Asset allocation

More conservatively-positioned portfolios, which may comprise 30% exposure to growth assets – usually shares - and a 70% holding in fixed income and cash assets have about 85-90% of their total risk coming from the exposure to shares. In other words the tail is wagging the dog: the small holding in shares is providing almost all of the risk in the portfolio. How can this be? Well, depending on the share market and time period we are talking about, the volatility in share returns is around 15% per annum. Some markets are more volatile, like emerging markets, and some periods exhibit higher or lower volatility than others. In contrast bonds have an annual volatility of about 3% and cash is about 0.5% and this has been fairly constant over time and across markets. So with five times more risk we can see why most of the risk in the portfolio is coming from shares, even when they represent such a small position.

This dominant exposure to equity market risk poses a challenge for professionals trying to build robust, conservative portfolios for risk-averse investors. Of course one option is to hold a smaller exposure to equities or even zero, however, then the portfolio is less diversified and the returns are likely to be very low. Another option is to replace equities with alternative asset classes such as high yield bonds, hedge fund strategies and commercial property, but these usually involve less liquidity and the more complex nature of these investments is not always palatable to risk-averse investors. Another solution are the so-called risk parity strategies which dial-up the total exposure to fixed income so that instead of being 70% of the portfolio, the fixed income exposure is increased to 250% through the use of leverage or derivatives such as bond futures contracts. However, although risk parity portfolio better balances risk so that it may be 50% fixed income risk and 50% equity risk, the total risk of the portfolio has been increased and how would such a strategy perform if interest rates rise off record lows? Ultimately, there is no single solution for portfolio constructors but there is increased research into finding ways to reduce the dominance of equity risk in more conservative portfolios.

Asset allocation summary

Asset Class	View	Comments
Cash	N	• Hold a neutral position • Given the banks are no longer chasing term deposits there is less of an incentive to lock into term deposits compared with the flexibility of at-call cash
Fixed Income	–	• Stay underweight in fixed income • Developed world government bonds are 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 but valuations are now about fair value • Favour selective industrials such as diversified 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	+	• Hold an overweight allocation • 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 returned 4.4% in October taking 2015 year-to-date returns to 0.5%. Energy stocks gained 8% helped by merger and acquisition activity in the sector. Telecommunications stocks fell 3% driven by a 4% fall in the Telstra share price. Smaller companies outperformed again with returns of 7.0% in October.

We remain positive on sectors such as diversified financials, healthcare and utilities. We are also positive on selected industrial and consumer discretionary stocks but stock selection is critical. Valuations are supported by a 5.1% cash dividend yield (plus franking credits) which is attractive given 10-year bonds yield just 2.63% per annum.

We suggest:
Remain underweight.
Valuations are about fair value but attractive, sustainable growth opportunities are scarce.

International Equities

Global equities returned 7.9% in October in local currency terms as the US Fed delayed its lift off in interest rates and the European Central Bank hinted at possible further rate cuts. Emerging markets shares returned 5.4% in local currency terms with Chinese A-shares gaining 10.8%.

With the bounce in equity prices, price-to-earnings ratio valuations in developed markets have returned to the 16-17 times range, which is fair given the earnings outlook and bond yields. We prefer Europe where valuations are lower than the US and we also favour Asia and Japan, which offers better growth than other regions.

We suggest:
Maintain a neutral (unhedged currency) exposure to international shares.
Overweight Europe and Asia.

Fixed Income

Australian bonds generated 0.29% in September as yields ticked up marginally. The 10-year bond yield rose from 2.61% back up to 2.63% per annum.

Internationally, the Barclays Global Aggregate Bond Index (A$ hedged) returned 0.49% as bond yields rose about 10-20 basis points in the United States and UK as investors swapped out of bonds into shares. Yields in Germany fell after the ECB hinted at possible further stimulus measures. Credit spreads narrowed in line with the rise in equity prices, with US corporate bond spreads 13 basis points tighter (to a spread of 165) and high yield bonds narrowed 74 basis points to a spread of 588 bps over US Treasury bonds.

We suggest:
Remain underweight overall to fixed income with an equal split between Australian and international bonds.
Corporate credit offers reasonable value given low default rates.

Cash

Australian bank bills returned 0.18% in September as three-month bank bill yields fell from 2.18% to 2.12% per annum as investors priced in rate cuts following the soft inflation reading and out-of-cycle bank interest rate rises.

At the November RBA Board meeting, official interest rates were left unchanged, as expected. The RBA appears a little more optimistic about the health of the labour market and the economy in general, however, they noted that the lower inflation outlook provides scope to cut rates, if needed.

We suggest:
Move to a neutral position.
Cash provides flexibility to buy other assets on a price pullback.
No preference for term deposits over at-call cash.

Alternatives

Hedge funds gained 1.5% in October after a period of weak returns. Last month's worst performing and best performing strategies swapped places this month. The best-performing funds were special situations funds with gains of 2.9% while last month's best performer; systematic macro and trend-following funds lost 0.9% for the month. Year-to-date funds that invest in mergers and funds that use equity market neutral strategies have returned 7.0% and 5.7% respectively.

We suggest:
Retain an overweight 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 11.6% in the 12 months to the end of September 2015. Average distribution yields range from 5.4% for retail property, 6.0% for offices and 7.6% for industrial property. REIT prices had a good month with Australian property securities up 5.0% and global REITs gained 5.7% in US Dollar terms.

Sentiment and capital flows are still favourable for commercial property, with the lower interest rate environment pushing property yields lower, particularly in markets such as CBD A-grade office buildings. Conditions in the corporate leasing market are, however, more challenging with high vacancies and lease incentives in many office markets and continued pressure on shopping centre landlords for lower rent.

We suggest:
Remain neutral
Reduce weighting to Australia and increase international exposure.