First State Investments
Colonial First State
Global Asset Management

The Investment Report.

Investing in a low growth environment.

October 2016

Contents

Setting the Scene: Economic Overview	1
Asset class commentaries:	
Australian Equities, Growth	7
Global Unconstrained Fixed Income	13
Unlisted Infrastructure	17
Global Resources	19
Emerging Markets Debt	25
Global Listed Property Securities	29
Global Listed Infrastructure Securities	33
Asian Fixed Income	37
Realindex Investments	41
Multi-Asset Solutions	47

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Welcome to Colonial First State Global Asset Management's (CFSGAM) 2016 Investment Report, 'Investing in a low growth environment', which explores the options for investors in the current low growth, low inflation, low interest rate world.

When the Global Financial Crisis (GFC) spread across the world in 2007-08, the economic impact was deep and significant, leading to recession in many of the world's major economies. This was followed by a recovery in 2010 as both fiscal and monetary policy action was taken to restore growth.

However, despite the unprecedented levels of policy easing, global GDP growth has been below trend at around 3% pa since 2012 and looks like it will remain at this level for the foreseeable future.

As a consequence, this is a challenging time for investors where securing alpha to deliver returns and meet objectives becomes even more critical.

The Investment Report consolidates views from CFSGAM's Head of Economic and Market Research and senior investment professionals from ten of our asset class teams. The Report has been designed in order to provide you with a comprehensive insight into the current state of the financial markets and gain an understanding of the potential investment (and alpha) opportunities that exist in the today's low growth environment.

Please contact your CFSGAM representative with any questions or feedback.

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The Economic Landscape

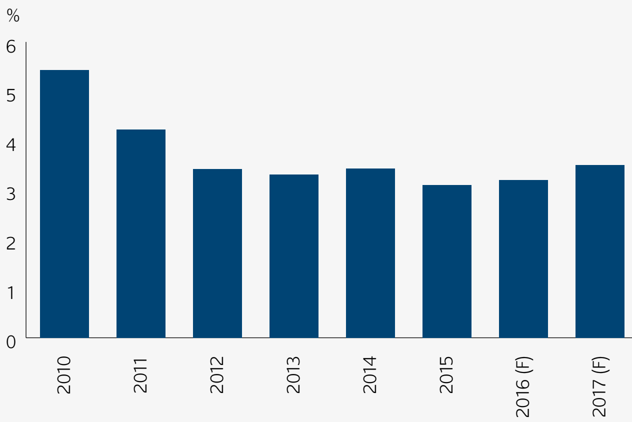
Nothing is changing

When the Global Financial Crisis (GFC) spread across the world through 2007-2008, the economic impact was deep and significant, leading to recession in many of the world's major economies. This recession was then followed by a solid recovery in 2010 (see Chart 1), as both fiscal and monetary policy action was taken to restore growth.

However, as also demonstrated in Chart 1, since 2012 global economic growth has been stuck at around 3% pa each year. 2016 and 2017 look like they will see growth very close to this level, despite the extraordinary amount of policy easing currently in the global economy.

In many ways, the current economic environment is nothing new. The world seems trapped in a low growth; low inflation; low interest rates environment. We expect this situation to persist.

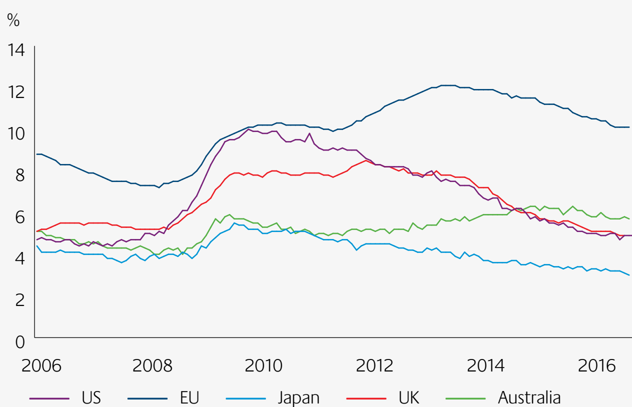
Chart 1: Global economic growth 2007-2017



Source: IMF data as at October 2016.

One important feature of the world economy that is worth remembering is that although 3% pa global economic growth is well below the pre-GFC trend (which was a little over 4%), it is far from a disaster. Indeed, as shown in Chart 2, 3% pa global gross domestic product (GDP) growth is evidently enough to support the labour market, with the unemployment rate trending down in all major economies. Importantly, this improvement in the labour market is not associated with rising wages pressure.

Chart 2: Major economy unemployment rates



Source: Bloomberg. Data to 12 October 2016.

Low inflation almost everywhere

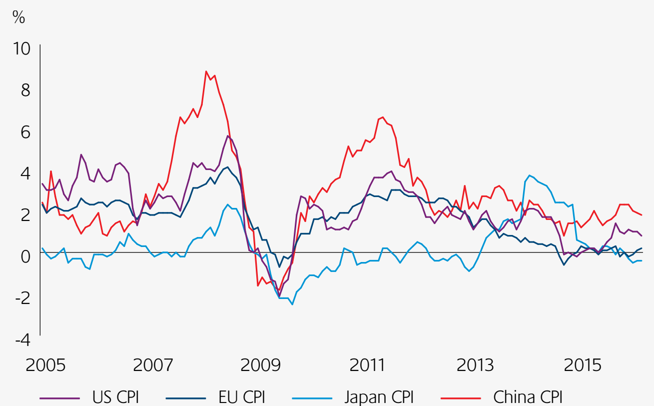
One of the major features of the post-GFC world is the fact that inflation is low almost everywhere. In our view, there are a number of reasons for this global low inflation environment; some cyclical and some structural.

In cyclical terms, inflation is being held down by the modest level of global economic growth as well as the low level of wages growth, which is partly a result of the large increase in the global supply of labour coming from countries such as China and India. Lower commodity prices, especially oil, have also had a noticeable impact on inflation and inflation expectations.

These cyclical developments have been aided by two major structural trends; demographics and technology. It is our view that demographics are playing a key role in subduing inflation, where aging populations in some of the world's major economies, especially Japan, are putting downward pressure on prices.

Technology has played a crucial role. With the rise of online shopping and the availability of an 'app' for everything, technology has enabled the supplier of any good or service to get much closer to the buyer, thereby removing many layers of 'middle-men' and significantly lowering costs and prices.

Chart 3: Inflation is low almost everywhere



Source: Bloomberg. Data to 12 October 2016.

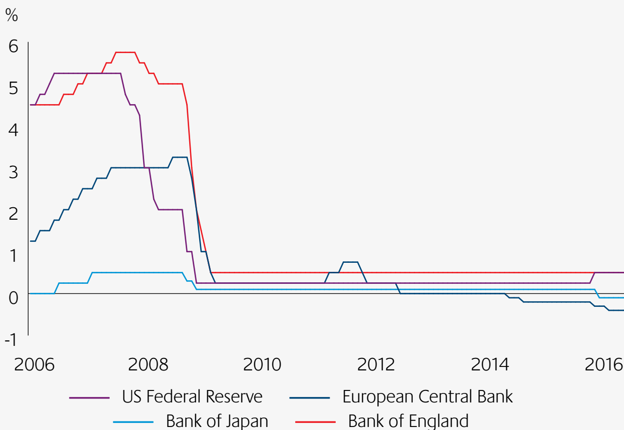
Monetary policy

The low inflation environment is critical to the outlook for financial markets, as it is having a significant impact on global monetary policy. As is well known, most major central banks target inflation at 2% ie. US Federal Reserve (Fed), Bank of England (BoE), European Central Bank (ECB), Bank of Japan (BoJ) and the Bank of Canada (BoC). The Reserve Bank of Australia (RBA) and the Reserve Bank of New Zealand (RBNZ) have more flexible arrangements, targeting 2-3% and 1-3% respectively. For much of the time, these central banks have worked with a 2% inflation target, the primary goal was to get inflation down to 2%. Now the challenge is to get inflation up to 2%.

This desire to increase inflation to the 2% target has led to the implementation of extraordinary monetary policy measures across most of the world's major economies. Quantitative easing ie. central bank balance sheet expansion by asset purchase programs, has become common-place in the US, UK, Europe and Japan.

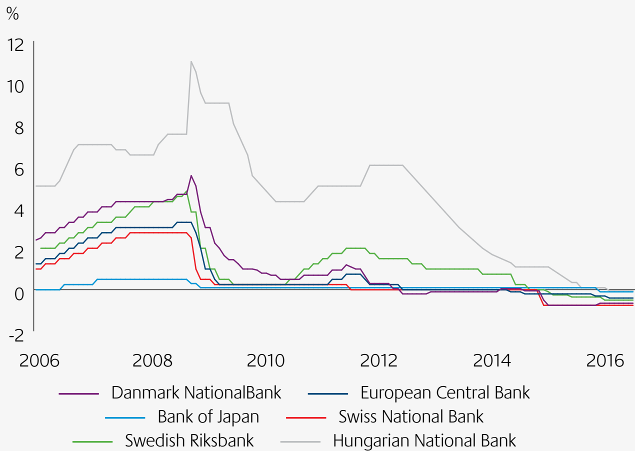
Official interest rates have been cut dramatically across nearly all major central banks, while six central banks currently have their official interest rate set in negative territory ie. in Europe, Japan, Denmark, Switzerland, Sweden and Hungary. For further details on the impact of negative interest rates, please see our report published in July 2016, **Negative Rates: Are there any positives?**

Chart 4: Major central bank policy rates



Source: Bloomberg. Data as at 12 October 2016.

Chart 5: Six central banks have gone negative



Source: Bloomberg. Data as at 12 October 2016.

Negative interest rates

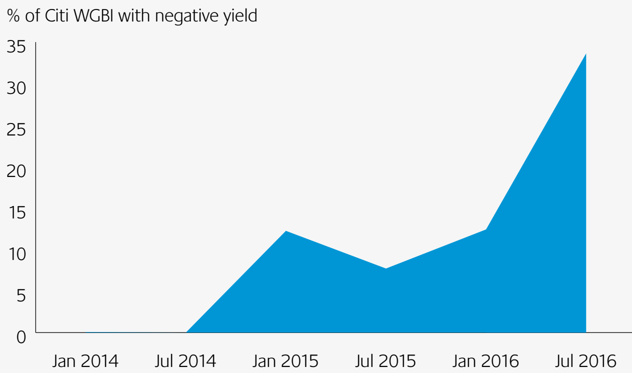
It is also interesting to note the impact of negative interest rates in places where they have been implemented.

One initial response of negative interest rates was an increase in the cost of funding for many banks around the world, with considerable uncertainty over what impact negative interest rates would have on the profitability of many banking models. This was especially the case in Japan and the European Union (EU).

In addition, negative official interest rates have had a significant impact on global bond markets. As shown in Chart 6, over the past year or so, there has been a surge higher in the share of the world's sovereign bond markets that are trading with a negative yield.

Bonds with negative yields now represent around 30% of the World Government Bond Index – which is over $US10 trillion worth of sovereign bonds – with most of these in Japan or the EU.

Chart 6: Share of WGBI in negative yield



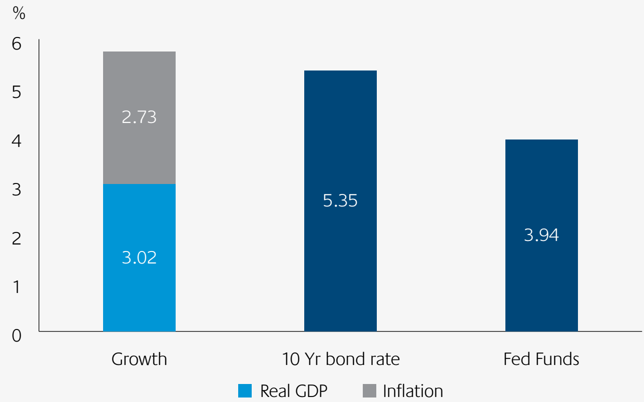
Source: Citigroup as at July 2016.

It is also interesting to observe human behaviour due to the effects of negative interest rates. Over the past year, the value of high-denomination bank notes in circulation in the EU, Switzerland and Japan has increased sharply. Data from Japan also shows a surge in the number of household safes being sold in order for individuals to keep high denomination notes at home and consequently earn a return greater than negative, ie. zero.

The 'new normal'

In this environment of very low and negative interest rates, there is a lot of talk of the 'new normal'. One way to represent this view is through Charts 7 and 8. From 1992 to 2008, the US economy averaged nominal economic growth each year of approximately 5.75% pa (split between real growth of around 3% and inflation of approximately 2.75%). Ten year bond yields averaged a little below this rate at approximately 5.35%, while the Fed Funds rate averaged just under 4%.

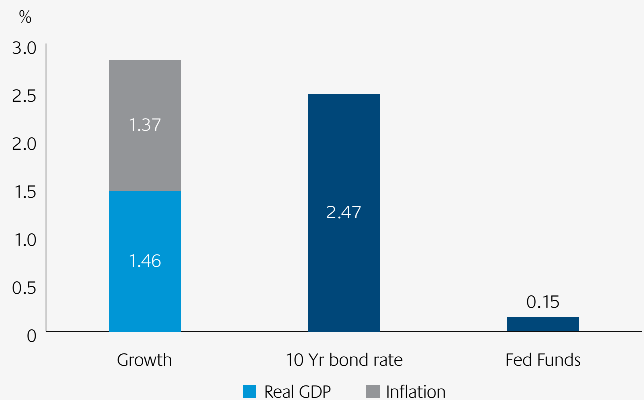
Chart 7: The 'new normal' US 1992-2008



Source: Bloomberg. Data as at 30 September 2016.

Since the GFC, however, this situation has changed significantly. Nominal economic growth in the US has averaged closer to just 2.8% pa (split between real growth of 1.5% and inflation a little lower than 1.4%). Ten year bond yields have average just under 2.5%, while the Fed Funds rate has barely been above zero.

Chart 8: The 'new normal' US 2009 – present



Source: Bloomberg. Data as at 30 September 2016.

To our mind, the 'new normal' represents the fact that whatever the given level of economic growth, the inflation rate and interest rates, and therefore the return on investments associated with that economic growth, is now likely to be much lower than in the past.

Another way to put this is that the 'new normal' is not a period of below-potential economic growth, but that potential growth itself has declined.

This is the defining issue for the post-GFC world and does not look like changing anytime soon.

We remain in a low growth, low inflation, low interest rate global environment.

Everything is changing

One area that is subject to constant change however, is global politics.

As we have written about previously (see **First Insights, July 2016**), there is a strong anti-globalisation trend underway in the political landscape of many countries. This is clearly demonstrated in the run-up to the US Presidential election and the 'Brexit' result in the UK Referendum, but also evident in recent elections in Europe and Australia.

While there are some justifiable concerns that the benefits of globalisation have not been evenly shared across nations and within nations, the political promise to either 'solve' these concerns or somehow turn-back time on globalisation carries with it great risks.

In our view, any implementation of anti-globalisation policies could lead to:

- Less global trade – which would be bad for global growth.
- Less immigration – which would be bad for the demographics of many countries.
- Governments are likely to become more interventionist and short-term in nature.
- Government resources could then be 'wasted' on less productive spending and attempts to 'protect' some economic sectors, rather than encourage the development of new sectors.
- Larger budget deficits and more government debt could result.
- Productivity enhancing micro-economic reform is less likely to be undertaken.
- This could further reinforce the recent trend towards more of the heavy lifting to create economic growth being put on central banks.
- This could exacerbate the trend to lower interest rates.
- This could also create increased volatility in global FX markets as countries try and 'borrow' economic growth from others, rather than create more economic growth.

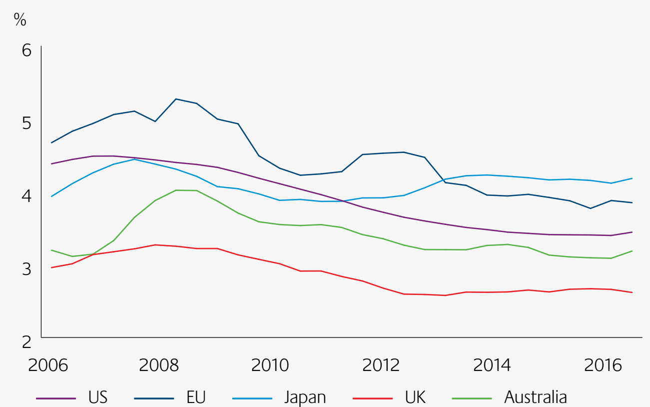
Upside risks

One potential source of upside risk for the global economy and markets could be developments in fiscal policy. We are now seeing the beginnings of a debate that suggests, with monetary policy potentially reaching the limits of its effectiveness, fiscal policy should play a greater role in helping to create economic growth.

With interest rates and government bond yields near historically low levels, the idea would be for governments to borrow and invest in productivity-enhancing assets, especially infrastructure. We have already seen this type of policy implemented in Japan and Canada, while the new UK Prime Minister and both Presidential candidates in the US have talked about using such policy and/or increasing infrastructure spending. Some jurisdictions in Australia have also been increasing infrastructure spending and this proved to be a solid source of support for the economy in the recent Q2 16 National Accounts.

As illustrated in Chart 9, after a number of years of a declining trend in government capital spending, plenty of upside remains.

