abrdn Sustainable Index MPS

Quarterly commentary

Q1 2024

Investors should remember that the value of investments and the income from them can go down as well as up and that past performance is not a guarantee of future returns.

This report is only for use by a financial adviser or a client who has received advise on investing in this managed portfolio service. It is not for use by non-advised investors or any other third party. For full important information and key risks, please refer to the end of this document.

Objective

abrdn Sustainable Index MPS aims to generate growth primarily through the use of sustainable, ethical and impact index tracker funds over the long term. It is intended for investors with a low attitude to a medium high attitude to risk. The diversified portfolio invests in a wide variety of assets, typically in equities, fixed interest, alternatives and money markets. This blend of assets should help to dampen down volatility over the long term.

Discrete annual returns - year to 31/03

	2020	2021	2022	2023	2024
abrdn Sustainable Index MPS 1	n/a	n/a	n/a	n/a	5.61%
ARC £ Cautious	-2.29%	11.34%	1.62%	-4.25%	4.66%
abrdn Sustainable Index MPS 2	n/a	n/a	n/a	n/a	8.60%
ARC £ Cautious	-2.29%	11.34%	1.62%	-4.25%	4.66%
abrdn Sustainable Index MPS 3	n/a	n/a	n/a	n/a	10.78%
ARC £ Balanced Asset	-5.44%	17.86%	3.46%	-4.52%	7.31%
abrdn Sustainable Index MPS 4	n/a	n/a	n/a	n/a	12.88%
ARC £ Steady Growth	-7.71%	23.53%	4.64%	-4.52%	9.29%
abrdn Sustainable Index MPS 5	n/a	n/a	n/a	n/a	15.53%
ARC £ Equity Risk	-9.65%	30.35%	4.84%	-4.61%	11.06%

Portfolio performance is based on abrdn Sustainable Index MPS hosted on the abrdn Wrap platform. Performance figures are net of the abrdn Portfolio Solutions Ltd management fee and underlying funds OCF. Source: abrdn, Financial Express. As at 31.12.2023. ARC Private Client Indices are based on actual client portfolio returns provided by various investment management companies. These portfolio returns are allocated to one of four categories based on the volatility of their returns relative to world equities, and an average return is calculated for each category. Grouping portfolios by their volatility differs from the traditional approach, which compares portfolios which have similar asset allocations. Instead, investment managers may use whatever asset allocation they consider appropriate to achieve the desired levels of return and volatility.

Key points

- Global markets enjoyed a buoyant start to 2024 but with more muted gains than the strong rally seen in late 2023. Various equity markets, including US, Japanese and European bourses, hit record highs during the quarter, spurred on by various economic data points and strong earnings, especially in the US technology sector, which suggested the global economy may see a soft landing instead of a deep recession.
- In December, markets had been pricing in a strong chance that various central banks would begin their rate-cutting cycle as early as March but gradually had their expectations tempered by consistently hawkish comments from the US Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of England (BoE). Much of the commentary provided by central banks continually noted they were in no rush to cut rates, with many remarking that the battle against price rises was not won quite yet.
- Due to such persistent inflation and hawkish central bank commentary, government bond yields made their way higher during the period, as investors' hopes of imminent rate cuts looked overly optimistic.

- Adding to worries about inflation were rising tensions in the Red Sea as Houthi rebels continually attacked cargo vessels in the area, either bringing about delays for goods coming from Asia to Europe through the corridor or forcing them to be rerouted completely, driving up transportation costs and ultimately inflation.
- In commodity markets, oil prices generally traded higher throughout the quarter, driven by tensions in the Middle East and rumours that the OPEC group of oil-producing nations were considering a production cut in the second quarter of 2024. Gas prices fell, however, as a warmer February led to weaker demand.

Market commentary

During a quarter in which the majority of domestic markets' focus was fixed on inflation and its various guises, it was refreshing that towards the end of the period we received an update on how the reading is calculated.

The ever-changing basket of goods that the Office for National Statistics uses not only helps track price changes but also offers invaluable insight into current fashions and spending habits. March's rebalance saw the departure of several popular pandemic items such as hastily bought hand sanitiser and takeaway coffees, replaced by trendier must-haves, such as air fryers and gluten-free bread.

However, there is also one item that has been added that will be music to many investors' ears. Vinyl is back after a 32-year absence – a reflection of the revival that physical music continues to enjoy. According to data from the British Phonographic Industry (BPI), vinyl purchases rose by 11.7% to 5.9 million units last year, the 16th increase in a row, driven higher by popular vinyl releases from artists such as Taylor Swift and the Rolling Stones.

