

FIRST STATE DIVERSIFIED GROWTH FUND

Multi Asset Solutions

Q4 2018 Review

The Fund aims to protect against UK inflation and provide capital growth by achieving a positive return (gross of fees and charges) of 4% in excess of UK RPI over rolling five-year periods.

The First State Diversified Growth Fund (DGF) returned -2.3%¹ in what proved to be a challenging 2018 fourth quarter. A global sell-off in equities markets, where the Fund had exposure through the Neutral Asset Allocation ('NAA') detracted, while the positive contribution of the Dynamic Asset Allocation ('DAA') helped to offset some of the impact. The UK Retail Price Index (RPI) increased by 0.6% over the same period.

The Fund has delivered 1.2% p.a. (net of fees and taxes) since the inception in June 2015, 1.4% p.a. under UK RPI, with a monthly volatility of 6.1%. For reference, over the same period the FTSE 100 delivered 3.5% p.a with a volatility of 10.5%.¹

Due to a challenging period of performance in 2018, the Fund is currently lagging the investment objective since inception. However, we remain confident in the Fund achieving its performance objectives over the long-term.

Performance overview

Annual Performance (% in GBP) to end-December	12 months to 31/12/2018	12 months to 31/12/2017	12 months to 31/12/2016
First State Diversified Growth B GBP Acc	-10.20	6.54	14.19
UK Retail Price Index	2.93	3.64	2.00
Excess (a)	-13.14	2.90	12.19

Cumulative Performance (% in GBP) to end-December	3 month	6 month	YTD	1 year	2 year	Since Inception
First State Diversified Growth B GBP Acc	-2.31	-6.97	-10.20	-10.20	-4.33	4.21
UK Retail Price Index	0.60	1.49	2.93	2.93	6.68	9.41
Excess (a)	-2.91	-8.46	-13.14	-13.14	-11.01	-5.20

Source: Lipper IM / First State Investments (UK) Limited.

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than the share class currency, the return may increase or decrease as a result of currency fluctuations.

Performance figures have been calculated since the launch date. Performance data is calculated on a net basis by deducting fees incurred at the Fund level (e.g. the management and administration fee) and other costs charged to the Fund (e.g. transaction and custody costs), save that it does not take account of initial charges or switching fees (if any). Income reinvested is included on a net of tax basis.

RISK FACTORS

This document is a financial promotion for First State Diversified Growth Fund for professional clients only. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** changes in exchange rates will affect the value of assets which are denominated in other currencies.
- **Emerging market risk:** emerging markets may not provide the same level of investor protection as a developed market; they may involve a higher risk than investing in developed markets.
- **Derivative risk:** the use of derivatives may result in large price fluctuations and gains or losses that are greater than an investment in the underlying asset.
- **Credit risk:** the issuers of bonds or similar investments may not pay income or repay capital when due.
- **Interest rate risk:** interest rates affect the value of investments; if rates go up, the value of investments fall and vice versa.

Reference to specific securities or companies (if any) are included to explain the investment strategy and should not be construed as investment advice, or a recommendation to invest in any of those companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

¹ Net of fees and tax for the B GBP Accumulation share class

Investment process

The investment process comprises two building blocks. The first, which we call Neutral Asset Allocation (NAA), sets longer-term, beta allocations on a long-only basis. The second part, which we call Dynamic Asset Allocation (DAA), allows us to exploit shorter-term alpha opportunities through proprietary strategies that aim to be uncorrelated to broader markets. Further, DAA strategies aim to help manage risk through protection strategies. We review the DAA on a weekly basis.

For a comprehensive description of the investment process, click [here](#)

Market review

Investor concerns regarding global trade and slowing global growth dominated sentiment which peaked in mid-December. A combination of rising US interest rates, protectionist policies such as trade tariffs, slowing Chinese growth and an unstable political agenda across the US and Europe, including Brexit, continue to form a difficult environment for high growth assets such as equities, high yield corporate bonds and commodities.

The prices of listed shares across the world fell sharply in the fourth quarter of 2018, erasing the year-to-date gains. The prospect of weaker global demand pushed energy prices lower while sovereign bonds provided positive returns as yields fell and precious metals provided a 'safe-haven' for investors.

