EQUILIBRIUM

Quarterly investment report

October 2023

Introduction

Welcome to our new style of quarterly reporting. We hope you find it informative. We'll be evolving the format over time and would welcome your feedback on what you value and what you'd like to see.

It might not feel like it, but on many definitions, we're in a new bull market.

A bear market is usually defined as a 20% fall or more. 2022 was a horrible year for investors with virtually every major asset class losing money and many, including bonds as well as equities, falling into bear market territory.

A bull market is when there is a sustained recovery from the lows. In 2022, the lows happened in mid-October and most stock markets (and portfolios) are still well above these low points, despite a recent pullback in markets.

However, the same cannot be said for government bonds, which suffered just as much as equities in 2022 but in many cases have seen further falls this year.

Despite very challenging conditions, our portfolios have produced strong long-term performance relative to our competitors, significantly ahead of cash and inflation despite the recent spike in consumer prices, as shown in **Table one**.

Three years ago, UK inflation (Consumer Prices Index – CPI) was 0.3%. In 2022 it peaked at over 10% and has now fallen back to 6.7%.

The Bank of England's base rate was 0.25% three years ago and is now 5.25%. It has increased by 5% in just the past two years and by 3% in the last 12 months alone. These are huge moves, and page four shows how markets have been affected by these developments.

It is worth remembering what an extraordinary period we've seen in the economy, which has therefore hit markets. Page three shows some key economic indicators and how they have changed over the past few years.

Page four also discusses the outlook for various asset classes, which we see as very positive. After recent falls, bond yields are now at levels which we have not seen for decades. We also see some good value in parts of the stock market, and at present, we particularly like defined returns products where we can see double-digit potential returns with much less uncertainty than some asset classes.

Table one:

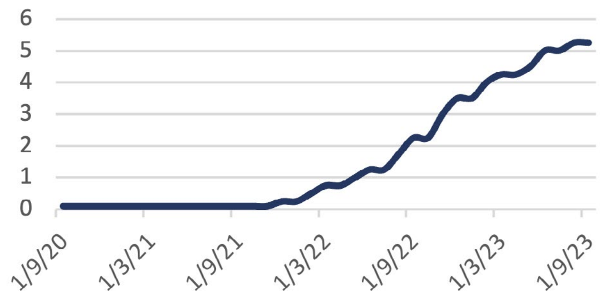
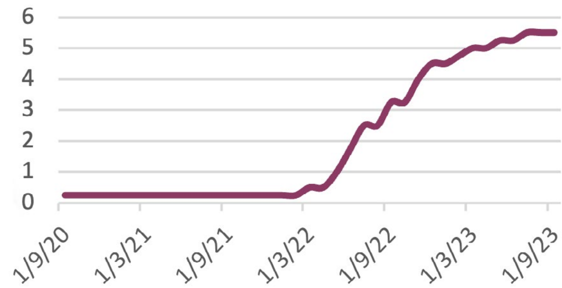
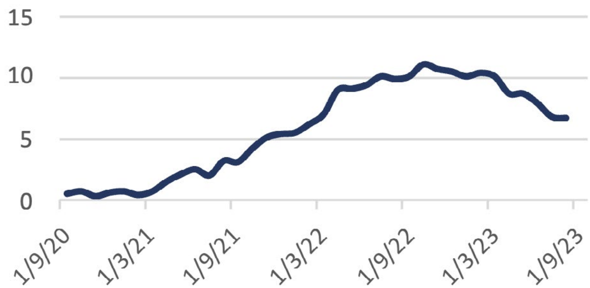
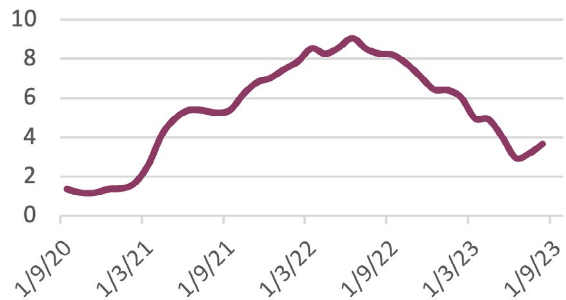
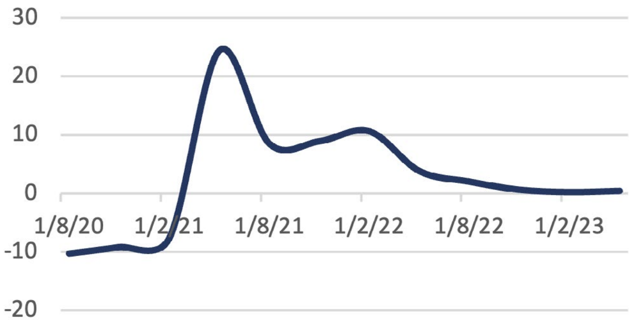
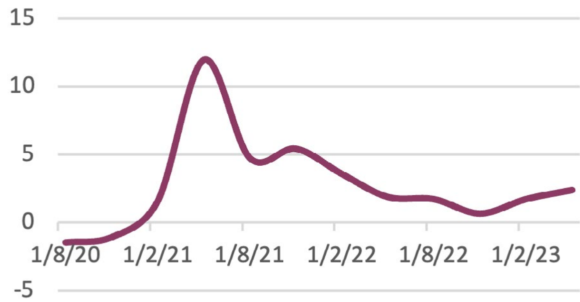
Portfolio	10-year total return %	10-year % p.a.
Cautious	43.46	3.67
Balanced	52.17	4.29
Adventurous	65.40	5.16
Competitor mixed investment fund (balanced)*	37.73	3.25
Competitor discretionary index portfolio (balanced) **	38.77	3.33
UK Inflation (CPI)	32.49	2.85
Cash (Bank of England base rate)	8.62	0.83

