Strategic Asset Allocation

moneyfarm

2024

Wealth, together.

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After two long years conditioned by the aftermath of the Covid outbreak, the state of economic flux is coming to an end. Despite a very positive year for investments, expected returns still remain higher than the historical average.

We are pleased to present to you the Moneyfarm Strategic Asset Allocation for 2024. Those who have been investing with us for some time know that the strategic asset allocation (SAA) process takes place every December. During the annual SAA, the Investment Committee focuses on long-term outlooks for a wide range of asset classes. The goal is to divert our attention from the daily fluctuations of the global economy and financial markets and reflect on where we might be in 10 years' time. It is an important time for us to further develop some of our fundamental principles: having a long-term focus, keeping costs and the number of transactions low, and not being too distracted by the daily news flow, especially during periods when the noise is louder than usual.

In the SAA process, we focus on key macroeconomic drivers for long-term expected returns, particularly economic growth, inflation and initial valuations. It is a fairly mechanical process, so there is relatively little room for human judgment.

As you will see later in the document, **this year the SAA indicates an optimistic outlook for financial returns in general, with expected returns exceeding the average of the last 15 years for almost all asset classes.** This result is consistent with what we saw at the end of 2022, although long-term equity returns are slightly lower following a stronger-than-expected 2023.

What needs to happen for these predictions to be proven correct and for investors to enjoy such positive expected returns? There are several points to consider. First, one of the assumptions of the SAA is macroeconomic stability. Specifically, we expect inflation to decrease and

Dear investor.

economic growth, albeit modest, to resume. In this respect, **after years in which key economic indicators have ventured into uncharted territories, we see the macroeconomic environment returning to a more familiar environment.** The direction is therefore encouraging, although many challenges remain on the horizon that deserve our attention.

Secondly, valuations must normalise towards their ten-year average, an assumption particularly relevant for developed markets outside the United States. Thirdly, implicitly, we assume that the profits of listed companies remain proportional to the size of the economy. In this way, we can use economic growth forecasts to estimate profit growth. We don't think these assumptions are particularly heroic, but it's worth emphasising.

What does all this say about 2024? Not much, at least in theory. Long-term expected returns are not a good indicator of what to expect in a single year, although, in general, they eventually prove accurate. 2024 will likely have its fair share of challenges, economically and geopolitically, but the SAA suggests that, at least regarding long-term returns, some risks are already priced into assets.

We hope you enjoy reading the reasoning behind our latest strategic asset allocation and that it's useful to you in understanding our portfolio positioning.

Sincerely,
Richard Flax
Chief Investment Officer

What is strategic asset allocation?

Strategic asset allocation (SAA) plays a fundamental role in Moneyfarm's investment process.

Every year, Moneyfarm's Asset Allocation Team (AAT) produces long-term (10-year) evaluations of all major asset classes that make up our portfolios. These evaluations are used to find the right combination of assets to create portfolios that are suitable for our clients and meet their risk and return needs. It is a complex yet critical process, a product of studying and monitoring the markets throughout the year.

What are strategic portfolios?

The ultimate goal of strategic asset allocation is the identification of the seven strategic allocations that form the basis of the portfolios we offer to investors. These combinations of assets are the final result of the SAA, and you can find each of them on page 46.

The strategic portfolios are then transformed into 'tactical' investment portfolios, which become the actual portfolios for our investors. They serve to:

- Delineate the long-term parameters within which we construct the portfolios to ensure adequate levels of risk and return
- Guide the Investment Committee's decisions regarding rebalancing
- Serve as benchmarks for portfolio performance

How are strategic portfolios constructed?

To construct strategic portfolios, forecasts must be developed regarding the following aspects of asset classes:

- Expected returns over 10 years
- Expected volatility over 10 years
- Correlations between asset classes

Expected returns are the forecast of the growth potential of various asset classes over the next 10 years. Expected returns are the result of our team's vision of how economic, demographic and social trends will impact asset valuations.

Expected volatility is a measure of risk and is estimated based on historical data. Correlations help us understand how the value of one asset moves relative to another. Once the three ingredients of strategic asset allocation are identified, it becomes possible to construct portfolios that meet predetermined long-term risk and return objectives.

How does the strategic asset allocation process work?

It is both a qualitative and quantitative process. Forecasts are made using a mathematical process, but there are various control steps, validations of results and interventions by the Investment Committee.

Correlations

This measures the tendency of assets to move together, in opposite directions or completely independently. This is the basis of diversification: asset classes that tend to move in different directions decrease the risk in the portfolio.

Estimation of volatility

Strategy cannot be separated from risk analysis. Volatility is estimated for each asset class based on historical data.

Expected returns

By looking at economic forecasts and current valuations of various asset classes, we estimate long-term returns.

Risk/return profile for each asset class

Provisional portfolios

Limits

The portfolio managers set limits for asset classes that the SAA cannot breach. This ensures the portfolios remain diversified and are not over or underexposed to any particular geography or asset class.

Robust optimisation

We carry out simulations to analyse the behaviour of the portfolio different scenarios. This allows us to stress test our models and our assumptions and to create portfolios that are tested in adverse scenarios.

Qualitative review

The Investment Comittee monitors the results obtained through the quantitative process and takes corrective action if necessary.

Strategic portfolios

Return to normality or a new normal?

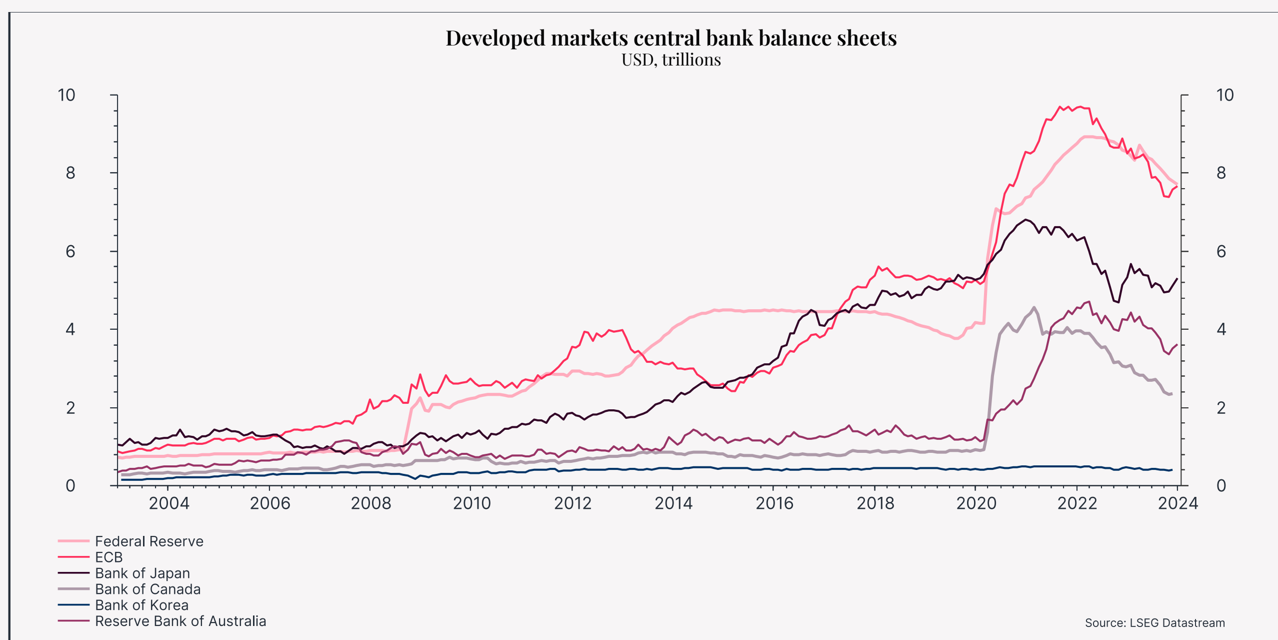
The long wave of the pandemic has now subsided, equity markets have returned to where they started after a very strong year, and investors are facing a new normal. Meanwhile, expected returns remain favourable for those investing with a long-term approach.

Let's start with a simple fact: the past 12 months have generally been a positive period for investors. The markets, which had retraced violently, have reversed course. Although the environment is still somewhat unsettled, we can now look to the future with greater certainty than before.

The state of emergency relating to Covid took the global economy into uncharted territory (to use the term we used in this document last year). Key economic indicators such as inflation, interest rates, growth, employment and debt had deviated significantly from the trajectory of recent history. This sudden and seemingly universal movement was accompanied by crises big and small, which increased the complexity in interpretation and risks, bringing even greater volatility to the market.

To understand the magnitude of what happened, let's rewind the tape. To address a global GDP slowdown of over 10% caused by the pandemic, expansive policies, both fiscal and monetary, injected further liquidity into a system that had been attuned to very low borrowing costs for over 10 years.

A sea of liquidity



The graph above shows how the balance sheets of the major central banks, already at record levels before the pandemic, have further expanded to support economies affected by lockdowns. In particular, the balance sheets of the Federal Reserve and the European Central Bank have increased by around two times.

This was one of the main reasons that inflation reached the highest levels seen in over 40 years. To try to bring prices back within manageable limits, major central banks raised rates at an unprecedented pace, accepting the possibility of potential collateral damage to the economy: the risk of recession loomed on the horizon due to monetary and fiscal tightening. As if that weren't enough, history didn't wait, with wars and international crises reshaping the boundaries of an increasingly divided world.

In short, a complex game was playing out over the relationship between growth, inflation and monetary policy, with significant tail risks. However, these tectonic shifts did not produce an earthquake; recession didn't arrive (thus far), and inflation did not spiral out of control. Markets, also driven by technological surprises that shifted the frontiers of innovation and growth, rewarded investors who chose to stay invested.

But if this is the story, what are the new short and long-term perspectives? In a situation where risks abound, we can assert that the great anomaly that has characterised recent years seems to be over. Key economic indicators are returning to more familiar levels. This 'return to normality' alone is not enough to guarantee short-term performance, but it certainly presents investors with a more stable economic environment, with a narrower and more predictable range of possible outcomes compared to 12 months ago.

Moreover, this environment has unprecedented conditions compared to the pre-pandemic world, and we believe that some of them may represent a new equilibrium around which to build our investment strategy going forward.

The prospect of a new monetary regime; higher interest rates; more orthodox monetary policies; a new role in portfolios for bonds; the disruptive push of innovation that could bring new sectors and companies into the spotlight; sustainability-linked investments; a world that has become more capable of confronting the limits of globalisation: these are the challenges and opportunities that will characterise 'the new normal'.

Certainly, risks will not be lacking, and we are well aware that the performance of the economy and markets, especially in the short term, can bring surprises. But the lesson we believe investors can draw from the past year is that, in a rapidly changing world, having confidence in the markets remains the best option for building a solid long-term financial future.

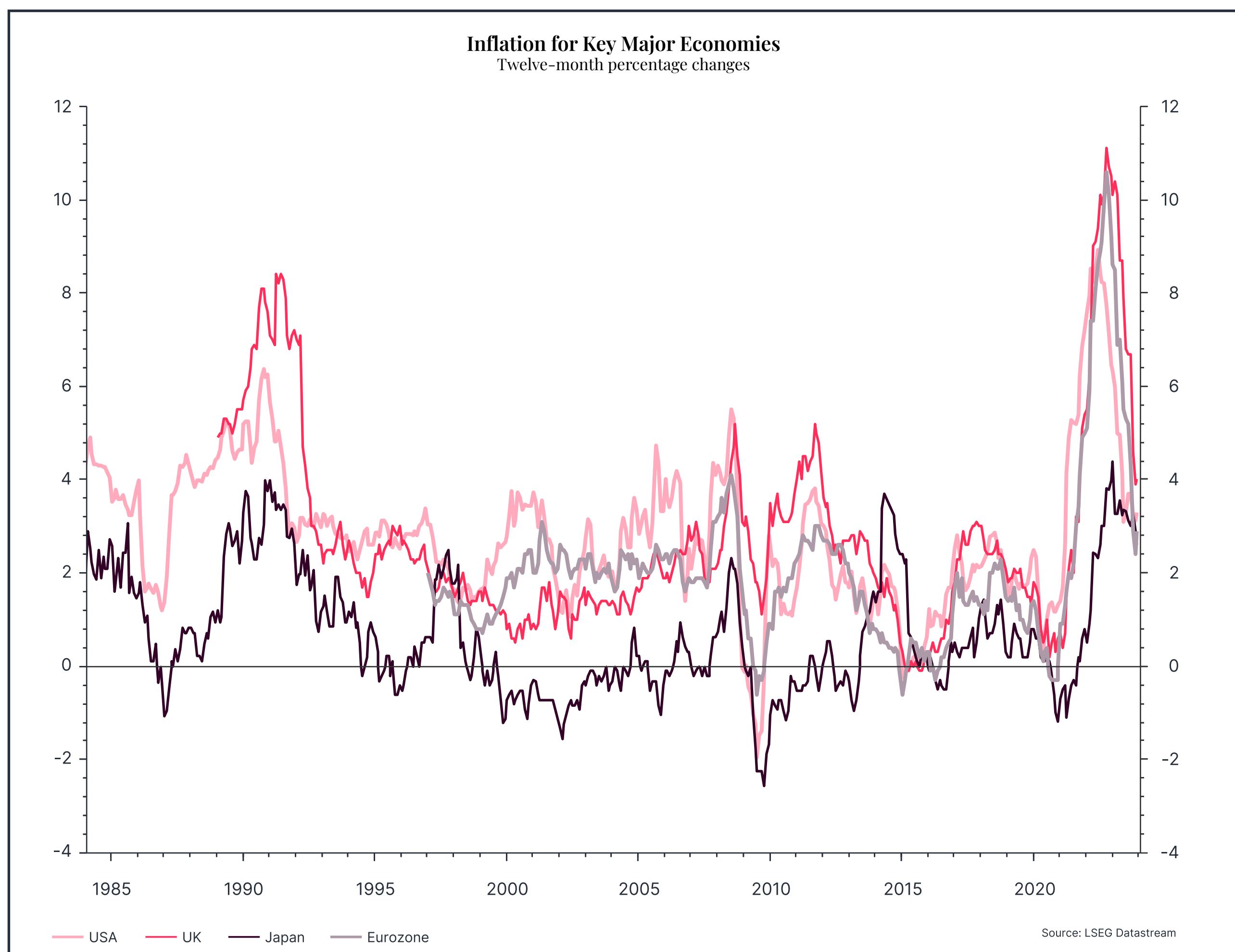
“To try to bring prices back within manageable limits, major central banks raised rates at an unprecedented pace, accepting the possibility of potential collateral damage to the economy”

The new equilibrium: A short-term outlook

But what are the characteristics of this new balance, and what are its consequences, both in the short and long term, for investors? To understand this, it is useful to delve into the main macroeconomic metrics that influence the markets, also trying to adopt a longer historical perspective.

