D R U M M O N D

CAPITAL PARTNERS

2023 STRATEGIC ASSET ALLOCATION REVIEW

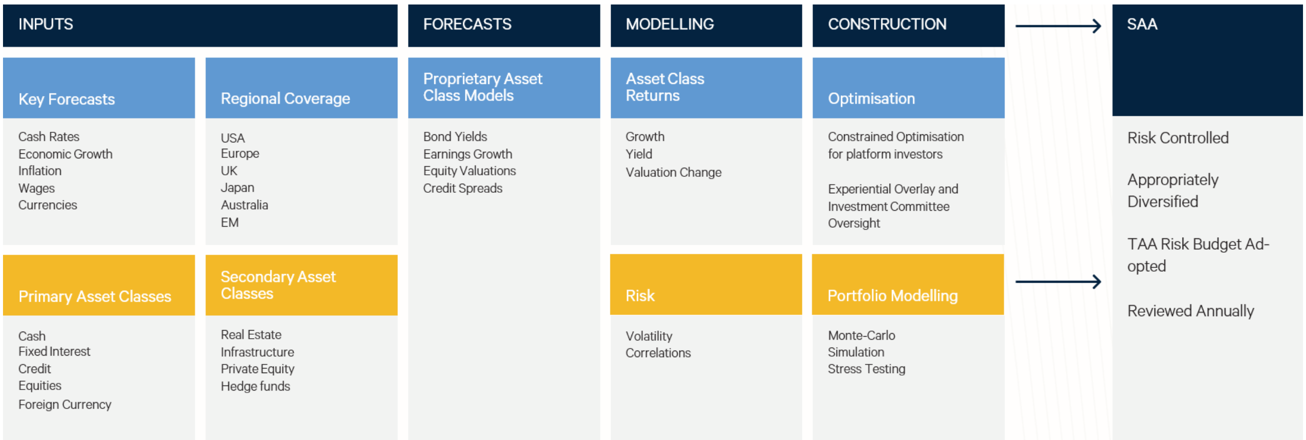
July 2023

TABLE OF CONTENTS

DRUMMOND'S STRATEGIC ASSET ALLOCATION

At Drummond, we believe in the power of asset allocation. We invest considerable time and resources into both strategic and tactical asset allocation. Strategic asset allocation (SAA) is the process of constructing a portfolio which is designed to best achieve the investor's objectives over the longer term. This portfolio is reviewed annually, and is agnostic to short term market movements, opportunities and manager skill. Alongside the SAA, we operate a separate tactical asset allocation (TAA) process, which aims to add value by dynamically managing the portfolio's asset allocation through the cycle, within risk limits. For those interested, we have written white papers overviewing both processes in detail.

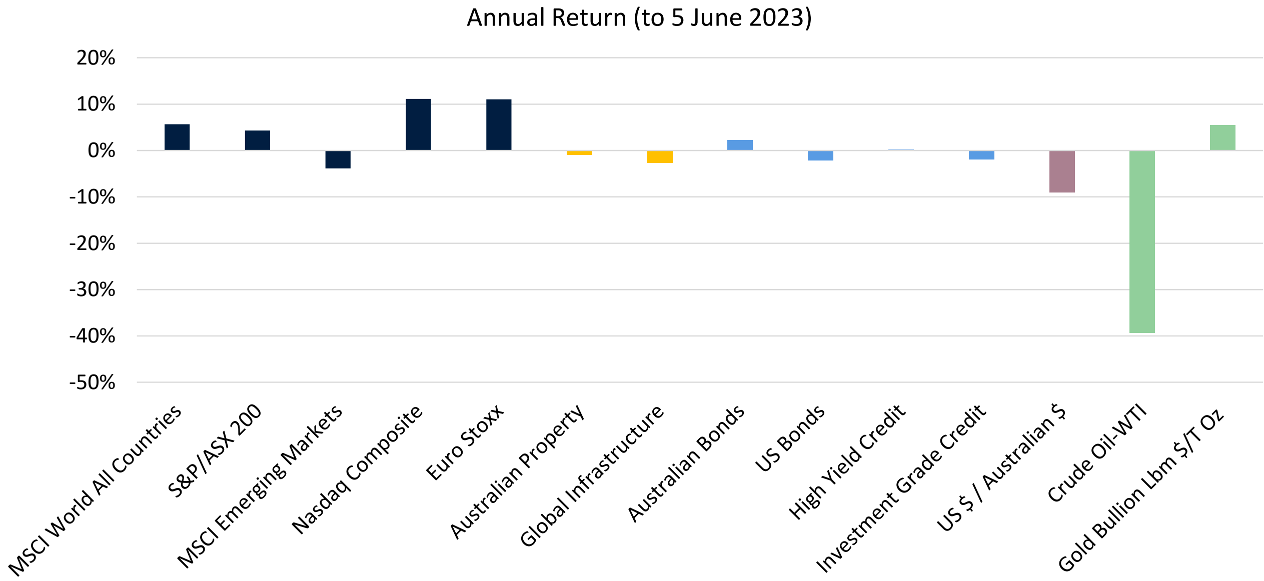
In the paper below, we present the outcomes of the 2023 SAA review. Our SAA review is a multi-stage, iterative process. We begin by formulating capital market assumptions (expected returns, volatility and correlations). Using these assumptions, we create portfolios using a combination of mathematical optimisation as well as the judgement and expertise of the investment team and Investment Committee. We then stress test these portfolios using simulation modelling against historical outcomes.



Below, we step through the process in a little more detail and show the resulting SAAs.

