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Multi Asset

THE RETURN OF VOLATILITY: DGF NAA REVIEW

Multi Asset Solutions

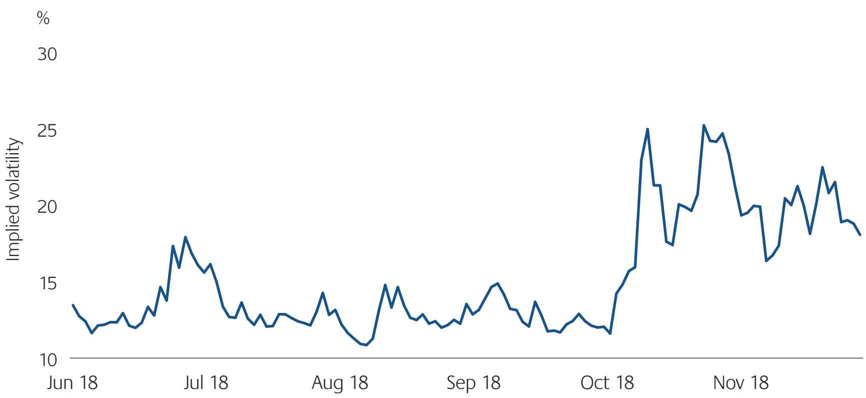
December 2018

We have recently updated economic climate assumptions for individual countries and, in turn, amended the Neutral Asset Allocation (NAA) for the Diversified Growth Fund. It's a process that we complete twice a year. This note summarises the key drivers of investment markets over the most recent six month period and, more importantly, outlines changes made to the NAA following the formal review process.

As part of our last NAA review at the end of May of this year, we discussed the increase in volatility. Investment markets subsequently enjoyed a period of relative calm, which persisted throughout the UK summer. The VIX index – a commonly referenced measure of volatility in global financial markets – remained below long-term averages around this time; a period of relative serenity as investors dreamed about football coming home.

The optimism didn't last, for the markets or for football fans.

Figure 1: VIX Index



Source: Bloomberg, 1 June 2018 to 30 November 2018.

As we've seen so many times before, calm conditions in financial markets rarely persist for long. So it was unsurprising when another bout of volatility buffeted markets in October – highlighted by the spike in the VIX Index in Figure 1. Markets appeared to pause for breath as investors reassessed the longterm outlook for economic growth and corporate profitability and increasingly questioned how higher interest rates will affect valuations. It remains to be seen how global markets react to the withdrawal of a decade of unprecedented support following the Global Financial Crisis (GFC). These are unchartered waters; nobody really knows how markets will respond as the era of cheap money comes to an end.

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.

Economic prosperity in the US

Regrettably the Brexit debacle continues to affect activity levels in the UK and has dampened business confidence, in particular. At the same time, conditions in Continental Europe have been affected by instability in Italy; specifically the perilous financial situation the country finds itself in. Friction between Italy's new populist government and EU officials threatens to undermine the political status quo, even after Britain's withdrawal in early 2019.

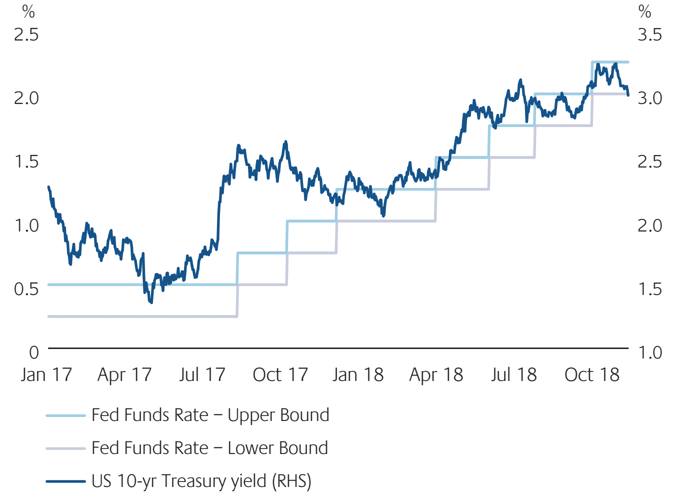
As we saw during November's Midterm elections, the US has political issues of its own, but economic conditions in America are unquestionably much stronger than on this side of the Atlantic. The US is in the midst of one of the most remarkable periods of economic expansion in modern times.

