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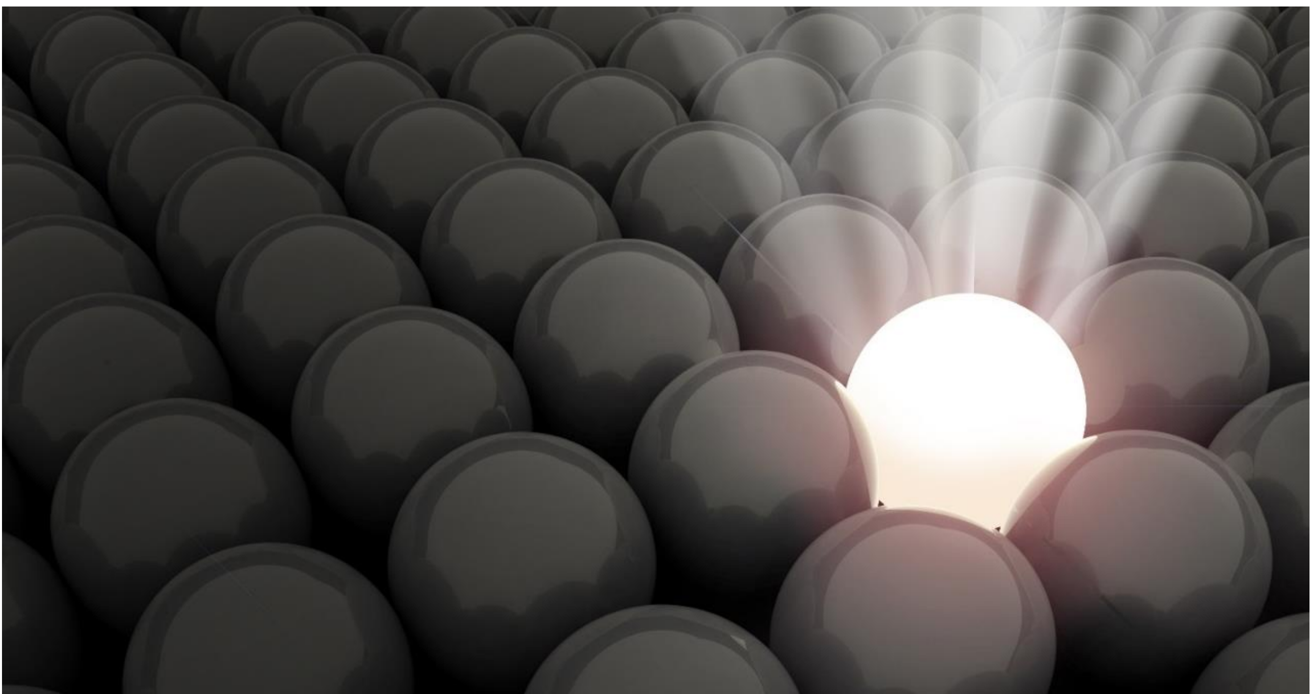
The Frontier Line

Thought leadership and insights from Frontier Advisors

Global perspectives on asset allocation

Issue 93, **April 2014**



Ashley is a Senior Consultant at Frontier and joined the firm exactly ten years ago in April 2004. His responsibilities at Frontier include providing consulting advice and preparing investment reports for Frontier's clients. Ashley also leads a group of investment staff who operate across several teams within the firm. He spent the early part of his career working in England on UK based pension scheme clients. Ashley completed a Bachelor of Commerce at the University of Melbourne, majoring in Actuarial Studies and holds a Postgraduate Diploma in Finance, also from the University of Melbourne.

Global perspectives on asset allocation

As many investors, both individual and institutional, become reacquainted with double digit returns, we surveyed a range of market participants about their *global perspectives on asset allocation* to analyse how investors have responded to the desire to stabilise investment portfolios following the Global Financial Crisis (GFC). This included valuable regional insights from our Global Investment Research Alliance (GIRA) Partners, Segal Rogerscasey (based in the US) and Lane Clark & Peacock (based in the UK & Europe). In looking forward, it remains important to remember the lessons learnt from the past and to identify the key risks and opportunities arising from the post GFC evolution in global asset allocations.

"Those who cannot remember the past are condemned to repeat it"

George Santayana

Changing approaches and global asset allocation flows

In terms of changes to investment approaches, the key themes are that some investors are lowering or removing return objectives, becoming more absolute return focussed, increasing their focus on capital preservation in a lower returning world, implementing risk factor frameworks and/or conducting scenario analysis/stress testing.