*UT Mixed Investment 20-60% Shares. ** ARC Sterling Balanced Index.

Source: FE Analytics to 5 October 2023. Green numbers denote outperformance of sector. All portfolios based on IFSL Equilibrium fund and discretionary model performance prior to launch. Defensive and Global Equity long-term returns based on backtested portfolio.

The economy

On this page, we look at some key economic indicators and how they have evolved over the past few years, focusing on the UK and the US which have the biggest effect on portfolios.

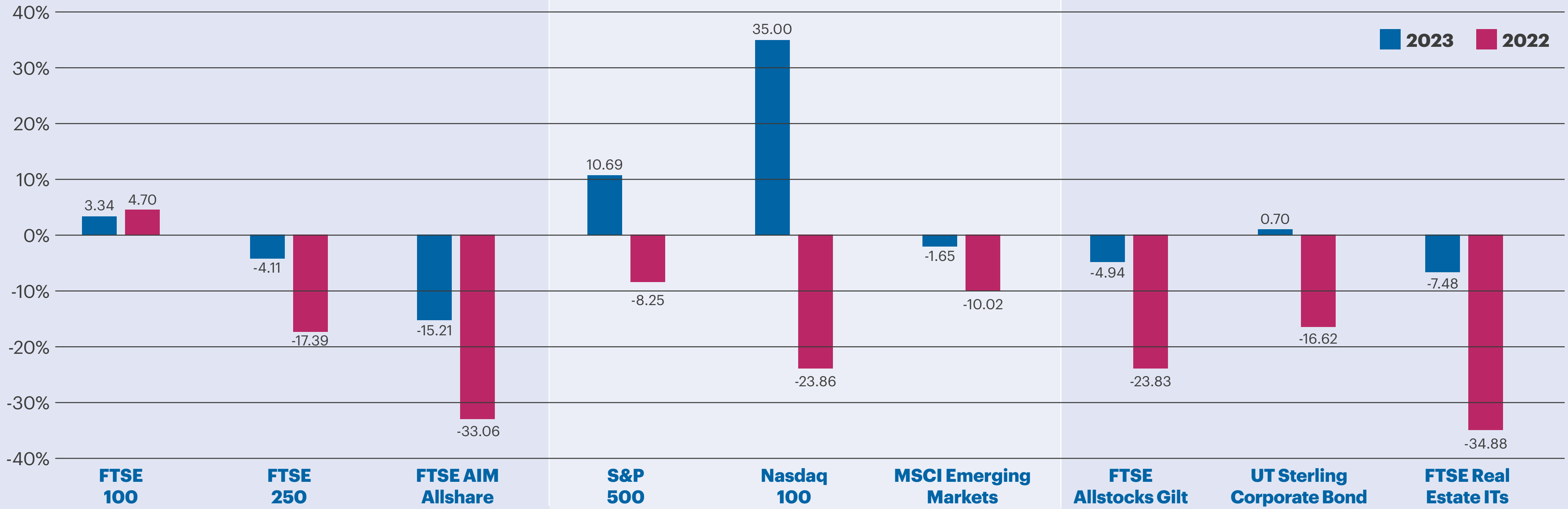
	UK	US	Equilibrium view
Interest rates %			Rates have gone up far more than most people expected. In the UK they've gone up by 5% in two years and 3% in the last 12 months. We've seen a similar increase in the US. We believe rates may have peaked with both central banks opting to "pause" at their latest meeting.
Inflation % p.a.			Inflation has stayed higher than expected, especially in the UK. It is now falling but core inflation remains high. US inflation has fallen more quickly than in the UK with less exposure to high energy and food price inflation.
Economic growth % p.a.			The UK economy has been weak but has remained just about in growth territory in 2022 and 2023. By contrast, the US economy has been much stronger than expected. In both regions, employment has remained strong despite sluggish growth. We now see signs of a slowdown in both the UK and US, with real-time data in the UK consistent with a mild recession.

Source: LSEG Eikon, ONS, Bank of England, Equilibrium Investment Management.

Markets

Chart one shows the returns of some of the major asset classes available to invest in over 2022 and 2023 so far. All but one of these assets fell in 2022. After a good start to the year, many have now fallen further in 2023, with the exception of large-cap equities.

Chart one:



UK equities	Overseas equities	Other assets
After a long period of underperformance, the FTSE 100 has had a good couple of years in relative terms due to its high exposure to energy stocks such as BP and Shell. However, UK small and mid-sized companies – which have typically outperformed over the long term – have struggled recently in the face of rising rates, high inflation and a sluggish economy.	US markets have done well in 2023, driven almost in the entirety by the big tech stocks. These were some of the worst performers in 2022 but have bounced back as investors enthused about artificial intelligence. By contrast, emerging markets which normally provide good long-term returns, have struggled recently due to China's issues with Covid and trade relations with the West.	Many of the non-equity asset classes have performed poorly, with similar or even greater losses than equity in 2022. In 2023, corporate bonds have had a weak bounce back whilst gilts and real estate have continued to lose money. The main reason for this poor performance is rising interest rates, with bond yields rising and therefore prices falling. In property, the rising cost of borrowing and the slowing economy have been an awful combination.

Source: Financial Express, total return in sterling to 5 October 2023. This is a non exhaustive list of some of the major asset classes we can invest in.

Portfolios

The tables below show our portfolios over various time periods, compared to other funds with similar objectives and risk tolerance.

