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Your asset allocation guide

While developed markets equities appear expensive relative to average long-run price-to-earnings ratios and, given relatively subdued earnings growth, many investors argue that they aren't expensive when compared with current bond yields. Academic theory suggests that risky assets such as equities should return, on average, about five to six percentage points more than "risk free" long term government bonds. This is based on long term studies comparing equity returns with bond returns.

With the 10-year Commonwealth Government bond in Australia yielding 2.66% per annum (at the end of April), theoretically equities should return about 7.5-9.0% per annum, on average, over the next few years. This return doesn't appear too demanding when looking at current equity valuations. At current prices, the local share market is providing a dividend yield of 4.5% per annum, another 1.5% per annum in franking credits (so a grossed-up yield of 6.0% per annum) and, if we assume that companies can grow earnings per share at about 3% per annum then we can easily get to 8-9% per annum in long run average equity returns, all else being equal.

Of course, if bond yields return to more "normal" levels - typically the rate of GDP growth plus inflation - so about 6% per annum, then equity returns need to rise through higher dividend yields (potentially involving lower share prices) or earnings need to grow more rapidly. For these reasons, asset allocators and investors need to understand the path of interest rate normalisation undertaken by central banks to avoid a situation, such as in 1994, when bond yields rose rapidly causing both bond and equity prices to fall in unison.

By Nick Ryder

Asset allocation summary

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 have an overweight position in fixed income until we identify opportunities in alternative investments to shift capital into • 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 such as financials, healthcare and utilities • 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 • Favour Europe and Japan over United States • Emerging markets are cheaper than developed markets so maintain exposure and favour Asia over other regions
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 • At current pricing, Australian and international property appears fair value • Favour international property securities over Australian

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.

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Asset allocation

Australian Equities

The S&P/ASX 200 Accumulation Index was down 1.7% in April. The financials sector was 4.2% lower as investors reduced holdings in the banks on fears of higher regulatory capital requirements, however, the energy sector rose 8.5% helped by a 25% bounce in the price of crude oil.

We remain positive on sectors such as financials, healthcare and utilities. While also positive on the industrials and consumer discretionary sectors, we believe stock selection is critical – particularly those companies with significant offshore exposures or plans to expand offshore. Valuations remain 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 returned 1.1% in April in local currency terms. After strong gains recently, stocks in Germany fell 4.3% in April after the Euro strengthened. The US market returned 1% posting new highs intra-month. Emerging markets shares were up 5.7% in US Dollar terms with strong gains in China and Hong Kong which were helped by additional government stimulus policies.

Developed market valuations are no longer cheap in an absolute sense but are attractive relative to other asset classes. Our preference is to move capital away from the United States to Europe and for emerging markets exposure to be overweighted towards Asian equities due to tailwinds from lower energy prices,
stronger fiscal and current account balances and scope for monetary easing.

We suggest:
Given high valuations maintain a neutral (unhedged currency) exposure to international shares.
Overweight Europe and Asia.

Fixed Income

Australian bonds lost 1.1% in April as yields rose across the entire yield curve. After hitting fresh lows in March, three-year Australian government bond yields jumped 25 basis points to 1.99% per annum and 10-year yields rose 32 basis points to 2.66% per annum.

Internationally, the Barclays Global Aggregate Bond Index (A$ hedged) lost 0.9% as yields rose in all of the major markets. The rise in equities saw credit spreads on US high yield bonds contract from 482 to 459 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 April as three-month bank bill yields rose marginally from 2.33% to 2.35% per annum.

At the May RBA Board meeting, official interest rates were reduced from 2.25% to 2.00%, as expected, with the RBA electing to make the cut to push up growth at a time that inflation remains relatively low. However, the RBA removed prior language from its post-meeting statement indicating that further cuts may be needed.

Following the most recent rate cut to 2%, economists and financial markets are now forecasting a an extended period of stability in interest 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 0.2% in April in what was a difficult market for traders. The best performing strategy was equity long/short funds focussed on growth stocks which made 5.5% for the month. However, the reversal in the US Dollar's uptrend and the bounce in oil prices hurt funds that follow market trends or make macro-economic bets, which were down 2.7% in April, the first monthly loss for 12 months.

At a time that equity and bond markets appear expensive, hedge funds continue to play an important role in portfolios with downside protection and low correlation.

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

Property

Returns from unlisted Australian core property funds were 9.4% in the 12 months to the end of March 2015. Average distribution yields range from 5.2% for retail property, 6.0% for offices and 7.5% for industrial property. REITs lost money again in April with Australian property securities down 1.1% while globally they lost 1.5%.

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 international exposure.

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