Let's start with inflation, which has been the central variable in market dynamics recently. From the following graph, we can see how it has spiked abnormally in recent times compared to the average of the last 20 years (and even beyond).

Record inflation

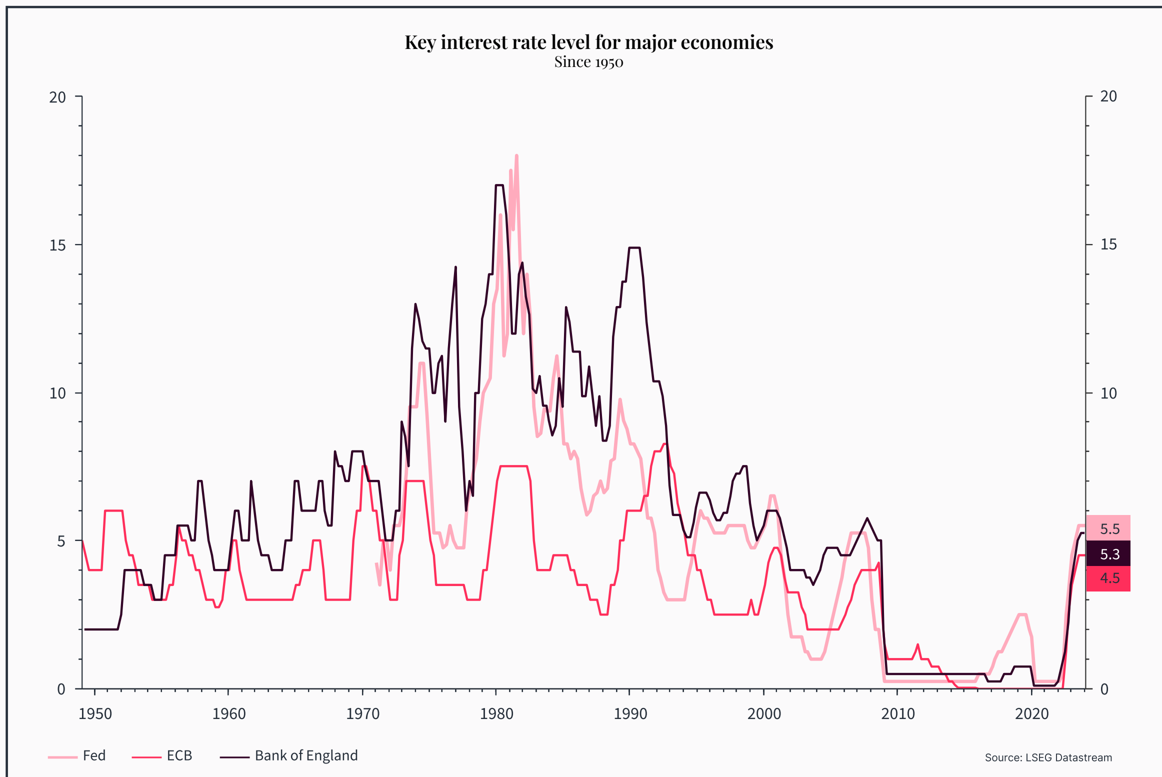


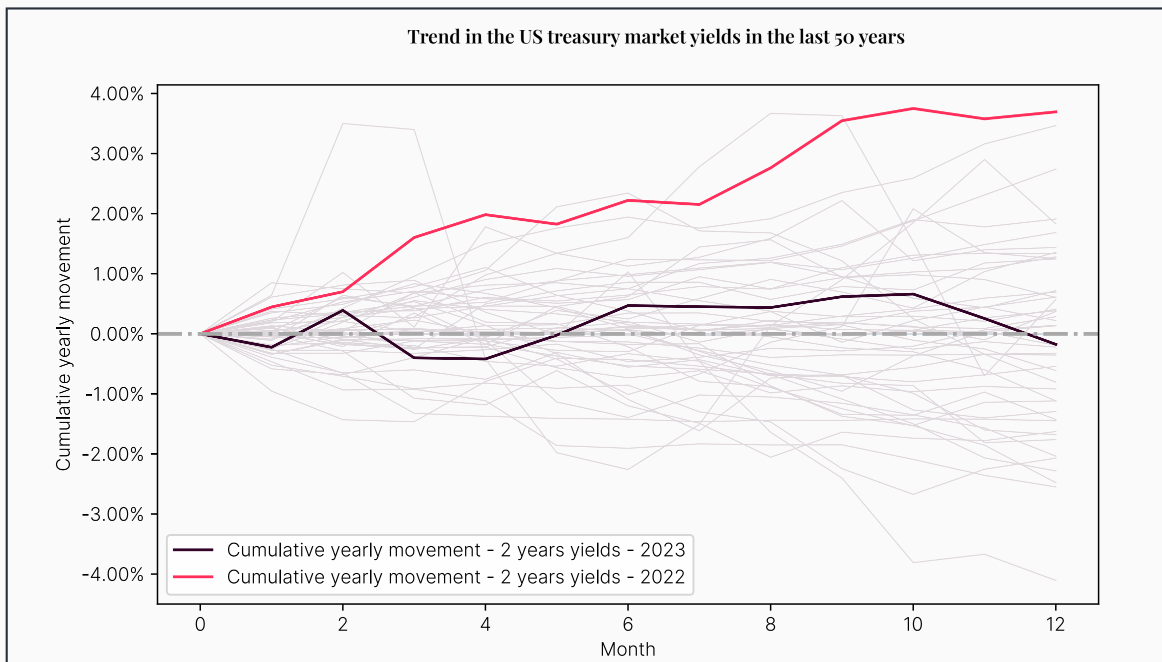
As can be seen on the chart, before retracing, inflation reached the highest level in the last 40 years.

The spike in inflation and its subsequent slowdown have been the metronome that has marked the rhythm of the markets in the last 12 months. Central banks have faced an unprecedented scenario and have had to 'test' their arsenal of policies to see if they were indeed capable of controlling price dynamics.

Interest rates, the main tool available to central bankers, have been raised at an unprecedented pace, as can be seen from the chart on the following page. Not only that, but the monetary tightening has also been accompanied by rather tough rhetoric, aimed at emphasising absolute determination in waiting for unequivocal signs of a price slowdown before considering a reversal of monetary policy.

Unprecedented rate hikes





The top graph shows the rise in interest rates in some of the major global economies. What is striking is not so much the absolute level of the rates (in line with those we were accustomed to before the 2010s), but the speed of the growth.
In the graph below,, we compare the growth of the benchmark rate in the United States from the beginning of each year for the last 50 years. As we can see, the dynamics that began in 2022 have no historical rivals.

This fundamental change in rhetoric seems to have finally occurred in the latter part of the year, accompanied by a clear repositioning of monetary policy expectations for 2024.

The shift signals that central banks feel confident enough in their ability to control prices from here on out. This conveys to the market the idea that monetary policy will pay closer attention to signals coming from the economy.

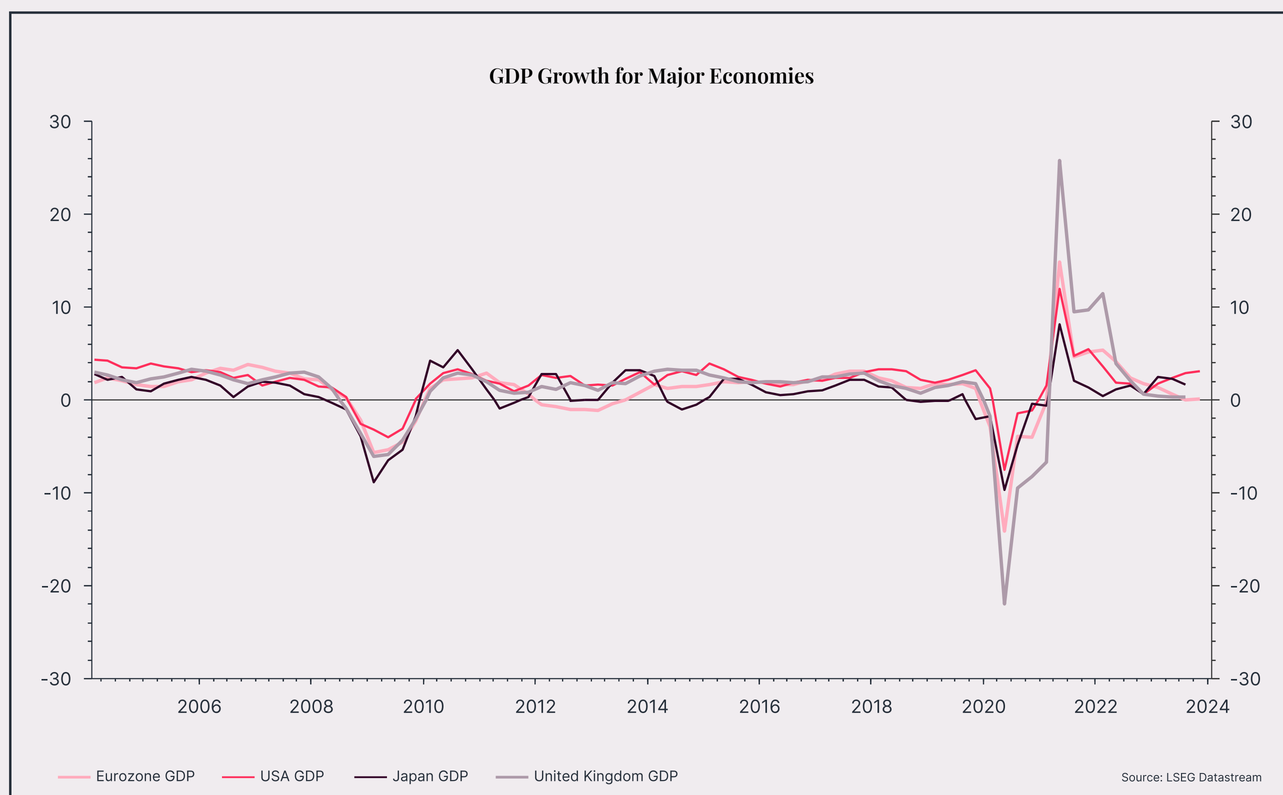
In the triangle linking inflation, monetary policy, and economic growth, the relationship that will be predominant in market performance in 2024 will shift from the axis between monetary policy and inflation to that between growth and monetary policy.

What, in our opinion, will move the market is the performance of companies and the ability of central banks to manage a potential economic slowdown. Therefore, we can outline a base scenario in which central banks accompany a gradual decrease in rates with an economic slowdown that is not excessively detrimental to corporate earnings. This dynamic, all else being equal, should support both equity and bond performance.
Such a scenario, upon closer examination, would not be too far from the famous soft landing of monetary policy.

An assumption that just 12 months ago was considered overly optimistic, illustrating how market prospects have improved.

Certainly, there is no shortage of risks that could veer the direction toward which the economy seems to be heading at this moment.
Growth prospects remain a fundamental concern.
The European economy is stagnating, while the United States has proven surprisingly resilient. We have said we do not expect a recession (at least in the United States) but only a slowdown in 2024, but there is always the possibility that GDP dynamics could surprise negatively.

Slowing growth



The graph above shows the trend of annual growth in the main geographies.

Markets may be overestimating the positive effect of monetary policy. As we have seen, the general consensus predicts fairly significant interest rate cuts for this year. We are quite confident that this will be the direction, but perhaps the cuts will not be as significant as expected.

Secondly, inflation, although not as alarming as it was a few months ago, has not yet been tamed. We believe that two key challenges revolve around it. On one hand, it could prove complex for monetary policymakers to bring inflation back to 2%. The last mile could be the most arduous, calling bankers to an additional effort beyond expectations. The second issue is: how will prices react to a possible easing of monetary policy? Central bankers may proceed with more caution than they have accustomed us to in the past decade (also considering the level of liquidity still present in the system). For this reason, in the new normal, we might expect a more orthodox and cautious monetary policy, with the natural rate therefore being higher than in recent history. In this sense, the risk is that markets may be overestimating the willingness of central bankers to support the economy through interest rate cuts.

Lastly, there are political risks (with the upcoming contentious US elections) and geopolitical risks, with international tensions in Europe, the Middle East, and the South China Sea. In short, as is normal and as 2023 has clearly reminded us, predicting the performance of financial markets is by no means simple. What is certain is that a normalised economic framework creates a less uncertain environment for investors with a medium and long-term perspective. By remaining invested, they can continue to seize the opportunities of this period of great change.

