Prudential Portfolio Management Group

2018 Strategic Asset Allocation Review – PruFund Growth and PruFund Cautious

This update aims to provide an insight in to the changes made within PruFund Growth and PruFund Cautious following the 2018 strategic asset allocation (SAA) review. The appendix provides detail on the process behind the SAA review.

Key investment outcomes

The overall percentage allocated to risk assets (equities, property and alternatives) has decreased from 70.5% to 68.1% for PruFund Growth and from 39.6% to 38% for PruFund Cautious, with small adjustments made within each sub-asset class.

Whilst portfolio construction is largely driven by the businesses view on what each asset class will deliver over the long-term, the decision to reduce exposure to risk assets is an acknowledgement that some developed economies, particularly the US, are at the later stages of the business cycle and equity valuations are relatively high, so a reduction is prudent at this stage.

PruFund Growth & Cautious 2018 Strategic Asset Allocation

The table below shows the new SAA benchmarks. Actual positions will differ over the course of the year due to portfolio drift, while some of the new allocations to Chinese equities, African equities and African investment grade will take time to be fully implemented.

Asset class	PruFund Growth 2018 SAA (%)	PruFund Cautious 2018 SAA (%)
UK Equity	16.49	9.00
North American Equity	6.87	3.75
European Equity	7.33	4.00
Japanese Equity	3.43	1.88
Asian Equity	7.79	4.25
Chinese Equity	0.57	0.31
Emerging Market Equity	1.72	0.94
African Equity	1.60	0.87
UK Property	10.64	6.02
North American Property	1.37	0.77
European Property	1.52	0.86
Asian Property	1.67	0.95
Private Equity	2.95	1.32
Hedge Funds	1.70	1.32
Infrastructure	2.45	1.76
UK Investment Grade	8.51	17.77
European Investment Grade	2.52	5.26
UK & Europe High Yield	1.58	3.29
US Investment Grade	8.60	18.37
US High Yield	1.23	2.62
Asian Investment Grade	3.01	6.44
African Investment Grade	0.32	0.67
Convertibles	0.55	1.17
Bridge Loans	0.40	0.86
Private High Yield	0.68	2.05
Cash	2.00	2.00
TAA Mandate	2.50	1.50

Source – PPMG – 1 August 2018

This is just for UK advisers – it's not for use with clients.

To summarise, the main high-level changes are:

Equities

- Small reduction in the allocation to UK, US and European equities
- African equities separated out from the Emerging Market portfolio and the allocation increased by 40 basis points. This is very much a long-term investment to take advantage of favourable demographics, current per capita output debt levels and future capital investment
- A new sleeve for Chinese equities added to gain access to the world's second largest economy which now allows greater foreign ownership of domestic companies

Property

- Reduced the exposure to UK property to further diversify into overseas property
- Within overseas property, increased allocation to Europe which offers a favourable medium-term outlook

Alternatives

- Exposure has been reduced slightly although the team expect exposure to increase over the next three years. Within the overall portfolio there is a slight preference to infrastructure, which continues to offer attractive opportunities globally

Fixed Income

- Overall increase in exposure primarily across US and Asian investment grade. The team believes that US fixed income benefits from being furthest along the path of policy normalisation and Asia remains positioned to benefit from the broadening and deepening of the market, along with continued structural reforms and a strong domestic investor base

Tactical Asset Allocation

- The Macro Investment Business (MIB) within M&G Investments is now responsible for tactical asset allocation (TAA) decisions
- The team is very experienced, and their investment process has been in place for many years. They believe a market sell-off driven by investor fear can be a buy signal if underlying fundamentals are still strong. The team describe these scenarios as 'episodes' which can be short-lived or last for several years
- Alongside this 'behavioural' approach MIB also have a long-standing valuation framework which helps the team assess and understand the long-term value of an asset class before any investment is made
- The team generally take more macro long or short positions in regional market indices and bonds. However, if a specific sector looks particularly over or undervalued they may take a position

Strategic Currency Overlays

- The fixed income portion of the portfolio remains fully hedged
- The risk asset exposure is unhedged

Summary

Whilst investors in PruFunds receive returns through Expected Growth Rates and Unit Price Adjustments, underpinning this is a large, globally diversified and actively managed multi asset portfolio. Many investment decisions will be made based on what Prudential believe different types of assets will deliver over the long-term but can also be influenced when shorter-term opportunities are presented, as evidenced by the new TAA mandate.

