ALL THE FUN OF THE FAIR: DGF NAA REVIEW

Multi Asset
May 2019

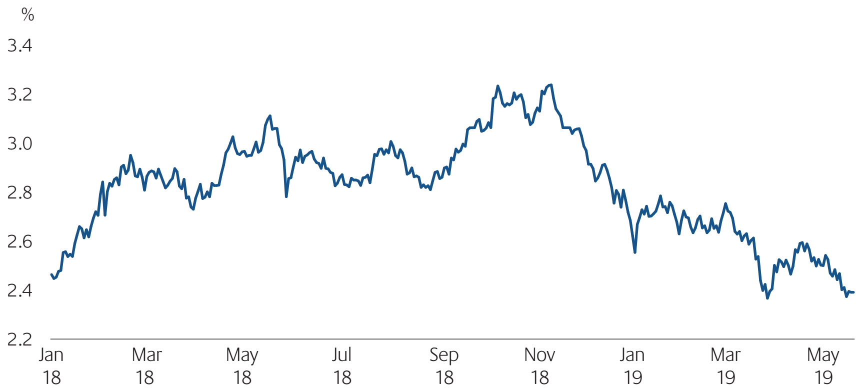
We have recently reviewed the Neutral Asset Allocation (NAA) for the First State Investments Diversified Growth Fund; an exercise that's undertaken twice a year. This note summarises the key drivers of investment markets over the last six months and outlines the changes made to NAA following the most recent formal review process.

Financial markets provided plenty of thrills and spills over the past few months. At times, investing felt rather like a trip to the funfair.

A helter skelter ride for bond yields

The experience for bond market investors was something like a ride on an old-fashioned helter skelter. Like an excited child heading skyward up those long staircases, US Treasury yields climbed higher and higher throughout 2018; breaking through the 3.20% level in the fourth quarter. What a view from the top! This was the highest Treasury yields had been since 2011 – surely, it was just a matter of time before they climbed through 3.50% and beyond?

Figure 1: 10-year Treasury yields



Source: Bloomberg, 1 January 2018 to 20 May 2019

In fact from there, yields spiralled rapidly downward, seemingly out of control. Like a hessian sack on a polished slide, this was a fast one-way ride to the bottom that left investors a little dizzy. Anyone with a short duration bias in their bond portfolio might even have felt a nasty bump when they hit the ground. By March 2019, Treasury yields had slid back down to 2.40%, very close to where they had started 2018.

What exactly is the NAA review?

The first step in our investment process is to determine the economic outlook, both globally and for individual countries. Twice a year, we formally review existing assumptions and determine the likely long-term values for inflation, risk free rates, long-term bond yields, and earnings growth.

Using current valuations as a starting point, these determinations enable us to calculate expected returns for various asset types globally. In turn, this helps inform the most appropriate mix of investments (NAA) that have the highest likelihood of achieving the Fund's long-term objectives.

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.

Like we have seen so many times before, movements in global bond markets set the tone for sentiment towards other asset classes.

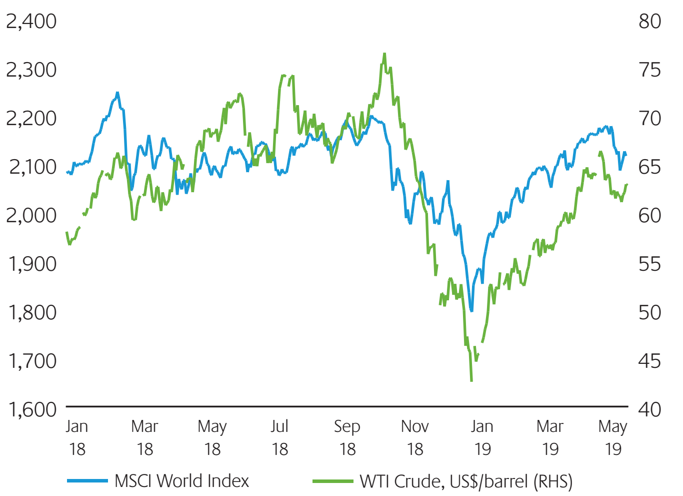
The sharp downturn in global bond yields in late 2018 and early 2019 was a reflection of the widespread deterioration we were seeing in economic data at the time. In most regions, a broad range of leading indicators suggested the pace of growth was likely to decelerate sharply. Manufacturing data was worsening in both Europe and Asia, for example, and various surveys implied the US economy may be coming off the boil following a period of stellar growth.