Calendar year returns %

Portfolio	2023 so far	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Cautious	-1.02	-9.62	6.51	3.60	12.37	-3.6	8.58	7.76	4.36	6.27	12.75
Balanced	0.27	-10.93	7.73	4.31	13.79	-4.12	9.75	8.93	5.53	6.43	14.20
Adventurous	1.54	-14.54	9.58	6.98	16.61	-5.60	12.79	12.44	6.21	6.35	13.42
UT Mixed Investment 20-60% Shares	**-0.04**	**-9.47**	**7.20**	**3.51**	**11.84**	**-5.10**	**7.16**	**10.32**	**1.21**	**4.85**	**8.85**
Global Equity	2.16	-18.37	11.10	13.36	20.99	-8.40	19.08	18.06	7.23	4.6	19.99
UT Flexible Investment	**1.30**	**-8.98**	**11.30**	**6.70**	**15.66**	**-6.72**	**11.21**	**13.82**	**1.99**	**4.89**	**14.54**
Defensive	-2.22	-9.21	1.93	7.39	6.29	0.01	4.95	4.64	0.90	4.21	4.09
UT Global Bond	**-1.14**	**-10.26**	**-1.05**	**6.03**	**5.57**	**-0.69**	**2.25**	**12.58**	**-1.32**	**3.81**	**-1.96**

Various time periods %

Portfolio	6 months	1 year	3 years	5 years	10 years
Cautious	-2.37	0.94	1.14	5.63	43.46
Balanced	-1.62	2.34	3.40	7.88	52.17
Adventurous	-0.71	2.94	4.08	10.43	65.40
UT Mixed Investment 20-60% Shares	**-2.02**	**2.21**	**3.93**	**7.52**	**37.73**
Global Equity	-0.55	1.97	3.58	15.66	89.65
UT Flexible Investment	**-0.71**	**2.70**	**10.22**	**16.51**	**61.42**
Defensive	-2.84	-1.36	-7.39	3.33	20.89
UT Global Bond	**-2.99**	**0.12**	**-11.05**	**-0.95**	**13.79**

Our core portfolios have produced consistent performance over the long term. Our Balanced and Adventurous portfolios have outperformed the aggregate of other funds, which have between 20% and 60% in shares in eight out of the last 10 calendar years, and are also both outperforming so far in 2023. Cautious has outperformed in seven out of 10 years, despite holding less equity than many funds in the sector. All the core funds have outperformed inflation over the long term.

Our Global Equity strategy is recovering well from the market falls of last year and has again produced long-term outperformance relative to competitors. Medium-term performance has suffered somewhat due to exposure to long-term growth areas such as smaller companies and emerging markets.

The Defensive fund is shown against the global bond sector and cash. It has held up very well during a period where bonds have fallen very sharply and outperformed cash over the longer term. We now think bonds look extremely good value.

Source: Financial Express, total return in sterling to 5 October 2023. Green numbers denote outperformance of sector. All portfolios based on IFSL Equilibrium fund and discretionary model performance prior to launch. Defensive and Global Equity long-term returns based on backtested portfolio

Drivers of performance

This table shows how each of our core asset class portfolios have performed over the past 12 months, along with the current asset allocation of the Balanced portfolio and what this was to a year ago. We have made similar changes in other portfolios to a greater or lesser extent.

Calendar year returns

Asset class	1-year return %*	Current allocation %	Allocation 1 year ago %	Change in allocation %	Commentary
Fixed interest	4.11	43	24	+19	Bonds have performed poorly as rates have gone up, although our fixed interest exposure has done well relative to corporate and government bond indices. As prices fell and yields rose, we have increased exposure to our highest weighting ever in many of our portfolios, after being underweight for some time.
Real assets	-14.10	9	15	-6	Infrastructure and real estate have both performed poorly in the past 12 months as both have proved sensitive to rate hikes. In 2022 our exposure to clean energy infrastructure initially helped our performance after the invasion of Ukraine, but since then it has fallen back. In property, we recently purchased an index tracking fund to gain broad market exposure to any recovery.
Defined returns	16.83	11	13	-2	Our defined returns are generally based on the FTSE 100, sometimes also alongside the S&P 500. These have been very successful investments, outperforming the FTSE 100 on which they're based, as well as most types of equity in recent times. We have recently increased exposure again after a reduction following kickouts earlier in the year.
Alternatives	2.84	5	11	-6	For the past few years, we have tended to have a higher weighting to alternatives such as absolute return funds, held in preference to fixed interest. As bonds have become more attractive, we have dramatically reduced alternative exposure as they have done their job in portfolios, holding up well when equities and bonds fell.
Equity	4.96	33	36	-3	We increased exposure to equities during the falls of last year. Specifically, we topped up our holdings of US equities. For example, we purchased a Nasdaq tracker fund in most portfolios which has performed very well so far this year. We have now sold this in most portfolios, instead switching to smaller US companies which have not yet had the same level of recovery. We have banked some of these gains and somewhat reduced equity over 12 months. We decreased our emerging market holdings, in particular reducing China exposure in particular in most funds. In the UK, we maintain our preference for smaller companies but also have increased large-cap exposure via the defined returns plans.

