LIONTRUST

MULTI-ASSET PROCESS

Multi-Asset Tactical Asset Allocation update: Q1 2023

Tactical Asset Allocation (TAA) is one of the five stages of the Liontrust Multi-Asset investment process – the others being the Strategic Asset Allocation (SAA), fund selection, portfolio construction and monitoring.

The Multi-Asset investment team has a medium-term view – 12 to 18 months – of the prospects for each asset class and this forms the TAA. Each asset class is assigned a rating from one to five, with one most bearish and five most bullish. TAA is the target (not the actual position) for every asset class and the investment team builds towards this within the funds and portfolios over time. Having a 12 to 18-month view means the team will increase positions when the valuations of the asset classes are attractive; their core approach is to buy low and they will not overpay for assets, however highly they score.

Multi-Asset Tactical Asset Allocation scorecard: Q1 2023

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	1	2	3	4	5	Direction of travel
Overall				●		↑
Cash		●				↑
UK gilts			●			↑
Global government bonds			●			↑
Investment grade corporate bonds			●			↑
Index-linked bonds		●				↓
High yield				●		↑
Emerging market debt				●		↑
Convertibles			●			↓
Equity overall				●		↑
US equity			●			↑
US small caps			●			↓
UK equity				●		↑
UK small caps				●		↑
European equity			●			↑
European small caps		●				↓
Japanese equity			●			↓
Japanese small caps			●			↓
Emerging markets equity				●		↓
Asian equity				●		↓
Real Assets			●			↑
Alternatives			●			↑

Source: Liontrust, as at 20.02.23. Not all the asset classes are used in all the MA portfolios and funds

The team reviews the TAA every quarter but it is important to stress this does not reflect a quarterly view. The rating is only altered up or down when there is a fundamental change in the assessment of a particular asset class, and by taking a longer-term view, the team is seeking to ignore short-term market noise and avoid trying to time the market. The table above shows the latest TAA and includes all asset classes regardless of whether they are included across the funds and portfolios. The direction of travel arrow shows the last change in the TAA, whenever this occurred.

Changes in this latest version (highlighted in green) are more positive than they have been for some time. Our overall ranking on markets has been raised from three to four, which we seriously considered doing in Q4 2022 because of a change in the underlying tone of markets. We have also raised our overall equity score from three to four, both European equity and UK gilts from two to three, and emerging market debt (EMD) from three to four. These two fixed income upgrades follow our only changes last quarter, which were to increase the score of high yield fixed income from a three to a four and investment grade credit back up to three after lowering it earlier in 2022. High yield represents the relatively low credit-quality borrowers and, as a result, investors cannot consider it to be a 'safe haven' in the way government bonds have been considered traditionally. The quantum of yields available from this asset class, however, presently offers ample reward in our opinion for the lower credit quality.

Asset class	**Q1 2023 Score**	**Direction of travel**	**Commentary**
Overall	4	↑	We raised our overall ranking from three to four in Q1. The world had a difficult 2022 with significant adjustments in the prices of financial assets as markets sold off. A lot of bad news has been factored into markets, including the risks of recession and persistent inflation, but there is a more positive underlying tone to them now and we believe it is a good time to invest with a longer-term view of one to two years rather than three to six months. We are cautious and expect further volatility, and while this might present even better opportunities, we opt for time in the markets rather than trying to time our entry. Headline inflation also appears to be dissipating, with energy and food prices becoming less influential, although core inflation is still an issue, not least because of wages and services inflation. Arguably, we are through the worst of inflation. It was never going to return to 2% in just a few months but the narrative appears to be that inflation is rolling back slowly. The discussion is more about balancing interest rates and economic growth rather than raising interest rates to tackle inflation. It is almost a given that central banks will not ease up on inflation any time soon, but nor will they wish to crash the economy. We continue to believe inflation should fall as the rolling base effects from Covid shutdowns and Russia's invasion of Ukraine work their way through the system. This should allow central banks to tread carefully and be less aggressive on the hiking front but there also remains a risk of policy surprises or unintended consequences, neither of which are supportive for markets. But the global economy remains on a fairly solid footing despite the recession fears. We expect a more technical, small 'r' recession rather than an aggressive, protracted one. With current newsflow remaining broadly negative, equity markets are attractively valued, particularly after the indiscriminate selling in 2022. The UK is still cheap despite the energy rally and value rotation last year, for example, and even the US is less unattractive after the approximately 18% fall in the S&P 500 Index in 2022. Within bonds, we appreciate the direction of yields will be upward over time (as interest rates climb) but, as ever, the