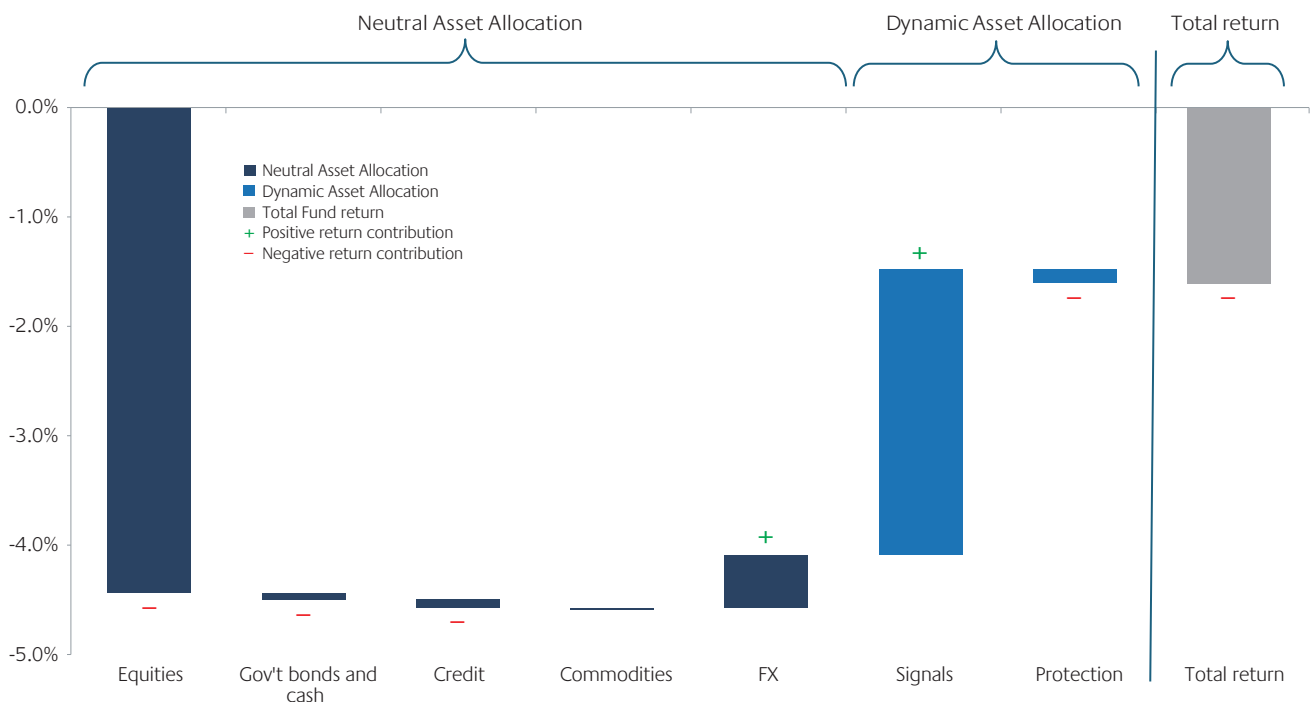
Portfolio performance and attribution

The NAA detracted from performance, as shown in Figure 1. This was driven by market exposure to equities while currency exposure provided a small contribution as Sterling fell. DAA positions provided positive returns which was almost entirely through Investment Signals.

Figure 2 provides a decomposition of returns for both the quarter and the year. UK and Global (ex-UK) equities detracted a total of 3.8% over the quarter, while exposure to sovereign and inflation-linked bonds provided a positive contribution. Corporate and hard currency emerging bonds detracted slightly. Currency exposure achieved through the Fund's equity and local currency emerging market bonds provided a positive return.

Investment Signals provided a welcome offset to performance of the NAA. Investment Signals within equities added 2.0%, while fixed income and currency exposures contributed 0.3% each to performance over the quarter.

Figure 1: Quarter-end performance contribution to 31 December 2018



Source: First State Investments as of 31 December 2018. Month end data since inception.

Figure 2: DGF return contribution

	Risk Contribution (%)	Contribution to 3m return (%)	Contribution to 1 yr return (%)
UK equities	1.17	-0.73	-0.35
World (ex UK) equities	3.92	-3.08	-1.67
Government bonds and cash	0.10	0.12	0.29
Inflation-linked bonds	0.00	0.28	0.45
Emerging market bonds (HC)	0.00	-0.09	-0.30
Emerging market bonds (LC)	0.38	0.31	-0.13
Corporate bonds	0.39	-0.07	-0.07
Commodities	0.00	0.00	0.00
Currency hedging	0.05	-0.85	-1.34
Protection strategies	0.00	-0.13	-0.18
Other	-0.07	0.00	-0.06
Investment Signals			
Equities	-0.75	1.98	-1.54
Bonds	1.09	0.32	0.79
Currencies	0.24	0.33	-4.16
	6.51	-1.61	-8.27

Source: First State Investments. Gross performance contribution might differ from official performance, due to data source, pricing, and timing.

