# Asset allocation

The asset class called “alternative investments” is a something of a catch-all term in the sense that there is no single definition as to what makes an investment alternative as opposed to traditional. In general alternative investments will typically include hedge funds – funds that are designed to hedge against movements in markets. But alternative investments can also refer to strategies which are not hedged against market moves such as commodities, long / short equity funds and market trend-following funds. Additionally alternative investments can also include a range of investments that would otherwise be influenced by market direction if they were traded and listed such private equity, private debt, infrastructure, forests and property.

Because of the diversity of alternative investments, it is challenging for asset allocators to embed them within diversified portfolios. This is because there is no single “alternative investments” index to measure the risk and return attributes of the alternative investment universe. Additionally, it can be tough to generate forecasts of the potential returns from alternative investments and to work out whether alternative investments are more or less attractive than traditional asset classes at any point in time. This is because the returns from individual alternative investment funds (for example a market neutral equity hedge fund) tend to be heavily influenced by the skill of the particular fund manager in selecting investments rather than whether asset prices in general are relatively cheap or expensive. For these reasons our current overweight recommendation for alternative investments is partly based on other traditional asset classes being unattractive rather than the current economic and market environment being particularly conducive to alternative investment strategies as a whole.

# Asset allocation summary

| Asset Class | View | Comments |
|---|---|---|
| Cash | N | • Hold a neutral position<br>• Given the banks are no longer chasing term deposits there is less of an incentive to lock into term deposits compared with the flexibility of at-call cash |
| Fixed Income | – | • Stay underweight in fixed income<br>• Developed world government bonds are expensive and offer poor absolute value, so prefer products with limited interest rate risk<br>• We suggest an equal split between Australian and (hedged) international bonds<br>• 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<br>• Growth outlook is lower than other markets but valuations are now about fair value<br>• Favour selective industrials such as diversified financials, healthcare and utilities<br>• Prefer quality small and mid-sized companies with structural growth |
| International Equities | N | • Given higher valuations in developed market shares, hold a neutral weighting<br>• Maintain unhedged currency exposure for now<br>• Favour Europe and Japan over United States<br>• Emerging markets are cheaper than developed markets so maintain exposure and favour Asia over other regions |
| Alternatives | + | • Hold an overweight allocation<br>• 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<br>• At current pricing, Australian and international property appears fair value<br>• Favour international property securities over Australian |

## About our recommendations

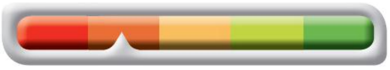
The asset allocation recommendations reflect NAB Private Wealth’s views on the relative attractiveness of the asset class over a 1–3 year holding period. A neutral allocation (orange) means hold a neutral strategic allocation to the asset class, single minus underweight (orange) or single plus overweight (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.

# Asset allocation

## Australian Equities

The S&P/ASX 200 Accumulation Index lost 5.5% in January. The market was impacted by declines in the materials, energy and financials sectors due to further commodity price weakness and selling by offshore investors. Defensive sectors such as telecommunications, utilities and REITs rose in January.

We remain positive on sectors such as diversified financials, healthcare and utilities. We are also positive on selected industrial and consumer discretionary stocks but stock selection is critical. Following the pull-back, equity valuations are more attractive, in line with longer term multiples, but stocks with attractive growth rates remain relatively expensive compared with market average valuation metrics.



**We suggest:**
**Remain underweight.**
**Valuations are fair value but attractive, sustainable growth opportunities are expensive.**

## International Equities

Global equities lost 5.4% in January in local currency terms with declines across all major markets, hurt by falling commodity prices and weak sentiment. Emerging markets shares fell by a similar amount, down 5.2% in local currency terms with a 23% fall in China.

With the decline in equity prices, price-to-earnings ratio valuations in developed markets have returned to the 14-16 times range, which is more attractive given the earnings outlook and bond yields. We prefer Europe where valuations are lower than the US and we also favour Asia and Japan, which offers better growth than other regions.

**We suggest:**
**Maintain a neutral (unhedged currency) exposure to international shares.**
**Overweight Europe and Asia.**

## Fixed Income

Australian bonds gained 0.7% in January as investors swapped into bonds pushing up prices. The 10-year bond yield fell from 2.89% to 2.67% per annum and the three year bond yield fell from 2.06% to 1.91% as investors worried that the financial turbulence would impact economic growth.

Internationally, the Barclays Global Aggregate Bond Index (A$ hedged) returned 1.7% as bond yields fell by 20-40 basis points in the major economies as investors priced in lower for longer official interest rates. Credit spreads continued to widen across all ratings with sub-investment grade spreads wider to yield 774 basis points over comparable US Treasury bonds due to increased fears of default – especially for resources and energy companies.

