



## **Asset Allocation**

### **The Evans & Partners Approach**

**An investor entering the Australian equity market in December 1969 had to wait until September 1985 for the performance of their portfolio to start outpacing inflation.**

The risk of being in the wrong place at the wrong time remains a key consideration for any investor. We believe that diversification across a range of asset classes is the only appropriate foundation for a long term investment strategy. Asset allocation is the simplest and cheapest way to manage market volatility, preserve your capital and protect against the unknown (i.e. the risk of being in the wrong place at the wrong time).

At Evans & Partners, we try not to be too prescriptive with respect to determining a strategic asset allocation benchmark for our clients. One size doesn't fit all and as such we prefer to set down some guidelines which can then be used by our advisers and yourself to tailor an outcome that best suits your investment objectives. Every investor will have a unique set of objectives that encompass investment horizon, income requirements, capital growth requirements, risk appetite, stage of life, estate planning etc. All these issues have to be built into your investment strategy and reflected in your asset allocation.

#### **Life cycle considerations**

An investment strategy is determined by the interplay of a return objective, ones risk appetite and a time horizon. In most cases, the time horizon will reflect life cycle considerations where convention suggests younger investors, whose income requirements are being met by employment, should favour a growth-oriented investment strategy (i.e. an asset allocation with a high exposure to equities). For retirees, however, access to a sustainable income stream generally takes on more importance than maximizing capital appreciation, thus favouring a more conservative asset allocation.

While such life cycle considerations are key inputs into any investment strategy, they need not dominate. Ultimately, it is an individuals or family's willingness to absorb market risk, rather than their age, that should determine an appropriate asset allocation. In this regard, we have found that many retirees are quite comfortable maintaining a relatively high exposure to equities given that a high-quality portfolio will deliver a growing and tax-effective income stream.

#### **The role of alternative investments**

Over the past decade, alternative investments have moved into the mainstream and are now commonplace in private, as well as institutional, portfolios. "Alternative investments" is a term that captures any asset class or portfolio strategy that falls outside a vanilla investment in equities, fixed interest, property or cash. As such, it includes assets such as private equity, high yield debt and emerging markets and a broad range of investment strategies that can utilize gearing, short selling, derivatives and a multi-asset class focus.

The term "hedge fund" relates to fund managers that employ these alternative strategies. In most cases, hedge funds operate with an absolute performance objective (i.e. aiming to always deliver a positive return) rather than a relative performance objective (i.e. aiming to do better than a particular market benchmark regardless of whether it is rising or falling).



The other common feature of most alternative investments is that the fee-structures are significantly more expensive than those applied to mainstream asset classes and investment strategies. As such, it is critical to assess the risk/return benefits which an alternative investment may bring to a portfolio on an after-fee basis.

It is now common for “*alternative investments*” to be classified as an asset class in its own right and incorporated into a traditional asset allocation framework. **We do not believe this is appropriate.** The value of alternative investments can only be assessed on a product-by-product basis. Each will have a unique risk profile, return profile, correlation with mainstream asset classes, fee structure, pay-out structure and liquidity requirements. As such, we believe that the suitability of alternative investments is best assessed at the individual level when your adviser is tailoring an investment strategy to meet your particular needs.

Another key consideration when assessing the suitability of alternative investments is that they can often be complex and lack transparency. No one should invest in a product or security they don't understand, hence our reluctance to automatically incorporate alternative investments into our asset allocation framework.

From a portfolio perspective, the theoretical attraction of alternative investments lies in their capacity to provide returns that have a low correlation with equity markets. As such, an appropriately constructed portfolio of alternative investments can bring diversification benefits to a balanced portfolio (i.e. lower the overall volatility of returns).

### **The role of tactical asset allocation**

Tactical asset allocation refers to an investment strategy where you try to capture a short term gain via favouring one asset class over another (e.g. sell shares and accumulate cash). While attractive in theory, it is a tough game to play in reality. To be consistently successful, you have to correctly predict the short term performance of each asset class, ranking them from best to worst, while also incorporating views on currency and interest rate moves. This is a lot to get right.