“For this reason, in the new normal, we might expect a more orthodox and cautious monetary policy, with the natural rate therefore being higher than in recent history.”

The new equilibrium: long-term horizon

Shifting the focus to the long term, which is the natural horizon for a strategic asset allocation, let's now try to highlight some trends that have emerged very clearly in recent times that we believe will be characteristic of this new phase.

- **Monetary policy will continue to set the pace of the markets,** but its limits have already been tested. The past few years have been a testament to central bankers' ability to normalise the economy and inflation. Despite some misjudgements, markets continue to place almost total trust in monetary policy institutions, which remain the main beacon for guiding performance. However, the onset of double-digit inflation in all major economies has reminded us of its limits, confirming that infinite liquidity cannot be the permanent solution to the problems in economic cycles. We believe that this awareness will translate into monetary policy moving more cautiously at least in the medium term, which means a higher equilibrium in interest rate levels.

- The consequence of the first point is **a renewed attractiveness in bonds**. Without considering various short-term risks here, which involve different maturities at different levels. According to the strategic asset allocation process, the expected returns over 10 years for this asset class range from 2.7% per year for the next 10 years for developed country government bonds to 5.5% per year for government bonds of emerging market countries. These levels are in line with those of last year and among the highest of recent decades for the entire bond sector. Expected

returns, while not a guarantee of future performance, remind us how **a higher equilibrium in interest rate levels can favour the medium-term performance of this asset class.**

- In the last two years, the topic of **energy transition** has slightly faded from the mainstream investment debate. However, behind the scenes, the evolution of this space has continued, not only with steadily growing flows but also with regulatory innovations. We believe that the drive for green transition, also linked to an increasing need to secure energy value chains, will continue in the coming years. We also believe that **the world of ESG and responsible investments has reached a level of maturity** to continue benefiting from this trend.

- Who would have thought that this year's performance would be driven by the big American **technology companies**? Those who have invested in the last 15 years have been able to generate huge profits by riding the wave of technological development. The stellar valuations of innovative companies had led many to prematurely predict the end of this phase, preaching that market growth should be sought elsewhere. On the contrary, we believe that **the past year has demonstrated how innovation still has ample room to drive economic and market growth**. Staying out could lead investors to miss valuable opportunities.

- The past year has seen an intensification of political crises, wars, and a general **increase in tensions between countries and blocs**. While the outbreak of these crises, as in the case of the war in Ukraine, has led the market to correct itself and added volatility in specific geographies and sectors. However, those who invested with a diversified approach have, in most cases, not suffered long-standing direct consequences. When it comes to international crisis the risk of escalation is always there, and it is necessary to continue monitoring the evolution of the situation, but one must not make the mistake of overestimating the market risk of even dramatic geopolitical events from a humanitarian point of view, which unfortunately will continue to accompany us in the years to come.

We live in an era of change, where the existence of many unpredictable factors that could influence the economy and markets in the long term cannot be denied. While these risks should not be underestimated, neither should society's ability to find unexpected solutions. The difficulty of assessing the effects of black swan events is often discussed, but it is even more challenging to imagine and incorporate into one's predictions the solutions they could trigger. Who would have imagined that the development of a vaccine in record time would propel a virtually stalled economy to rebound so quickly? Focusing too much on tail risks can lead investors to adopt overly conservative attitudes, missing out on important opportunities.

Looking at the evaluation of **expected returns**, which are the heart of the strategic asset allocation process, are slightly lower this year than the record ones of last year but still remain very high when considering their historical evolution. They are above the average of the last 15 years for all asset classes and are among the highest ever. Even in the new normal, long-term investment within a diversified strategy remains the best way to protect and increase the value of one's capital over time.

Takeaways

- After two years of anomalous results, the main economic indicators have returned to more familiar levels.
- Central banks have changed their rhetoric: they feel confident in their ability to control inflation and are shifting their focus to growth.
- In 2024, the expectation is that the decline in interest rates, all else being equal, will favour both equities and bonds.
- Monetary policy remains the primary factor capable of influencing market performance. We believe that in the medium term, we will see a more cautious and orthodox monetary policy and a higher equilibrium rate.
- According to the strategic asset allocation process, expected returns over 10 years for this asset class range from 2.7% per year for the next 10 years for government bonds of developed countries to 5.5% per year for government bonds of emerging countries. These levels are in line with those of last year and among the highest in decades for the entire bond sector.
- **Expected returns**, which are the heart of the strategic asset allocation process, are slightly lower this year than the record ones of last year, but still remain very high when considering history. They are above the average of the last 15 years for all asset classes and are among the highest since Moneyfarm was launched.

Could this be the year for bonds?

What if this were the year for bonds? After enduring the impact of an unprecedented rise in interest rates, the combination of higher coupons and a loosening of monetary policy could finally favour this asset class, which has yet to experience a true rebound from a dreadful 2022.

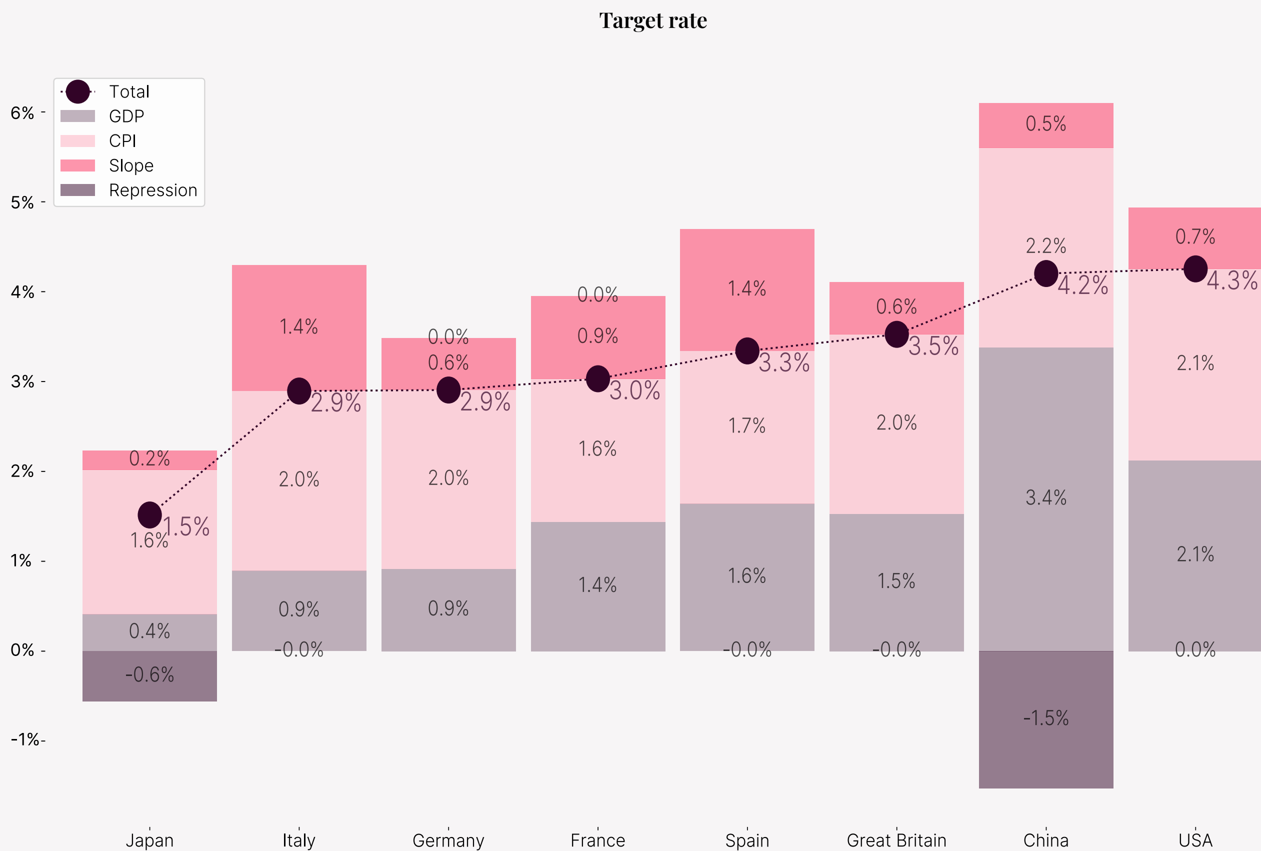
Without being misled by the narratives of those heralding the beginning of the bond era, let's analyse what role this asset class might play as part of a diversified investment strategy.
Last year, the continuous upward pressure on interest rate expectations (unexpected by many) led this asset class to underperform expectations. Only the repositioning of monetary policy in the last part of the year brought positive results in the last quarter.

At the beginning of 2024, we believe that the conditions for a rebound are finally more favourable. Price dynamics and central banks' narratives suggest that we have finally reached the peak for rates, most likely, there will be no further hikes, at least in the major developed economies.

What can we expect then in the short and long term?

Let's start with the long term. According to the fundamentals of economic theory (and common sense), and assuming that monetary policies will return to be more 'orthodox' in the next decade, the equilibrium rates of the economy should be in line with the expected nominal GDP growth. In a balanced economy, capital cannot yield more than economic growth. In this sense, looking at the next five years, estimates from the World Economic Outlook are clear, and rates will remain high, in line with nominal growth. This is good news for bond investors because it is predictable that, in general, this asset class has the potential to produce higher returns in the coming years than it did in the previous 10 years.

Long-term equilibrium rate



Source: Moneyfarm Research, data as of 31 December 2023.

This graph represents the ten-year long-term equilibrium rate according to current forecasts regarding economic growth and inflation. The equilibrium rate helps determine the expected returns of bonds in the long term.

In the short term, bond performance will be influenced by interest rate dynamics. In the USA, markets are already pricing in five or six rate cuts for 2024, compared to the three anticipated at the Fed meeting in December. In Europe, markets are even more optimistic, with the rate level priced near the lower end of analysts' estimates.

An easing of monetary policy dynamics should bring greater stability to the bond market, but clearly, what will matter is how reality unfolds compared to expectations regarding interest rate dynamics. If expectations were to be revised in a restrictive sense, rates could partially rise. Shorter maturities (up to two years) would be less affected, while longer maturities are more exposed to the effects of interest rates.

For this reason, the shorter end of the curve remains interesting, with the rate level still offering an attractive risk-return profile. On the other hand, longer-term bonds, after the excellent performance in November and December, entail additional risks, especially considering that yield curves remain inverted - investors are paid 'less' to lend money for longer periods.

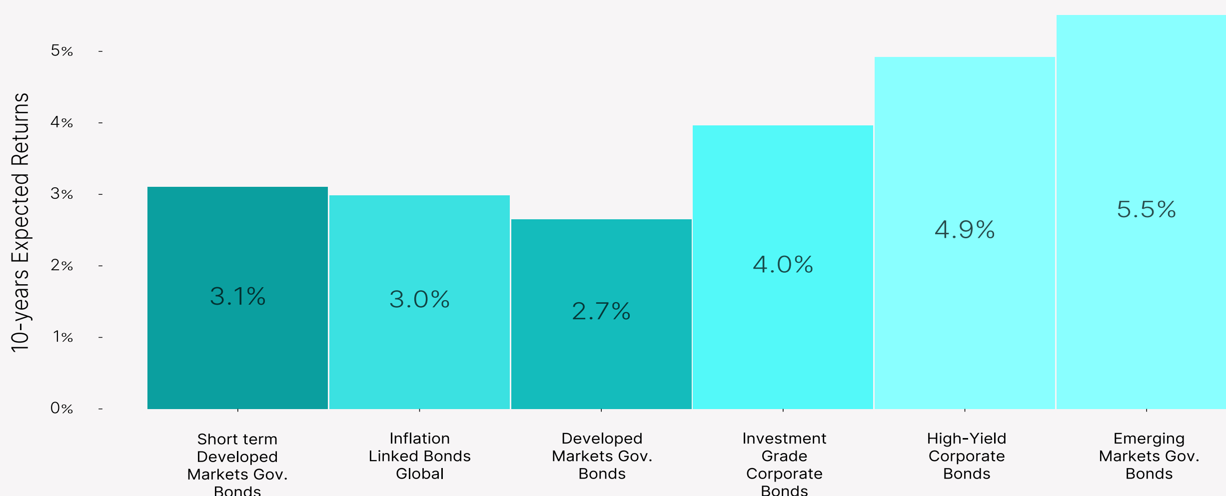
In short, interest rates are objectively very attractive, but bond investment is not without risks and challenges. Expected returns are at their highest levels in decades, which is good news for those investing with a long-term perspective within a diversified strategy. On average, the longer end of the curve for developed countries does not seem to promise extra returns compared to the less risky short end, while the credit sector shines.

Are we looking at a new era in bonds?

Some investors are so enthusiastic about the prospects of this asset class that they argue that their entire portfolio should be repositioned according to the bond component. Even many retail investors, as data shows, are increasingly drawn to the apparent promise of what they mistakenly consider to be 'guaranteed returns' and are turning with interest towards new bond issuances.

At Moneyfarm, we do not agree with this approach. Diversification remains incredibly important. Although the return prospects for bonds are improving, equities continue to offer better-than-expected returns than the long-term equilibrium rate (6.8% per year for the next 10 years for developed countries). Rather than a new era, we believe that this interest rate context represents a "new normal", with positive levels finally able to compensate investors' risk. However, it's important to remember that bonds come with risks and perform best when they are diversified and balanced with other asset classes that can enhance the risk and return profile of investments.. The dynamics of prices, the level of interest rates reached, and the narratives of central banks suggest that we have finally reached the peak of rates, creating a favourable environment for bonds to rebound.