Chart 9: Government fixed capital spending – % of GDP



Source: CBA as at February 2016.

Conclusion: Implications of low nominal GDP

It would appear that not much is likely to change in the economic outlook for the remainder of 2016 and into 2017. Over the year ahead, we are expecting the situation of low economic growth, low inflation, and low interest to persist.

This in turn is expected to keep the pressure on central banks to maintain, or even increase, the amount of monetary policy easing applied to support growth. The US Fed is expected to raise interest rates only very gradually, including a rate hike in December 2016 and two more in each of 2017, 2018 and 2019 to reach a peak of around 2%.

Both the ECB and BoJ are predicted to retain their extraordinary easy monetary policy conditions for some time to come.

Both the RBA and RBNZ are expected to ease monetary policy further.

Upside risks to growth could come from a greater focus on fiscal policy, with governments using the historic low level of interest rates and bond yields to borrow and invest in productivity-enhancing infrastructure.

A source of risk, however, is the concerning anti-globalisation trend now evident in the politics of many countries and the temptation for governments to 'intervene' or attempt to turn back the clock. Such policies are more likely to slow global growth and potentially harm those that they proclaim to support.

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Investing in a low growth environment.

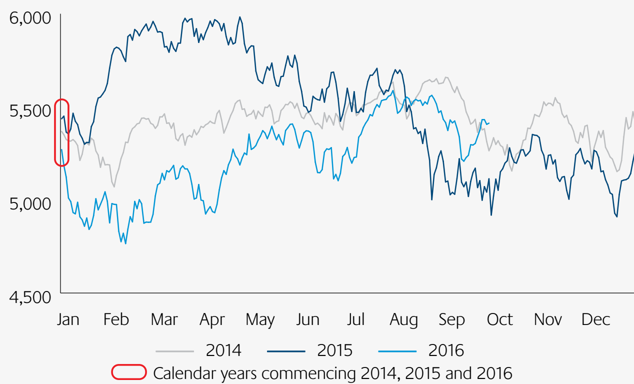
Australian Equities, Growth

Opportunities and resilience

Today's low return, low growth environment presents challenges to investors looking for income and capital growth. However, opportunities are out there – the key is knowing where to look. The Australian share market continues to be an attractive place to invest for domestic and international investors on many measures, and continues to compare favourably with other sharemarkets.

It has been a rollercoaster ride for investors in domestic and global equities in recent times. In the 10 months between April 2015 and February 2016, the S&P/ASX 200 Index traded in a range of 20%, from 5982 to 4765. However, calendar year returns for investors have masked this volatility. For example, the S&P/ASX 200 Index has finished the past three years back where it started, at around 5300 points. It is little wonder that equity investors may feel that they are not getting adequate returns for the risk they are taking on.

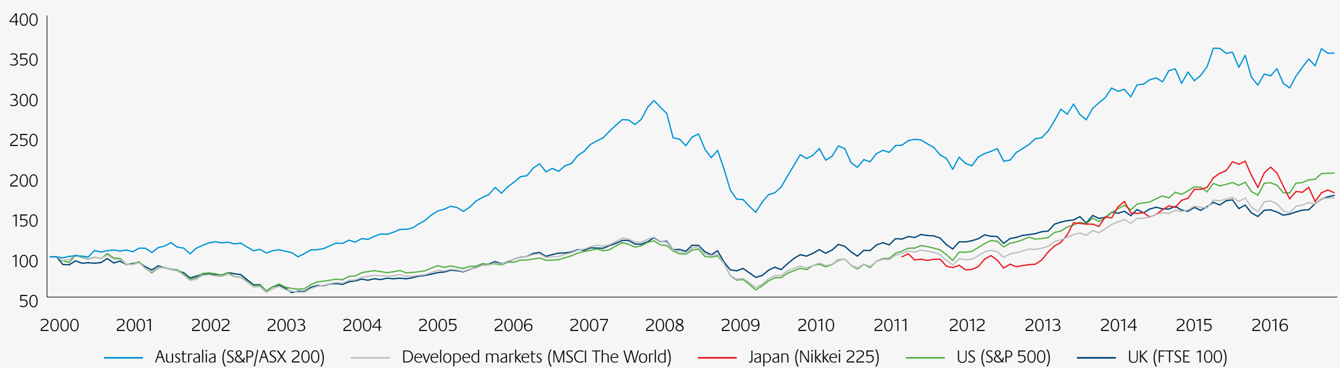
Chart 1: Calendar year performance of the S&P/ASX 200 Index



Factset, September 2016.

Add in dividends however and the picture begins to look a little different. The median yield of the Australian share market is 5%, which is around double that of its developed market peers. Over longer time periods and on a total return basis, the ASX 200 Accumulation Index has delivered a solid outcome – returning more than 11% pa for the five years to the end of September 2016.

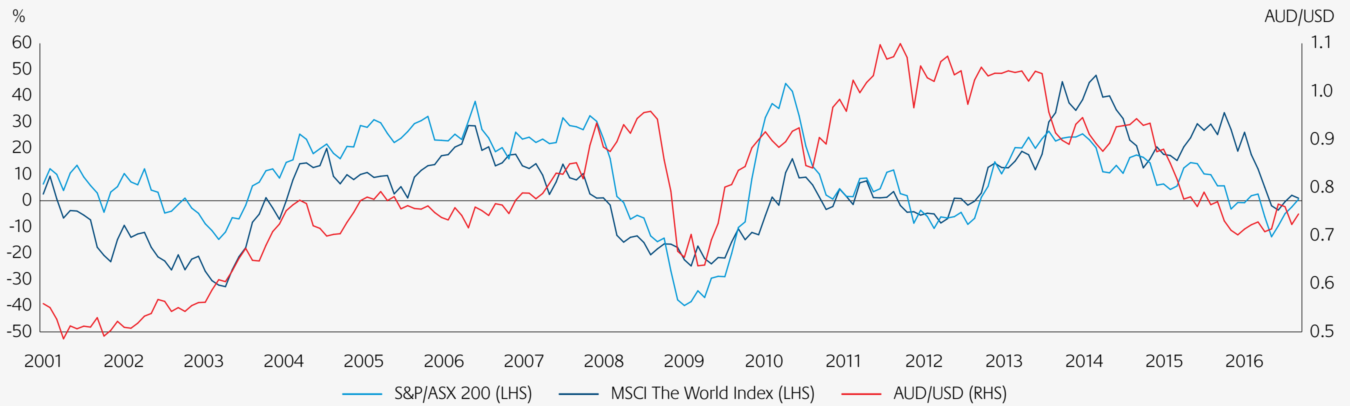
Chart 2: Equity market index total returns by country – June 2000 to June 2016



Source: Factset, September 2016.

The share market has recently underperformed international share markets when compared in Australian dollar terms, owing to the weaker domestic currency, as illustrated in Chart 3. However, the chart also shows that the market has bounced off its recent lows and now compares favourably against its global peers. This is a reflection of the resilient Australian economy and inherent vitality of select companies.

Chart 3: Rolling 12 month returns – Australian share market vs MSCI The World Index in AUD terms



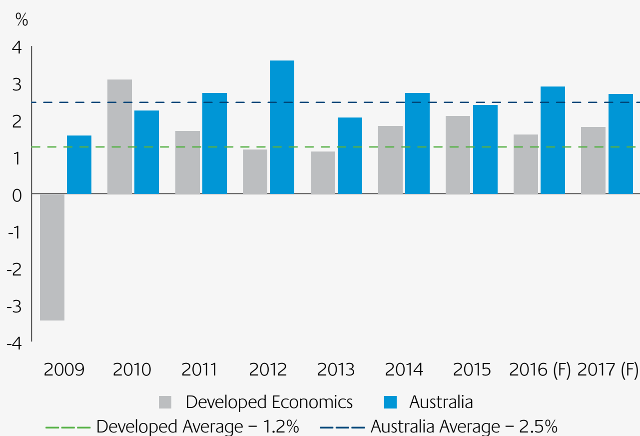
Source: Factset, September 2016.

A resilient economy

The domestic economy offers much more resilience and flexibility than many commentators would have us believe. For example, those that forecast a major downturn as the mining investment boom ended have been proven to be overly pessimistic, as Australia now marks 25 years without a recession.

Growth forecasts for this year, and next year, remain well above other developed economies. Australia has, therefore, been able to maintain an average level of annual growth more than double that of the developed world since the Global Financial Crisis, as illustrated in Chart 4.

Chart 4: GDP growth (%) 2009 – 2017

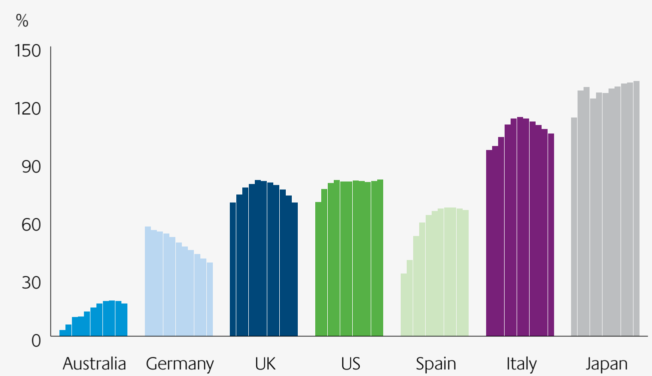


Source: IMF data as at October 2016.

The economy even appears to be successfully rebalancing post the mining boom, with consumer and business confidence remaining around long-term averages. GDP is growing, driven by public investment and government consumption. Portions of the economy, such as tourism and education, have also benefited from a weaker Australian dollar.

Although it has been rising it recent years, the Australian government has one of the lowest levels of debt as a percentage of GDP globally, which has helped fund public expenditure.

Chart 5: Government net debt as a percentage of GDP 2010 – 2020 (forecasts from 2016)



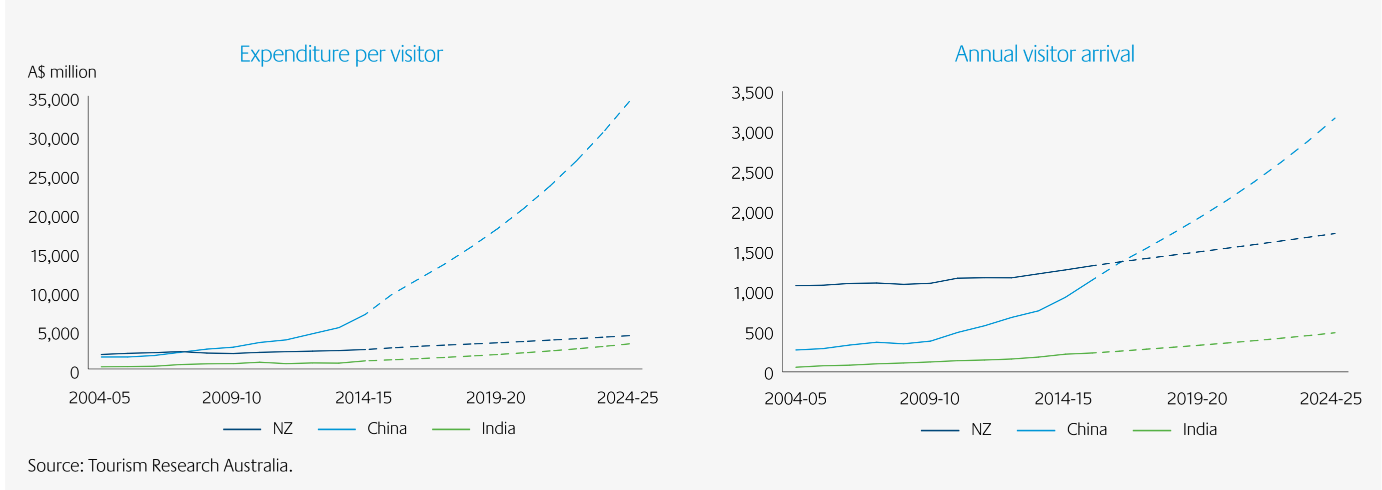
Source: Commonwealth Treasury – 2016/17 Budget.

Australia v developed economies

The health, education, infrastructure and tourism sectors are a particular cause for optimism for a number of Australian companies. In the tourism sector for example, Australia now ranks behind only the US and the UK as a destination for overseas students. The number of visitors from China surpassed one million for the first time this year, second in number only to New Zealanders. Arrivals from China and India have doubled over the past five years, and are forecast to double again within the next five years.

Importantly, Chinese visitors, and a number of other visitors from Asia, are each spending a lot more than visitors from richer, more developed economies. As Chart 6 illustrates, they are either already spending more – or are soon to overtake – visitors from countries such as New Zealand, the UK and the US.

Combine the growth in visitors with the higher expenditure per visitor, and it quickly becomes apparent how important Asian tourists are to the local economy. By 2025, the contribution from Chinese visitors is expected to exceed $34 billion (bn). This will be more than double the combined total of the other three developed countries' visitors at $16bn.



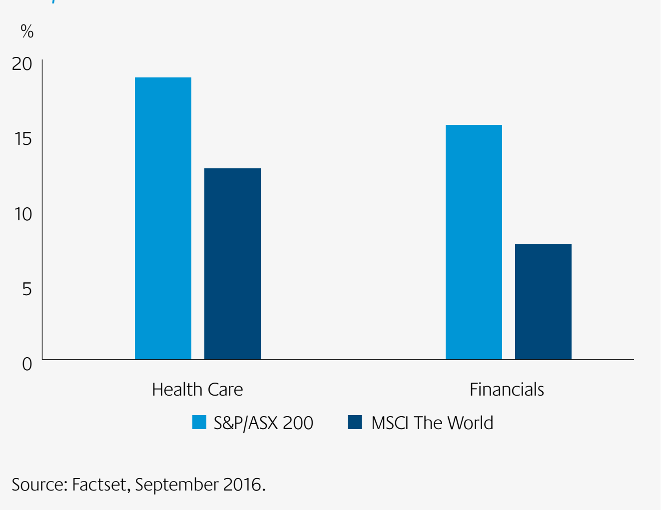
Source: Tourism Research Australia.

Strong growth prospects for Australian companies

Australian companies continue to score well on many economic and financial measures relative to their global peers. Companies in the Financials and Health Care sectors generally have a much healthier return on equity, as illustrated in Chart 7.

Despite Australia's relatively-small size, outward-looking strategies have seen many companies expand globally with great success.

In the Healthcare sector for instance, CSL, Cochlear and ResMed have all become global leaders in their product lines, and we have seen companies such as Sonic Healthcare, Mayne Pharma and Sirtex Medical, establish significant offshore operations.

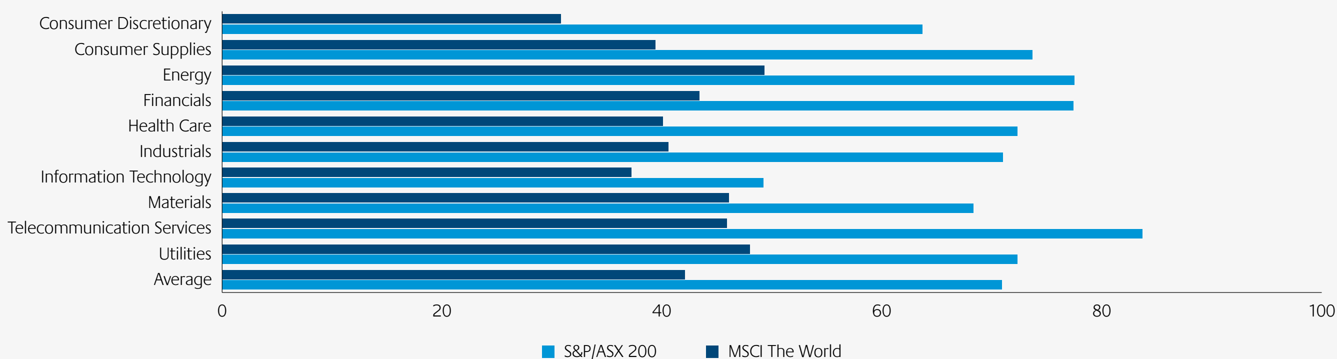


Source: Factset, September 2016.

Outside of the Healthcare sector, there is an abundance of quality companies that have great management teams and bright prospects in the areas of agriculture, tourism, education and infrastructure. Companies as diverse as Amcor (packaging), Brambles (pallet pooling), James Hardie (fibre cement products), Goodman Group (industrial property), Macquarie Bank (financial services), have all developed substantial and high returning businesses outside of Australia.

Australia also scores very well on a range of environmental, social and governance (ESG) measures. ESG risks are material investment issues that have the potential to impact long-term investment performance. A positive approach to ESG issues, supported by shareholder activism and a strong regulatory framework, is essential for achieving sustainable financial markets and a sustainable economy.

Chart 8: ESG score by sector – S&P/ASX 200 vs MSCI The World Index



Source: Factset, September 2016.

Of course there are risks in the Australian market as well. Concerns remain around the overheated property market, while wage growth and inflation remain lower than desired. Cost-cutting and productivity improvements continue to be the main source of earnings growth for companies, but clearly these cannot continue forever.

In the context of a world with political uncertainty in the US, somewhat opaque Chinese growth, re-adjustment in a post-Brexit UK and social upheaval in Europe, investors in the resilient Australian share market have reasons to be confident with the investment opportunities on offer.

