

Asset Allocation in a Low Return/More Risky World

Australian Business Economists 2002
Forecasting Conference

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4 December 2002

Overview

- Base case - low returns from traditional asset classes
 - average returns to be single digit
 - cycle lives on - more negative return years/increased volatility
 - smaller differential between asset classes
- Risk case
 - sustained secular bear market in the US
- Assets likely to benefit: commercial property, corporate debt, Asian equities, Australian equities
- Expect a cyclical equity bull market over the next year

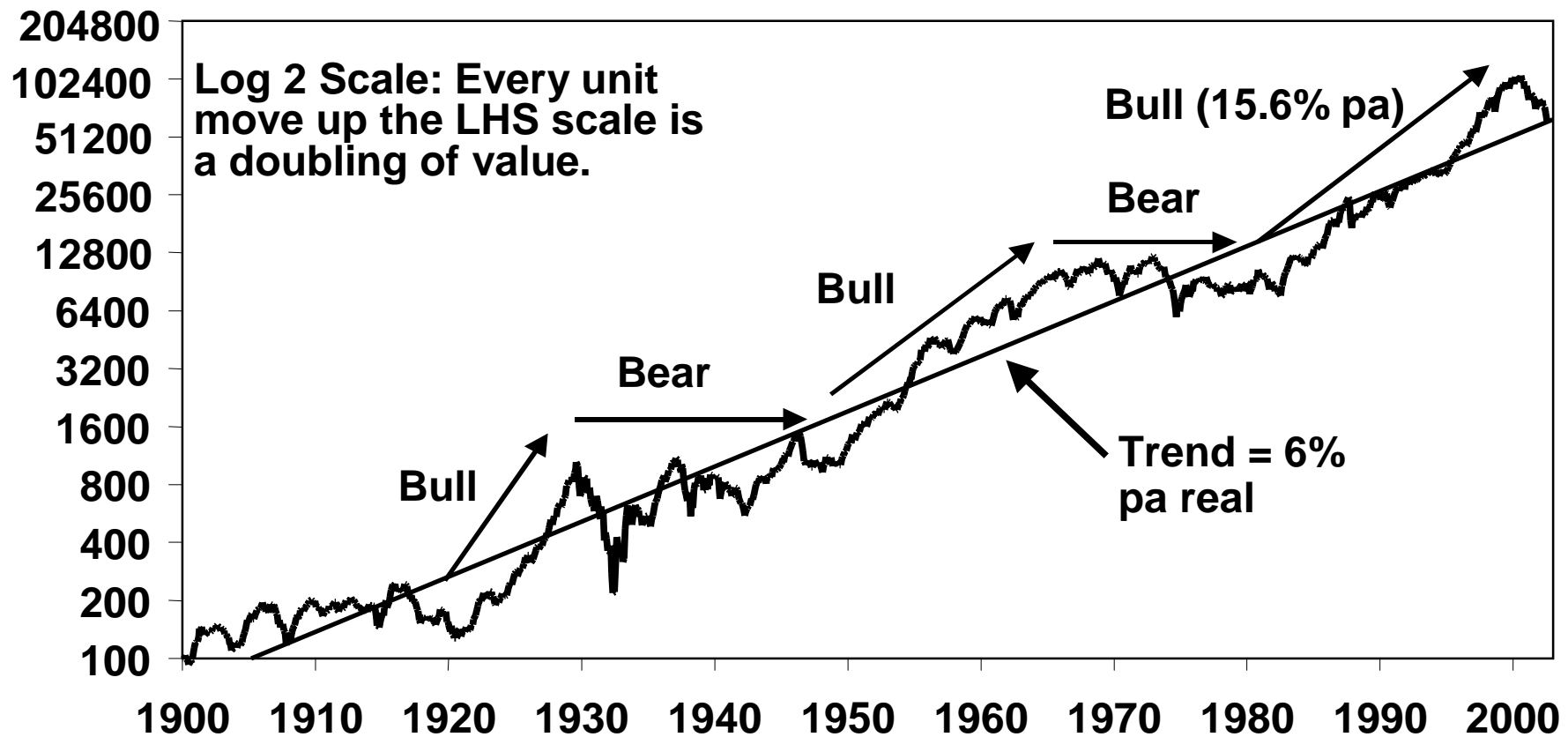
Strategic (5-10 year) view

Key features of the strategic outlook

- Low trend returns from equities (and bonds)
- Noticeable volatility around the trend giving a “roller coaster” experience
- ...more negative return years
- Risk of a secular bear market in US equities
- Income (yield) in fashion

