Research

3 August 2021

Investment Strategy Update #65

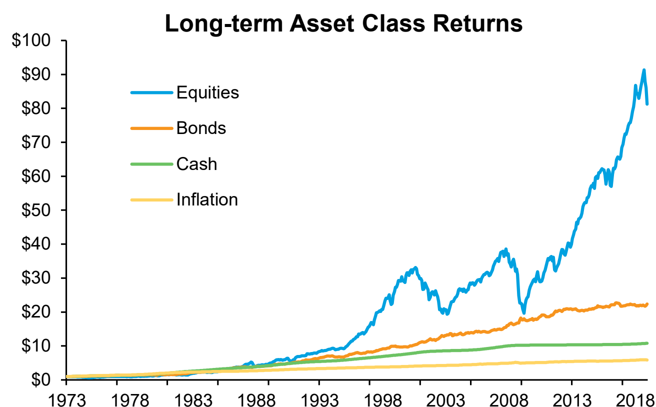
Asset Allocation - Building resilient portfolios

- Equities are the preferred asset for long term growth. For more than 100 years, equities have produced a higher long-term real return than both bonds and cash while also provided better (relative) insurance against the risks of inflation.
- Bonds increase risk adjusted returns, help mitigate short term share market volatility and protect capital during more significant equity market drawdowns. A combined allocation of equities and bonds has consistently delivered a smoother return profile for balanced portfolios over several decades.
- However, elevated equity valuations and low yields leave portfolios vulnerable to rising volatility and neither bonds nor equities perform well during high inflation periods. Consequently, even a 60:40 portfolio is not enough to protect against rising volatility and high inflation periods.
- We believe investors should look to other less traditional asset classes to add further resilience to portfolios.
  - Alternatives can help build portfolio resiliency through diversification, return enhancement and access to opportunity sets not available to traditional asset classes. We recommend a 15% allocation to Alternatives for a balanced portfolio.
  - Real Assets provide additional diversification, inflation hedging, relatively stable income and attractive yields.

Equities more vulnerable to unexpected events

Since 1900, global equity returns have significantly outpaced bonds, cash and inflation (Dimson, March, Staunton). Australian equities have performed particularly well averaging 11.6% pa versus bonds 5.2% pa, cash 4.5% pa and inflation 4.1% pa. Given these historical risk-reward characteristics we think equities should be the preferred growth asset class for long-term investors.

Long-term equity returns outpace inflation

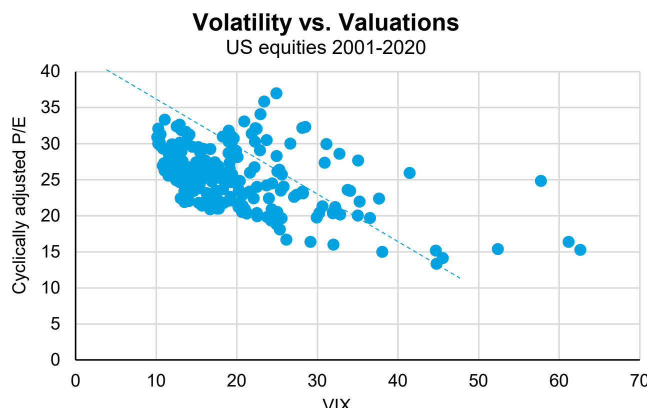


Source: Macquarie Research, July 2021

However, elevated valuations leave equities more vulnerable to unexpected inflation or deterioration in economic growth and earnings.

1. **Equites a poor hedge against "unexpected" inflation** - Historically, a low but rising inflation environment has been positive for risk assets. However, despite outperforming inflation over the long run, equities are not a good hedge against "unexpected" inflation. While equities provide a better "relative" buffer over bonds they have historically provided poor protection in absolute terms during these periods. Once inflation begins to rise above the long-term average, it acts as a headwind for financial assets particularly if bond yields are rising and/or policy is tightening.

