Timing key to successful asset allocation strategy

- DON STAMMER

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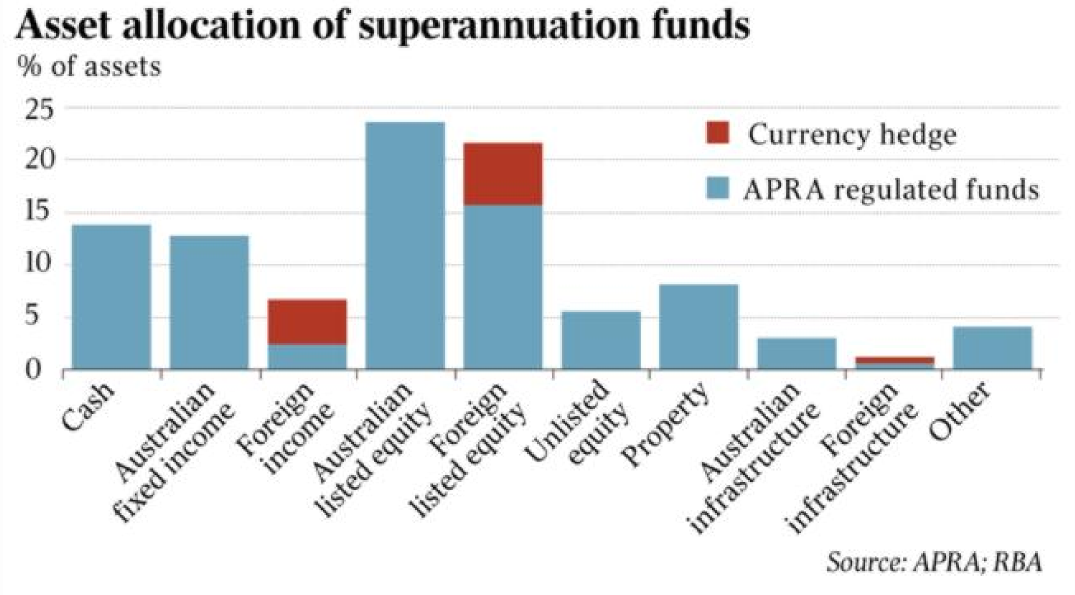

Asset allocation of super. *Source:* TheAustralian

Asset allocation is about choosing the mix of asset classes — such as shares, bonds, property and cash — that best suits the needs of each investor.

Asset allocation is often acknowledged as the key driver of investment returns.

Let’s look at the challenge of asset allocation in the exuberant markets of mid-2015.

Many successful investors think about their asset allocation over three time periods.

● First, they have a strategic asset allocation that sets the long-run framework of their portfolio — and takes account of the perceived long-term returns and volatilities of the individual asset classes, as well as their tolerance for risk.

● Second, dynamic asset allocation takes a medium-term horizon. It’s employed from time to time by investors with a high conviction there is significant mispricing in one or more asset classes — and who expect a return to “fair” or “normal” values over, say, three to five years.

● Third, tactical asset allocation has a short time horizon, usually a few months. The aim is to boost returns by temporarily reallocating some funds between asset classes because of what are seen as short-term anomalies in market pricing.

Here are some thoughts on what investors might consider when reviewing their asset allocations in a world of global monetary stimulus and highly priced asset markets.

● Starting with strategic asset allocation, Australian investors in general are over-invested in Australian shares and under-invested in overseas shares.

Self-managed superannuation funds have 31 per cent of their assets in Australian shares and less than 0.5 per cent in overseas shares. Shares in Australian companies can deliver valuable franking credit, and it's easier to keep the shares under close watch — but they provide less opportunity for investing in growth industries such as health, technology and pharmaceuticals.

As well, strategic asset allocations should allow for the risk of inflation picking up in coming years, as effects are felt from the global monetary stimulus and from the next cyclical recovery in global growth. Shares and property usually give effective protection against the impact of modest inflation, but investors — particularly those managing super savings — might also consider allocations to inflation-linked bonds, floating rate notes and infrastructure assets, which generally provide more effective hedges against inflation.

Investors might also consider making specific allocations to emerging economy shares given these countries are on stronger growth paths than those of the high-income countries.

In Australia, investors have traditionally focused on the leading companies — and might also consider a specific allocation to holding shares in smaller companies.

● Next to dynamic asset allocation. Given how far bonds have rallied, some investors might feel it's appropriate to consider cutting back on allocations to bonds and holding more in the way of floating rate securities, including residential mortgage-backed securities.

Yields on those assets are now low, but they enable investors to avoid the losses on long-dated bonds as interest rate increase.

● Finally, some suggestions to consider under the heading of tactical asset allocations. As mentioned earlier, valuations of most asset classes have become stretched in recent months, mainly due to the huge monetary stimulus by the major central banks.

In the past week, bond valuations have been pushed even higher by the European Central Bank beginning its program of quantitative easing and by renewed expectations the US central bank will be raising its cash rate very slowly.

Investors who remain broadly positive towards shares, but also feel share valuations have run ahead too far and too quickly, might consider taking some profits on their share investments, building up cash holdings, and awaiting opportunities to move back to being fully invested in shares when prices are lower.

At the least, share investors might consider letting dividend receipts build up as additional cash balances — to be invested in shares on market weakness.

Many investors expect the Australian dollar to fall further, particularly against the US currency. Investors who take this view, and are underweight to assets denominated in US dollars, might like to consider additional tactical exposure to US dollar assets.

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund and Altius Asset Management. The views expressed are his alone.