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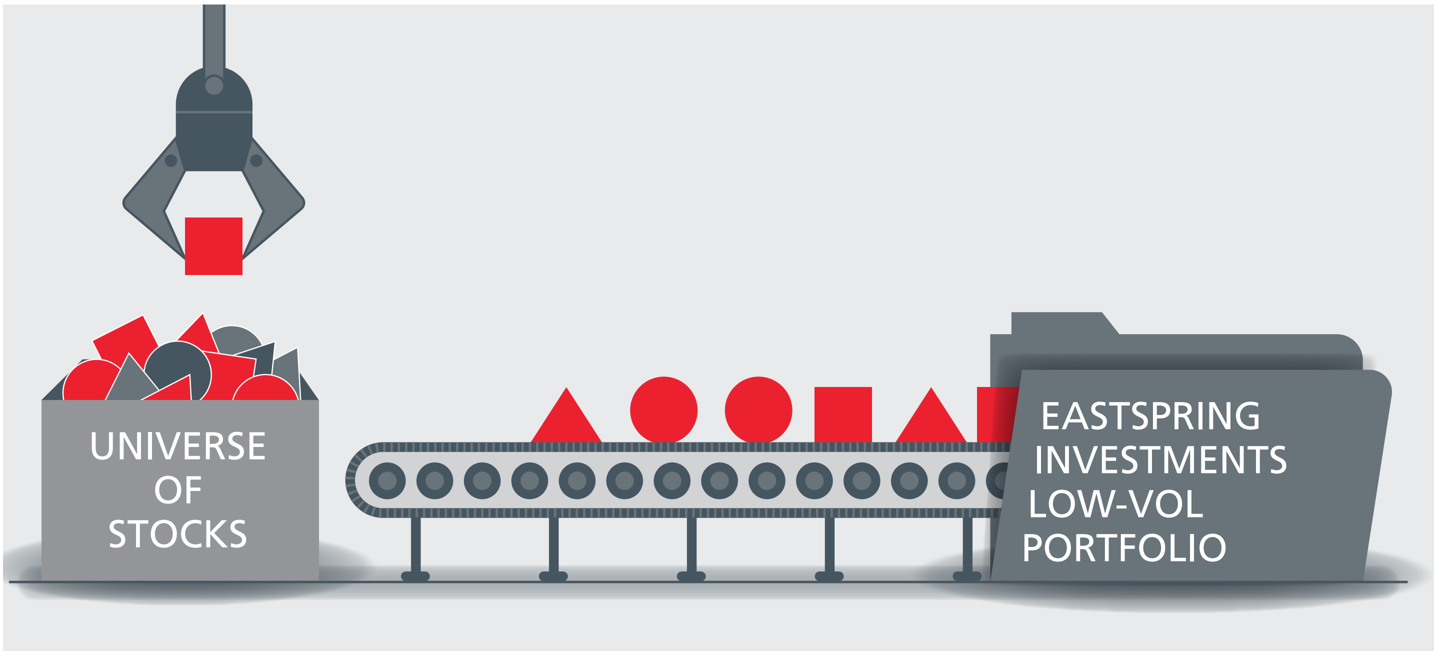
WHY ALL LOW-VOLATILITY APPROACHES ARE NOT EQUAL

