ASTUTE
INVESTMENT MANAGEMENT

VT Astute Funds

Quarterly Commentary

Q1 2021

Introduction

Thank you for taking the time to read our Q1 commentary. First and foremost, I hope that you and your loved ones all remain safe and well during what we hope will be the last phase of this pandemic. With 'normal' life tantalizingly close, it is more important than ever to avoid unnecessary risk, both in our personal lives and in financial markets.

Some of the themes emerging at the end of 2020 have grown in emphasis, while varying degrees of vaccine success have reduced the focus on pandemic risk. In my introduction this quarter, I discuss the short and long-term potential for a 'Roaring 20s' consumer boom.

In our **Astute Overview** section, we will delve deeper into inflation expectations that have been keeping investors up at night, and the implications these worries have for markets.

Our regular **Astute Perspective** shows the recent change to our conviction views, while **Astute Positioning** covers how those views translate into the portfolios, and what changes we have made in the past three months.

Finally, **Astute Observations** highlights some of the more interesting research, data or charts we have encountered recently with a few short and, hopefully, enlightening comments.

As always, we take a long-term approach to investing our clients' assets, but success is a journey, not a destination, and the short-term views expressed herein are aimed at managing risk and making your investment journey as smooth as possible. By taking a risk-adjusted approach to your investments, we aim to deliver reliable growth in line with our stated risk profiles and provide you, and your financial planner, the consistency and security to plan for your long-term financial future. Thank you for your continued support. If you have any further questions or require any additional information, please do not hesitate to contact your usual financial planner.

Fund Management Team

Scott Osborne
Chief Investment Officer

Toby Hulse
Investment Analyst

Mark Houghton
Investment Analyst

ASTUTE INVESTMENT MANAGEMENT LTD

2020s – Roaring or Boring?

As we pass the anniversary of the first UK lockdowns, it is astonishing to look back and see the change that has been wrought upon the world in the last 12 months. Never has the phrase "*there are decades where nothing happens, and there are weeks where decades happen*" seemed truer. Almost every aspect of our lives has been disrupted, and while some change may be permanent, a return to 'normal life' can't come soon enough for most. In the UK and the US in particular, high vaccination levels mean diaries are already filling with dates when previously forbidden acts are no longer off-limits (replacing "daddy trampoline" with soft play will be a big milestone for me personally). Significant financial support from governments has also helped to defend against the worst effects of a typical recession, meaning household budgets in many cases are healthy. This provides both the means and the motive to get out and spend, a scenario that has drawn comparisons with the post-war recovery of the 1920s.

While most agree that 2021 will be a bumper year for economic growth, the path beyond and the implications for financial markets are much less clear, and the debate continues as to the persistence of these emerging trends. In the short term, the combination of low-interest rates, government spending, and accelerating vaccination rates seems certain to drive a strong global recovery. This view is supported by a slew of positive economic data which has stoked fears of rising inflation. This is discussed in detail later (see Astute overview), but I wanted to touch on two key aspects before turning to markets and our portfolios. Firstly, the supply-demand dynamic, particularly in consumer services, will undoubtedly lead to price rises as pent-up demand outstrips supply (see our Astute observations). This 'excess' demand is likely to be transient however, after all, there are only so many meals out, theatre trips, and staycations one can make (or afford) before the renewed novelty begins to wear off. In this context, businesses may prefer to repair their balance sheets rather than investing to exploit a short-lived demand surge.

Secondly, unless subsequent years see similar price rises, any inflation impact is also temporary. Structural themes around demographics, productivity, and above all, labour supply, will be the key drivers of inflation beyond 2021. More entrenched pre-pandemic trends, such as automation and digitalisation, could once again assert deflationary dominance. In short, we expect inflation to roar, but question how long the echo will last.

