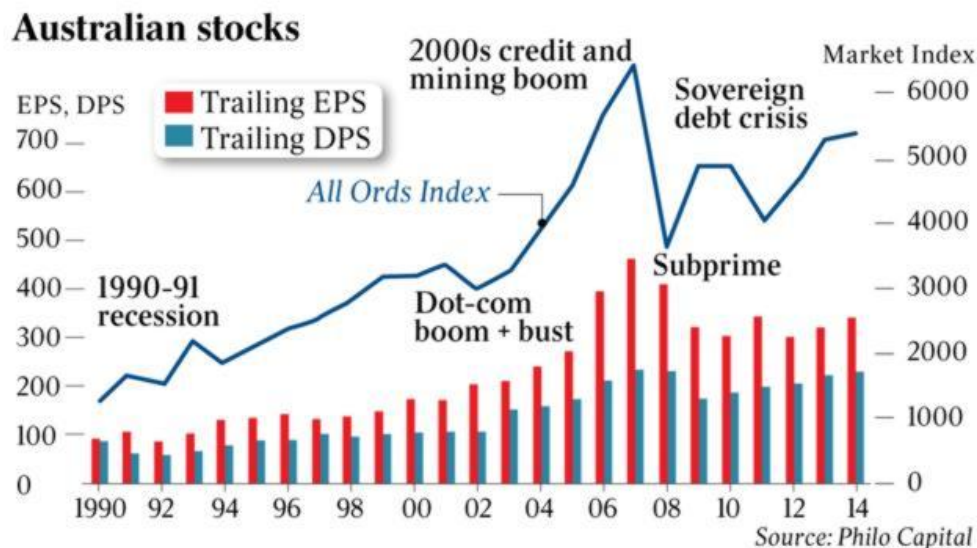


Asset allocation the key to improving returns

- DON STAMMER
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Australian stocks chart. *Source: TheAustralian*

NOW we're well into July, many investors are reviewing the performance of their investments and giving fresh thought to how their hard-won savings might best be spread across the main asset classes of Australian shares, overseas shares, bonds, term deposits, cash and property.

For the majority of investors, asset allocation contributes more to investment returns, over time, than good stock selection. As AustralianSuper has commented: "Research studies show that the long-term asset allocation of a fund, or its strategic asset allocation, is the key driver of returns, with tactical asset allocation and sector and stock selection playing secondary, but nonetheless important, roles."

Strategic asset allocations need to reflect the needs and risk tolerance of individual investors. Tactical asset allocations (also called dynamic asset allocations) work best when returns from the main asset classes are diverging — and investors can benefit from being overweight in assets that are temporarily cheap and underweight in assets that are temporarily expensive.

Some investors outsource the task of tactical asset allocation by choosing multi-sector managed funds or discretionary managed funds. Many more investors first choose their long-term benchmarks for allocations to the main asset classes; they express these benchmarks as ranges between minimum and maximum percentages of their total assets; and then, when opportunities present themselves to make tactical gains, the investors fine-tune their asset allocations within those ranges. A useful starting point in framing a tactical asset allocation is to list the main negatives and positives in the investment outlook.

Currently, these are the main negatives. Our economy is slowing. The US economy isn't seen to have achieved a convincing take-off. China might be growing at 7.5 per cent but could suffer a property shake-out. Europe is flirting with deflation and hasn't done enough to recapitalise its banks. US share prices, measured by the S&P 500 index, have set record highs on 26 days in the last six months — and, many commentators say, are due for a correction. Australian shares are highly priced. Geopolitical risks in Ukraine and the Middle East have heightened.

But defensive assets are extremely expensive: yields on government bonds are unusually low; corporate bond yields have narrowed towards government yields; and cash and term deposits pay skinny interest.

Now, the key positives in the investment outlook. The major central banks of the US, Europe and Japan are keeping their short-term interest rates at very low levels — and prospects are that, when it's time to start normalising their cash rates, increases will be modest and drawn out. The hunt for yield that's been the dominant force in investment markets since 2012 — and has particularly boosted shares and property — is not about to exit the global investment stage. Indeed, I can't recall times when investors were as dividend-aware as now. Here, the average dividend yield is a useful 4 per cent (plus franking credits). In the US, the dividend yield averages 2 per cent, but share buybacks add another 3 per cent a year to returns. In both countries, average dividend payments seem well-placed to rise by at least 6 per cent in the next 12 months.

On balance, I see a case to be modestly overweight Australian and overseas shares; given how buoyant sharemarkets have been, there's need also for a heightened emphasis on stock selection. Bonds look vulnerable; many investors might consider investing via positive return bond funds rather than investing directly or in bond funds that benchmark themselves against average bond returns. To meet their full allocations to fixed interest assets, many investors will need to seek out the best rates banks are offering on at-call and term deposits, including on honeymoon deals.

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

don.stammer@gmail.com