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Asset Allocation

In recent months, a rising number of commentators have warned that the current market environment looks eerily similar to 2007, before the financial crisis, and some are saying equity prices are due for a large correction. With the US Standard & Poor's (S&P) 500 index reaching new highs, record issuance of high yield bonds and low volatility in equity prices, such comments do have some credibility. However, if we were to move out of equities, what asset class should we move into? Every asset class looks expensive compared to historical levels – bonds are expensive, credit margins are relatively narrow, property in many markets appears expensive and cash returns next to nothing.

However, when we look at equities relative to bonds, and factor in earnings growth forecasts, valuations don't look too stretched. According to Bloomberg, the US S&P 500 Index has a forecast dividend yield of 2% and earnings growth in 2015 of 12%, implying a total return of around 14% before any currency impact and earnings multiple changes. These returns aren't bad compared with 10-year US Treasury bond yields of 2.5% per annum. For Australia's S&P/ASX 200 Index, the dividend yield is 5% but growth is lower at 8%, so the total return is around 13%. So, for investors with a medium to longer term time horizon, equities are still an attractive asset class. And, for investors worried about an equity market crash, low volatility makes option protection strategies cheap by historical standards.

By Nick Ryder, Investment Strategist, NAB Private Wealth

Your Asset Allocation Guide

Asset Class	View	Comments
Cash	–	• Although cash is still a preferred defensive asset, particularly relative to 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 • 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 preferred over benchmark 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
International Equities	+	• Maintain overweight allocation, as growth outlook is more attractive than in Australia. Prefer US equities over European given economic growth profile • 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.

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Asset allocation

Australian Equities

The S&P/ASX 200 Accumulation Index declined by 1.5% in June, with falls in most of the sectors except utilities and property trusts. Investors are still chasing yield stocks and that has seen defensive sectors continue to trend higher, in particular utilities and telecoms which have gained 12.7% in the past six months compared with a 3% return for the broader market.

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 1.4% in local currency terms in June, with the US S&P 500 making fresh highs again despite mixed economic data and geopolitical tensions in Iraq. Emerging markets shares gained 2%, with India again performing strongly, following the May elections, returning 5.4% in June.

Price to earnings ratios increased to 16.1 for developed markets (from 15.8 last month) and to 11.8 (from 11.4) for emerging market shares so valuations are becoming a little stretched. Overall we feel that improving economic growth in the United States and Europe will flow through to corporate earnings and support equity prices, particularly in the United States.

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

Fixed Income

Australian bonds returned 0.8% in June, as bond yields continued to fall, pushing up bond prices. Three-year government bond yields fell 16 basis points to 2.69% per annum, while 10-year Australian government bond yields fell from 3.67% to 3.54% per annum.

The BarCap Global Aggregate Bond index returned 0.3% for the month as yields fell on government bonds fell in some markets and rose in others.

Investment grade credit spreads contracted by two basis points in June with yields on investment grade bonds trading at 109 basis points over comparable US treasury bonds.

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

Cash

Australian bank bills returned 0.23% in June as short-term bank bill yields ticked down slightly. The three-month bank bill yield fell one basis point to 2.68% per annum in June. At the July RBA meeting, the RBA kept cash rates unchanged at 2.50% per annum and appears to be reasonably comfortable keeping interest rates stable for an extended period.

Current market pricing has a 30% chance of rate cut in the next year but the hurdle required for another cut is relatively high and the economy would need to weaken materially. Longer term bank term deposits of one to two years remain attractive relative to at-call cash and longer term government bonds.

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

Alternatives

Globally, hedge funds returned 0.9% in June with most of the strategies posting gains. So far in 2014 hedge fund performance has been subdued with year-to-date returns of 1.8%, behind the 5.8% for global equities and 4.5% for global bonds, but ahead US cash rates.

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

Returns from unlisted Australian core property funds were 8.8% in the year to the end of May 2014. Average distribution yields are 5.8% but range from 5.4% for retail property to 7.8% for industrial property. Listed property continues to perform well with 2014 year-to-date returns of 12.7% in Australia and 12.2% globally.

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 economic growth and accommodative monetary policy, however, conditions are challenging in the retail sector with softer consumer sentiment and spending in recent months. Property valuations are neither excessive nor cheap and appear at around fair value.

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