So, what does this mean for markets? As inflation picks up, so does the expectation that central banks will increase 'risk-free' interest rates. All else equal, that makes risky assets less attractive, and so prices should fall. Of course, all else isn't equal, as the economic outlook looks very positive for companies. Using the classic price to earnings or P/E ratio as a simple measure of value, rising rates applies downward pressure on prices, but improving earnings should act against it. Companies able to grow earnings at a sufficient rate will prosper through inflation. Bonds, however, are fixed income securities. What you get back is fixed by the price you pay. Conventional bonds have no mechanism to push back against rising interest rates - the coupon is the coupon.

This leads us into our positioning over the quarter. The losses seen in bond markets (Gilts fell 7% over Q1) underlined our longstanding negative view, but the pace and scale of the rise in bond yields (which move inverse to price) was faster than anticipated. Some of the concern around long term inflation seems unwarranted, but given the short-term volatility, it is prudent to further limit interest rate sensitivity across the portfolio. This includes an outright increase to equities in our Conservative fund and a continuation of the pivot towards more cyclical markets across the funds, a key part of which was upgrading our view on the UK (discussed in Astute positioning).

While the inflation debate rages, what will likely be a good year for economic growth could prove more challenging for financial markets. As ever, our active approach aims to chart the smoothest possible course through this short-term volatility, while retaining a firm focus on our long-term objectives.

Scott Osborne PhD CFA
Chief Investment Officer

HOT AIR – THE GREAT INFLATION DEBATE

The spectre of inflation has emerged as the principal risk for markets over the last 6 months. There are good reasons why we should expect some stand-out inflation prints throughout 2021, but what really matters is the path beyond that, and this is where debate rages within financial markets. As asset prices increasingly react to economic data, it is also where the key risks and opportunities lie for investors over the next 12 months.

There is no doubt that the bounce back from the pandemic will see an inflation spike. Barring the emergence of a vaccine-resistant COVID strain, governments across the world, but particularly in the US, are committed to spending on an unprecedented scale. There is a particular focus on the US, in part because the speed and scale of their stimulus places them at the front of the recovery queue, but also because US interest rates have the most impact on markets. Rising US treasury yields have already spilled over into European risk-free rates, despite a vastly different recovery outlook. Where the US leads, the rest of the world will follow it seems.

So how big is the US stimulus, and how high could inflation go? Biden's $1.9 trillion COVID recovery bill is around 9% of GDP, of which analysts estimate around 5% will be spent in 2021. Furthermore, the bill includes direct stimulus cheques, so-called 'stimmys'. This type of direct intervention is untested on this scale, which leads to greater uncertainty around how quickly it will translate into spending and inflation. However, the stimulus is only one source of spending, however. The scale of financial support throughout the pandemic means US households were in many cases net beneficiaries of the economic lockdown. This has swelled 'excess' household savings (the amount **above** the typical pre-pandemic savings level) to almost 8% of GDP. How much of this will be spent is again uncertain, but given the forced nature of the accumulation, it seems reasonable to expect a higher degree than would normally be the case.

This dry powder has already started to impact economic data. A composite measure of global manufacturing hit a 10 year high in March as production bottlenecks emerged and supply failed to satisfy rising demand. A good example is a spike in shipping container rates which have jumped from less than $2k in December to almost $5k today. Services are also looking very positive. March ended with the standard US measure of expected growth in services at an all-time high, and almost 1 million new jobs added, well above market expectations. All these data have led to soaring growth expectations. Despite a broader spread than usual, Q2 and Q3 consensus numbers now estimate around 9% growth on an annualised basis, falling back to 'just' 5% in Q4.

The Federal Reserve's own annual growth forecasts were upgraded from 4.2% at its December meeting to 6.5% in March. More importantly, they also forecast core inflation to exceed their 2% target. These projections were made before the strong March data, but it was clear already that inflationary pressures were building. Despite that, the Fed remained committed to keeping rates low, on the belief that any pick up on re-opening will be transitory in nature. Inevitable inflation spikes will certainly test the Fed's commitment to the new 'flexible average inflation targeting' mandate, i.e. they are willing to let inflation overshoot, so long as it averages 2% over a longer time period. The Fed believes, or so it seems, that one bumper year will not be sufficient to offset the prolonged below average inflation of the past 2 – 5 years. Of course, they don't provide any clarity on how that theoretical calculation might work, or at what level of inflation, or unemployment might make them blink on their commitment, so markets are left to speculate, and speculate they have.