With all this talk of vinyl during the quarter, it was only apt that investors saw a few records of their own, as stock markets around the world hit a multitude of new highs. They took a while to get into the groove however, with January seeing a buoyant start to the year albeit more muted gains than the strong rally seen in late 2023. Whilst economic data increasingly suggested the global economy may see a soft landing instead of the hard recession many had predicted last year, there were also signs that central banks would take more time to cut interest rates than previously envisaged.

Getting markets in something of a spin, commodity prices made their way higher during the first month of the year, with oil pushing above $80 a barrel following tensions in the Red Sea as Houti rebels continually attacked cargo vessels in the area. The continued interference either brought about delays for goods coming from Asia to Europe through the corridor or forced them to be rerouted completely, potentially driving up transportation costs and ultimately inflation.

Despite this, all major western central banks seemed to have pressed pause on any more rate hikes, with the US Federal Reserve (Fed) in particular acknowledging recent strong wage data whilst being quick to highlight easing inflation. Governor Jay Powell and co all but quashed hopes of a March rate cut early in the year, causing yields on government debt to rise, although investment grade corporate bonds generally performed slightly better.

If January acted as a strong debut for markets in 2024, then there were no worries about a difficult second album for February, as a mix of strong economic data and corporate results allowed markets to continue their strong run.

The Bank of England (BoE) was the only major central bank to meet during the month, once again holding rates against a mixed backdrop of economic data. GDP figures for the final quarter of 2023 showed the UK fell into a technical recession, with the economy having contracted for two consecutive quarters. Despite the negative news, inflation readings for the previous month came in lower than expected, though they rose slightly to 4% on an annual basis.

Topping the charts for the month was the US market, riding high after an upbeat earnings season for the technology sector. The meteoric rise of new artificial intelligence (AI)

abrdn Sustainable Index MPS

Quarterly commentary

Q1 2024

darling Nvidia continued after it announced results far beyond Wall Street's expectations for earnings and sales, and also forecast revenue during the current quarter to be higher than many had anticipated. In total, the company's total revenue rose 265% from a year ago, based on strong sales for its AI chips for processors and servers. With the company having passed the $1 trillion market cap level last year, an immediate 10% rise on the back of its results helped push US indices to yet more all-time highs.

The B side to such strong US earnings was to be found in Europe during the month, where corporate results were largely disappointing, with around half of those companies announcing their numbers missing expectations. However, hope that the European Central Bank (ECB) would soon move to cut rates allowed most countries' indices to rise, including Italy, Germany, France and Switzerland.

With markets refusing to change their tune, March saw yet more record highs breached for a host of global equity markets. Central banks remained a focal point, with investors' optimism that a rate cut in June would be up the sleeves of most central banks.

Keeping hopes on track, the UK's rate of inflation fell to 3.4% for the final reading of the quarter, making progress in synch with other CPI readings around the world and closing in on the 3.2% the US saw during the same period. Whilst price rises materially slowed throughout the first quarter, hawkish remarks from central banks led government and corporate bond prices to largely rise during March, with riskier credit outperforming higher-rated issues.

One economy that was dancing to a different beat however was Japan. Japanese workers secured their largest pay rises in over three decades during organised Spring wage negotiations across a range of industries. The practice, known as 'shunto', began in 1956 when Japan's postwar economy was booming, with unions demanding improvement in wages and job conditions by resorting to strikes in big cities. The marked increases could spell the end of years of anaemic inflation for Japan, forcing the Bank of Japan to end eight years of negative interest rates by declaring its first hike in 17 years and raising borrowing costs by 0.1%. It must be noted that such a move still keeps rates around zero in Japan and its fragile economy will likely force the central bank to take its time with any subsequent increases.

Staying in the Pacific area, stronger-than-anticipated economic data from China helped lift its index out of the doldrums it plumbed for much of the quarter. With the nation's vociferous appetite for natural resources, commodity markets finished March strongly, in turn moving the needle for the mining-heavy UK blue-chip index, which moved within just a few percent of its greatest hits.

Portfolio commentary

The first quarter of 2024 proved to be a period of reflection for some investors, while others decided it was time to throw caution into the wind.

It followed a final quarter of 2023 which saw just about everything rally as investors decided that central bankers had reigned in inflation without pushing the US economy into recession. This fine balancing act had been achieved in such a manner that by the year-end markets ascribed a high probability (80%-plus) that rate cuts would begin in March 2024, with five more by the end of the year (taking the US base rate from 5.5% to 4.0%). It turned out, however, that the picture is a little less clear than previously imagined.

