' emotions. But the global economy is not exactly in dire straits. Concerns around a global recession, which have caused the positioning of the SIS programme to come under pressure, most specifically on the more aggressive end of the risk profile, are in SEI's view unlikely to materialise. The risk to equities at the start of the 2019 would seem lower than it was at the start of 2018, potentially offering an attractive entry point for longer-term investors from a pure market perspective.

The opportunity for deployment of new capital into the SEI Strategic Portfolios may be further enhanced by the potential alpha opportunity in the valuation-focused aspect of the portfolios, which also have struggled last year. Currently levels of valuation dispersion, the difference between the most expensive and cheapest stocks in the market, point to an opportunity in valuation-focused strategies not seen since the tech bubble. In SEI's view, the risk to earnings is not justified by the current level of stock valuations.

Yes, there are an unusually large number of uncertainties and concerns, some of which could have a material impact on growth if the worst comes to pass. However, even in an extraordinarily unfavourable economic scenario in which the tariff wars with China and other countries deepen and the Fed raises interest rates too far and too fast, SEI doubt that the US economy would experience anything worse than a garden-variety recession by 2021. The economic and credit excesses that usually precede a deeper recession simply aren't to be found.

During periods of market volatility like the one we've been going through, SEI believe it is important to remind investors about the importance of sticking with a strategic and disciplined approach to investing that is consistent with personal goals and risk tolerances. Diversification is the key to that approach, and the construction of portfolios is consistent with our long-term capital market assumptions.



# Important Information on Performance

**Past Performance is not a reliable indicator of future results.** Standardised performance is available upon request. All data is as at 31 December 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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