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Multi Asset

Colonial First State Global Asset Management

SKYFALL – THE REAL RETURN FUND NAA REVIEW

Multi Asset Solutions

December 2018

We have recently updated economic climate assumptions for individual countries and, in turn, amended the Neutral Asset Allocation (NAA) for the Real Return Fund. It's a process that we complete twice a year. This note summarises the key drivers of investment markets over the most recent six month period and more importantly, outlines changes made to the NAA following the formal review process.

As part of our last NAA review in May of this year, we discussed the increase in market volatility. Investment markets subsequently enjoyed a period of relative calm, which persisted throughout the northern hemisphere summer. The VIX index – a commonly referenced measure of volatility in global financial markets – remained below long-term averages through this time; a period of relative serenity as investors turned their attention to the theatre of the World Cup in Russia. In the first half of the year we adopted a defensive posture in our asset allocations, as valuations portended a potential last stand, or Skyfall.

Figure 1: VIX Index

Source: Bloomberg, 1 June 2018 to 30 November 2018.

As we've seen many times before, calm conditions in financial markets rarely persist for long. So it was unsurprising when another bout of volatility buffeted markets in October – highlighted by the spike in the VIX Index in Figure 1. Markets appeared to pause for breath as investors reassessed the long-term outlook for economic growth and corporate profitability and increasingly questioned how higher interest rates will affect valuations. It remains to be seen how global markets react to the withdrawal of a decade of unprecedented liquidity following the GFC. These are unchartered waters; nobody really knows how markets will respond as the era of cheap money comes to an end.

Economic prosperity in the US

The US is in the midst of one of the most remarkable periods of economic expansion in modern times. That said, as we saw during November's Midterm elections, the US has political issues of its own, but economic conditions in America are unquestionably much stronger than on the otherside of the Atlantic.

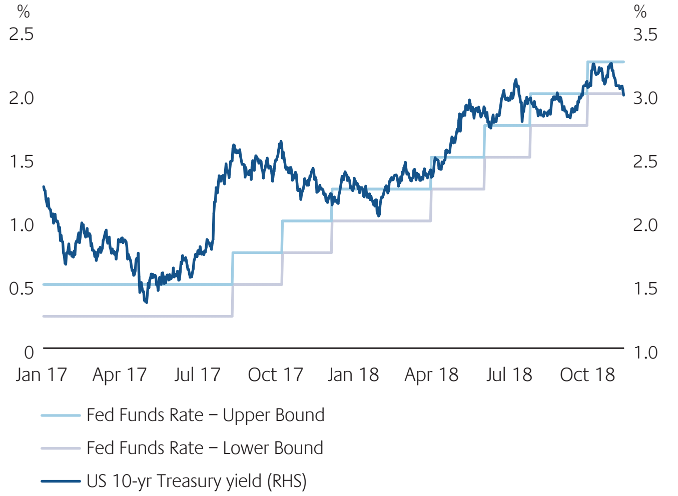
Regrettably the Brexit debacle continues to affect activity levels in the UK and has dampened business confidence, in particular. At the same time, conditions in Continental Europe have been affected by instability in Italy; specifically the perilous financial situation the country finds itself in. Friction between Italy's new populist government and EU officials threatens to undermine the political status quo, even after Britain's withdrawal in early 2019.

Growth in the world's largest economy accelerated to 4.2% yoy in the June quarter and while the pace slowed slightly in the September quarter, the 3.5% annual growth rate was nonetheless quite impressive. Government stimulus has helped promote solid, broad-based growth in the economy. Importantly, this has helped support employment; the US economy added more than two and a half million jobs in the year ending 31 October 2018, enabling the unemployment rate to fall to its lowest level in nearly 50 years. Unsurprisingly, though somewhat belatedly, these buoyant conditions are starting to feed through to wage growth.

Against this background, policy makers have been able to dance to a well-choreographed routine. For more than two years now, the Federal Reserve has been making it clear that interest rates will be increased at a measured pace towards a 'neutral rate' as policy settings are normalised following the GFC. The Federal Funds Target Rate was increased on two occasions over the past six months, both by 0.25 percentage points, lifting official interest rates in the US to between 2.00% and 2.25%. Exactly what the 'neutral rate' might be and at what level the tightening will be paused remains a subject of conjecture, particularly as Chairman Powell switched from a hawkish to dovish tone over the course of November. For now, it appears likely that the Fed Funds rate will be increased towards the 3% level – and quite possibly through it – during 2019.