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Global Asset Management

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Global Unconstrained Fixed Income

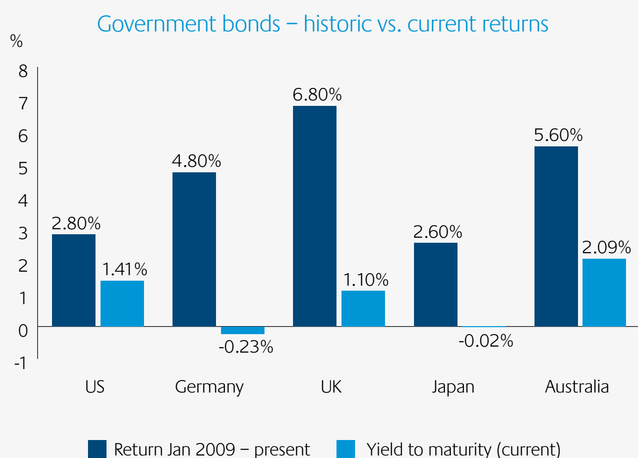
A global unconstrained approach needed in the current environment

What you see is what you get

Global fixed income markets have been both a beneficiary and a victim of the low-inflation, low-growth environment seen since the Global Financial Crisis (GFC). Falling yields do indeed have their benefits, particularly for investors who already own high quality fixed income securities. Many investors simply do not care that 10-year Australian government bonds trade at a meagre 2% yield when total returns so far in 2016 have been in excess of 6%. Looking in the rear view mirror (Chart 1), government bond returns in developed markets look seductively good, at least relative to the anaemic cash rates on offer.

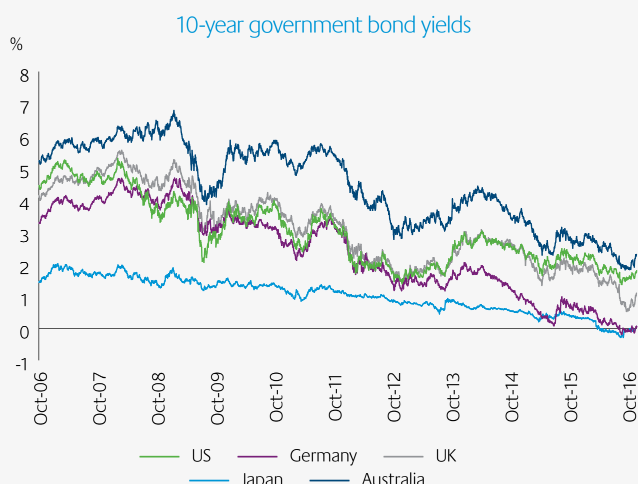
However, when asked to provide expectations of future bond returns, our best guess is always the same – it is the yield-to-maturity. In fixed income, what you see is what you get (assuming no defaults and holding to maturity). This means, right now we can expect investing for the next 10 years in high quality government bonds to generate 2.09% per annum in Australia, 1.41% in the US, 1.10% in the UK, -0.23% in Germany, and -0.02% in Japan. For those seeking return, it is a fairly dire state, even amidst a backdrop of relatively low growth and inflation.

Chart 1: Risk-free return or return-free risk?



Source: Bloomberg Barclays Global Treasury Index as at 14 Oct 2016.

Chart 2: Race to the bottom



Source: Bloomberg as at 14 Oct 2016.

This means other reasons are now given for holding high quality fixed income securities in a portfolio, including:

- Diversification against equities or growth assets.
- Anticipation of even lower yields and continued capital gains.
- Expectations of lower or negative growth/inflation, making 'real' yields look OK by comparison.
- Liquidity provision.
- Income generation.

While we will not debate the relative strength or merits of these rationalisations here, one thing is for sure: if return is what you seek, then beta alone will not get you there.

Higher, faster, longer, stronger

There are two tried and tested ways of increasing the return on a fixed income portfolio: increasing duration and increasing credit exposure. For those looking to squeeze a bit more out of their portfolio, both of these involve taking substantially more risk.

As it relates to credit, we would warn that there are no free lunches here. Although generally a sensible option, investors should invest in a diversified manner, preferably actively to ensure credit losses are kept at a minimum. But for a high quality core fixed income allocation, credit on its own is not overly defensive given the relatively high correlation to equities and other risky assets. To the extent that increased credit is desirable, we would recommend picking a dedicated and specialist global credit or high yield manager to navigate turbulent waters.

On the other hand, apart from hedging a specific long-dated liability, we would not recommend increasing duration since yield curves are relatively flat, and the increased yield generated by shifting out the maturity spectrum would not be sufficient for the increased level of risk. Additionally, as shown in Chart 3, duration across developed government bond markets has extended considerably in the past 10 years and before the GFC. Debt issuers are behaving rationally in that they are borrowing money when coupon payments are at or near all-time lows. Is it a surprise that the average duration of market capitalisation indices continues to go up? Unfortunately for the lender, this has both increased volatility expectations given the higher risk profile and dramatically increased capital loss expectations should interest rates rise sharply. So, what is left?

Chart 3: Extending yourself?

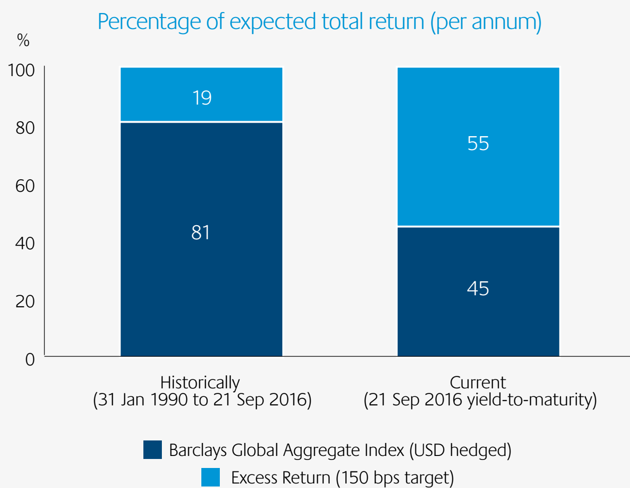
Source: Bloomberg Barclays Global Treasury Index as at 14 Oct 2016.

The alpha course

Conventional wisdom dictates that the vast majority of returns come from asset allocation decisions. Academic literature and research[1] seems to have settled on at least 80% being the amount of long-term return that can be explained through strategic asset allocations decisions. Therefore, developing an appropriate asset allocation and picking one's benchmark historically was of far more consequence than selecting an active manager. However, the low-yielding environment means that there is an increased likelihood that in fixed income, excess returns will exceed market returns in the period ahead.

For example (demonstrated in Chart 4), historically the global investment grade fixed income market (Barclays Global Aggregate Index – USD Hedged) has generated an annualised return of around 6.33% (since inception of the index in 1990). For an alpha target of say 150 basis points, this equates to around 19% of the total expected return per year. Indeed, conventional wisdom has been right. But currently, the average yield-to-maturity on the Barclays Global Aggregate Index is a mere 1.25%. Given that the yield is our best expectation of future market returns, this means that now – assuming a manager delivers on objectives – you can expect around 55% of total returns to be generated through excess returns. The choice of an active manager within fixed income is more important than ever.

Chart 4: Alpha now more important than Beta



Source: Bloomberg Barclays Global Aggregate Index (USD hedged) as at 14 Oct 2016.

To consistently deliver high quality alpha within portfolios, we have invested heavily to develop a network of investment capabilities worldwide to enable the creation of a global platform, which ensures that we are able to offer clients access to our best investment thinking, regardless of where it occurs. Along with assembling a collection of world-class investment teams who are specialists in their relevant fields, we have fostered a transparent, research-based investment culture underpinned by our proprietary, technology-based platform – the Investment Opinion Network. ('ION'). This platform allow us to deliver a 'Global Unconstrained' approach, which is necessary in the current environment.

What does 'unconstrained' mean to us?

The term 'unconstrained' has picked up in popularity in recent years within the fixed income world. But this term means different things to different people. In some cases, it is shorthand for a hedge fund. For others it means moving away from traditional fixed income benchmarks. Cynically speaking, unconstrained may be nothing more than a marketing buzzword used to repackage old ideas. We have a straightforward view of what 'unconstrained' means.

Simply put, we believe idea generation that develops free from traditional parameters such as region, sector, rating, and benchmark constituents generates the richest possible variety of global investment views. Hence, 'Global Unconstrained'.

The label 'unconstrained' is intended to convey that investment ideas are expressed regardless of any top-down imposed world view. As a global platform, we take great care to ensure alpha sources are uncorrelated to markets and each other. This is why idea generation is developed independent of an overarching 'house view'. Further, by intentionally decoupling idea generation and associated research from portfolio construction, we can combine alpha sources in many different ways so long as risk is balanced.

As we have established, in the period ahead, alpha will likely play a more important role than beta in a diversified fixed income portfolio. And we think we have built the ideal alpha platform to deliver an all-weather, balanced return stream that can squeeze a bit more out of a fixed income portfolio during this unusual environment and beyond.

1 Brinson, Gary P., L. Randolph Hood, and Gilbert L. Beebower. "Determinants of Portfolio Performance" Financial Analysts Journal 42, no. 4 (1986): 39–44.
Ibbotson, Roger G., and Paul D. Kaplan. "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance", Financial Analysts Journal 56, no. 1 (2000): 26–33.

First State Investments

Colonial First State
Global Asset Management

Perry Clausen
Managing Partner

Ritesh Prasad
Senior Investment Analyst

Unlisted Infrastructure

Time to shine

For starters, unlisted infrastructure plays a valuable defensive role in most institutional portfolios. Hence, a low-growth environment is precisely when this asset class is expected to shine.

The risk-return profile implied by the current and foreseeable macroeconomic environment is one with limited upside, but with the potential for large capital losses from 'black swan' events. This is not dissimilar to the risk-return profile of a typical regulated utility, where returns are capped by the regulator and where tail-risk events may exist on the downside.

There is a strong argument, therefore, that the performance of a well-managed core infrastructure portfolio should not be vastly different in a low-growth macro environment.

From a cyclical perspective, demand for essential services provided by water utilities and other regulated assets should remain resilient in the context of an economic downturn. In other words, these assets are 'low-beta' in nature.

However, the illiquid and long-term nature of unlisted infrastructure means that investors have the freedom to look through the economic cycle, and through short-term market noise.

This means focusing on the inexorable upward march of gross domestic product (GDP) per capita levels in a developing economy rather than the swings and roundabouts of year-on-year GDP growth. It means focusing on the step-change in renewables generation capacity rather than fluctuations in oil prices. It means assessing the permanent increase in propensity for international air travel from a newly-created Asian middle class rather than shorter term changes in an airport's passenger mix due to currency ebbs and flows.

Accordingly, we do not believe the current low growth environment warrants a change of strategy. Importantly, this includes avoiding the sort of 'style drift' that is currently being observed from other participants in the infrastructure market, who are looking to chase returns by moving higher up the risk curve into 'quasi-infrastructure' assets. Our experience over two decades suggests that this path has many potential pitfalls – foremost of which is the strong likelihood that these assets will not deliver the same defensive attributes as 'core' infrastructure assets.

Instead, there are three keys to investment in the current macro environment. One, maintaining an unwavering focus on tail-risk management. Two, focusing on sectors with structural tailwinds. Three, delivering returns through alpha. Let us deal with each of these in turn.

Risk management is perhaps not the most obvious way to deal with a low-growth environment, but it is important to understand this in the context of an unlisted infrastructure portfolio. A typical portfolio might have anywhere from 8 to 12 assets, which is far less diversified than a portfolio of listed securities, which might have hundreds of holdings. Risk management, therefore, is primarily about avoiding deleterious capital losses within the portfolio as much as possible.

One way of achieving this is by requiring strong governance to ensure an appropriate level of control over the portfolio assets. We typically have Board representation on our investee companies – in many cases owning 100% of the business. This acts as a tail-risk mitigant by allowing us to proactively steer management away from 'short-termism' or other value-destroying ventures.

Instead, we seek to ensure that long-term risks and opportunities, such as environmental, social and governance (ESG) factors are embedded in company strategy.

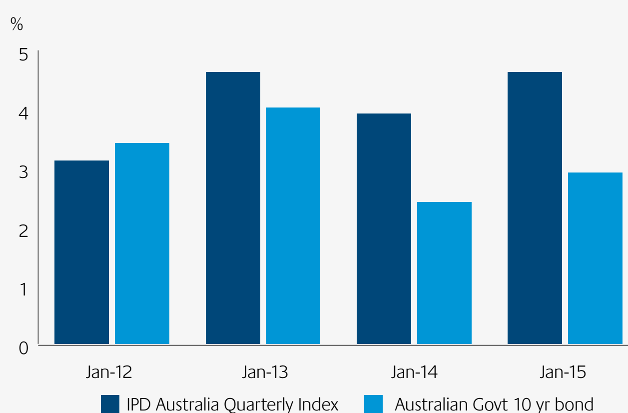
The second key is to ride tailwinds, not battle headwinds. Warren Buffett famously advised to 'only buy something that you'd be perfectly happy to hold if the market shut down for 10 years.' A similar logic applies to infrastructure assets, several of which exist in sectors undergoing structural change and transformation. These include generation (renewables displacing fossil fuel), rail (set to gain modal share as carbon pricing is widely adopted), ports (increased globalisation and trade), and toll roads (ongoing urbanisation). These structural growth trends will continue to unfold even in an environment of low overall growth. They also highlight why infrastructure is often described as a 'solution' for governments seeking to promote economic growth.

The third source of outperformance is delivering alpha via active asset management. In investment parlance, 'alpha' is uncorrelated with 'beta'. This roughly translates to the notion that manager 'skill' is (or should be) independent of prevailing market conditions. This is certainly true when it comes to managing infrastructure assets. Regardless of whether the broader economy is robust or sluggish, our asset managers are constantly seeking to implement initiatives in investee companies that either enhance revenue or trim costs – both of which add to profitability, and hence returns.

Two examples are the A$1.4 billion new parallel runway at Brisbane Airport, which is not expected to be operational until 2020; and the range of innovative projects Electricity North West (UK) has received funding for under the regulator's Low Carbon Networks Fund. Both are examples of initiatives where the ultimate payoff will be realised in years to come – with no indication of what the prevailing macroeconomic climate will be. These initiatives are also typical of our approach in managing assets with a wide range of stakeholders, often with competing interests.

Finally, no discussion of the implications of a low-growth environment for infrastructure would be complete without addressing the elephant in the room – the current 'lower for longer' interest rate environment. In an attempt to stave off the onset of economic stagnation following the global financial crisis, global monetary authorities have engineered the current environment of low government bond yields. Infrastructure yields therefore look relatively appealing to liability-driven institutional investors such as defined-benefit pensions funds and insurers as the chart below demonstrates.

Chart 1: Infrastructure yields look attractive relative to government bonds



Source: Bloomberg as at 21 Sep 2016.

This, coupled with the relative scarcity of high-quality infrastructure assets, has contributed to return compression.

This intense interest in infrastructure arguably creates more difficulties for investors than the weak macroeconomic environment itself (which, conversely, can be positive for investors insofar as fiscally-burdened governments seek to privatise assets and promote infrastructure spending). One potential solution for astute investors is to allocate capital to existing funds, which provide some insulation from aggressive bidding for 'trophy' assets while minimising execution and 'blind pool' risk.

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Joanne Warner
Head of Global Resources

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Investment Manager

Global Resources

It's a cycle but we are getting closer to the bottom....

Global resources equities and commodity prices are cyclical in nature. For the first decade of this century high prices provided both the incentive and funding for new projects and expansions. In some sectors, the timing of this new supply coincided with a slowing rate of growth in demand from China. Commodity prices were pushed lower, weighing upon investor sentiment.

The following five years have seen commodity prices decline to a level where a significant proportion of the industry is struggling to generate free cash flow. Producers are being forced to respond aggressively; cutting costs, jobs and high cost production. Later cycle, consumer-oriented commodities such as base metals, precious metals, diamonds and oil have the best potential for price recovery in the medium term, in our view. Bulk commodities like iron ore, coal and steel are likely to remain in over-supply for longer, despite recent supply discipline.

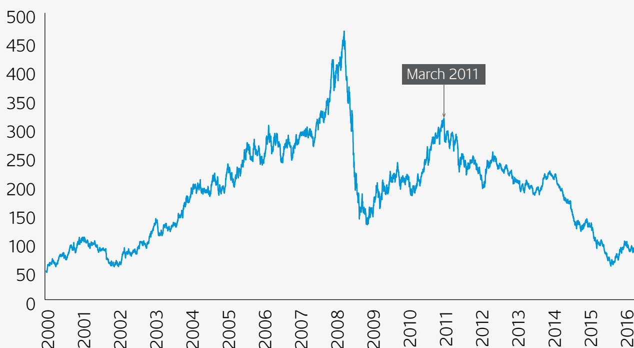
History suggests global resources equity turning points are often sharp and sudden, as evidenced by strong share price moves this year. Unfortunately few can predict when this will occur.

To reduce risk, we invest in quality companies that we believe can survive the cycle. We look for robust margins, strong balance sheets and rich geological endowments. These elements should provide the flexibility for a company to adapt to changing conditions, allowing it to weather an extended downturn and prosper when conditions improve.