Expected returns for fixed income



Source: Moneyfarm Research, data as of 31 December 2023. Expected returns of various asset classes according to Moneyfarm's strategic asset allocation. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee. Expected returns are estimates of average annual returns for the next ten years. Expected returns are gross returns. Actual returns may be lower due to the costs and charges associated with investing in these instruments.

Takeaways

- In the long term, equilibrium interest rates in the economy should be in line with expected nominal GDP growth. This means that the bond asset class has the potential to perform better in the next 10 years than it has in the past 10 years.
- Expected returns are at their highest levels in decades, which is good news for those investing with a long-term perspective within a diversified strategy.
- We do not believe that the era of bonds has begun, but rather we have reached a new normal.

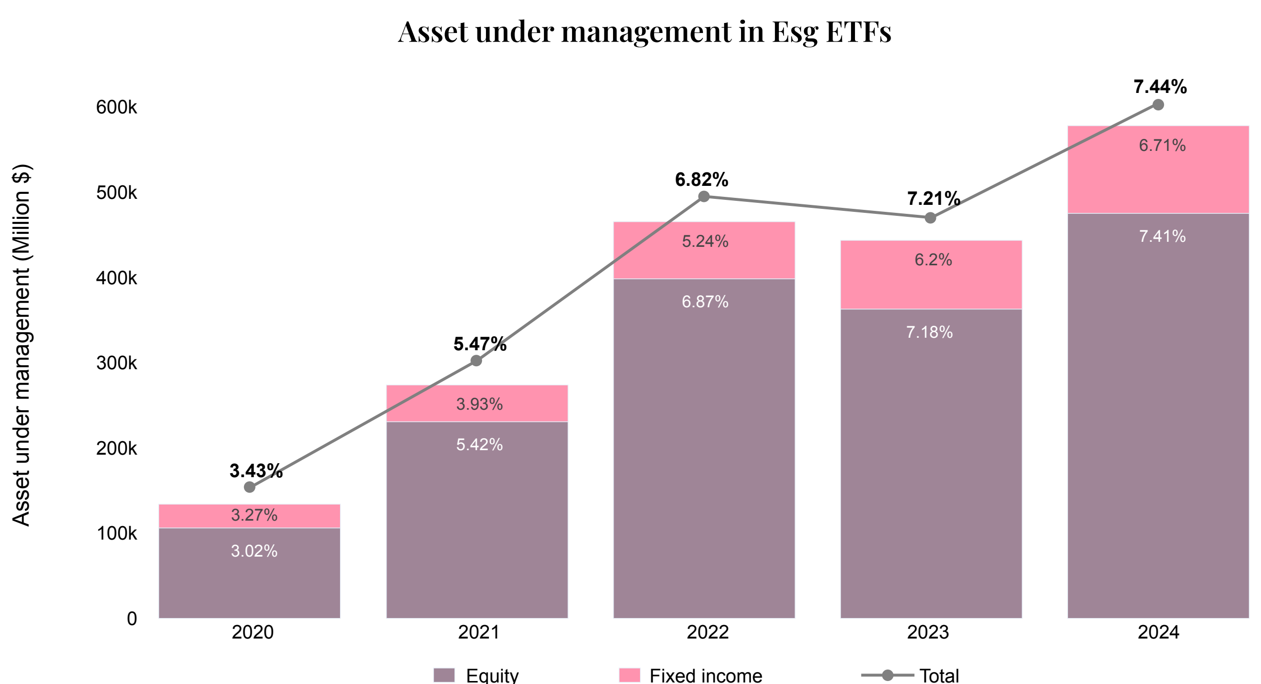
The new normal for responsible investments

Over the past two years, even a less attentive observer could sense a certain loss of momentum in the push towards a green transition and a lesser focus on sustainability in investments. The significant profits of companies in the oil and gas sector in 2022 undoubtedly led many investors to question the merit of environmental and social responsibility in investments. Energy crises have also forced countries to find quick solutions, not always aligned with emission reduction goals. In the United States, an anti-ESG movement has also gained ground with significant political weight, which has even influenced some global investment giants.

Are we perhaps moving backwards in the field of sustainability? We don't think so. We believe that the loss of centrality of the theme in mainstream debate has been dictated by some objective factors but also by a certain fatigue as regards communication, in some cases characterised by sensationalist and aspirational greenwashing. We believe that this short circuit is the natural consequence of an explosion of interest in a world still unprepared from a regulatory and technical point of view.

The truth is that, under the surface, **the ESG world has continued to grow and evolve, although not at the exponential rates seen between 2020 and 2022.** If we look at the percentage of ESG ETFs, it stands at about 7.4% of total assets (compared to 7.2% the previous year), a total of $600 billion.

Percentage of ESG ETFs



The graph above shows the evolution of managed assets for ESG bond and equity ETFs (left axis) and their proportion to the total managed assets by ETFs (numbers in percentage). Source: Bloomberg Intelligence, Data Processing by Moneyfarm.

The evolution of the ESG landscape

We're not just talking about purely quantitative growth here, but also qualitative growth. The past two years have shed light on the limitations of the responsible investment landscape and rhetoric which is sometimes more aspirational than pragmatic. But such setbacks and criticisms are necessary for any evolutionary process, and we believe it has led to increased maturity in the wider ESG investment trend. Also, thanks to this sometimes painful learning process, there is now a greater widespread knowledge of socially responsible investments, allowing for the analysis of the proposed tools and strategies through an active yet critical approach, rather than merely a receptive and passive one.

The world of responsible investing has continued to evolve in a pragmatic, timely manner, and on several fronts. The regulatory landscape, especially in Europe, has continued to evolve positively, offering solutions to some of the main problems in responsible investment, such as the lack of data, greenwashing and lack of uniformity.

In Europe, the bringing into force of the SFDR (Sustainability Financial Disclosure Regulation) has begun to standardise the definitions of ESG investment, providing more transparency to investors about the type of strategy adopted by the manager, with the aim of reducing greenwashing. To address the issue of analysts' complaints about the lack of data, the number of companies subject to the CSRD (Corporate Sustainability Reporting Directive) regulation will expand as early as 2024 and gradually in future years. This means that more and more companies will be obliged to report their sustainability data. The European Taxonomy, which aims to provide and standardise definitions of sustainable environmental activities, is expanding the spectrum of regulated economic activities. Consultations on the regulation of ESG Ratings have made progress, such as agreements on the CSDDD (Corporate Sustainability Due Diligence Directive).

In the UK, the regulator is implementing Sustainability Disclosure Requirements (SDR) and Investment Labels to assist consumers in navigating the sustainable investment market. The Financial Conduct Authority (FCA) is enforcing an anti-greenwashing rule for all FCA-authorised firms, emphasising that claims related to sustainability must be fair, clear and not misleading. There are also naming and marketing regulations for investment products to ensure accurate use of sustainability-related terms. The initiative includes the introduction of four labels to guide consumers in understanding investment products and to foster trust. Consumer-facing information will be improved to offer accessible details about the key sustainability features of a product. Additionally, detailed information will be provided to institutional investors and consumers seeking more comprehensive insights through pre-contractual, ongoing product-level and entity-level disclosures. Distributors are required to make product-level information, including labels, available to consumers.

Investment techniques have also continued on their path of evolution, with the launch of innovative strategies even in asset classes where we previously saw a lack of innovation, such as in government bonds.

Performance

From a performance perspective, 2023 rewarded investors with positive results. Moneyfarm SRI model portfolios generated returns ranging from 4.4% to 12.8% depending on the risk level. Remembering that past performance is not a reliable indicator of future performance, below we can see the performance extrapolated with longer time horizons.

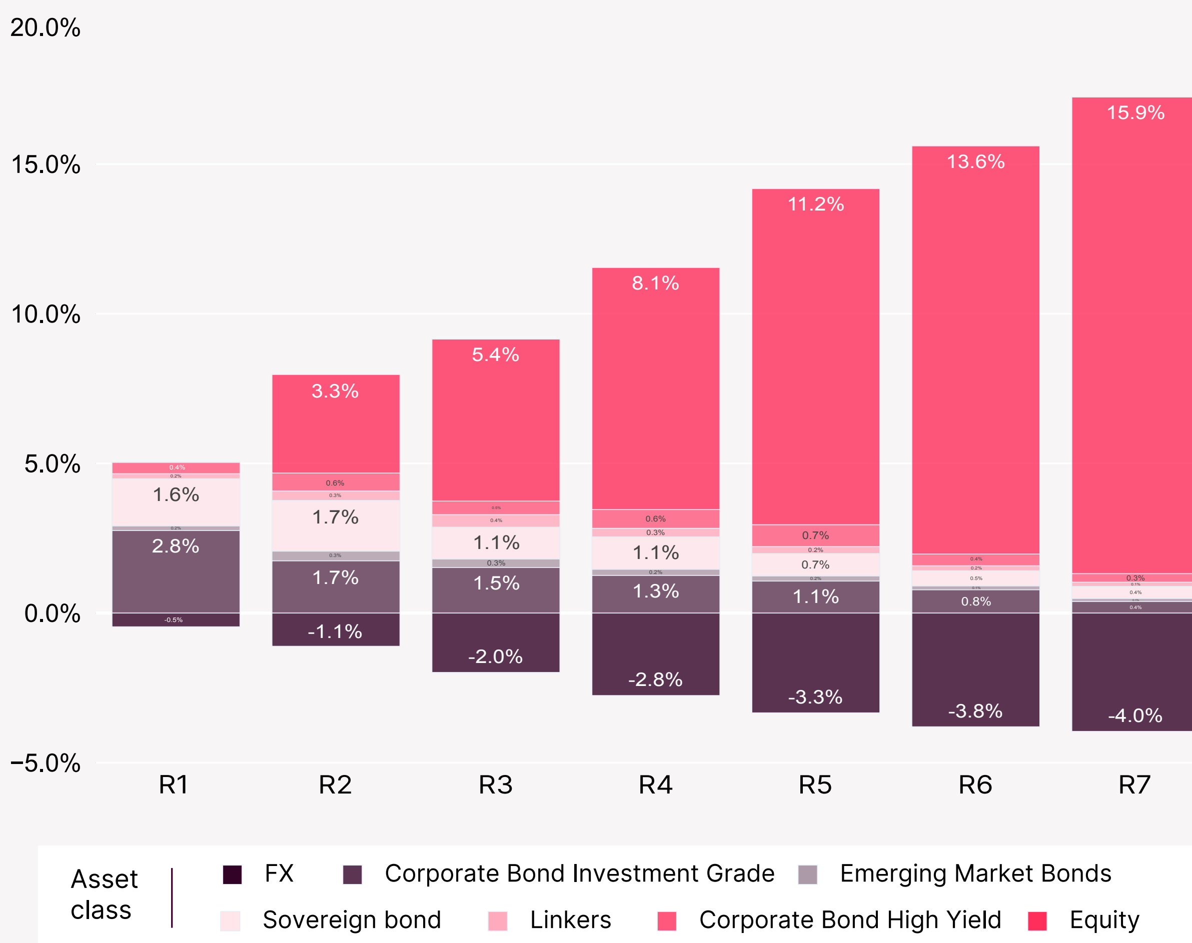
Year	P1	P2	P3	P4	P5	P6	P7
2023	4.0%	6.5%	6.7%	8.3%	10.2%	11.0%	12.4%
2022	-7.0%	-9.5%	-12.2%	-13.0%	-14.2%	-15.3%	-16.3%
2021	-1.7%	3.3%	7.4%	9.9%	12.1%	14.9%	18.1%
2020	2.9%	6.1%	8.3%	10.3%	10.9%	12.1%	13.3%
2019	3.5%	7.0%	11.3%	14.0%	15.4%	17.6%	20.1%

Portfolio performance as of 31/12/2023. The 5-year performance of the portfolio was simulated before the launch date on 01/10/2021. The data is presented for illustrative purposes only, and past performance and simulated past performance are not a guarantee of future results.
Data provided shows gross returns. Actual returns may be lower due to the costs and charges associated with investing in these instruments.

Equities took the lead. The ESG ETFs we use to invest in the US equity, Eurozone equity, and UK outperformed the generic index, while for other geographical regions, although still positive, equity performance was lower than the classic counterpart. The fixed-income component also contributed positively to the overall performance. In 2023, we still witnessed, albeit to a lesser extent, greater sensitivity of ESG portfolios to movements in interest rates, driven by a higher exposure of equities to growth and small-cap factors.

Performance attribution of socially responsible portfolios

Performance contribution by asset class 2022-12-31 2023-12-31



Source: Moneyfarm data. Attribution of performance of Moneyfarm's socially responsible portfolios by asset class in 2023. Past performance is not a reliable indicator of future performance. Data provided shows gross returns. Actual returns may be lower due to the costs and charges associated with investing in these instruments.

Looking ahead to 2024, all else being equal, interest rate dynamics could create a favourable environment for ESG investments, which continue to be generally more influenced by interest rate movements compared to general indices. This means they experience greater losses when rates rise, but also derive greater benefits when rates fall.

- Despite ESG investments apparently losing centrality in the mainstream debate, global flows have continued to grow. By the end of 2023, 7.4% of the assets managed by ETFs were in ESG funds.
- In 2023, Moneyfarm ESG model portfolios generated returns ranging from 4.4% to 12.8% depending on the risk level.