The 'last mile' when it comes to reducing inflation has proved trickier than anticipated. Since the start of the year, headline inflation in the US ticked up to 3.2% in February from 3.1% in January. This inflation data in conjunction with better economic growth data, a robust labour market and improving consumer and business confidence proved somewhat of a quandary for Jay Powell, governor of the US Federal Reserve (Fed) and the other members of the Federal Open Market Committee. In reality, it may be that markets had just got too far ahead of themselves concerning rate cuts. The Fed's dot plot in December suggested that the central bank would cut rates three times during 2024. By the end of the first quarter of this year, market expectations shifted to align more closely with the Fed's guidance, with slightly less than three cuts now expected in 2024.

Growth has been slower in geographies other than the US. As expected, the UK fell into a technical recession during the first quarter with the Eurozone avoiding the same fate by the slimmest of margins. Headline CPI in the UK continued to fall at a reasonably steady rate, but core inflation proved far more stubborn with the February reading still at 4.5% – more than double the target of the Bank of England (BoE). The slower levels of growth combined with the higher and more persistent inflationary environment is a headache for the BoE, which has to balance wanting to cut rates to buoy economic growth with the threat that this will spur future inflation. Germany seems to be the sick man of Europe, which is a considerable turn of events when you reflect on the region over the last decade. Its large manufacturing base faces considerable challenges, while the nation benefits less from the pickup in the service sector that has buoyed growth in countries such as Spain and Italy. The path back towards target from an inflationary perspective seems to be progressing marginally more positively across the Eurozone and at present markets expect the European Central Bank to be the first to cut rates, maybe as early as June.

From a markets perspective there was a clear differentiation between risk assets and those considered to be more defensive. Equities continued their rally that began at the end of October. In local currency terms the clear winners were Japanese equities (up by more than 17%), along with the US and European equities (up around 10% each). The UK, Asian and emerging market (EM) equity markets delivered positive returns, but these were more pedestrian (circa 2-3%). The performance of the US stock market was driven by an even narrower band of companies. Previous mega-cap darlings of the stock market Apple and Tesla suffered considerably during the period, shedding around 10% and 30% respectively, but the performance of Nvidia, which soared by more than 80%, more than offset these losses at an index level.
From a fixed interest perspective it was a very different story. The reappraisal of the path of interest rate cuts over the quarter saw developed world government bond yields rise considerably, up circa 40 and 32 basis points respectively for 10-year UK gilts and US Treasuries. This meant that US Treasuries and more broadly global government bonds delivered negative returns. Shorter duration global government bonds managed to deliver marginally positive returns, but these lagged those of cash. Credit markets tended to perform a little more positively in this environment. The lower levels of interest rate sensitivity benefited these assets, while spreads tightened notably since the start of the year. Short duration global investment grade bonds performed solidly against this backdrop with short duration UK investment grade bonds performing especially strongly. It was a similar story for global high yield bonds. The lower levels of duration and notable spread tightening over the quarter drove solid returns in this asset class. The strength of sterling versus a broad basket of developing world currencies weighed heavily on local currency EMD returns.

Currency had a notable impact on returns for sterling investors during the quarter. The higher rate expectation in the US especially saw the dollar strengthen notably against the pound (up by more than 2%). The pound held ground or strengthened against the other G10 currencies, with the Japanese yen and Swiss franc being notably weak (down 6% and 5.5% respectively). The overall effect of currency movements proved a headwind to sterling investors.

From an alternatives perspective it was a challenging quarter. Both global real estate investment trusts (REITs) and infrastructure have a certain amount of interest rate sensitivity, so the rise in government bond yields was a significant headwind. In sterling terms, REITs were flat overall, while infrastructure moved higher by about 2.8%.

SMPS Index 1
Fund selection was negative over the quarter.
Fixed income returns were boosted by Fund selection within global high yield. Credit spreads tightening benefitted the active managers held as they have been

running with a slightly higher beta to credit versus their benchmarks, helping the M&G Global High Yield ESG Bond Fund to outperform.

Within equities, the iShares ESG Enhanced Index Fund range avoids exposure to companies or activities that pose reputational risks or violate investors' values, while favouring those that reduce carbon emissions and minimise ESG risk. In partnership with Morningstar Sustainalytics, the parent index in each region is subject to ten business involvement screens (UN Global Compact, controversial weapons, tobacco, thermal coal, oil sands, nuclear weapons, civilian firearms, alcohol, gambling and adult entertainment). The remaining securities are re-weighted to minimise ESG risk rating while controlling for active risk, carbon emissions and diversification. The Funds also have a 30% carbon and other greenhouse gas intensity reduction target.