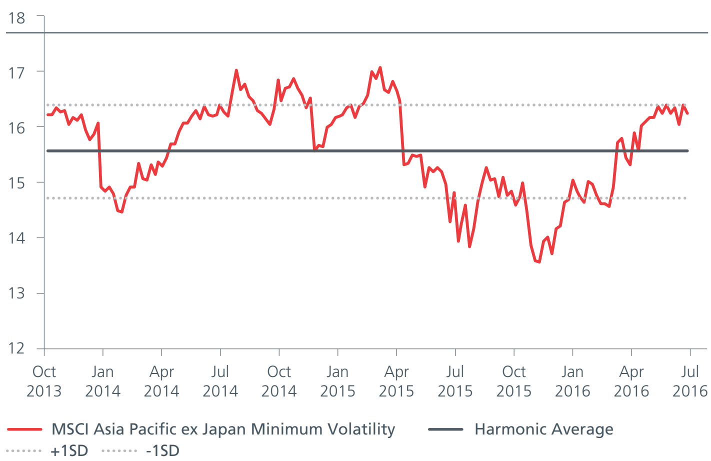


Since the Global Financial Crisis hit in 2008, Low Volatility (Low-Vol) equity investing has received increased attention by investors, prompting increasing flows into Low-Vol equity Exchange Traded Funds[1]. This has primarily been driven by the attraction of lower drawdowns[2] and the higher returns that Low-Vol indices have exhibited globally and in Asia[3]. Investors in Low-Vol equity strategies have benefitted from higher returns than the broader underlying capitalisation (cap) weighted indices with lower volatility, or risk[4].

As investors have sought to capitalise on this Low-Vol anomaly, the valuations for some Low-Vol equity indices and portfolios have edged higher. This has prompted concerns that these strategies may have become victims of their own success as they appear to be expensive. At Eastspring, we recognised this issue some years ago and incorporated value filters that eliminate expensive companies from our portfolio universe. We discuss this and our improved valuation metrics in the second part of this narrative.

The MSCI Minimum Volatility indices are typically more expensive than their broader cap weighted parent indices and this warrants further investigation. As per Fig. 1, the Minimum Volatility variant of the MSCI Asia Pacific ex Japan Index currently shows valuations to be rising rapidly, on a price-to-earnings basis.

Fig.1 MSCI Asia Pacific ex Japan Minimum Volatility Index, Price-Earnings Ratio



Source: Eastspring Investments, Bloomberg, MSCI, 30 September 2016. SD=Standard Deviation.
The Harmonic Average is the reciprocal of the arithmetic mean of the reciprocal Price/Earnings ratios.

[1] Financial Times, 'Factor Investing Wages Battle Against History', June 2016.

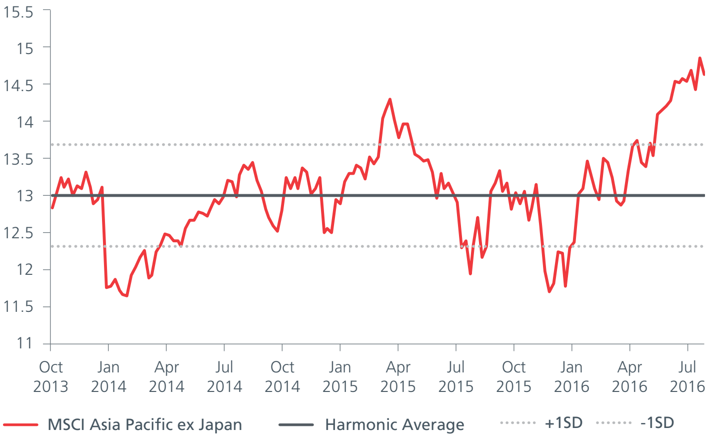
[2] The measure of how much a portfolio declines in value is termed as drawdown. During market declines, a portfolio with a lower drawdown would have fallen less whereas a portfolio with a higher drawdown would have fallen more.

[3] Financial Times, 'Case for minimum volatility investing looks robust', July 2016.

[4] The MSCI All Country World Minimum Volatility Index and MSCI Asia Pacific ex Japan Minimum Volatility Index have shown to outperform MSCI All Country World and MSCI Asia Pacific ex Japan Indices.

However, it is important to note that valuations have in fact been rising across the board for equities in the Asia Pacific ex Japan region (refer to Fig. 2).