We are regularly asked about Brexit and the impact on portfolio positioning, so thought the following comments may be helpful:

- the process of diversifying away from UK assets started some time ago although of course they are still a reasonable proportion of portfolios
- portfolios hold most FTSE 100 companies many of which are global businesses with multiple sources of revenue and in other currencies
- portfolios are positioned for the long-term and the headlines and uncertainty around Brexit have not influenced long-term investment decisions
- PruFund portfolios are truly globally diversified and hold many assets that will likely be unaffected by any Brexit scenario
- the risks are not one-sided – with some concern priced into Sterling there is clearly a risk (to a fund of largely Sterling based investors) of not having enough Sterling exposure if a deal is done and it subsequently rallies strongly
- No one yet knows the eventual outcome so all multi asset teams face the same uncertainty

As always, patience, a long-term view, global diversification, holding private assets and the ability to source investment opportunities not readily available to many other investors will allow portfolios to benefit from global growth, whilst potentially providing a buffer against market downturns.

Appendix

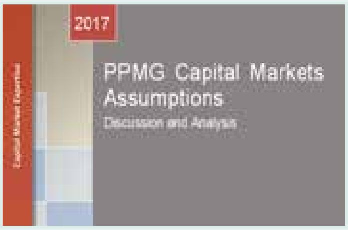
While long-term investment decisions are based on PPMGs views on markets implemented through SAA, they are also influenced by the overall solvency of Prudential's long-term business.

The Strategic Asset Allocation Review

An annual review of the SAA within multi-asset portfolios is carried out formally by the PPMG Long Term Investment Strategy (LTIS) team and approved by Prudential's Executive Investment Committee.

The analysis and modelling required is complex as the team must factor capital constraints and hedging requirements as well as metrics like volatility, economic growth and asset class correlation, whilst also estimating the medium-term valuations as well as long-term equilibrium returns and risks that are the foundation of PPMGs portfolio construction.

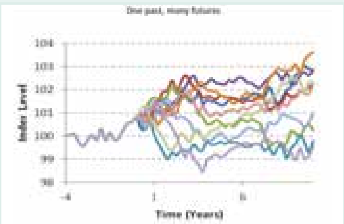
The diagram below provides a high level overview of the SAA process:



1. Capital Market Expertise

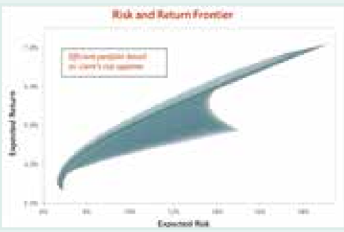
Takes into account a number of inputs:

- Medium and long-term capital market assumptions
- Market insight from PPMG Research and other internal/external research
- Manager insight and opportunities from across Prudential Group



2. Portfolio Modelling

- The capital market input feeds through into a full term structure of returns across different capital markets and scenarios
- Proprietary stochastic financial model
- Quality position papers on new asset classes



3. Client Risk Appetite

- The risk-return analysis takes into account the client risk appetite to come up with an optimal client outcome
- Portfolio optimisation along the risk-return space, in order to maximise returns for a given risk appetite

4. Strategic Asset Allocation

- Leads to a return optimised portfolio, diversified across asset classes and geographies

continued overleaf

The medium and long-term capital market assumptions are based on structural factors like demographics, economic growth, monetary and fiscal policy, debt levels and political risks. These are then combined with the short-term outlook based on valuations to give the full picture of asset class returns. These returns and risk assumptions are input into PPMG's proprietary economic scenario generator, GeneSiS, to give the full range of possible outcomes for individual asset classes as well as overall portfolios. This complete range of assumptions and possible outcomes are tested for thousands of portfolios to give an optimal portfolio in terms of risk and return.

PPMG views evolve to reflect the changing economic landscape, so for instance a proprietary Demographics and Economic Growth model has been built to help inform views on long-term risk and return assumptions.

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