The biggest drivers of performance have recently been our defined returns and our global established equity holdings, especially some of our global funds which have outperformed even the US market. Defined returns – which are largely bespoke products solely available to our clients – has been the best-performing asset class over the past three years. The biggest detractors of returns have been interest rate-sensitive areas such as fixed interest (bonds) and real assets like property and infrastructure.

The biggest portfolio change has been to increase exposure to fixed interest to almost double what it had been a year prior. As prices have fallen, the yields on bonds have increased, pushing up the future potential return. We have slightly reduced equity and defined returns over 12 months, banking gains as the stock market recovers somewhat. We are now looking to increase defined returns again as the potential returns have increased.

*Source: Financial Express, 12-month total return of relevant Equilibrium asset class portfolio 5 Oct 2022 to 5 Oct 2023. Equity is based on Balanced Equity mix. Real assets assumes 2/3 infrastructure and 1/3 real estate. Allocations will not add up to 100% - cash allocation is not shown in this table.

Commentary

2022 was an extraordinary year for many asset classes, most of which fell sharply. 2023 has so far been mixed.

Of the asset classes and indices shown on page three, only the FTSE 100 made money in 2022, driven by its high weighting to oil and gas. The war in Ukraine contributed to rising energy prices, which hurt the economy but boosted the profits of companies like BP and Shell.

Everything else lost money. The low point was in mid-October 2022 and since then many assets (though not all) have seen something of a recovery.

The worst-performing assets in 2022 were those most sensitive to rising interest rates, in particular bonds (gilts and corporate bonds) and property, as well as smaller company and technology stocks.

In 2023, interest rates have continued to rise more than expected as inflation proves stickier than hoped. This means that gilts and property have continued to lose money this year, whilst corporate bond returns have only been mildly positive. Our bond top-ups have largely been to corporate rather than government bonds.

Bucking this trend however have been the big US technology stocks, where hopes that artificial intelligence (AI) could boost their profits have driven share prices higher. In fact, of the positive returns of the US market, the S&P 500 is up 10.69% so far this year, and nearly all have been driven by these big tech stocks which make up such a big proportion of the index. Alternatively, if you equal weighted all the 500 stocks in the index, it would be DOWN 1.8% (Source: FE Analytics 1 January to 5 October 2023, total return in Sterling). This is quite extraordinary and the last time the gap was this big was back in 1999, during what we now call the "tech bubble".

Interestingly, looking back at the post-tech bubble period, whilst the market-cap-weighted S&P 500 fell sharply in 2000 and 2001, the equal-weight version of the index actually made money in both years.

We are now very wary about these stocks which look extremely expensive relative to history and to other parts of the stock market, but we do see some great value in other asset classes, including other parts of the US stock market.

Outlook

From an economic point of view, we think interest rates in the UK and US have peaked for now. There are signs that the economy is slowing, and we believe that further rate hikes might tip this into a full-blown recession, which Central Banks will want to avoid.

Inflation is now falling back around the world, even here in the UK where it has proved "stickier" due to our vulnerability to energy and food prices. Both these categories are now starting to fall, which should help the overall inflation picture going forward.

In terms of investment, the turmoil of the past couple of years has left many asset classes looking much cheaper, implying that the future return may well be higher in our opinion.