Again, at Evans & Partners we prefer not to be too prescriptive with respect to tactical asset allocation. We certainly provide research and views on the absolute and relative outlook for each asset class. In the event that we were to see a material realignment in absolute and/or relative valuations, we would not hesitate to recommend that our clients “*sell equities*” or “*buy bonds*”. It would be up to your adviser and yourself as to whether this recommendation is relevant to your circumstances.

***In seeking to enhance investment returns, we also believe there is more to be gained from getting the portfolio construction right within each asset class than there is trying to make short term trading calls between the asset classes.*** For example, if we were to believe that the Australian equity market was expensive, our skills and resources are best used looking for ways to efficiently reduce any valuation stress within your portfolio, or devise strategies to protect gains, than trying to pick the day the market will peak. For those investors seeking to exploit tactical opportunities, the combination of financial innovation, an increasingly dynamic global economy and the natural volatility of the market will ensure a constant flow of ideas that we can easily incorporate into portfolios.

### **The importance of portfolio construction**

Having tailored the appropriate asset allocation, it is critical that all the good work is not compromised by poor portfolio construction.



For each asset class, the portfolios must be populated in a manner that is consistent with the risk/return profile underpinning the asset allocation decision. For example, for those where a relatively conservative asset allocation strategy has been deemed appropriate, it would be counterproductive to have a relatively high risk (i.e. high beta) equity portfolio or an equity portfolio with an excessive exposure to stocks that are sensitive to interest rate movements. In the latter case, a rising interest rate environment would not only hurt the performance of a fixed interest portfolio (to which a conservative investor would have a relatively high exposure) but also the equity portfolio. The diversification benefits being sought via the asset allocation strategy would therefore be reduced.

Similarly, the performance of investments in corporate debt securities or hybrid securities is closely linked to the market's perception of corporate credit quality which is in turn linked to the market's views on corporate profits and the general outlook for business conditions. Accordingly, the performance of corporate debt/hybrids and the equity market can be highly correlated. As a result, it is inappropriate to populate a fixed interest portfolio solely with corporate paper. Government bonds may come with a lower yield, but their diversification benefits are material. Government bonds will appreciate in price (i.e. bond yields will fall) when economic conditions are weak and equity markets are struggling. In our asset allocation framework (see below), we recommend that the majority of the fixed interest allocation is devoted to government and semi-government securities.

### **Evans & Partners: Asset Allocation Framework**

Our asset allocation framework is outlined in Table 1. As noted previously, these various portfolios should be taken as a guide. Every investor will have a unique set of objectives that encompass investment horizon, income requirements, capital growth requirements, risk appetite, stage of life, estate planning etc. All these issues have to be built into your investment strategy and reflected in your asset allocation.

Table 2 provides an insight into the personality of each of the eight portfolios, both from an historic perspective and a forward looking perspective. Chart 1, plots the performance of each portfolio over the past decade on a risk (i.e. the standard deviation of annual returns) and return basis.

### **Asset Class Performance: Our long term expectations**

While history can provide a degree of insight into the personality of each asset class and their relationship with each other, it can also be very misleading.

Over the long term, the performance of all asset classes is ultimately derived from the prevailing nominal economic environment. The pace of nominal economic growth (i.e. the \$ value of all goods & services produced) determines the appropriate level of interest rates and the strength of corporate revenue growth. Not only will the nominal economic environment vary from year to year (the business cycle) but over the past 50 years there has been a number of distinct phases where we have seen the strength and/or character of the nominal economy undergo a structural shift. Such shifts have a major impact on asset class performance and thus, for a particular generation of investors, can foster a misleading impression about risk and return.

