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Asset allocation: Hedge your bets on international shares

2014 was another strong year for international shares. The MSCI World Equity Index (ex-Australia) delivered a 15% annual return in Australian Dollar terms (assuming no currency hedging). The same index returned 48% in 2013. Although part of the return from international shares was driven by the decline in the Australian Dollar (which fell 8.5% against the US Dollar in 2014) overall currency gains were less than this. This was because the Australian Dollar rose about 4% against the Yen and Euro reducing gains from currency to about 4-5%.

Given further falls in the Australian Dollar this year to US$0.77 – 78 and economist estimations of fair value at US$0.75, our expectation of further currency depreciation is much lower than previously. However, whether we shift our recommendation to fully or partially hedge international equities is undecided. In the past, there were significant income benefits from hedging against changes in the exchange rate. This is because short term interest rates in Australia were much higher than other major markets. Going forward, the outlook is for a second cut in Australian official interest rates while US interest rates "normalise" back up to pre-financial crisis levels. This means income from currency hedging is unlikely to be as great. The other fact to consider is the portfolio diversification benefits an investor receives by remaining unhedged. Our currency has tended to fall at times when investors are reducing risk (that is, selling shares or commodities) so currency can act as a good investment "shock absorber".

By Nick Ryder, NAB Private Wealth Investment Strategist.

Asset allocation summary

Asset Class	View	Comments
Cash	+	• Hold an overweight position in cash to be able to take advantage of new opportunities when they arise e.g. a sell-off in equities • 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 very 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 • Growth outlook remains lower than other markets and valuations are only fair • 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 for now • Emerging markets are cheaper than developed markets so maintain direct exposure, or indirectly through the emerging markets earnings of global companies
Alternatives	N	• Maintain a neutral allocation until opportunities emerge • Returns and risk in the alternative investments sector have been dialled back in recent years reflecting lower volatility and more conservatism by managers • 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 as larger investors seek to buy real assets with attractive rental yields • 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 finishing 2014 with a 5.6% return, largely from dividends, the S&P/ASX 200 Accumulation Index rose 3.3% in January. Income-generating sectors such as telecommunications, utilities and property securities were the standout performers. With declining oil prices, consumer discretionary stocks rose strongly while energy-related stocks fell further.

We still favour selective industrials, infrastructure, healthcare, consumer discretionary and diversified financials and are underweight the banking sector. The market is currently trading on 15.5 times forecast 2015 earnings multiple, however, forecasts may be adjusted in the next month as many companies report half year earnings.

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

International Equities

Global equities lost 0.5% in January in local currency terms. European stocks reacted favourably to the ECB's quantitative easing announcement with the German, Italian and French markets 8-9% higher. The US market fell 3% on mixed economic and earnings reports. Emerging markets shares rose 1.4% in US Dollar terms.

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 (unhedged currency) exposure to international shares.
Favour US over Europe.
Maintain exposure to emerging markets shares.

Fixed Income

Australian bonds produced a strong return of 1.6% in January after generating 10.4% in 2014. Three-year government bond yields fell 19 basis points to new lows of 1.97% per annum, while 10-year yields fell from a yield of 2.82% to 2.47% per annum.

Internationally, the material decline in bond yields in the US and Europe saw the Citi World Broad Investment Grade index return 1%. Corporate credit spreads were slightly wider, for example, yields on high yield bonds rose from 504 to 537 basis points over yields on US treasury bonds.

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 0.24% in January as three-month bank bill yields fell from 2.77% to 2.53% per annum due to increased speculation of a rate cut. At its February meeting, the RBA Board cut official interest rates from 2.50% per annum to 2.25%, the first move since August 2013. The RBA appears concerned that the economic growth is likely to remain lower and unemployment to rise further than they had previously expected.

Following the rate cut, many economists suggested that further cuts are likely in 2015 and market pricing is shows the market expects a further 0.36% rate cut in the next 12 months.

We suggest:
Retain an overweight position.
As other assets become expensive cash provides flexibility.
Bank term deposits preferred relative to government bonds and at-call cash.

Alternatives

Hedge funds returned -0.3% in January 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 2%, the ninth month of gains helped by trends in commodity prices, currencies and bond yields. The worst performing strategy was event-driven which lost 1.6%.

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 for incremental risk exposures.

Property

Returns from unlisted Australian commercial property funds were 9.2% in calendar 2014. Average distribution yields range from 5.1% for retail property, 6.1% for offices and 7.7% for industrial property. Listed property continues to perform well, with annual returns (to 31 January 2015) of 29% in Australia and 20% globally, well ahead of broad equity indices.

Sentiment and capital flows are still favourable for commercial property, with the lower interest rate environment helping to support investor demand which is pushing yields lower. In some international markets, property valuations are expensive, but in others they appear at around fair value.

We suggest:
Remain neutral
For listed property exposures, reduce Australian exposure and increase weighting to international property securities.