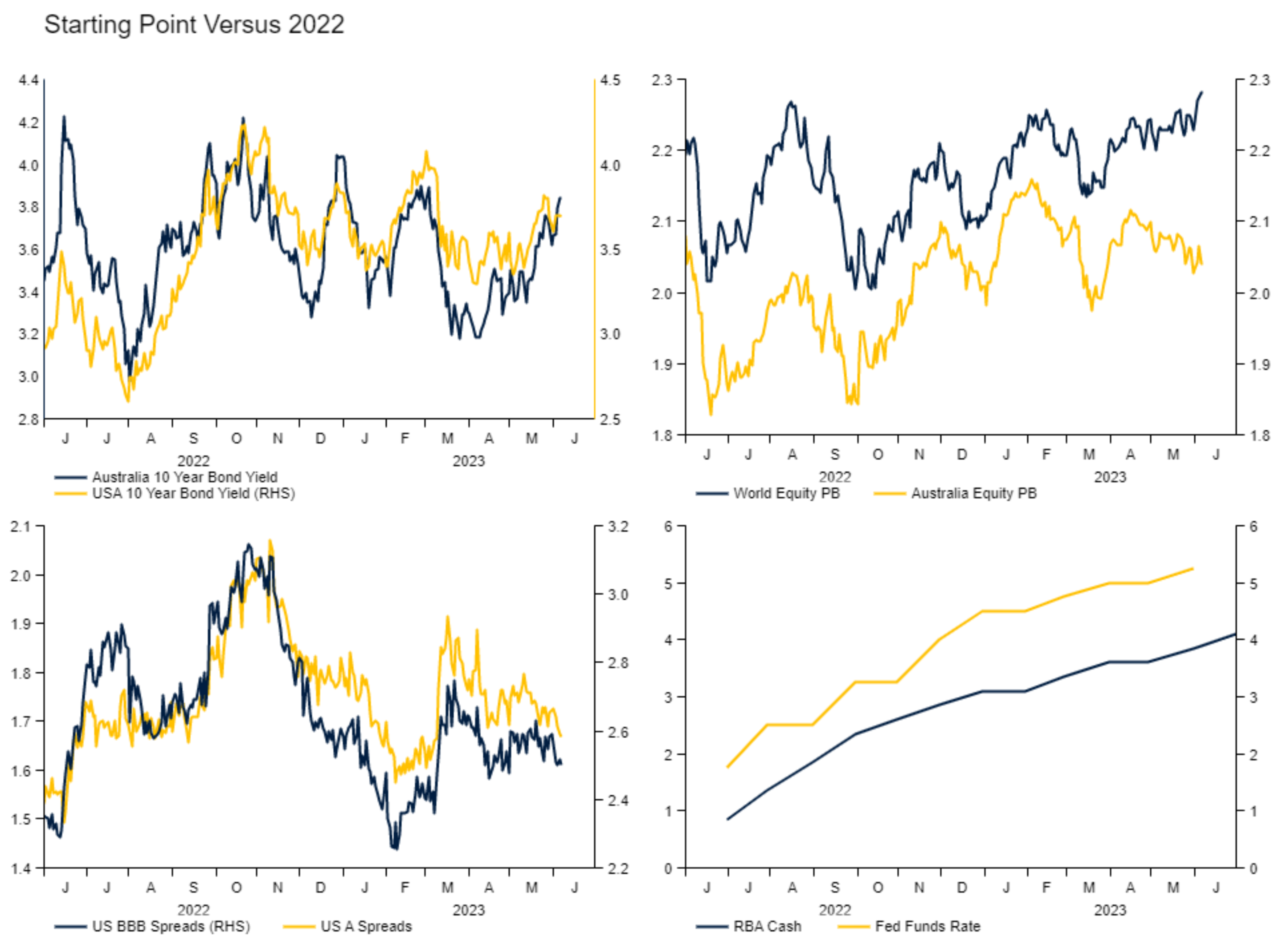
SETTING THE SCENE

Last year, we undertook our SAA review while equity and bond markets had been selling off sharply. This year, while volatile, equity markets have staged an impressive rally since making lows in October 2022. This rally has seen equity markets post a respectable return over the past 12 months, driven by the US technology sector in particular. Emerging markets have lagged, despite China's post Covid reopening, as structural issues continue to weigh on the world's second largest economy. Returns to property and infrastructure have lagged. Real estate is grappling with multiple headwinds. Financing costs have risen, as the US banking crisis constrains lending to the sector. At the same time, despite a push from corporates for workers to return to offices, offices remain much emptier than they were in 2019. Infrastructure has been held back by falling commodity prices and high discount rates. Bond yields were largely unchanged over the past twelve months, as inflation and rate hike expectations waxed and waned.



Source: Refinitiv DataStream, Drummond Capital Partners

So, the starting point for this year's SAA review is pretty similar to last year's. Equity market valuations, credit spreads and bond yields are broadly the same as when our capital market assumptions were developed last year. Cash rates are of course a lot higher, but that increase as was expected.



Source: Refinitiv Datastream, Drummond Capital Partners

The key surprises for the market over the past year were the stickiness of inflation across major economies and the resilience of equity markets to an almost universally forecast US recession this year. The key questions for the decade ahead are whether inflation will return to target, and what pain needs to be felt for that to occur, whether equity markets will recouple or decouple from the economic cycle and whether the post Financial Crisis period of low interest rates and inflation was an aberration.

THEMATIC CONSIDERATIONS

There are key thematic considerations which we incorporate into our portfolio construction process which sit outside traditional quantitative modelling. The key themes we wrote about last year continue to be relevant this year and thus have been refreshed in this year's *Review*. New themes have also been introduced and are detailed below.

US Exceptionalism

The United States dominates global equity markets, with companies listed in the USA making up around 60% of total global market capitalisation. In comparison, the US economy is around one quarter of the global economy, which, while large, is clearly much smaller. US equities have historically traded at a valuation premium to other markets (see below), and this is certainly the case today.

From a capital market modelling perspective, the naive consequence of the above is that expected returns to US equities are lower than other global markets. However, a more nuanced view is warranted. The primary reason the US market is more expensive than others is a solid track record of delivering earnings growth. While some of this reflects the dominance of the tech sector, even outside of the tech sector, US companies have a good track record of delivering earnings relative to their counterparts in the rest of the world.

