Inflection points

Invesco Select Trust plc: Balanced-Risk Allocation share portfolio

Pandemic outbreaks have had profound and lasting effects on societies throughout history. They have decimated cultures, determined outcomes of wars, and wiped out entire populations. They have also been inflection points for society, clearing the way for innovations and advances in medicine, politics and the economy.

One of history's deadliest pandemics was the global outbreak of bubonic plague that claimed one-third of the world's population in the 1300s. Another outbreak occurred in the 1500s and is largely credited with expanding the use of the printing press, which led to the increased literacy rates that paved the way for modern Europe.

At the time, books were generally restricted to the elite because they were rare, expensive and written in Latin. But as the death rate rose, the lower economic classes began to inherit the property of those that had died, enabling them to be able to afford books.

Martin Luther, a German priest seeking to reform the Catholic Church, was one of the first people to harness the power of the printing press. In 1517, he used the new technology to mass produce his preachings and widely distribute them across Europe, marking the beginning of the Protestant Reformation.

The exponential increase in the availability of books radically changed the political power dynamic, but it wasn't until the plague hit Luther's town of Wittenberg in 1527 that the movement accelerated and gained power. While in quarantine, Luther recognized the flexibility of the printing press and created a new format of mass communication – educational flyers posted on church doors. This new format was the Twitter of its day, concisely communicating important information quickly to the masses. It was this new method of communication that accelerated the impact of the Reformation.

A more recent example is the Spanish Flu of 1918, which infected one third of the world's population and by many estimates killed as many as 50 million people. The week before the flu had reached the US, an amendment granting women the right to vote was brought to the Senate floor and failed.

One week later, the pandemic hit the U.S. and the aftermath became an inflection point in American history. It opened new opportunities for women and transformed life in the United States. Having reached its peak at the end of World War I, the Spanish Flu disproportionately affected men. Women stepped in to fill the vacancies left by men in fields that had been previously closed to them like farming, manufacturing and textiles. Women became more visible and proved themselves to be invaluable to society. In 1920, only two years after being denied by the Senate, women had the leverage to ratify the 19th amendment and were finally granted the right to vote.

A century later, much of the developed world is facing multiple inflection points with the Coronavirus pandemic accelerating the rate of political, cultural and economic change. From an economic perspective, inflation poses one of the greatest threats to investors.

We entered the pandemic with low economic growth and historically low bond yields while the impact of the virus on the economy resulted in extraordinary fiscal and monetary stimulus on top of already unprecedented levels of government debt. The response lays the groundwork for inflation, but it is uncertain as to whether it can materialize and persist.

Regardless, if historical form holds, asset class outcomes should look quite different versus the recent decade, leaving investors to question how to best position their portfolio.

Market conditions

We entered 2020 on the coattails of the strong market performance in 2019 which marked the first decade in U.S. history to not record an official recession (since records began in the 1850s). It didn't take long into 2020 to reverse course when Covid-19 began to spread globally.

Surging cases and strict lockdown measures brought economic growth to a halt, sending equity markets into a freefall and the fastest decline into bear market territory in history. The 10yr US Treasury and UK bond yields also fell below 1% for the first time ever. The speed and magnitude of the market decline resulted in an unprecedented fiscal and monetary response. The extraordinary level of stimulus combined with the easing of strict lockdown measures ignited a stock market and commodity recovery with two distinct phases.

The initial stage was stimulus driven, primarily benefitting the technology sector as the economic and social consequences of the pandemic boosted technology platforms in retail, social media, streaming content and remote conferencing. Gold also benefitted from stimulus and the declining U.S. dollar, while industrial metals rallied due to supply constraints and Chinese fiscal stimulus.

The second phase of the recovery started with the arrival of vaccines in November, but markets had to first deal with another bout of volatility as a renewed surge of Covid-19 cases led to a correction in September and October. The vaccine announcements saw the secular growth sectors rally expand to include cyclical sectors that had been hit the hardest in the March drawdown like energy, financials and consumer discretionary, while the commodity recovery saw greater participation by agriculture and energy.

