THE CASE FOR MULTI-STRATEGY SOLUTIONS AS MONETARY STIMULUS IS WITHDRAWN

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AVIVA INVESTORS

Contents

MULTI-STRATEGY INVESTING IN A RISING INTEREST RATE ENVIRONMENT

Multi-strategy investing is about widening the sources of return by following an approach that is unconstrained from benchmarks, and is not wholly dependent on ideas that are linked to the economic cycle. While the diversification and risk-reducing benefits of a multi-strategy approach can be valuable in all market environments, this could be especially true now as the unprecedented monetary experiment of the past decade draws to a close.

Led by the US Federal Reserve (Fed), major central banks have in recent months begun to ease back on monetary support, as robust economic growth finally leads to a build-up of inflationary pressures (Appendix 1). The process of draining liquidity from the global financial system is likely to generate significant uncertainty for financial markets given the extent to which they have been manipulated by the actions of central banks ever since the financial crisis. Such a profound change of monetary regime is likely to lead to a marked increase in turbulence.

While it is hard to gauge precisely how financial markets will respond, the outlook is for a further rise in bond yields. Despite the sell-off seen in recent months, yields remain extremely low from a historical perspective since they continue to be artificially suppressed by the actions of the world's leading central banks. That means bonds no longer offer the downside protection to which investors have become accustomed. Indeed, with yields likely to rise further as the economic backdrop continues to strengthen, capital losses appear likely.

While the long-term outlook for equities and other growth assets is more positive, supported by continued robust global growth, equities are far from cheap. Moreover, they remain vulnerable to the risk of significant drawdowns in the event bond yields spike suddenly, as seen earlier this year. Furthermore, it is important to recognise there are sizeable risks to the economic outlook, the biggest of which is the threat of an escalating trade war on a global scale.

With bonds and equities facing such an uncertain backdrop, traditional multi-asset portfolios that rely on a combination of 'long' bond and 'long' equity positions could struggle as the tailwinds of recent years reverse course. In this context, a multi-strategy approach can effectively help investors limit downside market risk while aiming for long term capital growth. This paper will look at recent performance challenges, current investment opportunities and outline why multi-strategy investing can offer investors genuine diversification.

DRAWING ON DIVERSE SOURCES OF RETURN

In an environment where bond yields are rising, having the ability to deploy tools that exploit either falling or volatile markets to generate positive returns is potentially invaluable.

By investing in a highly diversified portfolio of 25-35 liquid strategies, each with different risk and return characteristics, the Aviva Investors Multi-Strategy (AIMS) Target Return fund aims to deliver steady long-term capital growth for investors, with limited volatility. While Market Returns strategies are market directional and expected to perform well when our House View materialises, Opportunistic Returns strategies aim to generate returns that are less dependent on the direction of the broader market. Finally, Risk-reducing Returns strategies play an important role in stabilising performance given their ability to offer downside protection. These strategies complement each other over time so the portfolio delivers a more consistent outcome for clients with less volatility than that exhibited by the broader market. In other words, the portfolio will be less reliant on market directionality to generate positive returns than a traditional multi-asset or balanced fund.

The fund attempts to profit from a wide range of investment opportunities and is not solely reliant on the traditional sources multi-asset investors rely upon: equity, credit and duration. The other main return sources include changes in levels of volatility, the shape of yield curves, implied inflation rates, and foreign exchange. For instance, as of 30 June 2018, equity, currency and duration strategies had each contributed close to a third of total returns since the fund's inception, with inflation strategies 13 per cent and credit strategies 12 per cent (Appendix 2).

As the fund does not have a structural bias to equity beta, credit spreads or duration, we expect a reasonable amount of protection against losses in an environment of weaker equity or credit market returns, or rising bond yields.

