

## Asset allocation

Our asset allocation recommendations contain suggested exposures to property but clients have many options as to how they allocate to it. They can buy commercial properties or invest in a managed fund that buys unlisted commercial properties or they can buy property securities traded on the stock exchange. Clients may also own residential investment property directly, or through a self-managed superannuation fund. What do we mean when we talk about property and should all forms of property be treated in the same way? For example, should property securities be defined as property or shares and will a leveraged residential investment property provide all the risk, return and diversification benefits required in a diversified portfolio?

Many advisers argue property securities (for example, Westfield Group) should be viewed as just another listed industry sector, like retailers or media companies, which are also listed on the stock exchange. And, many Australian share funds will also invest in property stocks anyway, so you get exposure to property securities through your allocation to Australian or international shares. Moving to residential property investments, many of us are already heavily exposed to that asset class. Rental yields are either very low or negative (if geared) so it isn't necessarily providing income or diversification, particularly if house prices are linked to interest rate cycles. Overall, residential property investment can be a more risky property class than commercial property.

Therefore, like institutional investors, we generally believe the best form of property investment is *core unlisted commercial property*, with low to moderate gearing, rather than property securities or residential property. This was best highlighted during the Global Financial Crisis (GFC), when securities in listed, highly leveraged property companies like Centro and GPT plummeted with equities markets, while core unlisted commercial properties retained their values, maintained their rental income streams and provided diversification..

By Nick Ryder, NAB Private Wealth Investment Strategist

## Your Asset Allocation Guide

Asset Class	View	Comments
Cash	+	<ul style="list-style-type: none"> <li>Hold a slight overweight position in cash until better opportunities emerge</li> <li>We suggest term deposits out to two years are preferred over at-call cash</li> </ul>
Fixed Income	+	<ul style="list-style-type: none"> <li>We suggest an overweight position in fixed income</li> <li>Developed world government bonds are expensive and offer poor absolute value, so we prefer products with limited interest rate risk</li> <li>We suggest an equal split between Australian and (hedged) international bonds</li> <li>Tactical income, absolute return fixed income strategies, floating-rate corporate securities and short duration fixed income are all preferred over benchmark-aware bond strategies</li> </ul>
Australian Equities	-	<ul style="list-style-type: none"> <li>Remain underweight</li> <li>Valuations are somewhat stretched and growth is lower than in other markets, meaning attractive opportunities in the Australian share market are harder to find</li> <li>Hold positions in quality smaller companies but do not add</li> </ul>
International Equities	N	<ul style="list-style-type: none"> <li>Given higher valuations in developed market shares, hold a neutral weighting</li> <li>An unhedged allocation gives some protection if global growth disappoints as the currency is likely to decline</li> <li>Emerging markets are relatively cheap so maintain exposure either directly, or indirectly through the emerging markets earnings of global companies</li> </ul>
Alternatives	N	<ul style="list-style-type: none"> <li>Maintain a neutral allocation until opportunities emerge</li> <li>We believe that alternative sources of risk and skilled active management represent important diversifiers for the future</li> <li>Alternatives as part of an overall strategy of building allocations to assets with low/moderate correlation to equities.</li> </ul>
Property	N	<ul style="list-style-type: none"> <li>Hold a neutral allocation to commercial property. Demand for core property is robust and rental growth fundamentals should improve</li> <li>At current pricing, Australian and international property appears to be fair value</li> </ul>

### 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 gained 0.6% in August, with gains in industrial sector shares of 1.4% offset by a 2.3% fall in the resources sector as the iron ore price dragged miners lower. Full year earnings results were broadly in line with expectations, which had been downgraded ahead of the reporting season. 31% of companies beat earnings forecasts, however, revenue results were a little weaker than expected and the outlook is unclear.

We favour the industrial and utilities sectors and companies with offshore earnings. With stocks trading at 15.8 times forecast earnings, stock picking 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

In August, global equities returned 2.7% in local currency terms with the US S&P 500 Index rising 3.8% to new fresh highs. European stocks were boosted by speculation of a fresh round of monetary stimulus from the ECB. Emerging market shares rose 1.8% in US Dollar terms with Brazil up 10%.

Price-earnings multiples for developed market shares have risen to 16.1 from 15.6 due mainly to the price rises. In emerging markets they have also increased from 11.8 to 12.1 times. While investor sentiment and company fundamentals are still supportive for global equities, valuations are less compelling.



**We suggest:**  
 Maintain a neutral exposure to international shares.  
 Favour US over Europe.  
 Maintain exposure to emerging markets shares.

### Fixed Income

Australian bonds returned 1% in August, as bond yields fell significantly. Three-year government bond yields fell

10 basis points to 2.64% per annum, while 10-year Australian government bond yields fell from 3.53% to 3.3% per annum during the month.

Internationally, falling bond yields pushed up the BarCap Global Aggregate Bond index by 0.9%. During August, German 10-year government bond yields posted a new record low of 0.86% per annum.

Investment grade credit spreads were slightly higher over the month.



**We suggest:**  
 Overweight your overall exposure with an 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 0.21% in August as short-term bank bill yields fell slightly. The three-month bank bill yield fell one basis point to 2.63% per annum over the month. At the September RBA meeting, the RBA kept official cash rates unchanged at 2.5% per annum and appears to be reasonably comfortable keeping interest rates stable for an extended period.

A recent speech by RBA Governor Stevens indicated that the RBA is unwilling to overstimulate the housing market through further rate cuts even though unemployment is rising. With the release of the stronger than expected June quarter GDP figures, markets have stopped pricing in a rate cut over the next 12 months and are now showing no interest rate changes.



**We suggest:**  
 Retain an overweight position. Bank term deposits preferred relative to government bonds and at-call cash.

### Alternatives

Globally, hedge funds posted gains of 1.1% in August with most of the strategies generating positive returns. The best performing strategy was long/short equity hedge funds with a

growth bias which returned 2.4% for the month. Funds that invest in convertible securities and distressed securities lost money during August.

Hedge funds are, in general, still conservatively positioned given that many asset prices appear expensive and volatility remains low. As with selecting individual shares, 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 8.9% in the year to the end of July 2014. Average distribution yields are 5.8% but range from 5.2% for retail property, 6.1% for offices and 7.7% for industrial property. Listed property continues to perform well, with 2014 year-to-date returns of 20.4% in Australia and 14.3% globally, ahead of broad equity indices.

Sentiment and capital flows are still favourable for commercial property with the lower interest rate environment helping support investor demand for local property. Property fundamentals are supported by economic growth at long-term trend levels and low interest rates. In some international markets property valuations are expensive, but in others they appear to be fair value.



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

*By Nick Ryder*