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Quilter Investors

Cirilium monthly commentary October 2021

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Our alternatives holdings were the month's star performers

The strongest regional equity performers were Europe and the US

A new holding was initiated in the R&M European Fund managed by James Sym

Market review

Inflation and how central banks will respond remained the most important story in October, as data showed US consumer prices growing at their fastest pace since the early 1990s. This meant that much of the action during the month was in bonds rather than stock markets.

Rising prices in the US have dented consumer confidence recently and while activity indicators remain elevated it is likely these will move lower in future months. However, this hasn't stopped the Federal Reserve (Fed) from edging towards the exit of its pandemic era policy support and bond markets have also moved to indicate earlier interest rates hikes than the Fed projects itself. Despite the expected withdrawal of monetary policy support, the MSCI USA index returned 5.2% over the month as corporate earnings releases in the third quarter were strong across all sectors.

The IHS Markit/CIPS composite Purchasing Managers' Index (PMI), in the UK rose again in October to 57.8 while the input prices series hit new all-time highs, indicating building inflationary pressures in the UK economy. Meanwhile, the FTSE 100 index returned 2.2% during the period, while the FTSE 250 index ended the month up a touch at 0.5%.

Recent communication from the Bank of England has strongly hinted that an interest rate hike is imminent, although Governor Bailey has also noted that raising rates will do nothing to help alleviate the supply chain bottlenecks that are driving much of the higher inflation experienced across the world.

In Europe, ECB president Christine Lagarde remained confident that inflation is a temporary issue and it would return below the 2% target in the medium term, however she declined to comment on market pricing of a rate increase by the end of next year. Consequently, yields spiked on euro area debt but the MSCI Europe ex-UK index returned close to 3%.

October's bond markets were choppy and, despite the UK 2 year yield ending the month 0.3% higher than it started, overall the UK market delivered positive returns as yields on longer dated bonds fell. The ICE BofA UK Gilt and ICE BofA US Treasury indices returned 2.3% and 0.03%, respectively in October.

Sterling, meanwhile, had a strong month, rising 1.5% against the US dollar and 1.8% against the euro.

Japan elected a new government in the Liberal Democrat Party, which was widely expected despite the eventual reduced majority. This will, however, make it more difficult for Prime Minister Fumio Kishida to implement his economic package. Over the period, the MSCI Japan index lost 5%, but most of this was down to currency weakness as the yen was 3.8% lower versus sterling.

The real estate sector continued to drag on returns from Chinese markets and economic activity was hampered by power rationing in some regions. The MSCI China index returned a modest 1.5% in October.

Finally, the oil price continued to march higher, with US crude oil topping $80 a barrel for the first time since November 2014. It is not likely to revert lower soon due to support from tight supply and strong demand. Natural gas and coal also rallied during October due to shortages affecting Europe and Asia.

Note: Currency hedging of foreign investments dampens the effect of currency fluctuations on returns and reduces the volatility of your investment. Under most circumstances, we currency hedge foreign currency bond holdings, except in cases where the foreign currency exposure is an explicit return-driver (eg emerging market local debt exposures).

(All performance figures in sterling terms and rounded to one decimal point, unless otherwise stated.)

Continued on next page

Performance review

The Cirilium Portfolios posted positive returns for the month, although these were held back by a stronger pound, weakness in Japan and the disappointing performance of two fixed income managers.

Equities contributed the most to returns across the portfolios, but it was our alternatives holdings that stood out as the month's star performers.

Regionally, Japan was the weakest developed equity market having been the strongest in the third quarter of the year. This was made worse for UK investors given the strong rise in the pound versus the Japanese yen.

Despite this setback, coronavirus infections have begun to decline in Japan and vaccinations are progressing well, enabling the government to reduce some restrictions on activity. Consequently, we expect economic growth to pick-up over the following quarters, much like in the UK, Europe, and US, thanks to a recovery in services consumption and a rise in capital expenditure momentum, which should be positive for equities.

The strongest regional equity performers were Europe and the US, both of which enjoyed a reversal of the pull-back sustained in September as companies posted positive results - aside from those sectors hampered by supply constraints.