Investors' Compass: A rebound year

Thinking about future market performance after a positive year is certainly easier, but when investing, you should try to ignore the background noise created by volatility and focus on the medium and long term. It's not always easy, which is why in last year's strategic asset allocation, we sought to address the most common questions from investors, attempting to analyse historical performance from a statistical standpoint. Our goal was to help those investing with us focus on the reasoning and opportunities presented by embarking on a long-term investment journey.

It goes without saying that past performance is not indicative of future results, but examining historical market trends can help put one's own situation into perspective and recall the logic and foundations underlying the Moneyfarm investment strategy. We believe that remaining invested for the long term, in line with one's objective, and aiming to fully exploit phases of growth in the market is the best strategy for successfully executing a personal investment plan.

A rebound year for investors

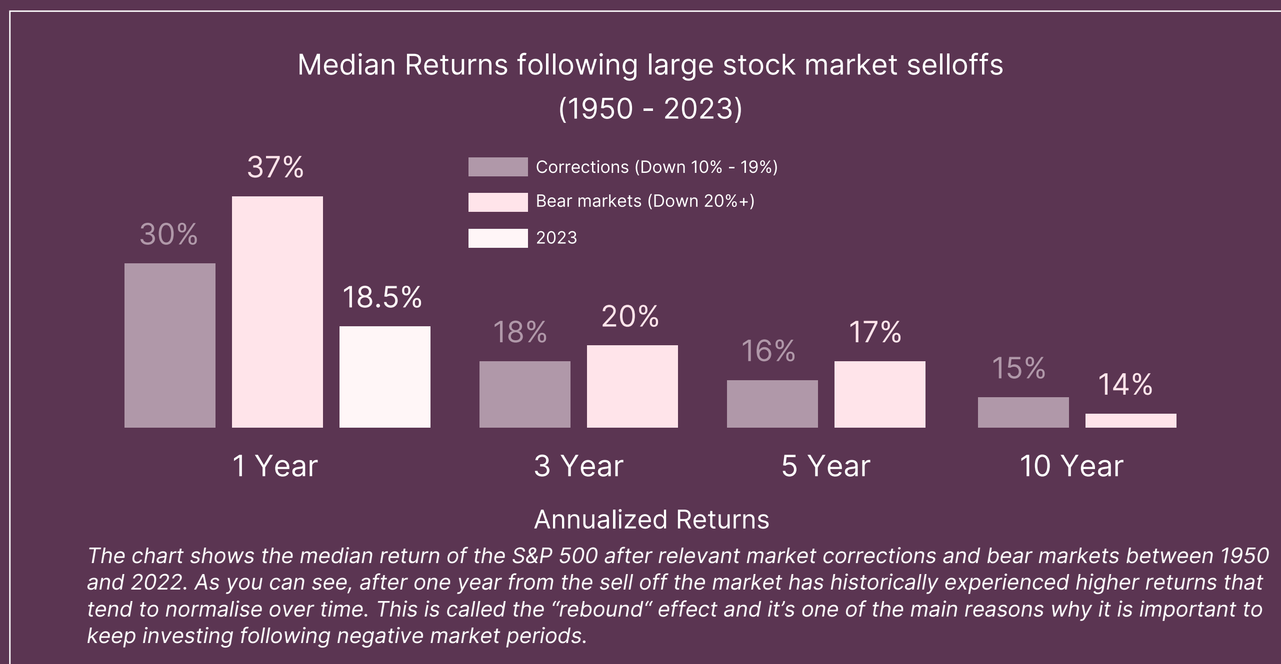
2023 was a very positive year for those who chose to trust the market by staying invested. Stock markets recovered from the heavy losses incurred in the previous year, and at the end of the year (on 12 January), the American stock market reached record heights. From the market's recent low, it took 426 days to recover from a 24.4% correction (29 December 2023). This may seem like a long time to investors who saw their portfolios turn negative, but it is a shorter recovery period than many past crises, as can be seen from the chart below.

Event	S&P 500 declines from peak	Days to recover
1988 Failure of long term capital	-19%	50
Dotcom Crisis	-47%	1,515
2008 Economic Crisis	-56%	1,286
2020 Covid	-34%	141
2022 Crisis	-24%	426

Investing your entire portfolio in equities could be risky. Even though the market took as little as 100 days to recover from some of the biggest financial crises of the past, recovery can take longer. Be careful, though: if you are already invested you don't want to miss the positive returns during the rebound.
Past performance is not a reliable indicator of future performance. Data provided shows gross returns.

Source: Moneyfarm Research, Bloomberg Data

Last year, we talked about the ‘rebound effect’, and indeed, 2023 followed the expected trajectory. When we speak of a ‘rebound’, we’re talking about a statistical effect that leads markets to have greater-than-average positive performance following a correction.



The chart shows the median return of the S&P 500 after relevant market corrections and bear markets between 1950 and 2022. As you can see, after one year from the sell off the market has historically experienced higher returns that tend to normalise over time. This is called the “rebound” effect and it’s one of the main reasons why it is important to keep investing following negative market periods.

Source: Moneyfarm Research, Bloomberg Data

The chart here shows the historical performance of the main American stock index (S&P 500) after a market correction of 20% and after a bear market of 10%, demonstrating the ability of stock markets to correct themselves and return to positive territory within a few years after a period of negative performance.

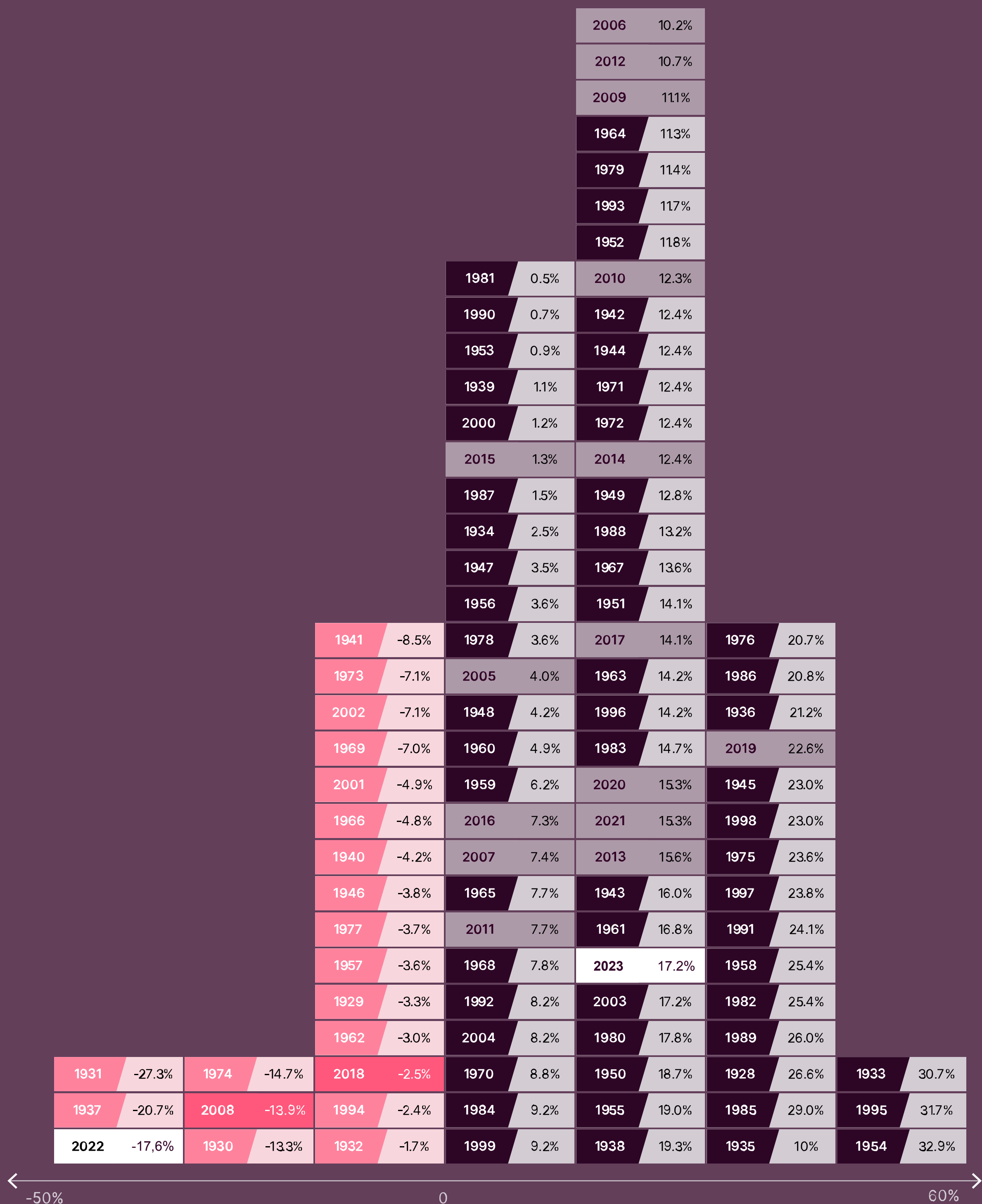
What followed the end of the correction - which went past the -20% mark by 13 June 22 - was positive, with the S&P 500 gaining 18.5% in just a year. What does this data tell us about the near future? Not much, but it helps us remember that negative moments in the market happen, but there is also a statistical tendency for markets to recover and outperform after negative phases, which is a trend you’re more likely to capture if you decide to stay invested for the long term.

Markets’ growth trend

We can clearly see markets’ tendency to grow in the table on the next page. It shows the performance of a 60% equity and 40% bonds portofolio (60% invested in the S&P 500 and 40% in US treasuries). In the table, which ranks annual results from 1950 to today, we’ve highlighted the last 20 years of market performance. This includes 2022 which, with a positive performance of 17.22%, ranks in the middle range between 10% and 20%, and 2022, which was one of the worst years ever.

This reminds us, on the one hand, that stock markets are volatile and that despite the clear majority of positive years, you can always experience a negative year. On the other hand it also reminds us that markets have a natural tendency to grow. Therefore we believe that diversifying to control volatility and staying invested for the long term is the best path an investor can take to protect and build their capital over time.

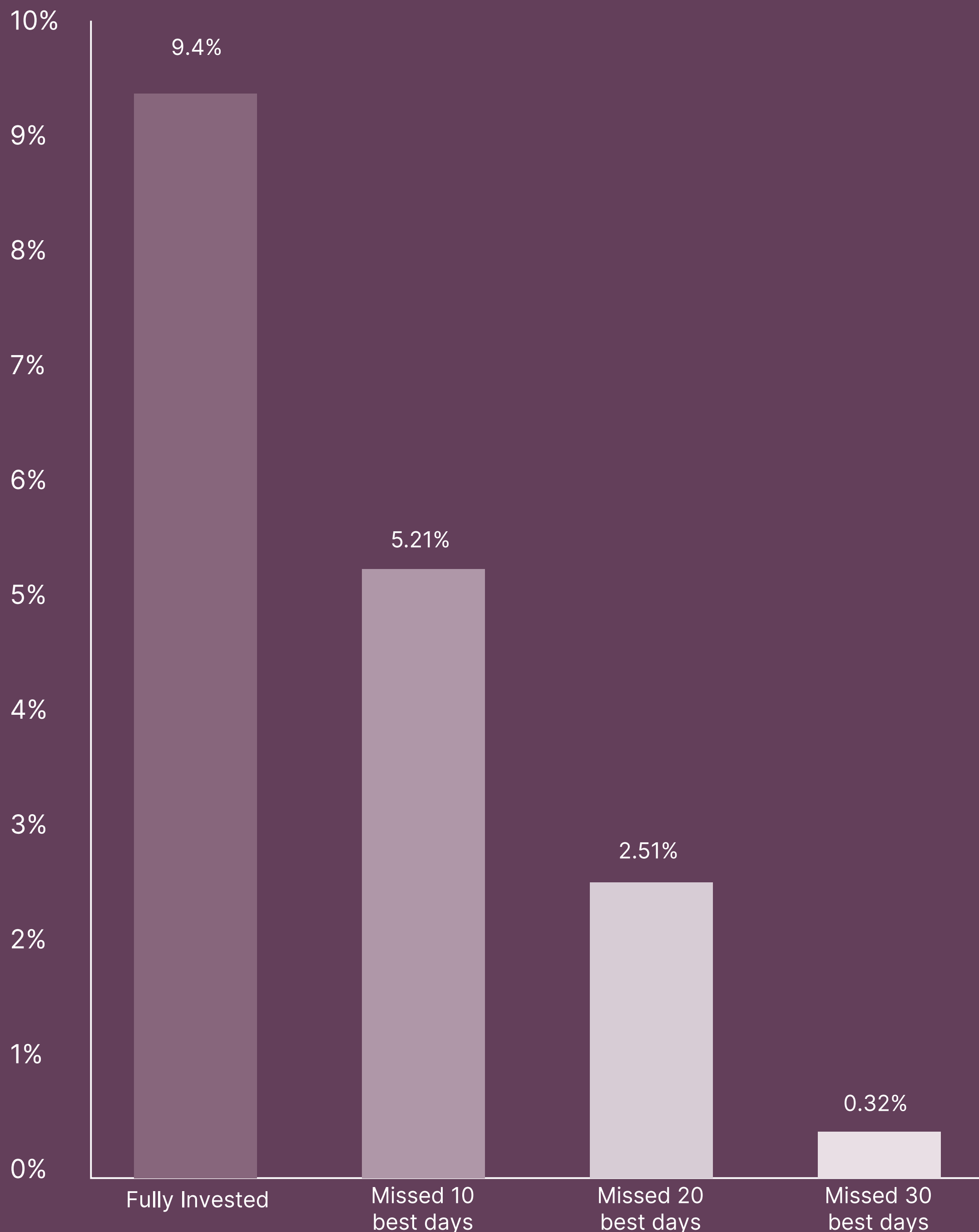
A step of growth



Past performance is not a reliable indicator of future performance. Annual performance of a portfolio invested 60% in the S&P 500 index and 40% in 10-year US Treasury bonds (total return).
***Source:** Moneyfarm Research.*

Also, because long-term financial returns are built with patience, through continuous market participation aimed at benefiting from a limited number of positive sessions. As shown in the chart, which takes into account the performance of American stocks over the last 20 years, missing 10 of the best performance days, which usually occur within 15 days of the 10 worst days, can almost halve the cumulative result of an investment journey.

