STONEWOOD
WEALTH MANAGEMENT

Quarterly Investment Report

Stonewood Asset Allocation Funds

31 December 2020

Stonewood Global Adventurous Fund -4th Quarter 2020 Review

December saw the end of what was a very unique year for everyone around the world. Financial markets, however, continued to show a disconnect from the current realities faced by many economies and companies marching onward and upward. We saw positive performance across all major asset classes in the final quarter of 2020, December being a particularly strong month. The final quarter performance resulted in the majority of asset classes ending the year in positive territory. Markets are juggling a combination of economic factors at present: US Elections results, Brexit, second/third waves of COVID-19, longer and more drawn-out lockdown measures across much of the Western world and the positive prospects of having numerous vaccines approved and rolled out in the first few months of 2021.

The fund performed satisfactorily over both the quarter and the month but remained behind our benchmark for all periods in question. Our benchmark has changed during December to a more appropriate benchmark for this strategy. The new benchmark chosen is the Morningstar ® Moderate Target Return Index, which is part of the Morningstar Target Return Index Series for USD denominated multi-asset portfolios. This specific benchmark has a global equity exposure range of between 50%-70% and currently is at 60%. The index utilizes the average exposures of asset allocations to specific equity and fixed income geographic regions based upon the universe of all USD multi-asset funds that are managed within this risk category according to its database. The benchmarks current allocations are a combination of 60% global equity and 40% global fixed income, inflation-protected securities and cash. The equity breakdown is subject to the average allocations of the fund universe.

The underperformance relative to our benchmark during the year and the last quarter is explained by the underweight exposure to global equities. At the end of the year, the portfolio had a 46% equity exposure which is still well below the benchmark although higher than the fund average for the year. We have reduced the underweight in equity slightly while simultaneously rotating our equity exposure to Developed Markets outside of the US and Emerging Markets. Furthermore, we have also reduced our long-dated US Treasury exposure in favour of inflation-protected securities and high yield/investment-grade credit. These are small changes in nominal terms but themes in the asset allocation of the portfolio that will continue to become more prominent through the first half of 2021. We have avoided increasing equity exposure just for the sake of chasing short-term performance to close the underperformance relative to the benchmark over the last 12 months but will be opportunistic in our approach to reallocate and rotate certain exposures as and when the market conditions prove appropriate.

Table 1: 2020 Fund returns vs. Benchmark

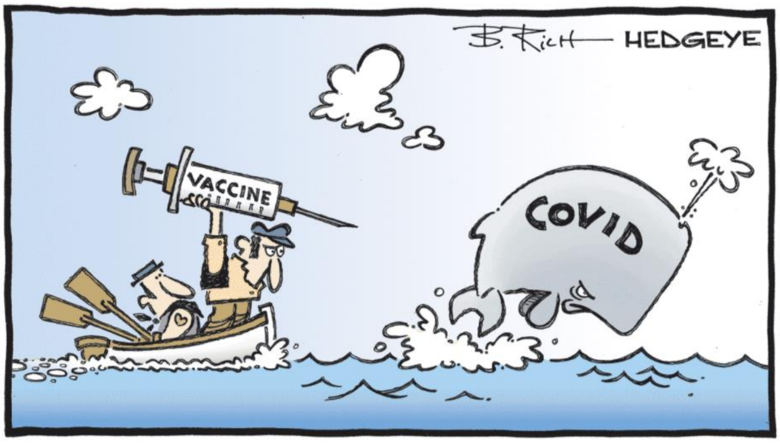
Return periods	Adventurous Fund	Morningstar ® Moderate Target Return Index*
Latest month return	2.9%	3.1%
Year to date return	4.3%	12.8%
Rolling 3 months	8.2%	10.2%
Rolling 6 months	11.2%	15.5%
Rolling 1 year	4.3%	12.8%

*** Benchmark of the fund was changed to the Morningstar® Moderate Target Return Index**

Source: Stonewood Wealth, Factset

Our US$ Asset Allocation Funds aim to deliver returns commensurate with a pre-determined targeted range of equity exposure.. Past performance is not a reliable indicator of future results. The Funds' share prices fluctuate and are not guaranteed. Returns may increase and decrease as a result of currency fluctuations. When investing in the Funds, an investor's capital is at risk. Performance data is presented for Class A shares for each Fund.

