First Sentier Diversified Growth Fund
Neutral Asset Allocation Review

First Sentier Investors

First Sentier Diversified Growth Fund | December 2020

For professional clients only

The Best Bond
(in honour of the late Sean Connery)

2020 has been a bumpy ride for many since the Covid-19 outbreak first took hold earlier in the year. Since our last Neutral Asset Allocation (NAA) review, there have been several developments, however attention is still dominated by the ongoing pandemic. At least as we say goodbye to this turbulent year, there seems to finally be a light emerging at the other side of this seemingly never-ending tunnel.

The year of the Covid

Almost ten months later, lockdown measures have been on and off in several regions, with parts of the world facing another brutal wave. The northern hemisphere has entered winter, accompanied by an increase in Covid-19 cases and associated hospitalisations in recent weeks and talks of existing restrictions to last into the foreseeable future. Similarly in the US, the battle continues with many states still facing an exceptionally high level of active cases. Things are however looking up as successful vaccine news has remarkably buoyed financial markets and general investor optimism. In the US and the UK, inoculation of the most vulnerable people has begun, with widespread distribution shortly on its way. With numerous successful vaccine candidates emerging, investors generally appear reassured that there will be a vaccine both available and widely distributed globally by early 2021.

Biden-Harris for the win!

The results are in and even despite subsequent recounts, President-elect Joe Biden and Vice President-elect Kamala Harris remain triumphant. The composition of Congress however has not been completely decided, with two Senate seat runoffs in Georgia in January, likely pointing towards a split legislative branch with a Republican controlled Senate and Democrats retaining the House of Representatives. This will determine how successful Biden will be in enacting some of his initial plans as President, such as approving an enlarged fiscal spending plan to help the United States economy further rebound from the Covid-19 associated fallout.

RISK FACTORS

This is a financial promotion for The First Sentier Diversified Growth Fund. This information is for professional clients only in the UK and Switzerland and elsewhere where lawful. 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.**
- **Charges to capital risk:** The fees and expenses may be charged against the capital property. Deducting expenses from capital reduces the potential for capital growth.
- **Currency risk:** the Fund invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Fund and could create losses. Currency control decisions made by governments could affect the value of the Fund's investments and could cause the Fund to defer or suspend redemptions of its shares.
- **Emerging market risk:** Emerging markets tend to be more sensitive to economic and political conditions than developed markets. Other factors include greater liquidity risk, restrictions on investment or transfer of assets, failed/delayed settlement and difficulties valuing securities.
- **Derivative risk:** derivatives are sensitive to changes in the value of the underlying asset(s) and/or the level of the rate(s) from which they derive their value. A small movement in the value of the assets or rates may result in gains or losses that are greater than the amount the Fund has invested in derivative transactions, which may have a significant impact on the value of the Fund.
- **Credit risk:** the issuers of bonds or similar investments that the Fund buys may get into financial difficulty and may not pay income or repay capital to the Fund when due.
- **Interest rate risk:** bond prices have an inverse relationship with interest rates such that when interest rates rise, bonds may fall in value. Rising interest rates may cause the value of your investment to fall.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.
If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

Some of the key policies expected from Biden during his presidency, termed "Bidenomics", are anticipated to most notably include improved Covid-19 testing; increased fiscal support for small businesses and families; adjustments to climate change and energy policies and to re-join the Paris Climate Accord; and eventually increased taxation among others. As it relates to the ongoing pandemic, continuing expansionary fiscal policy will provide a further boost to the US economic recovery, accompanied by the rollout of several Covid-19 vaccines in the very near future.

