INVESTMENT MANAGEMENT

VT Astute Funds

Quarterly Commentary

Q2 2021

Introduction

Thank you for taking the time to read our Q2 commentary. We hope that you and your loved ones all remain safe. As we move tentatively forward with post-pandemic life, it is more important than ever to avoid unnecessary risk, both in our personal lives and in financial markets.

As we took the first steps towards resuming normal life, the first half of 2021 was dominated by economic data, as market participants scrutinised every scrap of information for clues about future growth. With a strong recovery seemingly in progress, attention has now turned to the withdrawal of last year's emergency support measures, a topic I cover in my introductory note this quarter.

In our **Astute Overview** section, we will look in more detail at company earnings and labour markets, both areas where pandemic-related measures have muddied the waters of understanding.

Our regular **Astute Perspective** shows our current 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

The Long Unwinding Road

As the turbulent start to the year settles down into a more sedate summer, it seems a consensus has been established around inflation (probably transitory), the path for interest rates (flat until 2023), and whether "football is coming home" (yes – according to Goldman Sachs). By the time you're reading this, I expect we will know the answer to that last question (for better or worse depending on your allegiances), but given the positive market returns through the end of the second quarter, you could be forgiven for thinking the other two questions were settled as well.

We may have a quiet summer, but the drop in market volatility is as much a function of investors sitting on their hands as it is a 'Goldilocks' mix of global growth and mild inflation. There is little doubt now that the underlying economic rebound from the pandemic is stronger than expected, and that fears around rampant inflation and emergency interest rate rises have moderated significantly. This does not mean those risks are gone, however, nor does it mean there are no new risks to worry about. As prices adjust to more optimistic expectations the hurdle for positive surprises moves higher, and that makes us more cautious in our short-term view. In our Astute Overview, we highlight some early warning signs in earnings, and labour markets, but one area which concerns us less than most is central bank policy, which is what I want to dwell on here.

The next few months will see the US Federal Reserve lay the groundwork for tightening monetary policy, essentially removing some of the mechanisms that supported markets through the pandemic (and before). What might this unwinding road look like, and how rough or smooth a journey can investors expect? The first thing to say is that the two policy levers most central banks have these days are money printing (quantitative easing or QE) and interest rates. The seemingly universal belief is that withdrawal of QE precedes interest rate hikes. You take away the punch bowl before you start on the espressos. Most people only care about interest rates, because they affect 'real life', but ending QE is the canary in the coal mine, and the topic likely to receive the most attention in the next 6 months.

Here it is worth highlighting a few basic principles to counter the often alarmist reporting in this area. QE is the process of printing money and purchasing financial assets (mostly government bonds and mortgages) which then sit on a balance sheet. This process also works in reverse, as bonds and mortgages regularly pay interest or mature, this hands cash back to the bank and shrinks the balance sheet. When QE is active, a central bank is making new purchases every month as well as reinvesting any maturing assets, and so the balance sheet grows (see Astute Observations on the back page). When QE stops, those additional purchases are generally 'tapered' down to zero, but the bank is still re-investing any maturing assets, which keeps the balance sheet steady. Only when quantitative tightening (QT) begins does the balance sheet shrink. This is when maturing assets are not re-invested and any cash returned is magicked out of existence, reducing the money supply.

Luckily, we have been here before and so can learn some lessons. In 2013, the so-called 'taper tantrum' saw asset prices dip, as the market was wrong-footed by a surprise mention of tapering QE. This time around it has been well telegraphed and there shouldn't be any shock when the details are revealed, possibly in July or August. Assuming a similar timeline to 2013, the taper will likely begin in early 2022, with QE totally finished by Q4. Last cycle, it took another 12 months before interest rates went up, and 3 years (plus two more interest rate hikes) before QT was attempted. In summary, it's a long road to walk, and while there may be reasons to worry (see Astute Overview), we don't believe central bank tightening is top of the list.

