Asset allocation

With the large fall in the Australian Dollar over the past month, due to factors such as declining commodity prices (namely iron ore), a stronger US Dollar (due to higher US interest rate expectations), and rising equity market volatility, we are reminded that currencies can often be good “shock absorbers” in financial markets, as well as in the real economy. In this regard, the Reserve Bank of Australia (RBA) continues to try to talk down the Australian Dollar to assist in rebalancing our economy away from in-bound mining investment to manufacturing, tourism and other currency-exposed sectors that can benefit from a lower exchange rate.

In financial markets, falling equity prices often go hand in hand with a declining currency, particularly in small open economies such as Australia, where foreign investors can rapidly sell local securities and repatriate funds back into the safety of US Dollars or Japanese Yen. This was seen in September when global equities fell 1% in local currency terms but, on an un-hedged basis the MSCI World ex-Australia index actually rose 4.3% as the Australian Dollar fell 6.3% against the US Dollar. This is one of the key reasons that we have advocated an unhedged exposure to international equities: partly to see positive returns from currency gains in times when shares sell off, but also due to a view that the Australian Dollar was fundamentally overvalued and likely to move lower against the US Dollar over the next year or so.

Of course, like equities, exchange rates can be volatile and add to overall risk in certain types of portfolios without necessarily adding to returns. Hedging currencies, on the other hand, does have an expected return (based on interest rate differences between the two countries) and hedging reduces the impact of currency moves. In the case of portfolios designed to have lower risk with a greater focus on capital preservation and income, it makes sense to hedge foreign currency exposure arising from international bonds and property investments as these portfolios have a low exposure to equity movements and income payments and capital values of bonds and property are more stable and able to be more reliably predicted and therefore hedged.

By Nick Ryder, NAB Private Wealth Investment Strategist

Your Asset Allocation Guide

Asset Class	View	Comments
Cash	+	• Hold a slight overweight position in cash until better opportunities emerge • We suggest term deposits out to two years are preferred over at-call cash
Fixed Income	+	• We suggest an overweight position 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 • Valuations have pulled back but growth outlook remains lower than other markets • Favour selective industrials (I.e. offshore earners) • 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 • 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 fell 5.4% in September, with every sector lower, hurt by the dive in the iron ore price and a sell-off of bank stocks due to higher potential capital charges. It was the largest fall in the local market since May 2012 and appears to be partly related to foreign investors taking money out of the local market.

We still favour selective industrials, energy, healthcare, consumer discretionary and diversified financials especially those that can benefit from the lower currency. The fall in the market and has seen multiples fall from 15.8 times forecast earnings to 14.6 times, which is closer to long-run averages.

We suggest:
Remain underweight.
Valuations are at about fair value, but attractive growth or value opportunities are harder to find.

International Equities

In September, global developed market equities lost 1% but returns were mixed as the US S&P 500 Index fell 1.4%, Japanese shares rose 4.9% while. European stocks were flat on average. Emerging markets shares lost 4.4%, impacted by large falls in Brazil (11.7%) ahead of the election, and declines in Hong Kong due to the civic unrest.

Price-earnings multiples for developed market shares are back to 15.6 (from 16.1) and in emerging markets they are now 11.5 compared to 12.1 times last month. While investor sentiment and company fundamentals are still supportive for global equities, valuations in developed markets are somewhat less compelling.

We suggest:
Given higher valuations for developed market shares, maintain a neutral exposure to international shares.
Favour US over Europe.
Maintain exposure to emerging markets shares.

Fixed Income

Australian bonds lost 0.3% in September, as bond yields rose. Year-to-date, Australian bonds have returned 5.6%, ahead of equities which have earned only 2.4%. Three-year government bond yields rose 15 basis points to 2.78% per annum, while 10-year Australian government bond yields rose from a yield of 3.30% to 3.48% per annum during the month.

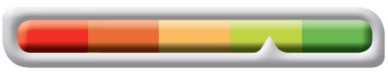
Internationally, the spike in bond yields and the slight widening in investment grade credit spreads pushed the BarCap Global Aggregate Bond index down by 1.6%.

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 0.22% in August as short-term bank bill yields rose slightly. The three-month bank bill yield rose six basis points to 2.69% per annum over the month. At the October RBA Board meeting, the RBA kept official cash rates unchanged at 2.50% per annum and appears to be reasonably comfortable keeping interest rates stable for an extended period.

Recent speeches by RBA officials indicate that the RBA and the bank regulator, APRA, are considering possible regulatory measures (known as macro-prudential controls) to curb lending to residential property in order to cool price growth, particularly in Sydney and Melbourne. If such measures are introduced (as they have been in New Zealand) then it gives greater scope for the RBA to hold rates lower for longer.



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

Alternatives

Globally, hedge funds posted losses of 0.8% in September with most of the strategies recording losses. The best performing strategy group was funds which invest based on macro-economics and trend-following. These funds returned 1.5%, the fifth month of gains and the best monthly return since 2009.

The pick-up in volatility and trending markets should assist certain hedge fund strategies (such as macro and trend following strategies) in coming months, however, 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 August 2014. Average distribution yields are 5.8% but range from 5.1% 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 13.9% in Australia and 7.2% globally, ahead of broad equity indices.

Sentiment and capital flows are still favourable for certain commercial property segments, with the lower interest rate environment helping support investor demand which is pushing yields lower. Property fundamentals are supported by economic growth that is currently around long term trend levels and low interest rates. In some international markets property valuations are expensive, but in others they appear at around fair value.

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