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Your Asset Allocation guide

After almost reaching 6,000 in mid-April, Australia's S&P/ASX 200 equity index has retreated to below 5,500 in early June, a fall of nearly 9%. Much of the decline can be attributed to a retreat in bank share prices which are down 17% over the same period. This is partly due to investor concerns about bank capital requirements and partly due to the recent rise in bond yields. Australian Commonwealth Government 10-year bond yields have risen from 2.35% per annum in mid-April to more than 3% per annum in early June. Similarly, German 10-year government bond yields have also jumped by a similar amount, from 0.15% per annum to 0.90% per annum, and Germany's DAX share market index has fallen 10% over the same period.

This link between bond yields and share prices in the last few weeks has spooked many investors as it has meant that bond and equity prices both fell at the same time hurting diversified multi-asset portfolios. However, the rapid rise in bond yields has been driven out of Europe as investors have shifted from expecting deflation and economic contraction, which pushed bond yields into (unsustainable) negative territory in much of Europe, to now expecting some inflation and moderate economic growth. This readjustment appears to have mostly run its course. It's hard to see bond yields moving much higher in the near term, particularly when central banks in Europe, Japan and Australia continue to cut rates and/or buy billions in longer term government bonds. Also, higher bond yields tend to imply improvements in future economic growth and moderate inflation, which is generally positive for equities over the medium term.

Overall, a rise in bond yields from unsustainable levels and a pull-back in equity valuations, particularly in the prices of "bond like" bank stocks in Australia, can be healthy and remind investors that yield isn't everything, that dividend yields can rapidly adjust higher and that portfolios need to be well diversified so that they aren't overly exposed to the single "bond yield" theme.

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 shorter maturity term deposits over at-call cash
Fixed Income	+	• We have an overweight position in fixed income until we identify opportunities in alternative investments to shift capital into • 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 strategies, floating-rate corporate securities and short duration fixed income are all preferred over benchmark-aware bond strategies
Australian Equities	–	• Remain underweight • Growth outlook is lower than other markets and valuations are above fair value • Favour selective industrials such as financials, healthcare and utilities • 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 • Favour Europe and Japan over United States • Emerging markets are cheaper than developed markets so maintain exposure and favour Asia over other regions
Alternatives	N	• Maintain a neutral allocation until opportunities emerge • 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 • At current pricing, Australian and international property appears fair value • Favour international property securities over Australian

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 returned 0.4% in May. The banks sector was 5% lower as investors continued to cut exposure on fears of higher regulatory capital requirements. Industrials shares rose 5.6%, helped by infrastructure stocks, while smaller companies returned 2.3%

We remain positive on sectors such as financials, healthcare and utilities. While also positive on the industrials and consumer discretionary sectors, we believe stock selection is critical – particularly those companies with significant offshore exposures or plans to expand offshore. Valuations remain slightly expensive being mainly supported by a 4.7% dividend yield.

We suggest:
Remain underweight.
Valuations are above fair value and attractive growth or value opportunities are scarce.

International Equities

Global equities returned 1.4% in May in local currency terms. Japanese stocks continued to make fresh 15-year highs, rising more than 5% in May. The US market also posted new highs intra-month but fell back to to close 1.3% higher in May. Emerging markets shares lost 2.5% in local currency terms with the largest fall in Brazil.

Developed market valuations are no longer cheap in an absolute sense with price to earnings multiples around 17 times in the US and Europe. However equities are still attractive relative to other lower returning asset classes. Our preference is to move capital away from the United States to Europe where valuations are lower and for emerging markets exposure to be overweighted towards Asian equities.

We suggest:
Given high valuations maintain a neutral (unhedged currency) exposure to international shares.
Overweight Europe and Asia.

Fixed Income

Australian bonds were flat in May as longer term yields rose marginally. Three-year Australian government bond yields fell two basis points, after the RBA cut official interest rates early in the month, to 1.97% per annum and 10-year yields rose eight basis points to 2.74% per annum at month-end.

Internationally, the Barclays Global Aggregate Bond Index (A$ hedged) lost 0.3% as longer term bond yields rose in all of the major markets, except the UK where they were marginally lower. Credit spreads were a little wider for investment grade corporate bonds and marginally tighter for high yield bonds.

We suggest:
Overweight 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 0.19% in May as three-month bank bill yields fell from 2.25% to 2.15% per annum following the RBA rate cut in early May.

At the June RBA Board meeting, official interest rates were left unchanged and the tone of the commentary suggests that the next move in rates is data dependent rather than explicit wording to suggest that the RBA is biased toward further rate cuts, if needed.

Given some of the mixed economic data, for example weak investment intentions, money markets are currently pricing in a 60% chance of another 25 basis point rate cut in the next year.

We suggest:
Retain an overweight position.
Cash provides flexibility to buy other assets on a price pullback.
Bank term deposits preferred relative to government bonds and at-call cash.

Alternatives

Hedge funds posted returns of 0.3% in May in what was a difficult market for traders. The best performing strategy was merger arbitrage which returned 0.8% as US merger and takeover activity in May was the highest on record. Equity long/short funds that target growth companies suffered a loss of 0.5%.

At a time that equity and bond markets appear expensive, hedge funds continue to play an important role in portfolios with downside protection and low correlation.

We suggest:
Maintain a neutral position.
Manager selection remains more important than strategy selection.
Liquid alternative investments such as hedge funds remain favoured for incremental risk exposures.

Property

Returns from unlisted Australian core property funds were 9.5% in the 12 months to the end of April 2015. Average distribution yields range from 5.2% for retail property, 6.0% for offices and 7.4% for industrial property. REITs were mixed in May with Australian property securities up 2.9% while global REITs lost 1.4% in US Dollar terms.

Sentiment and capital flows are still favourable for commercial property, with the lower interest rate environment pushing property yields lower. Conditions in the leasing market are, however, more challenging with high vacancies in many office markets and continued pressure on shopping centre landlords for lower rents. 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.