Commodity prices have rallied

Global resources equity and commodity markets have rebounded from multi-year lows that were experienced at the beginning of 2016. The Bloomberg Commodity Index (Chart 1) is up by over 5% this year (to 31 August 2016 in USD terms), but is coming from a low base. The recovery has occurred across a broad range of equities, with precious metals seeing the greatest gains.

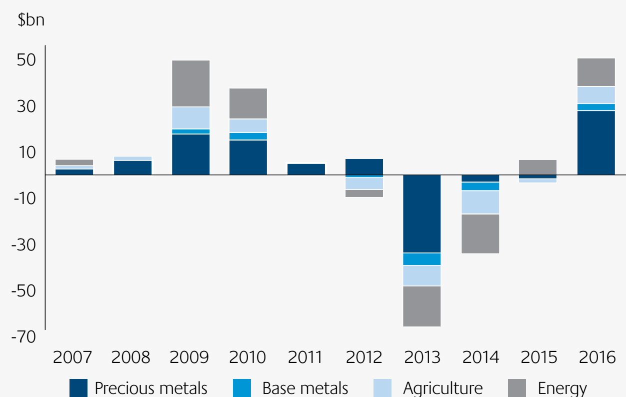
Chart 1: Bloomberg TR Commodity Index 2000 – 2016 YTD



Source: Bloomberg, in USD as at 26 September 2016. Past performance is not indicative of future performance.

There has also been a jump in investment flows, indicating increased investors optimism. According to Barclays, commodities saw investment inflows of US$54 billion (bn) between January and August, an all-time high for the first eight months of the year (see Chart 2). If the current trend continues, 2016 will mark the first year of net inflows into commodities for the first time in four years.

Chart 2: Commodity investment inflows by sector



Source: Bloomberg, ETP issuer data, Barclays Research.

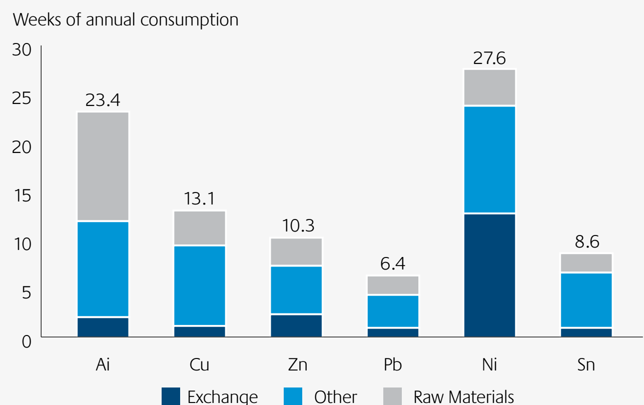
Previous periods of commodity price rises and increased investment flows were accompanied by strong global demand growth and supply constraints. However, neither of these are a feature of current market conditions. While demand has improved following credit stimulus in China, most commodity markets remain oversupplied, which suggests prices could move lower in the short-term. Ultimately, the cure for low prices, is low prices.

The outlook for global resources in the coming months

While some commodities are experiencing a rebalancing of supply and demand, given the recent run up in prices we are cautious on the outlook for most metals and bulk materials if global industrial output remains subdued. Precious metals are more difficult to forecast. Gold, in particular, is quite different to the other commodities because very little of it is consumed, and as a result, investor sentiment will always be the main driver of the price.

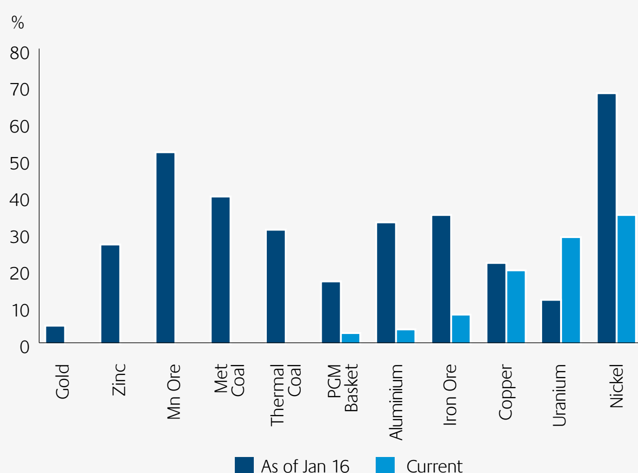
In our view, miners have made significant progress adapting to this lower growth and often oversupplied raw materials environment, scaling back or closing high cost operations to help reduce costs. Despite this improvement, inventory overhang still exists across several base metals. Ultimately, the supply response is going to be critical for the direction of commodity and equity prices in the short-to-medium term.

Chart 3: Estimated total stocks for base metals to end-August 2016



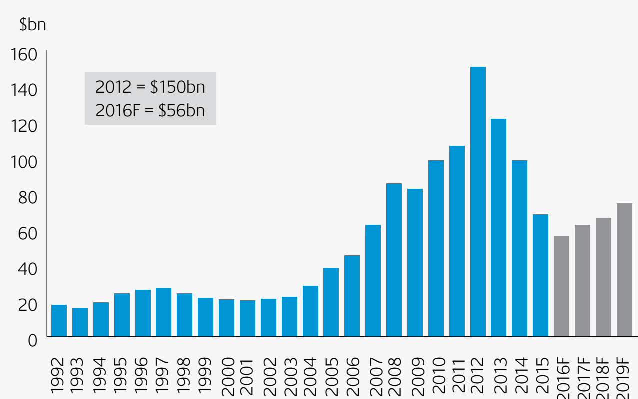
Source: CRU, IAI, Worldsteel, Macquarie Research, September 2016.

Whilst supply can be 'sticky' for a number of reasons, a cash negative operation cannot persist indefinitely. As shown in Chart 4, the proportion of commodity producers losing cash has declined in recent months. This has been driven not just by higher commodity prices, but by closures and cost control.



Source: Wood Mackenzie, CRU, HIS, Government data, Macquarie Research, September 2016.

The majority of major mining companies have aggressively reduced operating costs and capital investment. Companies with high debt levels have been selling assets and raising capital to repair their balance sheets. We expect to see miners continuing to adjust their operating and financial practices to ensure survival in a lower price environment.



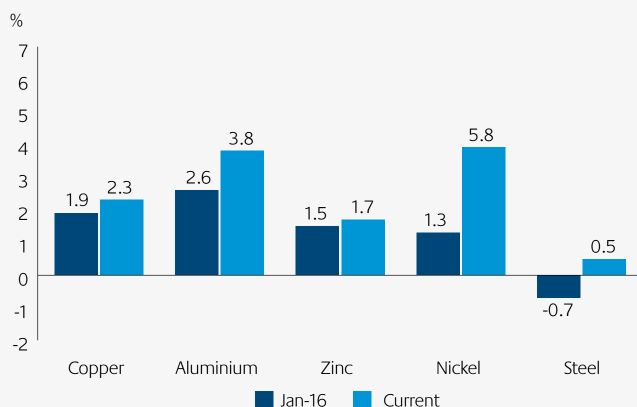
Source: Company data, Wood Mackenzie, Macquarie Research, September 2016.

At this juncture in the cycle, we would normally expect merger and acquisition activity to increase, the weakest producers to shut down production and supply-demand fundamentals to boost commodity prices.

Whilst we have seen the first leg of the long-awaited supply cuts announced, the recent uptrend in commodity prices and the downtrend in costs, aided by weaker producer currencies and lower energy prices, has provided enough breathing room for some marginal producers to survive. In the steel sector, we are starting to see some idled capacity restart as a result of improving margins. However, we believe a number of commodities are still in oversupply. Therefore, at some point, commodity prices will need to move lower to result in the supply cuts required for balanced markets.

Current demand, and hence prices, for most metals and bulk commodities are being supported by Chinese stimulus measures. Coal and steel are also receiving support from Chinese government policy targeting overcapacity in the local industry, forcing a reduction in domestic supply. In our view, if this support is withdrawn, the price for many commodities will weaken, especially steel and thermal coal. Under that scenario, 2017 may see further cuts in production, capital spending and dividends, as well as balance sheet restructurings and asset sales. For pricing tension to return, more needs to be done to address oversupply.

Demand for commodities has moderately improved, despite global economic activity being lacklustre. Commodity demand has been supported by China's manufacturing and property sectors. Even further downstream, sectors such as China's automobile industry are also seeing financial conditions improve. If the benefits of government stimulus continue and we see further investment by the private sector in the property sector in particular, this will be supportive for commodity prices.



Source: LME, Platts, CRU, Bloomberg, Macquarie Research, September 2016.

Increased US unconventional oil and gas production, combined with the removal of sanctions on Iran has resulted in additional oil supply, reducing price tension. In the absence of any major geopolitical disruption in the Middle East or Russia causing concern over security of supply, we think energy prices are likely to remain around current levels for several years.

Our current portfolio positioning

Despite a mixed outlook for commodity prices, there are still attractive investment opportunities in the metals and mining sector because we expect to see a wide dispersion in returns among industries and companies. We maintain a well-diversified portfolio representing as many commodities as possible, where we can find good quality companies or exciting growth opportunities.

At this point in the cyclical recovery, large cap miners and energy companies need to continue to demonstrate capital discipline and to maximise free cash flow. Amongst the mid-cap and intermediate producers, high asset quality, low costs and balance sheet strength are qualities that we emphasise. Smaller companies are inherently higher risk, and small positions can make a meaningful impact upon the portfolio. Catalysts such as exploration success, permitting and development, as well as operational turnarounds, are considered amongst the acorns in the portfolio.

A sustained low interest rate environment has been supportive for precious metals over base metals and bulks. Future actions by the US Federal Reserve will be key to investment demand for precious metals. Platinum and palladium are also benefiting from this, with growing support from a rise in global automobile demand.

Despite closure of some high cost domestic iron ore production in China and the curtailment of global swing production entering the export markets, the world remains structurally oversupplied as a result of new, relatively low cost supply coming from Australia and Brazil. In thermal coal export markets, any gap between Chinese domestic supply and production will have major ramifications for price. After years of loss making by its domestic producers, it would appear that the Chinese government policy is directed towards greater pricing stability. The aim is to underpin margins for efficient producers, whilst not encouraging new capital investment.

Amongst the base metals, the medium-term outlook for zinc and nickel appear more favourable. Closure of the large scale Century zinc mine in Australia and smaller operations in Ireland indicate a potential deficit for this metal. Political developments in both Indonesia and the Philippines to restrict the environmentally damaging export of nickel laterite ore to China will help to reduce the relatively large inventory of the metal.

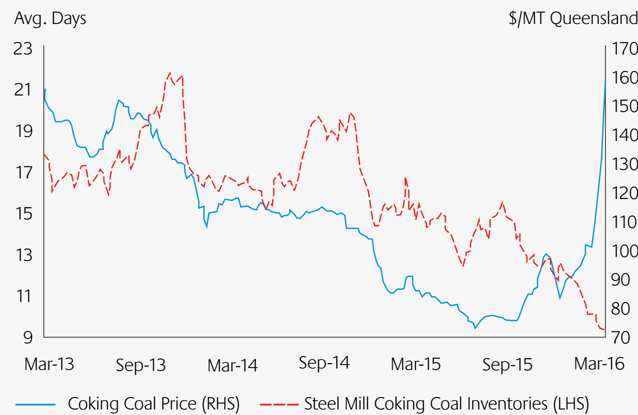
The energy sector offers a wide range of choices from major integrated players, regionally focused exploration and production companies as well as service providers. The latter sector has borne the brunt of the fall in energy prices. Exploration spending is the easiest thing to cut when cash flows are less than planned. The dramatic fall in demand for drill rigs and pressure pumpers over the last few years has devastated this industry. As the industry begins to readjust its business to the 'new norm' of oil prices closer to US$50 a barrel than US$100 a barrel, only the strongest and best will survive. We expect to see the negativity towards this sector reduce as a result of this rationalisation.

What could surprise on the upside?

China remains by far the largest consumer of mined commodities and the second largest consumer of oil and gas. In general, demand has remained robust, growing in absolute terms. However, the rate of growth has declined.

Market sentiment towards China turned very negative in 2015. In response, the government boosted demand through policy support to the industrial sectors of the economy. While we would have expected Chinese stimulus measures to have faded by now, it looks increasingly likely that demand will hold up until year end or even into early next year. China's manufacturing and property sectors are leading the charge.

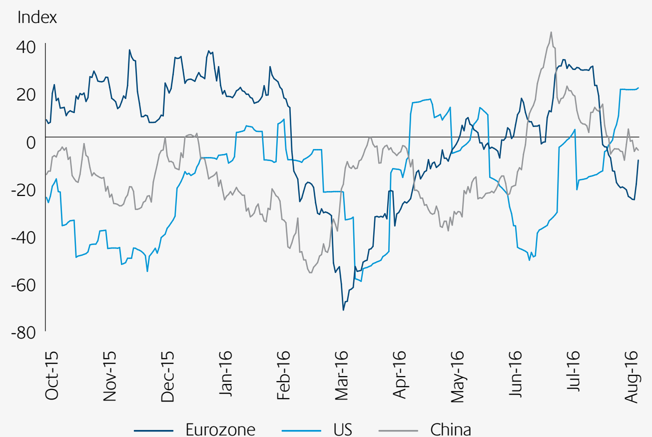
Chart 7: Coking coal prices rebound sharply in response to supply constraints



Source: Clarksons Platou Research August 2016.

Better-than-expected economic data releases and resilient demand this year have somewhat eased concerns around the potential for a 'hard landing' in China. The situation in the country remains uncertain, but if China continues to improve then this would likely see the mining sector surprise on the upside. A sustainable economic recovery in the US and Europe would lend further support for commodity prices.

Chart 8: Economic surprise indices turn



Source: Citi, Macrobond, Macquarie Research, September 2016.

The biggest risk to our view

The bounce-back in commodity prices and mining equities occurred very quickly and unexpectedly. Most generalist investors were caught off-guard as the Chinese boosted stimulus. In response, investors and speculators quickly reduced their short positions and slowly began to increase their exposure to commodities. Our concern is whether this momentum continues amid continued excess supply. While we are already seeing signs of the market re-balancing it is going to take time before we see more sizable supply rationalisation.

Seasonality is also a concern for us. We have passed the typical commodity peak in trade flows, production rates and deployment. Metal processors usually commence de-stocking in the September quarter, prior to the northern hemisphere winter when construction rates usually slow. A pullback in bulk commodity prices is likely with steel and steelmaking raw materials like iron ore and coking coal most vulnerable, given their somewhat elevated levels.

A stronger US dollar (USD) has historically been a headwind for base and precious metals prices. Should the USD strengthen due to rising US interest rates, this would likely have a negative impact on the USD-denominated commodity prices. However, it is important to note that should the USD strengthen due to increased safe haven buying, this would continue to be a supportive environment for precious metals.

In a low inflation and low global growth environment, should investors consider a global mining strategy?

We have all heard economists using the phrases “new normal”, “lower for longer” and “secular stagnation” to describe the current low growth and deflationary economic environment. This could equally apply to the mining sector as it rebalances in response to falling prices and oversupply.

As stock pickers, we are always looking for opportunities to invest in quality mining companies that have a better than average opportunity set to create value for their shareholders. Our oak trees and acorns approach, with a portfolio of high quality majors combined with high growth stocks can deliver better than average returns with less risk throughout the cycle.

Whilst inflation is expected to remain low for now, investing in mining and energy equities may provide a hedge against inflation and deflation.

Worries about global economic growth and negative interest rates has increased demand for gold, as has the desire of investors to benefit from volatility in individual commodities. Gold has been by far the single most popular commodity investment in 2016, with flows into physically backed exchange traded products climbing to a net US$27bn according to Barclays.

Commodities have historically had a negative correlation with the USD, providing currency diversification as well. When the USD is rising, commodities tend to underperform, but when it is falling, commodities can do well.

Mining equity performance historically has run counter to overall equity performance in the last five years, so the sector can be a hedge against weak secular performance in overall global equities, providing portfolio diversification. It is prudent to have some allocation to resources through the entire cycle because of the diversification benefits the sector provides.

The long-term underweight position in metals and mining equities that investors have held for a number of years has been gradually decreased over the course of this year, providing positive momentum. We expect investors to continue to seek alternative assets, such as natural resources, as they continue to hunt for ‘hard assets’ and yield in an era of historically low interest rates.

Helene Williamson
Head of Global Emerging Markets Debt

Amalia Nunez
Senior Investment Specialist

Investing in a low growth environment.

Emerging Markets Debt

The headwinds are turning

The performance of the world economy in the aftermath of the 2008 Global Financial Crisis has been characterised by an unusually slow and uneven recovery, notably in the United States (Chart 1). This weak performance has come in spite of extraordinarily loose central bank monetary policies and an unprecedented amount of Quantitative Easing. Several explanations have been put forward for the unevenness of the recovery: “a debt overhang” (Harvard Economics Professor Kenneth Rogoff), “global savings glut” (former Federal Reserve Chairman Ben Bernanke) or “liquidity trap” (City University of New York Professor Paul Krugman). Most recently, the US Federal Reserve seem to have adopted a central view close to Harvard Professor Larry Summers’ “secular stagnation theory”, which implies that neutral rates (r*) post-crisis are likely to be much lower than they were in the past. This suggests that absent a generous fiscal easing, which remains politically difficult to achieve, rates and global yields are likely to remain extremely low for an extended period of time, and possibly move lower.