Performance review

The Balanced Risk Allocation share portfolio ended 2020 in positive territory, with a net return 5.9%[1] over the year. Strategic bond exposure provided the largest contribution followed by stocks, while commodities produced gains in three of four sub-components, but losses in energy led to a net negative contribution.

Tactical allocation contributed to results led by commodities, which benefited from underweights to energy early in the year and timely overweights to energy and industrial metals as economies and markets recovered. Tactical equity finished the year with gains as timely overweights during the recovery outweighed losses from overweights during the Covid-19 decline. Tactical positioning in bonds produced flat results as gains from overweights during the first half of the year were negated by minor overweights in the second half of the year as yields rose.

Asset class review: Stocks

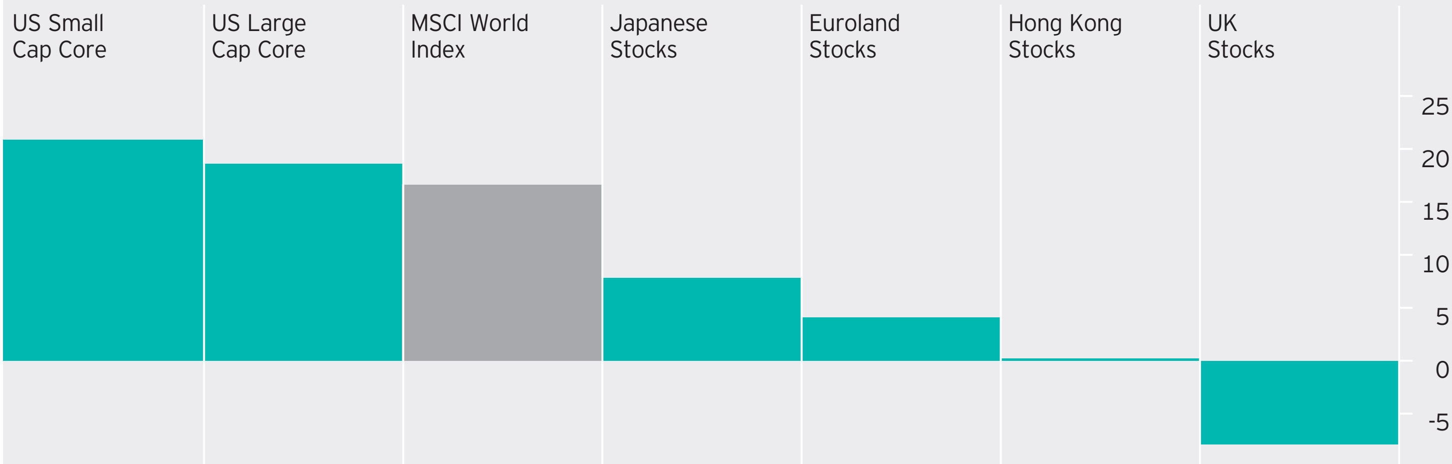
Global equities saw five of our six strategic stock exposures post positive returns. Despite several markets hitting new or multiyear highs, the path from March lows was volatile, swinging between risk-on and risk-off periods before news of an effective vaccine caused a year-end rally.

The magnitude of recovery varied across regions, largely depending on sector exposure and their ability to contain the virus and lift lockdown restrictions. US equities were the top contributor primarily due to the high allocation to technology and low energy exposure in the early stages of the recovery. Five of the largest firms that drove the recovery are US companies (Microsoft, Apple, Amazon, Alphabet, Facebook), boosting relative performance given they benefitted from COVID. US stocks closed the year at all-time highs with small caps outperforming large caps. The Russell 2000 had numerous names deliver double, triple and even quadruple-digit gains. The big winners came from biotech and clean tech that got an added boost with Joe Biden's election as President.

