October 2023 | Investment perspectives

Patience and commitment wins over the long term

The performance of cautious portfolios has been challenging over the past 18 months. We explore the reasons and explain why we believe returns should soon begin to pick up.

Introduction

If you've invested your money in a cautious portfolio, then no doubt you may have been surprised by the way markets impacted the value of your portfolio during 2022 and so far this year. However, we want to reassure you that these strategies remain on course to achieve their targeted returns over the long term.

This information should hopefully help answer some of the questions you may have about your investments. You do not need to do anything but please take the time to read this information. If there's anything you don't understand or you have any other questions then please speak to your financial adviser.

1. What investments are in cautious portfolios?

Cautious portfolios are designed to deliver a relatively smoother investment journey, along with steady returns over the long term (more than five years). In other words, the swings in performance should be less extreme than other types of investment strategies, such as balanced or adventurous portfolios. We describe this approach as lower risk, which also means the returns are likely to be lower than riskier investment strategies.

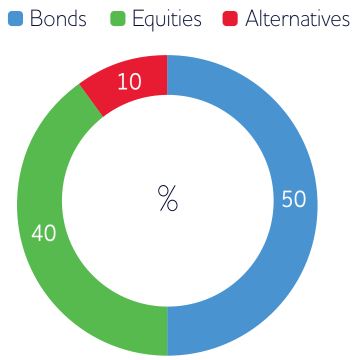
Before you invested in a cautious portfolio, you will have completed a questionnaire with your financial adviser. This exercise explored your financial circumstances and investment objectives, including your time horizon, age, appetite for risk and tax situation. Your adviser will then have recommended a cautious investment approach as the most suitable for you.

All investments come with risk but history shows that the performance of some types of assets is more volatile than others. Government bonds issued by developed countries such as the UK and US tend to be the least risky investments for a number of reasons. Notably, they pay a regular income (known as a coupon) and the issuer guarantees to repay the full amount when the bond matures.

Share prices tend to be more volatile than bond prices but also offer the potential for higher returns. Because bonds and share prices often behave differently, we blend them in a portfolio to manage the risk you want to take as a client while delivering the best return possible for that level of risk. Your cautious portfolio contains shares as well as bonds (figure 1).

Figure 1: A cautious approach

This chart shows the typical balance of assets in a cautious portfolio.



Source: Omnis.

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2. Why have cautious portfolios struggled?

Following a positive year for bonds in 2021, the underlying economic conditions that drive their performance then became unfavourable. By the start of 2022, central banks had begun to increase interest rates as part of their attempts to bring down the rate of inflation, which had been building up as the world continued to emerge from the Covid lockdown restrictions.

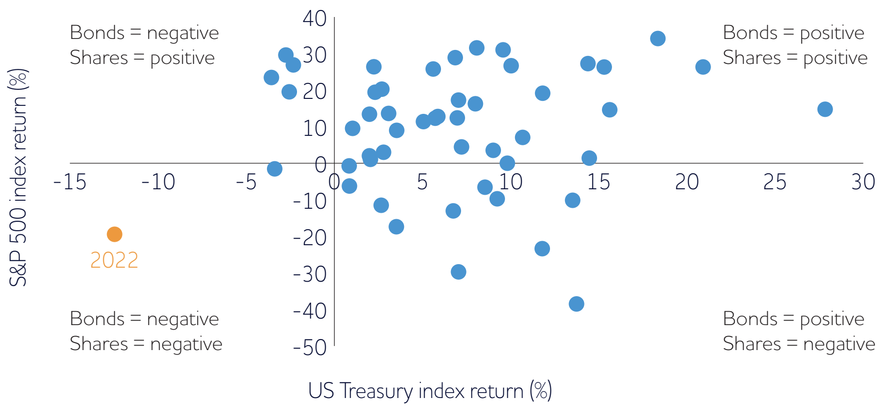
Russia's invasion of Ukraine added to these inflationary pressures, in particular from disruptions to energy and food supplies. As a result, inflation has remained higher for longer than expected and interest rates have risen by more than almost everyone expected at the time, and at a much faster pace.

When interest rates are rising, bond prices tend to fall, which explains why cautious portfolios fell in value during 2022 and 2023. Usually, when bond prices fall, investment in shares tend to cushion the blow. However, equities were also affected during this period with rising interest rates also weighing on company profits across most industry sectors and global regions. Figure 2 shows 50 years of annual returns for US Treasuries (bonds issued by the US government) and the S&P500 (a broad representation of the US stock market), which reveals how extreme markets behaved during 2022. We have used the past performance of US shares and bonds because there is more historical data available.

It is important to remember that when we put together a portfolio for a given risk profile, the mix of asset classes dictates the long-term expected returns for the portfolio and accounts for shorter-term periods where the portfolios will lag this long-term average.

Figure 2: US Treasuries and S&P 500 annual returns (1973–2022)

Bond and equity markets failed to provide diversification for investors in 2022.



Source: Bloomberg, indices are S&P500 index and Bloomberg Global Agg Treasury index. Returns are in USD.

