Stability-Focused SEI Strategic Portfolios

SEI Strategic Portfolios: Q1 2020 Quarterly Commentary

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As the Coronavirus Pandemic dominates the news, both fixed income and equity markets suffered in the last month of the quarter

Executive Summary

- The arc of global financial markets during the first quarter of 2020 corresponded with the unfolding realisation that controlling the outbreak would require government-mandated shutdowns of "non-essential" activity, impacting large cross-sections of the world economy. Governments issued stay-at-home orders as public health leaders advised of "social distancing" in order to "flatten the curve".

- Major developed government-bond rates plummeted to multi-year and all-time lows as credit spreads exploded for fixed-income securities regardless of credit quality, maturity, or other risk characteristics. Equities in developed and emerging markets around the globe tumbled in the first quarter of 2020, by between approximately 20% and 30% in most major equity indexes. Peak-to-trough declines were even sharper in many areas since most shares outside of China either climbed or remained buoyant through mid-February, before daily volatility returned to levels last seen during the depths of the global financial crisis (source: Bloomberg).

- Considering the Stability-Focused Strategic Portfolios, absolute returns were cushioned meaningfully by fixed income allocations, benefitting from the holding of government bonds. Short duration allocations also provided a cushion to returns, especially when considered against more economically sensitive debt. Frustratingly, in an environment of indiscriminate selling, the Global Managed Volatility Equities building block did not provide the expected cushion against declines but was able to provide meaningful risk reduction.

- SEI believes checking your portfolio's balance every day can be about as helpful as watching the news these days - it will not do anything to ease your nerves. At a portfolio level, we encourage investors to stay diversified and avoid short-term trading in these volatile markets. If you are a goals-based investor and your portfolio is aligned with your goals, time horizon and risk tolerance: be patient. Time should be on your side.

- If your portfolio was not aligned with your goals as the selloff began, SEI strongly believes it is too late to sell now. Doing so may mean you will risk missing the rebound that will inevitably happen. No one, including those of us in the financial services industry, knows exactly when that will take place. SEI remains confident that the markets will eventually have their comebacks, and that disciplined active management will result in positive outcomes for our clients. It may take months, but order will be restored.

- Until then, read, watch, listen and learn. You are seeing a real-life, albeit metaphorical, black swan. Use this experience to become a better, more informed investor. SEI will continue to monitor economic and financial-market developments and provide our insight to help you achieve that goal.

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- The Stability-Focused Strategic Portfolios returns ranged between -2.45% and -9.21% in Q1 2020 (GBP Wealth A Distributing, Net of Fees), compared to the 3.45% 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 1.18%. As a further point of reference, the FTSE All Share declined by -25.13% over the same period (Source: SEI)

Market Overview

- The modern world has almost never before seen the kind of sudden, dramatic global transformation as it did in early 2020. The New Year brought major developments that included the UK's official divorce from the EU, the signing of a "phase-one" trade deal between the US and China, and the emergence of COVID-19 in Wuhan, China.

- February saw an evolving realisation that COVID-19 would not be contained to China despite quarantines, border closures and air-travel restrictions. Halfway into the same month, Europe and the US began to contend with a possible widespread outbreak that would demand extreme containment measures, all of which became reality by the middle of March, as both regions committed to suppression.

- A dash for cash by investors concerned about the economic fallout created disorderly conditions across capital markets. Major developed government bond rates plummeted to multi-year and all-time lows as credit spreads exploded for fixed-income securities regardless of credit quality, maturity, or other risk characteristics. A subsequent shortage in US dollar funding caused its value to spike against other currencies. Emerging-market currencies came under heavy pressure amid investment outflows and collapsing output, partially on US dollar scarcity and withering demand for oil (source: Bloomberg).

- The US Federal Reserve (Fed) and other major central banks responded to the widespread disorder in March with a rapid return to global financial crisis-era playbooks. This appears to have helped re-route markets back towards orderly functioning.

- Equities in developed and emerging markets around the globe tumbled in the first quarter of 2020, by between approximately 20% and 30% in most major equity indexes. Peak-to-trough declines were even sharper in many areas since most shares outside of China either climbed or remained buoyant through mid-February, before daily volatility returned to levels last seen during the depths of the global financial crisis (source: Bloomberg).

- Economic fallout from widespread societal lockdown presented a separate severe challenge to governments around the globe. Trends that were many years in the making, including the explosion of online spending hurting bricks-and-mortar retailers, the rise of video streaming entertainment at home, and the expanded business use of tele-conferencing, all accelerated due to the shift. Meanwhile, OPEC+ splintered in early March on plummeting demand, triggering the largest one-day oil-price decline since 1991 on 8 March, sending oil prices to their lowest levels in 18 years.

- National government responses evolved sharply over time. The UK appeared intent on letting its population develop "herd immunity" through widespread infection in early March, acknowledging the likelihood of a high mortality rate. By mid-March, however, its government pivoted to suppression, closing most gathering places and recommending the postponement of local elections several months in advance. The country's economic relief plans included replacing most of the income lost to suppression-related unemployment, additional health funding, faster paid sick leave and unemployment benefits, business relief via subsidised loans, and the refunding of sick pay to small firms.