The US produces the world's most successful companies for a variety of reasons. It is an enormous single currency, single language market, full of wealthy potential customers. Regulatory and legal structures are amenable to growing a business. It is easier to raise debt and equity finance on Wall Street than anywhere else. The Americans have an entrepreneurial spirit unmatched elsewhere which draws the world's best and brightest. We do not want to discount this American exceptionalism completely. As a result, we model a higher fair value for US equities than other major markets, narrowing the gap in expected returns within the countries that make up global equities.

Emerging Markets Allocation

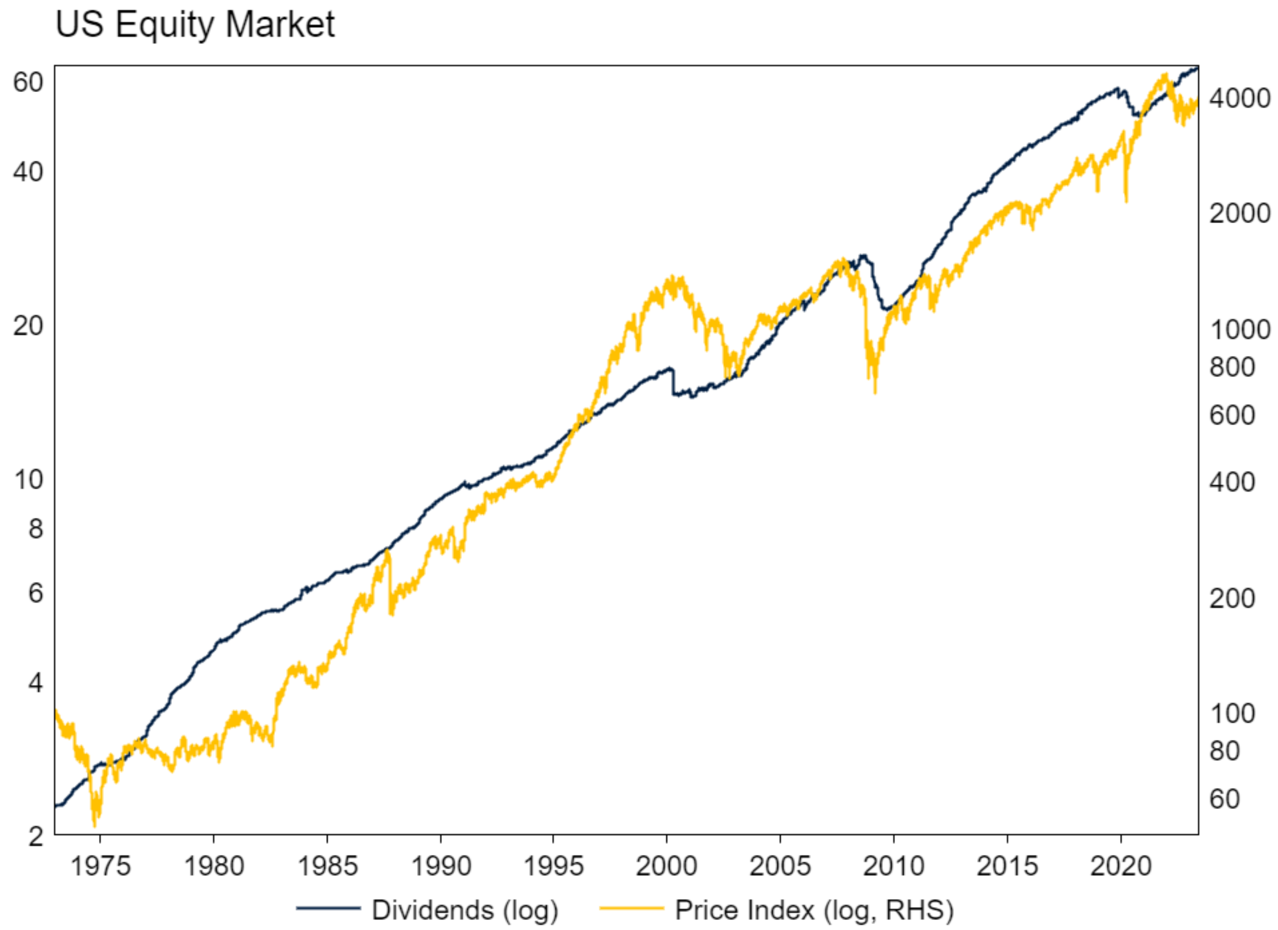
China is a very large part of the emerging market equity index. There are a number of reasons why we do not want to hold a structural allocation to China's equity market in the portfolios:

- The substantial deterioration in alignment between the objectives of the Government and those of private enterprise. While there have always been close linkages between the Government and private sector business in China, the balance of power has been tilted even more in the Government's favour under the leadership of President Xi. When the success or failure of a company becomes more about whether their sector or leadership is in the favour of the government rather than the fundamentals of the company, successfully investing in a region becomes much more problematic.
- Another China specific problem is the heavy debt load borne by the economy. The private sector in China now has more debt as a share of GDP than the USA or Australia. This will weigh on growth in the decade ahead.
- The final problem is the risk that China invades Taiwan in the next decade. China has become increasingly nationalistic under Xi and in an environment of slowing growth the risk of invasion is real. It is our expectation that any assets held in China would be marked to zero if this occurs.

This leads to the conclusion that the potential benefit of a structural allocation to emerging markets is not worth the risks incurred. We think a better approach is to only invest tactically, when the potential benefit is higher than normal.

Equity Market Resilience

There is a substantial body of academic literature which attempts to explain why financial markets are more volatile than can be justified by fundamentals. Why should a stock index fall 30%-50% because of a ~20% fall in dividends in one year which is recovered within a year or two? Or more bizarrely, fall 20% without a fall in dividends at all. After all, what is the value of an equity market if not the present value of the dividends received from investing in it? A sufficiently long horizon investor should ignore these sorts of events completely.