Once again Montanaro hogged the leader board with three funds in the top five best performers – Montanaro Better World, Montanaro European Income and Montanaro European Mid-Cap.

The Miton European Opportunities Fund was also a notable performer in the month, alongside Berkshire Hathaway, run by Warren Buffett, and the Granahan US SMID Select Fund. However, the award for the largest monthly gain goes to Pershing Square - held in the Cirilium Adventurous Portfolio - which gained more than 10% during the month.

Elsewhere, it was a disappointing month for our UK managers, who were largely confined to the substitute bench during October, although we can forgive their rest following a relatively positive third quarter.

Within alternatives, there were a variety of positive performers. For the lower-risk portfolios, specialist property trusts Ediston Property and the Impact Healthcare REIT (real estate investment trust) provided the strongest returns. It was also a good month for the Tages Eckhardt Systematic Short Term Fund, which as the name suggests is a short-term trend following manager.

For the higher-risk portfolios listed private equity continued to deliver strong returns, including Harbourvest Global Private Equity and Pantheon International. Raven Property Group

enjoyed a stronger month as improving sentiment led to a narrowing in its discount to net asset value, although the quality of their assets has never been in doubt for us.

Within fixed income, while the volatile market backdrop made for a challenging month for our broad range managers, it was specifically the disappointing performance of the Allianz Fixed Income Macro and Allianz Strategic Bond funds that had the biggest negative impact on fixed income returns.

It should be remembered that Allianz are exceptional managers in our opinion, which highlights that fixed income markets were far from normal in October and that Allianz are anything but passive managers. Markets often swing from one extreme to another, so we are watching carefully to see whether Allianz are either foresightful (but early) or have been wrong footed. On the positive side, closed-end credit funds enjoyed a positive month led by Raven Property 'preferred shares', which gained around 2% over the month, and more than 30% since we participated in the placement of the stock/bond overhang.

Aside from general portfolio maintenance, investment activity involved adding one new holding, removing a holding, and trimming a selection of funds that had done well and topping-up a selection of funds that we expect to play catch-up.

The new holding was initiated in the R&M European Fund, which is managed by James Sym, and was funded by the removal of the passive SPDR European Dividend Aristocrats ETF. We allocated to this manager as we believe he is well-placed to benefit from a European recovery, a shift in monetary policy and the transition from reflation to inflation. Furthermore, we expect active managers to outperform passive funds amid a more challenging backdrop.

Continued on next page

Elsewhere, holdings in the Polar Capital Automation & AI and Sands Global Leaders funds were trimmed following strong performance in the 'growth' factor. Similarly, Harbourvest Global Private Equity was reduced following a strong period of performance, as were several UK, US and European managers who had benefited from small and mid-cap outperformance, including the Montanaro UK Income, Granahan US SMID Select and Miton European Opportunities funds.

The proceeds were re-invested into funds with a higher exposure to larger companies and with a value tilt, including the Lyxor Eurozone ESG Dividend Aristocrats ETF and the Wells Fargo Climate 2.0 Fund, which should be less sensitive to rising bond yields while at the same time retaining exposure to quality businesses.

Outlook

While equity markets have delivered strong returns year-to-date, the fourth quarter has historically been a seasonally strong period for equity markets.

Pushing the rune stones to one side, companies should continue to provide the catalyst for further gains amid a backdrop of strong results and an upbeat outlook. That said, it is probably wise to recalibrate expectations for lower future returns, although we believe a challenging backdrop should provide a fertile environment for stock pickers.

In addition, there may be opportunities to add value through factor rotation. In plain English, rising bond yields could support a rotation towards more value-orientated sectors of the market at the expense of high growth companies. In addition, Scotland's hosting of COP26 is likely to increase investors' focus on environmental, social and governance (ESG) factors, with a widening gap between winners and losers across sectors.

Within alternatives we remain confident that our managers can deliver positive returns that will look attractive relative to a lower level of expected equity returns. However, it is much more difficult to get excited about fixed income, but we are following the sector just as closely for clues to both potential market direction and opportunities to add incremental value.