Drummond Dynamic Portfolio

Quarterly Investment Review – Q2 2022

We believe we are in an era of increased volatility and uncertainty regarding future asset class returns. The Drummond Dynamic Portfolio (DDP) has been created to provide exposure to a diversified set of global investments, with the aim of protecting capital in bad periods and growing wealth in good periods. This is our core, dynamically managed multi-asset investment portfolio.

Market Overview

Equity markets were weaker again in the second quarter, as higher for longer inflation risks increased near term uncertainty for investors

Global equity market weakness intensified in the second quarter. Weakness was broad based, with the MSCI ACWI index falling -13.5% in local terms and the Australian ASX200 falling -11.9%. The Nasdaq and Australian property sectors fell hardest (-22% and -17% respectively) while Japan and infrastructure fared better (though still negative). Central banks began lifting rates in earnest, with the RBA taking its cash rate from 0.1% to 0.85% and the Federal Reserve from 0.5% to 1.75% in the quarter. The spectre of stickier inflation and slower growth drove the weakness in the most interest rate-sensitive sectors and led investors to more defensive areas of the equity market. Value continued to outperform growth as a style, and fears over the impact of higher interest rates on valuations have now compressed market multiples at the 5th fastest rate in ~60 years.

As inflation fears intensified, so too did selling in the bond market, extending the selloff with volatility peaking after the release of the May US CPI data. Australian and US 10yr bonds fell -3.2% and -4.3% respectively for the quarter. Given the weakening economic outlook, corporate debt was also poor with investment grade and high yield spreads wider by 0.4% and 2.4% respectively.

Despite selling off in June, commodities were positive over the quarter with oil rallying over 7% and broader commodities (S&P GSCI Commodity Index) up 2%. Gold prices fell -7% while the AUD fell almost -8%.

Portfolio Performance & Review

Increasing government bond exposure as prices fell and the underperformance of develop market equities detracted from the relative performance of the portfolio over the quarter

Over the quarter, the Dynamic Portfolio returned -5.5%*. This was behind the FE AMI Mixed-Asset peer index that returned -4.8% over the period. As is shown in the table below, the portfolio continues to perform strongly when compared to the institutional peer group.

DRUMMOND DYNAMIC PORTFOLIO PERFORMANCE HISTORY

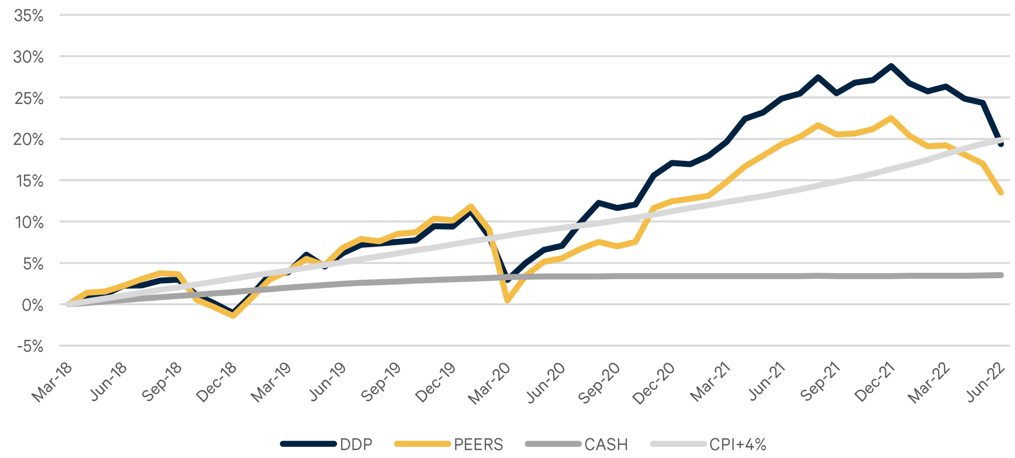
	3 month	6 month	1 year	3 year p.a.	Inception p.a.
Dynamic Portfolio*	-5.5%	-7.3%	-4.4%	4.0%	4.3%
Peers**	-4.8%	-7.4%	-4.9%	2.0%	3.0%
Outperformance	-0.7%	0.1%	0.5%	2.0%	1.2%

Source: Drummond Capital Partners, *BT Panorama, Refinitiv; **FE AMI Mixed Asset – Flexible Sector

The portfolio underperformed peers over the second quarter. Our allocation to Australian government bonds and the underperformance of developed market equities hurt the relative performance of the portfolio over the quarter. While the portfolio is much more balanced in terms of manager style than historically, this still detracted as value significantly outperformed other styles. The portfolio continues to be well diversified by asset class and manager.