A volatile and uncertain environment, and a recognition that asset allocation is the main driver of portfolio returns, has resulted in Dynamic Asset Allocation (DAA) being generally adopted across the globe, although the naming and implementation does vary by region.

With so many different investor types and countries, it is difficult to draw definitive conclusions, but the global asset allocation trends over the last couple of years appear to be as follows.

- Less listed equities despite increases in emerging market equities.
- Fixed income stable with increases to credit at the expense of government bonds.
- Significantly more alternatives, including core allocations to hedge funds as a diversifier, with infrastructure & core property currently on the rise.
- A search for uncorrelated, lower volatility returns and inflation sensitive assets.

"Know what you own and why you own it"

Peter Lynch

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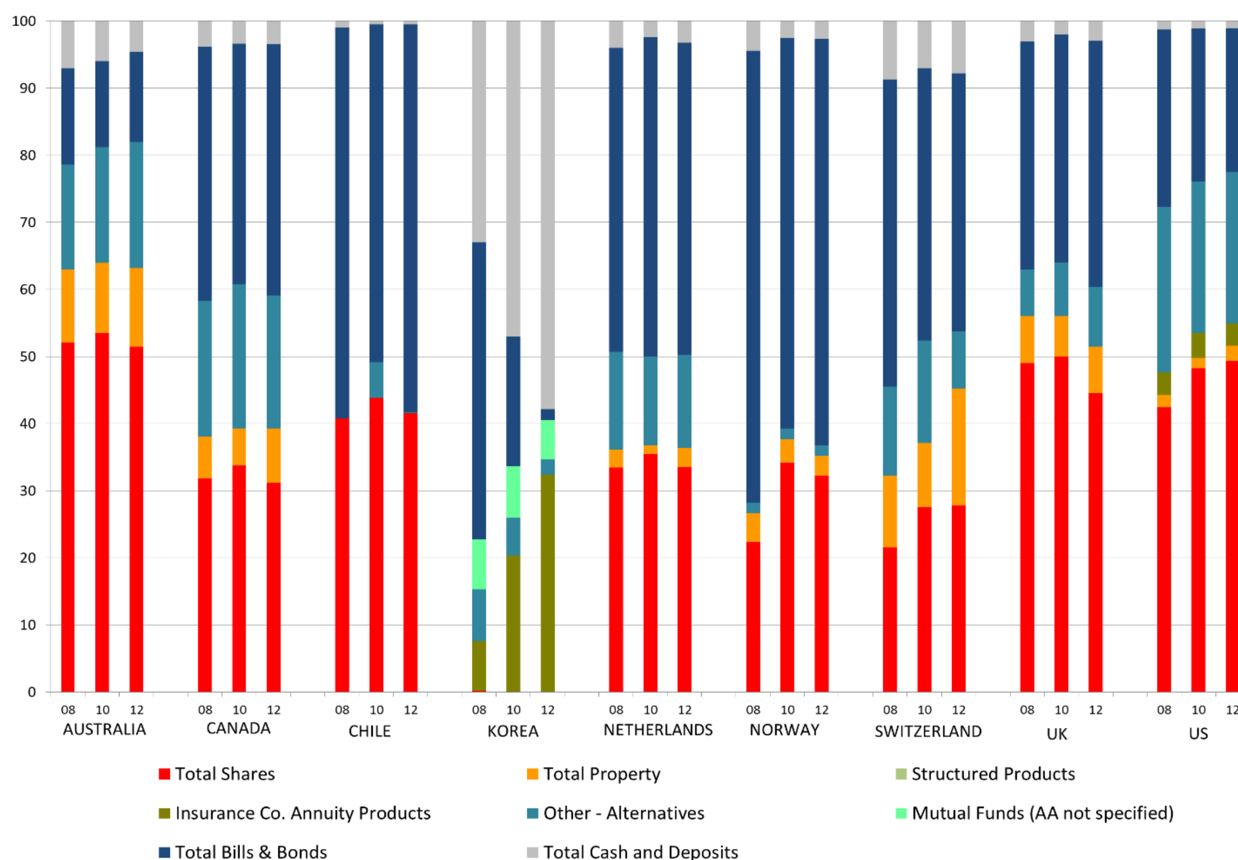
Changing approaches

Many Australian investors are moving in the opposite direction, reducing alternatives and perhaps becoming less diversified – mainly because they are starting from a relatively high allocation and have become more fee conscious (significantly reducing the appetite for private equity and hedge funds in particular).