Key drivers of performance over the period:

- NAA positions detracted 4.1%, primarily driven by returns from US and UK equities.
 - UK equities detracted -0.7% while global equities detracted -3.1%.
 - Developed market government bonds and cash contributed 0.4%, mainly from inflation-linked bonds
 - Emerging market bonds and currencies contributed 0.2%, with local bonds contributing and hard currency bonds detracting slightly
 - Small losses on corporate bonds
- DAA positions added 2.5%, with positioning within equities, bonds and currencies all contributing positively.
 - The Q4 selloff in equities benefited the positions informed by our equity signals as they added 2% led by shorts in France, US and Norway. The long positions detracted.
 - The contribution from positioning within bonds added 0.3%. Emerging markets performed well despite weakness in equities. Long positions in India, South Africa and China were the largest contributors, while short duration positions in Czech Republic and Denmark were detractors.
 - Currency positions added 0.3% to performance, which was due the preference for emerging markets and the long USD position performing well as a safe-haven currency.
 - We saw a modest loss from protection strategies. This position relates to ongoing Brexit-related uncertainty and is an insurance policy we will likely hold until we have more clarity.

Portfolio positioning

Neutral Asset Allocation ('NAA') positioning

In November we reviewed our NAA. As a result of higher growth expectations and lower prices for certain asset class exposures we made changes to our longer-term asset allocations.

The allocations to UK and global (ex-UK) equities increased from 35% to 50%. Within fixed income, we exited the allocation to inflation-linked bonds in the US and Australia. This allocation was introduced in early 2016, but the exposure is no longer attractive due to a subdued outlook for inflation as global growth returns to trend levels.

We re-introduced an allocation to corporate credit via US high yield. This allocation was removed at the end of 2017 as credit spreads compressed to levels that offered our strategy very little towards our return objective. As credit spreads have widened over recent months, the expected returns have increased, warranting a 10% allocation.

The next NAA review will be conducted in May 2019 or sooner if a market event changes our economic climate views.

Figure 3: DGF Neutral Asset Allocation

DGRF NAA	May-18		Nov-18	Change
Liquid securities	10.0%	▼	5.0%	-5.0%
Short-dated gilts	15.0%	▲	27.0%	12.0%
Long-dated gilts	0.0%	–	0.0%	0.0%
Global government bonds	25.0%	▼	0.0%	-25.0%
High yield	0.0%	▲	10.0%	10.0%
EM local currency bonds	5.0%	▲	8.0%	3.0%
EM hard currency bonds	5.0%	▼	0.0%	-5.0%
UK Equities	7.0%	▲	12.5%	5.5%
World (ex-UK) Equities	28.0%	▲	37.5%	9.5%
Commodities	5.0%	▼	0.0%	-5.0%
Total	100.0%		100.0%	

Source: First State Investments

Dynamic Asset Allocation ('DAA') positioning

We began the quarter with DAA positioning expressing a preference to reduce equity exposure. This preference increased over the quarter, as we preferred selective allocations within bonds, and the Fund ended December with a net reduction in equities of 24% from DAA.

Within fixed income our preference was to allocate towards emerging market governments bonds and avoid the UK and US. During the quarter, our views – informed by our Investment Signals – pointed to a more supportive environment for fixed income over the short-term. We added 3.8 years of duration via reducing the short in the UK, increasing exposure to the European governments of France, Germany and Italy, and adding to a basket on emerging market exposures such as Mexico, China and South Africa.