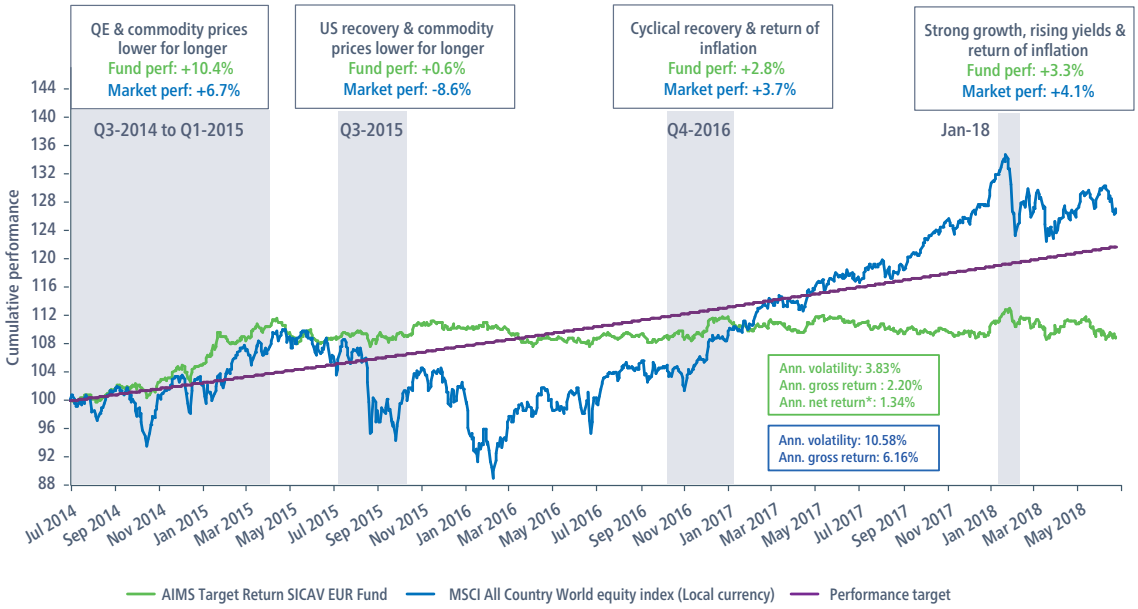
PERFORMANCE REVIEW – AIMS TARGET RETURN

While realised volatility has remained well within target level since the fund's inception on 1 July 2014, returns have fallen short of target. This can be explained by a fall in the hit ratio (the ratio of profitable to unprofitable strategies) over the past two years along with the overuse of options to implement certain trade ideas in 2017.

- A combination of factors explains the fall in the hit ratio. Aside from the fall in asset price volatility witnessed in 2017, several currency strategies detracted from performance, some driven by rising geopolitical risk like in the case of Mexico. Moreover, we had a number of strategies designed to profit from bond and inflation markets 'normalising' which proved unprofitable. Despite the synchronised upturn in global growth that was supportive of risk assets in 2017, inflation expectations struggled to rise and bond markets, consequently, remained distorted. In 2018, however, this key theme is materialising as inflation and bond yields begin to rise.
- As markets delivered strong returns in 2017, Market Returns strategies delivered positive returns as would be expected. However, core equity strategies where we had strong conviction were implemented via options rather than with physical positions or futures contracts. Given the fall in volatility observed, these positions did not capture the full market upside, and thus failed to compensate enough for other strategies in the portfolio that underperformed. Consequently, we hired a very strong candidate to lead the AIMS implementation team who has since enhanced the process to systematically monitor the benefits of different methods of implementing strategies in various market environments.
- While the hit ratio has been disappointing, its impact has been offset by 'positive skew'. In other words, since inception on average our `winning' strategies, have contributed more (+0.55 per cent) than our `losing' strategies, have detracted (-0.31 per cent) (Appendix 2).

Outperformance and underperformance of our target is inevitable at different points of the cycle. However, over the long term we expect to meet our performance target and deliver consistent outcomes for clients. We are confident that when our 'House View' themes play out, the fund has the potential to deliver strong returns as shown by the chart below. In other words, despite continuing to focus on preserving capital and minimising downside risk, we should be able to ensure investors' long-term return targets are not compromised.

Periods of strong performance in AIMS Target Return when House View themes materialise



Source:Lipper, a Thomson Reuters company, Aviva Investors as at 30 June 2018. Performance target of the AIMS TR strategy is ECB rate +5% p.a. over any rolling 3 year periods, before fees. Performance basis: Mid to mid, gross of fees, in EUR, unless indicated otherwise. *Share class I net performance, in EUR. Since Inception date 1 July 2014. The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested.