Like other parts of the globe, Australia has also seen a trend towards more asset allocation flexibility, via dynamic asset allocation and allocation to multi-asset and multi-sector credit funds.

Chart 1: OECD bi-annual pension funds asset allocation 2008 to 2012



Source: OECD and SuperRatings. All data to 31 Dec ex-Australia (30 June). Australian data is SR Median Balanced Default Option. UK 2012 data sourced from UBS. A ratio of key asset classes was used for the US “mutual funds” category.

Looming asset price bubbles … ?

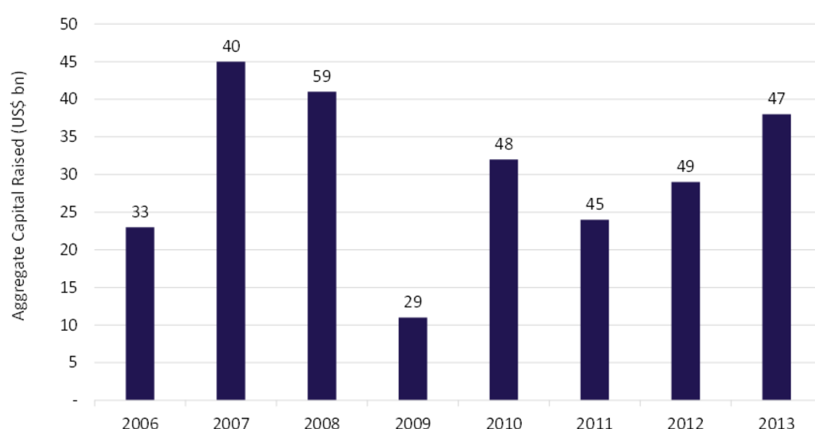
Unprecedented central bank behaviour and an abundance of liquidity has driven many asset prices up and given us a low return world, so investors have generally moved out on the risk curve in pursuit of the returns they want or need. Besides the most obvious one (Government Bonds), we believe global asset allocation flows could see one or more asset price bubbles emerge over the coming years.

"The less the prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs…" - Warren Buffett

Infrastructure

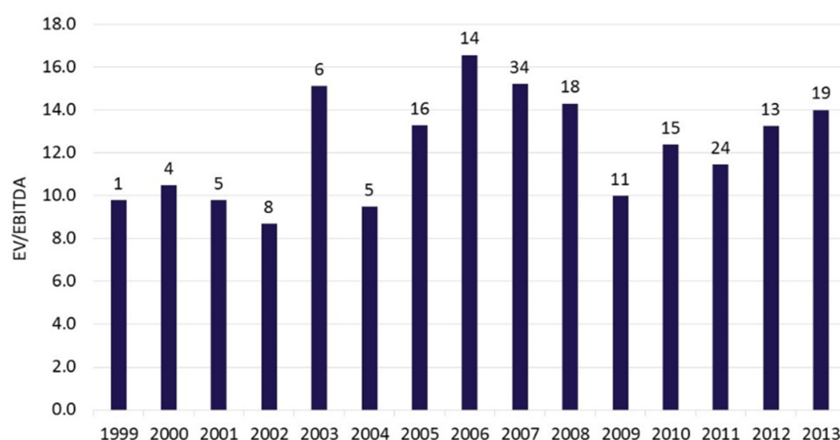
For some time now we have noted the risk that too much money is chasing too few deals within the infrastructure space. There are substantial fund raisings across the globe with material uncalled commitments, valuation multiples are on the rise and it is unclear what the level of secondary market sales will be.

