nabprivatewealth

Asset allocation

After last month's commentary about stretched valuations in equities (and the US Standard & Poor's 500 Index hitting a fresh record high), we have reduced our exposure to international shares, from an overweight position to a neutral weighting, with the proceeds used to increase the cash weighting from neutral to overweight. Regionally, we still favour US equities over other developed markets and the recent earnings season has confirmed that revenues and earnings in the United States are continuing to improve. About 75% of companies that have posted earnings this season beat analysts' estimates for profit and 65% exceeded sales projections. On the other had in Europe, Russian economic sanctions and sluggish inflation are likely to temper corporate sales and earnings growth. If global equity prices continue to fall on valuation and geopolitical concerns, as they have in late July and the early part of August then there may be selective opportunities to re-weight portfolios away from European stocks to US stocks, while maintaining a neutral overall position.

Bond yields in many markets have continued to fall, and central banks in the United States, UK and Australia are warning that investors are attaching a very low probability to any rise in global interest rates, or any other adverse event. For this reason the higher weightings to cash, floating rate securities and tactical fixed income strategies remain our preferred defensive exposures for the time being. In the less liquid and less homogenous investment classes of property and alternative investments, we remain interested in selective high quality opportunities and the higher weighting to cash is, in part, a place to park funds until opportunities in these asset classes emerge.

By Nick Ryder, Investment Strategist, NAB Private Wealth

Your Asset Allocation Guide

Asset Class	View	Comments
Cash	+	• Cash is still a preferred defensive asset, particularly relative to government bonds and we suggest a slight overweight position • We suggest term deposits out to two years are preferred over at-call cash
Fixed Income	+	• Fixed income is preferred over cash and alternatives at present • Developed world government bonds are expensive but and offer poor absolute value, so prefer products with limited interest rate risk • We suggest an equal split between Australian and (hedged) international bonds • Tactical income, absolute return fixed income strategies, floating-rate corporate securities and short duration fixed income are all preferred over benchmark-aware bond strategies
Australian Equities	–	• Remain underweight • Valuations are somewhat stretched and growth is lower the in other markets, meaning attractive opportunities in the Australian share market are harder to find • Hold positions in quality smaller companies but do not add
International Equities	N	• Given higher valuations in developed market shares, reduce exposure to international shares to a neutral weighting • An unhedged allocation gives some protection if global growth disappoints as the currency is likely to decline • Emerging markets are relatively cheap so maintain exposure either directly, or indirectly through the emerging markets earnings of global companies
Alternatives	N	• Maintain a neutral allocation until opportunities emerge • We believe that alternative sources of risk and skilled active management represent important diversifiers for the future • Alternatives as part of an overall strategy of building allocations to assets with low/moderate correlation to equities.
Property	N	• Hold a neutral allocation to commercial property. Demand for core property is robust and rental growth fundamentals should improve • At current pricing, Australian and international property appears fair value

About our recommendations

The asset allocation recommendations reflect NAB Private Wealth's views on the relative attractiveness of the asset class over a 1–3 year holding period. A neutral allocation (orange) means hold a neutral strategic allocation to the asset class, single minus underweight (orange) or single plus overweight (light green) recommendations are meant to rebalance the asset class progressively towards the bottom or top of your strategic asset allocation range using cashflows inflows or outflows to the portfolio. A double plus overweight (dark green) or double minus underweight (red) recommendation is intended to be rebalanced to the top end or bottom end of your strategic asset allocation range immediately by selling some assets and buying others.

Asset allocation

Australian Equities

The S&P/ASX 200 Accumulation Index rose 0.7% in May, with gains in all sectors except resources which declined by 1.2% on the back of the fall in the iron ore price. Investors are still chasing yield stocks and that has seen defensive sectors continue to trend higher, in particular utilities and telecoms. Bank stocks have also been bid up to multiples that are hard to explain except on a relative yield basis.

