For professional clients only

Semi-Annual Review | Multi-Asset Solutions

Never say never again

December 2016

Foreword from Epco van der Lende

For several decades the world has looked to the US for stability and order. Following the 'surprise' election result that had the prevailing politicians and pollsters aghast at hearing the words, 'President-elect Trump', gives a sense that the stability we have come to expect from the US can no longer be assured. More fundamentally, as Trump moves from President-elect to POTUS in 2017, there is a genuine prospect of massive fiscal stimulus (tax cuts and increased spending) and a move away from globalization. This clearly challenges the current low inflation, low interest rate equilibrium.

Once again our review of the economic climate was timely. It was conducted just prior to the US presidential election and we have revisited our assumptions post Trump's victory.

In this semi-annual note we discuss the US presidential election along with the major themes which we believe will shape the future economic climate such as central bank policy and the rebalancing of the Chinese economy. Following this we provide detail on our latest review and how this impacts the asset allocation decisions in our objective-based portfolios.

We conclude with a summary of an upcoming research paper where we examine the basis of variation in returns of the major asset classes and why this provides the opportunity for Multi-Asset strategies to add value to investment outcomes.

I hope you find this note interesting and useful. Of course I welcome your feedback and any comments you may have.

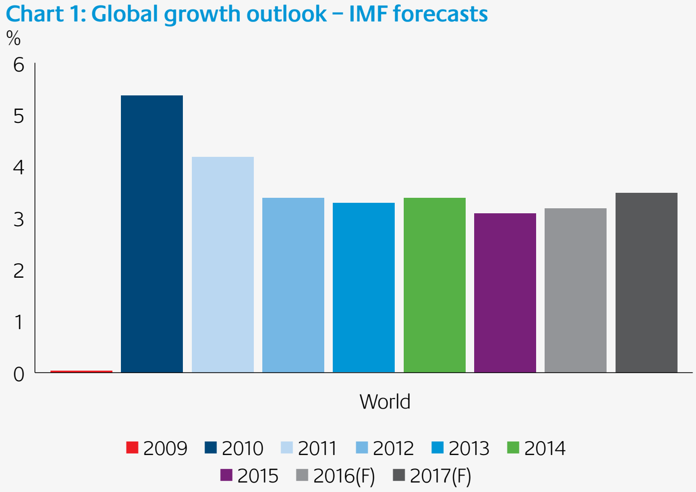
Regards,

Epco van der Lende
Head of Multi-Asset Solutions

Macro themes

As we approach the end of 2016, the forces shaping the global outlook continue to be macro-economic themes, such as an impending Brexit, China's ongoing rebalancing and more recently of course, the result of the US presidential election.

Chart 1: Global growth outlook – IMF forecasts



Source: IMF data as at October 2016.

Looking ahead to 2017, we have a number of political decisions in Europe, such as the French and German elections, ensuring a dark cloud remains over the region with politics continuing to have a large influence on markets.

Against this political backdrop we have a US equity market attempting to grind higher and global bonds valuations retracing since the last semi-annual review. In the lead up to the US election, sentiment to emerging economies had improved on mildly favorable macroeconomic news and some recovery in commodity prices. However, rising US yields and their support to the US dollar will create more uncertainty and volatility for these developing nations.

Before considering the markets and positioning in more detail, we will first summarise the current macro themes shaping the economic climate.

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 short-term opportunities in markets.

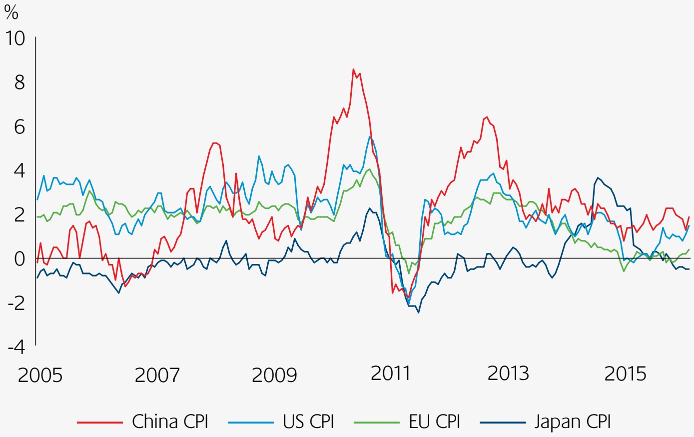
The first step of our NAA process is to set the economic climate for each country. We use the economic climate assumptions within our set of proprietary stochastic simulation models to determine forward-looking risk premia and expected returns. The process of determining the NAA uses these expected returns for the building blocks of the portfolio allocations incorporating the return objectives, constraints, and investment horizon of the portfolio. The process of determining changes to the NAA is based on the economic climate, prevailing market conditions, valuations of financial assets, and political and market risks.

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.

