IMAP Specialist series: Implications of Interest Rate rises

Session 3 : Portfolio Management Considerations

Brad Matthews, BMIS
Brendan Paul, Atrium Investment Management

Moderated by David Cohen, Evergreen Consultants

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How to ask a Question

Brad Matthews
Investment Strategies

Implications of interest rate rises on Portfolio Management

Brad Matthews
IMAP Webinar
25th March 2022

Where are interest rates headed?

Central banks and inflation are on a path to normalisation, which would imply the following interest rate structure is our central forecast scenario over the next 2-3 years in Australia:

- Inflation = 2.5%
- Cash Rate = 3.4%
- 10-year bond = 4.1%

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Why normalisation of interest rates is required

- Negative real interest rates have a number of undesirable consequences:
  - Discourage productive investment
  - Reduce housing affordability
  - Create wealth inequality
  - Ineffective at stimulating spending

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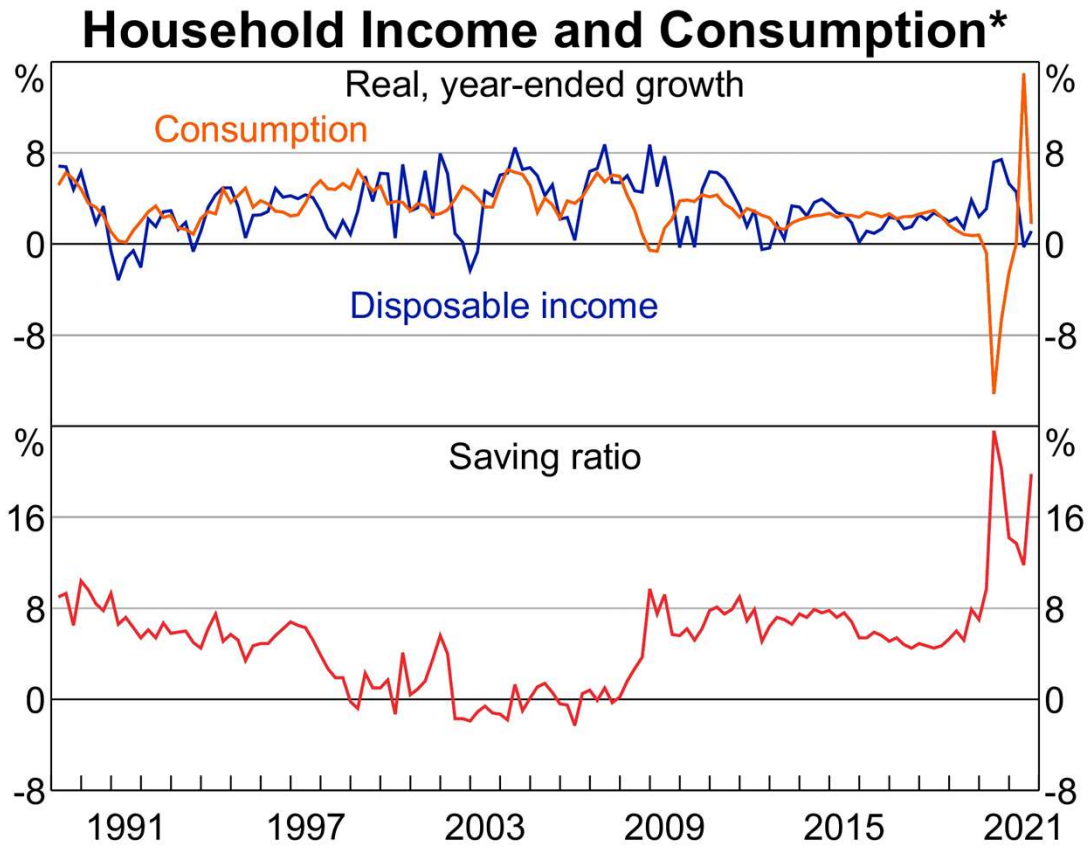
The private sector can absorb higher interest rate



* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; saving ratio is net of depreciation.

Sources: ABS; RBA

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Portfolio implications of higher rates and inflation

- Growth assets will ultimately protect value. A bias to the following may assist in managing impact:
    - Australian rather than global equities.
    - Property & Infrastructure.