Using Australia as an example, the shifts in the nominal environment over the past 50 years have been stark. The 1960's was characterized by solid economic growth and low

**Table 1: Evans & Partners Asset Allocation Framework**

(Note. Directly held property assets should be funded from the allocation to fixed interest and/or cash)

		Fixed Interest	Conservative	Conservative ~ Plus	Moderate
<b>CASH</b>		<b>20.0%</b>	<b>18.0%</b>	<b>12.0%</b>	<b>10.0%</b>
<b>FIXED INTEREST</b>		<b>65.0%</b>	<b>58.0%</b>	<b>52.0%</b>	<b>44.0%</b>
<i>Government Debt</i>	75%	<b>48.8%</b>	<b>43.5%</b>	<b>39.0%</b>	<b>33.0%</b>
<i>Corporate Debt</i>	25%	<b>16.3%</b>	<b>14.5%</b>	<b>13.0%</b>	<b>11.0%</b>
<b>DIRECT REAL ESTATE</b>		<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>
<b>EQUITIES - Australia</b>		<b>15.0%</b>	<b>24.0%</b>	<b>30.0%</b>	<b>34.0%</b>
<i>Industrials</i>	75%	<b>11.3%</b>	<b>18.0%</b>	<b>22.5%</b>	<b>25.5%</b>
<i>Resources</i>	25%	<b>3.8%</b>	<b>6.0%</b>	<b>7.5%</b>	<b>8.5%</b>
<i>REITs</i>	0%	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>
<i>Convertible securities</i>	0%	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>
<b>EQUITIES - Global</b>		<b>0.0%</b>	<b>0.0%</b>	<b>6.0%</b>	<b>12.0%</b>
<i>Currency Hedged</i>	50%	<b>0.0%</b>	<b>0.0%</b>	<b>3.0%</b>	<b>6.0%</b>
<i>Currency Unhedged</i>	50%	<b>0.0%</b>	<b>0.0%</b>	<b>3.0%</b>	<b>6.0%</b>
		<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
		<b>Moderate ~ Plus</b>	<b>Aggressive</b>	<b>Aggressive ~ Plus</b>	<b>Equity</b>
<b>CASH</b>		<b>8.0%</b>	<b>6.0%</b>	<b>6.0%</b>	<b>4.0%</b>
<b>FIXED INTEREST</b>		<b>38.0%</b>	<b>32.0%</b>	<b>20.0%</b>	<b>8.0%</b>
<i>Government Debt</i>	75%	<b>28.5%</b>	<b>24.0%</b>	<b>15.0%</b>	<b>6.0%</b>
<i>Corporate Debt</i>	25%	<b>9.5%</b>	<b>8.0%</b>	<b>5.0%</b>	<b>2.0%</b>
<b>DIRECT REAL ESTATE</b>		<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>
<b>EQUITIES - Australia</b>		<b>38.0%</b>	<b>42.0%</b>	<b>44.0%</b>	<b>44.0%</b>
<i>Industrials</i>	75%	<b>28.5%</b>	<b>31.5%</b>	<b>33.0%</b>	<b>33.0%</b>
<i>Resources</i>	25%	<b>9.5%</b>	<b>10.5%</b>	<b>11.0%</b>	<b>11.0%</b>
<i>REITs</i>	0%	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>
<i>Convertible securities</i>	0%	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>
<b>EQUITIES - Global</b>		<b>16.0%</b>	<b>20.0%</b>	<b>30.0%</b>	<b>44.0%</b>
<i>Currency Hedged</i>	50%	<b>8.0%</b>	<b>10.0%</b>	<b>15.0%</b>	<b>22.0%</b>
<i>Currency Unhedged</i>	50%	<b>8.0%</b>	<b>10.0%</b>	<b>15.0%</b>	<b>22.0%</b>
		<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

inflation. The 1970's by patchy growth and soaring inflation. The 1980's by stronger growth, but still high inflation. The 1990's by strong growth and disinflation and the bulk of the 2000's by very strong growth and a slight pick-up in inflation. At its high point during the 1970's & 80's, nominal economic growth settled in a 12%-16% range (hence the very high interest rates of the period). By the end of the 1990's, nominal growth had come back into a 5%-6% range (hence, the steady reduction in interest rates through that decade).