Central Bank Policy: Global inflation remains at levels below the stated targets of many central banks. The US Federal Reserve's ambition to raise interest rates a further 25 bps in December and take another step towards normalization will be bolstered, as inflation expectations rise on potential expansionary fiscal policies (infrastructure spending, tariff, immigration law), tighter labor market and the fading effect of low commodities prices. The question going into 2017 will be whether the Fed continues to be behind the curve? In September, the Bank of Japan (BoJ) launched a new kind of monetary easing by setting a cap on 10 year bonds at 0%, in an attempt to further experiment with unconventional monetary policy tools. However, only weeks after this announcement, they admitted it may take until 2019 before achieving their inflation target of 2%. In the UK, Brexit continues to challenge the Bank of England (BoE) both in terms of whether there will be a 'hard' or 'soft' exit and their role of stimulating the economy within the context of higher inflation. All of this leads us to retaining our expectation for a gradual convergence towards a normalization of global interest rates.

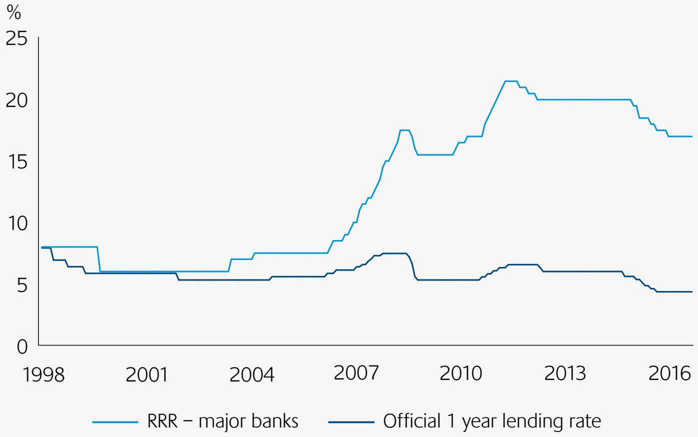
Rebalancing of the Chinese economy: China reported a relatively strong third quarter GDP growth of 6.7%. The sense of calm that comes from such a positive result was countered by the fact that they have reported exactly the same growth for the prior two quarters. While this is entirely possible and has indeed has been achieved by several other countries, the reaction from the market is one of skepticism of the data, rather than considering it to be a very positive signal. A closer look at the numbers reveals that housing was the main driver behind the recent pick-up in activity and the government seems intent on maintaining fiscal spending to cushion a potential property downturn. We believe the rebalancing that is taking place in the Chinese economy will make it more and more difficult to sustain the current growth rate over the long term. Given the significant levels of debt and property investment excesses, there has to be a move to a more consumer-led economy which, as we mentioned in our previous review, will remain hampered by structural problems, particularly with the slow pace of reform within state-owned enterprises.

Chart 2: Headline inflation



Source: Bloomberg data to 24 October 2016.

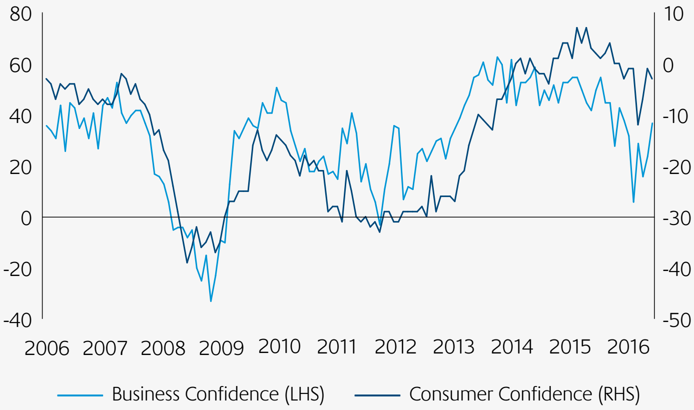
Chart 3: 1-year lending rate and RRR



Source: Bloomberg data to 30 September 2016.

Brexit: While the UK government's plan to start the formal process for Brexit by the end of March may not have been great tactics in the context of ceding negotiating power to Europe, it did provide some guidance in terms of timelines. That was soon vanquished, when the High Court subsequently ruled that under English law the triggering of Brexit should rest with parliament and not the government alone. In our July 2016 review, we outlined the changes to our economic assumptions for the UK on the back of the referendum result. There is still great policy uncertainty in terms of the likely model that will be adopted and indeed the timing. We believe the current assumptions already factor-in higher inflation and aggressive BoE actions to support the economy through this period.

Chart 4: Confidence falls after 'Brexit'



Source: Bloomberg data to 24 October 2016.

