Investment Strategy

Rebalancing Your Global Equity Exposure

It's time to revisit your global equity exposure. With global equities having topped the asset allocation performance tables for the second financial year in a row, investors may find their portfolio has been distorted by the magnitude of the advance, with implications ranging from inferior diversification to an asset allocation that may at odds with their current risk profile.

Shrugging off premium valuations and a muted local growth outlook, Australian investors have continued to leverage a strong local currency to focus on companies listed offshore, particularly those listed in the developed world, against the backdrop of an improving US economic recovery and cheaper relative valuations within Europe.

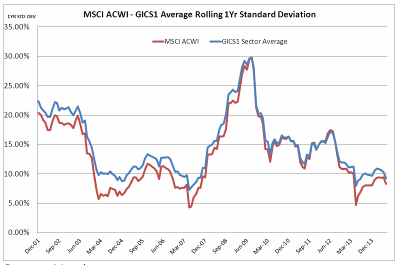
Regional and Sector Performance of the MSCI All Country World Index (local currency)

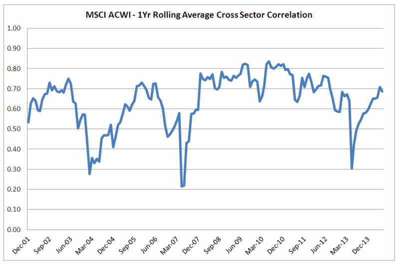
MSCI ACWI Regional Performance - Local Currency - 30 June 2014	2Yr Total Return	FY14	FY13
North America	47.9%	24.5%	18.8%
Japan	45.8%	12.0%	52.2%
MSCI AC World	*44.3%*	*20.8%*	*19.4%*
Europe	42.8%	20.2%	18.9%
AP ex Jap	30.2%	15.0%	13.1%
Emerging Mkts	20.7%	13.7%	6.1%

Source: Morningstar

MSCI ACWI Perf By Sector - LCL Currency - 30 Jun 2014	2Yr Total Return	FY14	FY13
Health Care	61.5%	25.9%	28.3%
Cons Disc	58.9%	19.2%	33.3%
Financials	51.6%	17.1%	29.5%
Industrials	50.4%	22.5%	22.8%
Technology	44.3%	29.9%	11.1%
MSCI AC World	*44.3%*	*20.8%*	*27.7%*
Energy	37.1%	26.1%	8.7%
Cons Staples	32.3%	11.5%	18.7%
Telecomms	30.0%	15.7%	12.4%
Utilities	27.6%	20.6%	5.8%
Materials	19.1%	19.2%	-0.1%

Equity Market Volatility and Sector Correlation





Source: Morningstar

The gap between the performance of developed markets (+45%) and emerging markets (+21%) has been stark over the past two years, with investors far more cautious (to varying degrees over the 2014 financial year) about the credit issues within China and select macro headwinds facing a number of emerging market nations.

At the industry level, the focus has clearly been towards superior growth characteristics or those with cyclical and/or financial leverage. Healthcare has led the advance (particularly bio-techs), alongside consumer discretionary shares, financials, industrials and technology stocks. Unsurprisingly, traditionally more defensive sectors, such as consumer staples and telecommunications, have lagged in a relative sense, but absolute returns have still been robust.

Other features to note is the rising correlations (investors become less discerning in their sector or individual stock investments) and falling volatility – factors which are commonly associated with investor complacency and feature toward the later stages of a market cycle.

While not at extreme levels, the trends are clear.

Asset Class Drift – the enemy of diversification

Let's begin with an assessment at the asset class level. Global equities have significantly outperformed defensive assets (cash and fixed income), as well as domestic equities. This is exacerbated even more so for those investors with unhedged investments offshore. The table below highlights this distortion for a moderate asset allocation, with the weighting to global equities increasing in size by 5% in that period. If left unchecked, an investor may end up with a portfolio that does match their long term investment objectives!

At the investment level, consideration will need to be given to which managed funds or direct holdings have performed the strongest and which of those have been the weakest.

What have been the underlying drivers of the performance? Is the performance sustainable? Clear consideration should be given to factors such as the level of exposure to developed versus emerging markets, is healthcare going to continue to deliver 20% annualised returns for the next couple of years? What exposure is there to hedged or unhedged investments? What will happen to my equity investments should interest rates rise from here? What will happen if the US economic recovery stalls?

Managed funds with strong style biases do not sit at the top of the performance tables on a consistent year-on-year basis. If the portfolio or investments are not rebalanced back to the originally designed position sizes, the performance of a portfolio will become increasingly sensitive to

Moderate Asset Allocation	Target	'Drifted' Allocation After 2 yrs	Drift
Australian Equities	30.0%	31.5%	1.5%
Global Equities	**30.0%**	**35.5%**	**5.5%**
Global Property	5.0%	5.0%	0.0%
Aust. Fixed Income	10.5%	8.3%	-2.2%
Global Fixed Income	10.5%	8.6%	-1.9%
Cash	9.0%	7.0%	-2.0%
Alternatives	5.0%	4.1%	-0.9%

Source: Morningstar, 360 Research

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Rebalancing Your Global Equity Exposure (continued)

that one investment due its larger size, thereby reducing the diversification properties of the portfolio and increasing overall volatility.

Value managers, after an almost 8-10 year hiatus, have led the performance tables, alongside those with a clear aggressive growth / cyclical bias. Those managers with more conservative, quality laden investment approaches (such as sustainable and long term track record of profitability, sound balance sheets, low cyclicality) have lagged quite markedly in the face of this market rally. In addition, any fund managers with any direct exposure to emerging markets is likely to have underperformed, purely as a consequence of the differential in performance between developed and emerging markets (e.g. North America 47% compared with a 20% return from emerging markets), even if the stocks in the fund have beaten their local country index.

These trends are unlikely to continue indefinitely. Ensuring the appropriate mix of investments is maintained to ensure there is no over reliance on 'yesterday's winners' is key. Markets have an all too familiar habit of punishing those investors who place too great a reliance on recent performance.

After such a large rally, and with global managed funds typically paying their largest (or only) distribution at June 30, investors should consider rebalancing their portfolio to ensure that the size of each global investment is not too large. If distributions are relatively low, consideration should be made to harvesting profits as a way of rebalancing the portfolio.

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