INNOVA
ASSET MANAGEMENT

REVIEWING TRADES AND POSITIONING FROM 2023

We provided commentary in December on the year of 2023, as well as our outlook for 2024 (click here to review that article), but thought it might be worthwhile examining trades we made in 2023, designed to set ourselves up for 2024 and beyond. Back in January of 2023 we reviewed our trades from 2022 and looked at their performance, but in retrospect performance over 3, 6 or even 12 months is generally too short a timeframe to determine success. 2022 was a bit of an exception though, as markets were largely down, so anything executed that protected capital had immediate positive effect on portfolios. 2023 was not a year dominated by falling markets, but was instead one where markets offered opportunities to rebalance portfolios, take some profits in some areas and re-deploy capital into new areas we think will pay off over the coming years – either by offering downside protection if things do turn bad, provide diversification of return sources given heightened uncertainty or outsized potential profits if a true new bull market emerges.

We believe 2023 was an important year where we needed to take our positioning from one that would protect in a high inflationary environment (which we experienced in 2022) and prepare for lower inflation and potential economic uncertainty in 2023 and beyond.

We summarize our portfolio changes in our *Portfolio Changes Report* and *Quarterly Outlook* report but let's have a look at how these trades have gone so far. In short, we did not have as successful a 2023 as we did 2022, but we think this market is likely only halfway through the game, so it's a bit early to call the final score. As mentioned above, 2023 gave us an opportunity to position ourselves for lower inflation and a potential peak in the rate hiking cycle, and move away from some of those inflation hedges.

2023 was dominated by 2 primary, but intertwined themes – the A.I. fuelled tech rally in the US, combined with speculation around the future path of interest rates in the US as determined by the Federal Reserve. Given the Tech sector is very richly valued, many years of future earnings are currently in the price, so changes to the expectation of future interest rates played a big part in their performance throughout the year. But what opportunities or risks did that present to us in 2023, and how have those decisions played out so far?

December 2022: Reduced Australian Equities and Bought Asia

This was an interesting trade, as we bought back into Australian Equities in November of 2023 (outlined below) just before the December Christmas rally. But how did our call to buy Asia compare to having a reduced exposure to Australian equities up until November?:

As at 16/11/2023	*Performance since 8/12/2022*
VAS Aus Equity ETF	2.14%
VAE Asia ex Japan ETF	5.77%

This was a good call up until 16 November, but since then Australian equities have outperformed their Asian counterparts – but since we reallocated to the area, we have benefitted from this rebound.

March 2023: Begin targeting the middle of the US yield curve

We made the decision to start allocating to the middle of the US yield curve in March – unfortunately we made the decision the day before the announcement of Signature Bank and SVB's collapse and we saw yields fall 100bps in 2 days (as yields fall, prices rise) – so we had to be a little patient and progressively allocate to this over the course of the year.

So far this has not added to performance apart from during December (the USTB ETF we chose to allocate to rallied 3.65% in December alone), but with the number and magnitude of potential rate hikes greatly diminished, we believe this position will be a great diversifier in portfolios going forward. *This is a key point*, most multi-asset portfolios hold a large allocation to fixed rate bonds in all periods under the assumption that they are negatively correlated to equities (i.e. they'll go up in price when equities go down) – however in 2022 allocations to fixed rate bonds performed exceptionally poorly along with US equities, and in 2023 they performed well when equities did well

(i.e. they were *positively* correlated). We think now this positive correlation has the potential to break down and for fixed rate bonds to provide some diversification to portfolios that they did not in either 2022 or 2023.

March: Sold physical Gold and allocated to cash

Around 20 to 22 March 2023, Gold reached an all time high in Australian dollars, factoring in future rate cuts from the fed prematurely. This did indeed prove premature, and Gold displayed a level of volatility in 2023 we were able to avoid:

As at 31/12/2023	*Performance*
GOLD ETF	3.34%
Cash	4.21%

So far, this trade has provided us with moderate success in terms of performance, but more importantly it has given us 2 important things for portfolios construction: 1. It reduced volatility in portfolios without sacrificing returns; and 2. Has provided us some liquid cash we can redeploy to assets displaying attractive future risk/return characteristics.

March: Exited Japan. Purchased South Korea

We were a little early in reducing our position in Japan, as it continued to rally since its exit at the end of March. However, this moderated in the 6 months to the end of December, and we are now set in a position with a much more attractive valuation profile:

As at 31/12/2023	*6 Month Performance*	*Performance since March*
IJP Japan ETF	1.65%	9.13%
IKO Korea ETF	2.19%	7.27%

With the benefit of hindsight, we'd have ideally waited a little longer before reducing the Japanese position, however, it had held up well and was trading at fair value, whilst Korea was arguably pricing in bottom-of-the-cycle earnings, meaning its long-term return prospects look substantially more attractive.