US Presidential Election: At the time of writing, we've had a couple of days to reflect on the possible implications of a Trump Presidency; for the US, the rest of the world and the European political landscape. Unfortunately the news to date hasn't really done much to fill in the holes in our knowledge about what President Trump implies, relative to what Candidate Trump said. His conciliatory tone and interactions with the media may have pacified markets for now, but as he forms his cabinet we will be getting a better insight into what he will attempt to follow through on, or at least intend to focus on, during the all-important first 100 days in office.

Trump Change?

What does it mean for our economic climate assumptions?

At this point, it seems appropriate to restate that our process does not attempt to precisely estimate the future level of economic parameters (e.g. what will the inflation print be 3, 5 or 10 years from today), but rather to define the economic climate. For example are we moving into a high/low growth and high/low inflation environment?

We considered the prospect of higher inflation on the back of the potential tax cuts and protectionists strategies that were referenced during Trump's campaign. We also considered whether higher inflation would translate proportionately to cash rates and long term yields, or if the higher inflation would, in fact, simply lead to lower real rates.

While it is possible to follow the logic that these strategies can lead to higher long-term inflation, it is also important to understand what are the current assumptions. In the review we conducted immediately before the election our long-term inflation expectation for the US was 2%. As well as being the US Federal Reserve's stated target rate, it is also at a level that is higher than we have been experiencing for some time, i.e. we are already factoring in a trajectory for higher inflation.

While it can be tempting to revise a number of assumptions on the back of what at first appears to be a new regime, we determined that in the immediate aftermath of the result, and the fact there are still three months until Trump's inauguration, there is not enough fundamental policy information to adjust our long term rational expectations at this point.

Real Return Fund Neutral Asset Allocations: The table below provides the neutral asset allocations as at May 16 and Nov 16, post their respective semi-annual reviews.

Asset class	May-16		Nov-16
Cash	5.0%	–	5.0%
Australian Government Bonds	10.0%	increase	15.0%
Global Bonds (hedged)	0.0%	increase	10.0%
Credit (IG & High Yield)	12.5%	increase	20.0%
Emerging Market Bonds	7.5%	increase	10.0%
Australian Equities	18.0%	increase	21.5%
Global Equites	38.0%	decrease	15.0%
Emerging Markets Equities	3.5%	decrease	0.0%
Commodities	4.5%	decrease	3.5%
Total	**100.0%**		**100.0%**

Setting aside the intraday volatility on the day of the US presidential election, there has been relatively low volatility in the second half of 2016. The economic backdrop in Q3 was very similar to the first half of 2016, which is divergent central bank policy and low inflation but the difference being that both commodity prices and inflation expectations are rising. While the fundamentals may be similar, both equity and bond markets are at high levels. The net result; on a forward looking basis we expect lower returns across most asset classes, with the exception of Australian equities for the Australian-domiciled Real Return Fund.

The implications for the NAA, is that without an improvement in the fundamentals, we see a need to rebalance to higher-returning assets to deliver on the portfolio's objectives:

Equities: Lower global equity return expectations; leading to increased allocations to domestic equities to maintain the return objective. As an Australian dollar denominated Fund, the global equity exposure remains unhedged in terms of currency risk.

Bonds: A normalization of interest rates is still factored into expectations over the long term. However, the pace at which this occurs is expected to remain slow, and with a lower equilibrium rate than historical yields. Despite the trajectory for yields pointing higher, there is an increase in duration due to an allocation to global bonds for further diversification. The allocation to local currency emerging market debt has been increased, not only due to the higher yields on offer than developed market bonds, but also for the diversification they provide to the overall currency exposure. Credit continues to play an increasing role in the portfolio due to the higher yields available, coupled with a lower risk profile than equities.

The NAA described above will be the dominant driver of returns for the next six months. However, it is important to note that the actual portfolio will reflect both our NAA and DAA views. In the Real Return Fund, the NAA provides the fundamental framework off which we hang our DAA tilts, both at a cross-asset level, and also within each asset class. Furthermore, there is scope for us to add protection strategies should we deem the overall risk setting of the portfolio too high for the returns available, or simply to protect the portfolio from specific event risk.

Table 1: Cross asset tilts from DAA views as at November 2016

Dynamic Tilts	
Asset class	**Attractiveness**
FX	✓✓
Equities	✓
Commodities	✗
Bonds	✗✗

FX: The Fund's long exposure is reflected by an allocation to the US dollar versus the Australian dollar, reflecting the expectations for the interest rate differential between the two nations to narrow. Consistent with our view for slower growth in China and the indirect impact on Australia's commodity exports, a short Australian dollar exposure can provide a diversifier to lower domestic growth.

Equities: The overweight to equities is reflected via a diversified allocation to the both developed and emerging markets based on our investment signals. At the time of writing these tilts include Japan, Mexico, Italy and Sweden.

Commodities: The underweight to this sector has been in place for most of 2016 and is currently reflected by a low exposure to energy and no exposure to precious metals.

