Multi-asset review Q4 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 December quarter and the outlook for 2017.

1. What drove markets during the fourth quarter 2016?

The December quarter was another good one for financial markets with growth assets in particular continuing to perform well. Volatility spiked early in the period amid rising bond yields, US rate hike speculation and uncertainty surrounding the outcome of the US presidential election before easing throughout much of November and December.

Two key themes emerged over the quarter which helped drive markets higher:

1. **Donald Trump wins US presidential election.**
   In early November, Donald Trump defeated Hillary Clinton in the race for the White House; an outcome that not only surprised many but also sent shockwaves through global financial markets as investors fretted over policy uncertainty and a potential global trade war. However, this negative sentiment quickly reversed as investors shifted their focus to Trump's promises of tax cuts, greater infrastructure spending and looser regulation. What followed was a strong rally across share markets and a sharp rise in bond yields that lasted through the rest of November and into December.
2. **Commodity prices rally.**
   The fourth quarter saw a strong rally in commodity prices, driven in large part by increasing Chinese demand, expectations of greater fiscal spending in the US and, in the case of oil, OPEC's historic decision to curb production.

Global shares rose 7.7%[1] in the December quarter with US stocks in particular hitting fresh record highs. Emerging markets were also positive for the period, though they did underperform their developed peers. Australian shares extended their strong run, rising 4.9% amid further gains from the 'Big Four' banks, higher commodity prices and renewed merger and acquisition activity.

The Reserve Bank of Australia (RBA) left interest rates unchanged throughout the quarter, with officials noting that the economy is continuing its transition following the mining investment boom. Given the market had anticipated the RBA's positioning on interest rates, this had limited impact on both stocks and the Australian dollar (AUD).

During the quarter, the AUD fell from 76.6c to 72.1c. This was driven largely by the US dollar (USD)'s rally in the wake of Trump's election win and the US Federal Reserve (Fed)'s decision in December to raise interest rates. However, stronger commodity prices – particularly iron ore – helped to support the AUD.

Interest rate sensitive assets such as bonds, listed infrastructure and global listed property all struggled as interest rates, which had fallen to historically low levels in mid-2016, spiked sharply higher in the final quarter. Australian listed property was also weaker, though it outperformed its global counterpart (on an AUD-hedged basis).

Improving risk appetites and the prospect of stronger growth boosting company earnings contributed to further gains for corporate bonds, while emerging markets bonds weakened amid higher US interest rates and concerns over Trump's protectionist rhetoric.

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

Absolute returns. The Russell Investments Balanced Opportunities Fund returned 3.1% for the quarter on a gross of fees and tax basis. Similar to last quarter,

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

performance was mainly driven by strong absolute returns from the Fund's domestic and global shares portfolios, as well as its exposure to global high-yield securities.

Returns relative to fund benchmark. Relative to its strategic benchmark, the Russell Investments Balanced Opportunities Fund outperformed by 0.6% on a gross of fees and tax basis. Key drivers of this outperformance were positive absolute returns for both the Russell Investments Global Opportunities Fund and the Russell Investments After-Tax Australian Shares Fund. Strong absolute performance by the Russell Investments Global High Yield Fund (AUD hedged) also added value after spreads contracted further over the period.

Returns relative to peers. Relative to the median manager in our peer universe, on a net of fees and tax basis, the Russell Investments Balanced Opportunities Fund outperformed the peer median by 0.2%[2].

Positive contributors include:

› Strong absolute returns from our shares and global high-yield portfolios.
› Underweight exposures to interest rate sensitive assets such as bonds, listed infrastructure and global listed property.
› Active currency positioning, including a short AUD position relative to the USD.
› Overweight exposure to commodities.

These were partially offset by:

› Underweight exposure to global shares.
› Negative absolute returns for the Russell Investments Emerging Markets Local Currency Fund.
› Overweight exposure to cash.

Historically, Russell Investments' multi-asset funds tend to outperform peers in volatile market environments due to our diversified and dynamic investment approach, which seeks to anticipate emerging risks and position our funds accordingly.

3. What is Russell Investments' outlook for 2017? How is it impacting your active multi-asset positioning?

We expect volatility to continue in 2017 as investors grapple with the transition of power in the US, Fed rate hikes, European elections and the longer-term impact of Brexit. As a result, the Fund currently holds higher levels of cash than in previous market rallies. In saying that, we believe 2017 will provide some real opportunities for active management compared to the prior 12-18 months.

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 Trump's 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 emerging markets represent superior value relative to developed regions on a longer time horizon, we remain 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. In saying that, this is tempered by the fact 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.

In terms of currencies, a combination of Trump's expected aggressive fiscal policy and the prospect of higher US interest rates may help drive the USD higher.

Overall, we expect global growth to remain positive this year, with downside risks of further market selloffs. The first half of the year 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, especially in the US. With this in mind, we will maintain a dynamic and diverse investment approach to help investors achieve their goals.

2. The peer benchmark on a gross of fees basis for the Russell Investments Balanced Opportunities PST is the Chant West Implemented Consulting survey. The peer median returned 2.9% for the December quarter 2016.

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