The initial response to rising inflation pressure was an increase in US government bond yields, which played out very rapidly throughout February. Even if you don't believe the Fed will raise interest rates, this is still a rational response because increases in inflation will erode the nominal value of your bond coupons. If you think your bonds are going to be worth less in real terms, i.e. after inflation, then why would you keep paying the same price? With fewer buyers for the same amount of debt issuance, the inevitable consequence was lower prices and higher yields. This added around 70bps to the US 10 year yield over 2 weeks, eventually topping out around 1.7%. This doesn't sound like a lot, but it is a huge move in relative terms and enough to cause US long-dated bonds to fall over 13%, the worst quarter since 1980.

With the Fed seemingly committed to keeping rates low, why is the market so keen on fighting them? The simple answer is they don't believe them. While the Fed's projections don't indicate a rate rise until at least 2023, current market expectations price the first rise at least one year earlier. Sceptics also point to the massive debt issuance required to finance Biden's spending plans. 30 years of falling yields have been good for interest costs even as the total debt burden has increased. The US government's net interest payments fell from 3.2% of GDP in 1991 to 1.6% of GDP in 2020. Maybe the 'independent' central bank is less worried about inflation than it used to be because it's a convenient way to shrink the national debt. This dynamic creates a stand-off akin to a game of chicken. Everybody expects short-term inflation, but while some see it as a herald of a new inflationary era, stoked by loose monetary policy and fiscal spending, others, including the Fed if you take them at their word, see it as a temporary blip before reverting to a more gentle rate below or close to 2%.

At Astute, we lean towards the second camp. For all the noise through 2021, the real drivers of inflation are long-term structural trends. While some of these, such as deglobalisation could contribute, labour bargaining power has always been the biggest driver of cost increases, and we think there remains significant slack here. A substantial shortfall in hours worked remains in both the US and the UK, which should provide further room for unemployment to recover over the next year or two before wage pressures start to kick in. Beyond that, the sustained drive for automation, efficiency, and digitalisation will continue to erode labour bargaining power, particularly as business investment in these areas may pick up early in this cycle. To draw a comparison from recent news, everybody is focused on the ship stuck in the canal and what that means for prices this year. The fact that 200 tonnes of goods can be moved around the world by a crew of just 25 people is taken for granted.

