

# FIRST STATE DIVERSIFIED GROWTH FUND

Multi Asset

December 2019

## Die Another Day

We have recently updated economic climate assumptions for individual countries and, in turn, amended the Neutral Asset Allocation (NAA) for the First State Investments 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.

Our first NAA review for 2019 occurred in May, at which point we discussed the increase in uncertainty at the hand of global geopolitical tensions and concern due to rapidly deteriorating economic data including closely watched leading indicators. Six months on, it appears the key concerns around global macroeconomic and asset class performance have yet to fully materialise although lingering worries still remain as we look towards 2020 and beyond. Indeed, it appears we will 'die another day' with respect to this seemingly never-ending global expansion.

Below we explore the main areas of concern which – for the time being – have yet to see the most extreme risks come to fruition:

### US-China trade war – gone but not forgotten

After more than 18 months of politically charged negotiations, the US-China trade war finally looks like it may be nearing the end – or at least the beginning of the end. A 'Phase One Trade Deal' is on the verge of implementation and markets are already behaving as if the entire issue has been resolved. While the global trade outlook appears to be moving in the right direction, the daily news flow indicates that this optimism can shift quickly. For example, in late November President Trump signed the Hong Kong Human Rights and Democracy Act into law, despite warnings from Beijing of 'consequences' for 'meddling' in China's affairs. This legislation endorsed by Trump will place sanctions on any Chinese officials found to have cracked down on Hong Kong protesters. Further, this will compel the State Department to certify on an annual basis that Hong Kong possesses enough autonomy to retain favourable trading terms with the US. If trade talks do stall, Chinese goods could face another rollout of tariffs mid-December and we will have to stick out this dispute well into 2020, perhaps dragging out through the US Presidential election in November. Meanwhile, the United States' multi-front trade war continues to expand with the latest proposals including tariffs on French goods such as cheese and champagne while threatening aluminium and steel tariffs on Brazil and Argentina.

### Brexit – kicking the can down the road...again

Since that fateful referendum took place in June 2016, the United Kingdom's withdrawal from the European Union, or Brexit, saga continues to run on borrowed time after receiving its third extension. With hopes of a resolution supposedly around the corner, the British pound has been remarkably resilient, finishing November at 1.30 vs the US dollar, which is a rise of 1.5% during 2019 so far. Since our last review, the FTSE All-Share Index has returned 5.4% between 31 May and 31 November 2019. However, if recent history is anything to go by, then this might not be the end of this complicated separation. Brexit continues to be a major risk for not just the UK but the rest of the world, particularly if a fragile European slips into recession as a result. Capital markets seem to now think that this Brexit problem will ultimately be 'figured out' but all that has really happened has been a delay (again) with a potential reckoning next year.

### 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.**

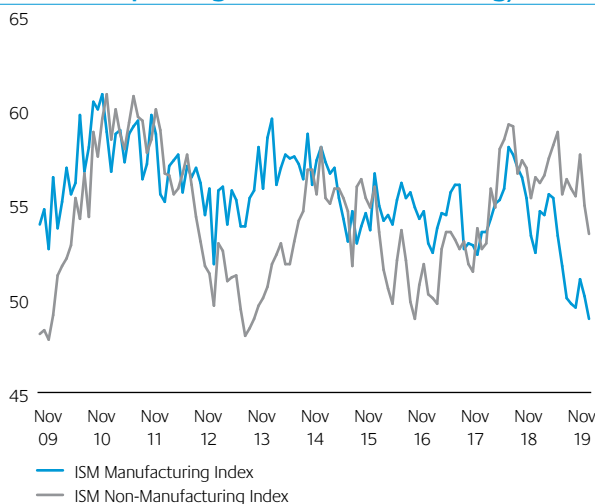
## What exactly is the NAA review?

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.

