Quarterly Portfolio Update

Pioneer Funds – Flexible Opportunities

30 June 2017

MULTI-ASSET

COMMENTARY

Market Review

The second quarter has been a positive one for the stock markets. Buoyed by better than expected economic data, the international markets have, for once, performed better than the U.S.

The MSCI made the decision to include Chinese stocks into its benchmark. Thus, both the A- and H-shares (traditionally under-owned) delivered very favourable returns. The European markets reaped the benefits of a less disquieting political scenario, plus very encouraging business and consumer sentiment. The improved outlook for 'risk-assets', as one would expect, took some of the wind out of the bond market. The inflation data, which was surprisingly tame, turned out to be more supportive to equities than fixed-income.

The measures of business sentiment came in strong around the world. What is even better, the forward-looking components (such as new orders and supplier deliveries) printed the best numbers in almost a decade. Analysts were encouraged to revise their profit estimates upwards, yet investors' sentiment remains very mixed. It is now eight years since, for example, the U.S. economy and stock market hit bottom, but strategists and commentators alike remain largely sceptical. Equities have delivered a very good performance everywhere in the world since March of 2009, but the event is rarely described as a bull market. Households and institutional investors (with the possible exception, in the latter category, of Japan's Government Pension Investment Fund [GPIF]) keep reducing the equity exposure and accumulating bonds. That leaves us puzzled.

The Portfolio's exposure to bonds remains close to the lows since inception. We see no value anywhere in the world and even in the sectors where some value can be detected, stocks represent a better proposition - for example, they offer better (dividend) yields. What makes us sceptical is not the inflation outlook, for, in contrast to most bears, we expect retail price-inflation to remain tame. Rather, it is the unprecedented concentration of resources exposed to fixed-income products, coupled with what we consider inadequate term-premia. Thus, for one, the Fed puts the term-premium on U.S. 10-year Treasury notes at zero percent. Not an encouraging starting point.

What may cause confusion among market-participants is the outlook for official rates. As the expectation of multiple rate hikes flies in the face of very low inflation data, pundits wonder whether the Fed has changed its well-advertised data-dependent attitude into something else. We continue to see the investment community as being overly fixated on the Fed Governors' speeches, and focused enough on economic data: confusion in the bond market space does not come as a surprise. We see the present circumstances more as a correction versus the start of a bear market. The third quarter outlook will be critical.

Meanwhile, the macro-picture cannot be ignored. There is a chance that U.S. nominal GDP growth accelerates towards 4.5% between Q2 and Q3, with similar uptrends in China, Europe and Japan. World economic growth is in better shape, with the U.S. ceasing to represent the exception. We also expect - provided unit labour costs, as we believe, remain tame - profit-margins to expand in the process, forcing analysts to revise upwards their profit expectations further.

Portfolio Review

Performance was strong within the Portfolio for the quarter, driven by strong equity across the globe. This included dividend paying equities, Buyback Achievers and real estate investment trusts (REITs), all of which experienced short-term, negative performance post the presidential election. However, by maintaining our long-term perspective and not buying into the short-term inflationary story, the Portfolio benefitted during the quarter.

The Portfolio’s asset allocation at the end of the second quarter was heavily biased toward equities, representing approximately 80% of the Portfolio. Within our equity component, approximately 39% was held in U.S. equities, 26% in other developed economies (ex U.S.) and 13% was in the Emerging

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ASSET MANAGEMENT

Markets. For the fixed income sleeve, approximately 14% was allocated into sovereign, government related, investment grade and high yield. The remainder of the Portfolio holds cash and Treasuries.

The Portfolio's themes and asset allocation have remained consistent over the quarter. While the bias towards equities versus fixed income securities has been persistent since the conclusion of 2011, geographic exposures, themes (think cyber security, aerospace and defence contractors, etc.) and indeed individual credits do rotate, depending on circumstance. Stocks remain the favoured asset class, with a preference for Aerospace and Defence, Dividend Aristocrats, Buyback Achievers, Healthcare (excluding the Pharma Sub-sector) and Real Estate (at a limited number of locations). In fixed income, preference is oriented towards long-duration bonds.

However, turnover was more muted throughout the quarter, as a by-product of what had transpired in the end of 4Q16 and 1Q17. Specifically, unwinding of the pronounced reflation trade produced strong recoveries in yield proxies (dividend aristocrats and buyback achievers), which represent a substantial exposure within the Portfolio. Additionally, the USD retraced all gains it had produced in the wake of 8 November 2016, which benefit Emerging and Frontier markets. The Portfolio holds a long history of maintaining a geographically diversified portfolio, and that diversification provided meaningful net-benefit, as the U.S. market burnished relatively muted returns in comparison to those of other locales.

Outlook

We continue to maintain a globally diversified Portfolio, by owning assets across both U.S. and foreign equity markets. Despite the appreciation of U.S. equities, large positions exist within foreign stocks, given the compelling value they presently offer (both absolutely, as well as relative).

Valuations are universally considered very high. In absolute terms, especially in the U.S. The challenge remains from a relative value perspective, that when compared with bond yields, those valuations still appear attractive. The Portfolio has reduced the equity exposure, but not to the benefit of the bond exposure.

We do not expect the third quarter to result in substantial changes to the world economic outlook. Moderate growth, tame inflation seem to be in the forecast. As of today, it is difficult to think what surprises could the summer (mostly a quiet season) could have in store. The second quarter reporting season, which is due to begin in a couple of weeks, should be an uneventful one, while the activity in the Western capitals will soon start slowing down, due to the summer recess.

On the currency front, the U.S. Dollar weakness also sparked interest in commodity markets, due to the positive currency translation effect for developing countries. We have long been sceptics of bulk/industrial commodities, on account of excess capex spending during the preceding cycle (which continues to cause supply to outpace demand). However, several markets now appear to offer more compelling value propositions. In particular;

- Palladium - a consistent area of interest given rising global vehicle demand
- Domestic and European steel producers - long-time sufferers of cheap Chinese exports, this industry has witnessed substantial capacity reductions, and consequently, inventory levels are now reasonable with stronger pricing
- Coking coal - primary component of blast furnaces for the smelting of steel

Longer-term, the basic assumption remains that, as the recovery grows older, financial markets should continue in their equity risk premium-compression model. What modest returns may be witnessed, may be concentrated in stocks, not bonds.

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