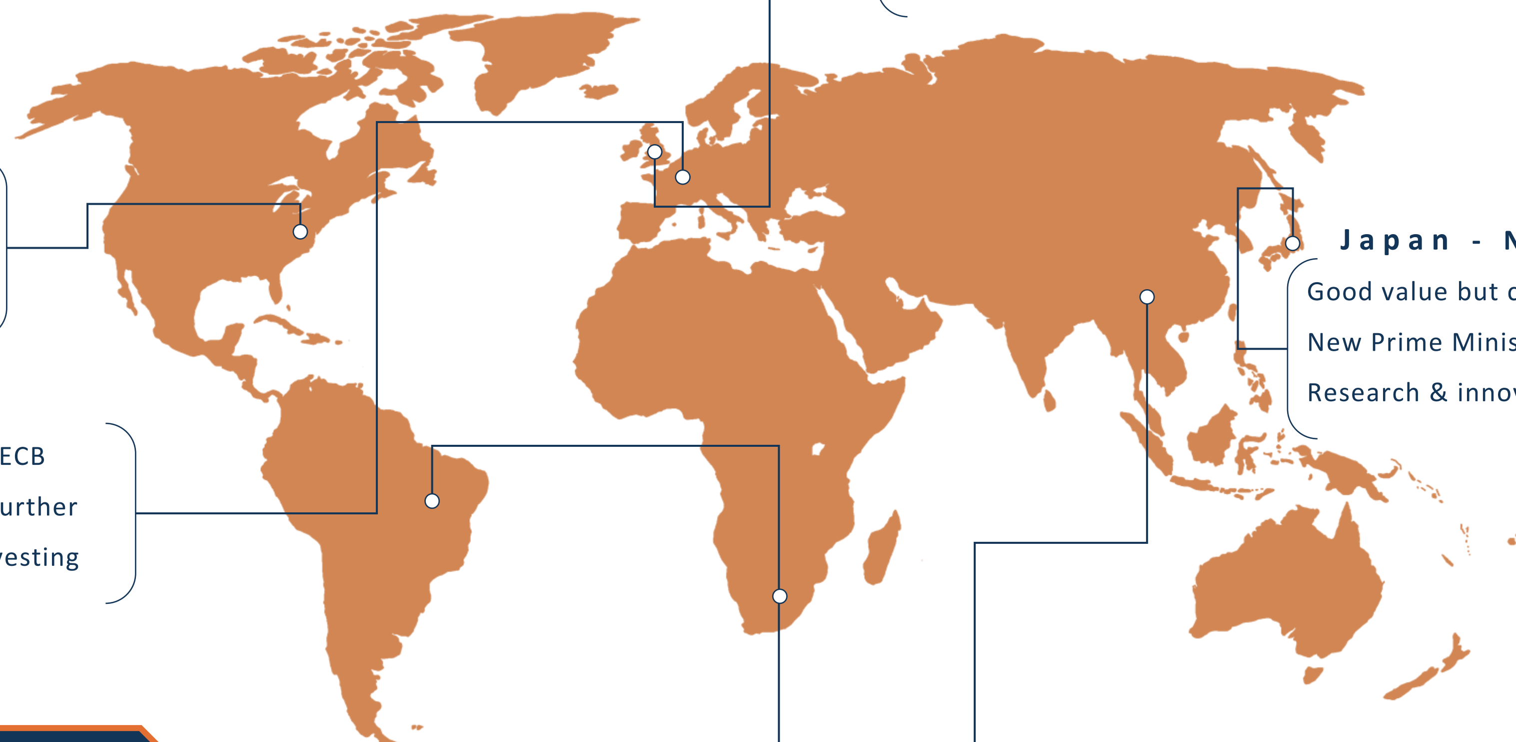
While our strategic view remains one of low or moderate inflation, we acknowledge the short-term risks. Not least that by the time we realise we're wrong, inflation could already be accelerating away and the Fed will either be behind the curve or quickly hiking rates to catch up. In short, the risk of being wrong is greater than the reward of being right, and so we believe it is prudent to tactically position for a reflationary environment in order to navigate this short-term volatility.

Astute Response:

It is hard to see any return for bonds in this environment, and as conviction in the recovery grows, so too does our preference for equity over fixed income. As a result, we moved overweight equity in the Conservative fund and further de-risked our bonds by adding strategies focusing on growth above inflation. This 'real return' focus sacrifices potential upside if rates move lower but preserves crucial diversification benefits.

In equities, we upgrade our view on more value-orientated markets, particularly the UK, and continue our existing theme of pivoting towards cyclical sectors across the regions. The value style may continue to outperform growth this year, but we could see attractive opportunities to return to quality growth stocks over the next 12 months as interest rate speculation dampens, and company fundamentals return to focus.

Astute Perspective



UK – Neutral/Overweight

- Larger companies remain structurally challenged
- Prefer smaller companies with growth opportunities
- Vaccine success key to short term growth prospects

N. America - Neutral

- Expect strong recovery led by record stimulus
- Rising inflation putting pressure on growth names
- Still good value in domestic and smaller stocks

Japan - Neutral/Overweight

- Good value but corporate nationalism persists
- New Prime Minister to continue beneficial reforms
- Research & innovation remains strong suit

Europe - Neutral

- Fiscal co-operation emerging, supportive ECB
- Vaccination delays extending lockdowns further
- Global leader in green and sustainable investing

Asia & Emerging - Overweight

- Long term growth from demographics & development
- China/USA decoupling creates two-track global economy
- China growth likely to slow versus western economies

Conviction Views

A key part of our process is building conviction ideas which are then expressed across each of the portfolios. While asset class and regional views are an important input into this process, the opinions outlined below will be the driving force behind any potential future returns.