- Progressively lean into duration as real interest rates increase.

- Gold could have a tactical role to play.

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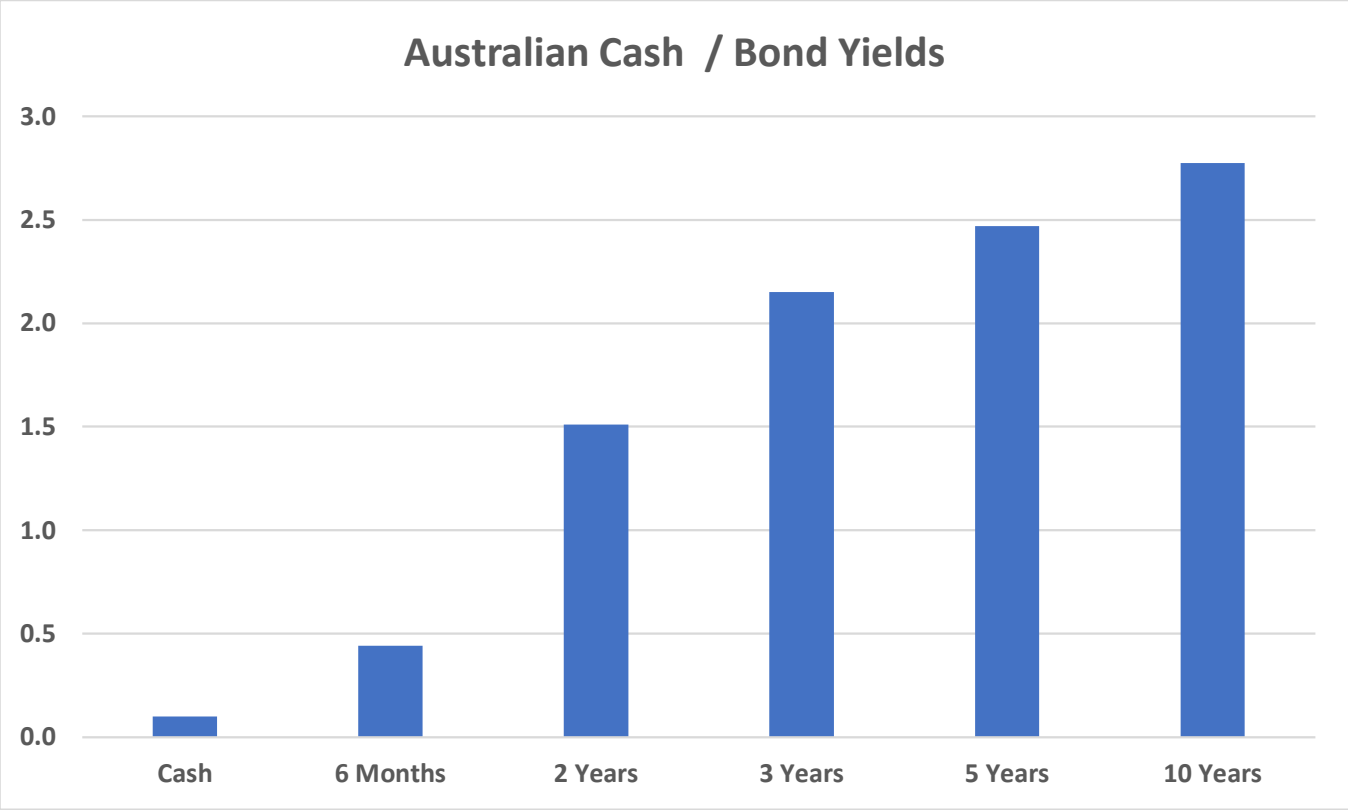
The 2-3 year part of the yield curve is starting to look interesting



Source: RBA. 24 March 2022

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Implications of Interest Rate Rises

Portfolio Management Considerations

March 2022

Presenter

Brendan Paul

Senior Portfolio Manager,
Atrium Investment Management

Before We Begin

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The Portfolio Construction Challenge

How to construct a multi-asset portfolio in the face of rising inflation and interest rates

- Rising inflation and interest rates introduces unique portfolio considerations.
- Macro-economic volatility is rising to levels not seen for several decades.
    - Risk premium is expanding and correlations are changing.
- Traditional 60/40 portfolio construction is not well suited to face these challenges.
- How does one address these challenges?
    - Genuine diversification through allocations to alternative asset classes and investment strategies will help “smooth the journey for clients” and maximise return opportunities.

