First State Investments

EXPECTING THE UNEXPECTED: A GLOBAL FINANCIAL CRISIS (GFC) PART 2 – CRASH AND RECESSION

- The crisis reaches fever-pitch: major institutions face insolvency
- Extreme volatility across all markets: September to November '08
- Widespread recession to Nov 9th 2009
- GFC lesson's 2 & 3 learned: cash is king in turmoil and so is flexibility, protecting investor's downside where necessary and capitalising on opportunities where possible

The Global Financial Crisis was a rare confluence of poorly understood risks, panic, and broad institutional failures. Following the Great Depression in 1930s, many lessons were to be re-learned. For the First State Diversified Growth Fund it has given fund manager Andrew Harman and his team the opportunity to analyse such rare and broad asset price shocks and use these insights to model similar events on the portfolio to help prepare and protect it for the future.

The previous article touched on the liquidity crisis ensnaring financial institutions and markets in the year up to July '08. To the dismay of many, it was about to get much worse.

September '08 bought with it the eye of the storm as the cascading effect of the credit crunch started to bear very real victims in the press. Freddie Mac and Fannie Mae kicked-off proceedings with the US Treasury pointing out that, because they were responsible for underwriting half of all outstanding US mortgages, they were 'too big to fail'. This rationale would be repeatedly underpinning many of the bailouts that would follow.

The Lehman Brothers bankruptcy on September 15th came next and was probably one of the highest profile scalps of the GFC. It proved to be a key mistake: the notion that any size of bank would be allowed to fail sent shockwaves across the financial system and the drawbridges up. Credit conditions instantly tightened in the interest of self-preservation.

It was the pinnacle of the crisis across markets and beginning of a global recession that would last years. The S&P 500 finally reached its lowest point on March 9th 2009, and it would cost the global economy trillions.

For investors the shocks across asset classes were wide and deep, leaving almost no safe havens during this time. The notion of 'cash is king' could not have rung more true; it's a core lesson for Andrew Harman. Cash not only protects investors during these sorts of shocks, it enables the fund manager to review whether the market panic has gone too far and there's opportunities available in assets trading below 'fair-value'. What has followed has been one of the longest and strongest bull-runs in history; investors who had the cash to buy in the trough profited well for their clients.

It also points to another important feature of the Fund: it has total flexibility to move across asset classes in order to meet its twin objectives of steady capital growth and downside protection.

The team analyse the need for broad switches to the asset mix every six months in their Neutral Asset Allocation (NAA) process, aiming to find the strongest 'beta' across markets and diversify portfolio risk across assets and geographies. This mix is then potentially adjusted at the margin in their weekly Dynamic Asset Allocation (DAA) review to maximise the 'alpha' generated in the short-term.

The current NAA mix demonstrates the rationale for the broad blend across the portfolio.

Equities make up around 35%, up from the previous NAA review, as the team perceive better earnings and tailwind tax-cuts in the US and stronger earnings growth in Europe. This allocation to equities is needed, they feel, to generate the inflation plus 4% gross target, but caution remains: profits are being returned to shareholders rather than invested and there are concerns over

where Brexit will take the UK, the build-up of leverage in China, and protectionism as Trump fuels a multi-lateral trade war.

Within credit - around 10% of the Fund - the team see no value in high yield, but the portfolio does hold positions in EM credit as carry seems attractive amid stronger global trade and commodity prices. As such the team has kept its allocation to local currency EM (and 5% in commodities) and only slightly reduced the hard-currency EM bonds to reduce the risk allocation due to price volatility.

In the rates market, DM bonds seem under pressure as the inflection point from a multi-decade long bull-run appears to have passed and investors see stronger inflation in the system. To the last point, inflation-linked bonds do offer value however, with the team adding a further 8% to the portfolio. In total, government bonds make up around 40%.

As the GFC demonstrated, maximum flexibility is a smart tool; equities and credit were nightmarish for investors during this time. If we see an oncoming disaster of similar magnitude there isn't a benchmark or requirement that ties the portfolio to minimum percentages of assets. This is why we believe we are 'investing with purpose'.

For a more detailed and transparent look at the portfolio's current asset allocation, including notes and NAA and DAA rationale through its history, please visit our DGF Navigator.

Important Information

This document has been prepared for informational purposes only and is only intended to provide a summary of the subject matter covered and does not purport to be comprehensive. The views expressed are the views of the writer at the time of issue and may change over time. It does not constitute investment advice and/or a recommendation and should not be used as the basis of any investment decision. This document is not an offer document and does not constitute an offer or invitation or investment recommendation to distribute or purchase securities, shares, units or other interests or to enter into an investment agreement. No person should rely on the content and/or act on the basis of any material contained in this document.

This document is confidential and must not be copied, reproduced, circulated or transmitted, in whole or in part, and in any form or by any means without our prior written consent. The information contained within this document has been obtained from sources that we believe to be reliable and accurate at the time of issue but no representation or warranty, express or implied, is made as to the fairness, accuracy, or completeness of the information. We do not accept any liability whatsoever for any loss arising directly or indirectly from any use of this information.

References to "we" or "us" are references to First State Investments.

In the UK, issued by First State Investments (UK) Limited which is authorised and regulated by the Financial Conduct Authority (registration number 143359). Registered office Finsbury Circus House, 15 Finsbury Circus, London, EC2M 7EB number 2294743. Outside the UK within the EEA, this document is issued by First State Investments International Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registered number 122512). Registered office: 23 St. Andrew Square, Edinburgh, EH2 1BB number SCO79063.

Certain funds referred to in this document are identified as sub-funds of First State Investments ICVC, an open ended investment company registered in England and Wales ("OEIC"). Further information is contained in the Prospectus and Key Investor Information Documents of the OEIC which are available free of charge by writing to: Client Services, First State Investments (UK) Limited, Finsbury Circus House, Finsbury Circus, London, EC2M 7EB or by telephoning 0800 587 4141 between 9am and 5pm Monday to Friday or by visiting www.firststateinvestments.com. Telephone calls may be recorded. The distribution or purchase of shares in the funds, or entering into an investment agreement with First State Investments may be restricted in certain jurisdictions.

Representative and Paying Agent in Switzerland: The representative and paying agent in Switzerland is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. Place where the relevant documentation may be obtained: The prospectus, key investor information documents (KIIDs), the instrument of incorporation as well as the annual and semi-annual reports may be obtained free of charge from the representative in Switzerland.

First State Investments (UK) Limited and First State Investments International Limited are part of Colonial First State Asset Management ("CFSGAM") which is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124. CFSGAM includes a number of entities in different jurisdictions, operating in Australia as CFSGAM and as First State Investments elsewhere. The Commonwealth Bank of Australia ("Bank") and its subsidiaries do not guarantee the performance of any investment or entity referred to in this document or the repayment of capital. Any investments referred to are not deposits or other liabilities of the Bank or its subsidiaries, and are subject to investment risk including loss of income and capital invested.