For professional clients only

First State Investments

Multi-Asset Solutions

Investment Case for Multi-Asset Solutions

July 2017

Executive Summary

First State Multi-Assets capabilities date back to 1995 with our flagship offering in Australia. In 2011, the current senior Multi-Asset Solutions team members led by Epco van der Lende joined First State, which is a team of senior multi-assets investors who have worked together for over 20 years, and expanded our Objective-Based Investing solutions to international investors globally.

The broader MAS team has on average 13 years of relevant experience, managing a range of objective-based and multi-asset strategies across geographies on behalf of a diverse range of clients, which include some of the world's largest strategic investors, pension and insurance funds and sovereign wealth funds.

Our Multi-Asset strategy is defined by the following characteristics:

– **Flexible and dynamic:** Our strategy is unconstrained for the purpose of alpha and beta generation and when combined with a robust risk focus minimises the likelihood of the portfolio not meeting its objectives. We blend advanced long-term strategic modelling of asset classes with shorter-term dynamic views in response to market and economic developments:

  1) Neutral Asset Allocation: anchoring the medium to long term absolute risk/return profile and corresponding allocations

  2) Dynamic Asset Allocation: adding additional value by anticipating dynamically on short to medium term opportunities in financial markets

– **Customised objective-based portfolios:** Depending on the desired outcome, we leverage one or both of the above asset allocation engines to customise objective-based portfolios. Our approach is consistent and disciplined, with a focus to deliver on client's objectives.

– **Qualitative investment ideas, quantitatively verified and qualitatively implemented:** Our investment process utilises our qualitative insights and investment ideas and verifies them through quantitative techniques. Given the breadth and scope of the investable universe there is a need for quantitative rigor; it also plays an important role in counteracting cognitive biases.

– **Internally generated research:** Research spans all elements of our teams' activities and is the basis of portfolio design and implementation. We believe that all research should be developed internally and not be dependent on third party. As such, all our tools and models are proprietary, and our scientific research process is designed to leverage our edge.

– **Fully discretionary, not "fund wrapping":** Our approach focuses on efficient implementation across a diversified mix of asset classes. This opens the door to dynamic asset allocation, providing high liquidity and low transaction costs along with efficient implementation.

Meeting our clients' needs requires diversity of thought, a coherent investment process and diligent execution. We believe the proven ability to marry multiple, sometimes conflicting, client objectives is a true differentiator and competitive advantage for our MAS team.

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Market Outlook

As global equity market enters the ninth year of the bull market, there is an eerie state of calm with implied volatility near its all-time lows despite much political and policy uncertainties. At the same time, the thirty years bull-run in the fixed income space with synchronised central banks easing efforts over the past years is leaving investors jittery over the sustainability of the low rates environment. Not surprisingly, the valuations of both asset classes are unattractive at this point for an astute investor to place all his faith in either single asset class. It is now ever more vital to be prudent, and take a diversified and flexible approach to investing.

Our proprietary asset return model has indicated lower expected returns for equities and bonds, with slower growth and higher inflation over next five years. This is consistent with our longer term view of a stagflationary environment. In the medium term, with the stronger global economic data, credit impulse and fiscal efforts, we expect the global economy to remain in decent shape. While we expect some pull back in risk appetite in the short term with investors disappointed with Trump's ability to deliver his promises and uncertainties over the upcoming European elections, we are not expecting stagflation as yet. Further out, we are not seeing any improvement in productivity growth trend, which has been tepid globally. Global debt has been rising and structural reforms have been slow to implement, which can be a recipe for stagflation longer-term. This is not to say that the market will not sniff out what they perceive the future outlook will be and move ahead of it. This is why there is rising interest in embedding so called "real" asset classes like infrastructure, commodities or property in multi-asset portfolios that historically or by their fundamentals may serve as a hedge for that economic constellation.