Source: Refinitiv Datastream, Drummond Capital Partners

Of course, for a variety of reasons, this is not what happens in practice. The risk premium investors demand for holding equities fluctuates wildly based on myriad of sentiments. But perhaps this time is different? Almost everyone expects a US recession this year, which will almost certainly be accompanied by a cut in dividends. Yet, equities have fallen only as much as would normally be expected due to the increase in bond yields (discount rate). Equity markets seem to be looking through the risk of a completely expected recession. We don't expect that will continue as weakness in economic data emerges, but it is worth considering whether the nature of equity investing has changed to resemble something closer to what the academic literature suggests it should be.

Bond Yields Normalise

Very low bond yields since the Financial Crisis left investors seeking assets which could replace the role bonds traditionally played in portfolios. Specifically, earn a reasonable carry and provide good diversification against equity risk. Typically, these allocations have tried to harvest systematic risk premia, or operate like low volatility hedge funds, where manager skill is the key source of return however both have been incredibly difficult to do in practice.

In the last couple of years, bond yields increased substantially. Indeed, major bond market indexes have suffered their largest drawdowns in decades. This reset means bonds can again play their traditional role as equity market diversifiers, while earning investors a good carry (across most of our scenarios at least). As a result of this, we have removed the structural allocation to what we called *Global Alpha Defensive* in this year's *Review*. There is no need to structurally rely on alternative risk premia or manager skill when traditional risk premia can again do the job. That said, like with emerging markets, the removal of a structural position does not preclude us from investing in these assets. The decision to do so will simply be a tactical one.

A New Neutral Real Rate?

A key point of discussion in this year's *Review* was whether neutral real interest rates would be positive or negative in the decade ahead. The neutral real interest rate is the interest rate (subtracting expected inflation) which would neither slow nor stimulate the economy. This rate is a mystery in the moment but can be estimated after the fact. For example, low growth and inflation following the Financial Crisis implied that neutral interest rates were deeply negative. Indeed, because of the effective lower bound in cash rates, central banks could not stimulate economies sufficiently to generate inflation back towards their targets. Now, post Covid, we have the opposite problem. Nominal interest rates have risen substantially with little apparent impact (as of yet, we still think it is coming) on broader economies and inflation. As a result, it could be argued that neutral real interest rates are now positive.

This is a key question for the decade ahead and has material implications for the path of economies and financial markets. As a result, our capital market scenarios feature a version of both worlds, as it is too soon to gauge if the world really has entered a new normal or if we are destined to repeat the 2010s experience.

CAPITAL MARKET SCENARIOS

Given the uncertain longer-term environment, we take a scenario-based approach to constructing the SAA. We create capital market assumptions and SAAs for each scenario and then probability weight them to get a final portfolio, which should be robust to a variety of potential outcomes.

This year, we added a fifth scenario. The introduction of a fifth scenario reflects in our view the roughly equal chance that neutral real interest rates are positive (which is "normal") or negative (as has been the case generally since the Financial Crisis). Otherwise, recent developments in AI provide a good starting point for a positive scenario. All scenarios this year feature a recession in major developed economies early on, but this doesn't have too much of an impact on the aggregate numbers over the ten-year horizon.

A high-level description of each scenario is shown in the table below.

Stagflation	Volatility	Return to Normal	Deflationary Quagmire	AI Boom
Inflation expectations become anchored at high levels as central banks and governments lack the will to do what is necessary to return inflation to target. Although central banks hike rates, inflation doesn't fall back due to fiscal stimulus. The net of the above is slower growth than normal. Valuations are penalised under this scenario leading to lower portfolio returns.	Markets and economies have become overly policy dependent. Monetary and fiscal policy now delivered in greater magnitude leader to shorter, sharper business cycles. Portfolio returns are lower in this scenario as high volatility leads to valuation compression and earnings are weighed down by economic recessions.	"Normal" in the true sense of word, with real interest rates remaining positive. The reset in expectations post Covid mean real interest rates remain positive. Growth is generally around long-term potential, inflation around target and bond yields equal to nominal GDP. Given the reset in real interest rates and equity valuations over the past couple of years, portfolio returns in this scenario are solid.	Rapid monetary policy tightening ends in recession and elevated debt levels lead to deflationary pressure re-emerging as the dominant macro theme. Essentially a repeat of the post GFC experience. Economic growth and inflation below trend and target and interest rates become anchored at the lower bound. Central banks respond re-introducing QE. Growth over value.	The world experiences a productivity growth boom similar to the 90's PC revolution. This boost potential GDP growth by 1.5% in US (less elsewhere). Neutral interest rates are higher given higher economic growth however inflation remains at target given productivity gains. Equity earnings are strong given strong GDP growth. Portfolio returns are the strongest under this scenario.
Moderate Probability		Most Probable	Moderate Probability	

Return to Normal

The post Financial Crisis period was odd by historical standards. Interest rates almost everywhere were stuck around zero for many years. Despite this, economic growth was sluggish and therefore the period also featured experimental monetary policy (quantitative easing, extended forward guidance, yield curve control) and bouts of fiscal stimulus to try and kickstart economies.

In this scenario, the post Covid inflationary period we are currently living through resets expectations and forces a regime change back towards the way economies used to operate. Specifically, central banks generally need to act to keep inflation contained, rather than act to increase inflation. In practice, this means interest rates are higher (real interest rates are positive) through this scenario than they were in the decade post the Financial Crisis. These higher real interest rates keep inflation in line with central bank targets, but at the cost of slightly lower economic growth than would have otherwise been the case.

Returns in this scenario are relatively "normal" within the context of history. For equity markets, a period of pain around the recession is mostly offset by the recovery thereafter. Bond returns are broadly in line with current yields.