Investment Insights



Ending the year often calls for a review of what we have seen, experienced and learnt during the calendar year. Although a calendar year is a completely arbitrary point in time and has no relevance in the world of asset prices and investment returns its often used as a period for reflection and understanding of what has transpired in the world and portfolios. It is important however to remember that the timeframe is of little significance.

2020 has been seen by many as a disaster and many things would give us reason to agree with that. However, looking at broad based asset price performance it's hard to collate the feeling of hardship and loss we have felt as individuals and businesses with the performance of listed asset prices we experienced over this same trying period.

Very few assets at a broad-based level ended the year in negative territory. In contrast to this, Energy and Real estate were some of the few areas of the market that did not have a fantastic 2020.

What this means is if you held an equity or multi-asset portfolio that was not overly concentrated in a specific sector that happened to be on the receiving end you probably had a reasonable year relative to the perceived realities experienced by almost all global citizens.

The insights we gathered from this year are easy to see in hindsight, but it is important to acknowledge the lessons and consider how those lessons impact portfolio construction, investor behaviour and asset price performance going forward.

1. <u>The market and the economy are often disconnected.</u>

We all get sucked into the belief that if the economy is performing poorly or in recession then naturally asset prices should follow suit.

If we look at the last 20 years, the correlation between economic growth and market performance has been exceptionally low in any given year. Meaning that if the economy is shrinking or growing it does not necessarily mean the market performance is following the same trajectory.

Let's look at a few important periods in recent times. The US equity market generated a negative return in both 2001 and 2002 despite the US economy displaying positive GDP growth in both of those years. In 2009 the economy shrunk by 2.5% and the stock market was up 26.5%. In 2018 the market dropped around 4.4% and the economy grew at 3.0%.We should not be surprised by this disconnect because market prices tells us more about what the market participants think about the future than what has happened in the past. It seems the market is telling us that the earnings will recover or continue to increase, economic growth will recover, and interest rates will remain anchored at rock bottom for a very long time.

In other words, the move in market prices despite the global economic contraction/recession is predicting that the future is far less dire than we anticipated and on aggregate, the worlds growth and value trajectory is better than it was pre-COVID. This has been explained by some as a result of structural changes in the global economy, the roles and policies of central banks and governments and pent-up demand that is unlikely to be unleashed when we return to “normal”

Our view at the time was that the level and duration of central bank intervention to follow, if at all,was not yet known and therefore the impact on asset prices and the possibility of widespread value destruction could not be quantified. The risk of widespread losses was too significant for us to ignore.

Related to this it was difficult to quantify and understand how severe and how long the economic impact of COVID would be with us. As it turns out, the impact on aggregate earnings seems to be severe in the short run, but less meaningful on aggregate the longer out into the future one looks. This is due to a range of factors including external market interventions like stimulus, but what this means is that cautious investors have been penalized for reducing the growth asset risk in their portfolios while taking the time to try and understand the market prospects.

We are still comfortable that despite the performance impact this is likely a decision we would make again into the teeth of the uncertainty around long term growth and valuation prospects. It is easy to be critical in hindsight, but with capital preservation at the core of our process this seemed logical and prudent at the time. It's important to remember that the story has not been positive for all markets and sectors. Many face the risk of failure even with the support that has been received. Failure means the permanent loss of capital which is the risk that every investor must avoid at all costs.

Chart 1: S&P 500 annual total return vs US GDP growth since 1994

Source: Factset

2. Valuations models are evolving.

It would appear on the surface that the mix of assets that make up the global market are evolving. At the same time, there appears to be a change in the way these assets are valued by the market.

This topic is contentious on many fronts but the support for the argument at least seems to be increasing based on the evidence of what is transpiring in markets.

Firstly, the mix of assets that make up the global market is quickly changing. The world has gone from capital and labour-intensive industrial businesses to capital-light and less labour-intensive, technology-enabled businesses. This has many implications. The size of a business in physical terms that is needed to serve a global audience has decreased and the ability for these businesses to scale and reach a global audience is astounding. This has a possible impact on profit margins once the product is built and the scale required or “network effect” achieved.

The speed at which these new businesses can reach global scale and power is staggering ~~making~~, meaning existing industries and market leaders have never been more vulnerable to being made irrelevant and redundant. What is also true is that market size is no longer limited to your geographic location or immediate audience. Which makes growth potential and scale a very difficult set of variables to assume.

