Colonial First State
Global Asset Management

Multi-Asset

Dr. No (Value): Semi-annual review

January 2018

The second half of 2017 was a very good year for equity and credit markets. It marks the tenth year of the current bull market, with phrases like "grab for yield" and "low volatility for longer" being chanted more frequently by investors. In this environment, what is the prudent thing to do for investors seeking a consistent long-term real return? Is it better to continue buying assets that look increasingly expensive (providing little or no value)? Or to leave something on the table as prices keep going up and risk missing out on further gains? In short, as markets continue to rise, the risk allocation dilemma has become an even harder problem for investors to solve.

In this semi-annual note, we discuss how we approach the asset allocation conundrum in a world where valuations look increasingly stretched – and the ever more important need to be flexible and dynamic to achieve a real return.

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 and is based on our view of economic fundamentals over the coming five years. 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.

Expected returns – where to from here?

2017 saw an impressive run for risk assets, with equities and credit markets posting solid returns. Markets have been preoccupied with tax cuts in the US; Brexit in the UK; and continued credit build-up in China – all the while they have continued rising. Markets have weathered the volatile political landscape of the last few years well, but looking ahead, we see potential headwinds. Stretched valuations provide a tricky starting point, making it difficult to remain optimistic that the last few years will be a good guide to the next.

The first step in our investment process is to decide on the outlook for the economy. This involves deciding where we think the global economy is moving and then for each country, determining 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.[1]

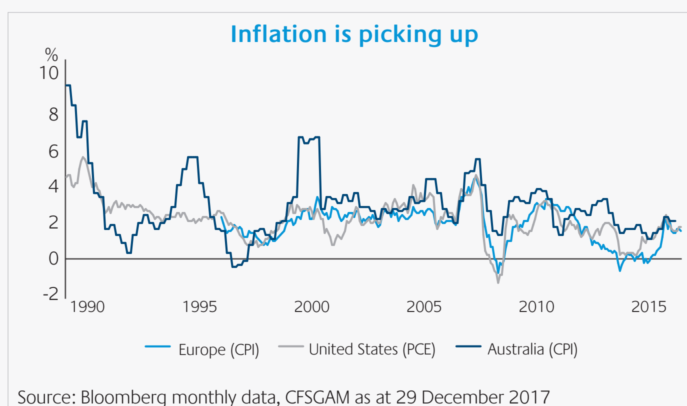
To give an example, for Australia the following views were taken into consideration:

- **Inflation** has been hovering at the lower end of the Reserve Bank of Australia's (RBA) target range, although looking ahead, the preconditions are arguably there for an increase in inflation with declining unemployment, and wages share of GDP, at near record-lows. On balance we did not change our equilibrium inflation assumptions from the last review.
- **Risk free rate** will remain relatively stable in the short term, both in real and nominal terms, but the RBA has stated that the current cash rate is below their perceived 'long term neutral rate'. We maintain an upward bias in our longer term assumptions.
- **Long-term bond yields** are expensive based on current market yields, particularly nominal bonds. We still believe there will be a normalisation in rates over time and as the term premium in Australia is influenced by global rates, particularly the US, we have increased our equilibrium levels marginally.

[1] For a more in-depth review of how we determine expected returns, please see our research paper #6 on the topic. http://www.cfsgam.com.au/au/insto/Funds/Research_Papers/

– **Earnings growth** expectations remain stable and very much in line with real Gross Domestic Product (GDP) forecasts, with the support of easy monetary policy. The Australian dollar will continue to have an influence on the substantial proportion of corporate earnings being earned offshore, coupled with key commodity prices having increased from the lows reached during 2017.

The attention on global inflation can been appreciated by this chart below, which illustrates the recent trend up in Europe and the US. The lower Australian dollar over the last couple of years, is seeing Australian inflation increase in unison. We think prospects for increasing growth in the US and Europe look robust, as wages keep up in those regions.