Chart 2: Unlisted infrastructure fundraisings



Source: Prequin. Number of funds closed on top of bars

Chart 3: Unlisted infrastructure median valuation multiples



Source: Frontier. Number of deals included in median on top of bars

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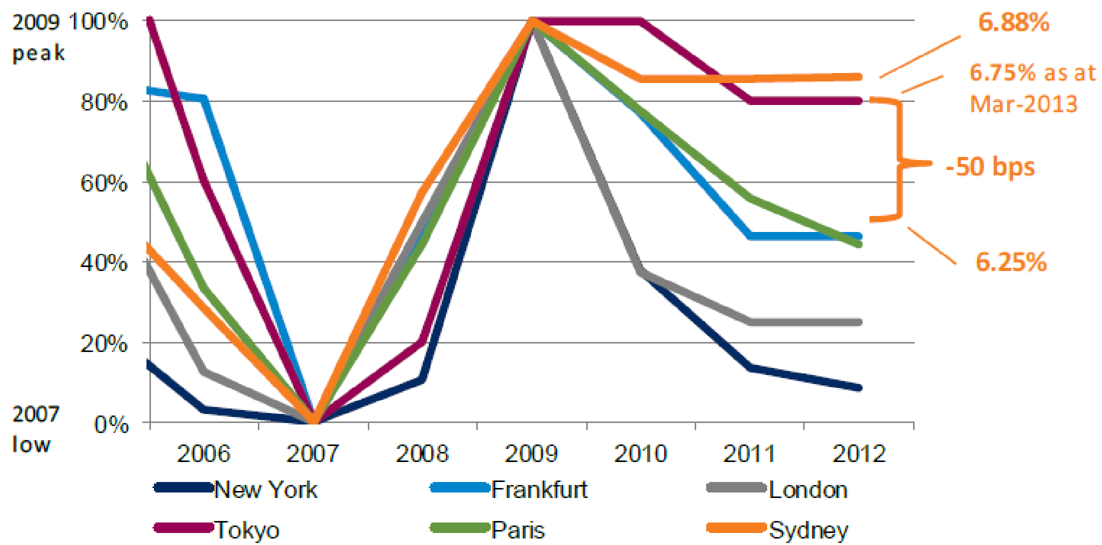
Looming asset price bubbles … ?

Core property

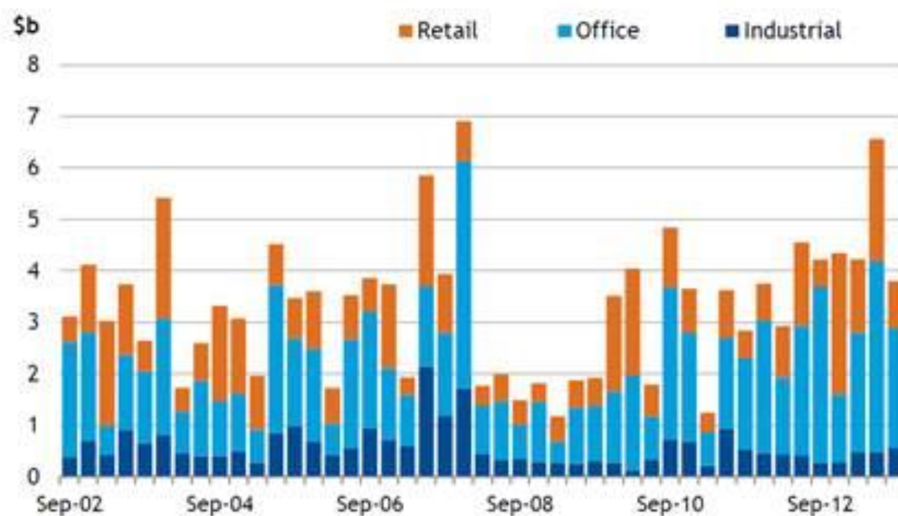
The search for “safety” and “yield” has led investors to chase higher yielding returns from core property, with asset pricing in the US & UK becoming particularly expensive. Domestic transaction volumes are also now the highest they have been since the GFC.