In the US, we are seeing some positives data in employment numbers, purchasing managers' index, business capital expenditures intentions and business and consumers' confidence. While we are of the view that US fiscal policy will remain stimulative, we are unsure if it will deliver to market expectations. The recent failure to repeal and replace Obamacare has cast doubts in investors' minds on President Trump's ability to deliver on the rest of his economic agenda, especially when it means lesser funding without incurring a larger deficit. Given that two-thirds of the US equities return have come from multiple expansion since the US election, we believe that some degree of the 'Trump trade' is priced in the US market. If that optimism were to falter and the promised reforms are unable to pick up the slack from an economic slowdown, the risk of market de-rating is still very much alive. Given the potential uncertainty and low implied volatility, it is possible to implement protection strategies that would provide convex payoff profiles, reducing the effect of market drawdowns. On the other hand, the Fed stance on its rate hiking path and reinvestment policy are unclear as it seeks to avoid an over-heating economy and at the same time, not to stifle growth, in the midst of policy uncertainty. The Fed is clearly ahead of other major central banks in its tightening cycle, and the trade-weighted real broad dollar has appreciated 20% since mid-2014, limiting corporates pricing power. The real rates differentials are understandably wide with policy divergence, which supports the dollar against major currencies. But this has been a consensus view for the past years. As we see global inflation turning up, we can expect to see rate differentials narrow, potentially with the dollar topping out. However, if Trump implements the "border tax adjustment", the dollar can certainly march higher. Short term doubts over "Trumpflation" can lower inflation expectations, bringing rates lower. Together with a potentially weaker dollar, the boost to profit margins for corporates can hold out the reflation trade a little longer. Not to mention, any success Trump gets to implement tax cuts and massive infrastructure spending will undoubtedly get reflation expectations going. Longer term, the outlook is less rosy as we are at a point where valuation are no longer attractive and both monetary and fiscal policies are at their limits, while productivity growth is still below trend. Investors have shifted from their deflationary mindsets not long ago as aggregate supply fell, closing the output gap. Looking ahead, a stagflation seems like the most probable outcome. In a stagflationary environment, we would expect gold to perform well, as rates march higher and growth falters.

In the UK, the clock has started to tick away as it sets out on its two years "Brexit" negotiation process. The weaker pound has helped to cushion the economic impact of 'Brexit' thus far. The EU is now, however, stuck between a rock and a hard place. On one hand, it needs the UK as a trading partner, but on the other hand, it needs to take a hard-line stance as a warning to the other Eurosceptic parties. The negotiation rhetoric between the UK and the EU will be interesting to watch. In the upcoming months, the outcomes of the presidential/parliamentary elections in Europe will also be of interest. Political risk has held back risk appetite in Europe even though we are seeing positive momentum in its earnings growth, making the region more attractive from a valuation's perspective. While there have been speculations on ECB tapering on its asset purchase programme, with its positive economic surprise, we are of the view that there needs to be convincing signs of inflation to avoid acting prematurely as it did in 2011, when it had to reverse course afterwards. The outcome of the French presidential election is also not to be undermined, as it may have implications on ECB stance. A Fillon or Macron win is likely to see the equity risk premium vanish and possibly, higher rates and stronger Euro as it is then more likely to implement pro-market reforms. While the probability of a Le Pen win is not high, recent history has taught us that a 'Brexit' repeat is possible, especially when recent polls has shown that about 40 percent of the voters are still undecided. Should that happen, we would expect to see risk assets sell off and the re-emergence of Eurosceptic momentum. The migrant crisis is also likely to deepen in the next couple of years, in which case, it is unlikely that anti-euro sentiment will wane. We do not rule out a Eurozone breakup as a possibility.

In Japan, inflation expectations and headline inflation are still way below its 2% target. As such, we expect BOJ to maintain its 10-year yield at zero until it sees sustaining signs of higher inflation. The lower yield makes JGBs unattractive relative to its counterparts, driving the yen lower, in turn, boosting the Japanese economy. Its dependence on a weaker currency also means that it is vulnerable to any risk-off sentiments as the unwinding of carry trades strengthen the currency.