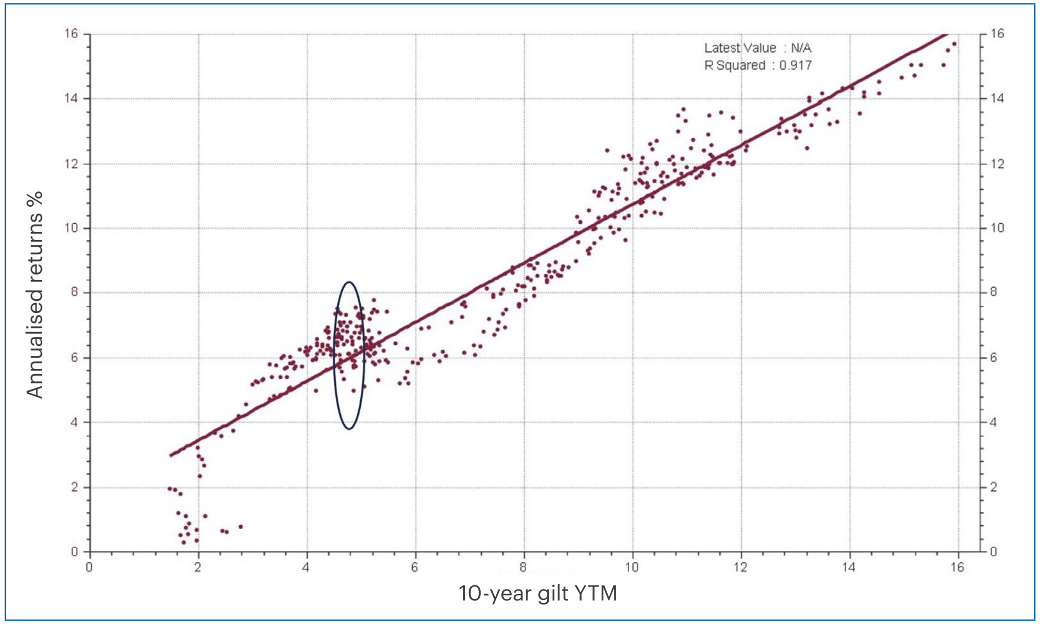
Each year, we carry out a detailed piece of research looking at what are the likely future returns of each asset class.

Most asset classes have certain metrics which in the past have given a good guide to what returns are likely to be. For bonds, the primary one is the yield – the higher the yield at the beginning of the period, the higher the return over the relevant time frame.

This is illustrated in **Chart two**. Each dot shows a different 10-year period for the gilt market, with the higher the dot, the higher the return. Across the horizontal axis is what the yield on the 10-year gilt was at the beginning of the period. There is a 92% correlation between the two. We have circled a past period with similar yields to now, many of which saw returns of 6% p.a. or more.

With gilts now yielding 4.6% p.a., corporate bonds yielding 6.5% p.a., and high-yield bonds yielding around 10% p.a., we can expect some decent returns from bonds if history is repeated. (Source: LSEG Eikon / Equilibrium Investment Management. For high yield this is based on data from the funds we hold in portfolios.)

Chart two: 10-year gilt yield vs 10-year annualised returns



Source: LSEG Datastream / Equilibrium Investment team

For equities, we look at metrics such as the ratio between the price of the market and the underlying profits produced by the companies. For many indices, the current price of the companies is relatively low in relation to their profits, and at levels where we've historically seen some very good returns.

Table two shows our “best guess” for returns over the next 10 years from each of the core assets we invest in.

These are all based on what has happened in the past when valuations have been similar to where they are at present.

The reason for doing this exercise is not because we expect the figures to be exactly right, but because it guides us as to how much we should invest in each asset class.

From the expected returns (and taking into account expected risk) we can work out our strategic asset allocation – the mix of assets that we think gives us the best chance of achieving the portfolio objectives, assuming we just buy the index, and hold it for the next 10 years.