Equity valuations suffer as volatility rises



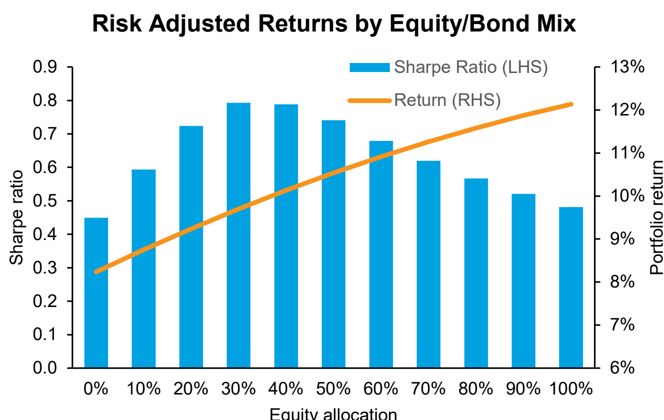
Source: Macquarie Research, July 2021

2. **Elevated valuations provide less buffer to rising volatility**- Despite a phenomenal run in equities since the end of the GFC, we think they can continue to push higher supported by a combination of factors including a recovery in global economic growth and corporate earnings, supportive monetary and fiscal policy and elevated dividend yield. However, high valuations leave equities with a more limited cushion should volatility rise. Factors such as 1) rising interest rates / volatility in the bond market or 2) unexpected economic or corporate earnings news have historically been catalysts for equity volatility.

Low yields diminish the bond "cushion"

Traditionally, adding bonds to an equity portfolio acts as a shock absorber offering capital protection during equity drawdowns. As a result, a mix of equities and bonds (typically 60/40) has provided a higher risk adjusted return, or Sharpe ratio, than equities alone. Put simply, adding bonds to an equity portfolio, 1) raises the risk adjusted returns; and 2) bonds provide downside protection for investors with shorter investment horizons.

Adding bonds improves risk adjusted return



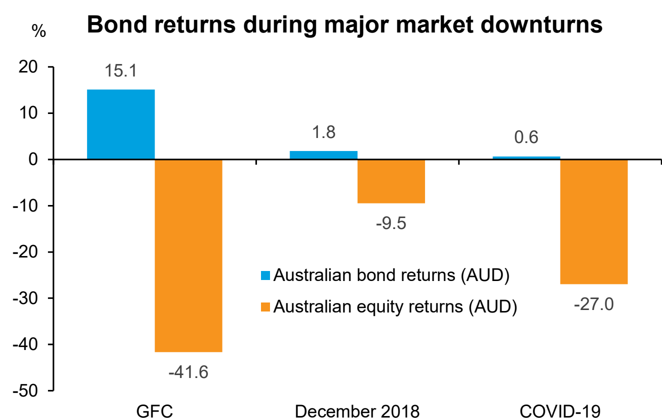
Source: Macquarie Research, July 2021

What happens to a portfolio when volatility begins to rise at the same time bond yields are at/close to record low levels?

We believe bonds can still retain their role as a strategic, risk-mitigating asset within portfolios, However, these benefits have been greatly reduced due to the absolute level of yields for sovereign, investment grade credit and high yield bonds. Low yields do not necessarily mean bonds lose their ability to alleviate overall portfolio risk. Bonds will still be able to help stabilise the portfolio return profile along with adding downside protection but just not as effectively as in the past.

Given this reduced diversification benefit from bonds, what can investors do to do boost portfolio resiliency? Holding longer duration bonds provides greater leverage to interest rate moves and can help provide greater downside support in equity market selloffs, however this comes with the increased risk of a greater loss should interest rates rise. Investors need to look outside the traditional equity/bond framework given the current market environment.

Bond yield cushions are shrinking



Source: Macquarie Research, July 2021

Build resiliency through non-traditional asset classes

We believe investors should look to other non-traditional asset classes that may offer better value or bring diversification benefits.

1. **Alternatives** – We classify Alternatives as either diversifying or return enhancing and recommend a 15% portfolio allocation to complement traditional investments (equities, bonds, cash).

   Alternative assets include private assets (private equity and real assets) and hedge funds that typically employ a vast array of investment strategies that seek to generate returns from different factors to those that drive equity and bond markets.