This is our baseline scenario – indeed this is the way economies should operate in a normal world.

Deflationary Quagmire

Deflationary Quagmire is effectively the inverse of return to normal. Ultimately, none of the factors which drove low interest rates prior to Covid, such as aging populations, low potential growth and high debt levels have really reverted. It is the return to a post Financial Crisis world of low growth, low inflation and low interest rates. Following a recession beginning early in the horizon, central banks again cut interest rates to zero, but, as in the post Financial Crisis period, this doesn't achieve a substantial lift in growth. The recession causes a sharp fall in inflation and household and corporate inflation expectations revert to 2010s levels. With sluggish growth, central banks struggle to achieve lift off in interest rates.

Lower terminal interest rates see relatively solid returns to high duration assets, as valuations expand over the forecast horizon.

AI Boom

The AI Boom is the most positive scenario. In this forecast, the rapid improvement and adoption of generative AI (ChatGPT for example) allows knowledge workers to materially enhance their productivity growth. From an economy wide perspective, the impact is of a similar magnitude to the widespread adoption of personal computers in the 1990s. Most of this impact is felt in the United States, with adoption elsewhere slower. Because this is a productivity driven supply side shock to the economy, growth is higher, but inflation remains around target. As a result, interest rates do not rise as much as they normally would in a strong growth environment.

Higher economic growth boosts earnings growth significantly in this scenario, seeing strong returns to equity markets in particular. As a result, overall portfolio returns are highest in this scenario.

Volatility

In this scenario, we accelerate and intensify the pace of the business cycle. Central banks normally take years to complete a full adjustment of policy, particularly when tightening. Governments also tend to withdraw fiscal stimulus put in place during recessions quite slowly, particularly if spending is related to infrastructure or other public investment. Now, extremely high levels of debt mean small changes in interest rates have a magnified effect, which shortens the length of central bank easing and tightening cycles. In addition, rather than drawn-out infrastructure packages, governments stimulate demand directly during slowdowns by depositing cash in household and business bank accounts, which accelerates the fiscal cycle as well.

In this scenario, we often find central banks and governments working against each other, or at least coordinating poorly. In the beginning, governments maintain very large levels of stimulus, which is offset by central bank tightening as inflation pressures build. This tightening leads to a recession, which quickly provokes more fiscal stimulus and interest rate cuts. This cycle repeats again in the second half of the forecast horizon, leading to a total of two recessions in the decade – which is quite unusual by historical standards. A key point of difference in this scenario is that bond yields remain elevated following the first recession, as the fiscal credibility of governments is called into question and inflation volatility remains very high.

Portfolio returns in this scenario are low, as high volatility and longer-term interest rates see valuations compress and overall equity earnings growth is weighed down by the economic recessions.

Stagflation

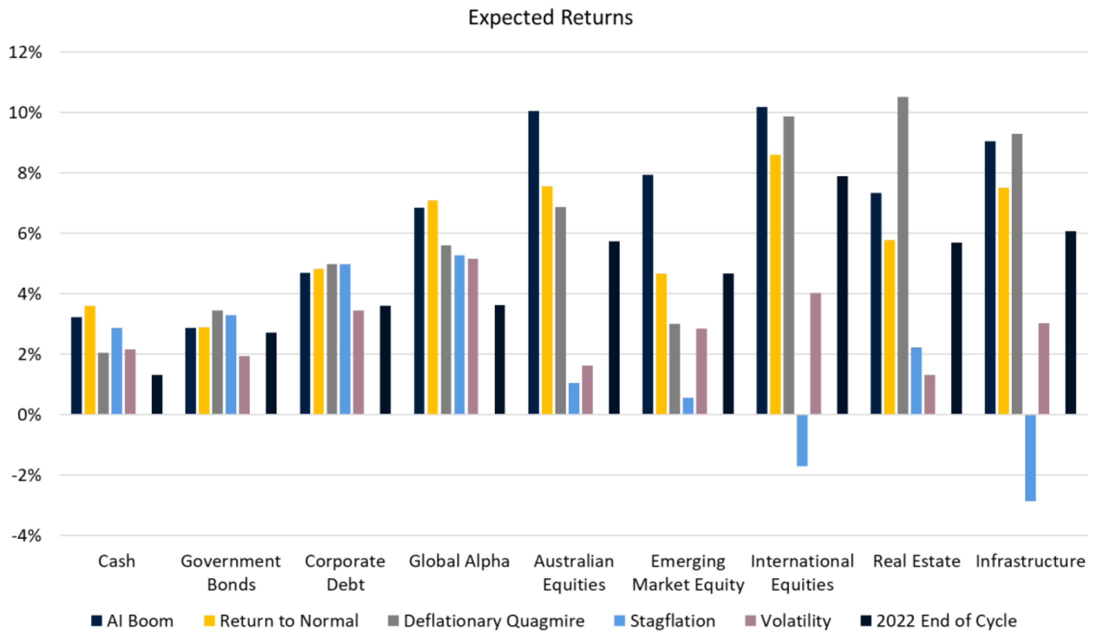
Stagflation is the most pessimistic scenario. A stagflationary environment is one which is characterised by high inflation and low economic growth. In this scenario, this outcome is driven by policy failure. Essentially, central banks fail to adequately combat inflation and economies are left with a new balance of higher inflation and lower growth than has been the case since the 1990s.

The scenario starts with central banks continuing to respond to inflation along the same lines as currently implied by market pricing. This leads to a recession in the short term. However, the slowdown in growth is too painful for politicians to bear and it is decided that a little bit of higher inflation is a small price to pay for recovery. Thus, central banks are co-opted by governments, either by a change to central bank mandates, either via the addition of other policy objectives (climate change or inequality for example) or simply via higher inflation targets.