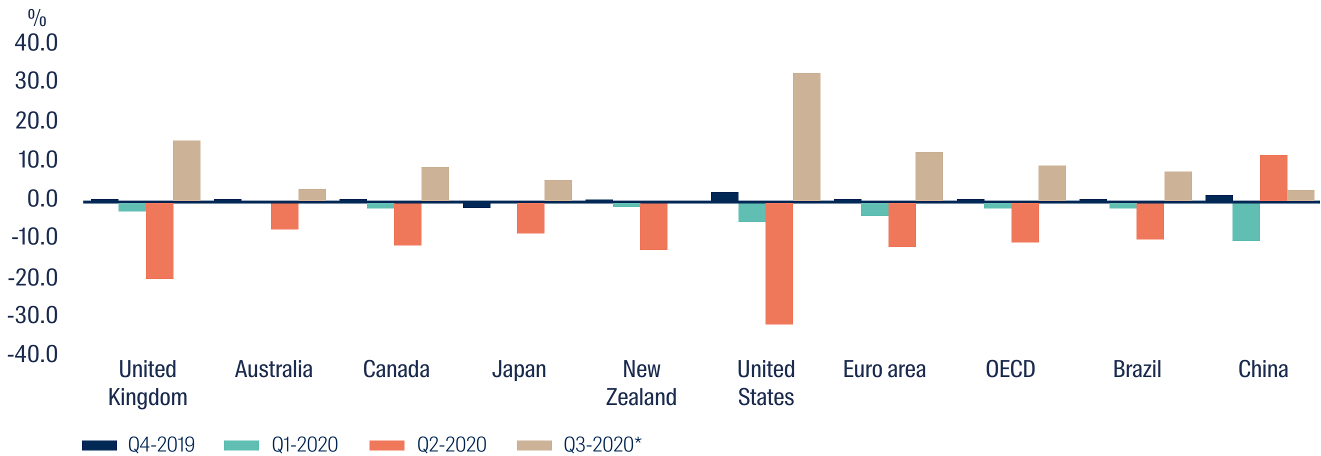
In terms of international relations, while President-elect Biden advised he has no plans to immediately remove tariffs from the China-US trade war, he does however plan to review the existing agreement and further work on a strategy with other allies in Asia and Europe. The plans for multilateralism in trade and in international diplomacy are likely to be good for global growth and potentially outperformance within regions such as Asia.

Global growth and equities are looking ahead to the good times

As we have seen over the past few months, global equity markets refuse to be discouraged as we look to the future for better times ahead. The election result also proved market-friendly with the MSCI ACWI continuing to trend upward ever since. Despite the constant barrage of 'equities reach all-time highs' headlines, it is important to note that it has not universally been 'good times' for equities this year. Further, the divergence between the winners and losers – both at the sector and individual company level – has continued to widen.

As for global growth, the pessimism seen in early 2020 has waned, with most key regions seeing forecast revisions on the upside. In the International Monetary Fund's (IMF) October 2020 outlook, global growth for 2020 was projected at -4.4% which was an improvement from the -4.9% forecast made in June 2020. This was a result of an improvement in second quarter GDP, particularly in advanced economies, after restrictions in several regions were scaled back and economic indicators released during the third quarter showed improvements. The IMF also projects global growth over 2021 to reach 5.2%, which is lower than the June 2020 projection but reflects the possibility that in some regions, social distancing measures may need to continue for a bit longer until the health risks are further mitigated. Despite the expected recovery, this has been a brutal global recession by historical standards, which makes share market performance around the world even more remarkable.