Japanese equities contributed to results but significantly lagged the US despite a less severe COVID outbreak given the country's larger industrial base. The Japanese stock market ended 2020 at multi-decade highs and returned to levels not seen since the early 1990s. Hong Kong posted minor positive returns for the year. The country had already been crippled by a recession sparked by political unrest when the pandemic hit, further compounding losses. Mainland China was able to open their economy much earlier than other countries since they were the first to contract the virus. The early recovery in China boosted Hong Kong performance in the second half of the year but the island nation had a bigger hill to climb relative to other countries.

The European stock markets delivered small gains as the broader economy remained suppressed longer than Asia and the US as lockdown measures were more restrictive, while the scale of their fiscal and monetary response also lagged China and the US. UK equities were the worst performing market given the country was slow to contain the first and second wave of the virus. From an index perspective, the FTSE 100 has higher exposure to energy that hurt early in the year but only low single-digit percentage exposure to the technology sector that led the recovery. The uncertainty around Brexit, despite finally being granted formal approval, further weighed on UK market results.

Figure 1
Representative stock performance returns (%)



Sources: Bloomberg and Invesco analysis. Data as of 31 December 2020 based on continuous future return indices. Euroland represented by the Euro Stoxx Index, Hong Kong represented by the Hang Seng Index, Japan represented by the Topix Index, UK represented by the FTSE 100 Index, US large cap core represented by the S&P 500 Index, US small cap core represented by the Russell 2000 Index. An investment cannot be made directly in an index. **Past performance is not a guarantee of future results.**

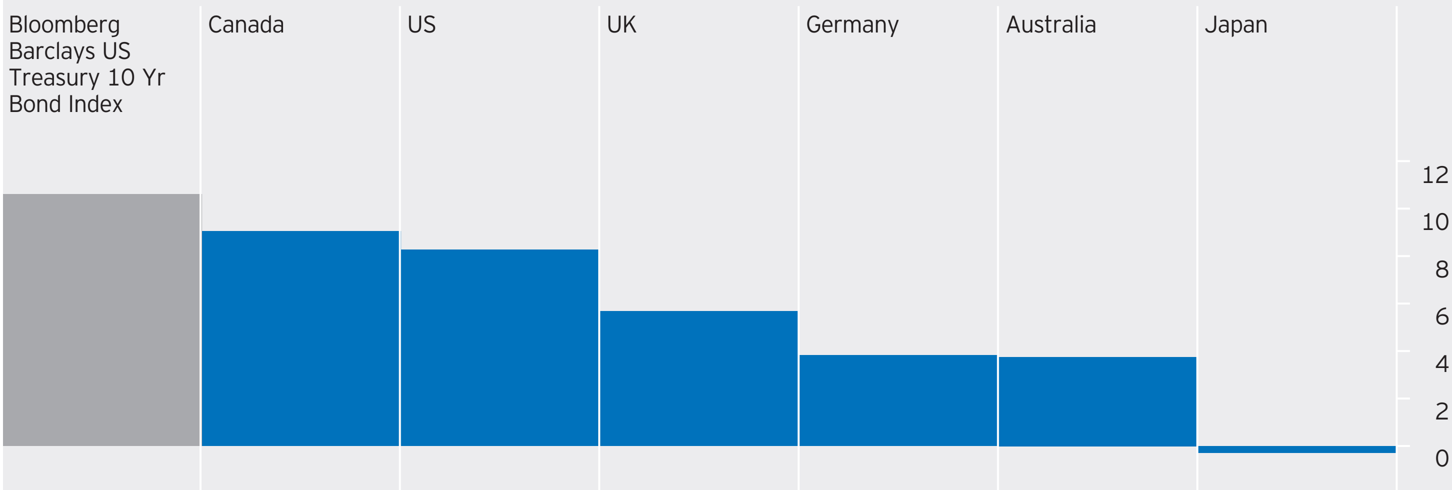
Asset class review: Bonds

Government bonds led performance for the year with five of the six markets in our universe posting positive returns. Gains were concentrated in the first half of the year as the deflationary economic shock led investors to safety, causing yields to reach all-time lows for all markets in our universe except Japan. Downside protection was reduced, however, due to a credit crisis triggered by a wave of liquidation selling in March which caused bond prices to reverse as government bonds provided a source of liquidity.