Similarly, we have confidence in the fund's ability to preserve capital or limit downside losses in more challenging market environments. Since inception of the AIMS Target Return Fund, Risk-reducing strategies have played an essential role in stabilising the portfolio during times of market stress as can be seen in the table below and in Appendix 3.

AIMS Target Return Fund's performance during the periods of greatest monthly drawdowns in equity markets

	Global equities	AIMS Target Return	MR	OPP	RR	Cash
29/05/15 - 30/09/15	-11.42%	-0.39%	-1.21%	-0.40%	1.24%	0.00%
30/11/15 - 29/02/16	-8.98%	-0.83%	-1.53%	-0.77%	1.57%	-0.11%

Source: Lipper, Aviva Investors as at 30 June 2018. Performance basis: Mid to mid, gross of fees, in EUR, unless indicated otherwise. Inception date 1 July 2014. MSCI All Country World equity index (LC). Cash includes currency hedges. The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested. Fees will reduce the actual return received by investors.

This pattern has been visible in the fund on a number of occasions since inception such as following the UK's EU referendum and Donald Trump's election. An exception was observed in the first quarter of 2018, when Risk-reducing strategies detracted from performance, although this impact was mitigated by several Opportunistic strategies that profited from rising bond yields.

HOW DO WE EXPECT TO DELIVER OUR RETURN TARGET GOING FORWARD?

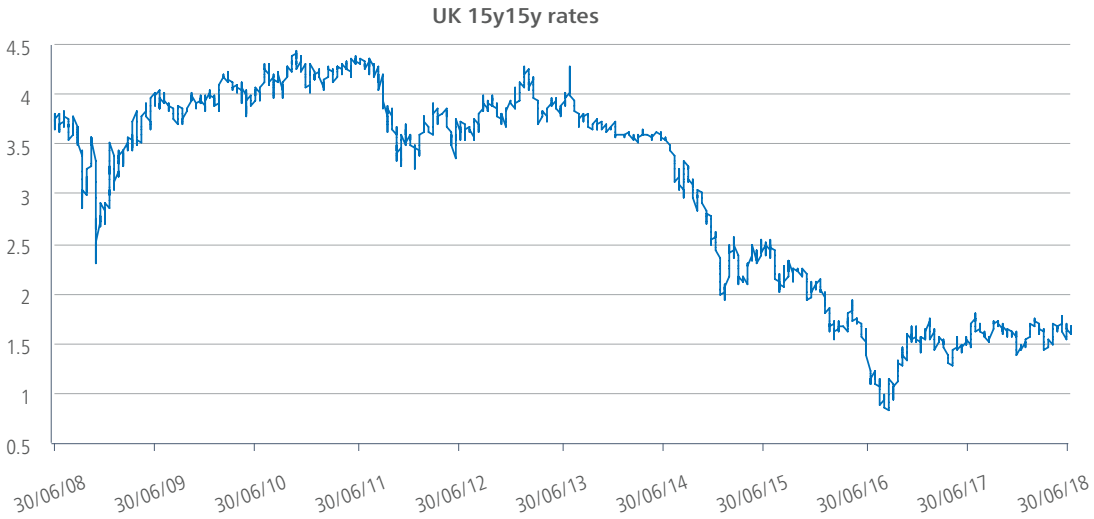
CENTRAL SCENARIO OF OUR HOUSE VIEW

We expect global economic output to expand by close to four per cent in 2018, with growth in the US, euro zone and Japan all expected to be above trend rates this year and next. With the US economy in its best shape since 2008, we expect the Federal Reserve will continue raising rates by 25 basis points each quarter through to the end of 2019 (Appendix 1). Since the economic cycle is more advanced in the US than elsewhere, we expect increased policy divergence between the Federal Reserve and other major central banks in the near term. However, over our two- to three-year horizon monetary policy is expected to tighten in other developed countries too as output gaps continue to close.