Equities: The big dippers

These same dynamics were playing out in equity markets too, as well as in the oil price. Both resembled a big dipper over the past six months – at times, we saw the whites of their knuckles as genuine fear gripped hold of investors. Faced with the prospect of slowing economic growth, stock markets plunged globally towards the end of 2018. The oil price also plummeted as growth forecasts were slashed. By late December WTI Crude was around US$42 a barrel, having traded above US$75 less than three months earlier.

There were some unexpected twists and turns to come on this particular rollercoaster ride.

Figure 2: Equity and oil markets



Source: Bloomberg. 1 January 2018 to 20 May 2019

As well as the general deterioration in economic data, inflationary pressures were moderating globally and Consumer Price Index (CPI) remained below target in almost all major regions. In turn, investors started to suggest that monetary policy settings might not be tightened as much as had previously been anticipated. As recently as late 2018, consensus expectations suggested the Federal Reserve would raise US interest rates twice during 2019 and most investors expected policy settings to be tightened in Europe and potentially in Japan.

These opinions shifted considerably and also quite quickly. In early 2019, investors increasingly pared back their expectations for policy tightening globally, most notably in the US. Those earlier forecasts for two rate hikes were quickly downgraded to one, and then to none. In fact, some commentators suggested economic conditions were deteriorating so substantially that policy settings might even need to be eased. In March, the Chairman of the Federal Reserve confirmed what markets had been saying for several weeks; that US interest rates were unlikely to be raised this year.

This significant reversal in policy was the catalyst for a strong and sustained rally in equity markets in the first quarter of 2019. Investors welcomed the prospect of global interest rates remaining low as accommodative policy settings are generally perceived to be supportive of equities and other risk assets. Like a rollercoaster car slowing as it approaches the station, equity investors have had a much smoother ride recently – by April, a renewed sense of calm had returned to stock markets globally. Oil regained its poise too, recovering almost all of its earlier lost ground.

Political developments spooked investors at times

Like a ghost train, the political background remained as dark and murky as ever. There were plenty of oohs and aahs to spook investors, not least the threat of an intensification in the global 'trade war' – specifically the likelihood of additional tariffs being introduced on goods imported into the US. Dialogue between US and Chinese officials continued and while updates on the discussions have been encouraging, no firm agreements have been made so far. The US President also threatened additional tariffs on European goods – quite a frightening prospect for auto makers and other large exporters in the region. The introduction of further import tariffs being introduced remains a key risk for markets; those already implemented have had a meaningful adverse influence on trade volumes in Asia, in particular, and have acted as a drag on growth.

At the same time, political tensions continued to bubble away just beneath the surface in Italy. Relations between the new government and European Union officials remain strained, particularly around Italy's potential fiscal deficit that might contravene EU rules. The Italian economy has dipped into recession following two consecutive quarters of contraction. There has been a sharp slowdown in France too and political stability has been rocked by the emergence of the populist 'yellow vest' movement. In April, French President Macron was forced to offer tax cuts to dampen the unrest. This was another reminder of how unexpected developments can have serious implications for major economies and, potentially, financial markets.

The political background in emerging markets remained somewhat unpredictable and perilous. In Brazil, for example, important economic reforms proposed by new leader Jair Bolsonaro struggled to pass through Congress. Elections have just been held in India, Turkey and South Africa and Argentineans will go to the polls later this year. Given crises in emerging regions have often been linked to political cycles, international investors will continue to scrutinise the policies and progress of newly-elected leaders.

A bruising ride on the UK dodgems

Of course, no trip to the funfair would be complete without a ride on the dodgems. The ongoing Brexit debacle provided exactly that. The drivers of the cars – UK politicians and other key stakeholders in the process – continually changed direction, zig zagging around and banging into one another at every turn.

The original target date for the UK to withdraw from the European Union in late March came and went without an agreement being reached, effectively forcing European leaders to agree to an extension of the deadline.

UK economic activity slowed in the last quarter of 2018 due to a big decline in investment spending. This was due to a drag on trade largely a result of ongoing Brexit uncertainty and slowing global demand. Ongoing Brexit uncertainty will continue to weigh on the economy, even with a tight labour market pushing the unemployment rate to a 44 year low of 3.8%.