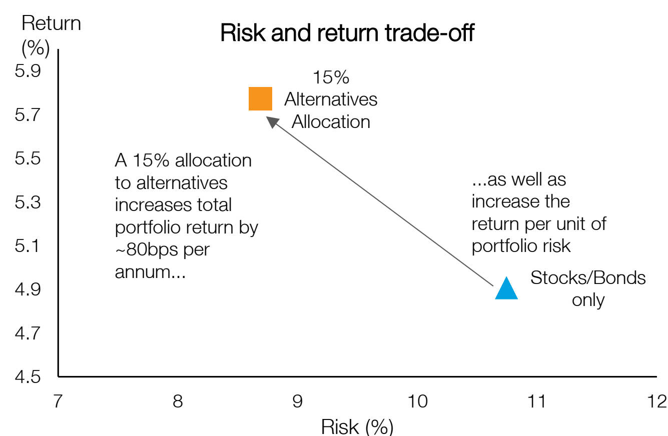
   Alternatives can help build portfolio resiliency through the following characteristics:

   a. **Diversification**: Diversify portfolio returns away from interest rate, equity market and credit spread risk which typically dominate multi-asset class portfolios, thereby lowering the volatility of the overall portfolio.

   b. **Return enhancement**: Deliver superior returns (capital or income) on a risk-adjusted or absolute basis through capturing stock or event specific over broad market risk; and

   c. **Access to a different opportunity set**: Access private market opportunities (debt or equity) that are not readily available to all investors.

Alternatives' allocation estimated to improve return/risk



Source: NFS, MWM Research, July 2021

2. **Real Assets** – An allocation to property, infrastructure and commodities can help build portfolio resiliency with the potential to enhance the risk/return profile of a portfolio.

   Property and infrastructure in particular can help build portfolio resiliency through:

   a. **Diversification**: Real assets are relatively uncorrelated with other 'traditional' asset classes, potentially making them a useful addition to a portfolio.

   b. **Inflation hedging**: The nature of the cashflows of real assets (often regulated and contractually linked to inflation) mean that real assets can potentially provide a useful hedge against inflation.

   c. **Relatively stable income stream**: Real assets tend to possess relatively more defensive earnings streams, given the nature of their difficult-to-replicate assets, which are often in monopoly-like industries where consumer demand is relatively inelastic (for example, a power generation station).

   d. **Relatively high yields**: Record low policy rates have seen yields on fixed income investments fall to record lows, with 'lower for longer' policy settings meaning low yields are here to stay. This has forced income-chasing investors to allocate ever increasingly to real assets, an income-generating asset class whose yields still compare relatively favourably.

Macquarie WM Investment Strategy Team

The report was finalised on 2 August 2021.

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

The analyst(s) responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited (ABN 94 122 169 279 AFSL 318062) (“MGL”) and its related entities (the “Macquarie Group”, “MGL”, “We” or “Us”). No part of the compensation of the analyst(s) was, is or will be directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited (ABN 41 002 574 923 AFSL 237504) (“MEL” or “We”), a Participant of the ASX. MEL is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Cth), and MEL’s obligations do not represent deposits or other liabilities of Macquarie Bank Limited (ABN 46 008 583 542). Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MEL.

This research contains general advice and does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. Past performance is not a reliable indicator of future performance. You should consider all factors and risks before making a decision. Please refer to MEL’s Financial Services Guide (FSG) for more information at **https://www.macquarie.com.au/advisers/financial-services-guide.html**.

This research has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient, you must not use or disclose this research in any way. If you received it in error, please tell us immediately by return e -mail and delete the document. We do not guarantee the integrity of any links, e-mails or attached files and are not responsible for any changes made to them by any other person. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research is based on information obtained from sources believed to be reliable, but We do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. The Macquarie Group produces a variety of research products, recommendations contained in one type of research product may differ from recommendations contained in other types of research.

The Macquarie Group has established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. The Macquarie Group, its officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. The Macquarie Group may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. The Macquarie Group’s employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research.

Important disclosure information regarding the subject companies covered in this report is available at **macquarie.com/disclosures**.