The darkest hour always precedes the dawn



The chart shows the annual return of an investment in the S&P in a 20-year period (January 2002 - January 2022) and focuses on some of the best days in the market. It highlights how performance would be impacted by missing the best days for markets - and therefore how important it is to stay invested, even during difficult periods.
***Source**: Moneyfarm Research*

Ultimately, no one can predict with absolute certainty the market performance over the next 12 months, but we believe that history shows that staying invested and having confidence in the growth potential of the stock markets is a good idea. The expected long-term returns, which are currently positive, can further reassure that there is still a path for growth and that the strategy of pursuing a long-term investment plan can continue to be a successful choice.

Strategic Asset Allocation 2024

Here we present the results of the strategic asset allocation process, from expected returns for asset classes to strategic portfolios.

Analysis of expected returns

After talking about the logic behind our thinking along with short and long-term outlooks, it's now time to focus our attention on our annual strategic asset allocation. This process uses a range of macroeconomic variables and financial metrics, such as initial valuations, to estimate future financial performance across major asset classes.

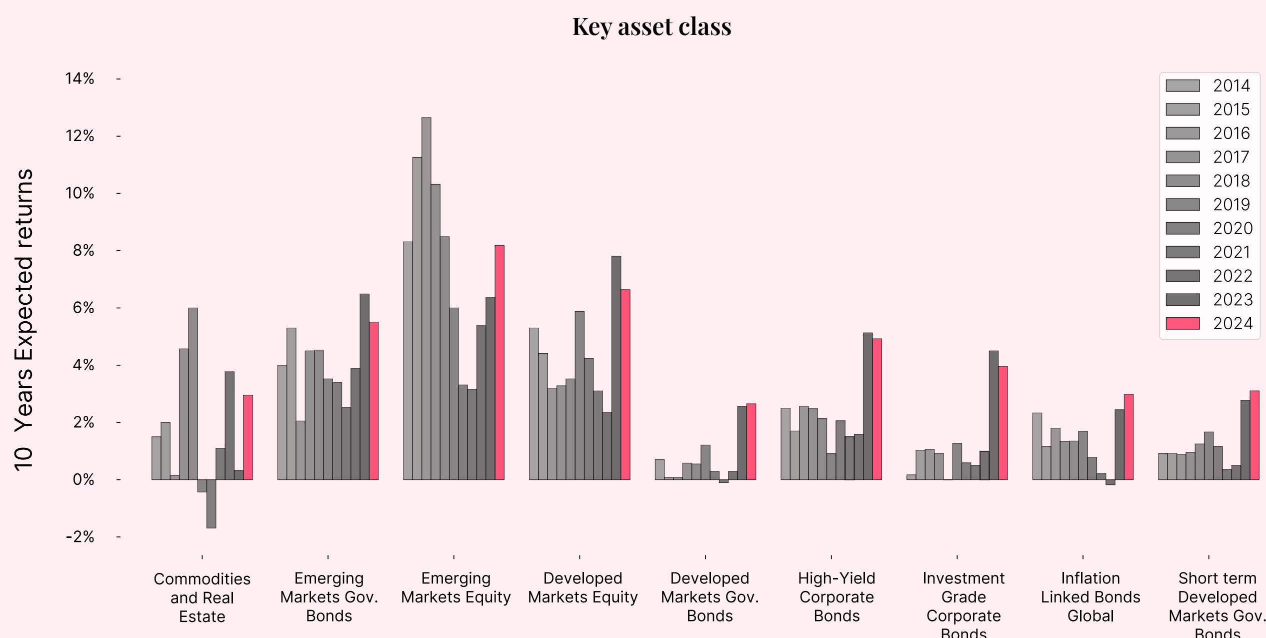
The expected returns over 10 years and the expected volatility for each asset class are used to construct the strategic portfolios. There are seven model allocations that, based on our forecasts, maximise returns for each level of risk over a 10-year horizon. They serve as guidelines for actual portfolios, which also take into account tactical choices dictated by the short-term context.

In this next section, we will delve into the details of the expected returns forecast for the major asset classes in 2024.

The long-term expected returns for 2024 are generally quite high, with emerging market equities continuing to be the asset class with the greatest potential. The equity risk premium, which is the extra return paid by equity investments compared to bond investments, is lower than last year, standing at around 3% (compared to 5%).

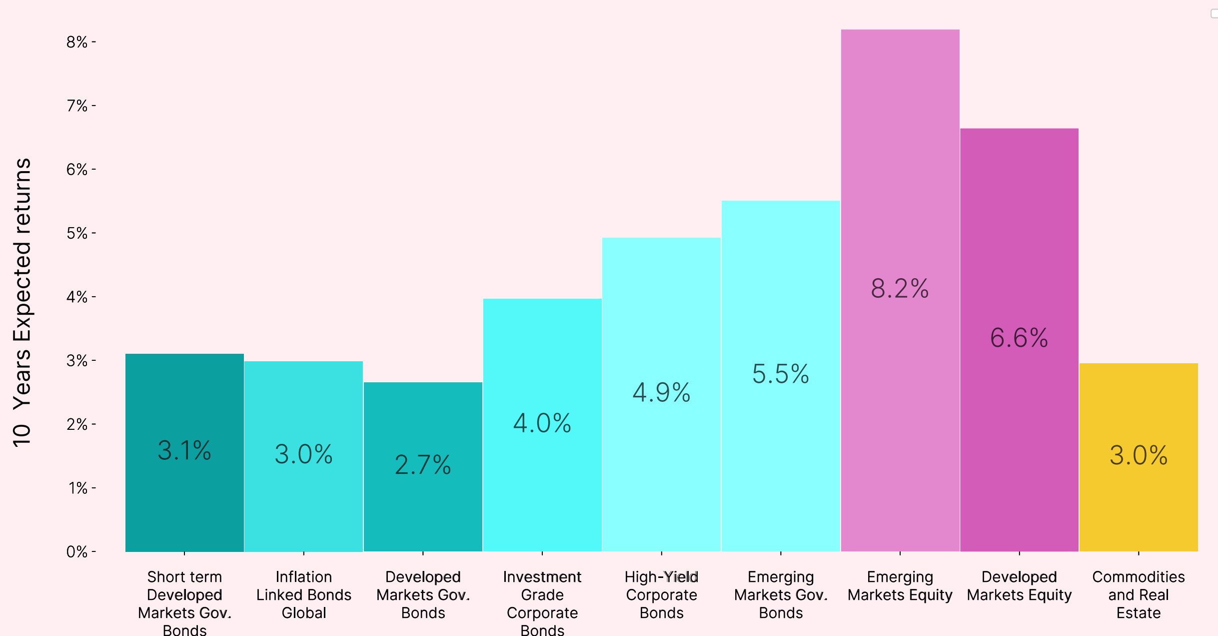
Long-term bonds provide no extra return compared to last year. While the returns of inflation-linked bonds and nominal bonds appear to be the same. High returns are expected for investment-grade bonds, while high-yield returns are less attractive compared to emerging markets.

Expected returns and historical performance



Source: Moneyfarm Research. Past performance is not a reliable indicator of future performance. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee. Data provided shows gross returns. Actual returns may be lower due to the costs and charges associated with investing in these instruments.

Annual expected returns by asset class



Source: Moneyfarm Research. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee.

Key takeaways

- In summary, bonds remain interesting, but expected returns for equities remain high, especially for emerging markets.
- The long-term expected returns for the SAA 2024 have slightly decreased compared to 2023. The December rally has reduced expected returns in almost all asset classes.
- Emerging market equities are the most promising asset class, with an expected return of over 8%.
- High-yield bonds offer an expected return only 1% higher than investment-grade bonds, which now promise nearly 4.1% long-term.

Equities

- Equity returns have remained relatively stable, with expected returns in most geographies decreasing only slightly year after year.
- Expectations have improved only for emerging markets and worsened for the United States..

Bonds

- Expected returns for developed market bonds have remained unchanged at 2.5%.
- Long-term government bonds have a lower expected return compared to short-term government bonds for developed markets, due to high target rate forecasts and curve shapes, while the outlook for inflation-linked securities, appears slightly better..
- Investment-grade corporate bonds offer attractive returns again, while considering riskier issues, emerging market government bonds appear better than high-yield.

The macroeconomic environment

Macroeconomic analysis is a crucial element of the strategic asset allocation process as it helps us estimate long-term earnings growth that influences equity outlooks and interest rate scenarios for bonds.

We utilise estimates from the International Monetary Fund to forecast the terminal rate for bonds and earnings growth for equities. For emerging markets, we do not consider nominal GDP and estimate earnings growth through export volume estimates, always using the International Monetary Fund's forecasts as a source.

Long-term expectations for real GDP are better than last year, with five-year expectations for the United States around 1.9% compared to a historical median of 2.4%. This applies to most geographies, except for the EU. Expectations regarding inflation remain higher than historical norms for the European Union and Japan, while for the United Kingdom and the United States, they seem to be in a better position, although they remain above central banks' 2% target.

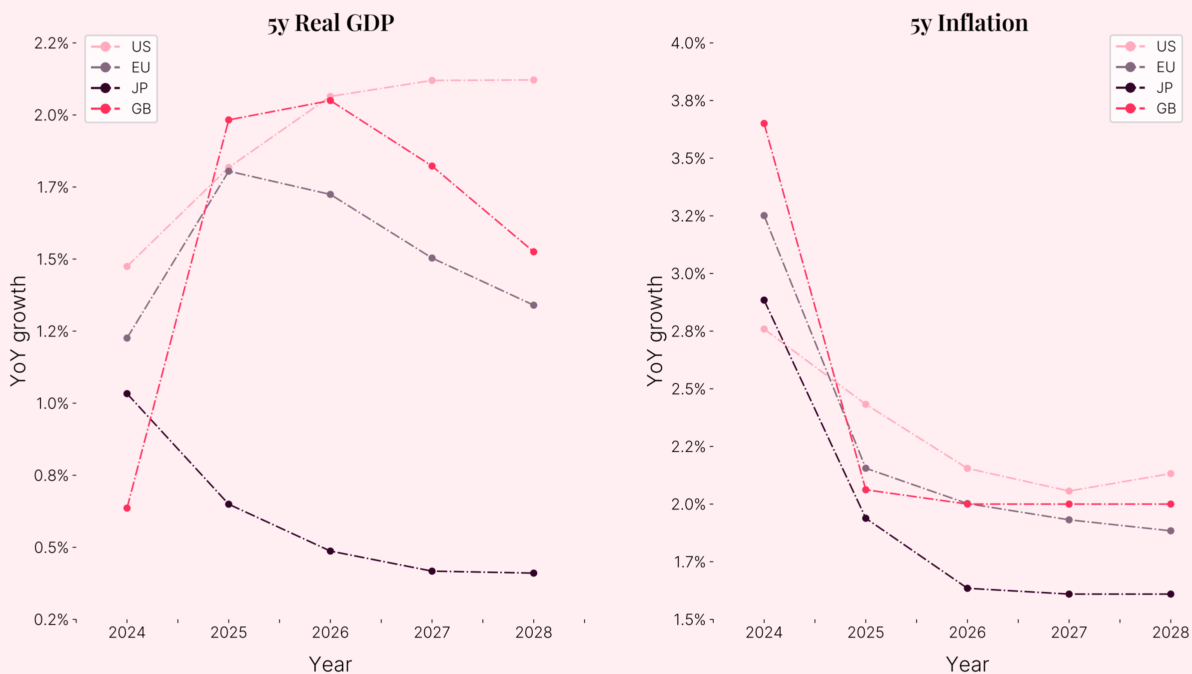
5-year economic growth and inflation forecasts and historical median

Source: Moneyfarm Research, the IMF

The graph depicts the relationship between current GDP and inflation expectations from the IMF compared to their historical median. As observed, GDP expectations are below the historical average, while inflation is expected to be higher, with the notable exception of the United States. Since we have used these forecasts to calculate long-term expected returns, we believe there is room for positive surprises on both fronts.

This year, long-term expectations for real GDP are better than last year

Dynamics of GDP and inflation in major geographies



Source: Moneyfarm Research

The following graph shows the projected evolution of real GDP growth and inflation over the next five years. Excluding Japan, the sequence of GDP growth is similar, with robust growth next year followed by a slowdown in the following years, except for the United States, which is expected to continue growing.

