Four fundamental portfolio construction decisions

Will Jackson | PortfolioConstruction Forum | 06 March 2017

Markets Summit 2017 brought together 21 leading investment thinkers from around the world, delivering high conviction ideas on how "The winds of change" are affecting the outlook for economies and asset classes – and the implications for portfolios.

To convert the Faculty's insights into practical portfolio construction decisions, delegates were asked to imagine that, in a month, they would be participating in an investment committee where they would be asked to make four fundamental asset allocation decisions for a multi-asset portfolio for a medium-term horizon, and to support their decisions with a rationale:

1. Growth assets: long or short?
2. Equities: over- or under-weight US?
3. Real assets and Alternatives: increase or decrease?
4. Debt: long or short duration?

As well as giving their immediate decisions at Markets Summit, delegates were invited to continue to investigate afterwards, using the materials in the online Markets Summit 2017 Resources Kit, to arrive at a final decision on each issue.

FACTORS TO CONSIDER

Tim Farrelly, principal of specialist asset allocation research service, farrelly's Investment Strategy, offered further guidance on how to tackle the four questions. Referring to the overarching theme of Summit, Farrelly noted that the recent – and long-awaited – upturn in Federal Reserve interest rate forecasts had fuelled growing expectations for a similar inflection point in monetary policy. But he urged delegates to question whether the inflation and rates outlook had changed fundamentally.

Noting that the "winds of change" were undeniably blowing through geopolitics, Farrelly recommended delegates consider the implications of rising populism in the developed world, including the likely impact of President Trump's policies on US corporate profits, the probability of trade wars, and whether the much-feared prospect of a eurozone break-up should in fact be viewed as desirable over the longer term given the flawed structure of the currency union. He noted that many portfolio construction practitioners struggle to convert geopolitical threats and opportunities into practical investment decisions – so he instead proposed an approach where increased allocations to domestic and real assets may be used to hedge against a general rise in uncertainty. "[These] are all things you might want to do as a sensible decision around portfolios, just on the basis that uncertainty has gone up – without having any view this is necessarily going to pan out," he said.

However, for Farrelly, the biggest consideration for investors remained interest rates, given the significant impact that rate changes might have on returns from bonds, term deposits, property, infrastructure and equities. Farrelly encouraged delegates to formulate a view on whether Australian government bond yields would rise substantially from recent levels – to the "old normal" of 5% to 6% – or would remain closer to a "new normal" of 3% to 4%.

Farrelly also discussed expectations for a "great reflation" in the US, and questioned whether such an effect would be easily transmitted around the world or would simply manifest in a stronger US dollar. Australian inflation would more likely be driven by Australian wage growth, he argued.

Regarding Australian sovereign debt valuations, calculations by Farrelly suggested that longer-dated bonds may represent an attractive investment, relative to shorter-dated securities.

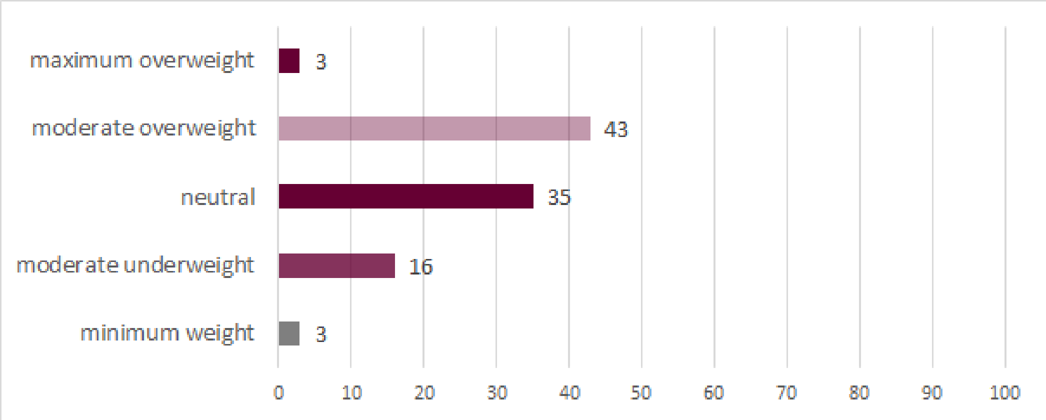
On equities, Farrelly noted that Australian and US stocks tend to command higher price/earnings (P/E) ratios when government bond yields are low, and that both markets appear fully-valued on this measure, relative to history. Equity bulls therefore would need to be confident that interest rates and inflation will not rise sharply from recent levels and that – in the case of US equities – Trump's policies will revive American corporate profits.