In summary, we continue to be positive on the outlook for risky assets, preferring equity to bonds, but are becoming more cautious. If positive news slows and expectations remain high we may look to reign in our risk appetite. As always we remain disciplined in our approach, with a focus on long-term objectives, but vigilant to developing short-term risks.

Scott Osborne PhD CFA
Chief Investment Officer

COMPANY EARNINGS – GREAT EXPECTATIONS?

Stronger than expected company earnings through the first half of this year have helped support the continued rally in equity markets. In part, this is because expectations were set so low, highlighting just how difficult it has been for analysts and companies alike to keep up with a fast-changing situation. Just as investment banks failed to fully appreciate the scale of economic damage in Q1 2020 they also failed to appreciate the speed and scale of the rebound. The astonishing success of the vaccination campaign, combined with easing pandemic restrictions, was a surprise to most, and number-crunchers on Wall Street were no exception.

Before the most recent reporting season was underway, analysts expected 25% earnings growth across companies in the S&P 500. In Europe, consensus expectation initially fell as the continent struggled with another wave of COVID-19, before settling around 47%. As earnings starting to roll in, however, it became clear just how wide of the mark these estimates were. The US delivered the best quarter in a decade, with year-on-year increases of 50%. In Europe, where the economy took a heavier hit in 2020, the final number is likely to be over 90%. In both cases, aggregate earnings growth was double analyst expectations, and on both sides of the Atlantic aggregate company earnings now surpass pre-pandemic levels.

Understandably, companies and analysts played it safe when guiding investor expectations through the rebound, but bumper earnings really were needed to justify lofty market valuations. The question now becomes where do we go from here? Well, the glass-half-empty approach seems to be gone. Normally, over the course of a quarter, forward earnings estimates decline. The average decline in S&P 500 earnings has been around 5% over the last 15 years (or 60 quarters). Through the second quarter of this year, analysts increased estimates by 7.3%, the largest increase on record. Smaller upgrades occurred in Q1 also, and as described above, they still fell well short of reality. However, as expectations rise, the hurdle to impress gets higher. If the market starts to price for perfection, the margin for error starts to look worryingly thin. For the next quarter or two, we don't expect this to be an issue; there is still some juice left in the rebound. "Irrational exuberance" may be on the rise, but can be justified by fundamentals in many cases, given the global growth backdrop and the potential consumer spending glut. Looking further ahead, however, headwinds are developing.

The decade-long trend of falling corporate tax rates has clearly gone into reverse. There are already announced increases in the UK, likely increases in the US, and a global minimum tax pact aimed at preventing conglomerates from "inverting" their tax base. It might not be tomorrow, but the writing is on the wall. A second challenge to the reign of global mega-caps is anti-trust legislation, the current poster child of which is Lina Khan, President Biden's newly appointed Chair of the Federal Trade Commission. Khan has been an outspoken critic of dominant technology companies and published a highly critical paper in the Yale Law Journal ("Amazon's Antitrust Paradox") when she was an unknown law student. So threatened by this is Amazon, they have requested Khan recuse herself from any decisions pertaining to them. With digital competition rules already in place in Europe, further steps to limit market dominance is another area that is beginning to feel like an inevitability.

Astute Response:

We remain positive on equities generally, but the relative case has started to weaken, and future analysis will focus more on downside risks. We will push our managers on their growth assumptions, in light of developing trends, and look to exit any strategies where we believe short-term valuations are stretched while simultaneously the long-term investment case is seeing new challenges emerge.

LABOUR MARKETS – MONEY FOR NOTHING

Throughout the first half of the year, nothing occupied more column inches in the financial press than inflation prospects. As discussed in the Q1 commentary, our view is that much of this will prove to be transitory, as base effects and supply bottlenecks settle down. The one area that did warrant closer observation was labour markets and wages. The lack of labour bargaining power has been one of the most significant deflationary forces for decades and any shift in that regime could have consequences in the post-pandemic world.