### US Economic Growth – despite old age, world’s largest economy lives to fight another day

In the midst of a declining global trade outlook, resilience remains the salient trait for the world’s largest economy as the US growth expansion has now entered its 11th year (and counting), making it officially the longest US expansion on record. Fickle trade negotiations have seen sentiment plunge amongst consumers and businesses alike. Along with impacting confidence, it appears that Trump’s trade war has started to flow through to the real economy, particularly hurting relevant manufacturing areas of the economy. The Institute for Supply Management (‘ISM’) said its manufacturing index sank to 48.1% in November from 48.3% the prior month (Figure 1). This was the fourth straight sub-50 reading, indicating a contraction in manufacturing activity. Also, we don’t need to guess as to the driver of this weakness – “Global trade remains the most significant cross-industry issue” as per the ISM. However, to-date we have not seen the manufacturing weakness spill over to the services sector. The ISM non-manufacturing sector grew for the 117th consecutive month, printing at 54.7% in October. Importantly, unemployment in the US has fallen to 3.6% - the lowest level since 1969 or over 50 years ago. Another sign of continued economic strength is a remarkably resilient corporate sector. As the earnings season finished for the quarter, almost 80% of companies beat last years’ estimates - not overlooking that these had been revised lower during the year. Housing permits have reached their highest levels since 2007. This resiliency may be attributed to the Federal Reserve (the ‘Fed’) easing, which had seen rates cut three times in 2019. Fed Chair Jerome Powell may have inferred that that monetary policy will stay where it is but markets anticipate one more cut early in the New Year. Whether or not this will continue only time can tell. With trade tensions unresolved and the 2020 US Presidential election approaching, political risks in 2020 have the potential to derail this seemingly neverending expansion.

**Figure 1: Institute for Supply Management Survey (above 50 is expanding, below 50 is contracting)**

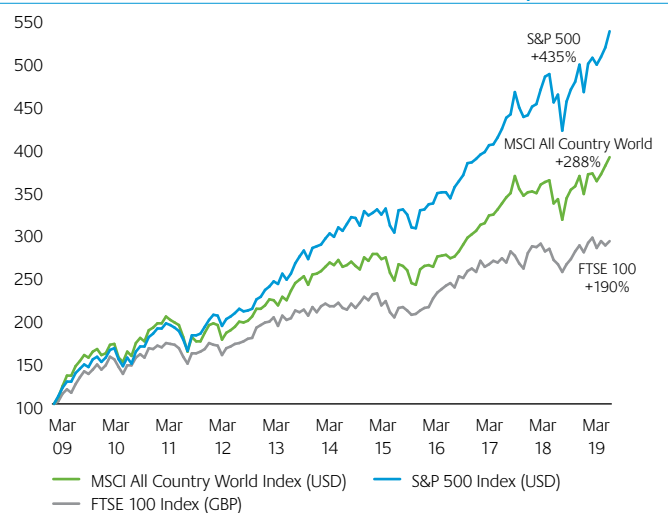


Source: Bloomberg as at 30 November 2019

### Equity Bull Run – Bad news is good news

We are currently living through the longest US equity market bull market run<sup>1</sup> on record – now in its 130th month! It appeared that the party was coming to an end a year ago during December 2018 – where we saw a sharp correction of more than 10%. But it turned out to be just that: a correction. After the brief wipeout, stock markets bounced back, and now we are likely going to see this bull market hit its 11th year. Other key equity markets have similarly performed well, albeit not quite to the same dizzying heights as the US (Figure 2). Along with the ebbs and flows of trade war rhetoric, the key driver of equity market sentiment has been the activity of central banks around the world. We have been sitting in a sort of goldilocks zone (i.e. not too hot, not too cold) for most of the year, where deteriorating data has been consistently met by loose monetary policy. Bad news in this case means good news for equity investors given this playbook has been in place for the better part of the past 10 years. The US central bank has cut rates three times this year to a current range of 1.5% - 1.75% as growth has moderated while inflation has been well behaved, albeit uncomfortably low for some at the Fed. Outside the US, the European Central Bank (‘ECB’) has continued to cut rates into further negative territory with the latest move to -0.5% and the resumption of its bond purchase program (€20billion per month) in the pursuit of lifting inflation and avoid a deflationary spiral. The Bank of England has kept its powder dry given the Brexit uncertainties but many other central banks around the world have shifted back to easing cycles: Australia, Canada, New Zealand, Hong Kong to name a few. Emerging markets are seeing even more extreme easing with too many to name here although the trend is clear – with the US dropping rates emerging market central banks are scrambling to match or exceed rate cuts in their countries to keep their currencies from appreciating too much and hurting exports.