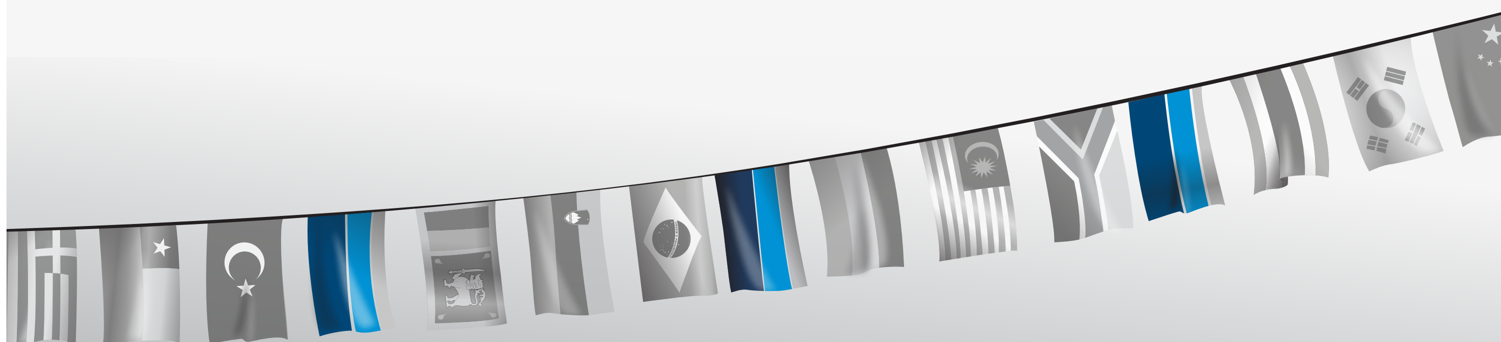
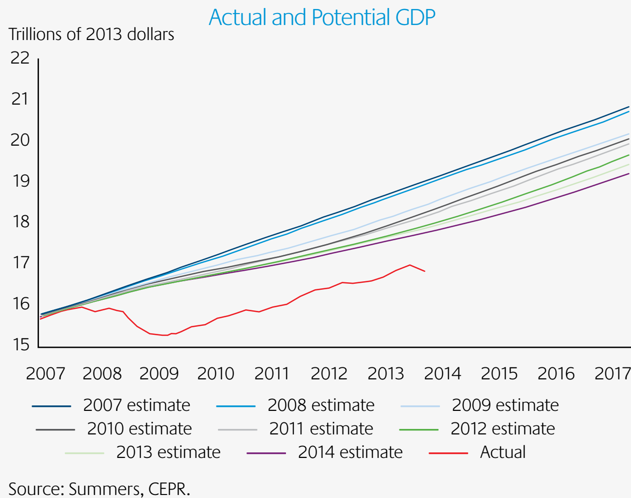


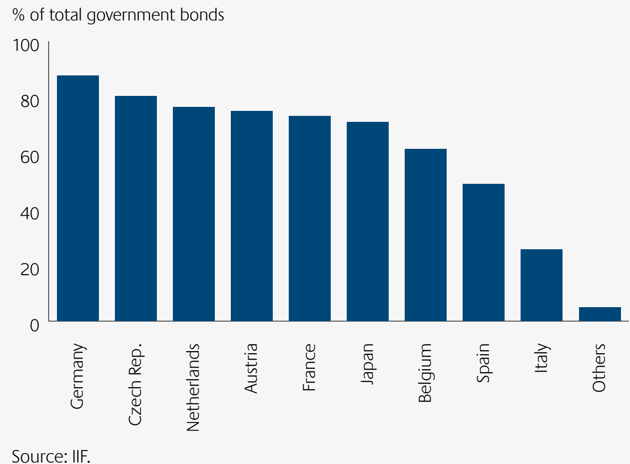
Chart 1: Long-term US economic projections have been consistently revised lower



Source: Summers, CEPR.

In the case of emerging markets (EM), the growth recovery has also been uncharacteristically slow, especially since 2012. The strong US dollar (USD) combined with tepid global growth has weighed on commodity producers who still represent a major share of the EM universe. In addition, manufacturing exporters, who should have benefited from the commodities repricing, have faced a slowdown in global trade. The structural transition in China from an investment-led to a consumption driven growth model has automatically caused weaker growth in its national economy (and global impacts). Finally, some countries (Brazil and Russia notably) suffered from one-off political shocks which led to very poor growth over that period. As a result, global investors initially retrenched from the asset class due to a weakening in credit metrics. However, it is important to note that unlike previous episodes of global tightening and commodity shocks, EM neither experienced a 'crisis' nor witnessed large scale capitulation from institutional investors. This demonstrates a level of maturity for the asset class which has now become a core part of the fixed income universe.

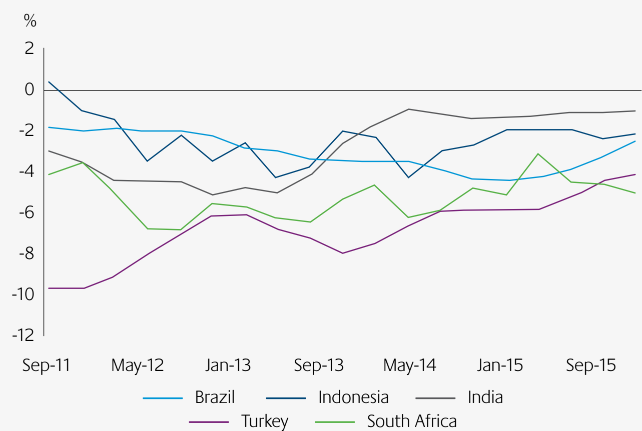
Chart 2: Negative yielding bonds now constitute a major share of the global sovereign bond universe



Source: IIF.

Since the start of the year, it appears that many of those growth headwinds have started to fade. The most striking fundamental improvement for EM has been the correction in the large trade deficits and current account imbalances (Chart 3) that were present in previous years and led to the moniker of 'Fragile-Five' in the case of Brazil, South Africa, Turkey, India and Indonesia. The current aggregate external position in EM (ex-China) is at its strongest surplus since 2009. Capital outflows from China have stabilised for more than six months following the introduction of a managed floating currency basket regime and the moderate depreciation of the renminbi has put the Chinese economy on a better footing (although many other risks related to excessive leverage remain to be addressed). Global foreign exchange (FX) reserves in EM have stabilised and real rate differentials with developed markets have widened, offering a further buffer against volatility in global liquidity. EM currencies have arguably undershot their fair value from a purchasing power perspective and continue to provide a competitiveness advantage.

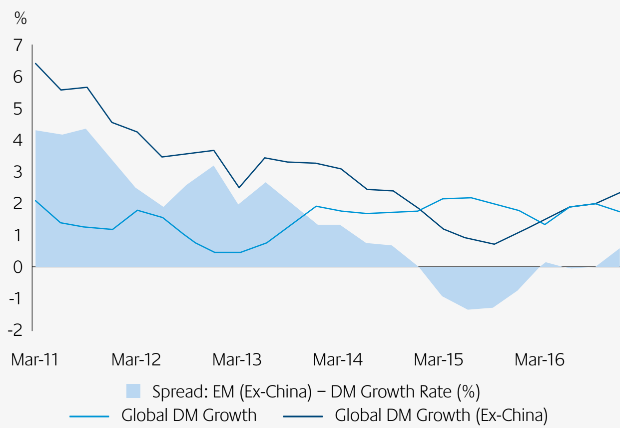
Chart 3: Current account imbalances have corrected



Source: National Statistics Office, Bloomberg.

A direct result of this mediocre global growth and inflation dynamic, combined with the extraordinary monetary stimulus, has been the increased share of negative yielding bonds, from a peculiarity when first introduced by Denmark in 2012, to a global feature with now almost 30% of the outstanding stock of government bonds trading with negative yields (Chart 2). Many income-seeking asset managers do not have the ability to hold those 'assets' and have been forced to seek higher yields. Within fixed income, EM have been a prime target of those inflows (Chart 5), particularly as the disappointment in economic data and rise in political risks seen in developed markets is coinciding with an acceleration in growth in EM (Chart 4) due to the improvement in fundamentals that we highlighted above.

Chart 4: EM growth has accelerated past DM over the past year



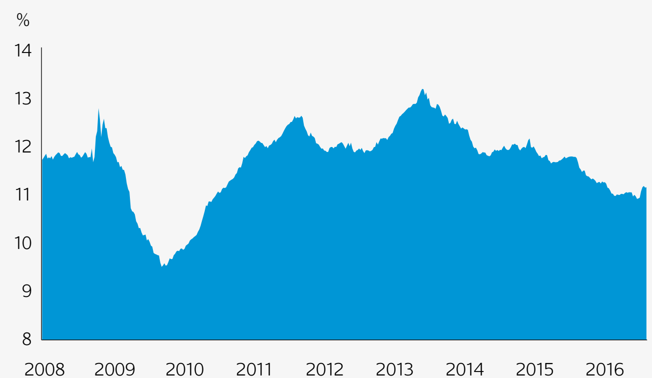
Source: National Statistics Office, Bloomberg, Economist forecasts, World Bank.

Investing in EM fixed income can be done through three main channels: hard currency sovereign bonds (mostly USD-denominated), hard currency corporate bonds and local currency sovereign bonds (denominated in local FX).

Our base case is that over the next stage of the ongoing low global growth environment, EM will continue to experience stronger growth than developed markets. This is likely to lead to a positive reassessment of the credit worthiness of those countries and contribute to a compression of risk premia. In addition, EM currencies, which offer cheap valuations at present would likely reprice favourably.

Going forward, we expect inflows to continue, due to the relative under-investment by global managers in the EM universe over the past several years (Chart 5). One note of caution is that an unusually large share of the most recent inflows has been executed through exchange-traded funds which are liquid and readily available so can be more prone to reversals due to short-term changes in sentiment. The main catalyst for such a reversal would be a further rise in populist political movements in core developed markets. This could lead to expectations of a further deceleration in global trade caused by protectionist measures against mercantilist Asian exporters (US presidential candidate Donald Trump for one supports such measures), and possibly a reduction in worker remittances to Eastern Europe and Latin America. Another potential trigger for a reversal would be that rate differentials start to favour developed markets again.

Chart 5: The share of portfolio allocations to EM has stabilised



Source: IIF, EPFR.

Chart 6: EM credit spreads have room to compress

Source: Bloomberg.

Conclusion

After several years of disappointment, growth in EM countries, particularly relative to developed market growth, is starting to pick up. Commodity prices appear to have stabilised and current accounts in some countries are improving, including in countries that are most dependent on external financing.

The need to avoid low and negative yields has encouraged global asset managers to increase their EM allocation as a share of total assets in recent months. We expect this effect to persist in a low growth environment, leading to further compression in credit spreads and the revaluation of EM currencies.

First State Investments | Colonial First State Global Asset Management

Stephen Hayes
Head of Global Property Securities

James Crawford
Global Head of Investment Specialists

Investing in a low growth environment.

The Investment Report.

Global Listed Property Securities

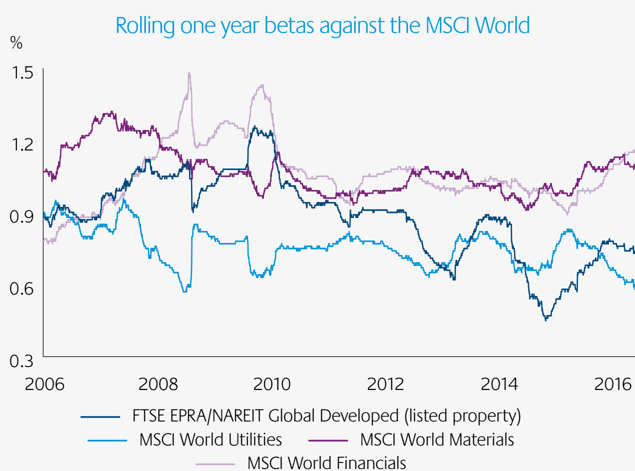
The global property market is behaving like a runaway train... Again

The global property market can be likened at present to an out of control passenger train. While other listed equity sectors are struggling in a low growth environment, property securities are being powered by ever-lower interest rates and the train is hurtling along a track with values hitting all-time highs. So if you are not on board already is it a good time to climb on? We think not. If you have missed this train then move on, it is moving too fast, in our view, to safely pick up more passengers. And we all know how this is going to end. We saw the same thing happen in the months leading up to the Global Financial Crisis (GFC). The difficulty is knowing what to do about it. As our mandates do not allow us to move fully into cash (the equivalent of jumping off), we really have to continue on with the journey, even though potential disaster approaches. However, we are adjusting the portfolio even more towards the type of stocks that will prove resilient in a downturn.

The tearaway property market – how much longer a defensive?

Historically, listed property has been considered one of the more defensive sectors within equities. The steady stream of rental income that property securities generate give them bond-like characteristics – similar to other defensive equities sectors like utilities. Chart 1 demonstrates that this defensive nature has resulted in both listed property and utilities generally having lower betas to the broader MSCI World Index than their 'cyclical' sector counterparts such as materials and financials.

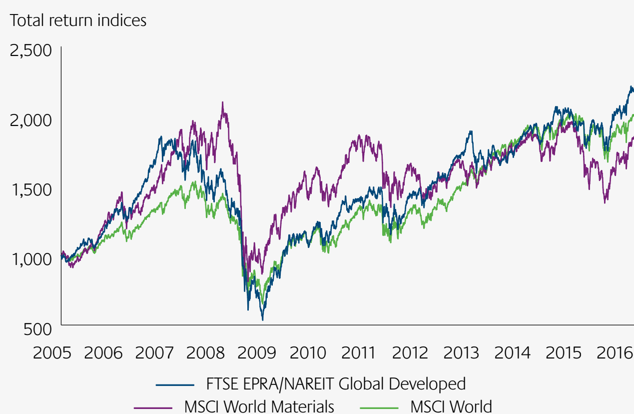
Chart 1: Listed property appears defensive today ...



Source: FTSE EPRA/NAREIT and MSCI.

So in periods of strong market performance, the cyclical sectors have tended to outperform the market and the more defensive 'boring' sectors have tended to underperform. During periods of low or even negative market returns, however, the defensive sectors have traditionally come into their own and outperformed the broader market as the cyclicals struggle. Yet, as shown in Chart 2, during the GFC in 2008, listed property securities failed to provide the defensive characteristics that some were expecting. What happened?

Chart 2: But listed property was not so defensive in 2008

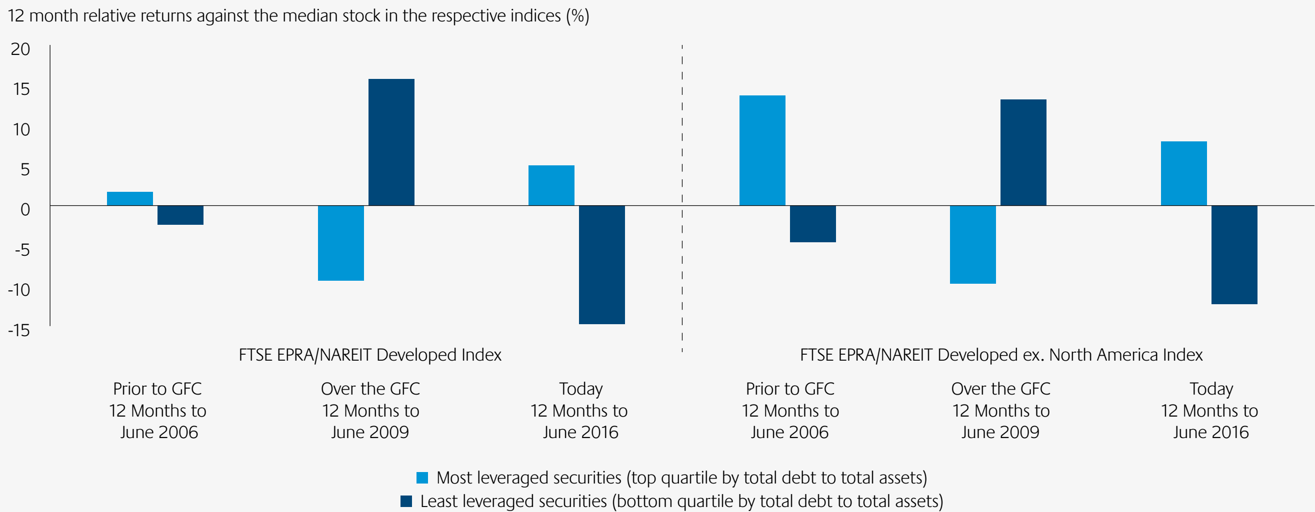


Source: FTSE EPRA/NAREIT and MSCI.

It was, after all, the bubble in developed country residential property markets that triggered the crisis in the first place. So little wonder that falling property prices were heavily correlated with plunging financial stocks and broader markets, with the FTSE EPRA/NAREIT Global Developed Property Index (in USD terms) falling almost 35% in the 12 months to 30 June 2009, plunging further than global equites over the same time-frame as the MSCI World Index fell almost 30%. However, not all property securities fell to the same extent.