MARKET RETURNS - Given our central scenario we remain positive on risk assets. Market Returns strategies in the portfolio currently include long global equities, such as European mid-caps and emerging markets as well as themes such as global financials and commodity-related shares which remain undervalued and display improving fundamentals.

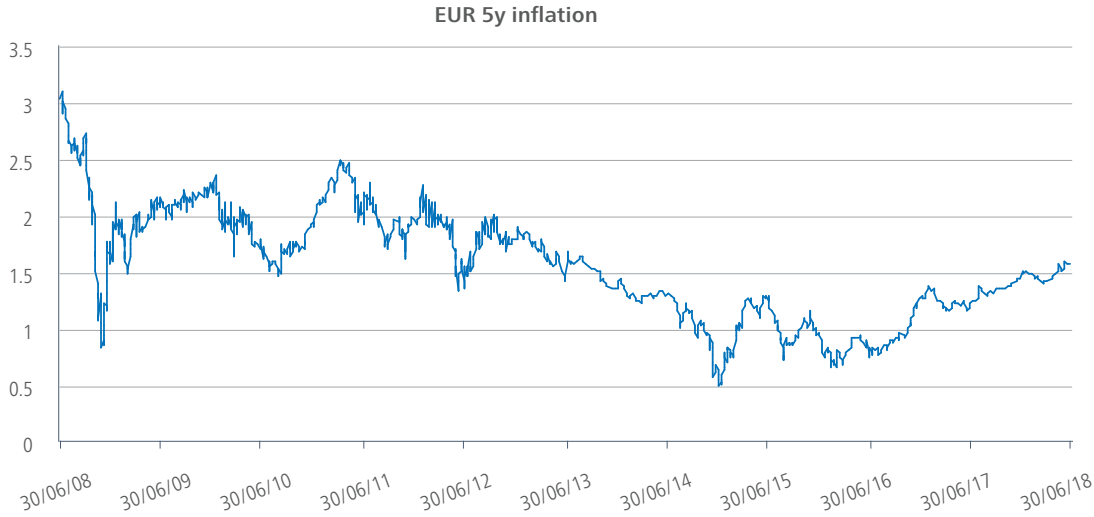
In addition, we have selective exposure to the currencies and debt of several emerging countries where prospective risk-adjusted returns look attractive. For instance, we like Brazil where short-term yields as at the end of June stood at over nine per cent (whereas policy rates are at 6.5 per cent) yet a weak inflation and growth outlook means the central bank should be on hold at least until the upcoming election. Brazil is facing political risks in the short term, yet we believe that the yields on offer more than compensate us for these risks. We also have exposure to India and Indonesia as we expect the market-friendly policies of both countries' governments, along with supportive demographics, to result in declining yields and stronger currencies over time.

OPPORTUNISTIC RETURNS - As central banks unwind their asset purchase programmes of the last decade, we expect bond yields to rise and yield curves to steepen. The fund is positioned to benefit from interest rates rising further in the US, UK and Europe as well as increasing inflation expectations in the US and Europe. We believe several related investment ideas have the potential to deliver strong returns. For example, we think UK long-dated yields are unsustainably low given that real yields are among the lowest in the developed world. UK long-end rates have fallen significantly after the European and Japanese central banks implemented asset purchase programs. Should yields rise back to the levels that pre-dated these programs in late 2014, this strategy could contribute around 2.8 percentage points to the performance of the overall fund. Furthermore, since downside risks appear much smaller, we believe the potential returns are skewed to the upside. The same is true for several other strategies employed within the fund such as curve steepener and inflation strategies.



Source: Bloomberg as at 30 June 2018. Forecasts above should not be considered a reliable indicator of future performance.

For example, markets are currently pricing in very little inflation in Europe over the next five years, yet the output gap is expected to close in less than a year's time. Should inflation rise back to the European Central Bank's two per cent target, this strategy could contribute half a percentage point or more to the overall performance of the fund.



Source: Bloomberg as at 30 June 2018. Forecasts above should not be considered a reliable indicator of future performance.