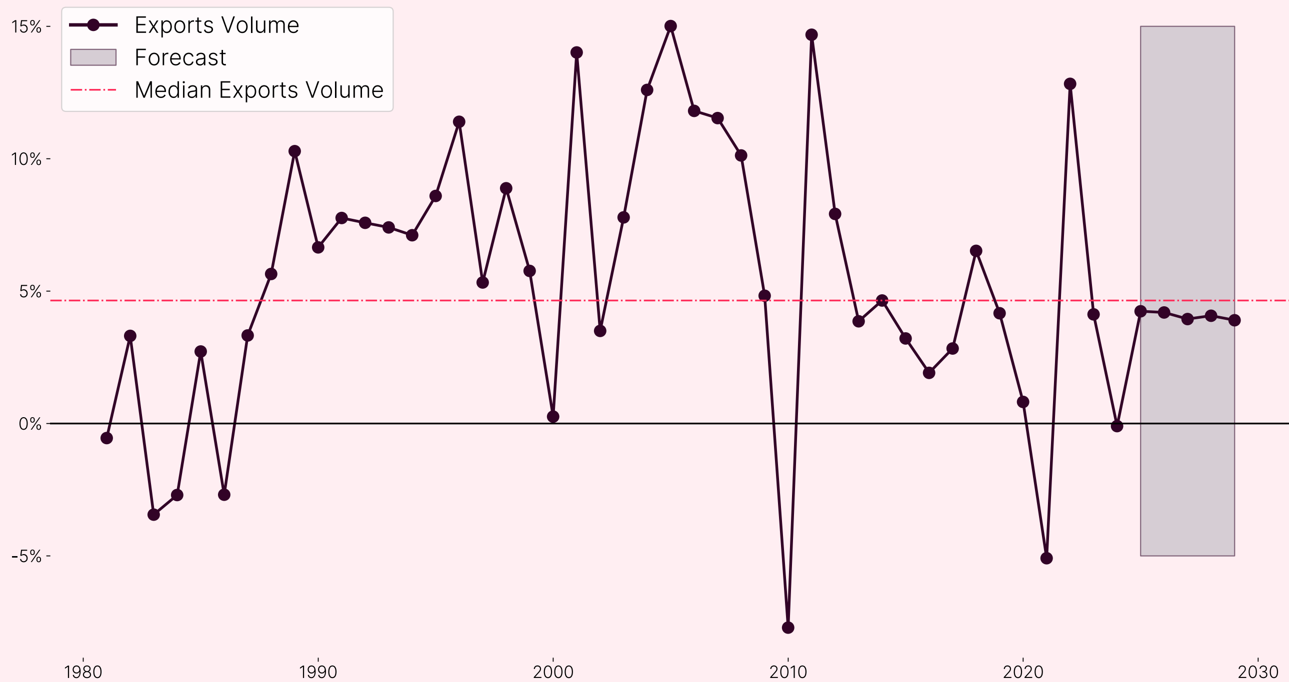
Inflation growth, on the other hand, is expected to normalise by the end of 2025 for all geographies except the United States. These expectations seem consistent with renewed optimism in the US economy, which has performed better than expected and appears capable of avoiding a recession.

“

After years of leading economic indicators marching into uncharted territory, we see the macroeconomic environment returning to a more familiar territory.

”

Export volume of emerging markets in the next 5 years



Source: Moneyfarm Research

For emerging markets, export estimates are relatively stable, close to their historical median, as shown in the following graph.

The volume is expected to remain in line with the historical median, signalling a more robust and sustainable rebound compared to the lows during the COVID period. This statistic is used, among other factors, to estimate long-term expected returns for emerging markets.

The main conclusions about the macro environment we see are:

- No recession is forecasted for the next few years, but growth will slow down in 2025 and 2026 for most countries.
- The United States is expected to continue outperforming but at the cost of a higher-than-target inflation rate.
- Compared to market-implied estimates, inflation expectations seem more optimistic for the United Kingdom (markets predict 4% for the next 12 months compared to about 2% from FMI) and more pessimistic for the United States (only 2.1% forecasted by markets for the next 12 months compared to 2.5%).
- The other main conclusion is that our expected returns (still positive and significantly higher than last year) take into account the fact that long-term growth estimates are rather conservative. This could leave room for a positive surprise in case of stronger long-term GDP performance.

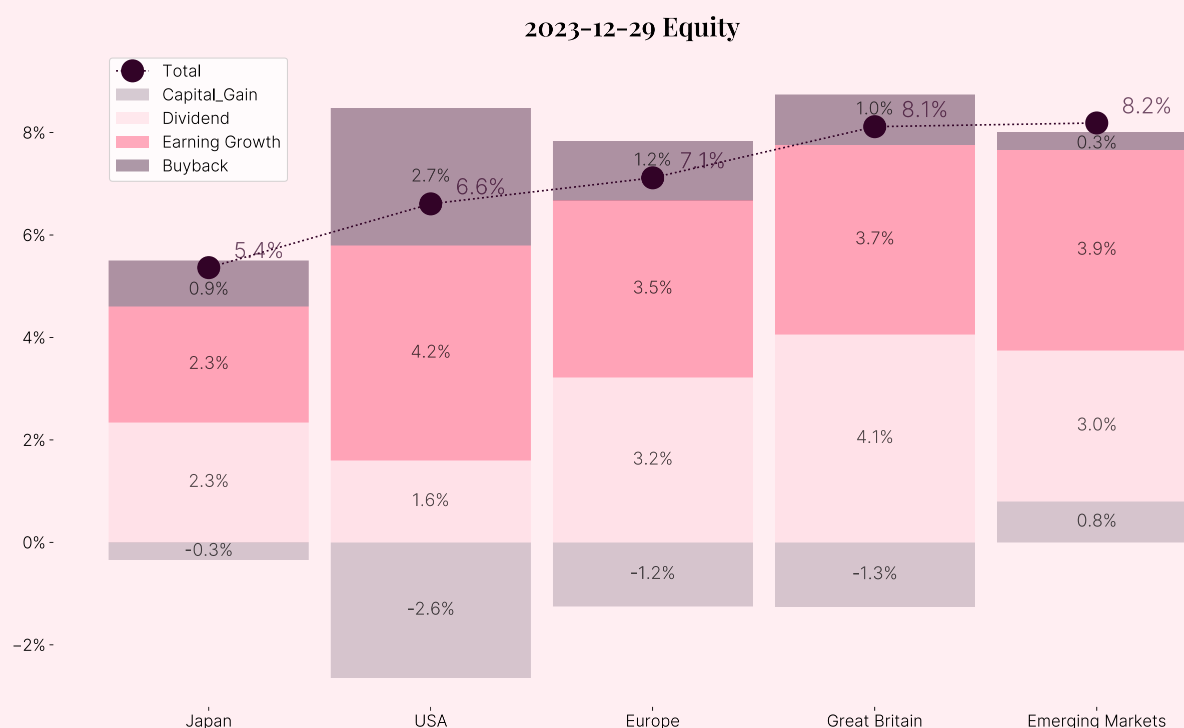
Analysis of expected returns by asset class

Equities

The chart below shows the different components contributing to the expected return (coloured containers) and the total expected return (points). Capital gains (i.e., those due to the return of valuations towards their long-term average) are irrelevant or negative for most countries, while dividend yield and earnings growth account for the majority of long-term expected returns. The United States remains an exception, given its rather high initial valuation.

Overall, emerging markets (EM) represent the best geography, supported by lower initial valuations and strong expected earnings growth. The United Kingdom also appears equally robust, with expected strong earnings growth and high dividend yield.

Expected returns for equity by geography and by key contributors



Source: Moneyfarm Research. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee.

Valuations: Valuations are important because they relate stock prices to earnings. Higher valuations should, all else being equal, lead to lower long-term expected returns. The current level of valuations is slightly above the long-term historical average, which means stocks are somewhat expensive, especially in Europe, the United Kingdom and the United States. This aspect is considered in the earnings growth component of the expected return (in blue on the chart), which has a negative impact on long-term expected performance.

Earnings growth: Earnings growth is a key factor for equity returns as it represents the forecasted growth of companies driving cash flows for shareholders. Our expectations are rather conservative and in line with forecasts of moderate GDP growth. Historically, the median earnings growth per share over the last 10 years for the United States (our largest equity exposure) is about 8%, while we forecast 4.2% for the next 10 years. Nevertheless, this still represents the biggest driver of our expected returns.

Dividends: Dividends and share buybacks are generally the least volatile component of equity returns. We assess dividend yield through the average of the last 10 years.

Government bonds

The expected return for government bonds is composed of three main components:

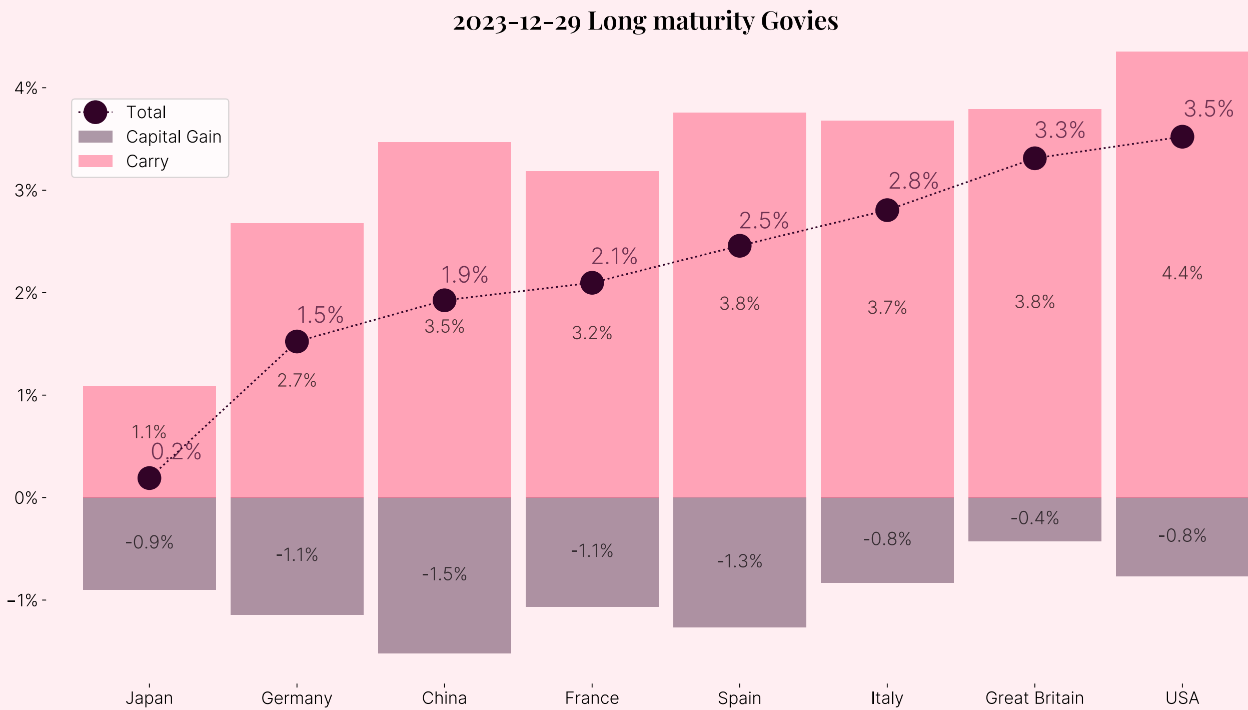
- **Yield to maturity (carry)**: It can be approximated as the coupon yield paid by the bond for its entire duration. Higher interest rates have a positive effect on expected returns but may be correlated with higher risk.
- **Capital gains and losses**: If a bond is not held until maturity, the difference between the purchase price and the selling price of the bond can generate a return or a loss. This price is influenced by interest rate movements. Higher interest rates negatively affect the bond price.
- **Expected default**: This component is generally limited in developed economies. An increase in default risk could generally result in wider spreads, leading to losses in capital gains.

We notice a small difference between the expected returns of short-term and long-term government bonds. The component related to rates (carry) favours short-term government bonds due to the inverted yield curves characterising the current context. The short-term US government bond yields around 4.2% today, while the long-term one has a coupon of 4%.

Regarding the interest rate dynamics, considering the long-term economic growth and inflation of the United States, we estimate that the 10-year equilibrium rate will be around 4.2% for short maturities and approximately 4.9% for longer maturities. This means that we expect a capital loss for long-term government bonds and a capital gain for short-term ones, which we therefore prefer over longer maturities.

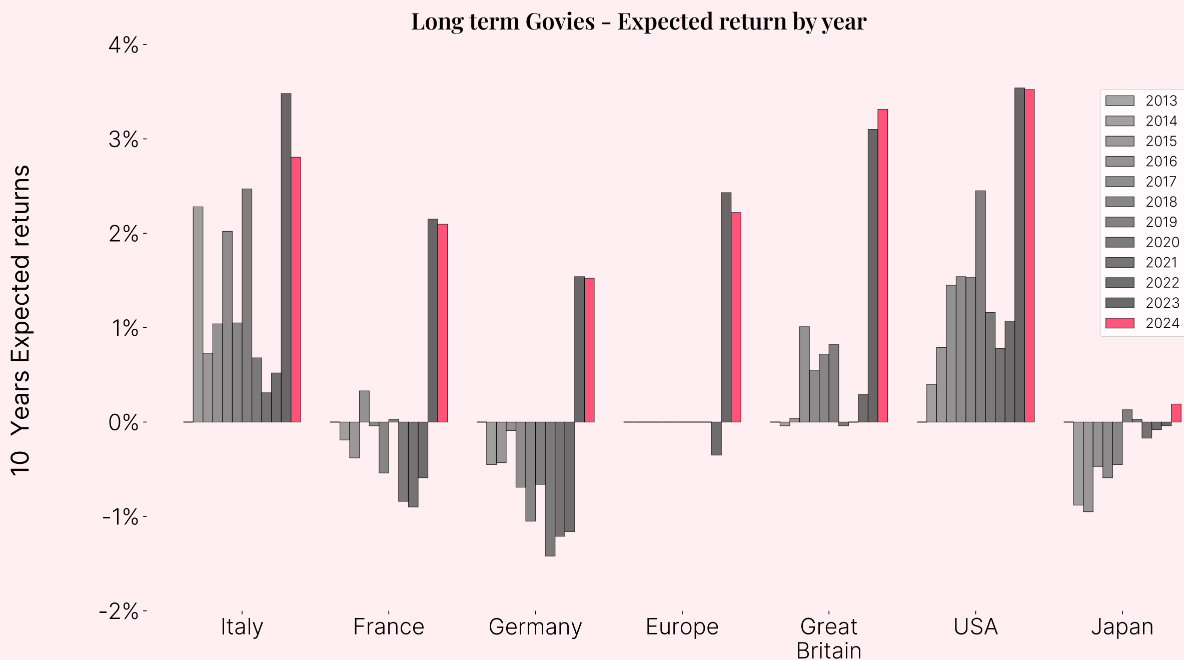
As the graph below shows, the expected returns of fixed-rate government bonds remain solid compared to history. However, as highlighted in our in-depth analysis of bonds, we are reminded that the bond component can perform best within a diversified strategy, given that expected equity returns continue to be higher.