Central bankers stepped in to stabilize markets, fuelling a recovery. Bonds then traded in a sideways consolidation pattern for much of the second half due to the unprecedented level of policy rates and firm commitments from central banks to maintain the historically low levels for the foreseeable future. The meaningful expansion of quantitative easing programs which target many of these bonds for purchase to inject liquidity into economies also further dampened volatility in bond prices. Yields did start to rise later in the year as vaccines raised expectations for higher growth and inflation.

Canadian bonds led within our universe as the Bank of Canada (BoC) cut rates and began weekly asset purchases of Canadian government and corporate bonds at the onset of the recovery. US Treasuries trailed Canadian bonds as the Federal Reserve cut interest rates to zero along with implementing unlimited quantitative easing. 10-year US Treasury yields bottomed in August before almost doubling by year end as markets priced in higher growth and inflation. UK Gilts contributed to performance as the Bank of England cut interest rates and provided loans directly to businesses. UK exposure within the portfolio was minimized throughout the second half of the year due to low yields approaching the zero bound. Australian government bonds also provided positive contribution as Covid-19 caused the country to finally experience a recession, breaking a 30-year streak of positive economic expansion. The contraction was short lived, however, as growth was reignited by demand from China, the country's largest trading partner.

Figure 2
Representative bond performance returns (%)



Sources: Bloomberg and Invesco analysis. Data as of 31 December 2020 based on continuous future return indices. Australian government bonds represented by the SFE Australian 10-year Treasury Bond Index, Canadian government bonds represented by the ME 10-year Canadian Government Bond Index, German government bonds represented by the Eurex-Euro Bund Index, Japanese government bonds represented by the TSE 10-Year Treasury Bond Index, United Kingdom government bonds represented by the LIFFE-Long Gilt Index, US government bonds represented by the CBT 10-Year Treasury Note Index. **Past performance is not a guarantee of future results.**

Asset class review: Commodities

Unlike stocks, commodities don't discount future cash flows; rather, their prices reflect a more concurrent outlook on supply, demand and economic conditions. As a result, commodities began their decline in January when China was the epicentre of the virus and didn't begin to recover until May once lockdown orders were eased and the US dollar began to fall.

Commodities prices were heavily driven by falling demand but were also impacted by bottlenecks in the supply chain once demand began to rise, particularly for metals and energy. Despite gains in agriculture and metals, losses in energy resulted in commodities delivering a negative contribution to net returns.