POTENTIAL RISKS

While the central scenario remains a positive one, downside risks have undoubtedly intensified. Trade tensions between the US and the rest of the world have recently escalated with the US and China now engaged in the early stages of a trade war. Given its potential impact on global trade, growth expectations and risk assets, we have implemented several investment strategies that could help limit losses at a portfolio level:

RISK-REDUCING RETURNS - A long Australian rates strategy should do well given the trade links between the Australian and Chinese economies. And a short UK inflation strategy would be expected to contribute positively in an environment of weak global growth as deflationary concerns took hold. Furthermore, a new strategy implemented in January to benefit from a potential depreciation in the Taiwanese dollar against the US dollar would be expected to perform well in such a scenario. The Taiwanese dollar appreciated materially in 2017. However, the country's key semiconductor sector faces increasing competition from other Asian economies. As the fund is positioned for sustained global growth via exposure to emerging markets, this strategy would be expected to provide portfolio protection in the event global trade tensions intensify, since the Taiwanese dollar would be expected to depreciate. It is also a good example of a Risk-reducing strategy which has positive carry of about 2.9 per cent per annum. More recently, we have shorted the Korean won and Singapore dollar against the US dollar for similar reasons. These strategies would also be expected to perform well in the event the Chinese economy slows materially, dragging on global output, which is another key risk to our central scenario.

Source: Bloomberg as at 30 June 2018. Forecasts above should not be considered a reliable indicator of future performance.

A different potential risk could arise if the Federal Reserve were to hike rates more aggressively either in response to higher inflation or should they 'fall behind the curve' by sticking to the slow and gradual approach currently in place. Strategies that could help mitigate losses include various US yield curve steepener strategies and short front-end US rates. In this scenario, the fund's positioning net short duration would help mitigate losses experienced in other more market directional strategies. Lastly, we would expect the fund's interest rate and equity volatility strategies to do well in this scenario, given that volatility would be expected to pick up from current all-time lows.

DIVERSIFICATION BENEFIT OF A MULTI-STRATEGY APPROACH

The AIMS Target Return Fund aims to deliver steady long term returns with a lower correlation to equity markets in stressed market environments, and therefore can appeal to investors looking for enhanced diversification in the context of an overall asset allocation. In addition, the fund may also be an attractive solution for investors looking for capital growth who have a lower tolerance for losses or a shorter investment horizon than that offered by a broad portfolio of risk assets such as equities.

	AIMS Target Return Fund	Balanced multi-assets
Diversification	Larger diversification benefit as risk is reduced by using a broad range of assets – traditional and non-traditional – as well as other uncorrelated sources of return.	Risk is reduced by using a broad range of assets – mostly traditional assets – to keep the portfolio balanced.
Dependency on Market Conditions to deliver positive returns	Less dependent on positive market conditions to deliver positive returns. Opportunistic and Risk-reducing Returns strategies may deliver positive returns in less favourable market conditions.	More dependent on positive market conditions to deliver positive returns. Portfolio consisting mostly of equities and bonds, most likely to struggle in market conditions where returns for these assets are negative.
Upside return potential	Can also exhibit high returns when the central case of the House View materialises given a wider range of return drivers. However, over a period of upward trending markets could exhibit lower returns than a traditional multi-asset portfolio with more market beta.	The fund will always have a substantial allocation to assets like equities which means it is likely to benefit from the general upward trend of markets over the long term. This might require a longer investment horizon, however.
Downside risk - capital protection	Greater chance of minimising downside losses versus a long multi-asset portfolio. More adaptive to turbulent markets as certain strategies aim to specifically benefit from unfavourable market conditions and offer portfolio protection.	A relatively large part of these portfolios will consist of long positions in assets like equities and bonds and therefore can be vulnerable to environments where both bonds and equities experience drawdowns at the same time.

CONCLUSION

If bond markets struggle as central banks remove some of the extraordinary support of recent years, in turn triggering rising volatility across markets, multi-strategy solutions could provide a useful source of diversification for wider portfolios. By harnessing the expertise from a broad bench of investment professionals globally across the firm we can access a wide range of ideas and enhance the sources of return and diversification. This is further enhanced by having an unconstrained mandate and making use of flexible implementation with dedicated teams focused on portfolio construction who are tasked with sizing ideas in the most effective way. Furthermore, having a portfolio construction process that allocates risk to different types of ideas, some more and others less dependent on market direction, underpins our philosophy to aim to preserve capital and deliver a more stable return profile over the long term for clients.