As shown in Chart 3, the securities with the most highly leveraged balance sheets (the top quartile of listed property securities by total debt to total assets) underperformed the median listed property security in the FTSE EPRA/NAREIT Global Developed Property Index by around 9% in the 12 months to June 2009. This represented an absolute fall of more than 40% in USD terms. Meanwhile, their less leveraged counterparts (in the bottom quartile of total debt to total assets) actually delivered the defensive characteristics one might expect from listed property over the longer term, outperforming the median listed property security by over 16% and only suffering an absolute fall of around 15% in USD terms, slightly less than half the fall suffered in the broader MSCI World Index. So if you were seeking the defensive characteristics of listed property securities, you would have been much better off focusing your portfolio towards balance sheets with less debt.

Chart 3: Not always best to be in or out of the most leveraged securities

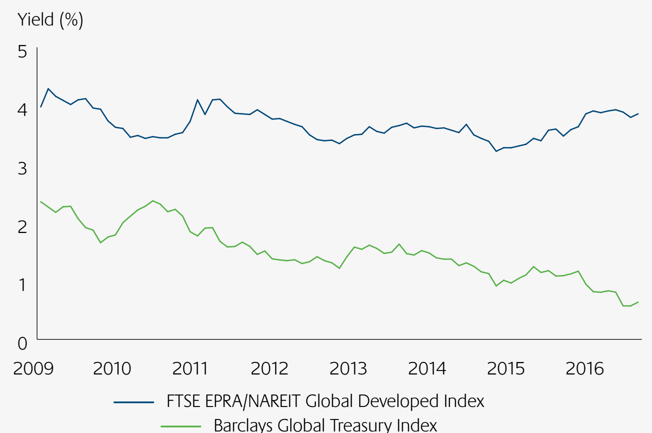


Source: FTSE EPRA/NAREIT and FactSet.

However, there is a shorter-term downside to holding the less leveraged securities. As is also shown in Chart 3, those property securities with less debt can also underperform their peers with greater balance sheet risk when the market is rising. This was the case leading up to the GFC and, if anything, the effect is even more pronounced now. On the right hand side of Chart 3, we have conducted the same analysis using the FTSE EPRA/NAREIT Developed ex-North America Index, as companies following US GAAP[1] accounting standards may overstate their total assets, compared to IFRS[2] accounting standards adopted by most other developed markets, owing to differing depreciation calculations. So even when we remove North American securities, the results are, if anything, more persuasive of the cyclical nature of the more leveraged property securities.

In the current low growth, low interest rate environment, the bond-like characteristics that have given utilities and listed property their defensive, but dull, risk/return profile have now become more attractive to investors. As central banks around the world have desperately sought to stimulate global economic growth through extraordinary and unconventional monetary policy measures, bond yields have continued to tumble, even down into negative territory. And yet the yields on listed property securities have remained high. This is influenced by a number of factors, including REITs growing their dividends.

Chart 4: Yields on listed property securites have held up as bond yields have plunged



Source: FTSE EPRA/NAREIT and Barclays.

The result is that investors have rushed into listed property and utilities as the availability of yield has dried up in the more defensive asset classes of cash and fixed income. While listed property securities have very secure cash flows (indeed some of the larger REITs have better credit ratings than a lot of sovereigns), they do not offer the return stability generally associated with cash or fixed income. However, they still tend to be one of the more defensive sectors within global equities, which also has some attraction to investors in these uncertain times of low economic growth and geopolitical uncertainty.

1 Generally accepted accounting principles.

2 International Financial Reporting Standards.

As a result, 'boom times' have returned to the more defensive equity sectors. Chart 2 shows that that the FTSE EPRA/NAREIT Global Developed Listed Property Index is continuing to set new highs while the MSCI World Index has more or less gone sideways for the last two years and the more cyclical sectors have underperformed.

But will listed property securities disappoint investors again as they did in 2008?

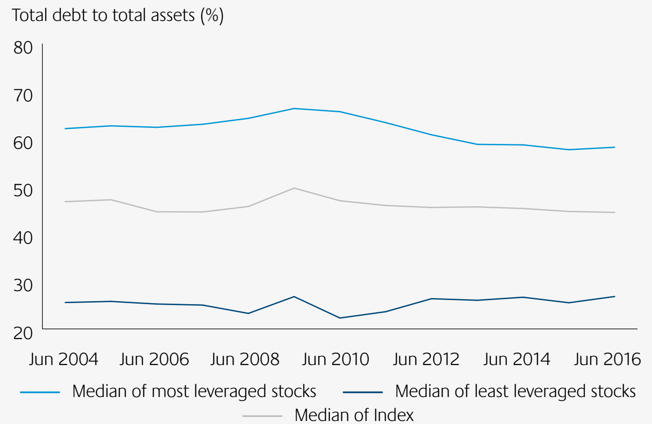
This time it is different? Surely we won't fall for that again

The extent of this price appreciation is now starting to raise concerns as we question the ability of 'bond-like' equity sectors to continue to exhibit the defensive characteristics that investors may be expecting. Have prices risen to the extent that potential capital losses might outweigh the attraction of the higher yields that these sectors offer?

We will concede that there are some differences between the property market today and the bubble conditions of 2005/06. The total debt levels of the top quartile and median listed property securities in the FTSE EPRA/NAREIT Global Developed Property Index have decreased around 11% since June 2006. And as shown in Chart 5, the level of leveraging has also fallen across the top quartile of property securities on a total debt to total assets basis. However, the median security in the top quartile of total debt to total assets remains just shy of 60%, which is not dramatically different from the levels that we saw leading up to the GFC.

More significantly, there remains a significant gap between the most leveraged companies and the least leveraged companies, where the median total debt to total assets in the bottom quartile of the FTSE EPRA/NAREIT Global Developed Property Index, at 27% is well below half the level of the top quartile median noted above. This gap is even wider if one looks at the corresponding medians in the FTSE EPRA/NAREIT Developed ex-North America Index where the median of the least leveraged securities are at almost a third of the most leveraged securities median. In short, while debt and leverage levels have fallen, the total debt to total assets remains worryingly high across those securities in the highest quartiles. Yet we are finding that there are also plenty of less leveraged (and now relatively cheap) investments to choose from if one wishes to adopt a more defensive stance. Our portfolio, for example, currently has a median total debt to total assets of 29% which is well below the median total debt to total assets of the FTSE EPRA/NAREIT Global Developed Property Index at 45%.

Chart 5: Total debt to total assets of the FTSE/EPRA NAREIT Developed Index



Source: FTSE EPRA/NAREIT and FactSet.

But is leverage really such a problem given that interest rates are so low and are only rising at a glacial pace? Surely one will have time to adjust portfolios should a crisis loom?

We are not convinced by these arguments. Few people are able to call the absolute top in markets and as the market volatility over the September quarter has shown us, many investors appear to have positioned themselves for interest rates being low forever and even the hint of a 25 basis point rise in September had security prices plunging. We think that in such conditions, investors are brave to think that they will have time to adjust before the rest of the market. As a result, we have already taken action to improve the resiliency of our property portfolio in these uncertain times.

As Chart 3 highlights, the listed property securities with the highest balance sheet leverage are again outperforming their less leveraged counterparts as passengers continue to pile onto the yield train. However, this train is now moving too fast for us. Our approach leads us towards quality securities at a reasonable price. As the market is currently favouring poorer quality stocks regardless of the all-time high values they are trading at, it is tempting to get off this train altogether. We have seen this all before in the three years leading up to the GFC in 2008. In remembering the results of that 'train wreck', it is sobering for us to think that we might be back on another runaway train. So we are focusing our security selection increasingly towards capital preservation while still delivering the level of returns that investors might think are more consistent with the defensive characteristics that are typical of listed property returns over the long-term.

This is not getting off the train – but we are steadily moving towards the caboose and insulating ourselves from the inevitable impact. This might mean that we underperform the extraordinary high returns of the index, but these returns exceed what one might typically expect of property. Furthermore, the individual highly leveraged securities driving these excess returns carry more risk than investors expect of property investments, and we are increasingly avoiding them as well.

First State Investments

Colonial First State
Global Asset Management

Peter Meany
Head of Global Infrastructure Securities

Investing in a low growth environment.

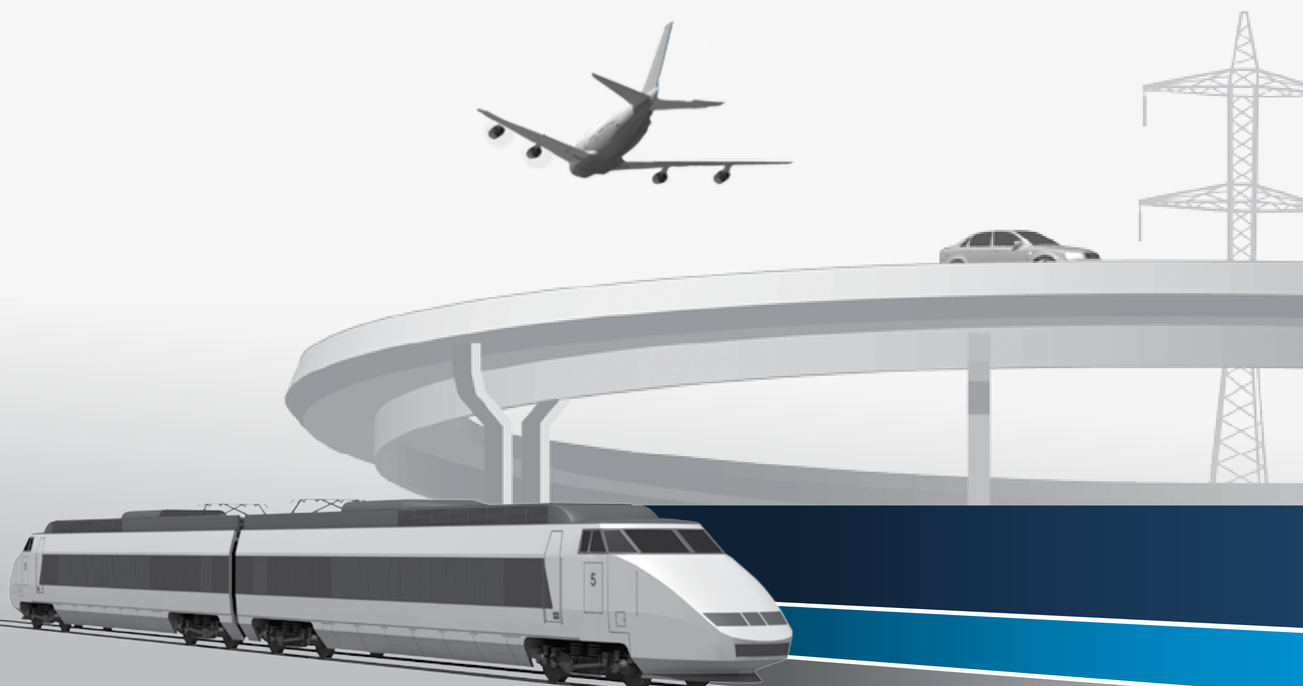
The Investment Report.

Global Listed Infrastructure Securities

Earnings growth supported by structural drivers

Global listed infrastructure consists of tangible assets that provide essential services. A combination of defensive earnings and structural drivers can support growth even during difficult economic environments.

This paper highlights how the global listed infrastructure strategy is positioned in toll roads, mobile towers, renewable energy and transmission assets, which can continue to deliver earnings growth when broader economic growth is low.

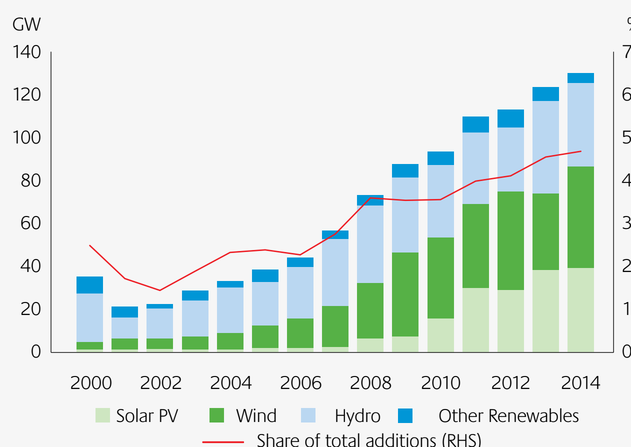


Utilities: renewables and transmission build-out

Utilities, a cornerstone of global listed infrastructure, have traditionally performed well during times of slower economic growth due to their stable cash flows and high dividend yields. As well as providing defence to a portfolio, many utilities are now deriving growth from the build-out of renewable energy; and the increasing need for transmission infrastructure.

The renewable energy space, in particular, is presenting some unique investment opportunities. Policy measures aimed at reducing carbon emissions are having a significant impact on how the electricity sector generates, transmits and distributes electricity. Wind and solar are rapidly taking market share from coal-fired and nuclear power stations. These two energy sources are estimated to expand their market share of the world's power capacity from just over 20% in 2012 to 29% in 2040. In contrast, coal-fired power stations are rapidly being closed. Coal's share of global power generation is forecast to decline from 40% in 2012 to 29% in 2040[1]. In the US, this large-scale capital investment in renewables is being led by big, publicly listed electric utilities including NextEra Energy, Xcel Energy and Iberdrola. The momentum behind growth in renewable energy is demonstrated in Chart 1.

Chart 1: Global renewables-based power capacity additions by type and share of total capacity additions



Source: IEA.

As electricity production evolves and becomes de-centralised, new transmission infrastructure will also need to be built, specifically to where wind and solar resources are strongest. Electric distribution grids will need to be upgraded, hardened and smartened to deal with two-way flow of distributed energy. Between 2016 and 2019, Californian utility PG&E proposes to invest almost US$1 billion in its 'Grid of Things'; a 21st-century power grid equipped to maximise the use of a growing array of advanced energy technologies from electric vehicles and rooftop solar to smart appliances and battery storage.

In order to support this investment, regulators are currently providing allowed rates of return to utilities of around 10%. We consider this very attractive, given these companies' low risk business models and the current low level of risk-free rates.

Toll roads: replacement investment cycle

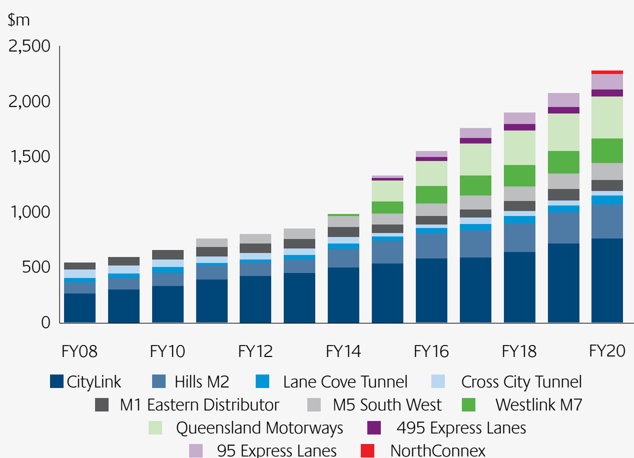
Governments have failed to invest in a wide range of infrastructure in recent decades. The growing need to improve road networks, combined with the inability of many governments to afford them, presents opportunities for the private sector.

Australia's Transurban, which operates Australian and US toll road concessions, provides a good example of this. It is the dominant operator in Australia's largest cities, giving it considerable economies of scale that can be used to its advantage when bidding for toll road concession projects that connect to its existing network. The company has a track record of successfully negotiating with governments to secure new projects, and of gaining concession life extensions in exchange for additional capex spending commitments.

Traffic volumes have become a less important driver of earnings growth in recent years as new projects and road widenings have become more significant, decoupling the company's earnings from broader economic growth rates. This strategy enables the company to pay a distribution yield of ~4.5% which is forecast to grow at over 10% pa between now and 2020. Chart 2 illustrates how Transurban's concessions and earnings have evolved and are forecast to continue to grow.

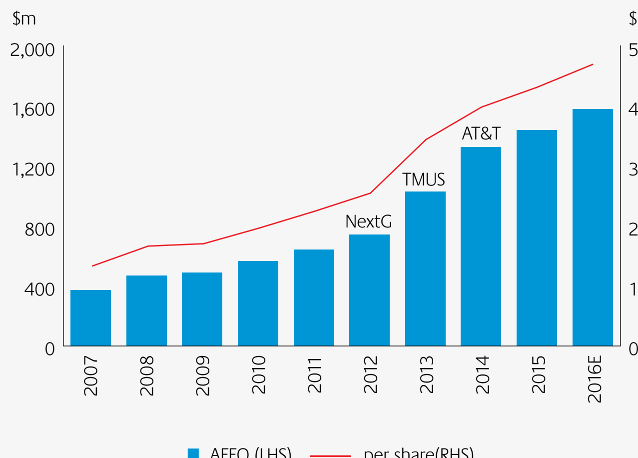
1 US Energy Information Agency: International Energy Outlook 2016.

Chart 2: Proportionate EBITDA



Source: Transurban, CFSGAM.

Chart 3: Crown Castle – adjusted funds from operations



Source: Company, CFSGAM.

Towers: ever-growing appetite for mobile data

Cash-generative mobile tower companies such as American Tower and Crown Castle continue to benefit as structural growth in demand for mobile data places telecom companies under ongoing pressure to improve network quality and capacity.