Over the forecast horizon, bond yields generally increase, driven by higher inflation and also a loss in central bank credibility. Investors demand compensation for the inflation risk premium which has re-emerged in the asset class. This is obviously a serious problem for equity markets, where current multiples are based on expectations for low interest rates forever. In a higher inflation and interest rate environment, equity markets derate sharply.

EXPECTED RETURNS

The chart below shows our ten year expected returns across the four scenarios modelled versus expected returns in the 2022 End of Cycle scenario.



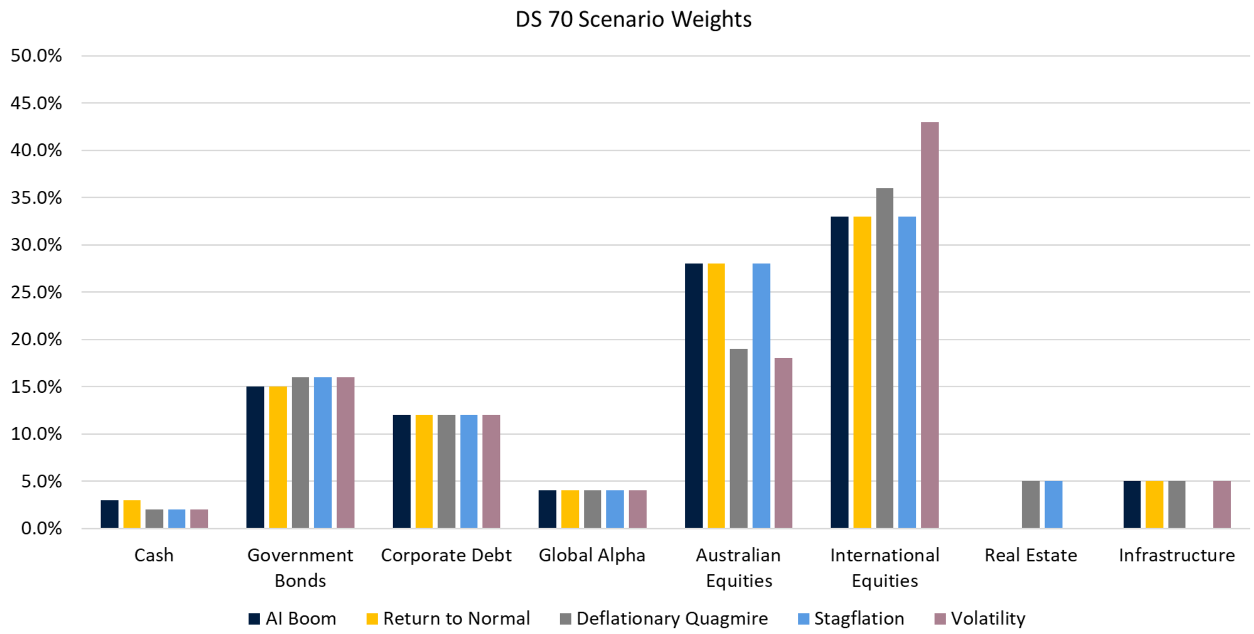
Source: Refinitiv, Drummond Capital Partners

Across most of the scenarios, returns have changed primarily reflecting valuation starting point changes. In particular, the return to government bonds and cash is generally higher reflecting higher interest rates and the return to global equities is better reflecting improved valuations.

OPTIMISATION AND PORTFOLIO CONSTRUCTION

Using these returns and assumptions for correlations (a measure of the movement between asset classes) and volatility, we then determine the optimal portfolios for each scenario. We optimise the portfolios to maximise their Sharpe ratio, a measure or return per unit of risk. The higher the Sharpe ratio, the higher the return per unit of risk taken. To ensure sensible and investible outcomes, we place some constraints on the optimisation process.

After these constraints are set, we create optimal portfolios under each return scenario. For the DSP 70 portfolio, these are shown below.



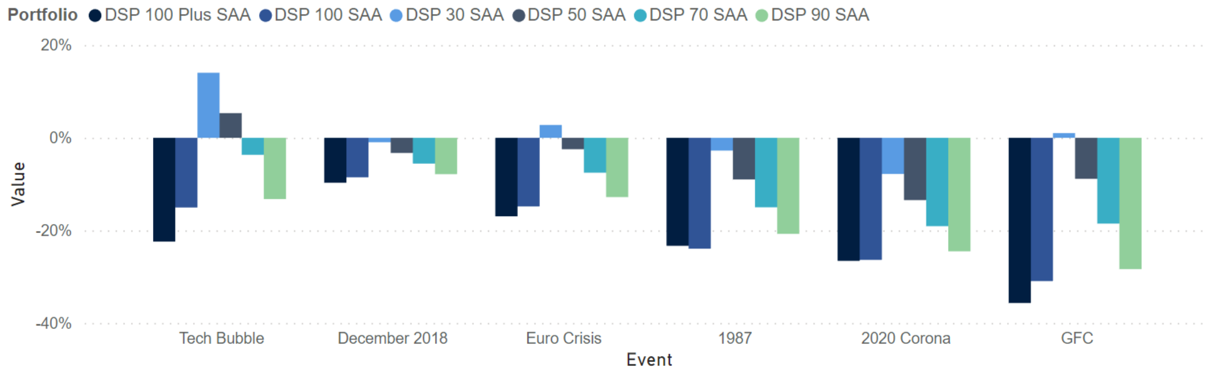
Source: Refinitiv, Drummond Capital Partners

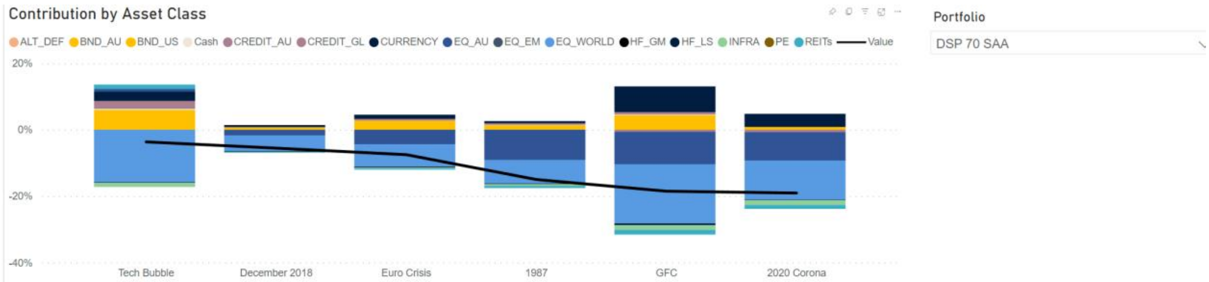
The average of the Investment Committee scenario probability weights is shown below. We have used this average to create the final SAAs.