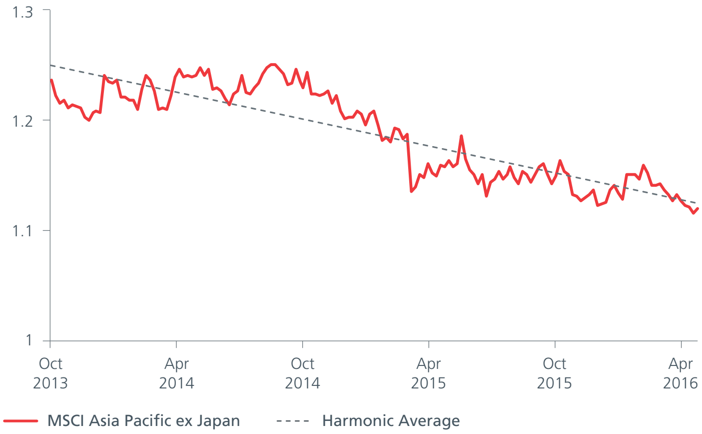
Fig.2 MSCI Asia Pacific ex Japan Index, Price-Earnings Ratio



Source: Eastspring Investments, Bloomberg, MSCI, 30 September 2016. SD=Standard Deviation. The Harmonic Average is the reciprocal of the arithmetic mean of the reciprocal Price/Earning ratios.

Interestingly, we also observe in Fig. 3 that the valuation premium which the Minimum Volatility variant commands above the MSCI Asia Pacific ex Japan Index has in fact compressed.

Fig.3 MSCI Asia Pacific ex Japan – Minimum Volatility / Parent Index (Ratio)



Source: Eastspring Investments, Bloomberg, MSCI, 30 September 2016. Parent Index refers to the MSCI Asia Pacific ex Japan Index.

While absolute valuations have drifted higher for the Minimum Volatility Index, the premium over the broader MSCI Asia Pacific ex Japan Index has actually decreased as the broad market's price-to-earnings ratio has actually risen even faster. As a consequence, the relative expensiveness of the Minimum Volatility Index has actually been declining.

EASTSPRING INVESTMENTS – ASIAN LOW VOLATILITY EQUITY FUND (THE "FUND")

We believe firmly that Asia's growth story remains intact, valuations remain attractive compared to developed market equities and bonds in particular, and there remain significant opportunities. However, we also recognise that the investment landscape is slowly shifting, making it ever more challenging for investors to remain invested amidst volatile conditions. In this regard, the Eastspring Investments – Asian Low Volatility Equity Fund can offer investors stability and resilience over the long term.

The Fund is not only designed to capitalise on the Low-Vol anomaly, but to do so in a reliable and systematic manner. The culmination of such an approach is potentially better risk-adjusted returns with a higher underlying portfolio dividend yield across market cycles, primarily through experiencing lower drawdowns during market downturns compared to the broad market.

We also acknowledge that starting valuations are critical and drive future performance. Valuation awareness is part of the portfolio construction process and this allows the portfolio to benefit from the valuation disparity currently benefiting Asian equities. We are aware that the MSCI Asia Pacific ex Japan Minimum Volatility Index is currently more expensive than the broader parent capitalisation weighted index (MSCI Asia Pacific ex Japan Index). As a consequence we reduce this valuation gap by excluding stocks with poor valuation and sentiment. Using value and sentiment filters help reduce the risk of buying into expensive stocks and those with increasing poor analyst sentiment that are more likely to underperform.

Another important stage of portfolio construction is our dividend filter. Dividend income has been a key driver of total returns, especially in Asia. We filter the portfolio by excluding stocks that are below the average dividend yield in each country across the region.