3. Why is it important to remain invested?

Investing is best approached as a long-term exercise so that you give your money the opportunity to grow and recover from any falls in value, which will inevitably occur from time to time. If you sold your investments now, you would be locking in the losses your portfolio has suffered and miss out on the market's recovery, which often happens quickly after a downturn.

It's impossible to time the market. History shows that having the patience and commitment to remain invested tends to deliver the best results. Using the US stock market as an example, we see that in many five-year periods after big drops in stock markets, the market recovers strongly. One of the most severe one-day drops was a 9% fall in October 2008. This was followed by a five-year return of 109% (figure 3).

With interest rates now over 5% it might be tempting to shift your investments over to a cash savings account or fixed-rate bond. However, it's easy to forget that rates have not been this high for many years (and is unlikely to remain at these higher levels for very long) and that over the long term the returns from cash tend to underperform substantially those from investing in diversified portfolios, which have exposure to investment markets. Furthermore, moving your portfolio to cash now means that would crystallise losses in your portfolio and you may miss out on any recovery we see in bond and/or equity markets.

Figure 3: Markets often rebound after big falls

The past performance of markets emphasises why it's important to remain invested over the long term.

Date	Reason	One-day fall	Return after 1 year	Return after 5 years
15 Oct 2008	Global Financial Crisis	-9.0%	24.0%	109.0%
01 Dec 2008	Global Financial Crisis	-8.9%	39.3%	146.3%
29 Sep 2008	Global Financial Crisis	-8.8%	-1.5%	69.9%
09 Oct 2008	Global Financial Crisis	-7.6%	20.9%	103.5%
27 Oct 1997	Asian Economic Crisis	-6.9%	23.4%	8.7%
31 Aug 1998	Russia defaults on loans	-6.8%	39.8%	13.0%
20 Nov 2008	Global Financial Crisis	-6.7%	48.8%	164.3%
08 Aug 2011	Eurozone debt crisis	-6.6%	28.1%	117.0%
13 Oct 1989	Black Friday	6.1%	-5.8%	63.8%
19 Nov 2008	Global Financial Crisis	-6.1%	39.2%	147.5%

Source: Schroders, using Refinitiv data. Past performance is not guaranteed to be repeated in the future. The returns are illustrative and do not include any costs or fees, but the data underlines the past resilience of shares over longer timeframes, even following shocks. Index is S&P500, returns in USD.

4. What is our outlook for bond and equity markets?

Inflationary pressures are easing around the world and most major economies look like they will either avoid falling into recession completely or suffer only a mild economic contraction. As a result, interest rates appear to be nearing their peak for this phase of the business cycle or may have already peaked in some countries.

A more stable economic environment should be good news for bonds, and we believe the outlook for returns is positive. The yield on bonds is now much higher than we have seen for some time, so portfolios would benefit from the higher income they are delivering. Furthermore, at some point during 2024 and 2025, interest rates are likely to begin falling, which means bond prices are likely to rise, resulting in better returns for investors. In order to take advantage of the expected pick-up as interest rates begin to fall, we've been adding to our bond positions in cautious portfolios where we have the permissions to do so.

The returns from equities may be volatile over the rest of this year and the first part of 2024 as the economy continues to reset. However, company earnings forecasts have already begun to stabilise, which should support further price gains.

5. What is the long-term outlook for portfolios?

The long-term outlook for portfolios is set by the Strategic Asset Allocation, which will drive the majority of the returns. We review the Strategic Asset Allocation every year and we'll communicate any updates through your financial adviser. For each of the portfolios, we will also make available the expected long-term returns for the portfolios (figure 4). These returns are the expected annual returns for the portfolio over the next 10 to 15 years.

Of course, markets do not move in a straight line so during the course of the next 10 to 15 years we may have years where your portfolio performs above or below this average. The long-term outlook for bonds and equities has improved significantly as a result of market conditions during 2022 and this has pushed up the expected long-term returns of all portfolios.

Figure 4: Expected annualised returns

This table shows the average annual returns we expect from our range of six investment strategies over the next 10 to 15 years.

	Cautious	Moderately Cautious	Balanced	Adventurous	Speculative
Expected compound return	5.7%	6.3%	6.9%	7.8%	8.1%
Expected volatility	Lower →				Higher

Source: Omnis.

Find out more

Please speak to your financial adviser if you have any questions about your investments or would like to review your situation and investment approach. For example, now might be a good time to refresh your risk questionnaire to make sure it's still relevant for you. Your financial adviser will also be able to help you with any other issues, such as meeting short-term cash needs while making sure your long-term investment plan remains on track.

At a glance

- If you've invested your money in a cautious portfolio, then no doubt you may have been surprised by how markets impacted the value during 2022 and so far this year.
- Cautious portfolios are designed to deliver a relatively smoother investment journey, along with steady returns over the long term (more than five years).
- All investments come with risk but history shows that the performance of some types of assets is more volatile than others.
- Investing is best approached as a long-term exercise so that you give your money the opportunity to grow and recover from any falls in value, which will inevitably occur from time to time.
- The outlook for bond markets is turning more positive as inflation continues to come down and we reach the end of interest rate hiking cycles. Equities may continue to be volatile in the short term as the economy resets.

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