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Private View

June 2014

Asset Allocation

Following the changes to our asset allocation recommendations last month, when we increased our fixed income weighting, bond yields around the world have continued to fall, resulting in returns of around 1.4% from fixed income indices. Ordinarily, falling bond yields would be seen as an indication that investors are nervous about future economic growth, and therefore swapping out of shares into the safety of government bonds. And with the tapering of US Federal Reserve bond buying, US bond yields should, in theory, be moving higher rather than lower. Yet over the same time period the US equity market (and the Australian market) has posted fresh post-financial crisis highs implying that investors are optimistic about future economic growth.

The synchronised movement in bond and equity prices has many strategists wondering what is going on; both the bond market and equity market cannot be right about future growth. One theory that has some merit is that the equity market is being driven higher by yield-driven investors who are not necessarily expecting much in the way of capital growth. If this is the case then falling bond yields and falling dividend yields at the same time makes sense. Equity sectors that have performed well include "bond" substitution sectors including real estate investment trusts, utilities, telecommunications and consumer staples. Over the past few months we have also noticed an increase in the number of "equity income" strategies being promoted by fund managers. These invest in Australian shares, international shares and even emerging markets shares with a focus on investing only in high dividend-yielding stocks. We suspect it's this theme that is driving equity prices higher, and it's likely to continue for so long as equity price volatility remains low and these shares behave more like bonds. Of course, unlike bonds, shares have no fixed maturity date or guaranteed redemption price, which may cause disappointment when bond yield rise or equity markets fall.

Your Asset Allocation guide

Asset Class	View	Comments
Cash	–	• Although cash is still a preferred defensive asset, particularly against government bonds, we suggest a slight underweight 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 • At current pricing, developed world government bonds offer poor absolute value, so prefer products with limited interest rate risk • We suggest an equal split between Australian and (hedged) international bonds • Tactical and absolute return fixed income strategies and short duration fixed income are all preferred over benchmark-aware bond strategies
Australian Equities	–	• Remain underweight • Valuations continue to be stretched and are now at the upper end of fair value, meaning opportunities in the Australian share market are harder to find
International Equities	+	• Maintain overweight allocation, as valuations and growth outlook are more attractive than in Australia • 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 through non-benchmark strategies such investments in as mid-sized stocks
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 should be 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

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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.

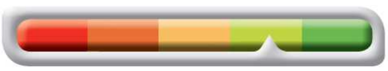
We continue to favour the energy, domestic cyclical sectors and companies with offshore earnings. With stocks at the higher end of fair value, stock picking within sectors remains the key to generating acceptable returns.

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.

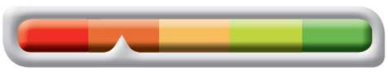
Credit spreads contracted by three basis points in May with the difference in yields on investment grade corporate bonds and comparable US treasury bonds down to 111 basis points.

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.

By Nick Ryder, Investment Strategist, NAB Private Wealth

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.