Economic data provided by government agencies are usually reliable indicators of labour market dynamics. However, the complete shutdown of some parts of the economy, combined with different government support schemes, has muddied the water. One example is the sharp spike in wages in April 2020, particularly in the US, as low-paid retail workers lost their jobs and the average rate of compensation increased. This is more apparent in America where support for workers was paid directly via social security, not via furlough schemes as in Europe. Essentially we've never seen an economy turn off and on like this, and so it's even more difficult to discern the signal from the noise than usual. With that caveat in mind, what can the data tell us about the recovery in jobs?

Non-farm payrolls are a measure of job creation in America and are seen as a key indicator of growth, basically how many new jobs have been created. By this measure, the recovery has been disappointing. This is also supported by unemployment data, the number of people actively looking for a job, which remains above pre-pandemic levels. Contradicting these, however, are "quits" and "openings". The first is the number of people voluntarily leaving their job (the implication being to take up a better position), and the latter is simply the number of jobs available. Both are above pre-pandemic peaks. In fact, some sectors are describing a crippling shortage of workers, resorting to incentives like signing bonuses, contributions to college tuition fees, or even a raffle for a car! The most convincing option is to simply raise wages, which is exactly what McDonald's, Costco, and Walmart have all unveiled plans to do, in order to attract and retain staff. Furthermore, in areas where these large corporates dominate low-skilled hiring, their wage policy becomes the de facto minimum wage. As an example, Amazon pays a minimum of $15 per hour versus the Federal rate of $7.25.

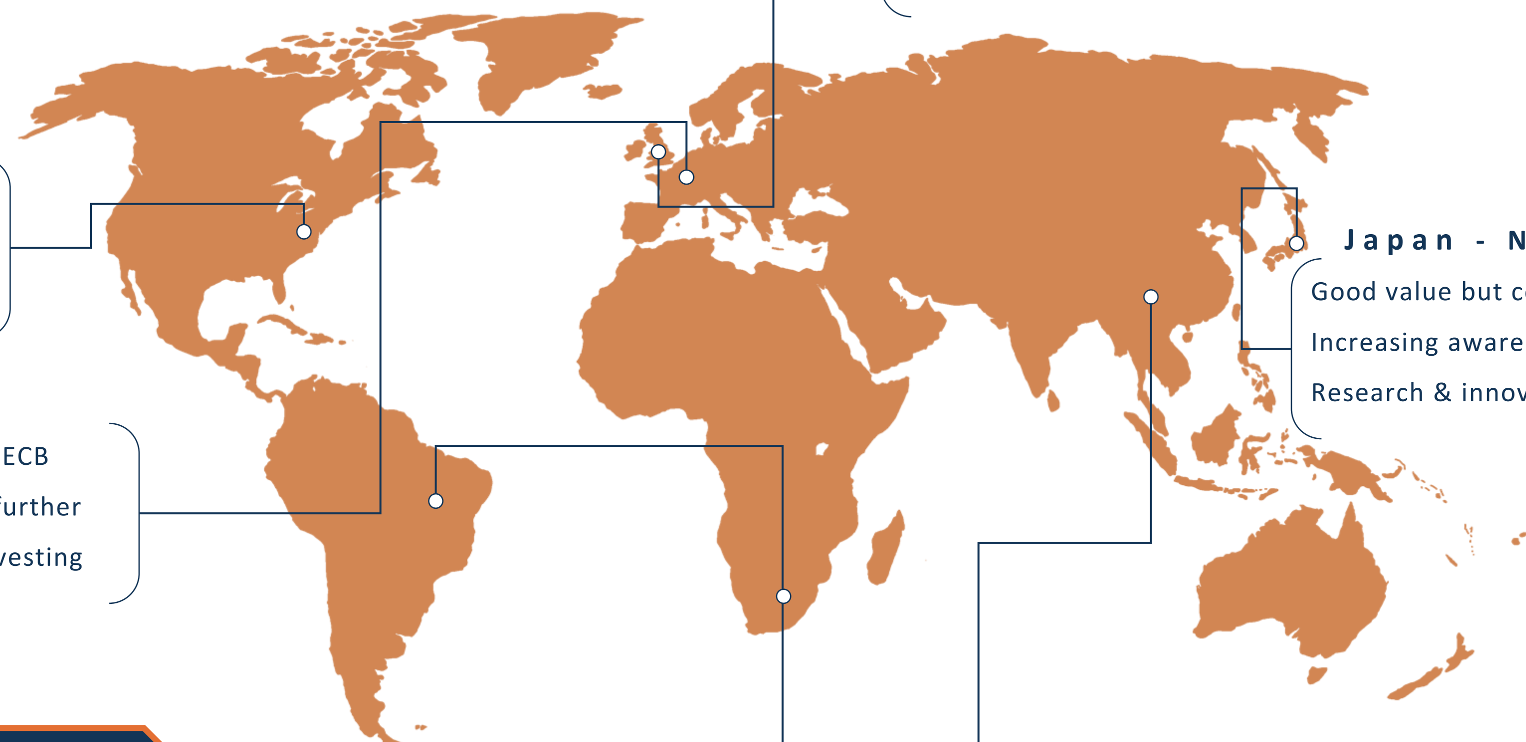
So there are contradictory signals. The disparity between openings and unemployment suggests either a skills or location mismatch. Migration is clearly down, not just across borders but internally too, causing some friction, a factor more pertinent in the UK following Brexit. There has also been a big drop in the number of working-age people actually available for work. Some economists estimate up to two million people retired early in 2020 in the US, but even that leaves around another one million who could work but aren't looking. Other reasons could include childcare issues or lingering fears of viral transmission. One thing that is doubtlessly influencing these numbers is the US CARES act, which effectively pays people to stay at home. Money for nothing is hard to compete with and in response to the sluggish jobs recovery many (Republican) states have slashed aid ahead of the September schedule. A good non-farm payrolls number in June (850k) could indicate those measures have already balanced some of the labour market mismatches, but other factors could persist for longer.

