Quilter Investors

Cirilium Blend monthly commentary October 2021

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The Cirilium Conservative Blend Portfolio suffered a small loss due to its high fixed-income exposure

The remaining Cirilium Blend Portfolios delivered modest positive returns in October

The Eckhardt Systematic Short Term Fund was the top performing holding

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's 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 while bond markets have also moved in expectation of earlier interest-rates hikes than the Fed projects.

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.

In the UK, the IHS Markit/CIPS composite Purchasing Managers' Index (PMI) rose again in October to 57.8 (showing expansion) while the input prices series also 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, European Central Bank (ECB) president Christine Lagarde remained confident that inflation is a temporary issue and it would return to 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 (meaning bond prices fell) but the MSCI Europe ex-UK index still returned close to 3%.

Japan elected a new government in the form of 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.

October's bond markets were choppy. Despite the UK two-year bond yield ending the month 0.3% higher than it started, overall the UK market delivered positive returns as yields on longer-dated bonds fell. Consequently, the ICE BofA UK Gilt and ICE BofA US Treasury indices returned 2.3% and 0.03%, respectively, 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's unlikely to ease any time soon due to tight supply and strong levels of demand.

** 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-currency debt exposures).*

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

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Performance review

With the exception of the Cirilium Conservative Blend Portfolio, which declined slightly (0.23%), the remaining Cirilium Blend Portfolios delivered modest positive returns in October ranging from 0.12% for the Cirilium Balanced Blend Portfolio up to 0.62% for the Cirilium Adventurous Blend Portfolio.

The Conservative portfolio suffered a small loss due its relatively high weighting in fixed-income during a month when global bonds retreated slightly for sterling investors while global equities delivered strong gains.

Within this, UK equities underperformed global stock markets. The FTSE 100 Index delivered a lacklustre 2.2% while returns from US equities, especially the mega-cap technology companies, were significantly greater.

Against this backdrop, October was a relatively disappointing month for the portfolios. This was largely a function of our equity manager selection where we favour not being exposed to large US technology stocks for valuation reasons. Elsewhere, our Japan exposure also lost ground after being a star performer in the third quarter.

The two standout equity performers in October were the Granahan US SMID Select Fund, which gained 6% during the month, and the Montanaro European Income Fund, which added 4.6% while broader European markets delivered just under 3%.

Both managers benefited from the continued strong performance of small and mid-sized companies in their respective regions, along with growth-oriented companies becoming more highly sought-after against a backdrop of weakening economic indicators and supply-chain issues.

The worst performer over the month was the Usonian Japan Value Fund; it declined some 5.5%, underperforming the local MSCI index as Japan's markets fell back to earth following the recent elections.

Away from equities, the Eckhardt Systematic Short Term Fund was the best performing strategy in absolute terms; it rallied some 7.4% during the month.

From an asset allocation perspective, we decreased our equity allocations by between 1% and 2% in in all the Blend portfolios with the exception of the Cirilium Adventurous Blend Portfolio.

At the same time, we also trimmed our fixed-income exposure to allow us to increase our target allocation to alternative strategies by up to 5% in the lower-risk portfolios, adding greater diversification. As a result, our overall risk exposure remains broadly the same (although we're now better diversified) and we expect to fill the increased alternatives target weight in the next two months or so.

Elsewhere, we began to switch our emerging market bond holdings from local currency to US dollar-denominated bonds as emerging market currencies are likely to take a significant hit as the US rate-hike cycle draws nearer.

During the month, we introduced one new equity manager, the M&G Japan Fund. We funded this via a reduction in our Usonian Japan Value holding. We also added to the Vanguard Japan tracker fund.

Within fixed income we introduced a holding in the Wellington Global Credit Plus Fund, an actively managed strategy that invests in investment-grade corporate bonds (issued by companies) with a global mandate. We also introduced the Vanguard US$ Emerging Markets Bonds tracker fund as a consequence of our switch from locally-denominated emerging market debt to US dollar-denominated debt.

Outlook

Although equity market valuations have remained stretched, we were pleasantly surprised by the resilience of many companies' profit margins in the most recent quarterly reporting cycle.

At the same time, the macro-economic environment is cooling somewhat, as government furlough schemes expire and central banks start to position for a reduction in their support measures.

As a result, investor sentiment has stabilised at a level that we would characterise as 'mildly bullish'; the extreme bullishness of earlier this year has receded somewhat.

For equities it still feels like the path of least resistance is a grind higher from current levels, supported by strong company earnings growth and the dearth of interesting opportunities in the bond market. However, we expect future returns to be somewhat more muted given where valuations currently sit. High valuations also mean markets have less room to weather disappointments.

With this in mind, this does not feel like the time to turn fully defensive. Consequently, we are building-in more 'ballast' to the portfolios in case markets stumble in the coming months by increasing our alternative investment exposure while retaining sufficient cash to put capital to work if markets offer us the opportunity to buy at more attractive levels.

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