**Figure 2: Equity market performance (March 2009 – November 2019, rebased to 100)**



Source: Bloomberg as at 30 November 2019

<sup>1</sup> A bull market is defined as an equity market rise of 50% or more over a period which ends when equities fall 20% or more (i.e. bear market).

## Bond bubble? – let (yields) slide

Are bond markets in a bubble? While we would not characterise current pricing as a ‘bubble,’ fixed income yields in many markets are certainly operating in uncharted territory. Monetary easing – both conventional and unconventional – is back in full effect by global central banks over the last six months. Both the US Fed and the RBA cutting rates three times in the second half of the year. In the last few months we have seen a price rally in the 10-year Treasury note which have pushed yields to new three-year lows. A similar story was seen amongst German bunds which is unsurprising with negative interest rates in the picture. In September bond markets were flashing alarm bells as the US yield curve inverted, with 10-year bond yields stooping below that of the two-year yields. This is of course contradictory to the concept that a longer-term bond should reward the holder with a higher return. While this has since corrected, inversion has typically been known as a recession indicator and has appeared before a majority of previous US recessions. The US yield curve has inverted before each of the last 7 recession, albeit with a lead time of between 11 and 23 months. There has also been one false signal in the 1990s around the time of the Long Term Capital Management (LTCM) crisis, when the curve inverted however this did not precede a recession (not until inverting again prior to the early 2000s recession). Perhaps of a bigger worry is the \$11.5 trillion or so of negative yielding debt which peaked at over \$17 trillion earlier this year (Figure 3). The prevalence of negatively yielding bonds does not indicate an imminent day of reckoning – that very well still may come. But what we do know is that expected returns have fallen in line with yields and although any future normalisation of rates has been pushed well out into the future, any rise in yields from here will likely see negative returns on this supposedly ‘defensive’ asset class.

**Figure 3: Government Bond Yields**

	Official interest rate	Government Bond Yields								
		6mth	1yr	2yr	3yr	5yr	7yr	10yr	15yr	30yr
Switzerland	-0.75%	-0.66%	-0.88%	-0.82%	-0.82%	-0.77%	-0.73%	-0.64%	-0.45%	-0.28%
Denmark	-0.75%	-0.77%	-0.77%	-0.68%	-	-0.55%	-	-0.34%	-	-
Sweden	-0.25%	-0.42%	-	-0.31%	-	-0.29%	-	0.01%	0.16%	-
Japan	-0.10%	-0.21%	-0.17%	-0.18%	-0.18%	-0.18%	-0.20%	-0.08%	0.09%	0.41%
Germany	0.00%	-0.63%	-0.64%	-0.64%	-0.66%	-0.59%	-0.53%	-0.36%	-0.23%	0.14%
Netherlands	0.00%	-0.76%	-	-0.64%	-0.65%	-0.54%	-0.42%	-0.22%	-0.09%	0.16%
France	0.00%	-0.62%	-0.57%	-0.60%	-0.58%	-0.36%	-0.29%	-0.05%	0.20%	0.72%
Finland	0.00%	-	-0.62%	-0.63%	-0.60%	-0.50%	-0.34%	-0.12%	0.11%	0.36%
Austria	0.00%	-	-0.61%	-0.59%	-0.58%	-0.44%	-0.31%	-0.13%	0.12%	0.44%
Belgium	0.00%	-0.63%	-0.57%	-0.63%	-0.59%	-0.41%	-0.29%	-0.07%	0.20%	0.74%
Ireland	0.00%	-	-0.48%	-	-0.47%	-0.36%	-0.17%	0.04%	0.32%	0.84%
Spain	0.00%	-0.54%	-0.56%	-0.39%	-0.36%	-0.10%	0.14%	0.41%	0.81%	1.28%
Portugal	0.00%	-0.54%	-0.52%	-0.56%	-0.36%	-0.10%	0.16%	0.40%	0.78%	1.32%
Italy	0.00%	-0.22%	-0.17%	0.02%	0.24%	0.56%	0.91%	1.23%	1.80%	2.36%
UK	0.75%	0.74%	0.67%	0.54%	0.50%	0.51%	0.50%	0.70%	0.94%	1.21%
Australia	0.75%	-	0.76%	0.68%	0.65%	0.69%	0.84%	1.03%	1.27%	1.62%
New Zealand	1.00%	0.94%	0.94%	0.97%	-	1.10%	1.21%	1.30%	1.66%	-
Canada	1.75%	1.68%	1.69%	1.58%	1.56%	1.49%	1.48%	1.46%	-	1.55%
USA	1.55%	1.57%	1.59%	1.61%	1.61%	1.63%	1.73%	1.78%	-	2.21%
China	4.15%	2.52%	2.62%	-	2.82%	2.97%	3.15%	3.17%	-	3.78%