Source: Add source here

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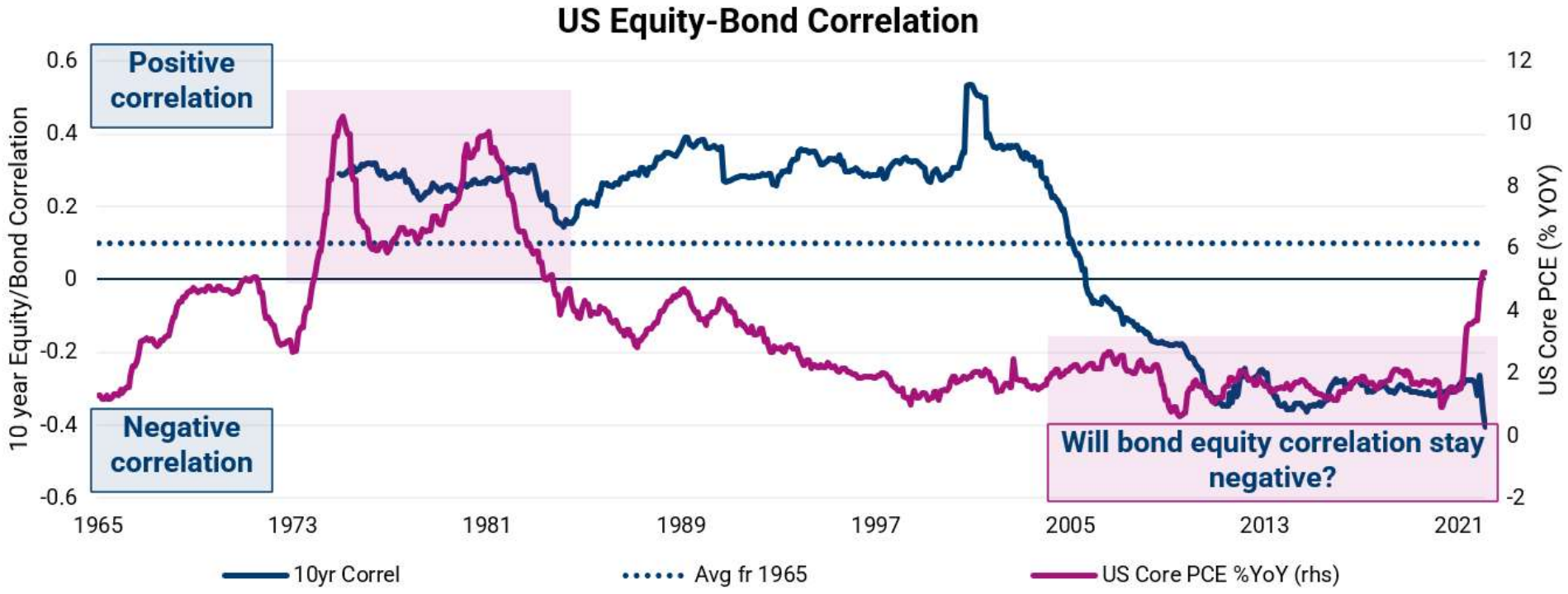
Inflation is a big deal for bond prices

Inflation concerns have meaningful consequences for interest rate direction and volatility



Source: Atrium Investment Management, Bloomberg. As at February 2022. Correlation based on S&P 500 index and 10yr UST yield.

