Asset allocation: What triggers a change in our recommendations?

Decisions to dynamically change asset allocation weightings are not always easy. Knowing when to reduce the proportion of equities in a portfolio and to increase exposure to other asset classes such as property, cash and bonds, can be part science and part art. To help with these decisions, it's useful to consider three factors that apply to asset classes: valuations, fundamentals and sentiment.

- **Valuations.** Are valuations in share, bond and property markets supportive or are prices trading above fair value?
- **Fundamentals:** What are the current fundamentals of the asset class? For example, are corporate earnings growing strongly, are balance sheets in good shape, are credit defaults rising, is inflation under control, how large are rental vacancies?
- **Sentiment:** Is investor sentiment supportive towards the asset class, is it weak or overly exuberant? For example if the proverbial shoe shine boy is handing out stock tips, it's probably time to get out of the share market

Currently, most asset classes are displaying reasonable fundamentals. Governments are mostly in the process of reducing debt, corporate balance sheets are in good shape, earnings are growing modestly and rents are rising slowly in the property market. Sentiment is also generally good across most asset classes, investors are comfortable buying riskier growth assets and even bonds at zero interest rates, IPOs and corporate bond issues are being well supported. There is also significant investor demand for commercial property. The valuation question is less clear cut. On the one hand, valuations appear expensive when compared with history, but reasonable when compared against near zero interest rates. So overall, there are no compelling reasons to change asset allocations this month.

By Nick Ryder, NAB Private Wealth Investment Strategist

Your asset allocation guide

Asset Class	View	Comments
Cash	+	• Hold an overweight position in cash to be able to take advantage of new opportunities when they arise e.g. a sell-off in equities • We suggest shorter maturity term deposits over at-call cash
Fixed Income	+	• We suggest an overweight position in fixed income • Developed world government bonds are very expensive 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 • Growth outlook is lower than other markets and valuations are above fair value • Favour selective industrials (I.e. offshore earners) • Hold positions in quality smaller companies but do not add
International Equities	N	• Given higher valuations in developed market shares, hold a neutral weighting • Maintain unhedged currency exposure for now • Emerging markets are cheaper than developed markets so maintain exposure
Alternatives	N	• Maintain a neutral allocation until opportunities emerge • 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 as larger investors seek to buy real assets with attractive rental yields • 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 was down 0.1% in March. The energy and resources sector were both 6% lower, due to declines in the price of crude oil and iron ore, however the industrial, financial and healthcare sectors rose 1.2-1.3%.

We still favour selected industrials, infrastructure, healthcare, consumer discretionary and diversified financials and are underweight the banking sector. Despite earnings per share growth of just 2.7% over the next 12 months the market is currently trading on 16.2 times forecast earnings, which is above long term averages, indicating the valuations are getting expensive with shares being supported by a 4.5% average cash dividend yield.

We suggest:
Remain underweight.
Valuations are above fair value and attractive growth or value opportunities are scarce.

International Equities

Global equities lost 0.4% in March in local currency terms. European stocks continued to rise after the ECB's January stimulus announcement and better economic data in Germany. The US market retreated from its highs falling 1.6%. In US Dollar terms, emerging markets rose 0.2% with strong gains in China after the government announced measures to stimulate the property market.

Markets are trading above fair value driven higher by zero or negative interest rates in many markets. Average price to earnings multiples are at 16.2 times, based on earnings growth of 6.3% over the next 12 months. However, some equity markets are pricing in future growth which may not eventuate in the medium term.

We suggest:
Given high valuations maintain a neutral (unhedged currency) exposure to international shares.
Favour US over Europe.

Fixed Income

Australian bonds posted a return of 0.8% in March. Three-year Australian government bond yields fell another seven basis points to new lows of 1.73% per annum and 10-year yields fell 13 basis points to 2.33% per annum.

Internationally, the Citi World Broad Investment Grade index returned 1.2% helped by lower yields and slightly narrower corporate credit spreads. Yields on US high yield bonds moved higher, from 443 to 482 basis points over comparable US Treasury bonds.

We suggest:
Overweight overall exposure to fixed income with an equal split between Australian and international bonds.
Stay underweight longer term government and corporate bonds.
Prefer tactical income and absolute return fixed income strategies.

Cash

Australian bank bills returned 0.21% in March as three-month bank bill yields fell from 2.33% to 2.23% per annum as expectations of further rate cuts increased. At the April RBA Board meeting official interest rates were left on hold again, however, the language from the RBA is that they are willing to cut rates further, if needed.

Economists and financial markets continue to forecast further rate cuts in 2015, which is being reflected in shorter term bond yields and term deposit rates potentially forcing investors into riskier assets. NAB economists expect one more 25 basis point rate cut in May (to 2.0% per annum) before a period of stability in rates.

We suggest:
Retain an overweight position.
Cash provides flexibility to buy other assets on a price pullback.
Bank term deposits preferred relative to government bonds and at-call cash.

Alternatives

Hedge funds posted returns of 0.3% in March with funds that follow market trends or make macro-economic bets the best returning strategy with a monthly gain of 0.7%. The worst performing strategy lost 0.2% for funds that seek to arbitrage value between different but related securities.

The pick-up in volatility seen in the first quarter along with trending commodity, currency and bond markets should assist certain hedge fund strategies (such as macro and trend following strategies) in coming months.

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

Property

Returns from unlisted Australian core property funds were 9.2% in the 12 months to the end of February 2015. Average distribution yields range from 5.2% for retail property, 6.0% for offices and 7.6% for industrial property. REITs lost money in March with Australian property securities down 2.1% while globally they lost 0.2%.

Sentiment and capital flows are still favourable for commercial property, with the lower interest rate environment pushing property yields lower. Conditions in the leasing market are, however, more challenging with high vacancies in many office markets and continued pressure on shopping centre landlords for lower rents. In some international markets, property valuations are expensive, but in others they appear at around fair value.

We suggest:
Remain neutral
For listed property exposures, reduce Australian exposure and increase weighting to international property securities.