			path will not be linear and we maintain exposure to this asset class for its long-term diversification to equities, some level of inflation protection and increasing income. To raise risk exposure in our funds and portfolios, we are increasing our investment targets in high yield bonds. This reflects the attractive spreads that are now available versus government bonds. For now, we retain a lower duration position in our fixed income allocation as central banks prevaricate over the timing and extent of rate rises and tapering.
Cash	2	↑	Cash remains a broadly unattractive asset class, but we moved the ranking up to two in Q1 2022 to reflect the fact that, on a relative basis, it looks better as a store of value in a rising interest rate environment. Compared against assets with duration such as government bonds, for example, where rising yields will erode capital values, there is a stronger argument for cash, although it is obviously hit by higher inflation.
UK gilts	3	↑	We raised our ranking for UK gilts from three to four in Q1. Their yields have drifted up from around 0.7% at the start of December 2021 to above 3.0% today and these could continue to rise in line with base rates. Gilts now offer the prospect of delivering real yields over four to five years once the inflationary spike abates. We remain neutral on them, however. Gilts currently offer their best value in a long time, especially on a longer-term view, and it makes no sense to be underweight in them. But we do not expect they will be a substantial driver of portfolio returns. They While more balanced today, the bias of risk still leans to the upside for yields (or the downside in price terms), especially if higher inflation persists. Gilts still provide a useful function as portfolio insurance in times of market duress but offer little more than a cushion to equities.
Global government bonds	3	↑	We raised our ranking on global government bonds from two to three in Q3 2022. There are attractive benefits now in diversifying beyond the UK. Yields are above 3% in the US, for example, and while that does not offer the prospect of real, inflation-beating yields, it reflects the fact that the Federal Reserve is further through its monetary tightening cycle than other developed market central banks. This also achieves greater diversification because of the various interest rate policies pervading around the world. Going forward, monetary policies may be less co-ordinated than they have been historically, so we want to have greater diversity within our fixed income allocation. A global basket of currencies and interest rate risks can result in a differentiated return stream versus UK gilts. Yields have increased and could climb higher, and, for now, the bias of risk remains to the upside (or downside in price terms), especially if higher inflation persists.

			These bonds provide a useful function as portfolio insurance in times of market duress but offer little more than a cushion to equities.
Investment grade (IG) corporate bonds	3	↑	We moved our ranking on investment grade credit back up to three in Q4 2022. We had moved it down to two earlier in 2022 in recognition that spreads had narrowed and no longer offered as much cushion for the additional credit risk. However, with spreads now around 150 basis points for global IG, the peak in spreads for this cycle could be behind us. The yield-to-worst range is approximately 550 bps for UK and US IG, which is relatively attractive but there is a risk spreads could go wider in the event of a significant recession.
Index-linked bonds	2	↓	We reduced our rating for Index-linked bonds from three to two in Q3 2022. This debt will benefit versus nominal government bonds if inflation continues to run ahead of expectations, although higher levels look to be reflected in elevated prices. Its value relative to gilts is not compelling. Index-linked bonds tend to have longer duration than the same tenor nominals, so duration positioning needs to be considered. It is best to buy inflation protection when the risk is underappreciated, which is certainly not the case today.
High yield (HY)	4	↑	We raised our rating from three to four in Q4 2022. This reflected the attractive spreads that were available versus government bonds. Global HY spreads are presently in the high 400 basis points, which is comparable to levels seen in 2016 and the Covid pandemic. Yields-to-worst levels just shy of 9% for global HY look interesting. Now is an attractive entry point that we believe is sufficiently rewarding to compensate for potentially higher default levels. There is more risk of bankruptcy in this market, especially if conditions worsen, so more cautious and active managers are recommended because of this. But HY assets tend to have shorter durations than government bonds, so this will help reduce our interest rate sensitivity at the margin. The running yield is more than sufficient to compensate for the additional risk of credit events that lower quality companies face in a higher interest rate environment.
Emerging market debt (EMD)	4	↑	We have raised our ranking from three to four this quarter (Q1). Valuations are attractive. Hard currency yields-to-worst levels are around the same as high yield at present: on the positive side, credit ratings in EMD are generally superior to HY, but the Russia situation shows the political risk inherent in these markets. Other positive factors include emerging markets tending to be further through their current tightening cycles with the prospect of loosening policy likely to come ahead of developed markets; the weakening dollar; and China re-opening its economy after its Covid lockdowns. Several emerging markets are financially better positioned than their developed counterparts because they refrained from