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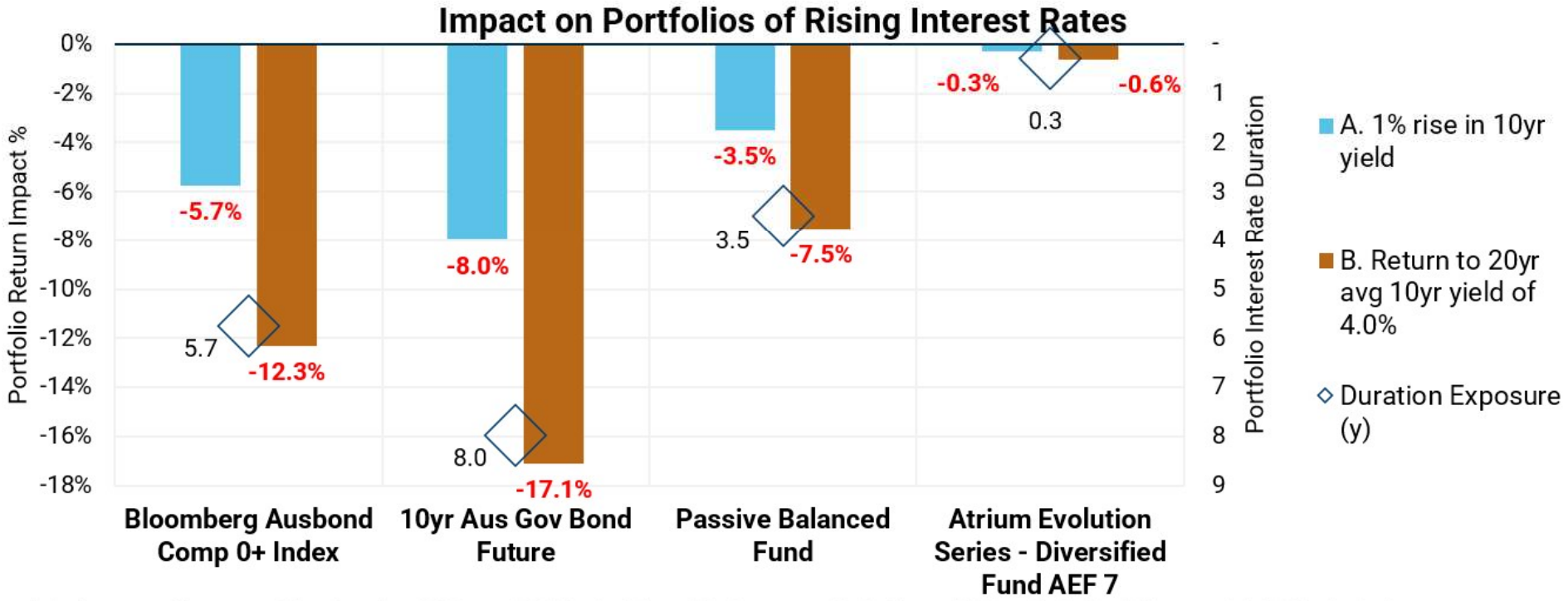
What happens to portfolios if bond yields rise?

A risk targeted approach is diversified to different outcomes & not wedded to bonds for diversification.



Source: Atrium Investment Management, Bloomberg. As at 28 February 2022. Passive Balanced Fund represented by the Vanguard Balanced Index Fund. *Assumes global yields also rise by the same amount. Some of the data used is Non Actual Information, predictive in character, may be affected by inaccurate assumptions or by known or unknown risks and uncertainties, and may differ materially from results ultimately achieved.