GDP growth over the Covid-19 crisis



Source: OECD as at 15 December 2020. *Q3-2020 contains a consensus forecast

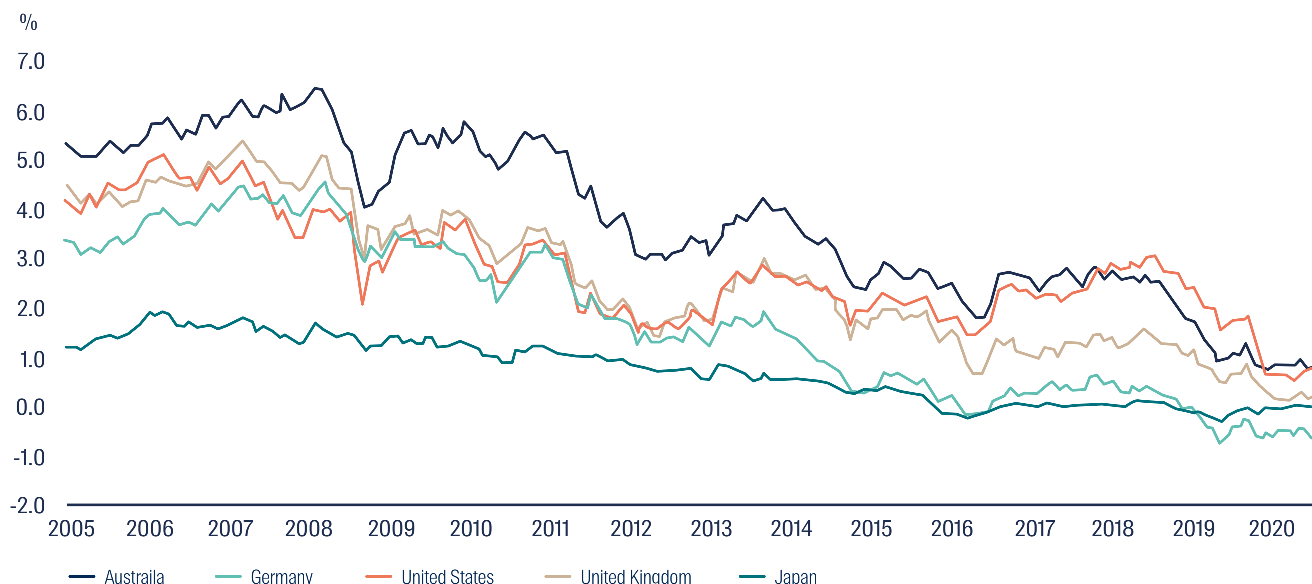
Bonds and the search for yield...

While riskier assets like equities have enjoyed gains from the recent improvement in sentiment, fixed income assets – particularly higher quality securities – are under pressure as interest rates remain at record lows. This has begged the question of many investors: is there a point to owning bonds or cash anymore? Cash still remains king as it pertains to liquidity to fund transactions and to have available during more volatile times to deploy in riskier asset classes.

Despite the low yields, higher quality government bonds still play an important defensive and diversification role in a broader portfolio. The traditional negative correlation between equities and bonds continues to benefit in most risk-off scenarios, however over longer periods there have been several examples where the two asset classes have moved in concert with each other – most recently during the initial Covid-19 outbreak. This relationship must be closely watched, as a paradigm shift could prove disastrous for investors relying on the diversification benefits that have been enjoyed for several decades.

Even so, holding high quality government bonds should deliver some benefits during periods of extreme volatility. For example, even markets with negative yields (Germany, Switzerland, and Japan) have seen yields fall during the recent sharp equity sell-offs, propping up bond prices. In any case, this low yield environment is providing very limited income to compensate for the volatility. As such, our view is that there is no one 'best bond' but rather a diverse mix of fixed income instruments should continue to provide the benefits of diversification while still generating a positive return and contribute to a portfolio's overall objective.

Government bond yields: 2005 to present



Source: Bloomberg

More monetary and fiscal firepower is (likely) on the way!

The continued, unprecedented central bank support has been a key factor in the economic recovery to date, despite the fact that the crisis is not yet over. Additionally, a staggering quantity of government fiscal support has also been a lifesaver this year, with the total global government spending as of 14 October 2020 sitting around US$14 trillion[1] and hopes of more to come.

In Europe, new restrictions have already started to stifle the region's recovery as the European Union (EU) continues to battle through negotiations with regard to both Brexit and its own budget. The EUR 750 billion pandemic recovery fund that was announced as part of the EU's budget earlier in the year in response to Covid-19 underwent months of debate, until the deadlock between EU leaders and Hungary and Poland was finally broken in December. On the monetary front, the European Central Bank (ECB) has kept rates low at -0.10%, and announced on 10 December 2020 the next round of stimulus to support the Eurozone recovery.

In the US, further fiscal support has faced debate within the bipartisan Senate for several months now. While the composition of the Senate is pending the result of the January Georgia run-off elections, on 1 December a smaller US$908 billion spending package was proposed after months of deadlock. While this is certainly short of the US$2 trillion package passed by the Democrats, president-elect Joe Biden has urged for a bill to be passed before he takes office, and suggested that any package passed now will just be the start in any case. Over to the US Federal Reserve (the "Fed"), Chairman Jerome Powell continues to appeal for more fiscal support to be unveiled, while keeping monetary policy accommodative. While the target federal funds rate remains low, the Fed's emergency lending facilities still have excess capacity. While extra firepower would otherwise provide comfort, recent threats from the Treasury to shut some of these facilities down could lead to a reduction in monetary support.