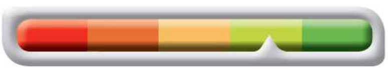
We continue to favour the energy, domestic cyclical sectors and companies with offshore earnings. With stocks at the higher end of fair value, stock picking within sectors remains the key to generating acceptable returns.

We suggest:
Remain underweight.
Valuations are at the upper end of fair value, meaning attractive opportunities are harder to find.

International Equities

Global equities returned 2.6% in local currency terms in May, with the US S&P 500 making fresh highs despite mixed economic data, a coup in Thailand and more clashes in Ukraine. Emerging markets shares gained 2.2%, with India the standout market returning 8.8% following the elections.

Price to earnings ratios are higher this month at 15.8 for developed markets and to 11.4 for emerging market shares. Equity prices have factored in strong future corporate earnings growth but they don't appear expensive relative to historical averages and to current bond yields. Pockets of attractive growth and reasonable value exist in select countries and sectors.



We suggest:
Stay overweight and favour quality companies with strong balance sheets and high returns on equity.
Unhedged exposure preferred.
Selective (eg mid cap) rather than indexed exposure to emerging market shares favoured.

Fixed Income

Australian bonds returned 1.4% in April, as bond yields continued to fall, pushing up bond prices. Three-year government bond yields fell 17 basis points to 2.86% per annum, and yields on 10-year Australian government bonds fell from 3.97% to 3.67% per annum.

The BarCap Global Aggregate Bond index returned 1.2% for the month as yields on government bonds fell in most markets.

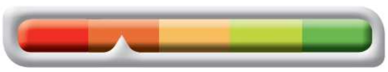
Credit spreads contracted by three basis points in May with the difference in yields on investment grade corporate bonds and comparable US treasury bonds down to 111 basis points.

We suggest:
Overweight overall exposure with equal split between Australian and international bonds.
Stay underweight long duration government and corporate bonds.
Overweight short duration and floating rate corporate bonds.

Cash

Australian bank bills returned 0.22% in May as short-term bank bill yields ticked down. The three-month bank bill yield fell 1 basis point to 2.84% per annum in May. At the June RBA meeting, the RBA kept cash rates unchanged at 2.50% per annum sticking with the stable interest rate theme again, despite a slightly more optimistic outlook.

The softer CPI outcome for the March quarter has given the RBA some breathing space before considering rate moves. Current market pricing has a 15% chance of rate cut before the end of 2014 with a full rate rise by late 2015. Longer term bank term deposits of one to two years remain attractive relative to at-call cash and government bonds.



We suggest:
Move to a slight underweight position in cash.
Bank term deposits preferred relative to government bonds and at-call cash.

Alternatives

Globally, hedge funds returned 0.5% in May with most of the strategies posting small gains except quantitative market neutral strategies which lost 1.8% after previously recording seven months of consecutive gains.

So far in 2014, hedge fund performance has been subdued with year-to-date returns of 0.8%, behind the 4.3% for global equities and 4.1% for global bonds over the same period. Hedge funds remain conservatively positioned given that many asset prices appear expensive and volatility remains low. As with equities, bottom-up individual manager selection is more likely to provide better returns than top-down strategy selection.

We suggest:
Maintain a neutral position.
Manager selection remains more important than strategy selection.
Liquid alternative investments including hedge funds remain favoured over equities for incremental risk exposures.

Property

Unlisted Australian core property funds returned 8.9% in the year to April 2014. Average yields are 5.8% but range from 5.5% for retail property to 7.9% for industrial property. This year global listed property has been the best performing equity sector with returns of about 11%.

Sentiment and capital flows are still favourable for commercial property with the lower interest rate environment helping support investor demand, particularly foreign demand, for local property. Property earnings in the near term continue to be supported by improving economic growth and accommodative monetary policy. Valuations are neither excessive nor cheap and appear at around fair value.

We suggest:
Remain neutral with no preference for Australian over global property.