In China, we continue to see improvement in economic indicators and credit remains supportive. The recent National People's Congress policy and the M2 target has also suggested support for growth. After the FOMC announcement, PBOC raised the rate on its reverse repo operations by 10bps in March, citing changes in market demand and supply as the reason. The PBOC tried to maintain that there is no shift in China's monetary policy stance, however, the timing of the rate hike indicates to us that maintaining currency stability is still very much a priority. Later this year, we will have the five-yearly reshuffle of China's political leadership. We expect the political leadership to be looking for economic stability ahead of the political changes. Valuations in China and most emerging markets are also relatively more attractive than that of developed countries. Given the high interdependencies among emerging countries, we expect relative stability in the region, absent any systemic sell-off at least up till the October/November Party Congress. IMF has cited China as a driver of global recovery this year as we see fiscal stimulus at work. The worry is that the fiscal stimulus can only keep growth going for so long. The lack of structural reforms in China and other emerging countries has suppressed productivity growth. Debt to GDP has also been rising. While the loan-to-deposit ratio is high in China to avoid a financial crisis, given the size of its economy, any slowdown or deflation scare will pose financial risk globally. Not to mention, the sheer size of China's shadow banking system remains a threat to financial stability.

Going forward, we expect macroeconomic and geopolitical themes, together with the central banks, to drive market sentiment. As mentioned, our proprietary asset return model has indicated lower expected returns for both equities and bonds at current valuations, making the environment more challenging to generate returns without taking on excessive risks. To navigate this challenging environment ahead of us and capitalise on market opportunities a disciplined multi-asset approach that is flexible and dynamic is needed.

Why Multi-Assets?

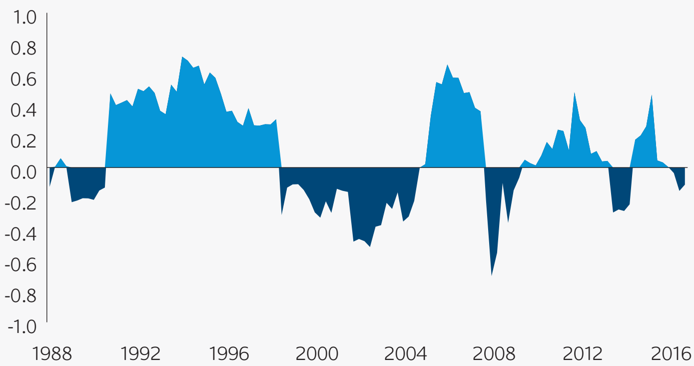
The aim of investing is to achieve financial goals. These financial goals may be a required level of income or an absolute return objective. To meet these goals, investment decisions need to be based on return ambitions, risk appetite, and time horizon. The challenge is that financial markets are dynamic and experience both booms and busts. In an environment where political uncertainty, low growth and low expected returns are more likely, most investors cannot rely on 'long-run average market returns'. To achieve investment success over a specified horizon, asset allocation decisions must be made to address the delicate balance between delivering the return objective whilst not taking excessive market risk.

Multi-asset investing offers the ability to invest across an entire universe of asset classes globally, including equities, fixed income, commodities, and cash. Each asset class provides different investment characteristics which respond differently in any given market environment.

History tells us that there are large dispersions amongst returns of various asset classes, with no consistency on the asset class that outperforms, making single asset investing extremely challenging. Looking through history, for example, the US equities have outperformed its bonds counterpart over the past hundred years. However, it is not without much higher volatility and drawdowns. Moreover, most investor's timeframe is less than multiple decades, and history is certainly not an indication of future performance. As such, diversification is the key to narrowing the return distribution.

Taking a step further, traditional portfolio construction theory in the Markowitz sense assumes correlations among assets to hold, which is hardly the case in practice. Any change in the correlation statistics will render a static portfolio vulnerable. On the chart below, we have the rolling three year quarterly correlation of equities and bonds. Since correlations and volatilities are not static, only a truly flexible and dynamic approach to Multi-Asset will deliver on investment objectives.