Chart 4: Global prime office yields – re-scaled



Source: Jones Lang LaSalle Research and Investa Research

Chart 5: Australian transaction volumes



Source: Jones Lang LaSalle, DEXUS Research

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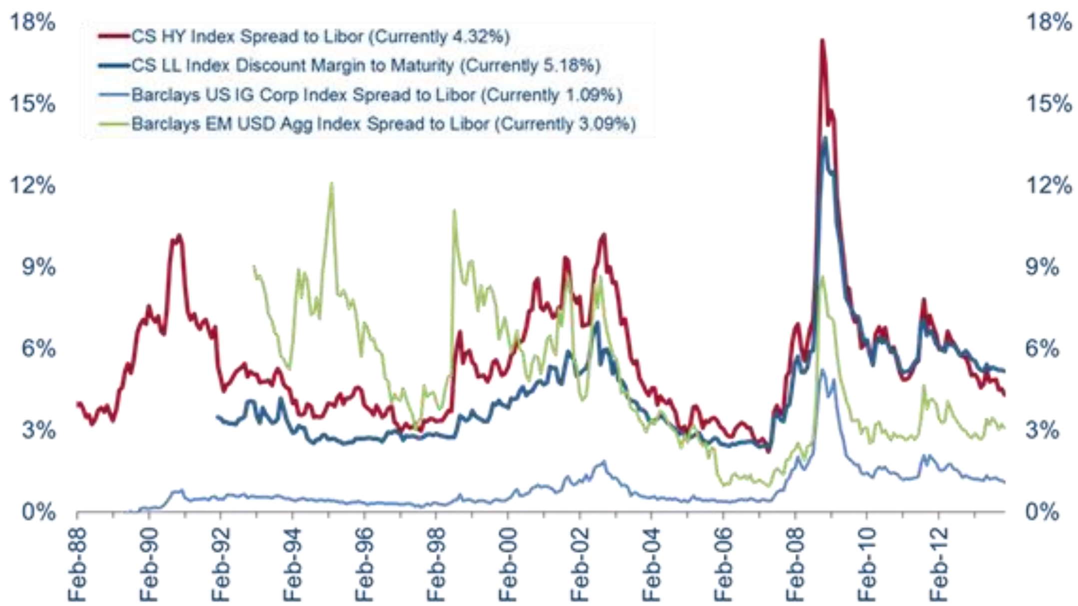
Looming asset price bubbles … ?

Credit

The post GFC fallout gave credit its day in the sun and there has been substantial flows across the credit spectrum resulting in significant spread contraction.

Chart 6: High yield (HY), bank/leveraged loans (LL), investment grade (IG) and emerging market (EM) spreads



Source: Bentham, Bloomberg, Credit Suise 31 Jan 1986 to 31 Dec 2013

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What about Australia?

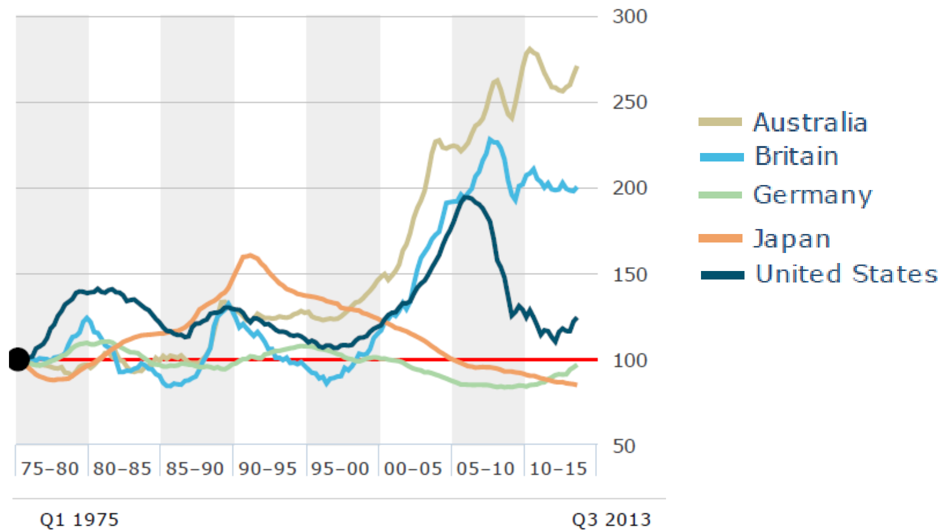
As an AAA rated country with a stable banking system and relatively high yields, flows from offshore investors are at risk of making Australia relatively expensive. The terms of trade remains elevated and the resources boom can't last forever.

In fact, many would argue Australian housing prices have been in bubble territory for years and our banks have had a relatively charmed run.

In an environment where the traditional defensive strategies (e.g. government bonds and cash) are expensive, and there are limited other attractive investment opportunities, Australian investors are no more diversified or protected against an equity market downturn than we were leading into the GFC in 2008.