Scenario	Probability
AI Boom	14%
Return to Normal	30%
Deflationary Quagmire	20%
Stagflation	18%
Volatility	18%

The investment team and Investment Committee incorporate their experiential overlay into SAA design at this stage of the process in order to ensure that the portfolios produced from this output will perform well across a variety of return environments, balancing expected returns and risk.

The final stage of the SAA process tests these proposed portfolios using our simulation model and stress testing tools. This helps us generate an understanding of the distribution of potential outcomes and the impact of return sequences on final portfolio balances. The historical stress testing shows us how the SAA would have performed in past equity market corrections. We break down the contribution to return by asset class in each event. Note that the below is the expected performance of the SAA. Good manager selection and tactical asset allocation (TAA) should reduce the magnitude of the expected loss as was the case in the 2020 Corona drawdown when the DS70 Portfolio lost 13% versus the stress test below of over 18%.

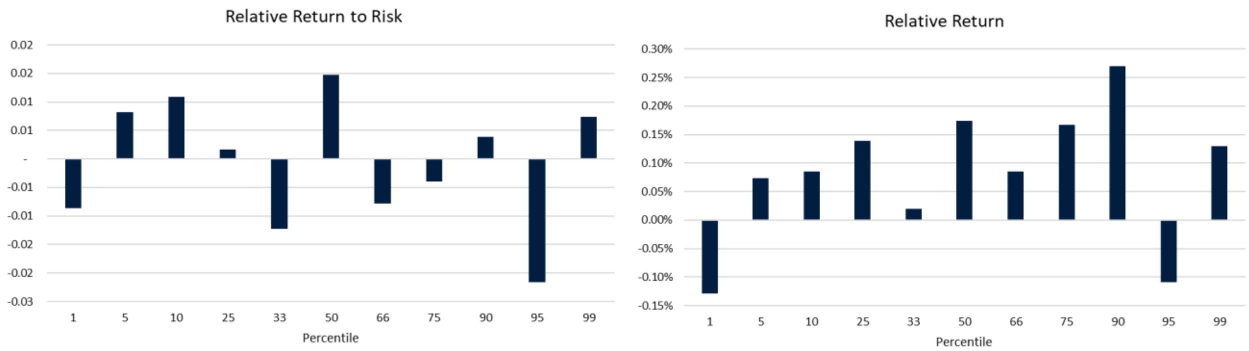




Source: Refinitiv, Drummond Capital Partners

We can also look at simulation outcomes at the left tails of the distribution to get a better understanding of the portfolio outcomes, particularly relative to last year's SAA. For the DSP 70, we can see across the distribution, the efficiency of the portfolio is pretty mixed. However, expected returns are higher.

DSP 70 SAA Simulation Comparison

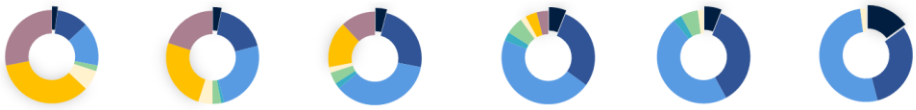


Source: Drummond Capital Partners

THE FINAL SAAs

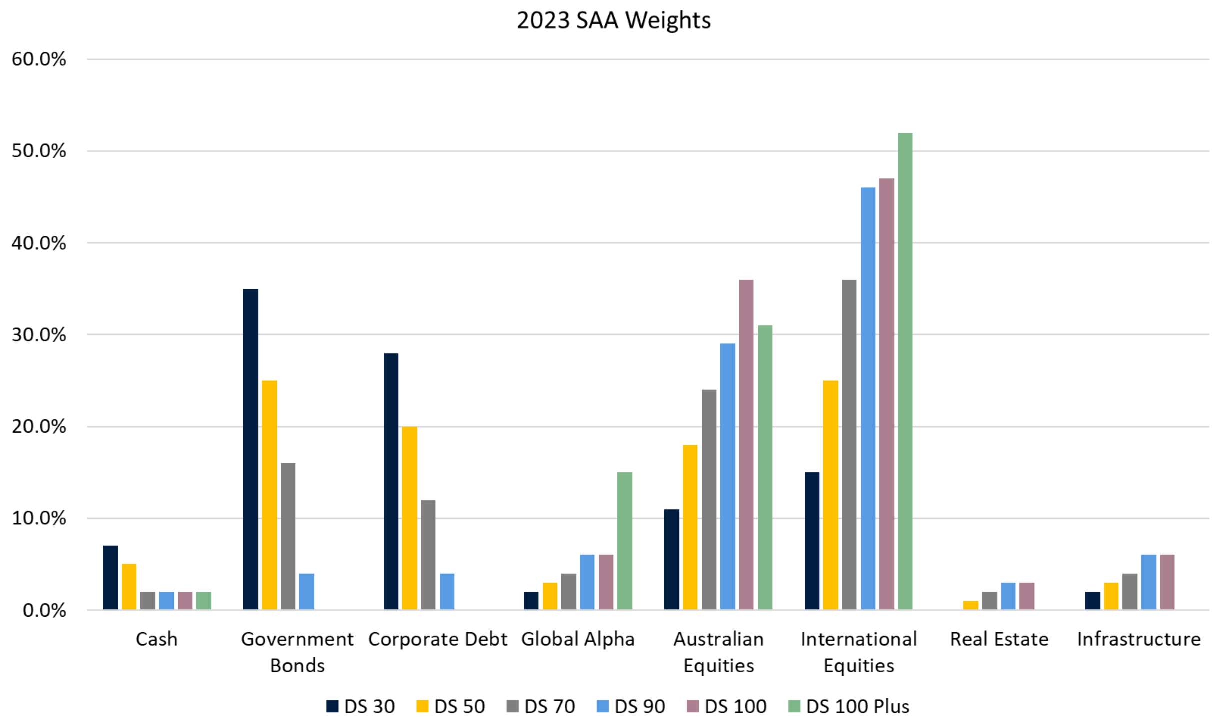
The table below shows the final outcome of the review, as well as relevant risk and performance metrics for each SAA. Note the below expected returns are gross of investment costs, but do not include the expected alpha generation from manager selection and TAA. We expect these activities to add around 1% per annum each to performance, offsetting the look through fees of around 50bps for each investment option.