KEY RISKS TO THIS STRATEGY

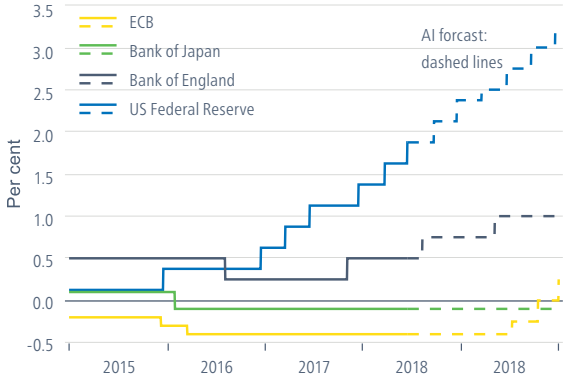
The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.

The Fund uses derivatives, these can be complex and highly volatile. This means in unusual market conditions the Fund may suffer significant losses.

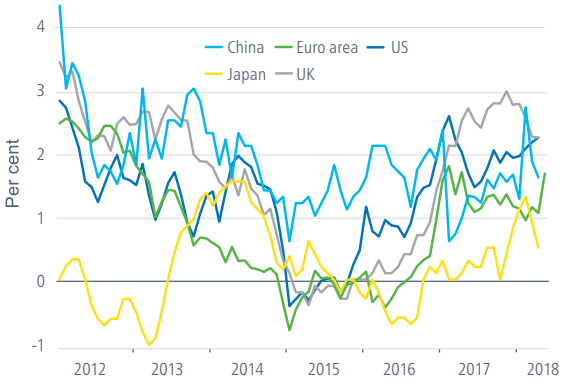
Certain assets held in the Fund could, be hard to value or to sell at a desired time or at a price considered to be fair (especially in large quantities), and as a result their prices could be very volatile.

