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Asset allocation and ways to boost your portfolio returns

At present, equity valuation measures such as Professor Robert Shiller's Cyclically-Adjusted Price Earnings (CAPE) ratio, imply that US shares are about 60% overvalued relative to long term averages. The corollary of this is that if the CAPE returns to long-term averages then US share returns could be as low at 0.2% per annum.

Similarly, the yield on ten-year (long-term) US government bonds is only 2.4% per annum. On this basis, returns from a relatively simple portfolio comprising 60% shares and 40% bonds, doesn't look particularly attractive - particularly before the impact of costs, taxes and inflation. Of course, Shiller's CAPE is just one measure and ignores the fact that revenue and earnings growth in the United States remains relatively robust. It also fails to take into account the fact that short term interest rates are near zero, which is likely not reflected in long run average price earnings ratios.

However, these tools do highlight the need to find additional sources of returns for portfolios, such as manager skill or the ability to select stocks that will outperform broad equity markets. In addition, credit returns from funding companies as opposed to funding governments, is another source of return that adds to expected returns. Other options include currency exposures, unlisted commercial property and hedge fund strategies that invest in distressed debt, futures and so on, which all have the potential to boost expected portfolio returns at a time when returns look like they will be relatively low going forward. The other way to boost returns is to correctly "time" different markets by underweighting and overweighting equities, cash, bonds and property in a portfolio. However, strong signals to shift asset allocation positions are rare – occurring maybe once every few years, although, opportunities to reposition within asset classes are more frequent as themes, sectors and countries fall in and out of favour with more regularity.

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.

Asset allocation

Australian Equities

After the sharp 5.4% fall in September, the S&P/ASX 200 Accumulation Index rose 4.4% in October. Bank shares rose 7.6% helped by reasonable earnings reports, while materials were flat and energy stocks 3.6% lower as the oil price continued falling. Smaller resources companies fell 8.6% and are down 16.6% so far in 2014.

We still favour selective industrials, infrastructure, energy, healthcare, consumer discretionary and diversified financials and are underweight the banking sector. The market is currently trading on 15.3 times forecast earnings with a cash dividend yield of 4.7%.

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

International Equities

Despite a 6.5% decline in the first half of October, global equities returned 1.2% for the month as Ebola fears and geopolitical tensions subsided. European stocks were down slightly (-1.4%) but other markets were higher. Emerging markets shares rose 1.3%.

In the US, 2014 earnings growth is estimated to be 6% while revenue growth is expected to be 3.7%. Estimated earnings growth in 2015 is 10.2%. The emphasis is on having continued strong exposure to US equities, with healthcare, technology and telecommunications the favoured sectors. Japan also has a preferred bias, a lower Yen leading to increased corporate earnings. Europe remains at a neutral weighting.

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 returned nearly 1% in October, as bond yields reversed September's moves higher. Three-year government bond yields fell 15 basis points to 2.63% per annum, while 10-year yields fell from 3.48% to 3.29% per annum over the month.

Internationally, the decline in bond yields was offset by a further widening in investment grade credit spreads which pushed the BarCap Global Aggregate Bond index up by 0.5%.

We suggest:
Overweight your overall exposure to fixed income with an equal split between Australian and international bonds.
Stay underweight longer term government and corporate bonds.
Prefer tactical income and absolute return fixed income strategies.

Cash

Australian bank bills returned 0.23% in October as three-month bank bill yields rose from 2.69% to 2.72% per annum. At the Cup Day RBA Board meeting, the RBA kept official cash rates unchanged at 2.5% per annum, for the 15th consecutive month, and appears to be reasonably comfortable keeping interest rates stable for an extended period.

The Consumer Price Index for the three months to the end of September showed an annual inflation rate of 2.6%, which was in line with expectations from economists and the RBA. With unemployment trending higher, wages pressures are low and weaker oil prices are also keeping inflation in check, giving the RBA scope to hold down interest rates for longer.

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

Alternatives

Hedge funds returned -1.3% in October with most strategies recording losses. The best performing strategy group was funds which invest based on macro-economics and trend-following. These funds returned 0.6%, the sixth month of gains. The worst performing strategy was event-driven which lost 5%.

The pick-up in volatility and trending markets should boost certain hedge fund strategies (such as macro and trend following strategies) in coming months, however, individual manager selection is likely to provide better returns than 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 September 2014. Average distribution yields are 5.8% but range from 5.1% for retail property, to 6.1% for offices and 7.8% for industrial property. Listed property continues to perform well, with 2014 year-to-date returns of 21.7% in Australia and 14.4% globally, well ahead of broad equity indices.

Sentiment and capital flows are still favourable for certain commercial property segments, with the low interest rate environment helping support investor demand, pushing yields lower. Property fundamentals are supported by economic growth (currently at long-term trend levels) and low interest rates. In some global 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.