The changes made to the portfolio during the quarter consisted of marginally reducing Australian equities in favour of global alpha and reducing global equities in favour of infrastructure and bonds. Corporate debt exposure was also reduced in favour of Australian government bonds as the bond selloff intensified. These changes improved the portfolios overall quality and defensiveness. Combined, these changes took overall growth asset exposure from 55% at the beginning of the quarter to 47% at quarter's end.

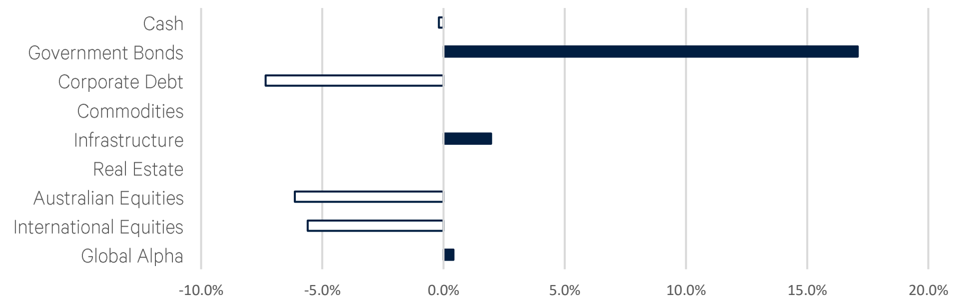
DRUMMOND DYNAMIC PORTFOLIO RETURN vs. PEERS**



Source: Drummond Capital Partners, Refinitiv, BT Panorama; ** FE AMI Mixed Asset – Flexible Sector

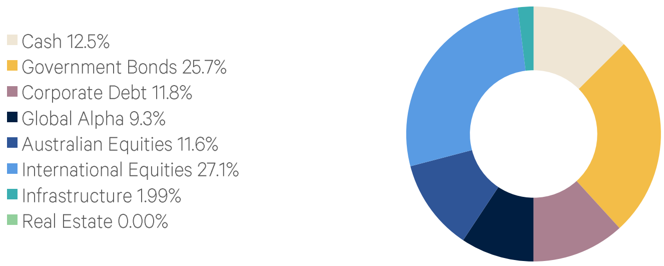
Allocations to growth assets were reduced as was exposure to corporate debt in the quarter while government bonds were increased

PORTFOLIO ASSET ALLOCATION CHANGES – Q2 2022



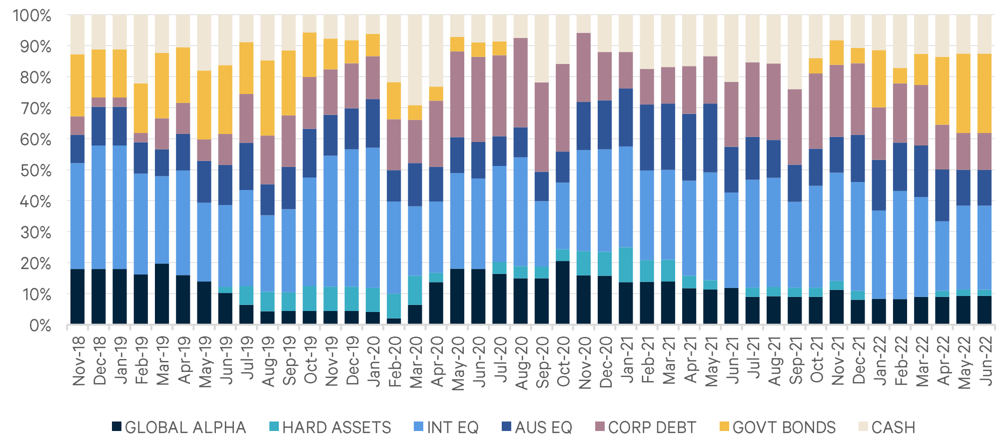
The portfolio is underweight growth assets, overweight cash and government bonds

PORTFOLIO ASSET ALLOCATION – Q2 2022



International equities and government bonds are the biggest asset class exposures

PORTFOLIO ASSET ALLOCATION HISTORY

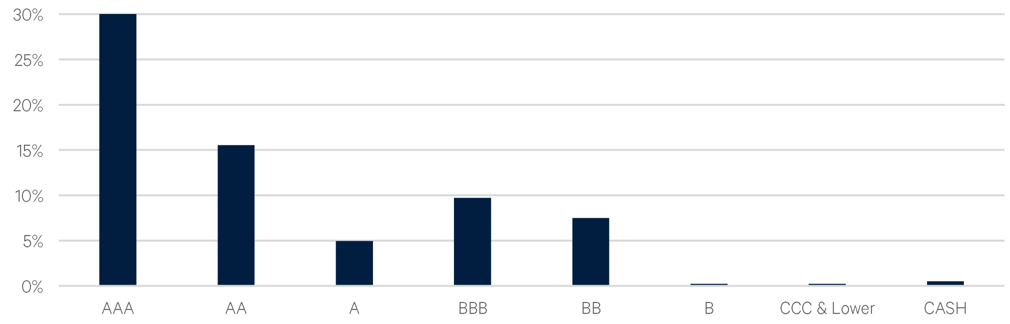


Corporate Debt

We continue to reduce overall credit exposure and have increased fixed vs. floating credit given the relative performance over the quarter