1. Pivot to Cyclical
   - Economic rebound will broaden growth opportunities benefiting cyclical sectors most
   - Valuations more attractive for growth linked to economic rebound but cautious on long term outlook and avoiding value traps

2. Overweight Technology
   - Technological revolution will continue, lean into disruptive areas, the strong get stronger
   - Look beyond current global leaders and use specialists to stay ahead of the curve

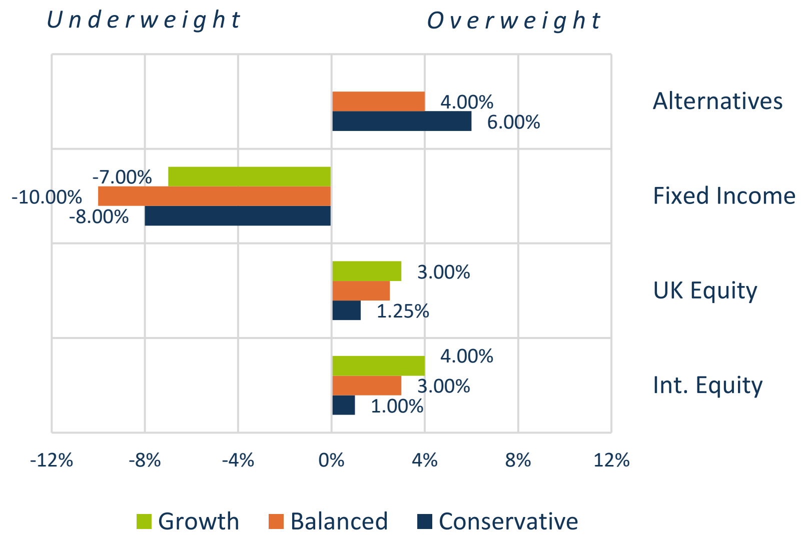
3. Invest Sustainably
   - ESG will become the default option, and the market will shift accordingly
   - If sustainable investing is the future, invest with those who have ESG way into their past

Asset Class Views

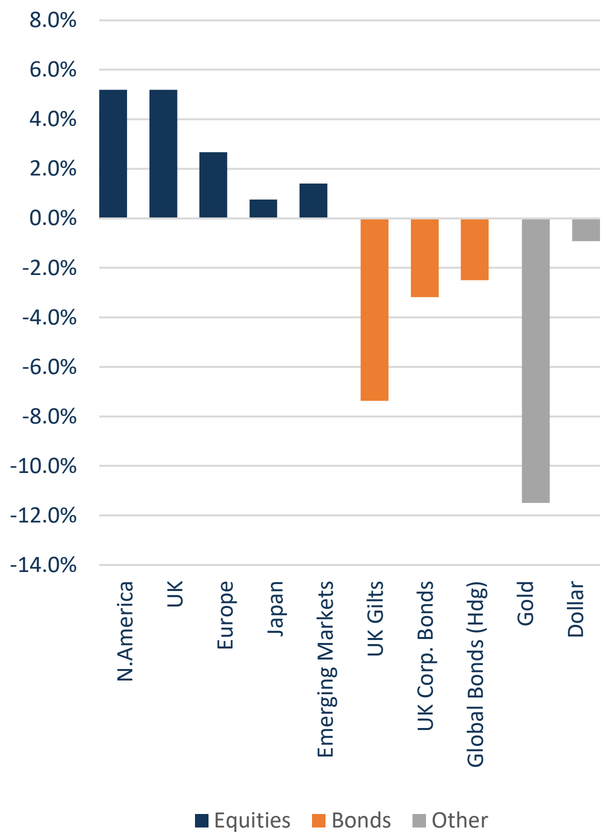
Fixed Income	Negative						Positive
Sovereign Bonds							
Corporate Bonds							
High yield bonds							
EM Debt							
Alternatives	Negative						Positive

Equities	Negative						Positive
UK							
Europe							
Asia & Emerging							
Japan							
US							

Tactical Asset Allocation[1]



Asset Class Returns[2]



Astute Positioning

Q1 saw the first asset allocation change on the fund as we increased the equity weight in the Conservative fund and moved from underweight the UK to marginally overweight UK equities across all strategies. The tactical allocation chart to the left shows the updated positioning at the end of the quarter. There was also a significant rotation within our regional fund selection as we continued our cyclical rotation. These moves began last quarter within our US component but have expanded to include our UK and European assets also.