- The Bank of England's Monetary Policy Committee cut the Bank Rate to 0.1%, the lowest in the 325-year history of the lending rate. It also announced a £200 billion asset-purchase programme, mostly of government bonds, to be conducted at a monthly pace that will eclipse previous rounds of quantitative easing. Additionally, it has launched a so-called funding-for-lending scheme to spur banks to lend to small- and medium-sized enterprises, as well as a commercial paper facility, with no cap limit, to be financed by central bank reserves.

- The European Commission waived Maastricht limits in order to provide national governments fiscal budgetary flexibility. Italy passed one of the earliest government relief programmes, although it will almost certainly need to do more given the severity of its outbreak. Germany and France, among other nations, have also been working to introduce major fiscal stimulus.

- The European Central Bank announced a new QE package, the Pandemic Emergency Purchase Programme, amounting to €750 billion, which should bring total QE-related asset purchases to more than €1.1 trillion in 2020. The central bank has also altered issuer limits on the amounts and types of securities it can buy. If needed, the ECB can also use its Outright Monetary Transactions program to purchase an unlimited amount of short-term government bonds.

- In the US, the COVID-19 response differed at the state level, with governors of more than 30 states issuing stay-at-home orders by the end of the quarter, while others abstained from substantive lockdown measures. The number of Americans filing for unemployment benefits in the last full week of March hit a record-shattering high of 6.64 million, just one week after already more than quadrupling the 1982 record of 695,000 jobless claims.

- President Donald Trump initially appeared to consider the outbreak a minor issue, but then shifted course, declaring a national emergency in mid-March and then eventually suspending import tariffs, enlisting the private sector to manufacture medical supplies, pausing evictions and foreclosures of government-sponsored mortgages, suspending government-sponsored student loan payments, and delaying most federal tax payments for three months. Congress passed three separate legislative acts appropriating more than $2 trillion in funding for large and small businesses, enhanced unemployment benefits, direct payments to Americans, state and local governments, and the health system.

- The US Federal Open Market Committee cut the fed-funds rate to near zero through two off-cycle ruts and committed to purchasing unlimited amounts of Treasuries and mortgage-backed securities. Additionally, the Fed established new, promoted existing, and revived retired, facilities to support commercial paper funding, primary dealer credit intermediation, money markets, investment-grade corporate bonds, asset-backed loans and, central bank foreign-exchange swaps, as well as implementing high levels of reverse repo funding.

Selected Asset Class Commentary

- US High Yield Fixed Income Asset Class: The building block performed well on a relative basis during the quarter. An underweight to energy, which was one of the worst performing sectors, helped. Allocations to leisure and telecommunications contributed. An overweight to retail hurt performance. JP Morgan Investment Management's underweight to energy contributed. An overweight to and selection within telecommunications also helped. Ares Management gained on a favourable underweight to energy. Selection within the sector further contributed. An underweight to leisure helped, with Benefit Street Partners' underweight to leisure notably beneficial. An underweight to and selection within energy also contributed.

- Global Managed Volatility Equities Asset Class: The building block provided risk reduction of 14%, but overall failed to deliver the expected degree of downside protection. Low volatility counter-intuitively did not perform well over this period. This was particularly evident during the most extreme selloff days, when defensive utilities dropped in-line with cyclical industrials and consumer discretionary sectors, indicating indiscriminate liquidation. There is no hiding, again, from the Big Tech effect. The "Stay at home" directive created a short-term tailwind to large software companies. With most of those stocks exhibiting significantly higher than market beta, the building block had little exposure to them, which was a significant negative over the quarter. At the manager level, both Acadian and WFAM performed in-line with low volatility factors, finishing the quarter marginally above the market. LSV delivered slightly worse results due to additional headwinds to their Value-oriented return model.

- Global Equities Asset Class: All of the building block's Value-oriented managers lagged as they faced style headwinds. Sompo Nipponkoa Asset Management (SNAM), Poplar Forest Capital and Towle & Company also struggled with stock specifics. Towle suffered headwinds against its small-cap bias and exposure to energy, airlines and auto parts makers. SNAM's exposure to lower-quality autos, steel makers, and industrials detracted. Poplar struggled with exposure to cruise operators, energy and insurance. The building block's

Momentum-oriented managers benefited from a benign environment to their process, as previously established positive trends in large-cap technology stocks proved particularly beneficial. In addition, Lazard Asset Management benefited from the short side of revisions as sentiment around weak companies broke down as the market sold off, with a big part stemming from the Japanese technology sector. Finally, the building block's "hedge" for stressful market conditions, Rhicon Currency Management, delivered good returns as expected. The manager's process tends to benefit from an environment of rising volatility. In the past two months, Rhicon's underweights to the Australian Dollar versus the US Dollar, the New Zealand Dollar versus the Yen and the British Pound versus the Yen all performed well.

Manager Changes

- None in the reporting period.