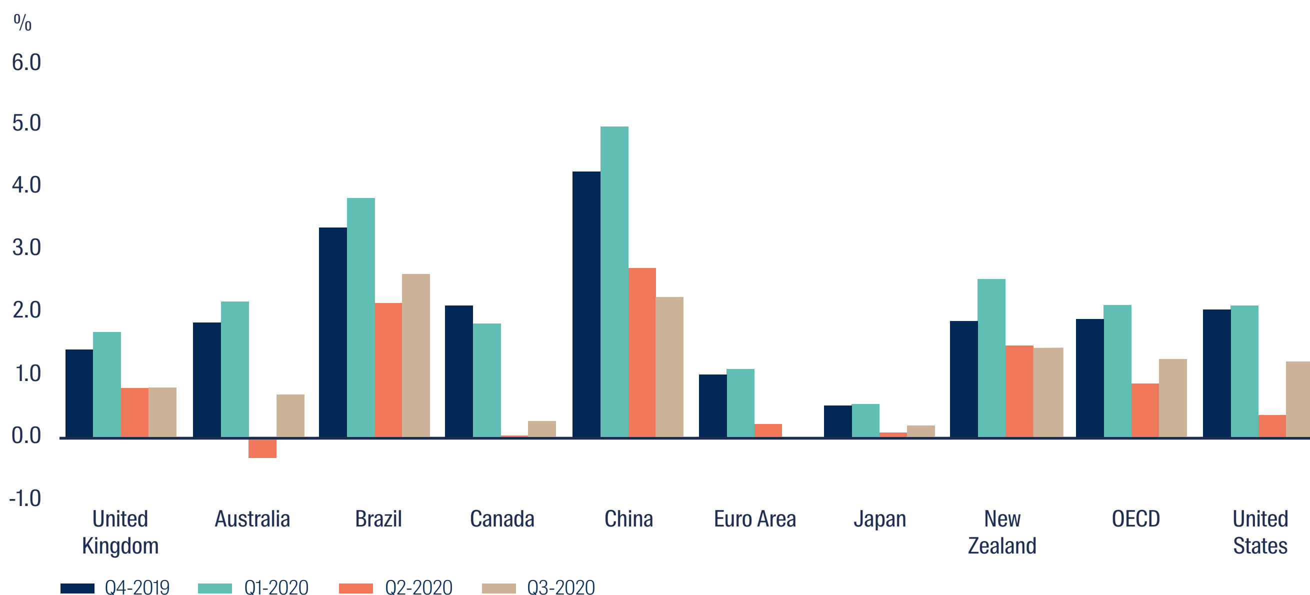
Inflation

An extended period of low inflation is almost a near-unanimous view across investors. Despite the extraordinarily loose monetary policy over the past decade, developed markets have been unable to generate much inflation. Even in recent years, unemployment rates have fallen in the developed world, particularly in the US, while inflation has hardly budged. Further, the current global recession makes the prospect of inflation less likely than deflation at present. In any case, recent guidance from the world's central bankers has been that these record low interest rates are here to stay, with the Fed advising they do not plan to respond to inflation for some time once it hits their 2 per cent target. This rather material shift in approach suggests central banks are likely to let economies run a bit hot before tightening policy through either traditional or unconventional means.

Similarly, in the UK the pandemic has pulled inflation down overall as slower growth in the economy reduced the rate of spending by consumers. In the 12 months to September 2020, CPI inflation only increased by 0.5% – well below the 2% target. The Bank of England forecasts inflation to remain at this level into the New Year, with a rise to 2% expected in two years' time. Despite this subdued forecast, the lack of progress in Brexit negotiations as the deadline approaches has pushed two-year inflation swaps surging upward with expectations that consumer prices may rise.