The appetite for mobile data has surged in recent years, increasing globally by 74% during 2015 alone. This growth is being underpinned by the increasing popularity of data-intensive activity such as audio and video streaming services and by consumers' growing expectations that a high-speed data connection will be available, even in the absence of Wi-Fi.

This demand enables tower companies to use fixed price escalators to automatically raise customer prices, typically by around 3% pa. Rising prices, combined with organic growth in tower sites and acquisitions, have enabled Crown Castle to deliver the steady earnings growth shown in Chart 3, through a period of turbulent world markets and muted economic growth rates.

This growth looks set to continue. Progress continues to be made in the wireless sphere; just as 3G gave way to 4G, providing a boost to mobile towers, the next wave of technology – 5G – is expected to start rolling out in the early 2020s. Emerging markets present additional opportunities. American Tower has recently invested in a portfolio of towers in India, where a majority of customers have yet to negotiate the transition from 2G to 3G technology.

Implications at portfolio level

Our largest overweight position today is the toll road sector. Revenues are robust, with consistently high operating margins of between 60% and 80%. We believe that the market does not yet fully appreciate these companies' ability to grow earnings through contracted toll increases, additional growth projects, concession extensions and organic traffic volume growth.

Mobile towers represent another overweight position. We like their high free cash flow, the long-term visibility of contracted revenues and the robust growth in mobile data demand that is underpinning earnings growth for this sector.

Our largest underweight position is in US Utilities. Some companies in this sector face challenging regulatory environments, are trading at full valuation multiples, or derive significant portions of their revenue from conventional energy generation, which now faces a vicious cycle of declining market share, reduced revenues and rising costs.

Our main holdings in this sector are made up of companies that are at the forefront of renewable build-out such as NextEra Energy and Xcel Energy; an area of the market that is experiencing a virtuous cycle of falling costs, improving productivity and growing market share. We also have exposure to companies which are participating in the build-out of much needed transmission infrastructure such as Eversource Energy and Dominion Resources.

First State Investments

Colonial First State

Global Asset Management

Jamie Grant
Head of Asian Fixed Income

Investing in a low growth environment.

The Investment Report.

Asian Fixed Income

Dealing with negative yielding markets

The current low growth environment has led to low and even negative interest rates in some bond markets, which has consequently created issues with benchmark construction. As stewards of our client's assets, we strive to invest where we think opportunities, risk and cost have beneficiary outcomes for clients. Traditional benchmarks have not evolved to address the current reality of low and negative yields, and as such, they penalise bondholders. We strongly believe that constructing dynamic and transparent new benchmarks that can adapt to changing yield levels gives us the opportunity to truly become responsible investors.

Background

Global government strategies can generally invest in government-issued securities located anywhere in the world, including the investor's own country. These strategies provide more global opportunities for diversification and return and act as a hedge against inflation and currency risks.

These strategies typically are managed against a benchmark provided by key benchmark providers. These benchmarks measure the performance of securities that are usually fixed rate, denominated in a multiple currencies issued by as many as 20 different countries. These benchmarks are constructed using criteria such as minimum maturity, minimum market size, minimum credit rating of the issuing country, criteria for accessibility and are weighted by market capitalisation. Several of these commonly used benchmarks have been in existence for multiple decades, providing important and credible guidance to investors as to performance of asset managers and providing to fund managers frameworks for portfolio construction.

However, in our opinion, the current methodology for constructing these benchmarks is failing the end users with regards to their saving objective. We trace the origins of these failings to the early 2000s in Japan.

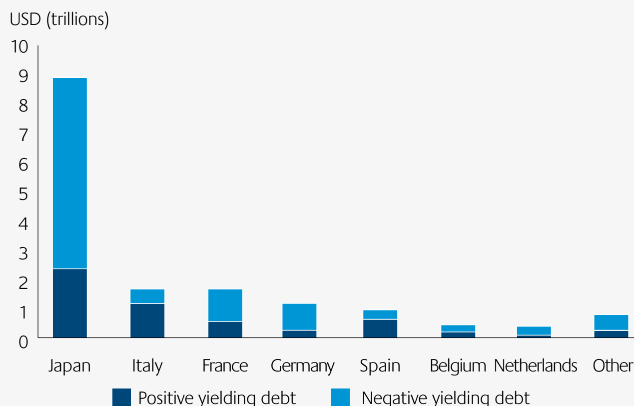
Quantitative easing

A policy termed 'quantitative easing' was first used by the Bank of Japan (BoJ) in an attempt to arrest deflationary pressures. This policy flooded commercial banks with significant liquidity, in an attempt to stimulate commercial lending. During the 2007-08 financial crisis and in the years after, central banks in the United States, the United Kingdom and the Eurozone joined the BoJ in this policy experiment as disinflation and deflation spread.

In mid-2014, one of the two policy tools used by the European Central Bank (ECB), the ECB Deposit Facility, introduced negative rates as a method to stimulate. In January of 2016, the BoJ Policy Rate moved into negative territory. Unsurprisingly, later in the year, financial market conditions globally had changed to such an extent that increased monetary policy action from central banks had driven lower bond yields globally, with significant parts of the yield curve negative throughout various European markets and the Japan bond market. Yet what does this actually mean? Investors who purchase negatively yielding government bonds, who are lending money to a government (through the purchase of these government bonds) are now effectively paying the government for that right. This is clearly a complete reversal of the principles of bond investment where bondholders are typically compensated for lending money to a government (or company) in return for interest in the form of a positive yield.

This current reversal in yields in several key markets represent a significant portion of these market capitalisation benchmarks. Often as much as 30 percent of the benchmark comes from countries where a large part of their yield curve is negative.

Chart 1: Negative sovereign yields worldwide



Source: Barclays 12 Sep 2016.

In fact, a recent research piece[1] published by Fitch estimates US$11 trillion bonds globally are negative yielding.

Yet the question remains, is anyone doing anything about this dislocation? We have asked ourselves whether using savers' money to pay for the right to lend a government money is true to our responsible investment principles. Unsurprisingly, it is not.

While there may be some unique circumstances (e.g. sharp slowdown and deflation) where a negative yielding bonds may make sense, this phenomenon is typically not in our clients' best interests over the long term. Simply, investors could store the money in a safe (or under the mattress) relatively cheaply and achieve a higher 'real' return over the term of an equivalent negative yielding bond. Additionally, the definition of speculation is buying an asset with the expectation of a return solely from someone else repurchasing the asset at a higher price, not dictated by its intrinsic value (i.e. the 'greater fool' theory). As prudent allocators of capital, not speculators, we do not feel this is a responsible investment.

So rather than remain tied to these unrealistic benchmarks that penalise savers, what can be done?

1 http://www.cnbc.com/2016/06/29/there-are-now-117-trillion-dollars-worth-of-bonds-with-negative-yields.html

Seeking alternative ways to protect saver's money, whilst delivering an alternate solution

We philosophically take issue with having to pay a fee (negative yields) to lend a government money (buying government bonds). Yet with the industry tied to the use of these (historically) credible benchmarks, what else can be done?

Never one to accept what is not true to our principles, we have been exploring various alternative solutions in dealing with the prevalence of negative yielding securities in benchmarks, whilst protecting the important attributes such as diversity, credit quality, yield and duration.

Constructing a new benchmark

An alternate approach is to construct a dynamic benchmark more relevant to investor needs. Investors invest in fixed income global rates products for (inter alia) market beta, diversification, performance and yield. Our analysis suggests that it is possible to construct benchmarks where the considerations such as market capitalisation are removed and criteria such as minimum credit rating (to maintain credit quality), market size (setting minimum market size to ensure the market is investible), market accessibility (not all markets are freely investible and may have restricted access to global investors or are unsophisticated) and exclude those markets that are consistently yielding negative.

The outcome of this analysis ultimately reallocates index weighting away from the low growth, heavily indebted regions of the worlds (and unsurprisingly yielding negative); and favours those countries with higher growth and positive demographic outlook. Unsurprisingly, this research has created a benchmark with a heavy focus on what remains the growth engines of the world, the Americas and Asia, whilst delivering a better yielding benchmark with a similar duration.

First State Investments

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Global Asset Management

Andrew Francis
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Investing in a low growth environment.

The Investment Report.

Realindex Investments

The investor's conundrum: Yield in a low growth world

The outlook for investment growth is not particularly favourable in today's market environment: interest rates and investor confidence are near all-time lows, inflation is muted and, GDP growth is anaemic. These conditions are not only prevalent in Australia, but also elsewhere around the world. Unsurprisingly, we find ourselves facing the conundrum of wanting to invest for income and long term capital growth, but not knowing where to do so and achieve a good return for a reasonable level of risk.

This conundrum is particularly troublesome for existing and upcoming retirees who are reliant on their investments to produce a viable income and support a sustainable lifestyle for a number of years. This segment of investors, more than others, need to generate income without depleting their capital base, which they ideally wish to grow as we live increasingly longer lives. Chart 1 demonstrates the declining yield offered by fixed income investments in comparison to the relatively steady yields offered by equity markets. Furthermore, it highlights the additional yield available in Australia through franking credits.

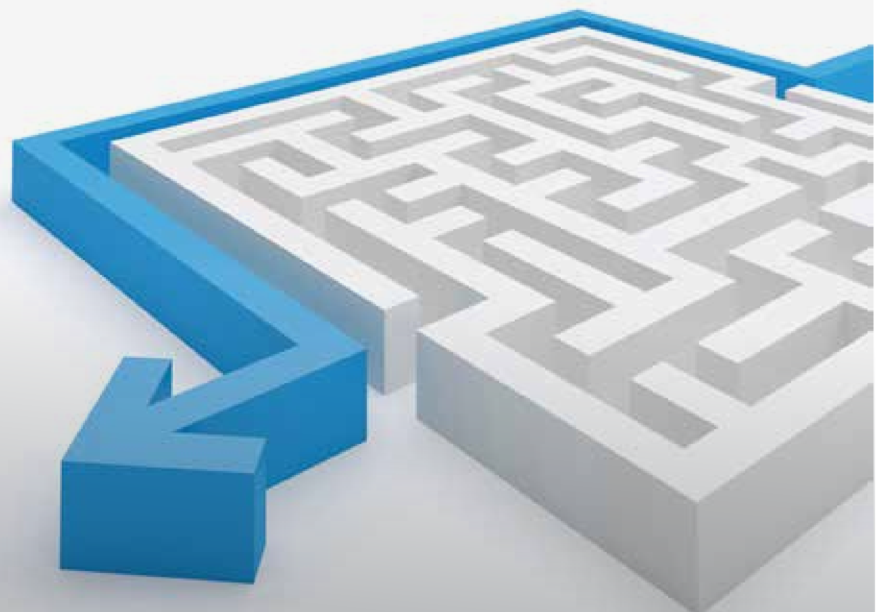
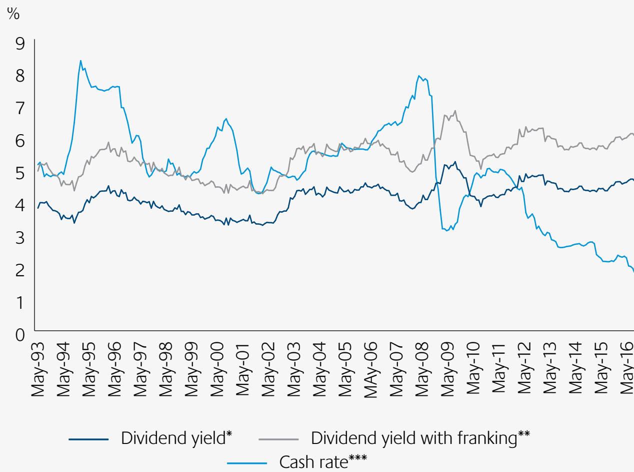


Chart 1: Comparison of cash and equity market yields in Australia



Source: S&P/ASX, RBA, Realindex.

* Trailing 12 month dividend yield for S&P/ASX200

** Approximate fully franked S&P/ASX200 dividend yield for a zero tax paying investor, based on current company tax rate and franking levels

*** Australian 3 month Bank Bill rate

Within the equity market, high yield investments remain an attractive source of income, however there are a number of pitfalls that investors should be aware of when pursuing yield. This paper aims to discuss the nature and characteristics of such pitfalls and offers insights into potential investment techniques to minimise them and assist investors in attaining a sustainable income portfolio throughout many market environments, including low growth.

High yield at the expense of capital growth

The search for yield as a source of income is not a new idea, especially for retirees. However, history has proven that while high yielding stocks might seem attractive from an income perspective, they can come at the expense of total return. Within the Australian equity market, investing in a portfolio of stocks that are selected purely based on the highest historic dividend yield has been an unprofitable strategy over the last 15 years. In particular, Chart 2 demonstrates that the highest yielding stocks have suffered negative total returns, and have significantly higher risk.

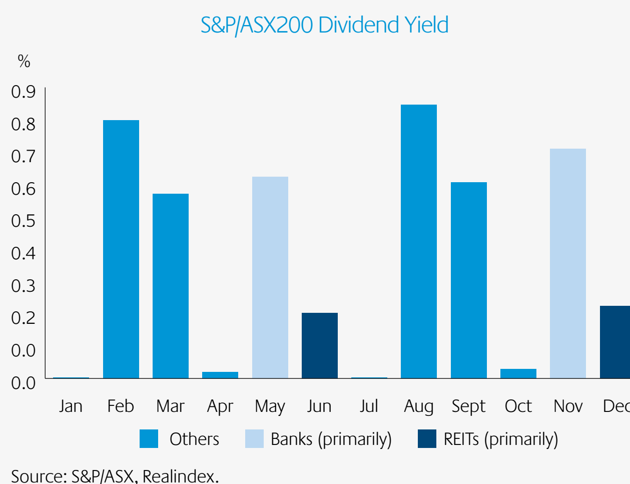
Chart 2: Performance characteristics of stocks ranked by yield

Source: S&P/ASX, FactSet, Realindex.

High yield is cyclical in nature

Investing on the basis of yield alone represents a 'single factor' exposure and there will be times when the yield factor outperforms the broader market and times when it underperforms. History has shown that these periods of underperformance can be prolonged and significant. Sophisticated investors who are incorporating this exposure into a diversified portfolio might be comfortable with this behaviour, however as a stand-alone investment, a single factor strategy will be hostage to this cyclicality. Further to this, dividend yield is highly cyclical in its nature due to concentrated reporting season calendars in the Australian market, as demonstrated in Chart 3. This market dynamic poses two key questions for investors, namely what should I invest in when it is not dividend season; and, which stocks should I choose when it is dividend season? Both decisions are key drivers of the performance profile, from a total return and benchmark relative perspective.

Chart 3: Realised dividend yield throughout the 2015 calendar year

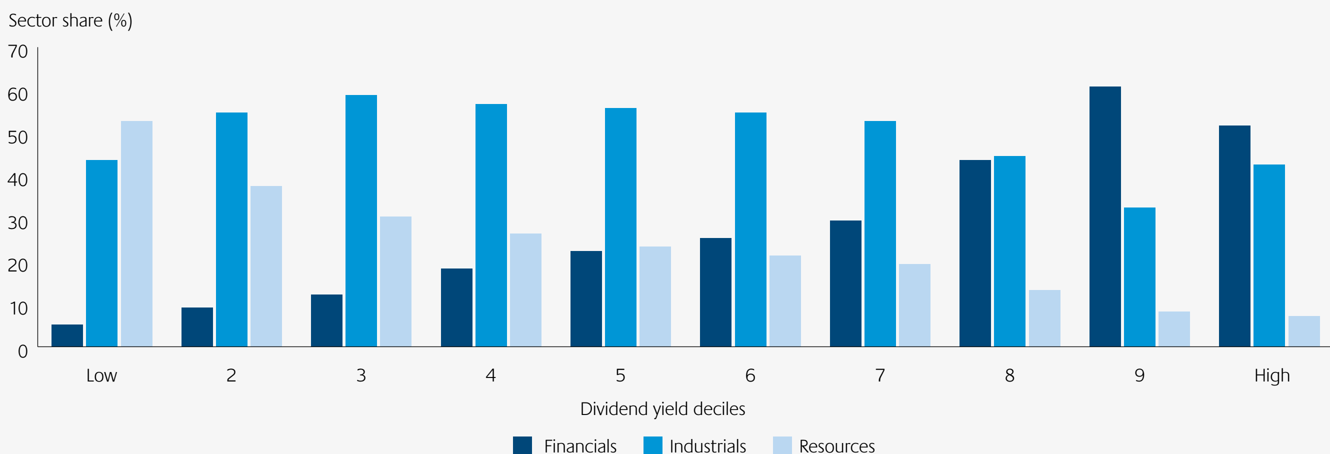


Source: S&P/ASX, Realindex.

High yield is concentrated

Related to this, is the observation that high yielding stocks are concentrated in certain sectors of the market. Chart 4 highlights that the highest yielding stocks tend to be concentrated in the Financials and Industrials sectors, whilst the lowest yielding stocks are more highly concentrated in Resources. This can lead to large sector biases and potential drawdowns due to a lack of diversification in the investment portfolio.