The policy tightening mantra regurgitated by Federal Reserve Board members in their public statements has helped propel Treasury yields higher. As shown in Figure 2, official cash rates and bond yields have moved almost in lockstep over the past few months. Benchmark 10-year yields in the US were close to 2.80% at the end of May, but, in spite of a reduction during November, are now nearly 3.00%. As we've said before, movements like these dampen the appeal of government bonds for investors with cash or inflation-plus return targets.

Figure 2: Joined at the hip: US bond yields and interest rates



Source: Bloomberg. 1 January 2017 to 30 November 2018.

On the equity front, the sell-off in October meant returns were negative in most regions over the past six months. Corporate profitability – in the US in particular – remained buoyant, but investors increasingly questioned for how long this will remain the case. The 20%+ annual increases in US company profits we've seen in recent months will not be sustainable over time.

Trade war-related concerns were also front of mind for investors, given the frequency and tone of media headlines on the issue. Ongoing dialogue between the US and China might be able to diffuse the situation, but there has been understandable concern among investors over how the introduction of widespread bilateral import tariffs might affect listed companies worldwide.

Export-oriented emerging economies appear particularly susceptible to lower trade volumes. Unsurprisingly their share markets have underperformed more developed peers in 2018. Sentiment towards the emerging markets complex as a whole – including bonds as well as equities – has also been affected by high inflation and indebtedness in some countries. Countries with high levels of US dollar-denominated debt came under particular pressure as investors questioned how they would handle more onerous repayment obligations. This reflected in extreme currency volatility in some cases. The political background in emerging regions also remains fragile, with a groundswell of support for populist candidates proving unsupportive of investor sentiment on the whole.

Commodity prices have been volatile, too. Again, following a period of relative stability over the summer months, oil prices dropped sharply in October and November. Prices came under significant downward pressure reflecting the unexpected waiver of sanctions against purchasers of Iranian oil, record output in Saudi Arabia and rising production in the US. Gold, which has been out of favour over the last six months, finally received some support during the recent bout of equity volatility, rekindling its perception as a 'safe haven' during periods of uncertainty.

Our Neutral Asset Allocation as at end-November 2018

Looking through the various headwinds that have buffeted markets over the past month or two, we see the balance of risks and opportunities being evenly balanced. Asset price fluctuations in October and November provided a timely reminder that markets will see periods of volatility as policy settings are normalised. The Real Return Fund remains well diversified across the available asset universe and retains liquidity to deploy as attractive opportunities present themselves.

Equities

Weakness in October and November improved the expected return profile from share markets and exposure to equities has therefore been increased to 45% from 39% previously. We have added to the Fund's exposure to both Australian and global equities.

The NAA suggests 40% of the overall equity exposure should be held in domestic shares. The remainder is spread across a diversified mix of overseas share markets, including an allocation to emerging markets where valuations appear more attractive.

Credit

The Fund has had no exposure to high yield credit in 2018 after the previous holding was sold in December 2017. Since then, we've seen an increase in spreads driven again by falling energy prices, as occurred in late 2015. This repricing provides an opportunity to introduce this allocation again, however, at this late stage of the business cycle in the US and with the addition of more equity risk as part of this review, we have retained the credit exposure to Investment Grade only.

Government bonds

Developed market government bonds are continuing a gradual break out of the multi-decade bull-run, although we have started to see a much flatter yield curve over recent months, as short term yields continue to normalise at a faster pace. We continue to take opportunities within this asset class via our DAA, however, the NAA allocations continue to avoid long dated bonds. In Australia, inflation-linked bonds offer some value and we continue to hold these, with the risk of higher inflation than we have experienced in the last couple of years.

Within emerging markets we have sold the Fund's local currency bonds, but reinvested the proceeds into hard currency. While the emerging market currencies did weaken in the first half of the year, making them more attractive, the hardest hit have recovered somewhat over the past few months. Coupling this with fewer catalyst to sustain US dollar strength and the Australian dollar receiving stubborn support at current levels, the reallocation was made within emerging market bonds.

Finally, exposure to commodities has been reduced on the back of lower expected returns while the cash weighting remained steady at 5%.

A summary of the changes outlined above and confirmation of the Fund's updated NAA is provided below.