Growth in the world's largest economy accelerated to 4.2% yoy in the June quarter and while the pace slowed slightly in the September quarter, the 3.5% annual growth rate was nonetheless quite impressive. Government stimulus has helped promote solid, broad-based growth in the economy. Importantly, this has helped support employment; the US economy added more than two and a half million jobs in the year ending 31 October 2018, enabling the unemployment rate to fall to its lowest level in nearly 50 years. Unsurprisingly, though somewhat belatedly, these buoyant conditions are starting to feed through to wage growth.

Against this background, policy makers have been able to dance to a well-choreographed routine. For more than two years now, the Federal Reserve has been making it clear that interest rates will be increased at a measured pace towards a 'neutral rate' as policy settings are normalised following the GFC. The Federal Funds Target Rate was increased on two occasions over the past six months, both by 0.25 percentage points, lifting official interest rates in the US to between 2.00% and 2.25%. Exactly what the 'neutral rate' might be and at what level the tightening might be paused remains a subject of conjecture. For now, it appears likely that the Fed Funds Rate will be increased towards the 3% level – and quite possibly through it – during 2019.

The policy tightening mantra regurgitated by Federal Reserve Board members in their public statements has helped propel Treasury yields higher. As shown in Figure 2, official cash rates and bond yields have moved almost in lockstep over the past few months. Benchmark 10-year yields in the US were close to 2.80% at the end of May, but, in spite of a reduction during November, are now nearly 3.00%. As we've said before, movements like these hardly support the appeal of government bonds for investors with cash- or inflation-plus return targets.

Figure 2: Joined at the hip: US bond yields and interest rates



Source: Bloomberg. 1 January 2017 to 30 November 2018.

On the equity front, the sell-off in October meant returns were negative in most regions over the past six months. Corporate profitability – in the US, in particular – remained buoyant, but investors increasingly questioned for how long this will remain the case. The 20%+ annual increases in US company profits we've seen in recent months will not be sustainable over time.

Trade war-related concerns were also front of mind for investors, given the frequency and tone of media headlines on the issue. Ongoing dialogue between the US and China might be able to diffuse the situation, but there has been understandable concern among investors over how the introduction of widespread bilateral import tariffs might affect listed companies worldwide.

Export-oriented emerging economies appear particularly susceptible to lower trade volumes; unsurprisingly their share markets have underperformed more developed peers in 2018. Sentiment towards the emerging markets complex as a whole – including bonds as well as equities – has also been affected by high inflation and indebtedness in some countries. Countries with high levels of US dollar-denominated debt came under particular pressure as investors questioned how they would handle more onerous repayment obligations. This reflected in extreme currency volatility in some cases. The political background in emerging regions also remains fragile, with a groundswell of support for populist candidates proving unsupportive of investor sentiment on the whole.

Commodity prices have been volatile, too. Again, following a period of relative stability over the summer months, oil prices dropped sharply in October and November. Prices came under significant downward pressure reflecting the unexpected waiver of sanctions against purchasers of Iranian oil, record output in Saudi Arabia and rising production in the US. Even gold – perceived to be the ultimate 'safe haven' during periods of uncertainty – failed to preserve its value, declining by around 6% over the past six months.

Our Neutral Asset Allocation as at end-November 2018

Looking through the various headwinds that have buffeted markets over the past month or two, we continue to see the balance of risks and opportunities being fairly evenly balanced. Asset price fluctuations in October and November provided a timely reminder that markets will see periods of volatility as policy settings are normalised. The First State Diversified Growth Fund remains well diversified across the available asset universe and maintains liquidity to deploy as attractive opportunities present themselves.

Equities

Weakness in October and November improved the expected return profile from share markets and exposure to equities has therefore been increased to 50%, from 35% previously. We have added to the Fund's exposure to both UK and global equities.

The NAA suggests a quarter of the overall equity exposure should be held in UK shares. The remainder is spread across a diversified mix of overseas share markets, including an allocation to emerging markets where valuations appear attractive.

Credit

The Fund has had no exposure to high yield credit in 2018 after the previous holding was sold in December 2017. Since then, we've seen an increase in spreads and valuations have shifted sufficiently to significantly improve the appeal of the asset class for a Fund of this type. An allocation to the high yield credit market has therefore been re-established.

Government bonds

Among the most significant changes made as part of the most recent NAA review was a down-weighting in overall fixed income exposure. Specifically, we have recently sold the Fund's inflation-linked bonds. Superior returns are now anticipated in shorter-maturity bonds, as rates have increased. We have therefore increased the Fund's exposure to short-dated gilts quite significantly. The Fund continues to avoid longer-dated UK bonds, whose return profile remains unattractive relative to other opportunities both domestically and internationally.