Source: Bloomberg monthly data, CFSGAM as at 29 December 2017

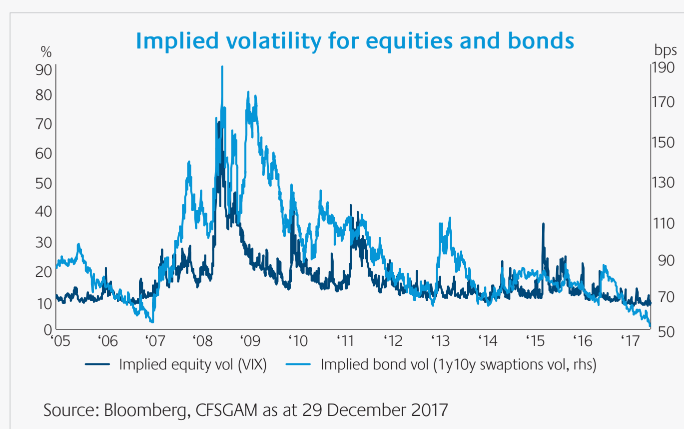
Outlook for equities

Estimated 2018 forward P/E ratios

Region	Index	2018 P/E
US	S&P 500	19.8
Japan	Nikkei 225	19.1
Australia	S&P/ASX 200	16.7
World	MCSI World	15.6
China	CSI 300	15.6
Europe	Euro Stoxx 50	15.3
EM	MSCI Emerging Markets	14.2

Source: Bloomberg as at 29 December 2017
Note: Forward P/E = Current price/next year's estimated earnings (average of forecasts)

Equity valuations in most major developed market countries are at elevated levels, with the US and Japan looking particularly expensive. In 2017, investors have seen high equity returns, but also very low volatility of those returns. This can be seen both in realised and implied volatility, where markets are currently pricing for a continuation of this low volatility environment.



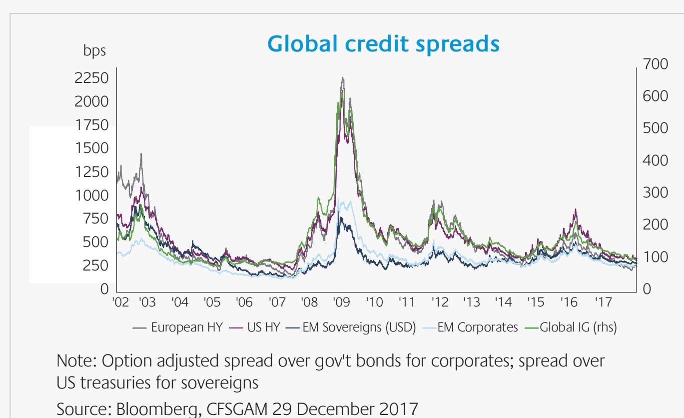
Source: Bloomberg, CFSGAM as at 29 December 2017

Without a commensurate increase in earnings, we see less incentive to hold equities. Two areas that we do see pockets of value in is Europe and emerging markets, where Asia (China, Korea, Taiwan) and Latin-America (Brazil, Mexico) offer value in stocks.

European growth has been broad based, with consumption growth coming from higher wages and employment, and capital expenditures are rising again. Earnings growth is healthy, and with the European market relatively cheap we see value in European equities. While emerging market valuations are less attractive after the rally of the last few years, global trade volumes are still expanding at a steady pace, benefitting emerging market equities by providing a catalyst for continued earnings growth.

Outlook for credit

Credit performance has been impressive over the last few years, with US high yield spreads compressing from over 800 basis points in February 2016, to under 400 basis points as at November 2017. Valuations are at the richer end of the spectrum and we do not see catalysts to drive spreads significantly tighter. Given where we believe we are in the economic cycle (late stage expansion), US and European credit is not offering sufficient rewards for the risks.

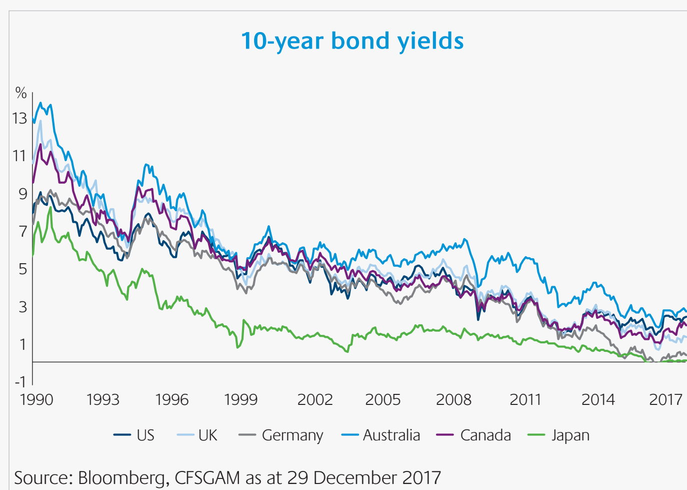


Note: Option adjusted spread over gov't bonds for corporates; spread over US treasuries for sovereigns
Source: Bloomberg, CFSGAM 29 December 2017

Credit in emerging markets, on the other hand, offers relatively good risk-reward, with global trade increasing and commodity prices underpinning expansion.