Credit markets remained weak during the quarter as the inflation/growth mix resulted in concerns over corporate margins and the increased likelihood of defaults in the coming 12 to 24 months. US Investment Grade credit spreads widened from 1.22% to 1.64% over the quarter, while US High Yield underperformed as spreads widened from 3.43% to 5.87%. Our preference for floating rate credit helped buffer against losses suffered by the broader sector over the quarter however we further reduced exposure given the weaker medium-term growth outlook.

PORTFOLIO LOOK THROUGH CREDIT GRADE EXPOSURE (CORPORATE DEBT & GOVERNMENT BONDS)



Source: Drummond Capital Partners, manager reports

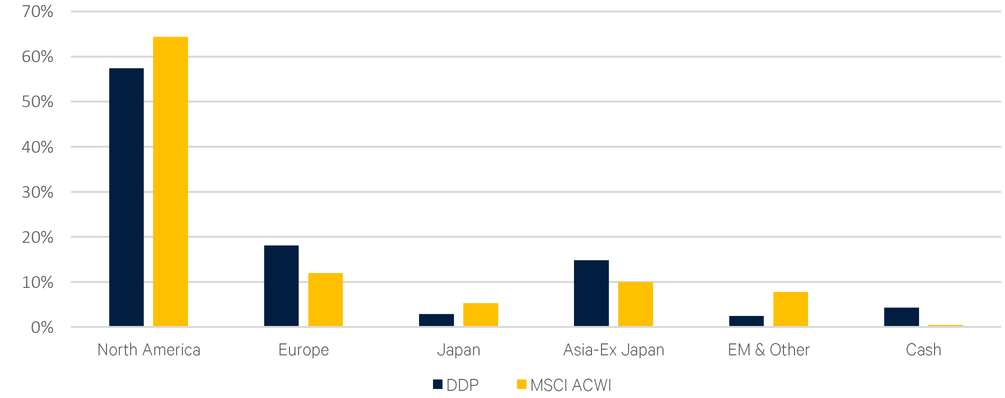
Government Bonds

We continued to add to Australian government bonds during the quarter as prices fell further

Government bond prices fell further over the second quarter due to ongoing strong inflation prints. The anticipation of expedited rate hikes led to yield curve flattening, however US 10yr yields still widened 60bps to 3.0%. Given the deteriorating liquidity backdrop, Australian bonds were more volatile with 10yr yields moving from 2.7% to 4.2% at the worst of the sell-off. As concerns over economic growth grew and commodity prices fell, buyers stepped into the market and Australian 10yr bonds finished the quarter yielding 3.7%. We continued to add to exposure to Australian government bonds during the sell off, leaving the portfolio with its biggest bond exposure since inception. As we said last quarter, we think there is value in government bonds with inflation likely to peak and economic growth slow.

International Equities

PORTFOLIO LOOK THROUGH COUNTRY EXPOSURE vs. BENCHMARK



Source: Drummond Capital Partners, manager reports

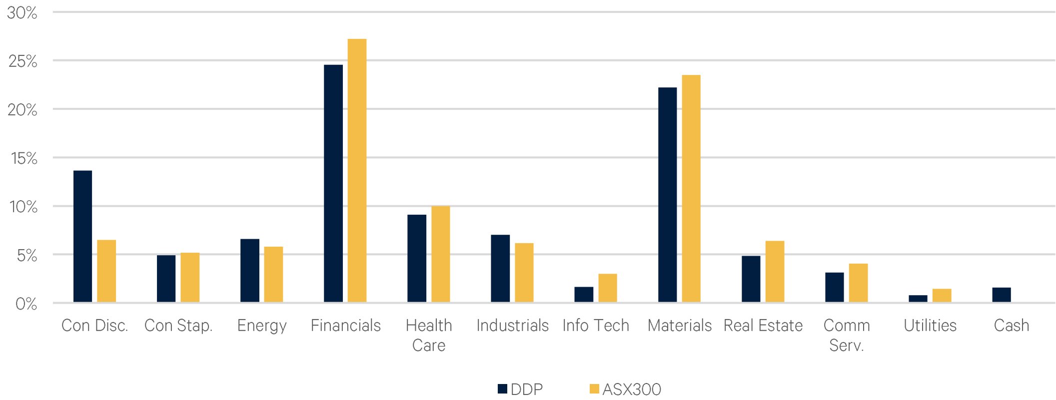
Developed equity markets fell heavily in the quarter as high inflation and slowing growth weighed on the outlook