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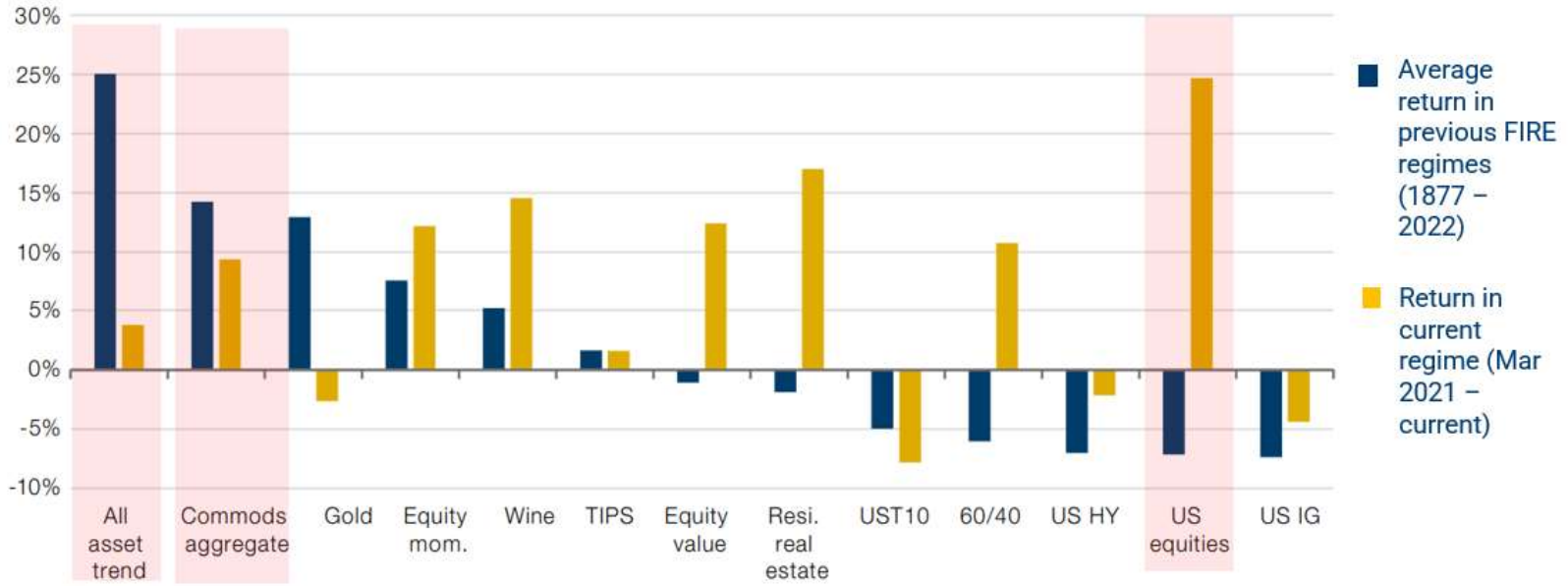
What works when inflation is high and rising

Expected multi-asset returns in an inflationary environment



Source: Man Institute, *The Inflation Head Fake of 2022*, January 2022. Equities are the S&P 500 using Professor Shiller's data. Bonds are UST10 from GFD. 60/40 is the monthly rebalanced 60% equity, 40% bonds portfolio. Commodities are proxied by an equal weight portfolio of all futures contracts as they appear through history. From 1877 to 1946, this is based off work done by AQR. From 1946, we use returns data from the Man AHL database. Sectors are the based off the 12 Fama-French industry portfolios. Similarly, styles are the Fama-French portfolios (SMB, HML, RMW, CMA and Mom., respectively), apart from Quality and Low Beta which are AQR (QMJ and BAB). Duration returns from GFD. TIPS prior to 1997 based off a backcast by William Marshall at Goldman Sachs, otherwise Bloomberg. Credit portfolios constructed by the DNA team from data provided by Morgan Stanley. Wine returns from Credit Suisse to 2001, and then the Liv-Ex 100 Fine Wine benchmark. Residential RE is based on the Case-Shiller index. All returns are total return. Current inflationary period is measured from March 2021 to present (inclusive). The current period is confirmed as an inflationary period as per the definition in the academic paper, the end of the regime (determined by the peak rate of inflation) is yet to be determined. All returns above for this regime to end October (the last inflation print), with the exceptions of All asset trend, and wine, which are to end September due to data availability issues.