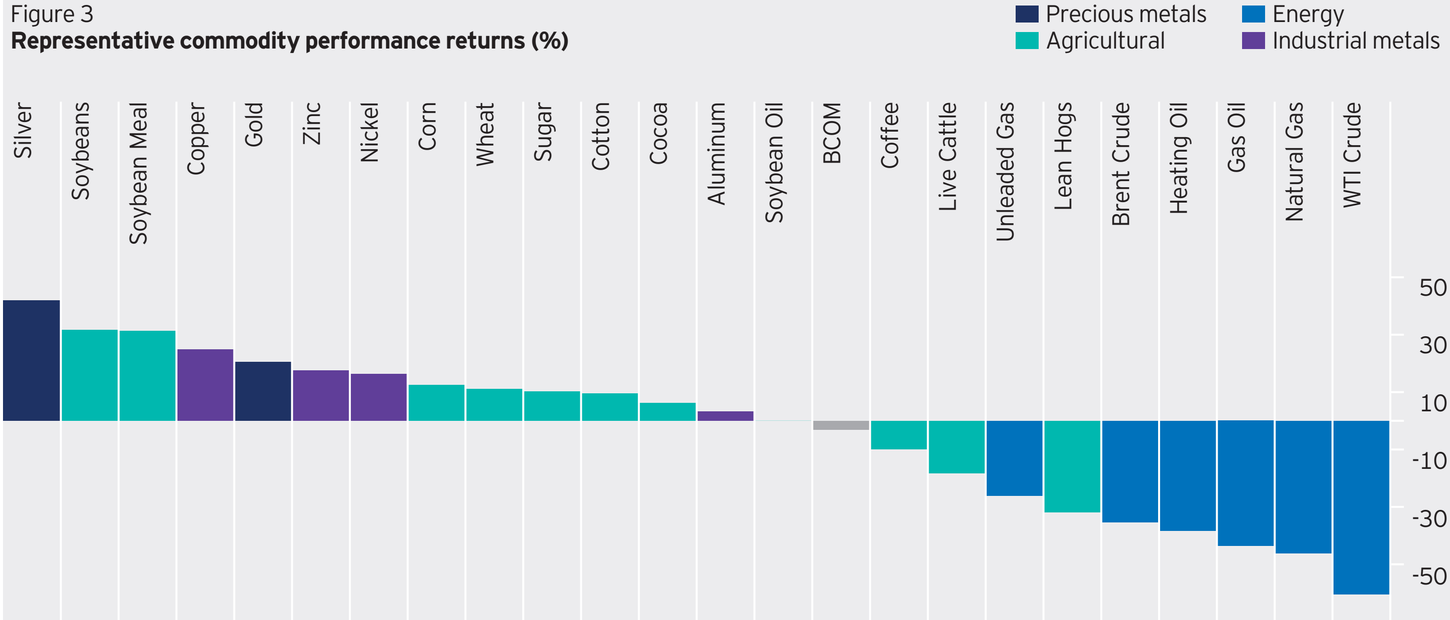
Energy was hit the hardest as COVID-19 reduced transportation demand while Saudi Arabia made the devastating decision on 9 March to engage in a price war. Oil prices plummeted with WTI crude hitting a record low negative price in April. Prices rallied but then consolidated for the next few months before resuming their recovery in the fourth quarter as optimism surrounding COVID-19 vaccines raised demand expectations. Supply constraints added to the late year rally as OPEC maintained production cuts and US oil output declined as rigs were taken offline.

The precious metals complex plunged during March's liquidation selling, but then quickly rebounded due to record fiscal and monetary stimulus given the resulting decline in real yields. Silver was the big winner as it had numerous factors driving its price higher including inflationary policies, its crossover uses as an industrial metal and as an input into clean energy including solar panels. After reaching all-time highs in many global currencies over the past couple of years, the month of August saw gold finally reach an all-time high in US dollars.

After initially plunging with the global spread of COVID, industrial metals ended the year as a positive contributor. Copper led the complex due to a strong recovery in Chinese manufacturing, while the tight supply for the metal was made worse as many metals mines either slowed or halted production altogether.

Agriculture began its recovery in the third quarter led by grains, and more specifically, the soy complex. Soymeal and soybean prices were driven higher by demand for feed from China as the Chinese work to rebuild their hog herds after they were decimated by swine flu last year. Supply constraints also put upward pressure on prices due to dry weather in South American growing regions, while a shipping strike in Argentina blocked corn and soybean exports from the country just as the US Department of Agriculture made further reductions to its 2020/2021 soybean production estimates and stock levels.

Figure 3
Representative commodity performance returns (%)



Sources: Bloomberg and Invesco analysis. Data as of 31 December 2020 based on continuous future return indices. Commodities represented by the Bloomberg sub-indices (price returns). An investment cannot be made directly in an index.
Past performance is not a guarantee of future results.

Outlook

Financial markets have entered 2021 with a sense of optimism as Covid-19 vaccines are available and being distributed while fiscal and monetary support remains at extreme levels. Despite our investment process being systematic and data driven, we can make some broad observations on the near-term environment.