[1] International Monetary Fund: Fiscal Monitor October 2020

Quarterly inflation



Source: Bloomberg

Brexit: deal or no deal

Negotiations for a trade deal between the UK and the EU are continuing in a somewhat theatrical manner, with the deadline creeping ever closer. Despite the ongoing stalemate, hopes of some sort of deal at the eleventh hour are still alive. Both Prime Minister Boris Johnson and European Commission President Ursula von der Leyen are committed to working on negotiations. With the 31 December 2020 deadline literally around the corner – upon which the UK stops abiding by EU trading rules – the two parties need to iron out the remaining sticking points on the most contentious issues like fishing rights. Whether a deal occurs or not, changes will still take place. Without a deal, border checks and taxes will be implemented for goods travelling between the regions, as per World Trade Organisation rules.

First Sentier Diversified Growth Fund: Neutral Asset Allocation as at December 2020:

Diversified Growth Fund NAA	Jul-20		Dec-20	Change
1-month Interest Rate UK	5.0%	◀▶	5.0%	0.0%
UK 2-year	30.0%	▼	26.0%	-4.0%
UK 10-year	2.0%	▼	0.0%	-2.0%
Global bonds (h)	0.0%	◀▶	0.0%	0.0%
Global bonds 1 - 3year	0.0%	◀▶	0.0%	0.0%
Global bonds 3 - 7year	21.5%	▼	17.5%	-4.0%
Barclays Global Agg IG	10.0%	◀▶	10.0%	0.0%
High Yield	0.0%	◀▶	0.0%	0.0%
EM Local	0.0%	◀▶	0.0%	0.0%
EM Hard	0.0%	◀▶	0.0%	0.0%
UK Equities	6.5%	▲	8.5%	2.0%
European Equities (h)	0.0%	◀▶	0.0%	0.0%
European Equities	0.0%	◀▶	0.0%	0.0%
World (ex-UK) Equities	12.5%	▲	16.5%	4.0%
World (ex-UK) Equities (h)	12.5%	▲	16.5%	4.0%
EM Equities	0.0%	◀▶	0.0%	0.0%
Commodities	0.0%	◀▶	0.0%	0.0%
Total	**100.0%**		**100.0%**	

Source: First Sentier Investors 16 December 2020

Key Points

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.

- Overall, substantial changes to the NAA have been made as our economic climate assumptions evolve in response to the ongoing Covid-19 crisis.
- We believe that although financial markets have stabilised in several markets, there is still much risk present and so caution is still required.
- We have maintained our inflation assumptions low across all markets, along with lower cash rates and long-term yields to reflect the significant action taken by central banks. These emergency settings are expected to remain in place for most regions until a meaningful recovery is made.
- While earnings growth took a tumble over 2020, a pick up to more normalised earnings is likely to return in 2021 after the Covid-19 vaccine begins distribution and lockdown measures eventually subside.
- Portfolio positioning has focused on the balance between equities and bonds. We have reduced our allocation to both domestic and global government bonds, but have kept our allocation to credit stable. As a result, we have increased our allocation to both domestic and global equities.
- We remain cautious on commodities and the Fund currently has no allocation to this asset class.
- While market conditions might appear risky and raise concern, this can also lead to opportunities. The risks that the economic climate can present are always dealt with diligently and in line with the Fund's investment philosophy and process.
- The Fund continues to strive for consistent returns above inflation while aiming to minimise drawdowns and preserve 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.

Equities

Since our last NAA set in July 2020, the portfolio's neutral allocation to equities has increased incrementally by 8% and 2% for global and UK equities respectively. While we still remain cautious as the ongoing Covid-19 crisis continues, equity markets have shown resilience amongst the volatility, with the several vaccine options providing a light at the end of the tunnel. As many countries are still experiencing lockdowns and social distancing measures, several of the hardest hit sectors may take a while longer to rebound; however the central bank and fiscal support continues to provide a cushion. Since our last review on 31 July 2020, the MSCI World Index rose by 8.12% (YTD 12.56%), while the FTSE 100 Index has delivered returns of 10.18% (YTD -12.88%), both in local currency. Despite several equity markets experiencing a rebound, it is important to remember both indexes experienced sharp falls in February, with the recovery uneven and US technology companies leading the charge. European bourses still remain in negative territory, with the UK being the biggest underperformer. So while there is room for opportunities in equities, a cautious stance must still remain.