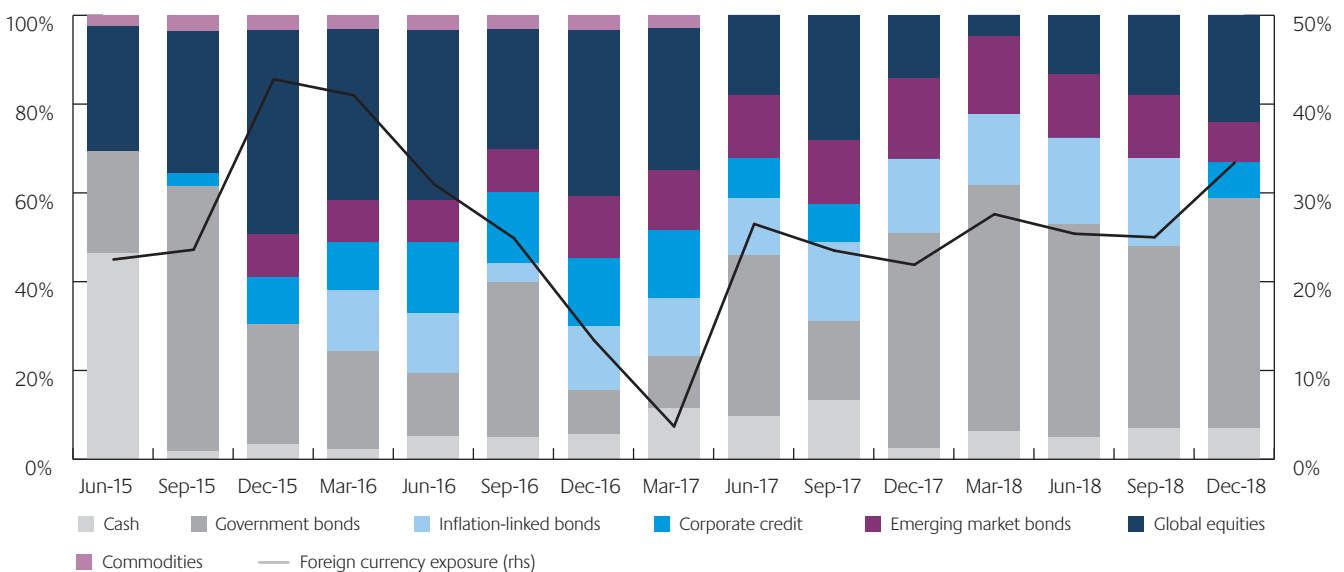
Within currencies the largest foreign currency holding was to the USD. Over the quarter we reduced the long held position in USD by half to 5% while adding defensive exposure to the CHF and reducing long positions in Japan.

Combined NAA and DAA fund portfolio positioning

The Fund only had a moderate overall exposure to equities at 24%; where we prefer the UK, US and Europe over emerging markets. The duration (interest rate risk) of the Fund is focused on emerging markets where we see the greatest opportunities. Foreign currency of the Fund increased over the quarter to 33%.

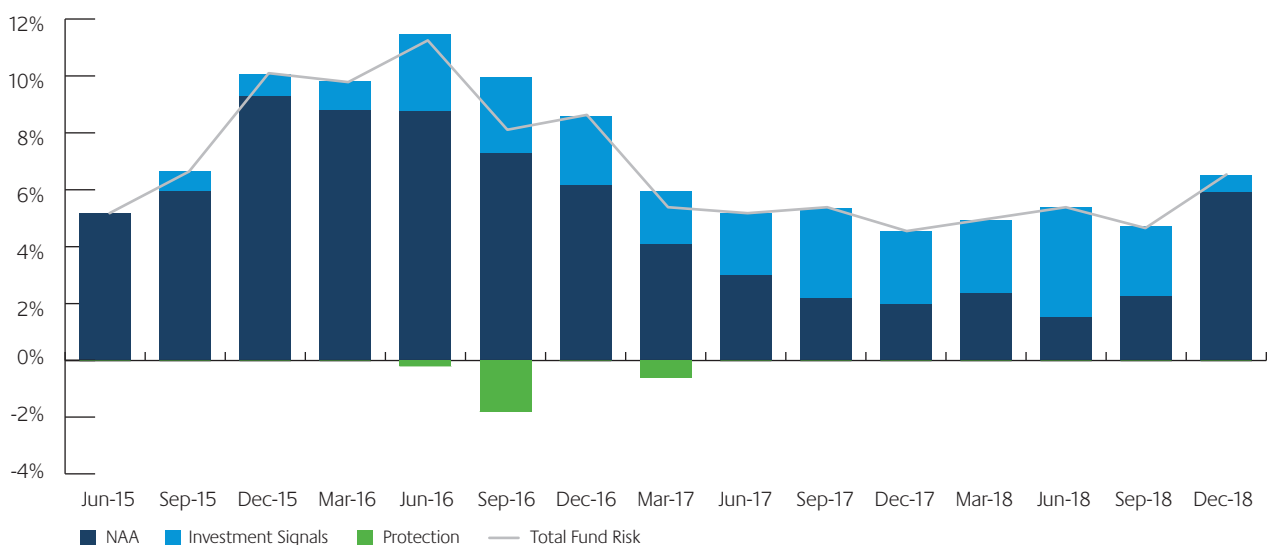
Given equity and bond valuations, we continue to believe the NAA will be unlikely to deliver the required return to meet the Fund's objective of RPI + 4% over a rolling 5 year period.