In our view, many developed market economies are set to experience a positive rate of change in GDP at a magnitude not seen since the World War 2 era. Additionally, it's difficult to find a better environment for inflation comparisons than a starting point that includes negative oil prices. We believe that the expected increase in growth and inflation provide a favourable environment for global equity markets, including dollar sensitive emerging markets and small cap equities as well as commodities; however, rising prices and valuations make markets more vulnerable to unexpected shocks similar to early 2020. Should markets continue to rise the critical question becomes what happens after the easy base rate comparisons off 2020 lows?

While the fear of rising interest rates has been a popular narrative over the last decade, global bond markets have actually delivered record low levels of interest rates, including negative yields. As a result, the role of government bonds within multi-asset portfolios is coming under increased scrutiny just as segments of the global equity market reach record valuations.

The search for a replacement of the defensive qualities that bonds bring to a portfolio has become even more critical. Over the course of many decades, bonds have demonstrated their ability to provide both a positive offset during periods of weakness in global equity markets and an incremental return to a portfolio. In other words, they have offered a unique insurance -like payoff without the drag of premium payments. Therefore, low current yields suggest that the portfolio's concise risk management and diversification framework needs an update. Our research is near completion on this matter and updates will follow as we get closer to full implementation.

While the 19th Amendment was a monumental accomplishment for women and broader society, it was inevitable given the social and economic change occurring at the time. But not all the forthcoming change will have as favourable an outcome.

Consider the preceding 18th Amendment that prohibited the manufacture and sale of alcohol in the United States. Prohibition was referred to as a noble experiment in motive and purpose by President Hebert Hoover. While the intention of the law was noble, the impact was detrimental as it proved difficult to enforce and actually led to higher crime. Change also does not come easy and today's highly polarized political environment is taking on characteristics of the Protestant/Catholic divide with each side taking to moral high ground and quick to point out the sins and failings of others while ignoring their own.

For investors, the uncertainty of future policy makes it necessary to be prepared for a range of outcomes. Balanced-Risk Allocation share portfolio offers a globally diversified, risk managed, portfolio that can help navigate changes in the economy and markets through a combination of strategic and tactical allocation.

Figure 4
Balanced Risk Allocation share portfolio
Standardised rolling 12-month performance (%)

	31.12.15 - 31.12.16	31.12.16 - 31.12.17	31.12.17 - 31.12.18	31.12.18 - 31.12.19	31.12.19 - 31.12.20
Ordinary share price	10.6	8.2	-5.6	9.9	5.9
Net asset value	13.0	8.8	-7.7	13.1	7.8

Past performance is not a guide to future returns. Ordinary share price performance figures have been calculated using daily closing prices with dividends reinvested. NAV performance figures have been calculated using daily NAV with dividends reinvested. The NAV used includes current period revenue and values debt at fair. The Benchmark performance shown is total return. All performance figures are in sterling as at 31 January 2021 unless otherwise stated. Standardised past performance figures are updated on a quarterly basis. Source: Morningstar.

Risk Warnings

The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested.

When making an investment in an investment trust you are buying shares in a company that is listed on a stock exchange. The price of the shares will be determined by supply and demand. Consequently, the share price of an investment trust may be higher or lower than the underlying net asset value of the investments in its portfolio and there can be no certainty that there will be liquidity in the shares.

As a result of COVID-19, markets have seen a noticeable increase in volatility as well as, in some cases, lower liquidity levels; this may continue and may increase these risks in the future. In addition, some companies are suspending, lowering or postponing their dividend payments, which may affect the income received by the Invesco Select Trust plc UK Equity Share Portfolio and the Invesco Select Trust plc Global Equity Income Share Portfolio during this period and in the future.

Fixed income securities may not always make interest and other payments nor is the solvency of the issuers guaranteed. Market conditions, such as a decrease in market liquidity, may mean that the product may not be able to sell those securities at their true value.

The product makes significant use of derivatives for investment purposes, which may result in the product being significantly leveraged and may result in large fluctuations in the NAV.

The product has exposure to commodities which are generally considered to be high risk investments and may result in large fluctuations in the NAV.

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