Astute Response:

We continue to see high inflation as a transitory, but increasing evidence of labour market tightness could lead to higher wages and some persistence in inflation. This shouldn't force faster increases in interest rates but may put more pressure on company margins. We become more focused on pricing power and quality, and avoid sectors prone to price competition, where companies may struggle to pass cost increases on to consumers.

Sources: Refinitiv, JPMorgan Asset Management, Factset, Capital Economics, Financial Times

Astute Perspective



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

Europe - Neutral

Fiscal co-operation emerging, supportive ECB

Vaccination delays extending lockdowns further

Global leader in green and sustainable investing

UK – Neutral/Overweight

Larger companies remain structurally challenged

Prefer smaller companies with growth opportunities

Vaccine success key to short-term growth prospects

Japan - Neutral/Overweight

Good value but corporate nationalism persists

Increasing awareness of shareholder activism

Research & innovation remains strong suit

Asia & Emerging - Overweight

Long-term growth from demographics & development

China tightening policy will slow growth versus peers

Vaccination catch-up a short-term hurdle to growth

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

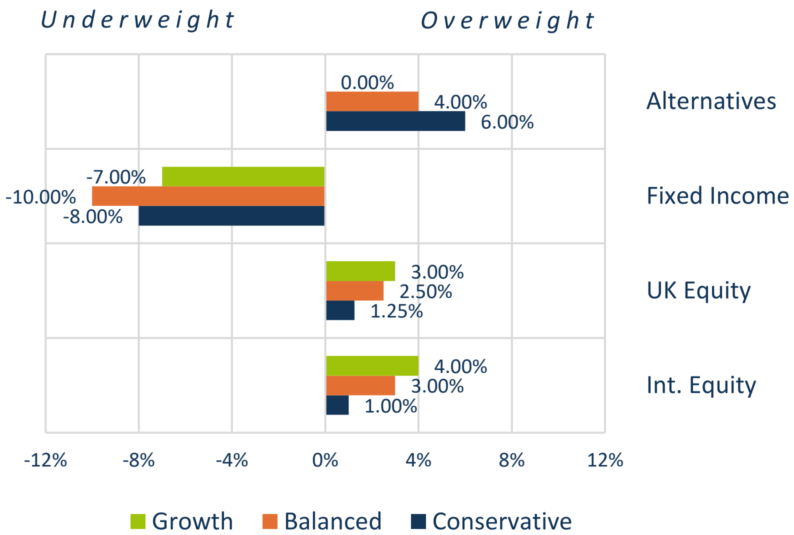
3. Invest Sustainably
   - ESG will become the default option, and the market will shift accordingly
   - If sustainable investing is the future, invest with those who have ESG way into their past