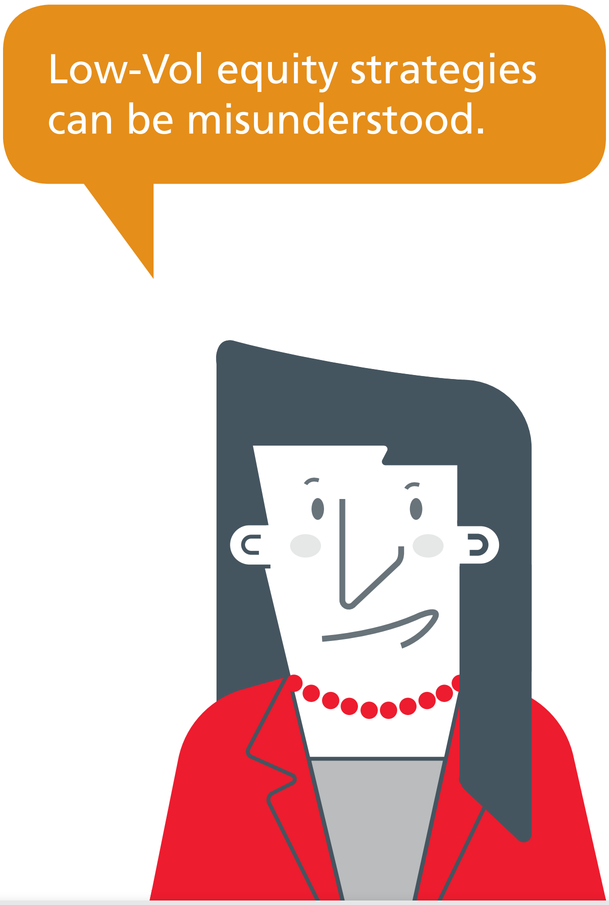
After making these adjustments the final valuation metrics for the Fund compared to the MSCI Asia Pacific ex Japan Index and the MSCI Asia Pacific ex Japan Minimum Volatility Index are shown in the chart opposite.

The Fund is cheaper than both indices on a price-to-earnings basis, cheaper than the MSCI Asia Pacific ex Japan Minimum Volatility Index on a price-to-book basis and also offers a higher underlying portfolio dividend yield.

The Minimum Volatility Index variant is constructed by MSCI and is but one of the many methods by which the Low-Vol anomaly can be exploited. Nevertheless, it maintains its merits as a reference point for the performance of the strategy for clients and asset managers.

Low-Vol equity strategies are broadly categorised into two groups: heuristic and optimisation-based. Heuristic approaches lean toward straightforward rank-based systems while optimisation-based approaches are more sophisticated and account for both volatility and correlation effects. Within each category exists even finer segregation methods, ranging in sophistication and complexity in execution. It is no wonder that Low-Vol equity strategies can be misunderstood.

Many of the above methods are documented well in academic journals and the purpose here is not to delve too deeply. However, an appreciation of a true Low-Vol equity strategy begins with the understanding that there are many ways to exploit this anomaly. Notably, not all methods are factor-based.



The Fund is innovative and we believe a unique strategy in the Asia Pacific ex Japan region. We seek to minimise volatility at the portfolio level and offer investors a low volatility solution for investing in Asia Pacific ex Japan equities, for which there is no Exchange Traded Fund with a similar strategy. The Fund benefits from a lower risk profile and a systematic approach which aims to accumulate wealth over the longer term with a higher underlying portfolio dividend yield and lower drawdowns than the broad market. As a result, it should fit well as a 'core' holding for most regional equity investors.

Source: Eastspring Investments, MSCI and Axioma, 30 September 2016. FY1= 1 Year forward estimate (Source: Factset). Any prediction, projection or forecast is not necessarily indicative of the future or likely performance.

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Distributions are not guaranteed and may fluctuate. Past distributions are not necessarily indicative of future trends, which may be lower. Distribution payouts and its frequency are determined by the Board of Directors, and can be made out of (a) income; or (b) net capital gains; or (c) capital of the Fund or a combination of any of (a) and/or (b) and/or (c). The payment of distributions should not be confused with the Fund's performance, rate of return or yield. Any payment of distributions by the Fund may result in an immediate decrease in the net asset value per share.

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