APPENDIX 1 – MARKET DATA

Major central banks expected to tighten policy in near-term

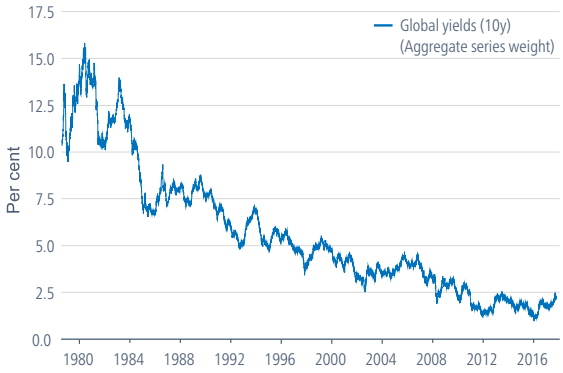


Headline inflation rising in the major nations, %

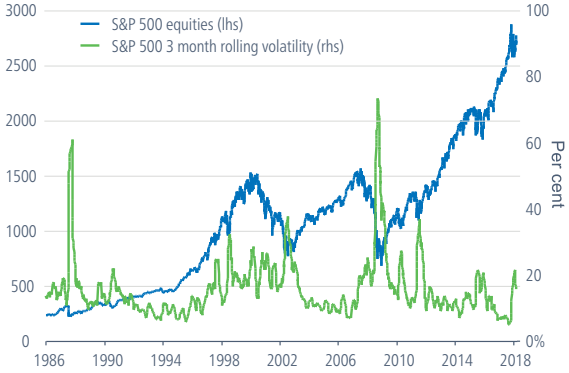


Source: Aviva Investors, Macrobond and Q3 House View as at 30 June 2018

Nominal bond yields globally over the last 30 years



US equities reaching all time highs, volatility at all-time lows



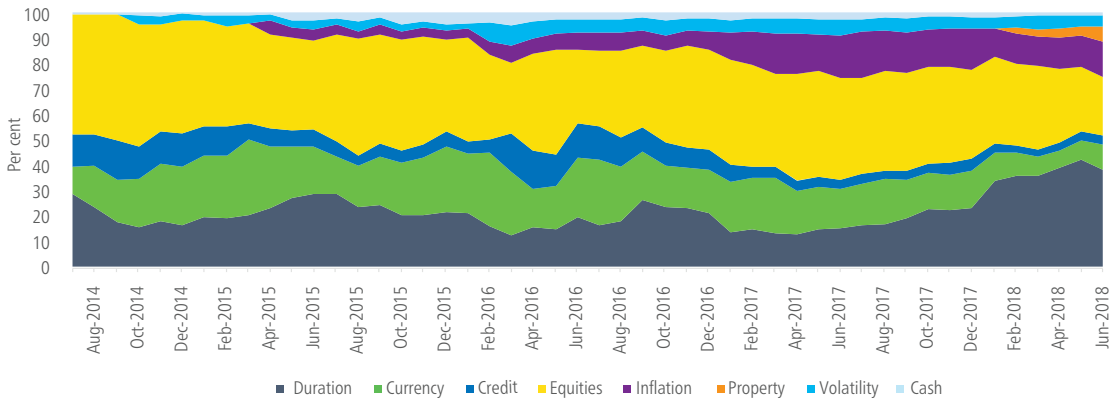
Source: Aviva Investors, Macrobond as at June 2018, GDP weighted (US, Germany, Japan, UK) left chart; Bloomberg as at 30 June 2018, right chart

APPENDIX 2- PERFORMANCE ANALYSIS

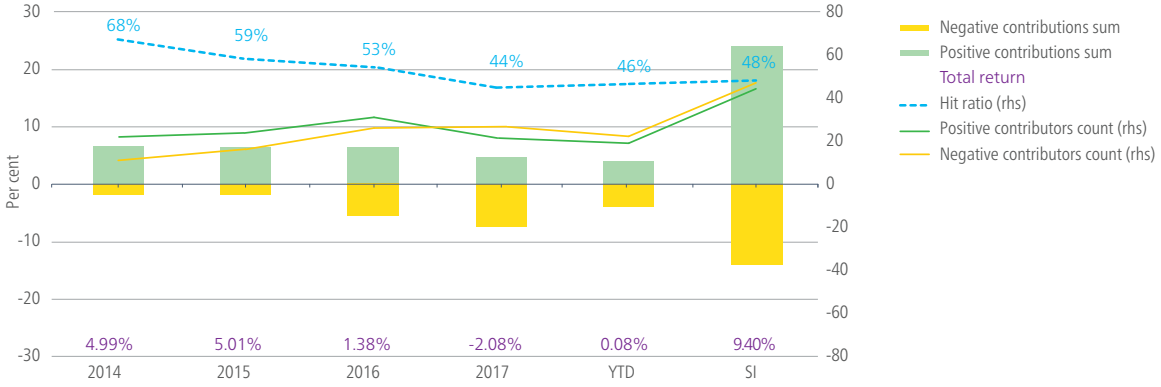
Performance by strategy type	SI
Market Returns	4.75%
Opportunistic Returns	-0.12%
Risk-reducing Returns	5.37%
Total Cash	-0.60%
Total	**9.40%**

Performance by risk drivers	SI
Credit	1.11%
Duration	3.10%
Inflation	1.20%
Currency	2.84%
Equities	2.63%
Property	0.26%
Volatility	-1.14%
Cash	-0.60%
Total	**9.40%**