Asset Class Views

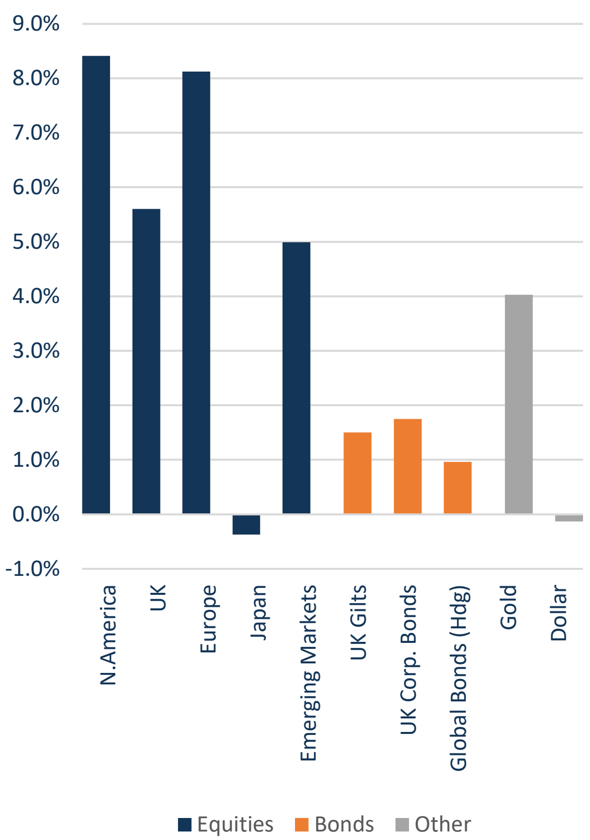
Fixed Income	Negative						Positive
Sovereign Bonds							
Corporate Bonds							
High-yield bonds							
EM Debt							
Alternatives	Negative						Positive

Equities	Negative						Positive
UK							
Europe							
Asia & Emerging							
Japan							
US							

Tactical Asset Allocation[1]



Asset Class Returns[2]



Astute Positioning

Following our cyclical rotation in Q1, we made no further asset allocation change over the last quarter. The high levels of volatility and increased uncertainty in economic data did however lead to some underlying position changes. The focus of these moves was to insulate the riskier parts of the portfolio from potential downside outcomes, principally an inflation surprise, and is discussed in more detail below.

Performance over the quarter was positive. Despite pressure on valuations, company earnings delivered, and this helped support equity markets generally. As the quarter developed, fears around inflation and interest rates also subsided, which helped fixed-income assets recover some of the losses seen earlier in the year. The biggest winners were developed equities, particularly the US and Europe, with the UK close behind. Japan was the only market to fall in Sterling terms, as investors preferred the vaccine roll-out and stimulus story in the west.

The biggest driver of performance for the Astute funds was the continued overweight equity position. Selection was broadly neutral as the growth versus value debate pivoted back towards growth over the period. Bond returns were positive but trailed benchmarks. As interest rate expectations continued to fall from their March peaks, long-duration bonds outperformed. We see this as a temporary blip on an inevitable journey to higher rates, and thus retain our low sensitivity to interest rate movements in this component. Our alternatives had a strong quarter as some of the more cyclical positions linked to real estate benefitted from the continued re-opening trend.