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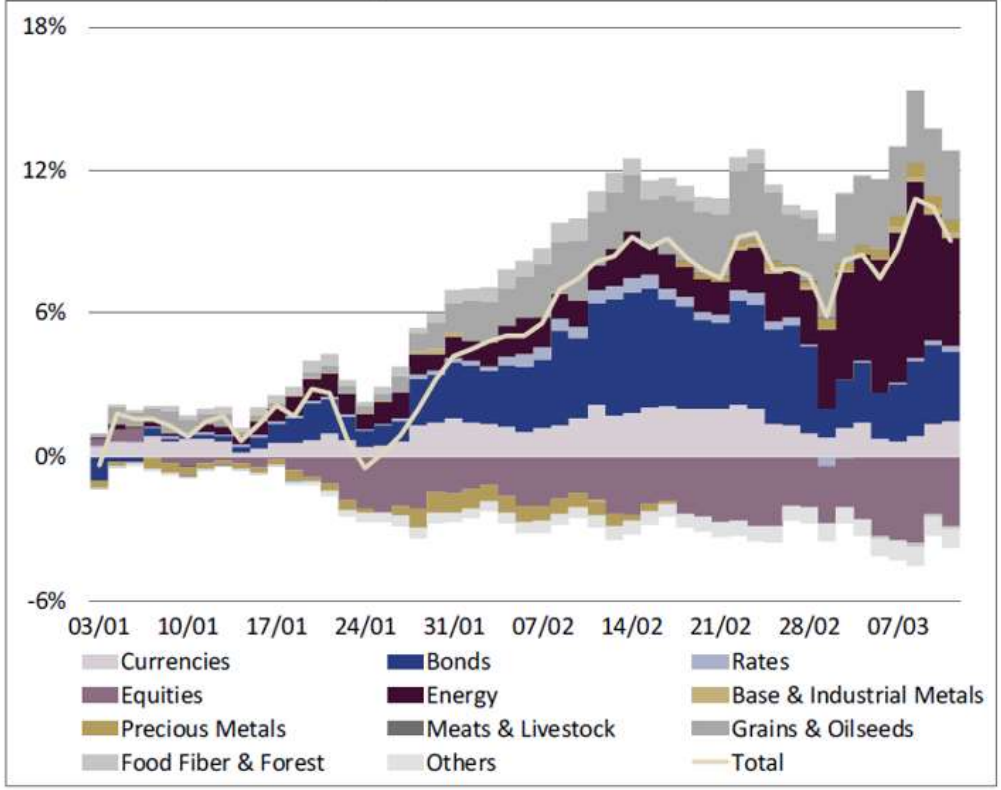
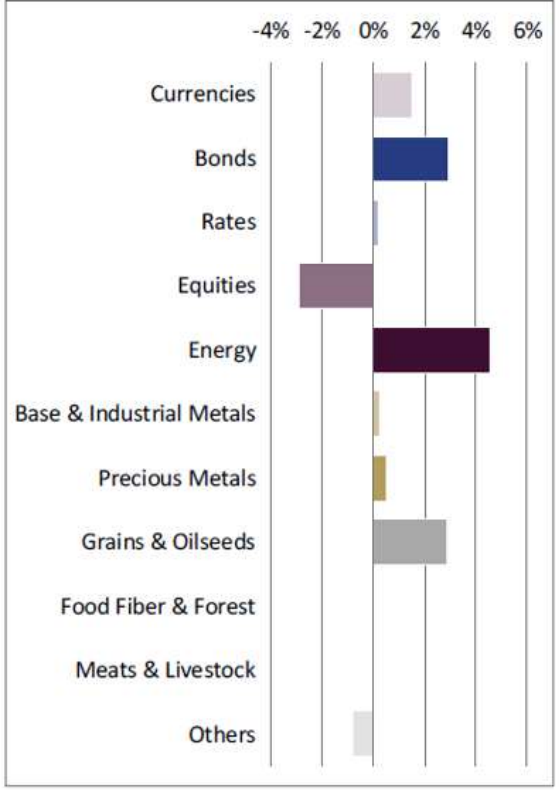
Trend Following

Capturing the opportunity from macro-economic uncertainty.

Sector contribution development YTD 2022



Sector contribution YTD 2022



Source: LGT Capital Partners. Data ranges from 1 January 2022 to 10 March 2022. Past performance is not a guarantee, nor an indication of current or future performance. Returns may increase or decrease as a result of currency fluctuations.