			injecting extreme levels of financial support into their economies. Our view remains that while spreads look reasonable, the idiosyncrasies of the emerging market environment are potentially better rewarded in EM equities. Dollar strength also represents an economic headwind for many EMD issuers and poses potential repayment affordability problems for hard currency EMD.
Convertibles	3	↓	We continue to see convertibles as providing an attractive risk/return profile thanks to their optionality and bond floor. Our view moved down from four to three in Q4 2021 as we took profits after a strong spell of performance and felt the asset class had potentially peaked for the current cycle.
Equities overall	4	↑	Our rating for equities fell from four to three early in 2022 to reflect the greater uncertainties that existed with respect to interest rate policies and economic growth, but we have restored it to a four this quarter (Q1). We are likely to add marginally to our equity exposure overall. This will take us to a slightly overweight position but still within our 'neutral' model limits. As with markets overall, now looks like a good time to invest, provided it is with a longer-term perspective. There is more focus on companies' valuations, and they are delivering reasonably good results in what appears to be a decent business environment. There are risks though. The obvious ones are tightening monetary policy and slowing growth but there is a sense that share prices, via corrections, have already factored this in. That said, we expect returns to be lower than seen in the recovery since the sharp Covid shock back in March/April 2020. We are starting to recognise the fact that markets have sold off a lot though and to that end, we are raising exposure to equities and particularly the US because we believe it is fairly cheap in historical terms. This, together with the entrepreneurial spirit in its economy and its energy independence, makes for a positive case. Amid an ongoing value rotation, growth stocks, particularly in the US, have fallen into a bear market given 2022's corrections, which offers the opportunity to top up growth and quality holdings. We have seen the US as prohibitively expensive for much of the last decade and while still not attractive, it is certainly less unattractive after these corrections. Elsewhere, we continue to favour markets such as the UK, which is still cheap despite a strong run this year. In a reflationary environment longer term, we expect the rest of the world to outperform the US, value stocks to outperform growth and small caps to outperform large. These outperformances will not all come at once, however, so we retain prudent diversification rather than making a significant gamble that one particular thesis pays off. But

			there are still opportunities to add value through regional and stylistic decisions.
US equity	3	↑	We have long been cautious on the expensive US but recent corrections have brought valuations back to more sensible, and less unattractive, levels. Looking forward, there are a few points to consider: the US has experienced a technology bear market that has taken some of the froth out of the growth end of the market, which may create opportunities; but an inflationary period does not typically support growth (or long-duration) stocks, which the US continues to have in abundance. Value can still be found beneath the technology behemoths and the US economy remains in relatively solid shape, potentially benefiting from its isolation in terms of energy policy and agriculture. Overall, history suggests returns from the S&P 500 index are likely to be lower in 2022, with performance after a 20%-plus year tending to sit around 8%. While valuations are looking more attractive and long-term earnings should be solid, active exposure is still definitely warranted, with rotation of styles a risk to market cap-weighted indices.
US small caps	3	↓	Our ranking on US smaller companies fell from four to three in 2022, bringing it back in line with the overall US market. Smaller companies have suffered in recent selloffs but, longer term, we continue to believe in the small-cap premium and the short-term re-rating could give us a buying opportunity. Overall, smaller companies in the US should benefit from the same broad themes as the large cap market with additional sensitivity to domestic economic conditions, whether positive or less so.
UK equity	4	↑	UK equities remain cheap despite the 2022 energy bounce and the overall skew to value. The UK outperformed other developed markets last year but there is still a long way to go, particularly if the value rotation continues: financials, for example, should benefit from a more forgiving yield curve and higher prevailing yields than we have seen for many years.
UK small caps	4	↑	As in the US, smaller companies have suffered amid recent selloffs but longer term, we continue to believe in the small-cap premium and the short-term re-rating could give us an opportunity. Overall, smaller companies in the UK should benefit from the same broad themes as the large cap market with additional sensitivity to domestic economic conditions, whether positive or less so.
European equity	3	↑	We have raised our score for European equities back up to three in Q1, having reduced it from four to three in Q2 2022 then down to two in Q3. Europe is the region most at risk from a protracted conflict in Ukraine, with all the geopolitical