Historical correlation between MSCI World and Global Bonds



Source: Bloomberg, First State Investments as of 31 December 2016.

Multi-asset investing, to us, is the process of allocating asset classes into one portfolio to maximise the probability of meeting investment goals and the ability to adjust portfolio positions for prevailing market conditions.

About First State Multi-Asset Solutions

Our multi-asset flexible and dynamic investing approach is designed to provide risk/return benefits that are not typically achievable by investing in a single asset class. We build multi-asset portfolios with a risk/return profile to meet individual investment needs such as a real return (return above inflation), income requirement, with a focus on preserving capital, and generating growth over the long-term.

Our investment philosophy and investment process

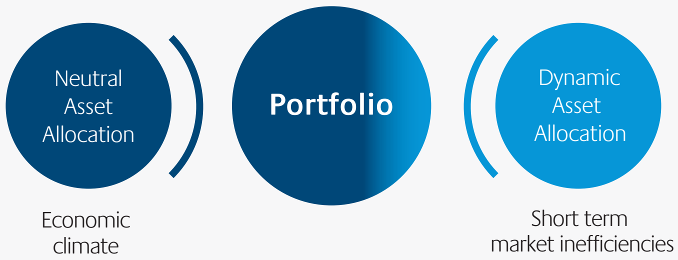
Our team's investment philosophy is based on the following principles:

- In the long run, fundamental valuations will assert themselves and be the most important driver of returns.
- In the short term, markets are not completely and globally efficient due to a variety of reasons for example forced hedging, regulations, benchmark constraints and supply and demand effects; providing an opportunity to enhance and protect returns.
- Decisions should be made with respect to the portfolio's objectives.

Our investment process is designed to consistently add value and deliver on return objectives via the following:

- Designing the asset allocation to reflect economic climate expectations; and dynamically adjusting to market developments;
- Systematically exploiting market inefficiencies by focusing on key fundamental drivers of returns (Value, Momentum, Carry, Macro, Market Structure); and
- Blending disciplined quantitative underpinnings with qualitative experience and expertise across the broadest possible opportunity set of markets and financial instruments.

The asset allocation strategy of our portfolios depends on two components: a medium term allocation that establishes what we term our Neutral Asset Allocation ("NAA") for asset classes; and a shorter-term component, our Dynamic Asset Allocation ("DAA") that allows us to extract alpha from shorter-term market disequilibria. The graphical illustration below provides a holistic depiction.



There are three building blocks to our investment process.