Returns of government bonds in developed markets



Expected yields for government bonds by geography and main contributors. Source: Moneyfarm Research. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee.

Expected returns of government bonds in developed countries compared to history



Expected yields for government bonds by geography and main contributors compared to recent history. Source: Moneyfarm Research. Past performance is not a reliable indicator of future performance. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee.

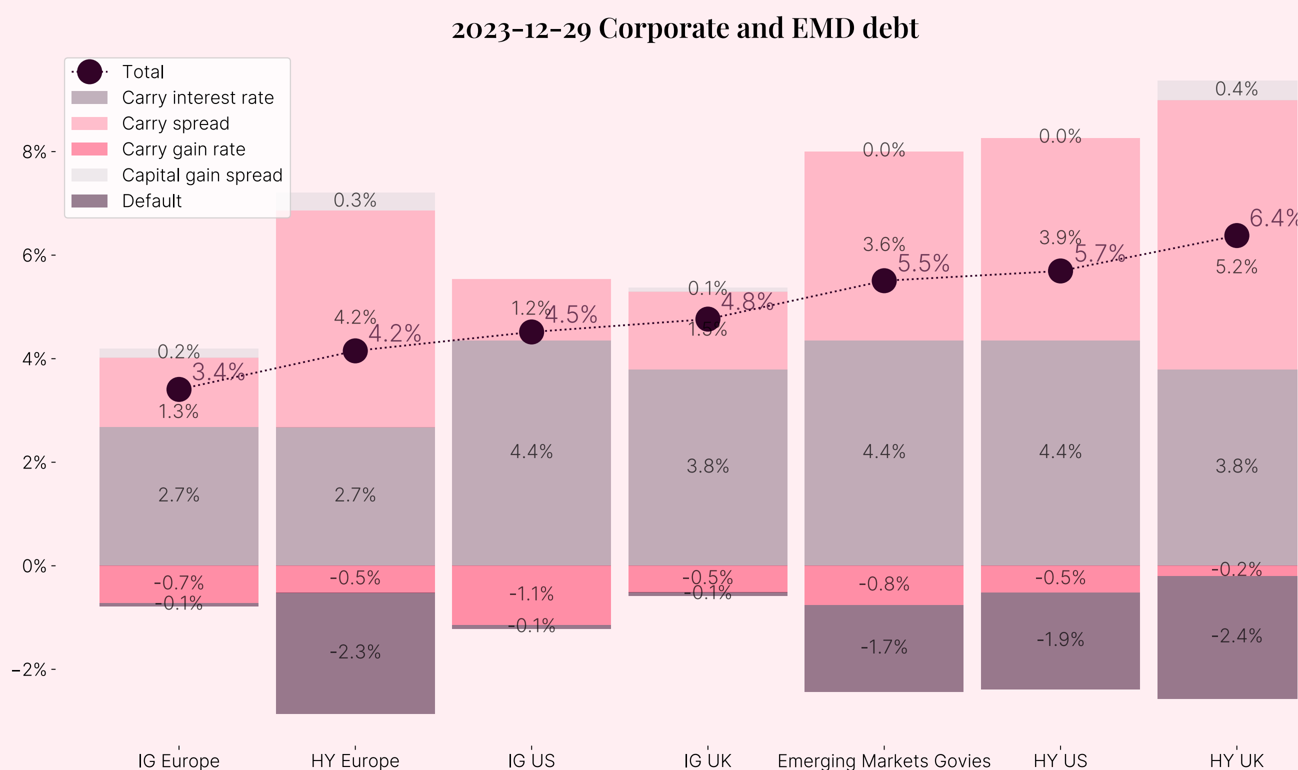
Corporate bonds and emerging market debt (EMD)

All asset classes in the credit space have a very strong expected yield. In fact, the expected yields for all asset classes are the highest ever forecasted by Moneyfarm. High-yield bonds lead the pack, benefiting from both a strong carry (mainly driven by interest rate levels) and good spreads.

Investment-grade corporate bonds follow closely and show excellent risk-adjusted expected yields. In fact, the expected default rate for this asset class is marginal, and they tend to underperform government bonds only under stressed conditions.

Also, emerging markets appear promising, with a slightly lower spread justified by an expected default rate lower than high-yield bonds.

Expected returns of credit by asset class and components



Expected yields for credit by geography and main contributors. Source: Moneyfarm Research. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee.

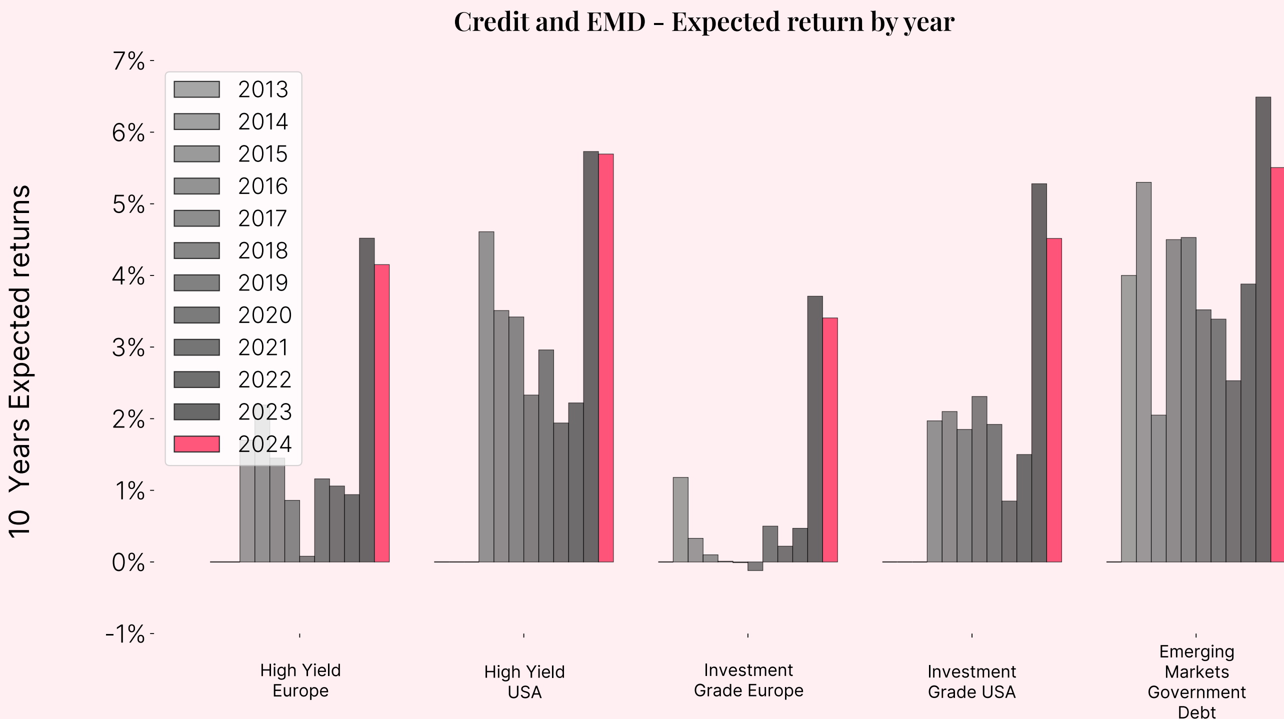
The expected yield for corporate bonds consists of three main components:

- **Yield to maturity**: This can be approximated as the coupon yield paid by the bond for its entire duration. Higher interest rates are positive for expected yield but could be caused by higher risk. The yield to maturity of corporate bonds is measured in terms of spread compared to risk-free government bonds. The spread is the risk premium paid by corporate bonds (you can find the risk-free yield and spread highlighted in light pink and dark grey on the graph). As you can see, summing up these components results in a very strong yield.

- **Gains/losses in capital**: If a bond is not held until maturity, the difference between the purchase price and the selling price of the bond can generate a return or a loss. This price is influenced by movements in interest rates and spreads. Higher interest rates or spreads negatively affect the bond price level (you can find risk-free capital gains and spread capital gains highlighted in blue and light grey on the graph).

- **Expected default**: The bond's default rate. This component tends to be correlated with credit risk. As you can see in the chart above, it is more relevant in high-yield products, which are the riskiest.

Expected returns of credit compared to history



Expected returns for credit by asset class compared to recent history
Source: *Moneyfarm Research.*
Past performance is not a reliable indicator of future performance. Projections are never a perfect predictor of future performance, and are intended as an aid to decision-making, not as a guarantee.

Strategic portfolios

The final stage of the strategic asset allocation process is the creation of our strategic portfolios. Once the spectrum of risk levels is identified, we select different combinations of assets that maximise the expected return for each portfolio. Optimisation was carried out at the end of December 2023.

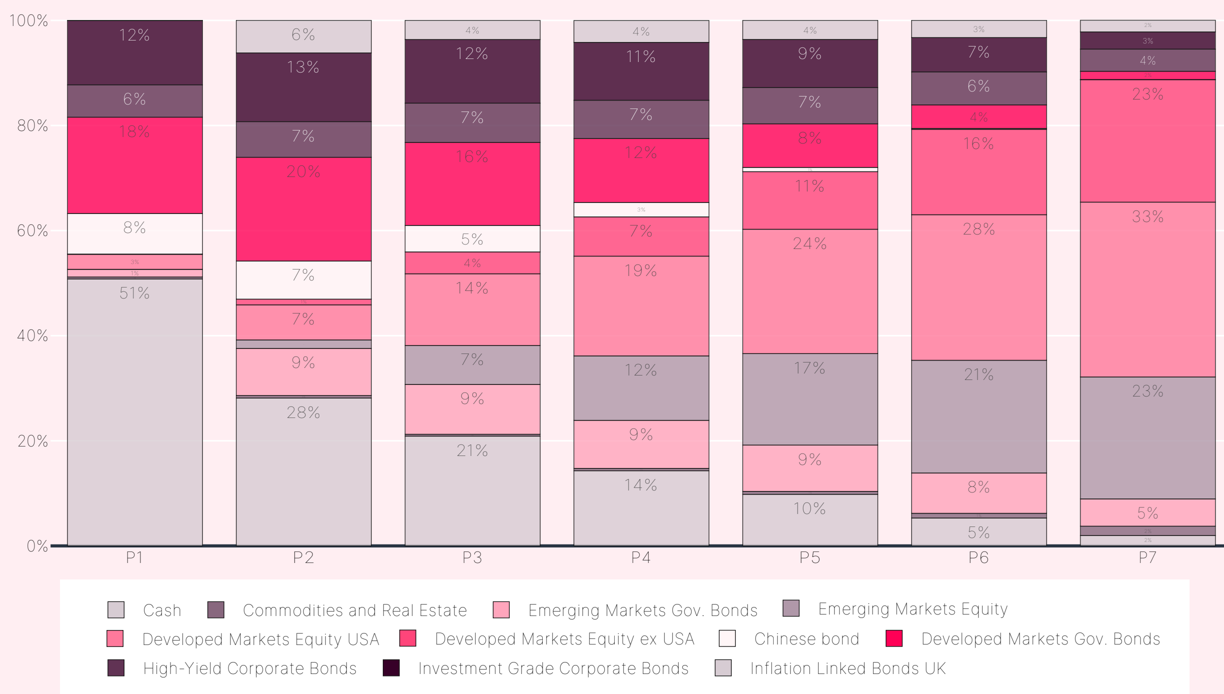
Finding the optimal composition means considering expected returns, expected volatility, and the correlation between different asset classes. To simultaneously consider these three elements, we use mathematical formulas and processes, incorporating precautions against risk underestimation.

Subsequently, quality checks are carried out on both input and output phases. Every assumption - from the risk level of asset classes to the estimation of expected returns and expected diversification benefits - is subject to verification by members of the Asset Allocation team, as well as the Investment Committee.

The result is a series of portfolios that optimise the expected return for the investor at each risk level.

Strategic Portfolios 2024

Here are the strategic portfolios for 2024. Despite the good bond returns, optimal multi-asset allocations continue to heavily rely on equities to maximise long-term returns.



Source: Moneyfarm Research

- The expected returns are positive and higher compared to historical data for all the main asset classes. However, equities still play a key role in optimising returns.
- Positive expected bond returns make this asset class have a very relevant space in portfolios.
- We prefer short-term bonds for developed countries' government securities.
- Portfolios are more oriented towards emerging market equities, liquidity, and commodities due to higher expected returns compared to last year.

Contact us

Support@moneyfarm.com

+44 203 745 6990

As with all investing, your capital is at risk. The value of your portfolio with Moneyfarm can go down as well as up and you may get back less than you invest. If you are unsure investing is the right choice for you, please seek financial advice.

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