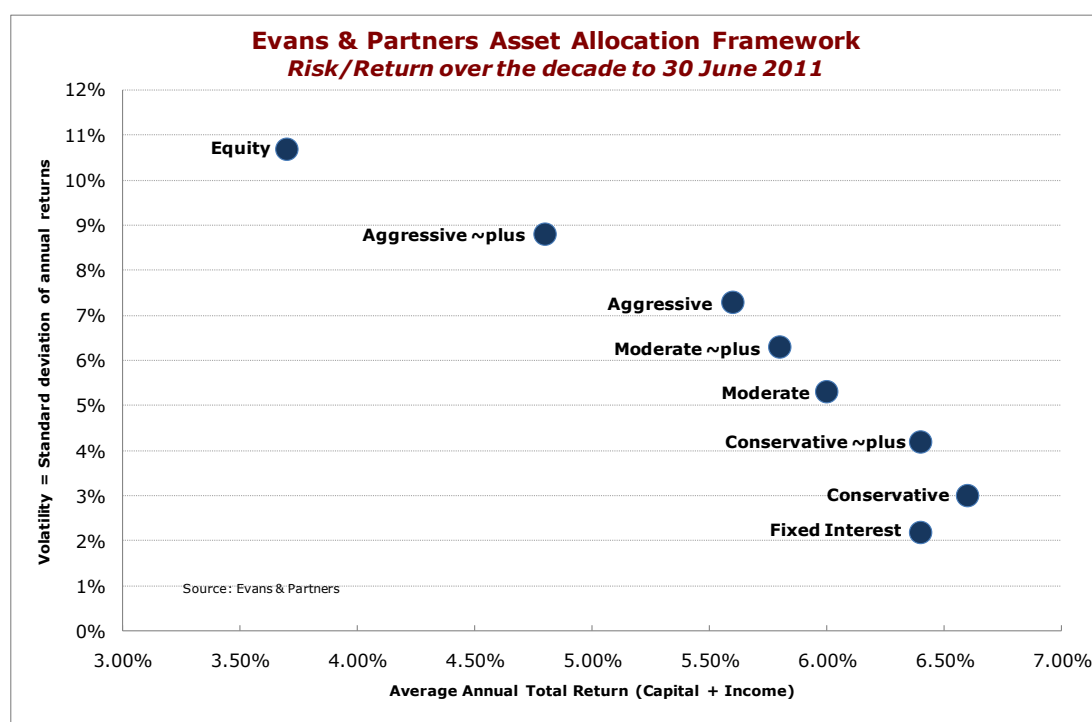
When considering the outlook for asset class returns, the level of interest rates (which is determined by the strength of the nominal economic environment) is the critical input. The prevailing 10 year government bond yield is of particular importance as this is the benchmark risk free return available to all investors. Accordingly, when valuing the cash flow generated from a company, a corporate bond or a property, the first step is to compare the expected return with that on offer from the 'risk-free' alternative.

In general, when the 10 year government bond yield is high and/or rising (refer the 1970's & 80's), it will depress the present value of the cash flows available from other asset classes (e.g. price/earnings multiples will contract). When the long term yield is low and/or falling (refer the 1990's), it will generally boost the valuation of other financial assets (e.g. price/earnings multiples will expand). It is this relationship that can distort the historic profile of financial asset returns.

**Table 2: Evans & Partners Asset Allocation Framework - Performance Characteristics**

PORTFOLIO	Performance History (Period ending 30 June 2011)						Future Performance Expectations	
	Average Annual Return			Average Annual Volatility			Return	Volatility
	3yr	5yr	10yr	3yr	5yr	10yr		
<b>Fixed Interest</b>	6.3%	6.0%	6.4%	2.4%	2.2%	2.2%	6.5%	2.9%
<b>Conservative</b>	5.6%	5.7%	6.6%	3.5%	3.2%	3.0%	6.8%	3.7%
<b>Conservative ~ Plus</b>	4.5%	5.1%	6.4%	5.2%	4.7%	4.2%	7.2%	4.1%
<b>Moderate</b>	3.5%	4.4%	6.0%	6.7%	6.1%	5.3%	7.6%	4.9%
<b>Moderate ~ Plus</b>	2.7%	3.9%	5.8%	8.0%	7.2%	6.3%	8.3%	5.9%
<b>Aggressive</b>	1.9%	3.4%	5.6%	9.3%	8.3%	7.3%	8.2%	6.7%
<b>Aggressive ~ Plus</b>	0.4%	2.4%	4.8%	11.2%	10.0%	8.8%	8.6%	8.5%
<b>Equity</b>	-1.4%	1.0%	3.7%	13.5%	11.9%	10.7%	9.1%	10.1%