On real estate, Farrelly argued that – barring a sharp increase in interest rates – Sydney prime commercial property may represent good value and, additionally, provide protection against geopolitical risk. Similarly, domestic residential property, infrastructure and gold may offer insurance against negative events elsewhere in the world, he concluded.

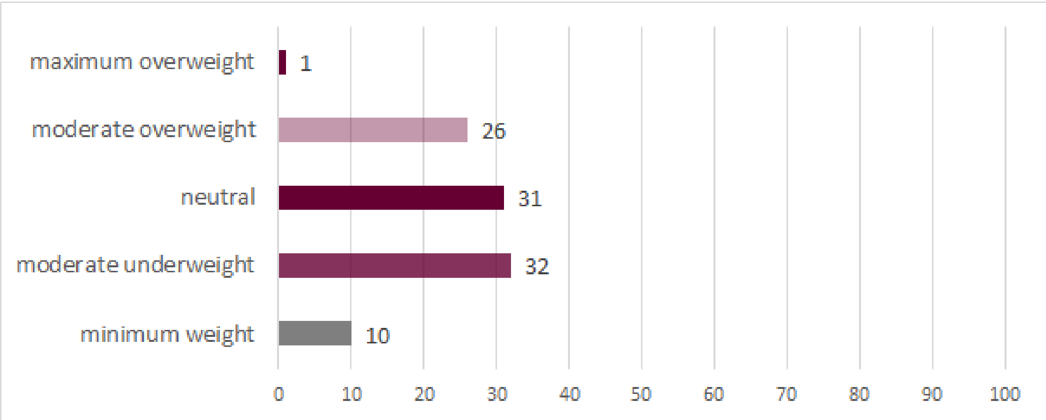
MARKETS SUMMIT DELEGATE VIEWS

Polling conducted towards the end of Markets Summit revealed that, in aggregate, delegates had little appetite for long duration bonds, relative to short-dated securities and cash. They were somewhat bullish on growth assets in general, but cautious on US equities. And while there was no clear trend in relation to property and infrastructure, a substantial minority viewed gold exposure as attractive.

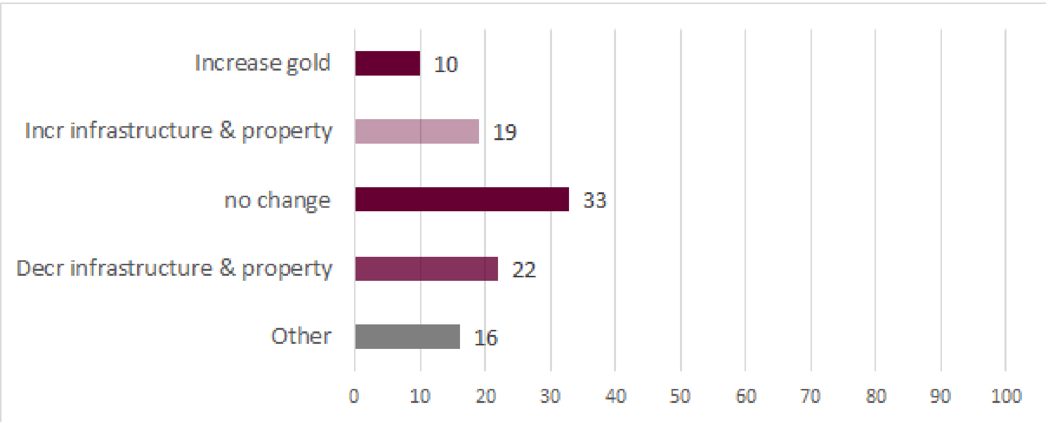
Decision 1: Growth assets – long or short?