The tilt towards companies with stronger ESG credentials was detrimental during the quarter with the iShares ESG Enhanced Index Funds underperforming in most regions. The degree of underperformance was relatively modest, and most extreme in Asia where our allocation is quite small. While returns from the iShares US Equity ESG Index Fund were only slightly behind the buoyant US market, our larger allocation meant this was a more meaningful detractor from portfolio performance. Europe and Japan stood out as the iShares Continental European Equity ESG Index Fund and iShares Japan ESG Equity Index Fund both outperformed their respective benchmarks.

Fund selection was disappointing in alternatives, with iShares Environment and Low Carbon Tilt Real Estate Index Fund and First Sentier Responsible Listed Infrastructure both underperforming and therefore detracting from returns across both infrastructure and property.
There were no changes to asset allocation or Fund selection during the quarter.

SMPS Index 2
Fund selection was negative over the quarter.
Fixed income returns were boosted by Fund selection within global high yield. Credit spreads tightening benefitted the active managers held as they have been running with a slightly higher beta to credit versus their benchmarks, helping the M&G Global High Yield ESG Bond Fund to outperform.

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abrdn Sustainable Index MPS

Quarterly commentary

Q1 2024

SMPS Index 3
Fund selection was negative over the quarter.
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There were no changes to asset allocation or Fund selection during the quarter.

SMPS Index 4
Fund selection was negative over the quarter.
Fixed income returns were boosted by Fund selection within global high yield. Credit spreads tightening benefitted the active managers held as they have been running with a slightly higher beta to credit versus their benchmarks, helping the M&G Global High Yield ESG Bond Fund to outperform.

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Fund selection was disappointing in alternatives, with iShares Environment and Low Carbon Tilt Real Estate Index Fund and First Sentier Responsible Listed Infrastructure both underperforming and therefore detracting from returns across both infrastructure and property.
There were no changes to asset allocation or Fund selection during the quarter.

abrdn Sustainable Index MPS

Quarterly commentary

Q1 2024

SMPS Index 5

Fund selection was negative over the quarter.
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Fund selection was disappointing in infrastructure, with First Sentier Responsible Listed Infrastructure underperforming and therefore detracting from performance.
There were no changes to asset allocation or Fund selection during the quarter.

Outlook

Despite hopes of a rate cut being persistently rebuffed by central banks, investors seemed largely unperturbed. They pushed their expectations back until June and their continued purchasing of risk assets allowing markets to hit a number of record highs during the period.
Throughout the quarter, the balance of probabilities shifted to the point where we now believe the US economy is likely to avoid a recession. Activity has been remarkably resilient in the face of higher interest rates, helped by strong consumer and corporate balance sheets, positive supply shocks and looser fiscal policy. Although these tailwinds are likely to fade in 2024, we still believe growth will moderate to below trend.

With inflation continuing to fall in a synchronised way across most developed economies, we expect the Fed, ECB and BoE to each make an initial move to cut rates in June, although those chances could easily dissipate if we see further stronger inflation and economic data releases as the year progresses.

However, no matter what the future holds, much like vinyl once again appearing in inflation calculations, investors would be hard pressed at this time into finding a better solution that a long-term, diversified and well-researched portfolio to navigate the challenges ahead.

abrdn Sustainable Index MPS

Quarterly commentary

Q1 2024

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Risks
All investments involve risk. The risks of some of the funds may be comparatively high. The risk descriptions at the end of this document correspond to the main risk factors for each fund within the model. "General Risks" mostly apply to all funds within the model. A fund could potentially be affected by risks beyond those listed described in this document, nor are these risk descriptions themselves intended as exhaustive. For full information and key risks, please refer to the end of this document.

Credit risk: The fund invests in securities which are subject to the risk that the issuer may default on interest or capital payments.

Interest rate risk: The fund price can go up or down daily for a variety of reasons including changes in interest rates, inflation expectations or the perceived credit quality of individual countries or securities.

Equity risk: The fund invests in equity and equity related securities. These are sensitive to variations in the stock markets which can be volatile and change substantially in short periods of time.

Emerging Markets risk: The fund invests in emerging market equities and / or bonds. Investing in emerging markets involves a greater risk of loss than investing in more developed markets due to, among other factors, greater political, tax, economic, foreign exchange, liquidity and regulatory risks.

Derivatives risk: The use of derivatives carries the risk of reduced liquidity, substantial loss and increased volatility in adverse market conditions, such as a failure amongst market participants. The use of derivatives may result in the fund being leveraged (where market exposure and thus the potential for loss by the fund exceeds the amount it has invested) and in these market conditions the effect of leverage will be to magnify losses.

High Yield Credit risk: The fund invests in high yielding bonds which carry a greater risk of default than those with lower yields.

For more information visit abrdn.com

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