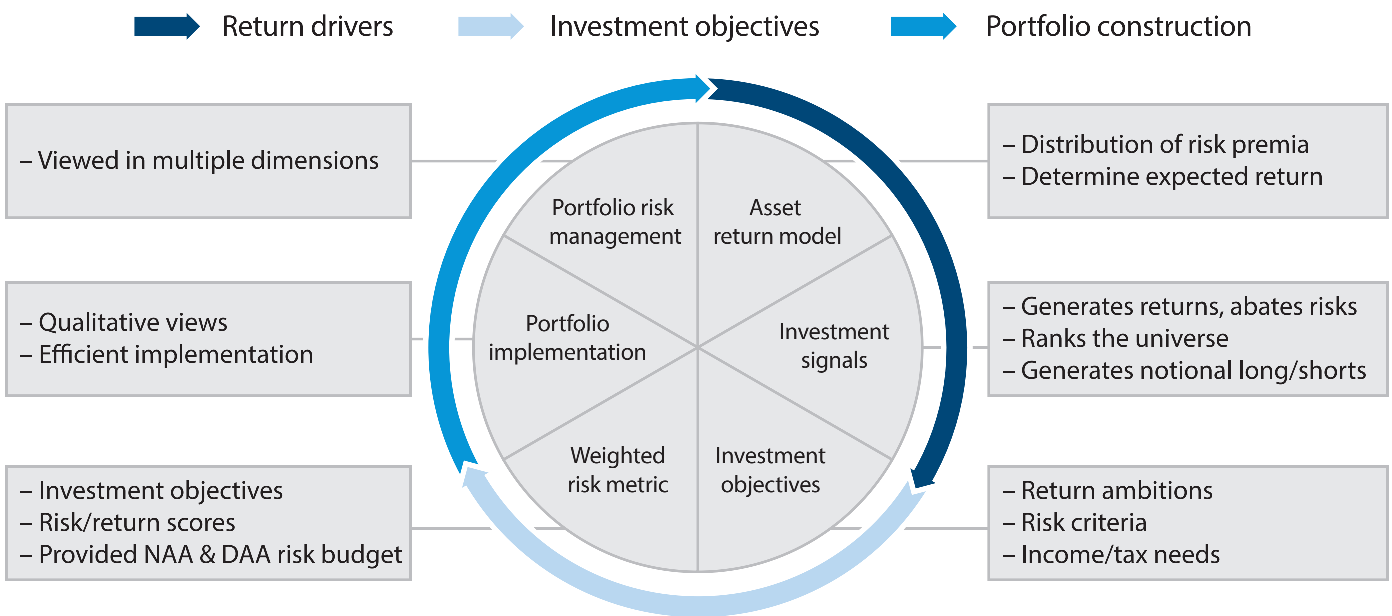
1. Return drivers
2. Investment objectives
3. Portfolio construction

In the current lower return environment it is critical to have the flexibility to blend alpha and beta strategies to deliver on our clients' investment objectives. Our investment process and investment philosophy is geared to provide our clients the highest probability of obtaining their objective.

In summary our key differentiating features are:

- Flexible and dynamic investment process
- Our approach is truly objective-based
- Qualitative investment ideas are quantitatively verified and qualitatively implemented

We believe that our Multi-Asset team is in a superior position to be stewards of your capital.



First State Objective-Based Investing Strategy

Our longest track records, over 20 years are in traditional balance funds. As the multi-asset market has evolved towards objective based funds, we have launched a number of new capabilities targeting returns over inflation and cash. We also provide solutions for different risk appetite, varying use of leverage, derivatives, active use of currency management and asset class restrictions.

Depending on the desired style, we leverage one or both of these asset allocation engines to customise objective-based portfolios. Examples of some of our objective-based portfolios include the following:

Product	Index	Objective
Real Return portfolio	Australia CPI	Australia CPI + 4.5% over a rolling 5 year period
Diversified Growth portfolio	UK RPI	UK RPI + 4% over a rolling 5 year period
Total Return portfolio	Total return of 6% p.a.	Total return 6% p.a over a three year investment period

Performance (%, AUD terms) Ended 28 February 2017	3-months	6-months	1-year	Since inception 3 December 2012 (p.a.)
Real Return portfolio (Gross of fees)	2.58%	1.94%	8.03%	5.18%
Reference Index (AU CPI)	0.56%	1.07%	2.03%	2.21%
"Real Return"	2.02%	0.88%	5.95%	2.97%

Performance (%, GBP terms) Ended 28 February 2017	3-months	6-months	1-year	Since inception 23 June 2015 (p.a.)
Diversified growth portfolio (Gross of fees)	5.97	5.71	17.27	7.72
Reference Index (RPI)	0.55	1.18	2.37	1.75
"Real Return"	5.42	4.53	14.91	5.98

Performance (%, SGD terms) Ended 28 February 2017	3-months	6-months	Since inception 1 February 2016 (cumulative)	Since inception 1 February 2016 (p.a.)
Total Return portfolio (Gross of fees)	2.58	2.63	7.27	6.70
Benchmark Return[1]	1.45	2.93	6.49	5.98
Active Return	1.13	-0.30	0.78	0.72

[1] Benchmark since inception: Absolute return of 6% p.a., compounded daily (net of management fees). Past performance is no guarantee of future results.