What this means is you have a generation of businesses that are being created that are very difficult to accurately value and this is distorting a lot of what investment professionals have come to know and trust when allocating capital.

This is compounded by the low-interest rate environment and central bank support points made already. However, valuations are not a result of these but rather importantly something to consider in conjunction with these two points.

A side note here is that these types of businesses are impacted far more significantly by low-interest rates as the majority of their value is yet to be achieved and therefore needs to be discounted back from far further in the future meaning low discount rates have a far greater impact in any discounted cashflow valuation consideration.

If correct this will have long-reaching impacts on the market and portfolio construction going forward.

This is not a conclusion, nor does it have a direct impact in our portfolio construction but is a trend and concept we are grappling with in terms of making capital allocation decisions.

3. Traditional diversification methods need to be reviewed

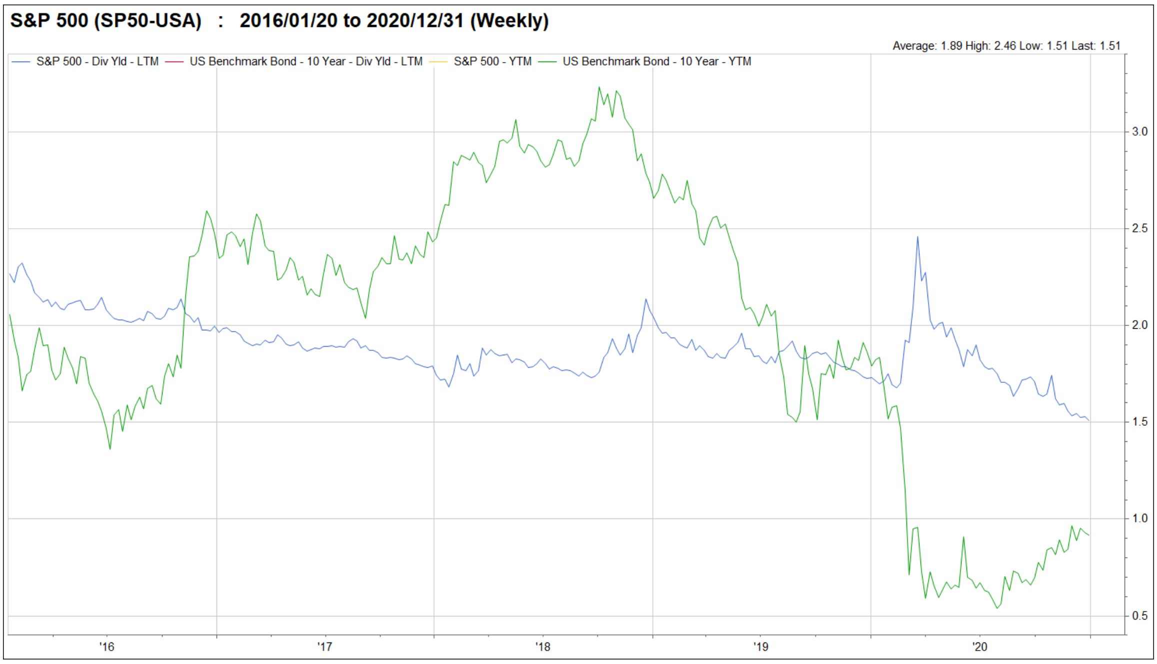
Traditionally nominal government bonds and cash were seen as good diversifiers for a global portfolio. If stocks and other risk assets were to drop the bond portion of the portfolio would tend to do well. There were two primary reasons for this (assuming you held good quality bonds). Firstly, is that the yield commitment on the bond would be valuable in the hands of the investor, creating portfolio income and offsetting growth asset losses. Secondly, the monetary policy interventions used to stimulate markets and investors rushing to acquire safe-haven assets would drive the price of bonds higher as interest rates dropped and demand for secure assets increased. This made the bond portion of the portfolio a great counterweight in periods of weakness.

If you look at the traditional bond of choice the US Treasury Bond as a proxy for global safe-haven diversifiers in the current environment, then you realise that the role they have traditionally played may be in question. The starting yields are exceptionally low (US 10-year yield at 31 Dec was around 0.93%) meaning that If you gave the US Government money for 10 years you would earn 0.93% per annum. Not very attractive especially if inflation is going to increase to the target of around 2% per annum on average over this period, that would lead to a negative annual real return.

