Please note that the commentary is for the retail class of the Fund.

Equity markets declined by 1% over the third quarter, with a weak September (down approximately 4%) ending a strong run of consecutive positive monthly gains since February this year. The global bond market was down by a similar amount for the quarter (0.9%), bringing the year-to-date decline to -4%. Despite these price declines, the US 10-year Treasury bond yield is still low, at around 1.5%.

In what was a torrid year for almost all asset classes, the fourth quarter of 2022 (Q4-22) provided some respite, with both global equity (+9.8%) and global bond markets (+4.5%) advancing. Despite this recovery, the year still ended firmly in negative territory, with global equities down -18.4% and global bonds down over -16%. The Fund had a strong quarter, advancing 5.7%.

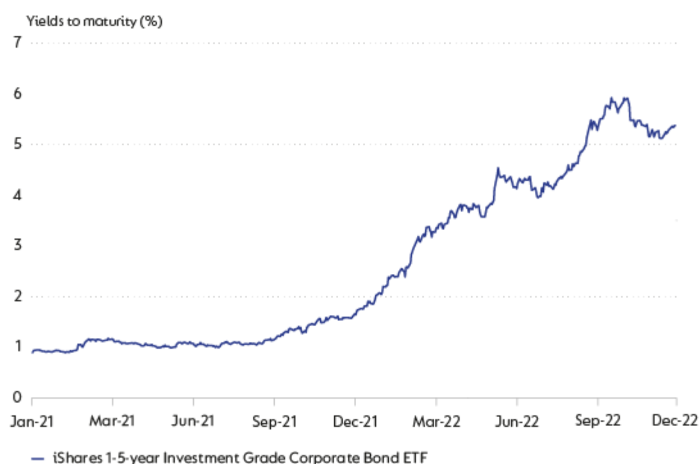
The market in 2022 has changed in a number of ways. For the Fund, perhaps the most notable difference compared to a year ago is the opportunity set that has emerged in the fixed income space. For the last decade we have run out of ways to say that "we see no value in developed market government bonds" or "fixed income markets offer little in the way of return, while assuming a significant degree of risk". And for much of this period we looked foolish as interest rates plumbed new lows (meaning prices hit new highs). That all changed last year as the high yield, investment-grade credit, emerging market debt, and developed market government debt markets all registered double-digit declines. This is not what investors seek from (supposedly safe) bonds!

For the portfolio, these declines have given us a long-awaited opportunity to put meaningful amounts of capital to work. At this time last year, we held over 20% of the Fund in short-dated US Treasury Bills (T-Bills). These instruments, with maturities of typically less than three months, yielded virtually nothing. Today we hold only 2% in T-Bills. The capital has primarily been re-allocated to Investment-Grade Credit, where exposure has more than doubled from 17% to 37%.

The chart below gives a sense for how significant the moves have been. For the iShares 1-5-year Investment Grade Corporate Bond ETF (a proxy for the short-dated investment-grade corporate bond market) yields to maturity have moved from 1% in 2021 to over 5% currently.

Figure 1

MOVES HAVE BEEN SIGNIFICANT IN THE SHORT-DATED INVESTMENT GRADE CORPORATE BOND MARKET



Source: ICE

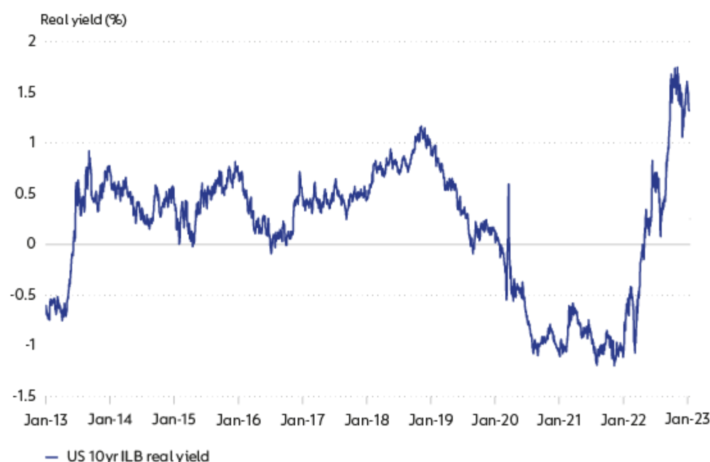
The Fund's exposure to inflation-linked bonds (ILBs) has also increased, from virtually nothing last year, to 9% today. These bonds work differently to typical fixed income instruments. Instead of locking in a nominal rate of return, ILBs allow investors to lock in a real return (i.e. a return over inflation). A simple example may clarify the mechanics of this type of bond: let's say an investor buys a 10-year US Treasury bond with a yield to maturity of 4%. If that investor holds the bond to maturity[1], then his/her return is guaranteed to be 4%. Now, if inflation over that period is 2.5% per annum, then the investor will have earned 1.5% real (or 1.5% after inflation). If inflation surprised to the upside at say 5% per annum, then the investor would have earned less than inflation, or -1% real.

In contrast, if the same investor bought a 10-year ILB at a real yield of 1.5%, then no matter what inflation does, if held to maturity, the investor will be guaranteed a return of 1.5% over inflation. So, if inflation materialises at 2.5% per annum, then he would have been indifferent between owning the Treasury bond (with its fixed nominal coupon) and the ILB. Both real and nominal returns would be the same. But in the instance where inflation surprises to the upside, the holder of the ILB would earn inflation of 5% per annum plus the 1.5% real yield, given a nominal return of 6.5%, and be much better off.

While our base case is that inflation trends lower from currently very high levels, there is a risk that it proves stickier and more volatile than the market expects, in which case removing inflation risk and locking in real returns becomes particularly valuable. Furthermore, real yields have increased significantly so ILBs are now more attractively priced than they have been for the last decade.

Figure 2

ILBs NOW MORE ATTRACTIVELY PRICED THAN THEY HAVE BEEN FOR THE LAST DECADE



Source: Bloomberg

At quarter-end, the portfolio was positioned as follows:

- 37.3% in investment-grade fixed income instruments
- 13.3% in inflation-linked assets (including 4.4% in gold)
- 9.8% in high yield fixed income assets
- 3.6% in real assets (listed infrastructure and property)
- 32% effective equity

The remaining 4.0% is invested across a range of other assets.

Equities remain an important building block for the portfolio. We believe the equity bucket is high quality and well diversified, and it delivered 4% outperformance against the MSCI All Country World Index (ACWI) during 2022. However, this healthy relative return could not shield the portfolio in the face of the ACWI's 18% decline. We continue to find a wide range of opportunities and, particularly after such declines, believe the current allocation to equities is sized appropriately for the Fund's mandate. The near-term volatility equities inevitably create is a small price to pay for augmenting the returns of long-term investors.

Thank you for your support and interest in the Fund.

Portfolio manager
Neil Padoa
as at 31 December 2022

1 and assuming coupons are re-invested at the same rate