Outlook for government bonds

Developed market government bonds have been in a multi-decade bull-run, with rates now at levels that make them unattractive to hold to deliver real returns. Some inflation-linked bonds offer value, and we continue to hold these, as do emerging markets in both hard and local currency.



Source: Bloomberg, CFSGAM as at 29 December 2017

Our NAA as at end November 2017

As a consequence of our outlook for the global economy and the current valuation levels we have made a number of changes to our Neutral Asset Allocation (NAA). Most notably, we have sold all of our exposure to high yield and reduced our exposure to global developed bonds. We have increased our equity allocation slightly, and included emerging markets. We have also increased our allocation to cash to be able to take advantage of opportunities should they arrive. Finally, we have reintroduced an allocation to commodities.

Asset Class	Apr-17		Nov-17
Cash	5%	▲	10%
Australian Government Bonds	20%	■	20%
Global Bonds (hedged)	15%	▼	2%
Credit - Investment Grade	15%	■	15%
Credit – High Yield	5%	▼	0%
Emerging Market Bonds – Local	5%	▼	3%
Emerging Market Bonds – Hard	5%	▲	10%
Australian Equities	15%	▼	14%
World Equities	15%	▲	16%
Emerging Markets Equities	0%	▲	5%
Commodities	0%	▲	5%

Our NAA has exposures to markets we think are still attractive on a risk and reward basis and offer a good expected return for the level of risk looking out five years. With valuations where they are, we do not have to be invested in any asset class in our NAA, and moving the credit risk into equity and cash gives us the option of participating in the strong market while preserving capital when volatility picks up.

However, the NAA is only the first step in setting our overall Real Return strategy allocation. To ensure that we maximise the probability of reaching our five-year real return objective, we use our Dynamic Asset Allocation to add alpha to the strategy via long-only exposures to supplement the return from the NAA.

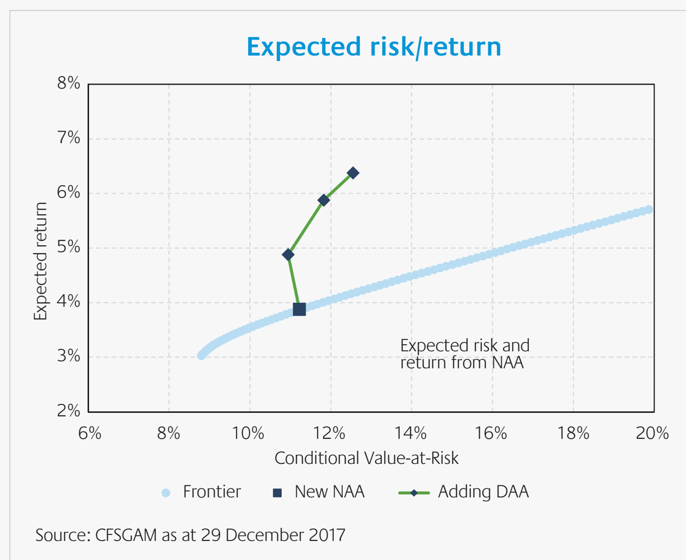
How do we determine the right mix of NAA (beta) and DAA (alpha)?

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. We incorporate this analytically and the chart below illustrates the impact that both tracking error and alpha can have on the risk and return characteristics of the portfolios on the efficient frontier.

The investment objective of the strategy is Australian Consumer Price Inflation (Trimmed Mean) +4.5% gross of fees. The NAA strategy, shown in the following chart provided a nominal return of just under 4%, leaving a shortfall in required returns to meet the strategy's objective. Based on this NAA and the required return for the strategy, we have maintained the DAA tracking error risk budget at 5% to maximise the probability of reaching our investment objective, as outlined below.



Source: CFSGAM as at 29 December 2017

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 4.5% for the strategy over five years. Our investment process and philosophy provides our clients the highest probability of obtaining a real return, with the current outlook making our Dynamic Asset Allocation paramount.

Why Colonial First State Global Asset Management?

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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