Chart 4: Sector concentration ranked by yield

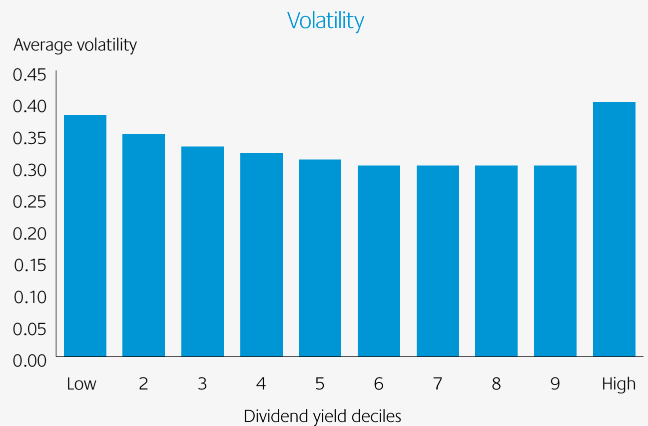


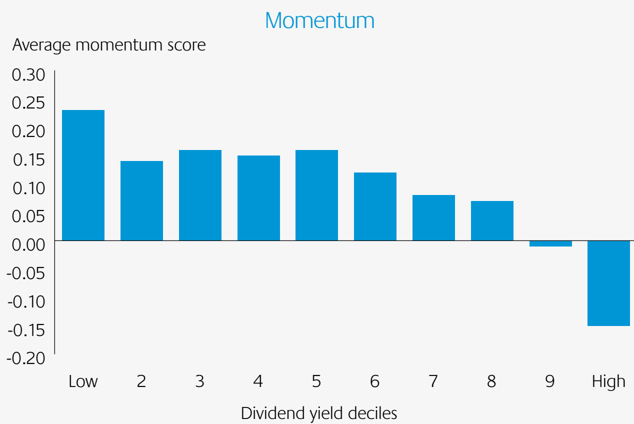
Source: UBS, Aspect.

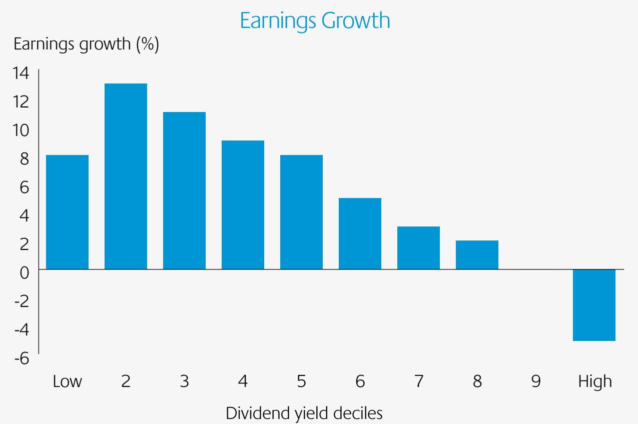
Understanding the characteristics of high yield

Higher yield at the expense of capital growth, a cyclical return profile and significant sector concentrations and drawdowns relative to the broader market seems far from ideal. Digging a little deeper to understand the potential drivers of underperformance amongst high yielding stocks, we analyse the average characteristics of stocks ranked into deciles by yield, where decile 1 is low yielding stocks and decile 10 high yielding stocks. Chart 5 demonstrates that stocks with the highest yield have the lowest average Quality, Momentum, and Earnings Growth scores, and the highest average Volatilty. This highlights that a naive approach of picking the highest yielding stocks to form a yield oriented portfolio is not sensible or sustainable, leaving investors open to the potential risk in any price-linked valuation measure. Importantly, these results do not indicate that all high yield stocks have these characteristcs, rather that these are the average characteristics. The challenge is to identify the high yielding stocks that have other attractive investment characteristics to replace the poorer quality, price-distressed high yield alternatives.

Chart 5: Factor characteristics of stocks ranked by yield





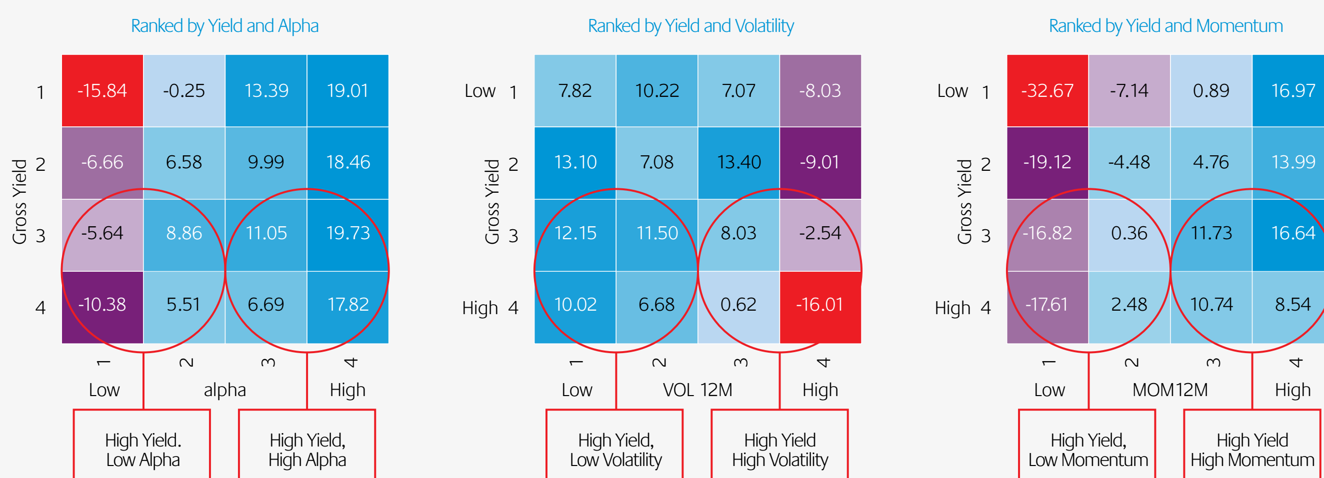


Source: S&P/ASX, FactSet, Realindex.

Protecting high yield

Given these characteristics, is it possible for investors to systematically harvest yield without sacrificing returns? By conditioning on a combination of factors referred to as 'Alpha', our research has shown that avoiding high yielding stocks with poor alpha, high volatility and low momentum, whilst favouring high yielding stocks that have strong alpha, positive momentum and low volatility delivers a better return on average. Chart 6 demonstrates that conditioning yield on these factors, on average, effectively avoids the poorer performing stocks and focuses on the better performing stocks.

Chart 6: Identifying yield traps, annualised return June 2000 to December 2015



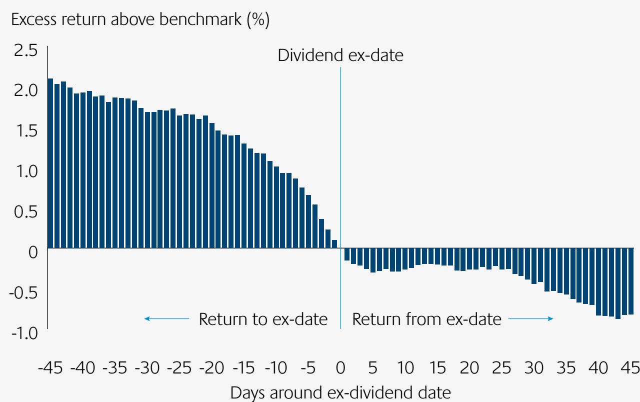
Source: S&P/ASX, FactSet, Realindex.

Boosting yield with franking credits and dividend run-up

Whilst it appears we can avoid yield traps, can we tilt to yield to increase income and return? Dividend run-up is a well-known phenomenon where stocks approaching their ex-dividend date are often observed to outperform the broader market. This behaviour has been noticed in a number of equity markets around the world, including Australia. However, as seen earlier, the Australian market offers additional yield via franking credits which can make a significant difference to the income realised by tax-aware investors due to differences in the taxation rates for companies and some investors. Investors in the retiree-space can benefit substantially by opportunistically investing in franked stocks during dividend season given their low tax rate. In Australia, the requirement to hold stocks for 45 days around their ex-dividend date in order to be eligible for franking credits creates an additional market dynamic that supports the run-up effect. Our research indicates that the run-up pattern extends beyond 45 days before the ex-dividend date for highly franked stocks, while the average run-up window for unfranked stocks is 10 to 20 days.

Amongst all dividends that were paid by stocks in the S&P/ASX 300 over a 15 year time period, the average excess performance of stocks in the 45 days to ex-date (inclusive of the net dividend) is 2% above the S&P/ASX 200 benchmark, as illustrated in Chart 7. The tendency for stocks to underperform the market (on average) after their ex-dividend date is also observed. However, as with any quantitative signal, these trends represent a statistical likelihood and not a guarantee. To achieve the average return a diversified approach is required.

Chart 7: Average excess return around all ASX300 dividend ex-dates 2000 to 2015



Source: S&P/ASX, FactSet, Realindex.

Conquering the conundrum

Investors wanting both income and long-term capital growth need to be careful what they wish for. Poorly constructed portfolios targeting historic trailing yield can be a mirage for investors. They give the illusion of a high income, but this comes at the cost of total return and this illusion is only compounded further in a low growth environment. However, this investment objective is not unobtainable if we are cognisant of the potential pitfalls embedded in high yielding stocks and open to a systematic and diversified investment approach.

By employing systematic strategies which:

1. Target a range of investment factors (not just yield alone);
2. Minimise exposure to stocks that are potential yield traps;
3. Selectively maximise exposure to stocks with attractive yield;
4. Maximise the after-tax benefits of franking and share buybacks; and
5. Control risk through disciplined portfolio construction.

We believe investors can achieve a yield that is significantly higher than the S&P/ASX 200 across the cycle, whilst outperforming the market-cap index over the medium-to-longer term. Now that is something attractive in a low growth environment.

Epco van der Lende
Head of Multi-Asset Solutions

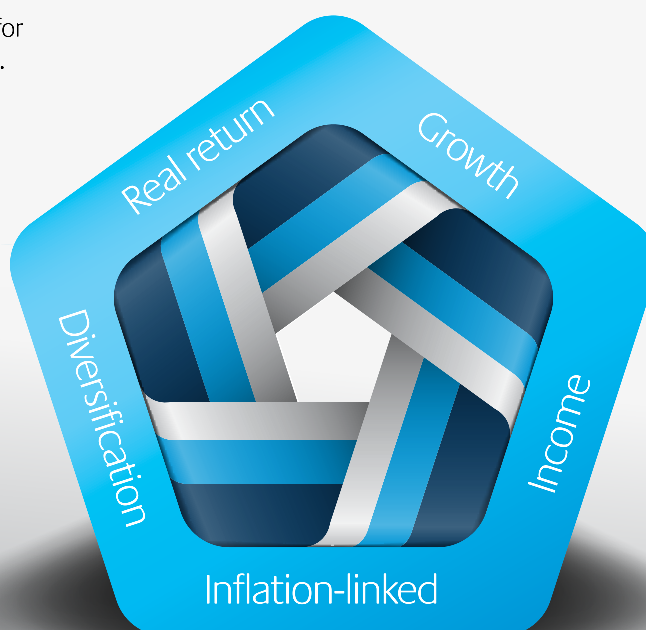
Multi-Asset Solutions

Getting real about returns

We are in an economic climate of sub-trend growth, modest inflation and low-to-negative interest rates. In this environment, traditional low-risk investments – such as government bonds and term deposits – may no longer provide sufficient income nor capital growth to adequately protect against inflation. Moving up the risk spectrum into equities, the strong demand for high-yielding, high-quality stocks has created unattractive (at best) valuations in many segments of the global equity market.

In this environment, objective-based multi-asset strategies have a distinct advantage over a 'set and forget' approach. Objective-based strategies ensure investment decisions are made with the ultimate goal of consistently delivering a particular return, while minimising the chance of failing to meet objectives. While returns can never be certain when taking investment risk, we seek to balance the trade-off between upside potential and downside risk, which we believe can generate consistent results.

As a manager of 'real' return funds, we focus on consistently delivering a particular return outcome and preserving purchasing power. Beating a benchmark index means little for investors if the markets fail to deliver returns above inflation.



Alpha beta building blocks

To achieve our investment objectives, we have two building blocks available to us to; Neutral Asset Allocation (NAA), and Dynamic Asset Allocation (DAA).

NAA sets longer-term asset allocations and provides *beta*. The process of determining NAA incorporates the return objectives, constraints, time horizon, economic climate, prevailing market conditions, valuations of financial assets, and political and market risks. This process occurs formally on a semi-annual basis, although specific events with potential longer-term implications, such as the Brexit referendum, can invoke an off-cycle review.

DAA, meanwhile, allows us to exploit short-term opportunities in markets and provides *alpha*. Our DAA process takes into account shorter-term market dynamics to help deliver additional returns and abate portfolio risks. This part of our investment process, which includes our investment signals and qualitative overlay, is formally reviewed each week and considers market events and fundamental data to take advantage of possible dislocations.

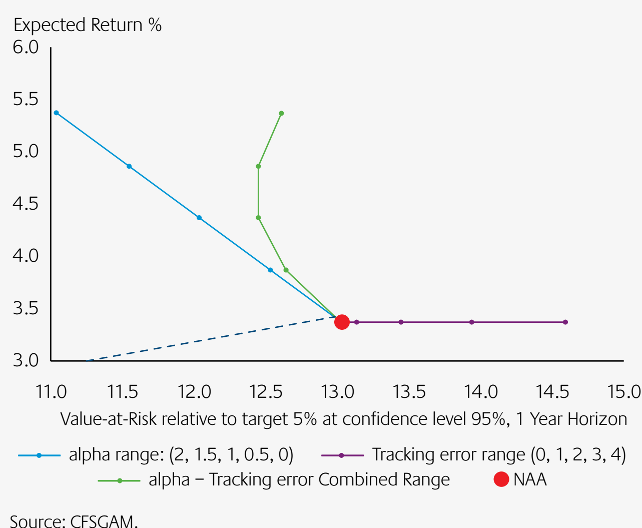
Getting the right mix

It is becoming increasingly evident that relying solely on market returns (beta) may not be sufficient to meet real return objectives. By adding an uncorrelated return source (alpha) we can improve the portfolio's likelihood of meeting its investment objective. This is where we adopt our DAA process to take into account shorter-term market dynamics to help deliver additional returns and abate portfolio risks.

The combination of NAA and DAA requires the careful consideration of existing allocations to avoid unwanted additional risk. We consider a variety of risk metrics including tracking error along with the expected return, when assessing the portfolio's ability to meet its investment objective.

The ability to add scalable alpha to portfolios via DAA provides flexibility to deliver on the investment objective, even in a lower return environment. Chart 1 illustrates the impact that both tracking error and alpha can have on the risk and return characteristics of the portfolios on the efficient frontier.

Chart 1: Combining DAA (alpha) with NAA (beta)



Source: CFSGAM.

Adding uncorrelated alpha without any tracking error – represented by the blue line – to any portfolio increases the expected return and reduces the 'Value at Risk'. Conversely, adding tracking error without any alpha – represented by the purple line – has no impact on the expected return but only increases the 'Value at Risk' for the portfolio. Of more interest is the combination of adding alpha and tracking error, which is represented by the green line.

Putting it in to practice

Earlier this year (and again after Brexit) we reviewed the NAA for our objective-based strategies. We considered our positioning against an economic backdrop of divergent central bank policy, negative interest rates, lower commodity prices and low inflation, coupled with weakness in China's growth trajectory. Against this background we have a US equity market at all-time highs and global bond valuations at historically high levels. Needless to say it was an interesting time to be reviewing our asset allocations.

The net result of this review? On a forward-looking basis, we expect lower returns across all asset classes. Consequently we increased allocations to both domestic and global equities amid marginally-lower return expectations.

We factored in a normalisation of interest rates over the long-term. However, the pace at which this occurs is expected to remain slow, and with an equilibrium rate at levels lower than historical yields.

Despite the slower pace towards higher rates, we maintained the bias to minimise duration exposures, with the following distinctions:

- No allocation to global bonds. This is perhaps not surprising given the lower level of yield on offer from developed markets bonds and the increasing asymmetric risk of rising yields, particularly over the five year investment horizon.
- While there is no allocation to global bonds as part of NAA, we can still allocate to these securities from time-to-time via DAA.

We increased allocation to high yield corporate bonds in the US and Europe. This allocation was introduced to the portfolio at the last semi-annual review and has performed well. This allocation implies that we are moving along the risk spectrum within fixed income assets. However, at this point in the cycle, we see high yield corporate bonds as a lower-risk alternative to equities, while delivering a higher return profile.

The allocation to local currency emerging market debt, was also maintained. They offer higher yields than developed market bonds and provide diversification to the overall currency exposure.

It is important to remember, however, that actual portfolios will reflect both our NAA and DAA views. In our funds, the NAA provides the fundamental framework, off which we hang our DAA tilts, both at a cross-asset level and within each asset class.

We have the flexibility to increase the DAA tracking error risk budget (alpha) to ensure we maximise the likelihood of meeting investment objectives. Adding any uncorrelated alpha to the portfolio increases the expected return and reduces risk. The flexibility to adjust the DAA risk budget can be particularly advantageous in today's low growth environment.

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 a specific event risk, such as the upcoming US Presidential election.

While these are indeed challenging times, even in a lower return environment we still have confidence that our investment process will deliver on our client's real return investment objectives, through the dynamic blending of our alpha and beta strategies.

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