## Key points driving our thinking

- The setting of the economic climate involves deciding on where we think the global economy is moving, and then for each country we determine the likely long-term values for inflation, risk free rates, long-term bond yields and earnings growth. By taking current valuations as a starting point, this allows us to determine expected returns for global assets from this point forward.
- Most recently, we have lowered our inflation assumptions across Europe and the majority of Emerging Market countries. As a result, we see lower risk free rates and bond yields across many markets.
- Portfolio positioning has focused on global equities, short-maturity UK government bonds, and credit. We remain cautious on global government bonds, European equities, and commodities.
- Overall, the changes to the NAA are modest.
- Just because the key risks impacting global economies and asset prices have not materialised in a dramatic fashion doesn't mean there were not risks over the past year. And we continue to believe these risks have the potential to play out more negatively in the period ahead. 2020 may be 'No Time to Die' either but we suspect at least some of these key risks will come to a more definitive resolution.
- While market conditions might appear risky and raise concern, this can also lead to opportunities. The risks the economic climate can present are always dealt with diligently and in line with the Fund's investment philosophy.
- The Fund continues to strive for consistent returns above inflation while minimising drawdowns and protecting investor capital.
- As a highly experienced team with over two decades' experience, the Multi-Asset Solutions team will continue to implement the Fund's established and methodical NAA investment process and then adjust positioning through the Dynamic Asset Allocation (DAA) process as opportunities arise.

## Neutral Asset Allocation as at November 2019

### Equities

Overall, the portfolio's allocation to equities has remained consistent with that from our last review earlier in the year at 50%. Developed world equities have been on a steady upward trajectory through most of the year. Since our prior review in May, the MSCI World Index returned 13.3% through 30 November 2019. Risk assets have been positively responding to the perceived progress in geopolitical frictions in both the US, China and the UK. After the European Union allowed the UK another extension to negotiate Brexit plans, European equities rose during October with some indices reaching two-year highs. The Japan TOPIX was the strongest performer for the third quarter as well as October. The economic data releases from Japan indicate a growing disparity between a weakening manufacturing sector and a strengthening service sector. World equities however now account for a 40% allocation in the NAA while UK equities has been reduced to 10%.

### Government Bonds

While 2019 has seen a considerable repricing of bond markets around the world with yields plummeting, more recently there has been a pullback due to improved economic data and encouraging political developments. Bond yields around the globe have been subject to monetary easing in many developed markets. While economic conditions remain subdued and inflation low, there appears limited scope for bond yields to rise significantly in key regions. This means that our expectations for returns in global government bond markets are to be low and relatively unappealing – hence exposure remains at 0%. The Fund maintains a strategic allocation to cash, which can be deployed when attractive investment opportunities present themselves.