Keeping our feet on the ground

While volatile market conditions can be daunting for investors, fluctuating valuations present opportunities as well as risks. Managing these risks diligently and systematically is central to the Fund's investment philosophy. As well as targeting returns that are consistently above inflation, the Fund seeks to minimise drawdowns and preserve investors' capital. It's important to keep our feet firmly on the ground, even as the sights and sounds of the fairground fill the air around us.

With more than two decades' experience managing multi-asset portfolios, we know there's no crystal ball. So you won't find us in the clairvoyant's tent. Instead, we will continue to implement the Fund's established and methodical NAA investment process and then amend positioning through the Dynamic Asset Allocation (DAA) process as and when opportunities present themselves.

First State Investments Diversified Growth Fund: Neutral Asset Allocation as at May 2019

Equities

Exposure to equity markets remains unchanged following the most recent review – a mix of UK and overseas shares continues to account for half of the Fund's NAA. Both have performed well over the past six months, but conditions appear to remain supportive and we believe equity markets can make further progress in the months ahead. Global GDP forecasts have been revised a little lower, but growth of more than 3.0 per cent this year should nonetheless help underpin investor sentiment. Listed companies continue to benefit from relatively low funding costs and it appears unlikely that interest rates will be increased in key regions. In turn, solid profitability should enable companies to reward investors with reasonable dividends as well as the prospect of capital growth.

Credit

At 10%, the allocation to high yield credit is also unchanged. Encouragingly, corporate earnings are holding up well – in the US, for example, most results releases for the March quarter were ahead of, or at least in line with consensus expectations. Corporate bond issuers are comfortably able to meet their debt repayment obligations currently and default rates remain low. With inflation under control and bond yields under downward pressure in key regions, risk free rates are expected to remain subdued. The additional yield pickup from credit markets could therefore remain appealing. Income seeking investors have continued to allocate to the asset class since the beginning of 2019; inflows into high yield credit markets started 2019 at their fastest pace since 2012. These inflows should ensure that demand for issues in the primary and secondary markets remains strong and could see credit spreads grind tighter from current levels. Spreads have narrowed substantially in the past few months, but remain well below their lows from early 2018. The main risk is that economic data softens or that unexpected macro events cause a seismic shift in sentiment, which could put valuations under pressure again.

Within emerging markets, the Fund's previous investments in local currency bonds have been sold. Returns have been supported recently by the strength of emerging market currencies versus the US dollar, but we question the sustainability of the rally and have taken the opportunity to lock in profits from this position. Sentiment towards emerging markets is notoriously fragile – this certainly appears to be the case currently, with trade-related concerns continuing to cloud the outlook for emerging economies that are typically reliant on export demand for growth. As mentioned earlier, changes to geopolitical sentiments are likely to hit emerging markets particularly hard.

Government bonds

The previous exposure to emerging market local currency bonds has been reallocated into short-dated gilts. Following this move, UK government bonds now account for more than a third of the Fund's NAA. As recently as late 2017, inflation in the UK was running at around 4 per cent; above the Bank of England's target. Since then inflationary pressures have moderated sharply, pushing RPI down to 2.4% in March 2019. Gilt yields have fallen sharply against this background as investors have tempered their expectations for further increases in official UK interest rates. Money markets currently suggest there is less than a 20 per cent probability of a rate hike within the next six months. With inflation under downward pressure and activity levels in the domestic economy continuing to be affected by Brexit-related uncertainties, we believe there is scope for yields to go lower still in the near term, potentially supporting returns from short-dated gilts. The NAA is currently targeting a zero allocation to overseas government bond markets, where expected returns remain low and relatively unappealing for a product of this type.

The NAA currently has a zero allocation to commodities. The oil price has been particularly volatile over the past six months and gold has made positive progress. At times, the Fund has made dynamic allocations to the latter as a hedge against volatility in other asset classes.

The Fund maintains a strategic allocation to cash, which can be deployed when attractive investment opportunities present themselves.

A summary of the changes outlined above and confirmation of the Fund's updated NAA is provided below.