World equities (MSCI ACWI) fell heavily in the second quarter, retreating 13.5% in local terms. Attempts to regain ground were made in May though the release of the stronger than expected CPI data saw markets continue to lose ground over the quarter. Emerging markets outperformed developed markets on the back of cheaper starting valuations and the Chinese government acting to stimulate rather than cool economic growth. Valuation compression saw growth managers continue to underperform value managers. We are increasingly wary of the ability of value managers to continue to outperform however given the typical bias towards more economically sensitive exposures. The portfolio's exposure to global equities was reduced over the quarter in favour of infrastructure and bonds. While valuations have fallen a lot this year, they are not yet cheap, and earnings strength in the energy sector is masking already falling earnings estimates for the broader market.

Australian shares had another strong relative quarter despite underperforming late in the quarter on weaker commodity prices

Australian Equities

AUSTRALIAN EQUITIES SECTOR EXPOSURE vs. BENCHMARK



Source: Drummond Capital Partners, ASX

Australian shares fell 11.9% over the quarter, outperforming global equities again after a strong relative Q1. While the domestic market had benefitted from investor rotation towards defensive value sectors and commodities, as the second quarter dragged on this became a headwind. The threat of continued high inflation pressures that drew central banks into faster rate increases brought with it increased concern over global growth as well as a higher USD. This is the worst mix for commodities which weighed significantly on the market late in the quarter. Overall exposure to Australian shares was decreased over the quarter in favour of global alpha strategies.

We increased exposure to infrastructure during the quarter as economic uncertainty increased

Hard Assets (Infrastructure / Real Estate / Commodities)

Portfolio exposure to infrastructure was increased in April at the expense of global equities. As we said last quarter these assets can be more defensive than equities in uncertain times and as such, we sought to increase the defensiveness of the portfolio as faster rate hikes darkened the economic outlook. Exposure to real estate was unchanged and there is no direct commodity exposure.

Global Alpha

Performance of our global alpha growth managers continues to be strong as equity and bond market weakness persisted. Rapidly rising interest rates to combat inflation continues to lead us to believe that non-directional global alpha funds are well placed to outperform as rising interest rates create opportunities across both growth and defensive asset classes whilst also providing diversification benefits to the portfolio.

Outlook

Higher than expected inflation is forcing central banks to tighten monetary policy, increasing the odds of a recession

Equity and bond markets haven't had it this rough for a long time, swayed by negative inflation news in the second quarter. The cheap money fired at the world economy due to the Covid pandemic and supply side constraints were supposed to have abated by now. Instead, inflationary pressures have intensified.

This leads us to believe that an economic recession will be hard to avoid and instead is a matter of timing and severity. Our base case is that central banks need to ignore near term economic softening and continue to raise rates. Broadening US inflation at 9% is too high to ignore. Thus, we expect a recession, albeit a relatively mild recession with a small fall in earnings, similar in magnitude to the 1990s. Corporate and household balance sheets in the USA are very healthy (household debt to GDP in the USA is around 2003 levels and corporate debt to GDP is around the post 1990s average), and there are no obvious excesses or imbalances in the financial system.

We also assume that interest rate increases currently priced into markets will be sufficient to get inflation back under control. Interestingly, cash rate derivatives markets in the past weeks have begun to price the risk of recession in a more meaningful way. Estimates for the peak in cash rates have fallen (from above 4% in Australia to around 3.5% now) and markets have begun to price rate cuts through the second half of 2023. Commodity prices have also begun to price a growth slowdown. Industrial metals and crude oil prices are all now well off their peaks.

This tempering of near-term inflation pressures has led to perhaps the beginnings of a relief rally. After entering bear market territory and enduring significant valuation compression, equity markets no longer exhibit the heady valuations of last year. Sentiment is on many different measures, washed out. Despite this, with multiple outcomes still possible, we don't think valuations are cheap enough.

Markets typically fall 35% in recessions and as of writing the MSCI ACWI Index in local terms is -17.7% year to date. Consensus earnings estimates are drifting but are not yet contracting let alone negative while corporate profit margins remain near all-time highs. The drumbeat of negative economic news continues to be heard from China, now steadfast in following a Covid zero strategy. And of course, the assumption that inflation is brought under control before central banks create a harder landing is also just that. We therefore continue to maintain our cautious investment stance, with an underweight to growth assets and overweight to government bonds, awaiting further clarity and a more attractive opportunity to change tack.

Regards,

The Drummond Capital Partners team

*Inception date is 31/3/2018. Source: BT Panorama. The returns shown are net of fund manager fees and do not incorporate any other fees including Advisory Fees, Admin Fees or Portfolio Manager Fees. They are calculated from the model portfolio within BT Panorama and as such may vary over time and vary by individual client.

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