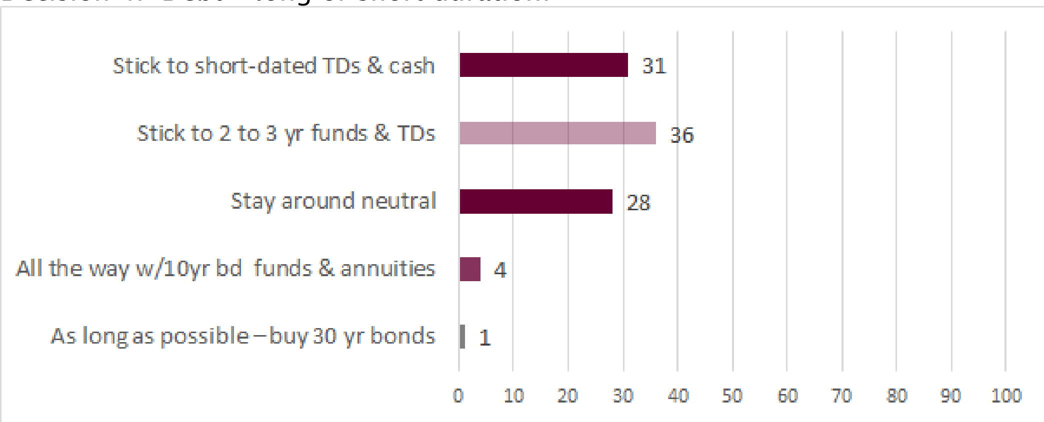
Decision 2: Equities – over- or under-weight US?



Decision 3: Real assets and alternatives – increase or decrease?



Decision 4: Debt – long or short duration?



After Markets Summit, we also asked a panel of nine senior practitioner delegates what they'd decided – and their rationale...

Growth assets – long or short?

In line with the broader delegate views shown above, our panel of nine portfolio construction practitioners are largely positive on growth assets over the medium term.

Giselle Roux, chief investment officer of Escala Partners, and Peter Eichmann, partner at Sydney financial advisory firm, Park Street Group, both view growth assets as attractively priced, with Roux noting that "there are enough sectors/regions without excess valuation".

Meanwhile, Fil Andronaco, an asset consultant at InvestSense, is overweight growth assets – but wary on the outlook. "[I'm] currently long but would begin to progressively reduce," said Andronaco. "On a forward-looking basis, implied returns from growth assets offer better long-term return prospects than cash or bonds. But in risk-adjusted terms, growth assets are looking stretched with some pockets of relative value. In our view, the prospects of a reasonably significant drawdown are higher than they were a matter of months ago given where valuations have moved to."

Among those who are underweight growth assets, senior investment research analyst Hamish Bell of ClearView/Matrix, said he would need to see "a decent correction" before moving overweight. Growth assets are fully-valued on most long-term measures, he said, citing Shiller P/Es, Tobin's Q and total market cap to gross national product ratios. And while the election of Donald Trump had unlocked some animal spirits and US consumer sentiment appears robust, Bell remains cautious, citing the long-term headwinds facing the world's largest economy, including massive indebtedness, low productivity and adverse demographics. "The current rally could continue. But we want a bit of good old-fashioned Benjamin Graham 'margin of safety'," he added.

Chris Molloy, chief investment officer of Morrows Private Wealth, is upbeat on the near-term prospects for growth assets, but similarly bearish on a medium- to long-term time horizon. "[We are] happy to be long over the next three to six months, on the back of Trump optimism," Molloy explained. "[But] growth assets are expensive by historical measures and the cycle is looking mature, so the downside risk far outweighs the upside return potential, in our view. Preserving capital is more important to us than chasing high risk returns in the current environment. Investors need to ask the question "Are we being adequately rewarded for taking on risk at this point in time?", he concluded.

Equities - over- or under-weight US?

Our panel of nine practitioners are predominantly bearish on US stocks. Even those who are broadly overweight risk assets have underweight exposures to the region - reflecting their view that US valuations are stretched, relative to other markets.

