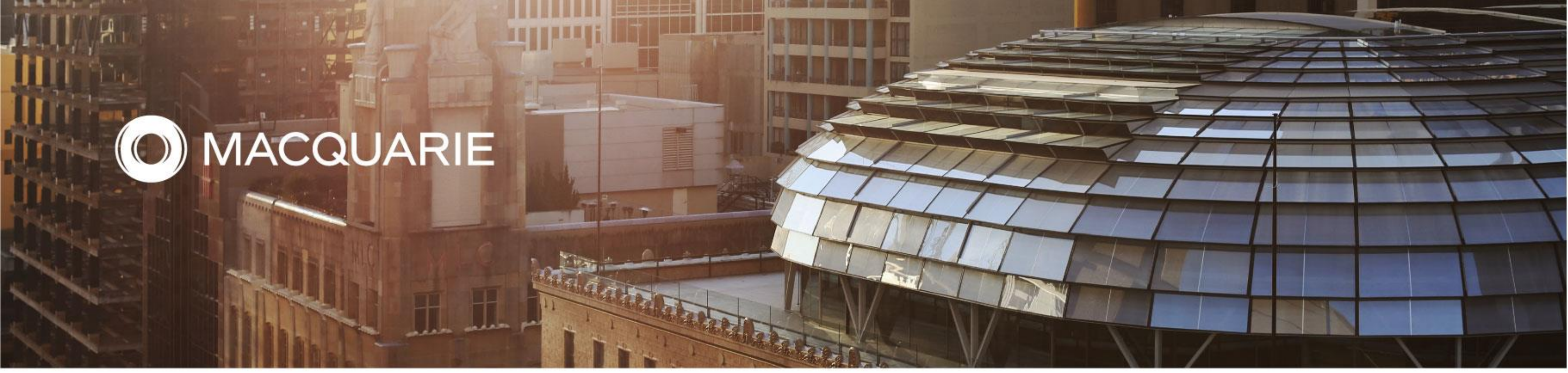


Investment Strategy Update #144

Asset Allocation: Diversification is the best defence against elevated uncertainty

- Elevated economic and financial market uncertainty implies the potential for many different outcomes. Under these types of circumstances, we think a **fully diversified portfolio** that should perform under a range of outcomes is most appropriate for satisfying long term investment objectives.

- Over the past 6 months, both economic growth and financial markets (particularly equities) have surprised on the upside and moved against consensus expectations. This has raised talk about the need to be defensively positioned. We don't think this is the correct portfolio strategy as it only offers the best risk-reward outcome if growth slows, and markets fall. Under all other scenarios it will underperform.

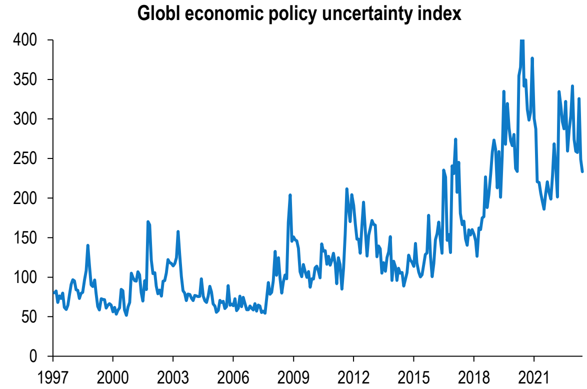
- A well-diversified portfolio minimises both upside and downside risk. In contrast, defensively positioned portfolios generally deliver performance under only one outcome. Consequently, we think a diversified and not a defensive portfolio is best suited when macro and financial market uncertainty and volatility is high.

- Portfolios should be diversified across regions, asset classes and sectors with less emphasis on style tilts (such as growth versus value) and more emphasis on gaining exposure to structural themes that are less reliant on the cyclical outlook and/or ensuring that there is sufficient exposure to income generating assets as well as lower correlated assets.

- At this time, investors should be using weakness in areas where they are underexposed relative to traditional strategic asset allocation benchmarks. This is most likely to be in alternative and real assets where we recommend 20% of a balanced portfolio allocation.

- We do want to take advantage of mispricing opportunities across more cyclical assets (equities and fixed income) but believe there needs to be more transparency on the outlook in order to ensure confidence in outcomes is greater and it may take some time before this occurs. We think protecting downside while also having some exposure to upside is a better strategy than betting that the current market trend will reverse.

The macroeconomic outlook remains highly uncertain



Source: MWM Research, www.policyuncertainty.com, June 2023

Diversified not defensive

Some investors may be tempted to move portfolios to a more defensive positioning given the slowing economic growth environment. We think investors will be better served by a diversified rather than a defensive portfolio for three key reasons:

#1 Elevated economic and financial market uncertainty implies many potential outcomes:

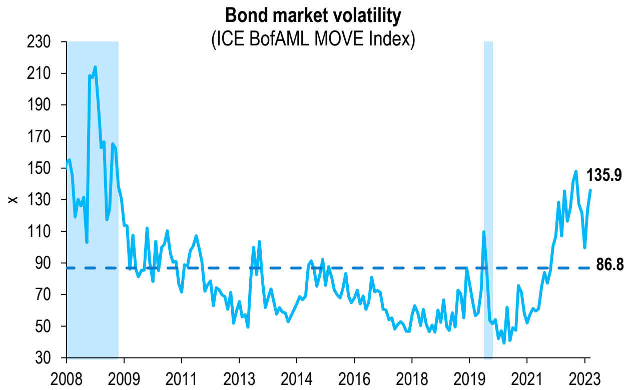
Elevated uncertainty means there are many potential outcomes for key economic variables and hence the path for financial markets. While Macquarie has a base case (most likely outcome), the distribution around this central forecast is much wider than normal.