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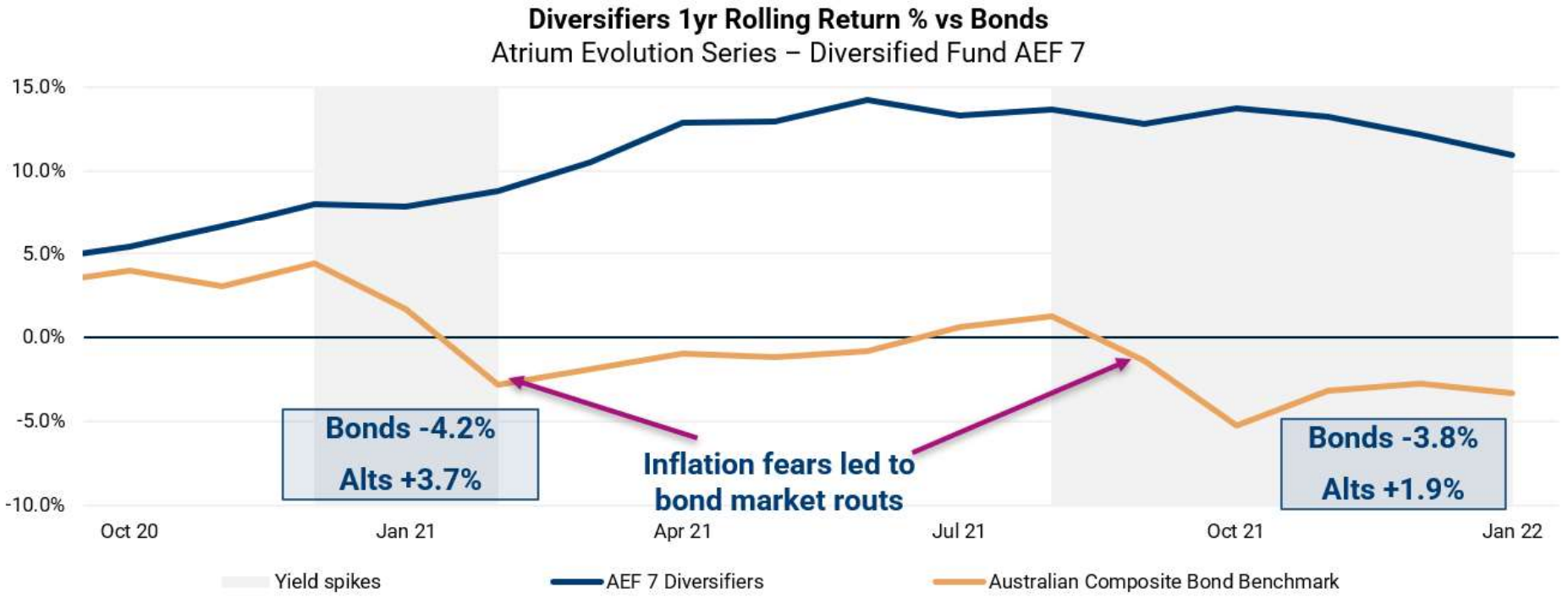
True diversification with alternatives

Portfolios relying on bonds for diversification in this environment have been unsuccessful



Source: Atrium Investment Management, Bloomberg . Aus Bonds = Bloomberg Ausbond Composite 0+ Index. Data as at 31 October 2021. Past performance is not a reliable indicator of future returns.

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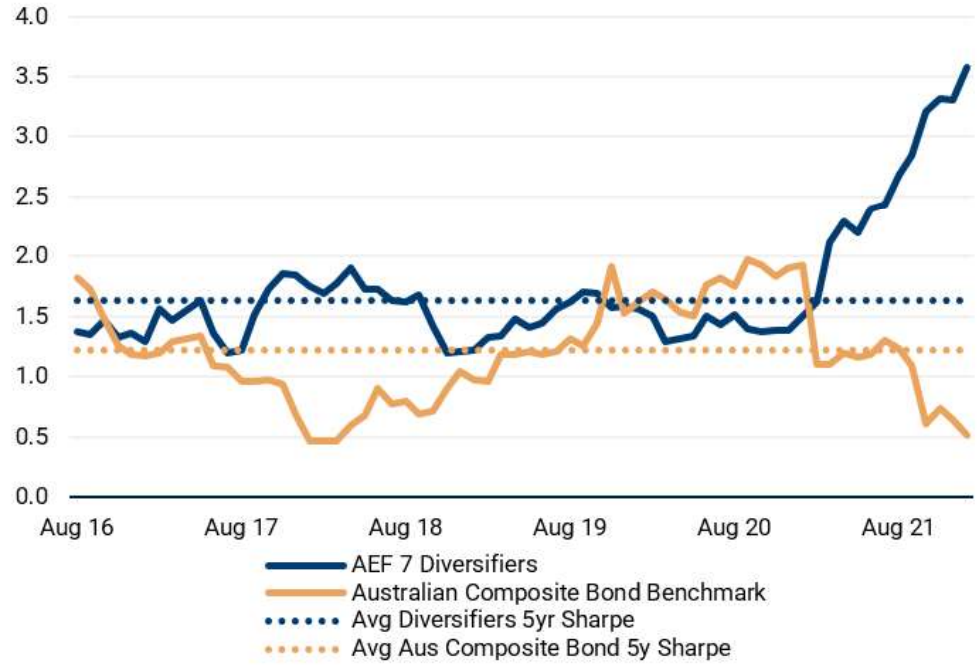
Diversifiers are key to maximising return for a level of risk