As mentioned above, changes over the quarter focused on tactically protecting against a shock inflation number. This involved an increased weighting to US financials, an area we were underweight due to the general growth bias, and a strong pivot toward value in our small-cap component. While we see our growth managers as fundamentally more attractive on a long-term view, these holdings have a solid outlook for the year ahead and will provide a good hedge if a surprise increase in interest rates materialises.

Elsewhere we continued to expand our real assets holdings within the alternatives bucket. We had been incrementally building positions in property assets over the course of the first quarter and expanded the scope of this through Q2. Starwood European and Real Estate Credit Investments are both trusts which own loans secured against property assets. Both companies are backed by large institutional lenders (Starwood & Cheyne) which dominate lending in Europe. These investments benefit from strong yield potential (6-7%) while retaining a cushion from falling valuations through the loan to value i.e. the property can fall in value and still be worth more than the entirety of the loan, providing an additional level of security compared to owning the property directly. Assets are typically commercial property but with a reasonable degree of “mixed-use” including residential. The cyclical nature of the underlying assets has led to stronger performance as economies reopen, while investing via loans helps retain the protection of seniority in the capital structure.

We also increased our positions in LXI REIT and GCP Student property. LXI is a UK-based property portfolio targeting long leases (usually 20 years or more). The team focus on secure income and a diversified portfolio but have built an excellent reputation in funding the development of small assets for national brands like ALDI, Morrisons, or Costa Coffee. This has added material capital upside to the stable lease income. The other physical property asset is GCP student living, comprising a portfolio of high-quality student accommodation assets, mostly in and around London. This trust continued to trade at a material discount to history despite the improving outlook for students returning to university. With similar assets transacting for much higher valuations in private markets, this offers good potential for short-term capital growth, supported by quality income generation in the longer term.

Fund Activity

New Purchase	Real Estate Credit Investments Ord	Con
	Starwood European Real Estate Finance	Con & Bal
	Xtrackers MSCI USA Financials ETF	Bal & Gro
	SPDR® MSCI USA Small Cap Val ETF	Bal & Gro
Top Ups	River & Mercantile European	Con, Bal & Gro
	GCP Student Living Ord	Con & Bal
	LXI REIT Ord	Con & Bal
Trim	Invesco Physical Gold ETC	Con & Bal
Sold	Gravis UK Infrastructure Income	Con & Bal
	iShares MSCI Europe Mid Cap ETF	Con, Bal, Gro
	iShares MSCI USA SRI ETF	Bal & Gro
	iShares S&P SmallCap 600 ETF	Bal & Gro

Sources: Refinitiv Lipper for Investment Management & Astute Investment Management as at 30.06.2021. 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

MONETARY POLICY - PRINT FINISH

Since the global financial crisis, and the extraordinary monetary response by central banks that followed, there has developed an often-repeated belief that markets only go up when banks are printing money. Indeed, one of the unintended effects of quantitative easing (QE) has been asset price inflation. Printing money and buying assets pushes up prices. This does not mean, however, that markets must fall when QE stops, and the charts to the right show why.

The first chart is simply the Federal Reserve Balance sheet – one of the few charts on which you will ever see a trillion-dollar axis. This highlights two things: the three successive rounds of QE following the GFC, and the magnitude of the response to COVID-19. The period highlighted in red is when the Fed began to taper purchases, and is shown in greater detail in the second chart, alongside the growth in the S&P 500.

This is a very busy chart but stick with it. The blue line is as above, showing the Fed's balance sheet. The orange line shows the growth in the S&P 500 index in US Dollars over the same period. Vertical lines show key policy tightening dates, QE taper in red, and interest rate increases in grey.

The third red line is when QE actually stops and the balance sheet levels off. It starts to shrink again by the fifth red line as quantitative tightening starts. Can markets go up without central bank support? Clearly yes. Cherry-picking the worst period, from the point QE stopped to the drop at the end of 2018, there were nine interest rate rises and around $410bn of QE withdrawn. The S&P 500 returned 75% or an annualised rate of 8%.

Sources: US Federal Reserve, Refinitiv Lipper