In particular, there is a debate around a number of key variables including 1) The path for inflation: This is receding, albeit not in a straight line with considerable uncertainty surrounding how long it will take to reach Central Bank targets; 2) The depth and duration of an economic growth slowdown:

Growth is slowing but there is uncertainty around how fast. Macquarie's base case remains a three quarter (developed world) recession starting in 2H23 with growth contracting -1.6%.

This ongoing debate around how quickly inflation declines and whether the Fed can engineer a soft versus hard landing implies investors should be positioned for a range of outcomes rather than just the base case.

Bond market volatility is not far off GFC levels



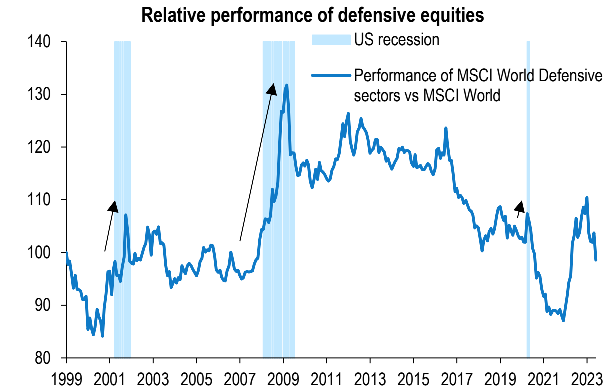
Source: MWM Research, Bloomberg, June 2023

#2 Defensive positioning delivers in one outcome

Being "defensive positioned" is a style choice based on a negative view of the macroeconomic and financial market outlook. For example, a defensively positioned portfolio would typically be underweight cyclical assets and overweight less cyclically exposed, low correlated and/or high-income earnings assets.

This portfolio skew should perform (relatively) well, should economic growth slow more than anticipated or a recession and growth / cyclical assets weaken. But it is likely to underperform a diversified portfolio in all other scenarios, such as when there is economic resilience.

Defensive equities perform best when growth is weak(er)



Source: MWM Research, FactSet, June 2023

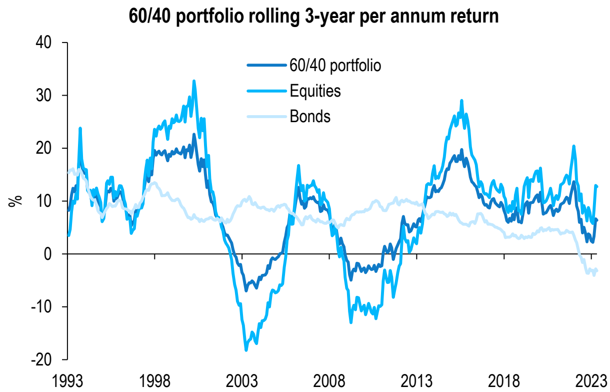
#3 Diversification delivers across a range of economic / market outcomes

Diversification is central to asset allocation and ensures that the portfolio has exposure to a range of assets that perform differently across a range of macroeconomic and financial market regimes. Diversification across risk and return drivers sets up the total portfolio well to perform in a range of different economic/market scenarios and minimises both upside and downside risk.

The most common criticism of diversification is "all correlations go to 1 during times of stress", that is, all markets are experiencing drawdowns at the same time. This may be true, but this ignores that a diversified portfolio – whilst it is still likely to experience underperformance and/or drawdowns (particularly at times of market stress) – will likely experience a lower drawdown than a less diversified portfolio.

This is significant, because a smaller drawdown implies a shorter time to recover, which, all else being equal, should lead to superior long-term performance simply due to the power of compounding. For example, a portfolio that experiences a 10% drawdown, needs to earn ~11% to get back to where it started. However, the required return to recover posts a 30% drawdown, is ~43%, which takes a lot longer.

Bonds reduce volatility and provide downside protection



Source: MWM Research, FactSet, June 2023

Ensuring portfolio diversification

To achieve long term investment objectives, portfolios should be reviewed regularly to ensure that market movements have not pushed them outside the bounds of their investment objectives. In addition, a diversified portfolio should be aligned with the following:

- **Broad exposure across asset classes, regions and sectors**. Portfolios should be positioned and within asset classes for the full benefits of capital growth, income, and downside protection. For instance, equities provide long term capital growth, bonds provide risk-adjusted yield and downside protection, real assets can provide inflation protection (and income stability) while alternatives can provide a lower correlated source of returns.

- **Avoiding (strong) style and/or sub asset tilts:** When uncertainty is high, there is little confidence that particular style tilts will provide consistent performance. Hence it is prudent to position in the "middle" rather than at the tails. For instance, as we wrote in *Investment Strategy Update #132: Growth Stocks - still stuck on a red light*, we think it is too early to make a call on "growth" versus "value".

- **Exposure to inflation linked cash-flows.** Core real assets particularly ‘regulated’ infrastructure assets (such as utilities) with cashflows explicitly linked to inflation are likely to be well positioned to cushion the impact of above-target inflation. Infrastructure (particularly direct) is also a source of low volatility and uncorrelated returns.

- **Exposure to alternative investment strategies.** We think alternative and real assets should make up around 20% of a diversified portfolio. In a world of elevated uncertainty and potentially declining returns to traditional assets, the heterogeneous and low correlated nature of these (sub) assets improves long-term portfolio return outcomes by providing downside protection, (dampening volatility), raising income.

Macquarie WM Investment Strategy

This report was finalised on 19 June 2023.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return