Multi-asset review Q3 2016

RUSSELL INVESTMENTS' DYNAMIC APPROACH DELIVERS A SUCCESSFUL QUARTER

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Andrew Sneddon, Managing Director – Multi-Asset Solutions, discusses Russell Investments' performance in the September quarter and the outlook for the remainder of 2016.

1. What drove markets during the third quarter 2016?

The September quarter proved constructive for financial markets with both growth and defensive assets performing well. Volatility compressed significantly early in the quarter as Brexit concerns eased and growth assets rallied, but moved higher in September against a backdrop of heightened geopolitical uncertainty and rising US rate hike expectations.

There were two key themes to emerge over the quarter that helped to drive markets higher:

1. **Further central bank stimulus globally.** The Bank of England cut interest rates to a record low in August as it moved to limit the potential economic fallout caused by Britain's decision to leave the European Union, while the Bank of Japan introduced further stimulus measures of its own aimed at boosting growth. By contrast, whilst the US Federal Reserve (Fed) left interest rates on hold during the quarter, a December rate hike now seems likely.
2. **Encouraging US data and corporate earnings.** US economic data continued to point to steady growth, with jobs, consumer spending and housing figures all showing signs of improvement. This would suggest that the US economy is strong enough to withstand higher interest rates. At the same time, quarterly corporate earnings surprised on the upside with profits, for the most part, beating expectations.

As a result, global shares rose 2.1%[1] in the September quarter with US stocks hitting new record highs and emerging markets assets extending their strong run. Australian shares were also positive, rising 5.2% amid strong gains from some of the larger banks and mining names.

The Reserve Bank of Australia (RBA) cut interest rates in August following further soft inflation data. This provided a further boost to Australian shares, but paradoxically led the Australian dollar (AUD) higher.

During the quarter, the AUD appreciated from 74.5c to 76.6c, partially driven by the growing belief that the RBA may not cut interest rates again in the foreseeable future.

Interest rate sensitive sectors such as bonds, listed infrastructure and global listed property continued to deliver positive absolute returns in the September quarter, however these assets came under pressure as the quarter progressed with interest rates globally beginning to rise off historically low levels. Australian listed property underperformed significantly, driven in part by the RBA's recent shift to a more neutral monetary policy outlook.

Investors' thirst for higher-yielding assets ensured corporate bonds performed well while emerging markets bonds issued in their own currencies continued to benefit from strong investor demand.

2. How did Russell Investments' active multi-asset portfolios perform in the September quarter? What was rewarded by the market and what wasn't?

Absolute returns. The Russell Balanced Opportunities Option in the PST returned 2.7% for the quarter on a net of fees and tax basis, mainly driven by positive absolute returns from the Option's domestic and global shares portfolios. The Option also benefited from its exposures to high-yield debt and investment-grade credit, as spreads narrowed throughout the period amid ongoing demand for higher-yielding assets.

1. Global shares measured by the Russell Developed Large Cap Index (in unhedged AUDs)

Returns relative to fund benchmark. Relative to its strategic benchmark, the Russell Balanced Opportunities Option outperformed by 0.2% on a gross of fees and tax basis. A key driver of this outperformance was our exposure to high-yield debt, which continued to perform well. We became more defensive late in the quarter by building underweight positions to equities when the Fed signalled its intention to raise interest rates later this year. An overweight to Australian listed property also weighed on benchmark-relative returns, though this was offset by an underweight to global lis-ted property.

Returns relative to peers. Relative to the median manager in our peer universe, on a net of fees and tax basis, the Russell Balanced Opportunities Option underperformed the peer median by 0.3%[2]. This placed it in the lower quartile of its peer group.

Negative contributors include:

- Underweight exposures to domestic and global shares, mainly in US and emerging markets.
- An overweight exposure to Australian listed property, which sold off after the RBA shifted to a more neutral stance on interest rate policy.

These were partially offset by:

- An overweight exposure to high-yield debt.
- An underweight exposure to global listed property.

Russell Investments' multi-asset funds tend to outperform peers in volatile market environments due to our diversified and dynamic approach, which seeks to anticipate emerging risks and position our funds accordingly. However, the Russell Balanced Opportunities Option underperformed its peers this quarter due largely to its more defensive positioning throughout the period.

3. What is Russell Investments' outlook for the remainder of 2016? How is it impacting your active multi-asset positioning?

Volatility looks set to continue over the remainder of this year and into next as investors grapple with the transition of power in the US, a likely Fed rate hike in December and the longer-term impact of Brexit. As a result, we will maintain a dynamic approach to managing our exposure to growth assets, such that we maximise our upside participation in rallies whilst being mindful of protecting against the downside.

Relative to the US, we currently believe other developed markets represent better value, though we would like to see further signs of earnings growth and more confidence in the economic growth outlook. Emerging markets were thrown a curve ball by Donald Trump's recent election victory, as the possible rejection of international trade deals and the threat of higher global yields are both expected to have negative impacts. Although we believe the sector represents the best value of all the regional share markets on a longer time horizon, we are cautious about buying any dips.

We have a neutral outlook for both government and investment-grade bonds as the bond market has become oversold since Trump's win, however this is tempered by the fact that interest rates have remained depressed for quite some time. We feel bonds are still expensive and may face headwinds in the form of potential rising inflation and higher US interest rates. We also believe other expensive defensive assets such as listed property and infrastructure face similar issues due to their greater sensitivity to interest rate movements.

A combination of Trump's expected aggressive fiscal policy and the prospect of higher US interest rates may help drive up the US dollar and support our short AUD positioning.

Overall, we expect global growth to remain positive though at a slower pace, with downside risks of further market sell-offs. The next three to six months is likely to be a modest growth environment as markets adjust to higher levels of interest rates and potential changes to monetary and fiscal policy (particularly in the US), which is likely to represent new pockets of opportunities and risks compared to the prior 12-18 months. In light of this outlook, diversification and dynamism matters even more to help investors achieve their goals.

2. The peer benchmark on a net of fees basis for the Russell Balanced Opportunities PST became the Chant West Implemented Consulting – Custom Growth survey effective 1 October 2015 and includes MySuper competitors (including retail and industry super funds). The peer median returned 3.0% for the September quarter 2016

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