Bonds: The Fund's duration has been low in 2016, less than 1.5 years but post the rise in yields following the US election result, we have increased this exposure to 2 years. This is diversified across Australian and global and emerging market (local currency) sovereign bonds as well as global credit.

Why Multi-Asset investing needs to be dynamic?

Over time equities are expected to deliver higher return than bonds but with higher volatility. Furthermore, a large part of the financial theory (and products developed) is built on the fact that equities and bonds are good offsets; or in Markowitz' terms that the covariance between the two is negative.

This idea has been at the core of asset pricing theory since Markowitz (1952, 1959) came up with a mathematical model for how to optimise a portfolio by breaking it down into two factors: expected returns and portfolio risk. The assumption was that investors will want to minimise risk for any given level of expected return, but also it is the portfolio risk that matters, and not the risk of each security.

Over the last 100 years, there have indeed been large dispersions between returns of various asset classes. Equities have returned more than bonds in the US and the UK, but with much higher volatility. Since 1920, UK equities have returned, on average, 6.5% annually over inflation, meaning if you had invested £100 at the start of 1920, your investment would have grown to the equivalent of £41,781. A corresponding investment in UK bonds would have yielded only £1,099 in today's money.

For most investors, it is the real (inflation adjusted) return that matters, as we want our investments to keep up with inflation and provide a return in addition. Starting in 1920, the average annual returns for some large asset classes are shown below:

Average yearly real return (%), 1920-2016	
UK Equities	6.5
US Equities	6.2
World Equities	4.4
UK Bonds	2.5
US IG Credit	2.4
US Bonds	1.6
UK Cash	1.2
Global Bonds (USD)	0.8
US Cash	-0.1
Commodities	-2.0

Source: Global Financial Data, First State Investments.

Looking at it like this, one can be forgiven for thinking, "why would I buy anything but equities?" The answer is that most people do not invest for decades and, while returns are important, so is the volatility and potential drawdown of a portfolio. If we drill into real returns per decade, and sort it by the best returning asset class at the top to the lowest, it is clear that equities are often at the top and the bottom, while fixed income is in the middle.

The argument for being diversified is a well-trodden one. There is only one problem; being diversified today does not necessarily mean the same as it did 20 years ago. Throughout most of history, UK bonds and equities were positively correlated, meaning that they moved up or down together. The last 20 years, in that regard, is actually a bit of an anomaly, as bonds and equities have been negatively correlated (when equities go down, bonds go up.) This made it somewhat easier to be diversified, as 60/40 equity/bond portfolios did very well on a risk-adjusted basis. What happens if correlations change again though? A portfolio needs to be forward looking, as static asset allocation can leave returns vulnerable.

We are completing a detailed research paper on this topic. In the meantime if you would like to discuss this topic in more depth, please contact your relationship manager.

About us

Multi-Asset Solutions

The Multi-Asset Solutions team provides a range of services to institutional clients around the world in the fields of portfolio management, asset allocation, asset/liability management, portfolio construction and risk management. We advise on and design bespoke investment solutions and implement these solutions in the form of tailored risk managed multi-asset mandates and/or funds.

We are a team of nine, spread across Singapore, Sydney and London. Our experienced team members come from a variety of academic backgrounds, including mathematics, civil engineering and aerospace engineering. Each team member brings unique perspectives and collaborates across the organisation to provide solutions to our clients. Varied problems require diversity of thought and the courage to challenge conventional wisdom; traits we seek in our team members.

Our investment philosophy is based on the following beliefs:

- Fundamental valuations will ultimately assert themselves and be the most important driver of returns.
- Markets are not completely and globally efficient in the short-term due to investor behaviour. This provides opportunities to enhance and protect returns for our clients.
- Investment decisions should be made with respect to the portfolio's objectives.

Disclaimer

This document refers to the Colonial First State Multi-Asset Real Return Fund – Class A (ARSN: 161 207 165).

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352 AFSL 232468 and Colonial First State Managed Infrastructure Limited ABN 13 006 464 428 AFSL 240550 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance.

The Commonwealth Bank of Australia (Bank) and its subsidiaries do not guarantee the performance of the fund or the repayment of capital by the fund. Investments in the fund are not deposits or other liabilities of the Bank or its subsidiaries, and investment-type products are subject to investment risk including loss of income and capital invested.

No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of Colonial First State Asset Management (Australia) (CFSAMA) ABN 89 114 194 311 AFSL 289017. This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy none of CFS or CFSAMA offers any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them. This material has been prepared for the general information of clients and professional associates of CFS and CFSAMA. To the fullest extent allowed by law, CFS and CFSAMA exclude all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by any of CFS or CFSAMA. No person should act on the basis of any matter contained in this material without obtaining specific professional advice. Past performance is not an indication of future returns. All monetary amounts are in Australian dollars, unless otherwise indicated.

Colonial First State Global Asset Management is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124.