Diversifiers are strong contributors to better risk adjusted returns

AEF 7 Diversifiers vs Aus Bonds Cumulative Return %pa

AEF 7 Diversifiers vs Aus Bonds – 5 yr rolling Sharpe Ratio



Source: Atrium Investment Management, Bloomberg . Aus Bonds = Bloomberg Ausbond Composite 0+ Index. Data as at 31 January 2022.

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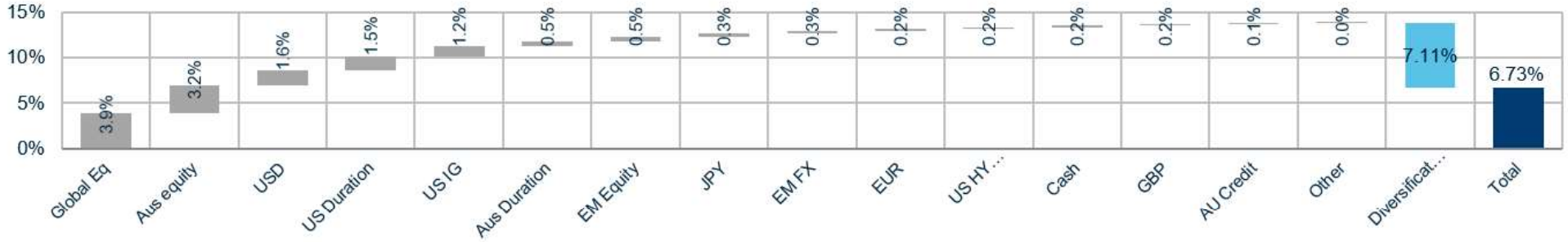
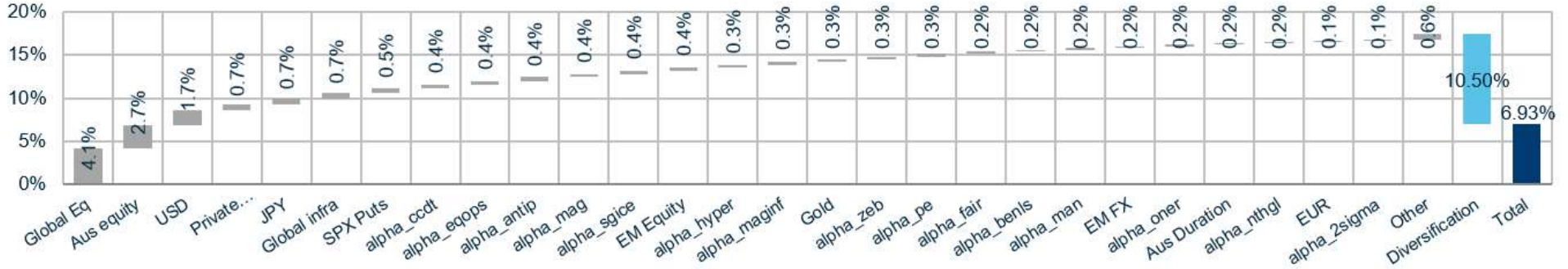
Diversifying allocations must be material

A smoother ride requires breadth and real diversification

Drivers of Risk – Passive Balanced Fund



Drivers of Risk – Atrium Evolution Series – Diversified Fund AEF 7



Source: Atrium Investment Management, Vanguard, Jacobi. Data as at 31 January 2022. Passive Balanced Fund represented by the Vanguard Balanced Index Fund. Risk allocation for underlying risk factors is portfolio exposure multiplied by forecast volatility. Diversification benefit is determined by incorporating a correlation estimate. Risk assumptions are calculated based on historical data obtainable from independent sources as well as judgments and assumptions that Atrium Investment Management believe to be reasonable, but that can be inherently uncertain and unpredictable. The data shown is Non Actual Information, predictive in character, may be affected by inaccurate assumptions or by known or unknown risks and uncertainties, and may differ materially from results ultimately achieved.

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Thank you

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