April and June: Reduce credit and increase fixed rate bonds

In April we reduced our allocation to the SUBD ETF, one that is lower on the credit quality spectrum than our core positions and more subject to fluctuations in credit premium, and chose to further allocate to the USTB US Treasury ETF. This proved premature as credit continued to rally whilst US Government bonds continued to remain volatile.

We made a similar trade in June, but chose to allocate to Australian Bonds via the Western Asset Australian Bond Fund. This was also funded from a sale of the FOOD ETF in select portfolios.

Since June the combination of these trades has benefitted portfolios in terms of performance, but more importantly, positioned us away from positions that are likely to benefit from rising rates and inflation, and towards a position likely to benefit from falling inflation and potential future rate cuts:

As at 31/12/2023	*Performance*
SUBD ETF	3.91%
FOOD ETF	-0.65%
Western Asset Australian Bond Fund	3.65%

With inflation receding, and the strong possibility rate hikes have now peaked, we believe holding assets that will benefit from moderating inflation and potential rate cuts seems sensible, and the Western Asset Australian Bond Fund provides us with such positioning because of its fixed rate bond exposure, whilst SUBD and FOOD are both likely beneficiaries from higher inflation – something we believe no longer needs to be a major position in portfolios given where we are in terms of the inflation cycle.

November: Bought Australian Equities, reduced cash and credit

Our timing on this trade worked out well, with both cash and credit posting positive returns, but Australian equities posting substantially higher returns to 31/12/2023. The 3 Australian equity positions we chose, index, Invesco and the QOZ ETF all performed exceptionally strongly from 16/11/2023 when we made the allocation:

As at 31/12/2023	*Performance*
Macquarie True Index Aus Share Fund	8.82%
Invesco Aus Share fund	7.79%
QOZ ETF	7.47%

Australian equities are still trading on reasonable valuations even after the exceptional rally in the last 6 weeks of the year. This trade was a re-allocation to Australian equities after we sold them at the end of 2022 as pointed out above. We believe the positioning continues to make sense, as whether markets are more volatile in 2024 or we see a continuation of the bull market of 2023, Australian equities are much more attractively priced than their US counterparts.

Looking to the future

As mentioned previously, we think it is too early to call whether our positioning and trades were right or wrong in 2023, with our hit-rate at roughly 50%. The key point though is that we used 2023 as a year to re-allocate the portfolios post the 2022 selloff into regions that offer an asymmetric payoff profile, increase diversification, reduce allocations geared towards higher inflation but maintain our defensive posture. Our performance lagged a broad-based index in 2023, but that was because we stayed divested from expensive areas that got even more expensive, and believe a simple index construction over-exposes investors to the nosebleed valuations of US mega-cap tech. The last 2 times we saw tech trade at these valuations were late 2021 and in 2000 during the tech-bubble – neither scenario ended well for positions highly concentrated in those areas. So, we are more than happy to underperform an index in that environment if it means keeping investors away from risks we don't believe they are being well compensated for. Pleasingly, we did manage to keep up with our peer set during 2023, even without allocations to the high-flying A.I. sector. 2024 may be the year we are proven either right or wrong on that call.

Important Information

This document has been prepared by Innova Asset Management Pty Ltd (Innova), ABN 99 141 597 104, Corporate Authorised Representative (402207) of Innova Investment Management Pty Ltd, AFSL 509578 for provision to Australian financial services (AFS) licensees and their representatives, and for other persons who are wholesale clients under section 761G of the Corporations Act.

To the extent that this document may contain financial product advice, it is general advice only as it does not take into account the objectives, financial situation or needs of any particular person. Further, any such general advice does not relate to any particular financial product and is not intended to influence any person in making a decision in relation to a particular financial product. No remuneration (including a commission) or other benefit is received by Innova or its associates in relation to any advice in this document apart from that which it would receive without giving such advice. No recommendation, opinion, offer, solicitation or advertisement to buy or sell any financial products or acquire any services of the type referred to or to adopt any particular investment strategy is made in this document to any person.

All investment involves risks, including possible delays in repayments and loss of income and principal invested. Any discussion of risks contained in this document with respect to any type of product or service should not be considered to be a disclosure of all risks or a complete discussion of the risks involved. Past performance information provided in this document is not indicative of future results and the illustrations are not intended to project or predict future investment returns.

Although non-Fund specific information has been prepared from sources believed to be reliable, we offer no guarantees as to its accuracy or completeness. Any performance figures are not promises of future performance and are not guaranteed. Opinions expressed are valid at the date this document was published and may change. All dollars are Australian dollars unless otherwise specified.