Source: Evans &amp; Partners



Thus, while not ignoring history, we feel it is wise to work with a set of risk/return assumptions for each asset class that are based on a particular view of how the nominal economic environment will look as we move into the next decade and beyond. These assumptions are presented in Table 3.

Looking past the deep global recession of 2008/2009, we expect nominal economic conditions will be firmer in the decade ahead; a result of strong growth in the emerging economies and higher inflation. Accordingly, the level of interest rates will be at least in line with what has prevailed over the past decade. Given such an environment, we believe annual equity market returns will average around 9.5%. This figure is based on the assumption that an equity market will deliver a return that matches the average cost of capital of its constituent companies. In a world where the long term government bond yield is ~5.75%, the equity risk premium ~5.8% and the cost of debt funding ~7.5%, the weighted average cost of capital will be ~9.5%.

On the risk/volatility side, we view the low risk/high return environment that prevailed through the bulk of the 1990's and 2000's as an anomaly. This was painfully rectified by the 2008/2009 global recession. The resulting reassessment of risk – across all asset classes – will not be quickly forgotten. Accordingly, we believe that asset class volatility in the decade ahead will remain relatively elevated, particularly for the Australian equity market which is now leveraged to the performance of emerging economies. If the global economy is in fact moving into a period of stronger nominal activity, then the transition –



from the depressed environment of 2009 - will inevitably accentuate asset class volatility via the impact of higher interest rates and inflation on the business cycle, asset valuations and risk premia.

**Table 3. Asset Class Performance Characteristics**

	Performance History (Period ending 30 June 2011)						Future Performance Expectations	
	Average Annual Return			Average Annual Volatility			Return	Volatility
	5yr	10yr	15yr	5yr	10yr	15yr		
<b>Inflation</b>	3.0%	3.2%	2.7%	na	na	na	2.75%	na
<b>Cash</b>	5.6%	5.4%	5.5%	0.4%	0.3%	0.3%	5.75%	0.35%
<b>Government Debt</b>	6.5%	6.2%	7.1%	2.9%	2.9%	3.3%	6.00%	3.50%
<b>Corporate Debt</b>	na	na	na	na	na	na	7.00%	4.75%
<b>Australian Equities</b>								
<b>ASX300</b>	2.4%	7.2%	9.4%	15.9%	13.5%	13.1%	9.50%	13.25%
<b>ASX300 Industrials</b>	0.3%	4.9%	8.9%	16.1%	13.3%	13.1%	na	na
<b>ASX300 Resources</b>	8.2%	16.4%	13.3%	22.7%	21.1%	21.5%	na	na
<b>REIT's</b>	-10.6%	1.8%	5.8%	22.8%	17.3%	15.7%	7.50%	10.50%
<b>Global Equities</b>								
<b>Local currency</b>	1.1%	2.3%	5.2%	17.0%	15.4%	15.4%	9.50%	12.75%
<b>Australian Dollar</b>	-5.7%	-4.1%	2.7%	12.4%	12.3%	13.0%	9.50%	12.75%

Source: Evans & Partners, ABS, UBS, ASX, MSCI.

## Conclusion

When designing an investment strategy, asset allocation and portfolio construction are the two critical inputs. This discussion has highlighted the issues that need to be addressed when establishing an optimal asset allocation for your individual requirements. Your Evans & Partner Adviser will assist you through this process. More importantly, they will also undertake regular reviews to ensure that your asset allocation strategy remains aligned with your objectives.

**Mike Hawkins**

**Chief Investment Officer**

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