Figure 4: Asset allocation as at 31 December 2018



Source: First State Investments

Figure 5: Portfolio ex-ante risk



Source: First State Investments

Market outlook

For 2019, we believe that monetary and fiscal policies will continue to dominate, and trade tensions will periodically rattle the investment landscape.

A plethora of market risk factors ranging from worsening US-China trade tensions, Fed's overly hawkish stance, a potential no-deal Brexit, ending of ECB's quantitative easing programme, prolonged US government shutdown, escalation of yellow vest protests in Europe, China's slowdown acceleration, etc. are risks that could potentially spook the markets further in 2019.

We believe that rising volatility, geopolitical uncertainty, and late-cycle market conditions call for an increased focus on portfolio resilience. More than just being overall conservative and defensive, selective risk exposure is essential for meeting portfolio's long-term objectives. We align this theme with our investment strategy where we combined our medium to long-term view through the setting of our NAA, and overlay it with our DAA which extracts alpha from shorter-term market disequilibria.

The portfolio's current NAA reflects an increasingly favourable view towards emerging market assets post the significant sell-offs in both equities and fixed income and as such, we have increased our allocation to EM assets and duration. Our DAA, however, paints a slightly more cautious picture due to the recent volatility; overweighting duration, underweighting equities and selective foreign currency positions. Portfolio positioning and trade decisions should strive towards capital preservation and its return objective.

As the saying goes, 'A smooth sea never made a good sailor'. 2018 provided a prelude to how fragile the markets can be after a decade-long bull run. 2019 is likely to be another turbulent year full of crosswinds. However, if navigated well, these winds can be exploited and redirected to propel the portfolio towards its objective. In summary, we believe our portfolio strategy has a consistent and systematic approach that can best improve the portfolio's potential of recovering recent losses and meeting the investment objective over the mandated investment horizon.

A summary of the Fund's positions, along with changes over the quarter, can be found in Figure 6:

Figure 6: Fund positioning and quarterly changes

Equity allocation by region	NAA	DAA	NAA + DAA = Portfolio as at December 2018	3m change
UK	12.7%	5.4%	18.0%	▲ 7.5%
US	12.3%	-6.0%	6.3%	▲ 0.8%
Eurozone	9.7%	7.8%	17.5%	▼ 0.8%
Japan	4.8%	3.3%	8.1%	▲ 8.9%
Other Developed Markets	1.8%	-16.6%	-14.8%	▲ 4.1%
Emerging Markets	7.1%	-18.1%	-11.0%	▼ 14.5%
	48.4%	-24.3%	24.1%	▲ 5.9%

Duration contribution by region	NAA	DAA	NAA + DAA = Portfolio as at December 2018	3m change
UK	0.3	-1.2	-1.0	▲ 1.0
US	0.3	-0.9	-0.5	▼ 0.7
Eurozone	0.0	1.5	1.5	▲ 1.4
Japan	0.0	0.0	0.0	▲ 0.5
Other Developed Markets	0.0	0.1	0.1	▼ 0.3
Emerging Markets	0.3	3.4	3.8	▲ 0.4
	0.9	3.0	3.9	▲ 2.2

Currency exposure by region	NAA	DAA	NAA + DAA = Portfolio as at December 2018	3m change
UK	73.9%	-7.3%	66.6%	▼ 8.4%
US	-0.4%	5.1%	4.7%	▼ 3.3%
Eurozone	1.5%	-6.0%	-4.5%	▲ 1.0%
Japan	4.1%	-2.1%	2.0%	▼ 4.0%
Other Developed Markets	5.3%	-6.8%	-1.5%	▲ 10.5%
Emerging Markets	15.5%	17.1%	32.6%	▲ 4.0%
	100.0%	0.0%	100.0%	0.0%

Source: First State Investments

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For wholesale enquiries contact enquiries@firststate.co.uk

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