Timely review of asset allocations key to investment returns

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Asset allocation — how individual investors allocate their savings across the main asset classes — is a key determinant of investment returns.

Selection of a preferred asset allocation can relate to any one of three time periods:

● Strategic asset allocation sets longer-term guidelines for the investor's portfolio.

SAA needs to take account of both the prospective returns and volatilities of the main asset classes over the longer-term and the individual investor's tolerance of risk.

● Dynamic asset allocation takes a medium-term horizon — say two to three years — and looks for relatively minor shifts in asset allocations to cope with potential cyclical turning points in investment markets or with apparent misprising in one or more of the asset classes.

● Tactical asset allocation has a shorter timeframe. It comes into play when an investor considers there to be a serious anomaly in market pricing and expects the misprising to be soon corrected.

For today's purpose let's look exclusively at dynamic asset allocation for 2016.

The conclusions I draw suggest investors might consider being a bit overweight in their allocation to shares, particularly overseas shares, while maintaining a good allocation to interest-bearing assets, though at the same time being underweighted to bonds.

And the considerations I've set out relate not just to their implications for asset allocation but also to the selection of particular investments for the main asset classes.

Cash

With interest rates at exceptionally low levels, setting preferred allocations for cash and bonds is unusually perplexing. The US is likely to increase its cash rate several times in the next 12 months — but from a near-zero base.

The eurozone seems on course to lower its cash rate into deeper negative territory. In Australia our cash rate could be left unchanged. There's not much cheer for investors holding cash and term deposits — but the current outlook for cash rates hardly seem a threat to share or property markets.

However, bond yields could well rise cyclically as global growth picks up a little in 2016 and as the fears of worldwide deflation further dissipate. And, of course, if market yields rise, market prices of bonds, especially long-dated bonds, must decline.

In a blog called “The end of the latest deflation scare”, Gavyn Davies of Fulcrum Asset Management provides a useful overview of the main influences on bond markets: global industrial production has started to rebound; inflation rates in advanced economies have stopped falling; inflation expectations in markets have started to rise again; and China’s devaluation risk has abated for now.

Bonds

I’d suggest investors allow for at least a modest sell-off in bonds in 2016; favour absolute return bond funds over bond funds that use market returns as their benchmark; consider the better yields available on corporate bonds where the issuer has a sound reputation; shop around for the best rates that banks, cash management trusts and credit unions are offering at the time; and maintain a good holding of interest-bearing investments even though the return will be frustratingly modest.

Shares

Doubtless, many investors are considering cutting back on allocations to shares. That’s because markets are trading at relatively high valuations in price-to-earnings terms, and many companies are finding it much harder to grow earnings and dividends.

It’s important to look at the wider picture. Growth rates in the US, Europe and Australia seem to be picking up a little. The Chinese economy appears to be stabilising. Even with prospective rises in the US cash rates and higher bond yields, interest rates in most countries are likely to remain well below averages for recent decades. Dividend yields appeal to investors. And many companies are well cashed up.

Those considerations would point to positive but moderate returns from shares in the next year or two. But sharemarkets are also likely to be highly uneven by country, sector and individual stocks. Australian investors need take note of the heavy concentration of our market towards banks and resource companies, both of which still face headwinds.

Earnings in resource companies are being seriously crimped by the low commodity prices resulting from global oversupplies — which show very few signs of being cut back. Bank shares offer attractive — and in my view maintainable — dividends but further growth in their earnings and dividends are likely to be modest.

Mid-cap and small cap shares

Australian investors might also look to the investment opportunities offered by a selection of medium-sized and smaller listed companies.

I’d remind readers that I chair (and hold shares in) QV Equities, which is a listed investment company that invests in ASX 300 companies other than the top 20 stocks. That large group of medium-sized and smaller companies — which account for 40 per cent of our sharemarket by market capitalisation — includes a number of businesses with good prospects of growing their earnings, are (or soon will be) paying dividends mostly with franking credits and which, relative to the market leaders, are under-researched.

Offshore stocks

Australian investors tend also to be underweight in foreign stocks, which can provide wider access than is available from local companies to growth industries. Some of the industries where offshore markets such as the US offer a much wider choice in stocks would include healthcare including pharmaceuticals, technology, social media and brand names.

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