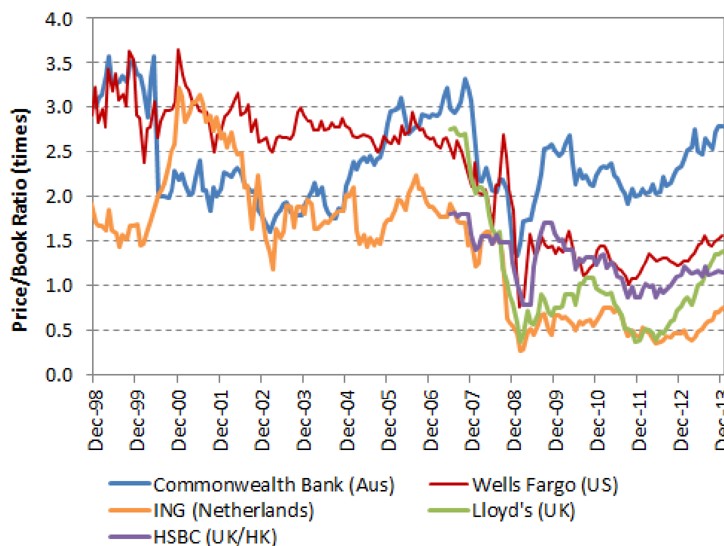
As a result, there is an increasing case for downside protection strategies.

Chart 7: House prices in real terms – The Economist Interactive



Source: Jones Lang LaSalle Research and Investa Research Q1 1975 = 100

Chart 8: Global banking stocks – Price/book ratios



Source: Jones Lang LaSalle, DEXUS Research

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Looking forward. Risks and opportunities

The key determinants of the path taken by each group of investors appear to be their respective starting points in 2007 and the factors that drive their decision making.

- If you haven't already, consider revisiting your investment objectives and investment philosophy to ensure they are clearly defined and agreed by trustees.
- Ask yourself whether you have a complete understanding of risk?
- If you have adopted (or are considering adopting) DAA, make sure your framework is appropriately formalised, structured and performance monitored.

The key risks to look out for relate to potential asset price bubbles in infrastructure, core property and credit, caused by excessive flows.

In terms of Australia, maybe Geoffrey Chaucer was right in 1374 that "all good things must come to an end"?

Although it is a difficult environment for investors, the Australian market's heightened focus on MERs and what competitors are doing will see opportunities come to those investors with the ability and willingness to be different and that are genuinely focussed on long-term, absolute, net of tax and fee outcomes.

While the global economy appears to be improving, many asset classes are becoming expensive and equity-biased portfolios are exposed to a downturn scenario. So remember this, if you ever find yourself scratching your head and thinking that everything is expensive, then maybe it's time to take profits, build some dry powder and/or start "walking the walk" on those downside protection strategies, like we all wish we'd done in 2007/08?

"History does not repeat itself, but it does rhyme…" - Mark Twain

Appendix: Different strokes for different folks

Table 1: Comparison of key factors across Australian, North American, UK and European markets

Australian funds	Typical return target	Short term liquidity requirements	Fee considerations	Regulatory constraints	Competitor landscape	Typical fund structure	
						Internal or external management	Team size
Endowments	CPI+	Medium	Medium	Medium	Low	Externally	Small
Pension funds (DB)	CPI+/ Liability matched	Medium	Medium	High	Low	Externally	Medium
Pension funds (DC)	CPI+	Medium	High	Medium	High	Externally	Medium
Sov wealth funds	CPI+	Low	Medium	High	Low	Externally	Medium

North American funds	Typical return target	Short term liquidity requirements	Fee considerations	Regulatory constraints	Competitor landscape	Typical fund structure	
						Internal or external management	Team size
Endowments	Varies[1]	Medium	Low	Low	Medium	Externally	Medium
Pension funds (DB)	Liability matched	Medium	Medium	High	Low	Externally	Medium
Pension funds (DC)	CPI+	Medium	Medium	Medium	High	Externally	Medium
Sov wealth funds	Varies[2]	Low	Low	Medium	Low	Externally	Medium

UK & European funds	Typical return target	Short term liquidity requirements	Fee considerations	Regulatory constraints	Competitor landscape	Typical fund structure	
						Internal or external management	Team size
Endowments	Varies[1]	Medium	Low	Low	Low	Externally	Small
Pension funds (DB)	Liability matched	Medium	Medium	High	Low	Externally	Medium
Pension funds (DC)	CPI+	Medium	Medium	Medium	High	Externally	Medium
Sov wealth funds	Varies[2]	Low	Low	Medium	Low	Externally	Large

1: Endowment target returns vary from Policy Portfolio (SAA style benchmarks) to a Real Retun target of 5% p.a.

2: SWF target returns vary from CPI + 4.5% p.a. to a stated target of “investing funds on behalf of the Government to secure and maintain the country’s future welfare”.

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Level 16, 222 Exhibition Street

Melbourne, Victoria 3000

Tel: +61 3 8648 4300

www.frontieradvisors.com.au

@frontier_adv

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