Outlook

- Black swans, once largely presumed a myth because only the white variety was ever observed in nature, have become symbols of events that are exceptionally rare in occurrence and severe in impact. Today we are confronted with a black swan in the form of a pandemic, as COVID-19 continues its rapid spread and causes financial markets to plunge across much of the world.

- The sudden and widespread stop in economic activity by government fiat is something that has never before been experienced on such a scale. The ultimate impact on GDP is truly anybody's guess. The first quarter of 2020 could see a decline at an annual rate of between 3% and 5%. The second quarter will likely be one for the record books. Wall Street economists forecasted a quarter-to-quarter annualised decline ranging from 12% to 30% as of late March.

- National governments have been quick to respond. All central banks are in crisis-fighting mode, having learned valuable lessons during the 2008-to-2009 global financial crisis, re-establishing unconventional bond-buying programmes and creating some new facilities to expand the types of accepted collateral in order to extend cash to companies that need it.

- The Fed and other leading central banks have moved with an alacrity and forcefulness that we find commendable. However, central banks cannot single-handedly support this economic shutdown. In our view, fiscal policy—in the form of direct income support, tax deferrals, loan guarantees and outright bailouts of industries badly damaged by the halt of economic activity—must be the prime tool used to conduct the response to this crisis.

- The fiscal response is occurring with a speed and decisiveness that has seldom been seen. The U.S. Congress has passed into law a fiscal response that should top 10% of GDP—meaning that the overall deficit this year in the US could approach 15% of GDP. Even before the ink dried on the latest package, there already is talk of the need for another funding package for states and local governments.

- Other developed countries are looking to pursue a similar strategy of massive income support and liquidity injections. Germany, a country that typically keeps its wallet closed, is setting the example for Europe. The government has proposed a package equivalent to a whopping 30% of the country's GDP, counting contingencies. Since Germany has built up large reserves in its existing income-support program, the supplementary budget is expected to push the country's on-budget deficit only toward 5% of GDP in 2020, following several years of surplus.

- Few other countries in Europe have the fiscal strength of Germany. Italy, the European epicentre of the virus, will be particularly hard-pressed to do all that will be needed to stabilise its economy. Italy's government debt-to-GDP ratio is already well above other major European countries.

- Commentators have cited that the only way a financial crisis can be averted is through the ECB backing up the debt. This is now-or-never time for the EU and Eurozone. The stronger countries must come to the aid of the

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weaker, or face an intensified popular backlash that could threaten the unity of the economic zone. To date, Germany and the Netherlands have not moved to come to the rescue and are standing in the way of the EU issuing "corona bonds." We anticipate this opposition will melt in front of the unfolding disaster.

- The onslaught of developments presented by the spread of COVID-19 and a simultaneous collapse in oil prices has forced financial markets to recalibrate prices sharply as expectations about different industries and the overall economy shift at a breakneck pace. Investors should gain some reassurance, however, from the fact that a virus-containment-induced earnings recession is generally only expected to last a couple of quarters or so. If market prices are based on a long-term, multi-year expectation, then this fallout should represent a relatively small part of the market's forward-looking focus.

- In any event, there is no question that markets have entered deeply oversold territory in technical terms, although it is too soon to say that the market bottom has been established. Nonetheless, we are grateful that the chaotic trading seen in recent weeks has eased considerably thanks to the liquidity provided by central banks and the fiscal package passed by the US Congress.

- Only time will tell whether markets have sufficiently discounted the pain that lies immediately ahead. We have to be cognisant of the fact that earnings estimates will be coming down hard—maybe by 40% to 50% on a year-over-year basis—over the next two quarters. These waterfall declines in earnings could drag equities down with them, but likely not to the same extent. It all depends on how willing investors are to look beyond the valley.

- If there is a belief that the fiscal and monetary measures taken in the past two weeks will successfully prop up the global economy, then markets should prove resilient. SEI believes that a great deal of volatility is still ahead of us, but another big decline along the lines of the past month could be avoided. Indeed, if there are signs that the infection rate is beginning to peak in Europe and the US, it might not matter at all where earnings go in the near term. Investors will likely begin to bid stock prices higher in anticipation of an economic recovery, as they almost always do.

- During periods of chaos in financial markets, investors often picture professional portfolio managers frantically trading in an effort to avoid the worst of the carnage while seeking opportunities to profit. At SEI, that reality could not be further from the truth.

- With a pandemic crippling the global economy and an oil glut exacerbated by suspended activity around the globe, we find ourselves in an environment almost completely void of reliable information—which, to us, makes frantic trading an especially unwise approach to financial stewardship. So, what is SEI doing?

- SEI is remaining steadfast to our investment philosophy and process, remaining disciplined in our positioning, maintaining our view that diversification is a sound approach over full market cycles, which include bull markets (some of which last for more than a decade) and bear markets (which can vary in terms of length and severity).

- SEI builds and maintains long-term-oriented portfolios by being attuned to the evolving correlations, or relationships, between asset classes. SEI continues to believe that our multi-asset, diversified strategies are robust and built to handle environments just like this.

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Past Performance is not a reliable indicator of future results. Standardised performance is available upon request. All data is as at 31 March 2020.

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- 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.
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