If the figures are correct, portfolios should be able to achieve returns ahead of target with less risk than we’ve had to take at times in the past.

Key to this is of course what happens to inflation and interest rates. Here, we have simply taken the aggregate market expectation which we can work out from bond and derivative markets.

We are basing our assumptions on 2.5% p.a. average inflation and 4.5% average interest rates over 10 years. Our suspicion is they could potentially be lower than this, but when doing this research our intention is to remove our views from it as much as possible, and simply go with “what the spreadsheet says”.

Table two:

Asset class	10-year expected return %
Inflation	2.5
Cash	4.5
Gilts	4.5
Corporate bonds	6.25
High yield	7.5
UK equitites	10.5
US equities	7.5
Europe ex UK equities	7.5
Japan equities	6.5
Global Emerging Market equities	11.5
China equities	14.5
India equities	6.0
Real estate	8.0
Infrastructure	6.0

Source: EIM / LSEG Eikon / Long-term investment assumptions Sep 2023.

Skewing the odds in our favour

With higher yields on bonds, allocating a significant portion of portfolios to this asset class can provide attractive long-term returns, but with less uncertainty than equities. In essence, with a bond you are lending money to someone – a company or a government. Provided they don't default, the yield tells you what return you will get if you hold to maturity (although of course in the short term, the price can move higher or lower than this implied return).

In equities, where we would sum up the expected returns as being "good" rather than "outstanding", we'd expect c.9% to 10% per annum on average from a diverse portfolio of equities over the long term.

Here is where we can make short-term "tactical" changes to improve things – in particular by using defined returns.

These are bespoke products created especially for our clients, which pay a fixed rate of return as long as an index, such as the FTSE 100, stays at the same level or higher over a given period. At the moment they provide very attractive double-digit potential returns.

For example, we've just invested in a new defined returns product which will pay 12.4% p.a., provided the FTSE 100 and S&P 500 does not fall below the set level over the five-year term.

Not only does this have a potential return higher than our long-term expectation for both underlying markets, it comes with greater certainty as we only need markets to move sideways in order to get the return.

Over recent times, our defined returns have really helped portfolios. Over three years, they have outperformed both the FTSE & the S&P on which they are based, as shown in **chart three**.

We'd expect to be using more defined returns in portfolios over the next few months (for more information – see **The Pulse – September 2023**).

The full long-term investment assumptions research will be published shortly along with all the supporting data and charts.

After the turmoil of the past few years, we understand that many investors are sick of volatility and may be attracted by the certainty of cash. However, by being selective and creative about what we invest in, we believe we can decrease some of the uncertainty of investing but maintain the potential for extremely attractive returns.

Chart three:

A - Defined returns portfolio 06/10/2022 (44.35%)
B - S&P 500 (40.49%)
C - FTSE 100 (40.33%)

Source: 02/10/2020 - 04/10/2023. Data from FE fundinfo2023.

Risk warnings and notes

Past performance is never a guide to future performance. Investments will fall as well as rise.

Any performance targets shown are what we believe are realistic long-term returns. They are never guaranteed.

None of the information in this document constitutes a recommendation. Please contact your adviser before taking any action.

Unless stated otherwise:

- All performance statistics are from Financial Express Analytics on a bid-bid basis with income reinvested.
- All performance data is to 5 October 2023.
- Model portfolio performance is stated after a 0.5% investment management fee with no adjustment for financial planning or platform charges.
- Your own performance may vary from that shown due to dividend pay dates, transaction dates, contributions and withdrawals.
- Actual performance may also differ slightly due to constraints over how we can reflect fees and discounts from fund managers. These are assumed not to change over the whole investment period. In reality, discount levels change as we change the funds in which we invest.
- Individual sector portfolios are shown with no charges taken off or fund manager discounts applied.

For details of your own portfolio performance, please refer to your half-yearly statement from the wrap platform in which you are invested. We will also provide personalised performance information at your regular reviews.

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