Within emerging markets we have sold the Fund's hard currency bonds, but reinvested some of the proceeds into local currency issues that are more attractively valued following weakness over the past few months.

Finally, exposure to commodities has been removed and the cash weighting was halved – from 10% to 5% – as a result of other allocations.

A summary of the changes outlined above and confirmation of the Fund's updated NAA is provided in Figure 3 below.

Figure 3

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%**	

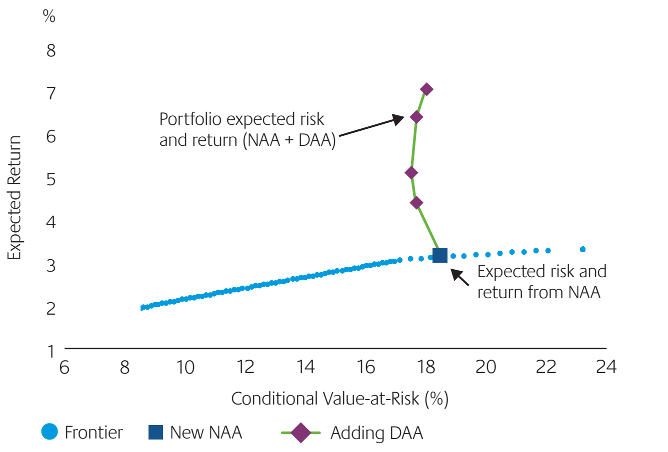
Source: Fisrt State Investments.

Expected returns from the various asset classes suggests we are unlikely to be able to generate sufficient returns to meet the Fund's performance objective from NAA alone. As such, Dynamic Asset Allocation (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.

Our DAA process complements the longer-term, strategic NAA positioning; taking into account shorter-term market dynamics. 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 annual investment objective of UK RPI + 4% gross of fees.

Given the increase in market volatility recently, a smaller allocation of the Fund's risk budget is currently being allocated to DAA. Over the investment horizon, we would expect around two-thirds of the Fund's total returns to be generated by market returns, i.e. NAA, with the remainder generated from DAA.

Figure 4



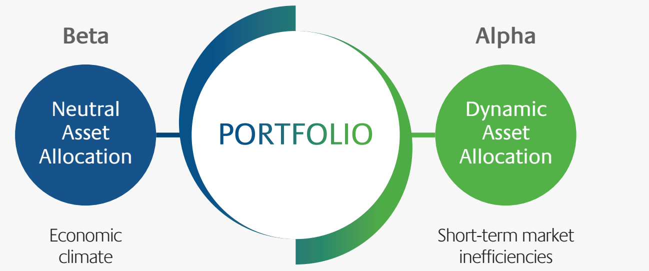
Source: First State Investments

Investment process

Within our investment process we have two building blocks. The first, which we call Neutral Asset Allocation (NAA), sets longer-term asset allocations. The second part, which we call Dynamic Asset Allocation (DAA), allows us to exploit shorter-term opportunities in markets.

The first step of our NAA process is to set the economic climate for each country. We use the economic climate assumptions within our set of proprietary stochastic simulation models to determine forward looking risk premia and expected returns. The process of determining the NAA uses these expected returns for the building blocks of the portfolio allocations incorporating the return objectives, constraints, and investment horizon of the portfolio.

Our DAA process, on the other hand, takes into account the shorter-term market dynamics to deliver additional returns and abate portfolio risks, such as tail events. This part of our investment process, which includes our investment signals and qualitative overlay, is formally reviewed each week and looks at (among other things) markets and fundamental data to take advantage of possible dislocations.



Performance overview

Annual Performance (% in GBP) to end-November	12 mths to 30/11/2018	12 mths to 30/11/2017	12 mths to 30/11/2016
First State Diversified Growth B GBP Acc	-7.83	9.00	9.16
UK Retail Price Index	2.98	3.65	1.89
Real Return	-10.81	5.36	7.26

Cumulative Performance (% in GBP) to end-November	Since Inception 23/06/2015	2 years	1 year	YTD	6 mths	3 mths
First State Diversified Growth B GBP Acc	6.46	0.47	-7.83	-8.26	-6.21	-0.48
UK Retail Price Index	9.30	6.74	2.98	2.83	1.81	0.89
Real Return	-2.84	-6.27	-10.81	-11.10	-8.02	-1.36

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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