AIMS TR SICAV Percentage of total portfolio risk by risk driver



AIMS TR SICAV Portfolio returns distribution



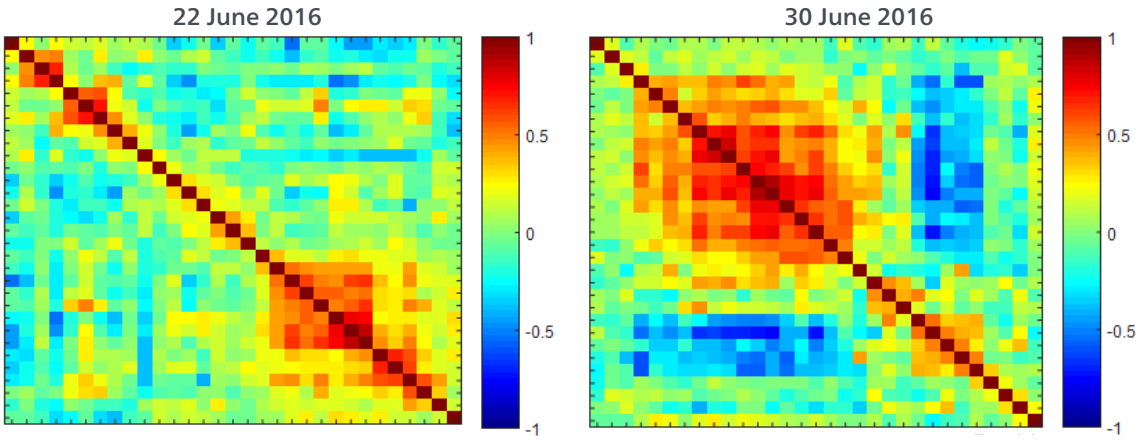
AIMS TR SICAV	2014	2015	2016	2017	YTD	SI
Maximum return	0.94%	0.87%	0.80%	1.23%	1.25%	2.22%
Minimum return	-0.43%	-0.26%	-0.51%	-0.81%	-0.82%	-0.90%
Positive contributions average	0.32%	0.28%	0.22%	0.25%	0.22%	0.55%
Negative contributions average	-0.18%	-0.10%	-0.19%	-0.27%	-0.19%	-0.31%

Source: Aviva Investors as at 30 June 2018 for the AIMS Target Return SICAV Fund. Performance contribution is shown gross of all fees, in EUR. Cash included as a strategy in the calculations above. Inception date 1 July 2014. The data shown is based on ex-ante volatility which is a forward-looking measure. Potential returns are based on a number of assumptions, may not be realised and are subject to risk. Past performance is not a guide to future performance. **The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested.**

APPENDIX 3 – RISK ANALYSIS

In benign market conditions (left chart below) strategies in the portfolio tend to have low correlation to each other. On the other hand, during times of market stress (right chart below) several strategies within the portfolio tend to become negatively correlated and help in offsetting losses in other strategies.

Correlation matrix of strategies before and after the UK referendum (simulation of current portfolio)



Source: Aviva Investors, MSCI RiskMetrics, correlation matrix (60 days) simulation of current portfolio as at 30 June 2018

DAILY STRESS AND SCENARIO TESTING

Risk-reducing strategies within AIMS Target Return are designed to soften any losses experienced from more market directional allocations elsewhere in the portfolio in times of market stress while not being a drag on performance in our central case scenario. On a daily basis, a range of historical, hypothetical and single factor push stress and scenario tests are run on the AIMS fund range. The stress and scenario tests below highlight the benefit of the differing components within AIMS Target Return and expected positive returns provided by the Risk-reducing return strategies under a range of scenarios.

Stress	Market Returns	Opportunistic Returns	Risk-reducing Returns
Black Week 5D (2008)	-6.59%	-1.38%	1.26%
January 2016 Falls (20151231 - 20160120)	-3.54%	-2.22%	1.65%
February 2016 Falls (20160129 - 20160211)	-2.76%	-2.01%	0.31%
2003 Bond Rally	3.67%	-1.60%	-0.16%
2003 Bond Sell-Off	0.96%	5.00%	1.03%
Taper Tantrum (20130502 - 20130905)	-3.11%	1.31%	1.98%

Source: Aviva Investors, MSCI RiskMetrics 30 June 2018

Over time this approach can deliver better downside protection and a greater focus on risk and drawdown control (chart below).

Maximum drawdown (fund inception 1/07/2014 – 30/06/2018)
AIMS Target Return SICAV: -5.2% (gross of fees)
Global equities: -19.1%

Source: Aviva Investors as at 30 June 2018 for the AIMS Target Return SICAV Fund. Performance contribution is shown gross of all fees, in EUR. Past performance is not a guide to future performance. The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested.

Hypothetical events and data shown do not reflect actual investment results and are not guarantees of future results. Potential returns are based on a number of assumptions, may not be realised and are subject to risk.

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