Asset class	May-18		Nov-18	Change
Cash	5.0%	–	5.0%	0.0%
Australian Government Bonds	20.0%	decrease	18.0%	-2.0%
Global Bonds (hedged)	0.0%	–	0.0%	0.0%
Credit - Investment Grade	15.0%	decrease	14.0%	-1.0%
Credit – High Yield	0.0%	–	0.0%	0.0%
Emerging Market Bonds - Local	3.0%	decrease	0.0%	-3.0%
Emerging Market Bonds - Hard	11.0%	increase	14.0%	3.0%
Australian Equities	15.0%	increase	18.0%	3.0%
World Equities	18.0%	increase	20.0%	2.0%
Emerging Markets Equities	6.0%	increase	7.0%	1.0%
Commodities	7.0%	decrease	4.0%	-3.0%
Total	**100.0%**		**100.0%**	

Source: CFSGAM, as at 30/11/18.

Expected returns from the various asset classes suggests we are unlikely to be able to generate sufficient returns to meet the Fund's performance objective from NAA alone. As such, Dynamic Asset Allocation (DAA) will continue to play a key part in the risk we take in the portfolio, and as a driver of total returns going forward.

Our DAA process complements the longer-term strategic NAA positioning, taking into account shorter-term market dynamics. DAA positioning can deliver additional returns and help mitigate portfolio risks such as tail events. By adding this return source (alpha), we increase the likelihood of achieving the Fund's annual investment objective of Australian CPI + 4.5%.

Given the low expected returns, we maintained the allocation of the Fund's risk budget currently allocated to DAA. Over the investment horizon, we would expect around two-thirds of the Fund's total returns to be generated by market returns, i.e. NAA, with the remainder generated from DAA.

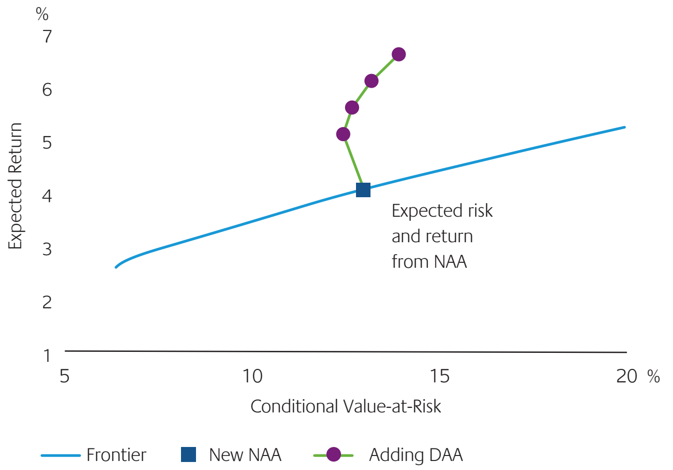
How do we determine the right mix of NAA (beta) and DAA (alpha)?

Based on our assumptions for the economic climate and our expected returns, we can determine the likelihood of meeting the portfolio's investment objective over the investment horizon. It is becoming increasingly likely that relying solely on the NAA in a constrained long-only, un-levered environment, will not be sufficient to meet the return objectives. This is where we use our DAA process to take into account shorter-term market dynamics to deliver additional returns and abate portfolio risks such as tail events. By adding an uncorrelated return source (alpha) we can improve the portfolio's likelihood of meeting the investment objective.

The combination of NAA and DAA requires the consideration of the current allocations; as the extent to which active management may be used is managed through the portfolio's risk budget to avoid unwanted additional risks. We consider both the tracking error (as well as other risk metrics) and the expected return, in assessing the portfolio's ability to meet its investment objective.

The ability to add scalable alpha to portfolios provides flexibility to deliver on the investment objective; even in a lower return environment. We incorporate this analytically and the chart below illustrates the impact that both tracking error and alpha can have on the risk and return characteristics of the portfolios on the efficient frontier.

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



Source: CFSGAM as at 31 May 2018.

Therefore, even in a lower return environment, by allowing the blending of alpha and beta strategies to be more dynamic within the framework described above, we still have the potential to deliver on our client's investment objectives.

In the current low return environment, it is critical to have the flexibility to blend beta and alpha to deliver a real return of 4.5% for the strategy over five years. Our investment process and philosophy provides our clients the highest probability of obtaining a real return, with the current outlook making our DAA paramount.

Why Colonial First State Global Asset Management?

Our investment strategy blends the qualitative views and experience of the team with the discipline and rigor of quantitative analysis resulting in a flexible approach to design and implementation of investment portfolios.

Investment decisions are taken with respect to the overall portfolio objective, unconstrained by conventional benchmarks or fixed asset allocation. Our flexibility to blend alpha and beta strategies is a key differentiator and essential to deliver on the investment objective over time.

Risk management is integral to our investment process. We continually seek to balance the trade-off between upside potential (meeting our investment objectives) and downside risk (capital loss), which we believe can generate consistent results.