### Credit

The high yield credit allocation has been maintained at 10%. The recent quarterly corporate earnings reporting season has come to an end with more than three quarters of firms announcing positive earnings surprises despite less impressive top line revenue growth. These solid fundamentals combined with low interest rates should help maintain already low default rates while continuing to boost investor sentiment. At the same time in Europe, credit markets were supported by the recommencement of the European Central Bank's asset purchase program. So far around a quarter of the ECB's asset purchases have been in corporate bonds, equating to an additional €5 billion per month of demand for European credit. Corporates took advantage of firm demand and favourable market conditions by increasing issuance. The pace of new supply has increased through the year, reaching nearly US\$100 billion per month in the investment grade sector although some proceeds are funding mergers and acquisition activity which tends to be unfriendly to bond holders. However, all of this new supply was absorbed with few signs of market stress, underlining the appeal of corporate bonds among income-hungry investors.

Figure 4: DGF Neutral Asset Allocation

DGRF NAA	Apr-19	Nov-19	Change	
Cash (liquid securities)	5.0%	–	5.0%	0.0%
Short-dated gilts	35.0%	–	35.0%	0.0%
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	0.0%	–	0.0%	0.0%
EM hard currency bonds	0.0%	–	0.0%	0.0%
UK Equities	12.5%	▼	10.0%	-2.5%
European Equities (h)	0.0%	–	0.0%	0.0%
World (ex-UK) Equities	37.5%	▲	40.0%	2.5%
Commodities	0.0%	–	0.0%	0.0%
<b>Total</b>	<b>100.0%</b>		<b>100.0%</b>	<b>0.0%</b>

Source: First State Investments

### Performance overview

Annual Performance (% in GBP) to 30 November 2019	12 mths to 30/11/2019	12 mths to 30/11/2018	12 mths to 30/11/2017	12 mths to 30/11/2016	12 mths to 30/11/2015
<b>First State Diversified Growth B GBP Acc</b>	<b>12.2</b>	<b>-7.8</b>	<b>9.0</b>	<b>9.2</b>	<b>N/A</b>
UK Retail Price Index	1.9	3.0	3.6	1.9	N/A
<i>Real Return</i>	<i>10.3</i>	<i>-10.8</i>	<i>5.4</i>	<i>7.3</i>	<i>N/A</i>
FSTE 100 Net Tax TR GBP	10.1	-0.7	12.3	11.0	-1.9
FTSE All-Share TR	11.0	-1.5	13.4	9.8	0.6
MSCI AC World NR GBP	12.1	5.1	15.0	24.9	1.4
MSCI World NR GBP	13.0	6.2	14.1	24.3	3.3
S&P 500 NR	13.8	12.1	12.7	29.3	6.2
Topix NR	6.5	-0.9	16.7	23.5	14.0

Cumulative Performance (% in GBP) to 30 November 2019	Since Inception 23/06/15	3 years	2 years	1 year	YTD	6 mths
First State Diversified Growth B GBP Acc	19.5	12.7	3.4	12.2	14.6	8.6
UK Retail Price Index	11.4	8.8	5.0	1.9	1.8	1.4
<i>Real Return</i>	<i>8.1</i>	<i>3.9</i>	<i>-1.6</i>	<i>10.3</i>	<i>12.8</i>	<i>7.2</i>

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.

## 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 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 deliver on the investment objective; even in a lower return environment.

In this 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 increase the likelihood of delivering a real return of 4% pa above inflation over rolling five year periods before fees and taxes. We believe our investment process and philosophy provides our clients the highest possibility of obtaining a real return, with the current outlook making our DAA paramount.

## Why First State Investments?

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.

For further institutional enquiries contact [institutionalenquiries@firststate.co.uk](mailto:institutionalenquiries@firststate.co.uk)

For wholesale enquiries contact [enquiries@firststate.co.uk](mailto:enquiries@firststate.co.uk)

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