**We suggest:**
**Remain underweight with an equal split between Australian and international (hedged) bonds.**
**Corporate credit offers reasonable value given low default rates.**

## Cash

Australian bank bills returned 0.19% in January as three-month bank bill yields fell from 2.38% to 2.29% per annum as the low inflation reading for the fourth quarter provided scope for the RBA to cut interest rates if financial conditions should tighten in the months ahead, due to financial market volatility.

At the February RBA Board meeting, official interest rates were left unchanged, as expected. The RBA appears happy with the strength in the labour market and more subdued house price growth but continues to monitor international economic and market developments for any potential spill-over impact on the domestic economy.

**We suggest:**
**Hold a neutral position.**
**No preference for term deposits over at-call cash.**

## Alternatives

Hedge funds lost 2.8% in January in a volatile month for most asset classes. Funds that trade macro and trend-following strategies returned 0.9% over the month benefiting from downtrends in equity, currencies and commodity prices. At the other end of the return spectrum, equity long/short funds lost 4.5% with poor performance across all regions and styles, i.e. growth and value-based stock picking strategies.

**We suggest:**
**Retain an overweight 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 12.7% in the 12 months to the end of December 2015. Average distribution yields range from 5.4% for retail property, 6.0% for offices and 7.4% for industrial property. REIT prices were mixed with Australian property securities gaining 1.1% and global REITs losing 3.9% in local currency terms.

Sentiment and capital flows are still favourable for commercial property, with the lower interest rate environment pushing property yields and capitalisation rates lower, particularly in markets such as CBD A-grade office buildings. Conditions in the corporate leasing market are, however, more challenging with new supply in several markets, high vacancies and high lease incentives in many office markets and continued pressure on shopping centre landlords for lower rent.

**We suggest:**
**Remain neutral**
**Reduce weighting to Australia and increase international exposure.**

# About NAB Private Wealth

NAB Private Wealth is a part of National Australia Bank's Business Banking division. NAB Private Wealth offers a range of wealth management and transactional services to high and ultra-high- net-worth individuals. We have offices in all major states across the country and our capabilities include wealth planning, estate planning, investment advisory, relationship banking, capital markets, risk management, asset servicing, cross-border solutions, trusts and philanthropy. For further information visit www.nabprivatewealth.com.au

# About the NAB Private View

This information may be regarded as general advice. That is, your personal objectives, needs or financial situations were not taken into account when preparing this information. Accordingly, you should consider the appropriateness of any general advice we have given you, having regard to your own objectives, financial situation and needs before acting on it.

For further information regarding the content of this report, please contact your NAB Private Wealth banker, adviser, or contact NAB Private Wealth on 1800 060 172 (VIC/SA/WA) or 1800 771 523 (NSW/QLD). No part of this report should be reproduced in any form, or referred to in any other publication without express written permission of NAB Private Wealth.

The NAB Private View reflects the view of NPW strategy and solutions team on different asset classes and investment markets, after taking into account the views and research sourced from a variety of internal and external sources including JANA Investment Advisers, MLC Investment Management, ThreeSixty Research, NAB Wholesale Banking Global Markets Research, JBWere, leading buy-side fund managers, and sell-side research.

The Asset Allocation recommendations reflect the team's views on the relative attractiveness of the asset class over a 1–3 year holding period. A neutral allocation means hold a neutral strategic allocation to the asset class, single minus or single plus underweight and overweight recommendations are meant to rebalance the asset class progressively towards the bottom or top of the strategic asset allocation range using cashflows inflows or outflows to the portfolio. A double plus or double minus overweight or underweight recommendation is intended to be rebalanced to the top end or bottom end of the strategic asset allocation range immediately by selling some assets and buying others.

Opportunistic themes are designed to be implemented by clients who hold cash outside their strategic asset allocation portfolios to implement concentrated thematic investment ideas across short, medium, and long-term time horizons.

## Analyst Disclaimer

The person or persons named as the author(s) of this report hereby certify that the views expressed in the research report accurately reflect their personal views about the subject matters discussed. No part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in the research report. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Private Wealth Division of National Australia Bank Limited (ABN 12 004 044 937, AFSL 230686). The views of the author(s) do not necessarily reflect the views of the National Australia Bank Group ("NAB") and are subject to change without notice.

## New Zealand

In New Zealand the publication is for Bank of New Zealand internal use only

## Disclaimer