Further to that, the short-term interest rates in the US are at “rock bottom”, currently at between 0.00%-0.25%, meaning that unless you expect negative rates the only place interest rates can go is up, which hurts the price of bonds significantly. Not only are the long-term return contribution prospects very poor (US Equity Dividend yields are currently around 2.0%, well above the 10 Year Treasury Bond Yield) but the prospects of rate increases are probable meaning that the price of the bonds are unlikely to improve from current levels, even if another crisis were to transpire. See the chart below showing the dividend yield of the S&P 500 vs the US 10 Year Yield for the last 5 years.

As investment managers we need to consider different ways to reduce long term drawdown and market volatility risk in a portfolio, the 40% Bond Segment of the well-known 60/40 portfolio is unlikely to provide the same level of protection that it has over the last 50 years.

Chart 2: S&P 500 dividend yield vs US 10-year bond yield

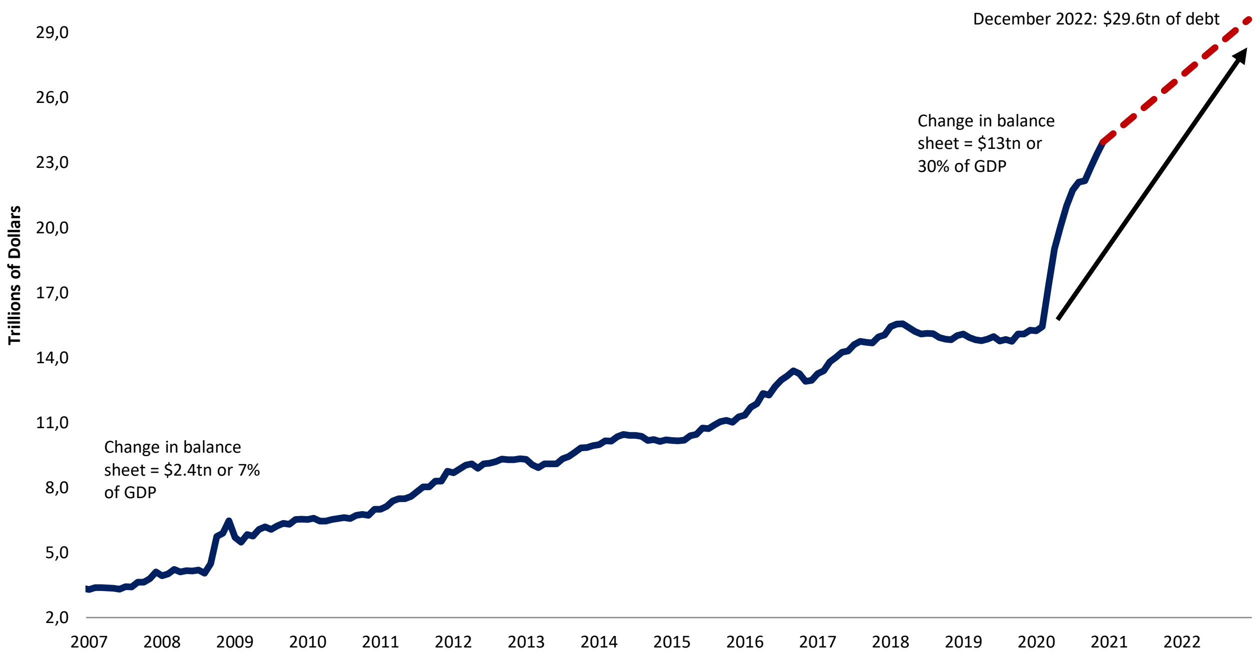


Source: Factset

4. <u>Central Bank and Government interventions are likely to be permanent features.</u>

The role of central banks since the GFC has been increasingly significant. In the 2008 crisis, the Federal Reserve effectively bailed out the US banking system and economy and therefore to some extent the rest of the world. Many central banks have offered similar types of support to their economies with regularity since then. The types and styles of intervention differ. The magnitude of the support however has been somewhat eye-watering.

Chart 3: G4 Central Bank – Change in Balance Sheet (US$tn's)



Source: RMB Morgan Stanley

When one considers that such interventions have been required globally in varying forms for the last 13 years, with increasing regularity you realise that central bank policy is no longer just a lever that is pulled in the times of crisis but likely to be something that is a permanent feature of financial markets for the foreseeable future if not indefinitely.