Bonds

As central banks maintain that accommodative policy settings are here to stay (at least in the medium term), UK government bond yields have reached record lows. While exposure to defensive assets such as UK gilts can be beneficial during times of uncertainty, as conditions continue to improve we need to return to our search for yield. As a result, we have adjusted the NAA from July 2020 and have reduced the overall allocation to domestic government bonds, lowering the exposure to both short-dated gilts by 4.0% and completely removing the small allocation to longer-dated gilts from 2.0% to 0.0%. Additionally, we have reduced our allocation to longer-dated global government bonds from 21.5% to 17.5%.

As our risk and return expectations for these asset classes continue to evolve, we remain cautious in our NAA and will rely on our DAA signals to exploit shorter-term opportunities.

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 which aims 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 Fund'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% 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.

For further institutional enquiries contact institutionalenquiries@firstsentier.com
For wholesale enquiries contact enquiries@firstsentier.com

Important Information

This document has been prepared for informational purposes only and is only intended to provide a summary of the subject matter covered and does not purport to be comprehensive. The views expressed are the views of the writer at the time of issue and may change over time. It does not constitute investment advice and/or a recommendation and should not be used as the basis of any investment decision. This document is not an offer document and does not constitute an offer or invitation or investment recommendation to distribute or purchase securities, shares, units or other interests or to enter into an investment agreement. No person should rely on the content and/or act on the basis of any material contained in this document.

This document is confidential and must not be copied, reproduced, circulated or transmitted, in whole or in part, and in any form or by any means without our prior written consent. The information contained within this document has been obtained from sources that we believe to be reliable and accurate at the time of issue but no representation or warranty, express or implied, is made as to the fairness, accuracy, or completeness of the information. We do not accept any liability whatsoever for any loss arising directly or indirectly from any use of this information.

References to "we" or "us" are references to First Sentier Investors.

In the UK, issued by First Sentier Investors (UK) Funds Limited which is authorised and regulated by the Financial Conduct Authority (registration number 143359). Registered office Finsbury Circus House, 15 Finsbury Circus, London, EC2M 7EB number 2294743. Outside the UK and the EEA, issued by First Sentier Investors International IM Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registered number 122512). Registered office: 23 St. Andrew Square, Edinburgh, EH2 1BB number SCO79063.

Certain funds referred to in this document are identified as sub-funds of First Sentier Investors ICVC, an open ended investment company registered in England and Wales ("OEIC"). Following the UK departure from the European Union, the OEIC has ceased to qualify as a UCITS scheme and is instead an Alternative Investment Fund ("AIF") for European Union purposes under the terms of the Alternative Investment Fund Managers Directive (2011/61/EU). Accordingly, no marketing activities relating to the OEIC are being carried-out by First Sentier Investors in the European Union (or the additional EEA states) and the OEIC is not available for distribution in those jurisdictions. This document does not constitute an offer or invitation or investment recommendation to distribute or purchase shares in the OEIC in the European Union (or the additional EEA states). Further information is contained in the Prospectus and Key Investor Information Documents of the OEIC which are available free of charge by writing to: Client Services, First Sentier Investors (UK) Funds Limited, PO Box 404, Darlington, DL1 9UZ or by telephoning 0800 587 4141 between 9am and 5pm Monday to Friday or by visiting www.firstsentierinvestors.com. Telephone calls may be recorded. The distribution or purchase of shares in the funds, or entering into an investment agreement with First Sentier Investors may be restricted in certain jurisdictions.

Representative and Paying Agent in Switzerland: The representative and paying agent in Switzerland is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. Place where the relevant documentation may be obtained: The prospectus, key investor information documents (KIIDs), the instrument of incorporation as well as the annual and semi-annual reports may be obtained free of charge from the representative in Switzerland.

First Sentier Investors entities referred to in this document are part of First Sentier Investors a member of MUFG, a global financial group. First Sentier Investors includes a number of entities in different jurisdictions. MUFG and its subsidiaries do not guarantee the performance of any investment or entity referred to in this document or the repayment of capital. Any investments referred to are not deposits or other liabilities of MUFG or its subsidiaries, and are subject to investment risk including loss of income and capital invested.

Copyright © (2021) First Sentier Investors

All rights reserved.

MAR000762_0121_UK