Dinyar Irani, a research manager with Innova Asset Management, is neutral on growth assets and underweight US equities. "[I am] underweight US equities on relative valuation grounds, though cognisant of risk of a bubble emerging in [the] US stock market, due to increased eurozone fears and hot money flows to US dollar-denominated assets," Irani said. Such "hot money flows" are more likely to go towards US equities than bonds, he added.

Amongst the other members of the panel, one emphasised the need for careful stock selection in the US following the market rally - "an active manager rather than ETFs would be more suitable," he proposed. Others queried the validity of the question, given that they assess equities from a global standpoint and avoid making regional calls. "Equities - US or non-USD - misses the point somewhat," one argued. "The best companies on a global perspective should be chosen first, currency [is a] secondary consideration." Currency hedging may be achieved via an overlay, and would become attractive if the USD/AUD rate declines to 0.65, he added.

Real assets and alternatives - increase or decrease?

There was broad appetite among the nine practioners for property and infrastructure, despite some concern over valuations.

"[I am] keeping steady in property and infrastructure, [and] ignoring commodities, futures, gold," said one. "My client base is retirees. This is a mixture of wanting stable and rising income, stable asset values and sleep-at-night portfolios. Although good diversifiers, some of these assets are very volatile in nature - that is, it is possible to make significant losses - so they fail the sleep-at-night criteria. Others such as property and infrastructure are interest rate-sensitive but provide the inflation-linked income and values my clients need."

Regarding alternatives, Molloy and Andronaco both advocate the use of strategies which are lowly-correlated to traditional assets. Brad Matthews, principal of Brad Matthews Investment

Strategies, was similarly upbeat on non-traditional approaches. "With real interest rates so low, alternatives need to take on a larger role in portfolios than has traditionally been the case," Matthews said. "Their hurdle rate of return to justify inclusion is relatively low in this environment."

Bell said he is seeking to reduce his overweight to listed infrastructure but does not view hedge funds as a suitable replacement. "Once you put a two-and-20 [fund fee structure] handicap on anything it's very hard to see alpha come out the end for clients," Bell said. "We're looking at things that may have a structural advantage, such as [catastrophe] bonds and global micro equities."

Roux was similarly wary. "Too many [practitioners] are hoping that alts will cover what fixed income has and/or compensate for them making a call on equities. That's a cop out," she added.

Debt - long or short duration?

The views of the nine practitioners on duration largely ran in line with the broader delegate view at Summit - strongly favouring short-dated bonds and cash, although some foresee a buying opportunity in longer-dated debt.

Molloy argued that, while interest rates are unlikely to rise to the "old normal", long duration bond holders will nevertheless experience capital losses. "Long duration government bonds are no longer the 'risk-free' asset and just because they have always been included in traditional [asset allocation] models doesn't mean that they will reward investors over the next five to 10 years," he said. However, while better opportunities currently exist elsewhere, Molloy speculated that a spike in yields, triggered by rising inflation, may allow investors to accumulate long-dated bonds at attractive prices, in advance of the next market downturn/recession. His view was echoed by Bell, who said he would likely increase his exposure to Australian duration "if yields go much higher".

For Roux, the duration decision depends on what the bond allocation is designed to achieve within the multi-asset portfolio. For stock-heavy portfolios, interest rate-sensitive, longer-dated bonds may be appropriate, she said, given their role is to offset equity volatility. In contrast, short-dated securities may be suitable for bond-heavy portfolios, given such mandates are likely to have more conservative income and capital stability goals. Roux additionally sees value in using flexible, go-anywhere fixed income funds. "It's been the unconstrained global strategies that have shot the lights out, year-to-date - those that held their nerve on high yield, or took on [treasury inflation-protected securities] and [residential mortgage-backed securities] or judged where to go in [emerging market] debt. These will move quite rapidly on duration as they see fit. If they can judge this, it makes a big difference as we have seen recently, with bond yield moving at beck and call to Twitter news," she added.

What's your view?

Make your own decisions on the four fundamental decisions for a medium-term multi-asset portfolio - and if you're not sure of your view, you can investigate further using the online Markets Summit 2017 Resources Kit (whether you attended the live program or not).

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