The impact this has is difficult to know exactly but there are some interesting considerations if this turns out to be the case.

There are some possible permutations to consider:

- Are interest rates ever going to return to historic norms? If not, what impact does this have on global asset valuations?
- Will the purchase of corporate credit by central banks intervene in the capital market risk and return structure by removing a key dynamic in the risk spectrum?
    - Does this change the behaviour of global corporates, rewarding reckless borrowing and distorting risk premiums?
    - Are less creditworthy borrowers being made to look "safer" than their true characteristics, leaving investors with far higher tail risks inside their portfolios?
    - Will more central banks intervene in equity markets by purchasing global stocks (the previous two points are as valid to this point as they are to the bond market)

This is not an exhaustive list but are meaningful things to consider. If these considerations are all true, then the way we look at asset prices and risk vs. return need to be reconsidered completely both in the short and long term.

Asset Allocation

Our current asset allocation strategy is driven by the following:

- Equity valuations are at elevated levels across the spectrum as a result of liquidity provision and stimulus measures. Avoiding relatively overvalued areas of the market is likely to be a prudent strategy going forward. This means favouring oversold sectors, developed markets outside of the US and emerging markets.
- Despite a strong year of equity market performance, with the expectation of continued economic stimulus and a global vaccine rollout we could easily experience another good year for equity markets broadly speaking. This ignores heightened valuations.
- We continue to rotate out of sectors that we perceive as fully valued and into geographies and sectors where we see relative value, this was initiated in the last quarter and has continued through quarter four.
- Inflation expectations have continued to rise during the 4th quarter. We have already increased our exposure to inflation-protected securities and maintain a fixed gold exposure at our strategic allocation target.
- Duration in the portfolio has been reduced to reduce the risk of long-term inflation manifesting and impacting portfolio performance.
- Nominal Government bonds and treasuries continue to show very limited value to the portfolio at current yield levels. We have reduced exposure on the longer end of the curve but are keeping an eye on the yield environment. If yields continue to rise, there may be a point where both the yield and diversification benefits of nominal government securities become of relative importance to the portfolio construction. Central banks have continued to signal that there will be no movement on short term rates in the foreseeable future. This will continue to impact on asset prices and general discount rates.
- Economic growth has improved across the globe with Asian economies approaching pre-COVID levels, the Western world remains below trendline but the expectation of a sharp recovery during the latter part of 2021 as a result of vaccination rollouts is the base case being priced into financial assets.
- Considering the above points, changes to our asset allocation strategy are:
    - reduce the amount of duration exposure in the portfolio.
    - Increase exposure to inflation-protected securities and other assets that benefit from more inflationary environments.
    - Increase in non-US investment-grade credit exposure.
    - Increase equity exposure in areas of relative value (i.e. Emerging Markets and Developed Markets outside the US, value and cyclical market sectors)
    - Continue to reduce energy exposure as valuations increase.

Table 2: Current fund positioning

Current asset allocation	Weight	Comment
Equity	46.0%	Increase exposure in areas of relative value (non-US DM, EM value and cyclical market sectors. Reduce energy exposure as valuations increase.
Fixed income	43.0%	Reduce duration exposure, increase exposure to inflation protected securities & non-US IG credit.
Commodities	8.4%	Maintain gold position and looking at industrial commodity exposures
Cash	2.6%	
Total	100.0%	

Source: Stonewood Wealth

Conclusion

As we start the new year, we want to thank all our existing clients and partners for their support for the 2020 year.

2021 will no doubt bring a host of surprises as evidenced by the first two weeks of the year. Markets will go up and of course they will go down. We will have periods of market panic, uncertainty, euphoria, and excitement. We will continue to possess no more (and no less) predictive power than the teams/market participants that we compete against.

Our team has been bolstered both in terms of depth and experience in the last 12 months and we expect this to add to what was an already robust investment process and capability set.

We continue to see the Adventurous Fund as a core building block in any global investor portfolio. The breadth of asset exposures and the diversification benefits of various geographic, sectoral and style allocations make for a robust base that any holistic client portfolio can be built off. We retain the flexibility in our mandate to tactically adjust when necessary and we believe this attribute allows us to stand out in a competitive landscape.

We look forward to communicating with you throughout the year and thank you again for your trust on this journey.

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