DRUMMOND STRATEGIC SERIES	DS 30	DS 50	DS 70	DS 90	DS 100	DS 100 Plus
Asset Allocation						
Global Alpha	2%	3%	4%	6%	6%	15%
Australian Equities	11%	18%	24%	29%	36%	31%
International Equities	15%	25%	36%	46%	47%	52%
Real Estate	0%	1%	2%	3%	3%	0%
Infrastructure	2%	3%	4%	6%	6%	0%
Cash	7%	5%	2%	2%	2%	2%
Government Bonds	35%	25%	16%	4%	0%	0%
Corporate Debt	28%	20%	12%	4%	0%	0%
Growth Total	30%	50%	70%	90%	98%	98%
Defense Total	70%	50%	30%	10%	2%	2%
Growth Range	20-40	40-60	60-80	80-100	90-100	90-100
Defense Range	60-80	40-60	20-40	0-20	0-10	0-10
Neutral Growth Exposure	30%	50%	70%	90%	98%	98%
Risk Metrics						
Time Horizon	3+	5+	7+	9+	9+	9+
Expected Return**	5.0%	5.9%	6.7%	7.6%	7.9%	8.2%
Expected Volatility**	6.3%	8.1%	10.6%	13.2%	14.6%	14.0%
2022 Expected Return**	4.1%	4.8%	5.6%	6.2%	6.7%	
Expected MER	0.5%	0.5%	0.5%	0.5%	0.5%	0.7%
Estimated # of negative years over 20yr period	4.3	4.7	5.3	5.7	5.9	5.6



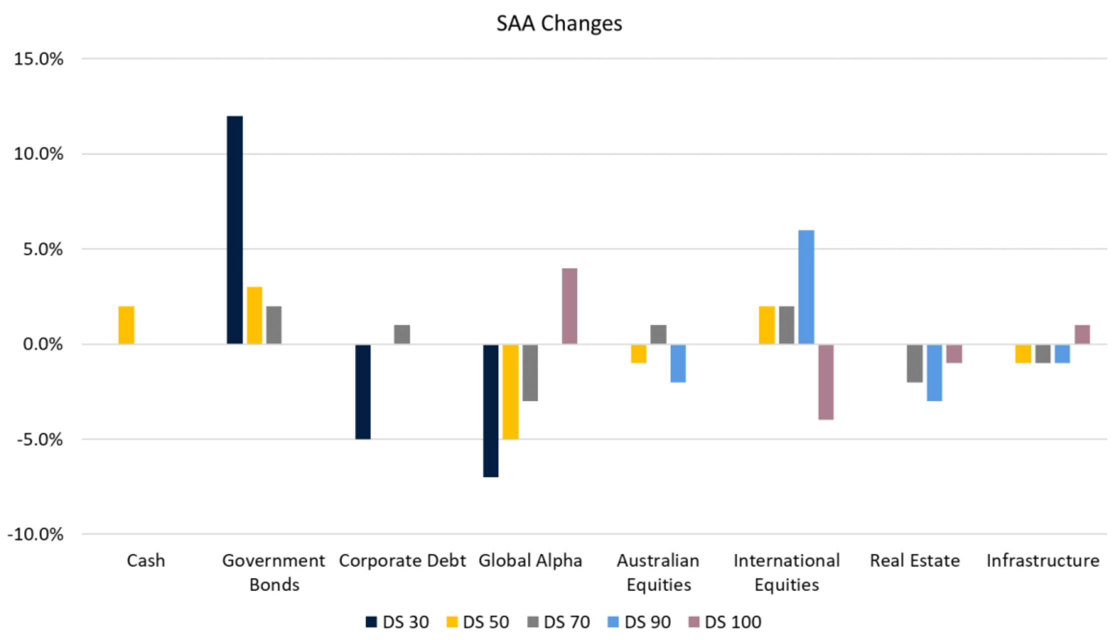
*** 2023 outcomes based Return to Normal Scenario. 2022 returns are based on the End of Cycle Scenario.*

The figure below shows the SAAs by asset class.



Source: Drummond Capital Partners

The figure below shows the changes to the relative SAAs by asset class.



Source: Drummond Capital Partners

The key changes are as follows:

- Exposure to global alpha has fallen, largely as a result of the removal of a structural exposure to alternative defensives. This has generally moved to government bonds.
- Infrastructure and real estate exposure has generally been reduced, going towards a larger international equities exposure.

CONCLUSION

We hope the above gives insight into the 2023 SAA review process. Our intention in providing the detail above is to demonstrate that the process by which we develop our SAAs is scientific, robust and repeatable. Being transparent about our investment processes with our investors is part of our commitment to service delivery. We welcome discussion on the inputs to the process and can deep dive into any aspect for those that wish to understand in more detail.

DISCLAIMER