			fallout and sanctions that may bring. Parts of the bloc are heavily reliant on Russian energy and the transition away from that will likely prove painful. The region's equities have been unloved post Russia's invasion of Ukraine and have come under a lot of pressure. Arguably, they have been impacted disproportionately now, given that Europe is home to many multi-national businesses linked to the global growth story, like the UK's large caps. We remain neutral though. Europe is still relatively less attractive than the UK, while the European Central Bank's fight against inflation looks increasingly challenging. Its one-size-fits all approach to policy means there is greater risk of inflationary hotspots. As in the Global Financial Crisis, the ECB must act unilaterally and has little room for nuance, meaning the prevailing policy could be inappropriate for large parts of the bloc.
European small Caps	2	↓	We downgraded European small caps from three to two in Q3 2022, having reduced it from four in the previous quarter, based on the risk of recession and inflation overshooting in certain countries if the ECB proved to be reluctant to move aggressively on interest rates.
Japanese equity	3	↓	Our conviction on Japan has fallen over recent quarters (from four to three) but while the market sold off in line with others in 2022, it is largely unaffected by prevailing geopolitical risks. Where current conditions may impact the region is as a market reliant on exports (although yen weakness may be positive here) and, as with Europe, softening global growth could be problematic. The country's central bank is also sitting outside the hawkish camp for now, with rates expected to stay low, and it remains to be seen whether this period results in some imported inflation (after decades of deflation) and how the country's conservative consumers react to that.
Japanese small Caps	3	↓	Again, smaller companies in Japan should benefit from the same broad themes as the large-cap market with additional sensitivity to domestic economic conditions, whether positive or less so.
Emerging markets equity	4	↓	Emerging markets (EMs) are proving themselves to be much better at dealing with inflation than their developed counterparts. Central banks in EMs are arguably further ahead of the curve and are implementing more appropriate policies. While long-term positive fundamentals remain intact, shorter-term pandemic shocks and recent policy shifts, both centred on China, have hit sentiment. China's zero-Covid policy continues to create uncertainty, but the government retains plenty of firepower to keep the economy on an even keel. Chinese stocks on the CSI 300 index dropped to their lowest level in two years in April 2022 as the government shut areas of Beijing and ordered mandatory Covid testing in one

			district. This came after China's central bank unveiled a suite of measures designed to support the economy and the billions in yuan wiped off stock prices over the month was clearly not in the script. Chinese equities recovered from their April lows, although they were down over 2022 after they sold off in June amid ongoing uncertainty. They are not looking well-supported. EM equities remain highly geared into sentiment shifts – both positive and negative – and are also sensitive to domestic and international politics.
Asian equity	4	↓	As with EMs, Asia is benefiting from the reflation trade and loose monetary policies. A weak US dollar provides a supportive environment. These economies generally fared well through Covid but a lot clearly rests on China and how it supports its economy in the months ahead. Risks remain from the perspective of global sentiment as well as regional political tensions, although Asia has performed well thanks to its commodity links.
Real assets	3	↑	Property still offers a reasonable yield pick-up compared to other asset classes, as well as some protection against inflation. However, there is also uncertainty surrounding several property types in a post-Covid world: the anticipated demise of the office and high street retail sectors could be overstated but current pressures on tenants will have long-term repercussions. We tend to favour more specialist parts of the property market enjoying structural growth, such as healthcare, logistics and digital infrastructure. Commodities have rebounded strongly off their lows and are not as attractive a value play today, although the situation with Russia and Ukraine has created short-term volatility in energy and soft commodity prices. Brent crude has fallen by more than a quarter from its March 2022 high of $127, however, and has settled in a mid-$80s range today. Over the medium to long term, commodities should remain correlated to global economic activity. Broad allocations to commodities should also provide some protection if inflation surprises on the upside. Conversely, downward price pressure could resume if growth disappoints.
Alternatives	3	↑	Given time, the right hedge fund strategy can provide a diversified return stream compared to more traditional asset classes. These funds are unlikely to keep up with a raging bull market but should post reasonable returns in a constructive environment for risk assets. We have recently moved towards real assets in our 'alternatives' allocation, which also offer an element of inflation protection. Well-chosen absolute return vehicles can be a useful diversifier to overall portfolio risk thanks to their low correlation with traditional asset classes. But they are unlikely to keep up with ultimate safe havens such as

			government bonds in times of market duress. We have recently moved towards real assets in our 'alternatives' allocation, which also offer an element of inflation protection.