Turning to the asset allocation change on the Conservative fund initially. We have been, and continue to be, materially underweight fixed income, with the lion's share of that capital reallocated to alternatives. While we see better risk-adjusted returns in alternatives, we were cautious on maintaining some interest rate sensitivity through fixed income as portfolio insurance against tail risks, such as the potential re-emergence of COVID. As the success of the vaccine program became clear, and economic growth looked more certain, we further reduced our interest rate sensitivity by buying more inflation-linked bonds. This includes the PIMCO and M&G funds shown in the table below. This inflation, or 'real return' focus represents a relative de-risking of both interest rate and corporate credit risk, helping to improve diversification in our bonds versus our equity positions. As a result, we felt more confident moving overweight equity where the outlook was improving, a change we funded by trimming our largest Alternative fund holdings.

This move into equity mostly involved new purchases in the UK, where we raised our outlook from underweight to neutral/overweight. The inputs into our house view examine fundamentals, valuations, and technical factors, and while UK valuations have looked attractive for some time, fundamental issues like Brexit concern and out of favour sectors have held back sentiment. However, following the vaccine rally in Q4 2020, we saw technical factors improve as flows into more cyclical value markets improved. This was followed by the resolution of Brexit (whether positive or not), perhaps most crucially, the better-than-expected vaccine rollout, and a generally supportive fiscal stance from Rishi Sunak. This removed some of the negative factors and significantly improved the relative growth outlook in the short term. To take advantage, we proportionally reduced our existing international equity positions (US, Japan & Emerging markets) to fund purchases of the River & Mercantile UK Recovery fund. This strategy has an excellent long-term track record of outperforming value led markets and was launched in the wake of the global financial crisis to exploit the market dynamics seen in a sharp economic recovery.

Earlier in the quarter we also continued our cyclical rotation within US equities. We had already begun moving down the market cap, into smaller more cyclical companies, and following the Georgia run of results, which gave Democrats control of the Senate, we accelerated these purchases on the expectation of more stimulus. This included the Granahan strategy, a concentrated mid-cap growth fund, and the iShares S&P 600 tracker, which is more balanced in style but has a smaller company focus. This also served to further reduce our large-cap growth exposure, where valuations were increasingly under pressure from rising interest rate speculation.

As global growth expectations improved, we also increased cyclicality in our European holdings by swapping our defensive tracker fund for a pragmatic value strategy in River & Mercantile European. This was a relatively new launch after the manager left Schroders where he demonstrated an excellent 10-year track record. By supporting a manager and strategy we know well at a new investment house, we were also able to lock in attractive early investor rates, helping to deliver on our value for money commitment to our clients.

Fund Activity

New Purchase	River & Mercantile European	Con, Bal, Gro
	River & Mercantile UK Recovery	Con, Bal, Gro
	Granahan US SMID Select	Bal & Gro
	iShares S&P SmallCap 600 ETF	Bal & Gro
	PIMCO Mortgage Opportunities	Con & Bal
	M&G UK Inflation Linked Corp Bond	Con & Bal
Trim	BlackRock European Absolute Alpha D	Con
	Protea ECO Advs ESG Abs Ret F GBP Acc	Con
	iShares MSCI USA SRI ETF USD Acc	Bal & Gro
	L&G US Equity ETF	Con, Bal, Gro
	iShares MSCI EM SRI ETF USD Acc	Bal & Gro
	Baillie Gifford American B Acc	Bal & Gro
	Comgest Growth Japan GBP U Acc	Bal & Gro
Sold	Brown Advisory US Sust Gr GBP B Inc	Bal & Gro
	iShares Edge European Min Vol ETF	Con, Bal, Gro
	Royal London Short Duration Gilts Z Inc	Con & Bal
	Vanguard UK Short Term Inv Grd Bond	Con
	Vanguard UK Investment Grade Bond	Con & Bal

Data sourced: Refinitiv Lipper for Investment Management & Astute Investment Management as at 31.03.2021. Past Performance is not a reliable indicator of future results.