Figure 3

DGRF NAA	Nov-18		Apr-19	Change
Liquid securities	5.0%	–	5.0%	0.0%
Short-dated gilts	27.0%	▲	35.0%	8.0%
Long-dated gilts	0.0%	–	0.0%	0.0%
Global government bonds	0.0%	–	0.0%	0.0%
High yield	10.0%	–	10.0%	0.0%
EM local currency bonds	8.0%	▼	0.0%	-8.0%
EM hard currency bonds	0.0%	–	0.0%	0.0%
UK Equities	12.5%	–	12.5%	0.0%
World (ex-UK) Equities	37.5%	–	37.5%	0.0%
Commodities	0.0%	–	0.0%	0.0%
Total	**100.0%**		**100.0%**	

Forecasting returns from the various asset classes continues to suggest that NAA alone is unlikely to deliver the Fund's performance objectives. As such, DAA will continue to play a key part in the risk we take in the portfolio, and as a driver of total returns going forward.

Taking into account shorter-term market dynamics and valuations, the DAA process complements the Fund's longer-term, strategic NAA. DAA positioning can deliver additional returns and help mitigate portfolio risks, such as tail events. By adding this return source (alpha), we increase the likelihood of achieving the Fund's long-term objectives.

How do we determine the right mix of NAA (beta) and DAA (alpha)?

Based on our assumptions for the economic climate, and our expected returns, we can determine the likelihood of meeting the portfolio's investment objective over the investment horizon. It is becoming increasingly likely that relying solely on the NAA in a constrained long-only, unlevered environment will not be sufficient to meet the return objectives. This is where we use our DAA process to take into account shorter-term market dynamics to deliver additional returns and aim to abate portfolio risks, such as tail events. By adding an uncorrelated return source (alpha) we can improve the portfolio's likelihood of meeting the investment objective.

The combination of NAA and DAA requires the consideration of the current allocations; as the extent to which active management may be used is managed through the portfolio's risk budget to avoid unwanted additional risks. We consider both the tracking error (as well as other risk metrics) and the expected return, in assessing the portfolio's ability to meet its investment objective. The ability to add scalable alpha to portfolios provides flexibility to try and deliver on the investment objective; even in a lower return environment.

The investment objective of the Fund is UK Retail Price Inflation +4% gross of fees over a rolling five year period. The NAA strategy, shown in ~~the following chart~~ provides a nominal return of just under 3%, leaving a shortfall in required returns to meet the Fund's objective. Based on this NAA and the required return for the Fund, we have maintained the DAA tracking error risk budget at 5% to maximise the potential of us ~~of~~ reaching our investment objective, as outlined below.

Therefore, even in a lower return environment, by allowing the blending of alpha and beta strategies to be more dynamic within the framework described above, we still have the potential to deliver on our client's investment objectives.

In the current low return environment it is critical to have the flexibility to blend beta and alpha to deliver a real return of 4% for the Fund over five years. Our investment process and philosophy provides our clients the highest possibility of obtaining a real return, with the current outlook making our DAA paramount.

Performance overview

Annual Performance (% in GBP) to 30 April 2019	12 mths to 30/04/19	12 mths to 30/04/18	12 mths to 30/04/17	12 mths to 30/04/16	12 mths to 30/04/15
First State Diversified Growth B GBP Acc	-3.2	2.1	13.4	-	-
UK Retail Price Index	2.1	3.4	2.9	-	-
Consumer Price Index	1.5	2.4	2.7	0.3	-0.1
MSCI World Index	12.5	6.3	29.8	0.5	18.0
WTI Crude CR	-6.9	39.0	7.2	-22.9	-40.4

Cumulative Performance (% in GBP) to 30 April 2019	Since Inception 23/06/15	2 years	1 year	YTD	6 mths	3 mths
First State Diversified Growth B GBP Acc	12.4	-1.2	-3.2	7.9	6.6	4.0
UK Retail Price Index	9.4	5.6	2.1	0.0	0.2	-0.2
Real Return	3.0	-6.8	-5.4	7.9	6.5	4.2

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

Why First State?

Our investment strategy blends the qualitative views and experience of the team with the discipline and rigor of quantitative analysis resulting in a flexible approach to design and implementation of investment portfolios.

Investment decisions are taken with respect to the overall portfolio objective, unconstrained by conventional benchmarks or fixed asset allocation. Our flexibility to blend alpha and beta strategies is a key differentiator and essential to deliver on the investment objective over time.

Risk management is integral to our investment process. We continually seek to balance the trade-off between upside potential (meeting our investment objectives) and downside risk (capital loss), which we believe can generate consistent results.

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