[1] – Relative positioning is expressed versus Astute's long term strategic weights. [2] – Total returns in GBP. Broad market indices are used to represent the performance of different regions over the period

Astute Observations

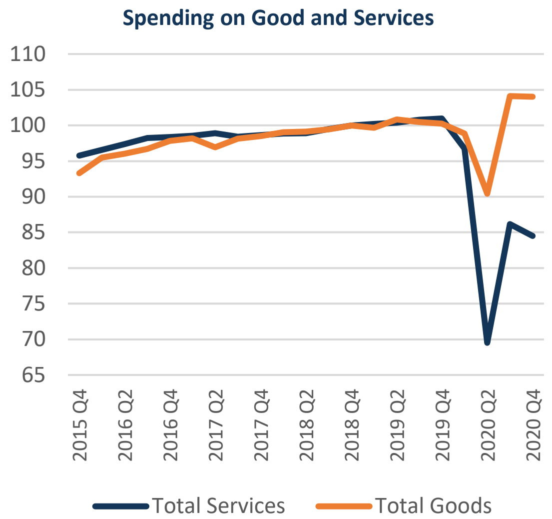
Inflation.
Hair today, gone tomorrow

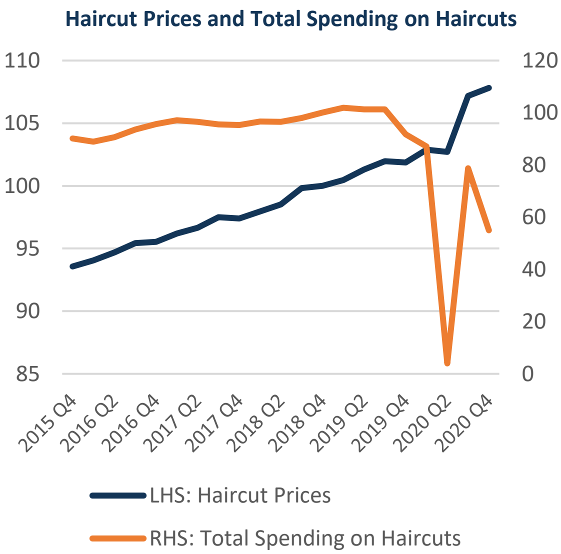
The past 12 months forced lots of changes in our daily lives. As we look forward to a resumption of more normal economic activity, the pent-up demand accumulated throughout the various lockdowns will likely be released. Naturally, as restrictions were introduced, the service sector took the most impact, and as you can see from the graph to the right, spending in that sector dropped considerably as a consequence. Meanwhile, as patterns of consumption changed, goods have already recovered to pre-pandemic levels, not least because of online sales.

The short-lived easing last summer gave us a taste of what a sudden demand shock might look like for services. We explore an extreme example in hairdressing inflation on the chart to the lower right. You can see that while stable spending saw prices rising generally in line with inflation, the demand surge of the summer produced a sharp spike in prices. This is a rational response when demand outstrips supply.

In this scenario, everybody wanted haircuts at the same time, and the supply of haircuts is relatively inelastic, i.e. it takes time to train new hairdressers. If anything, total supply may have fallen as circumstance forced career changes. The key to long-term inflation, however, is the sustainability of that demand. While everybody will want a haircut at the same time this summer, it is unlikely they will want twice as many as usual from now on. From a long-term perspective, structural demand may even fall as some people master DIY cutting (we at Astute have not been so successful in that endeavour!). As such, we expect a serious demand shock to lead to steep price increases in the short term, but that this boost will be temporary.

Sources: Office of National Statistics





**Both charts shows indices rebased to the end of 2018. Q4 2018 =100*