US sharemarket - great long term returns ...interrupted by secular bear markets

Cumulative Real Returns

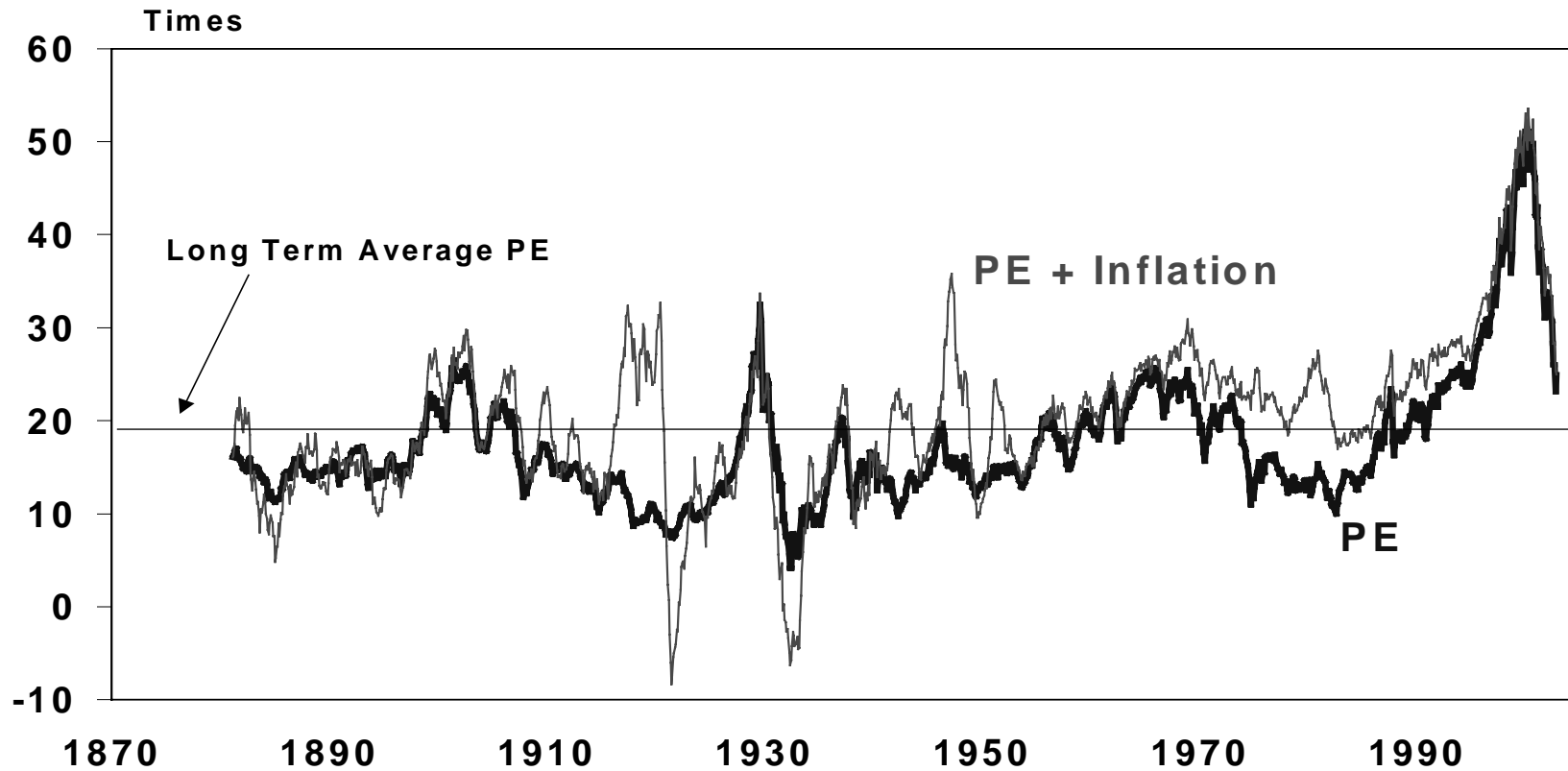


Bull market drivers under pressure

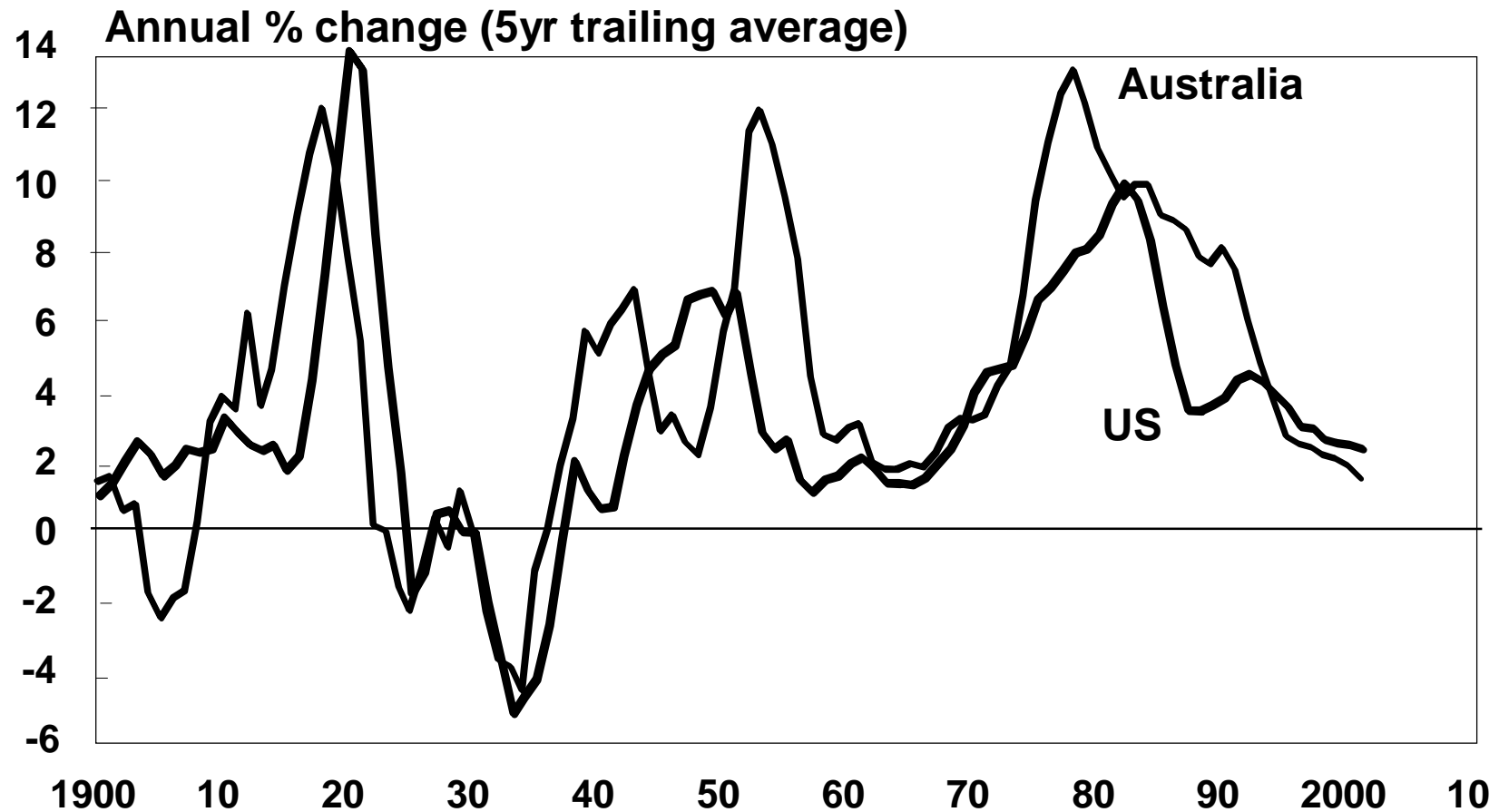
- Attractive valuations* - some fear still expensive
- Shift to low inflation* - benefits have been seen
- Free market economics* - subject to backlash
- Peace dividend* - Sept 11, Iraq, War on Terrorism
- Positive investor psychology* - damaged by 50%+ fall in global equity markets

US Shares - long term valuation

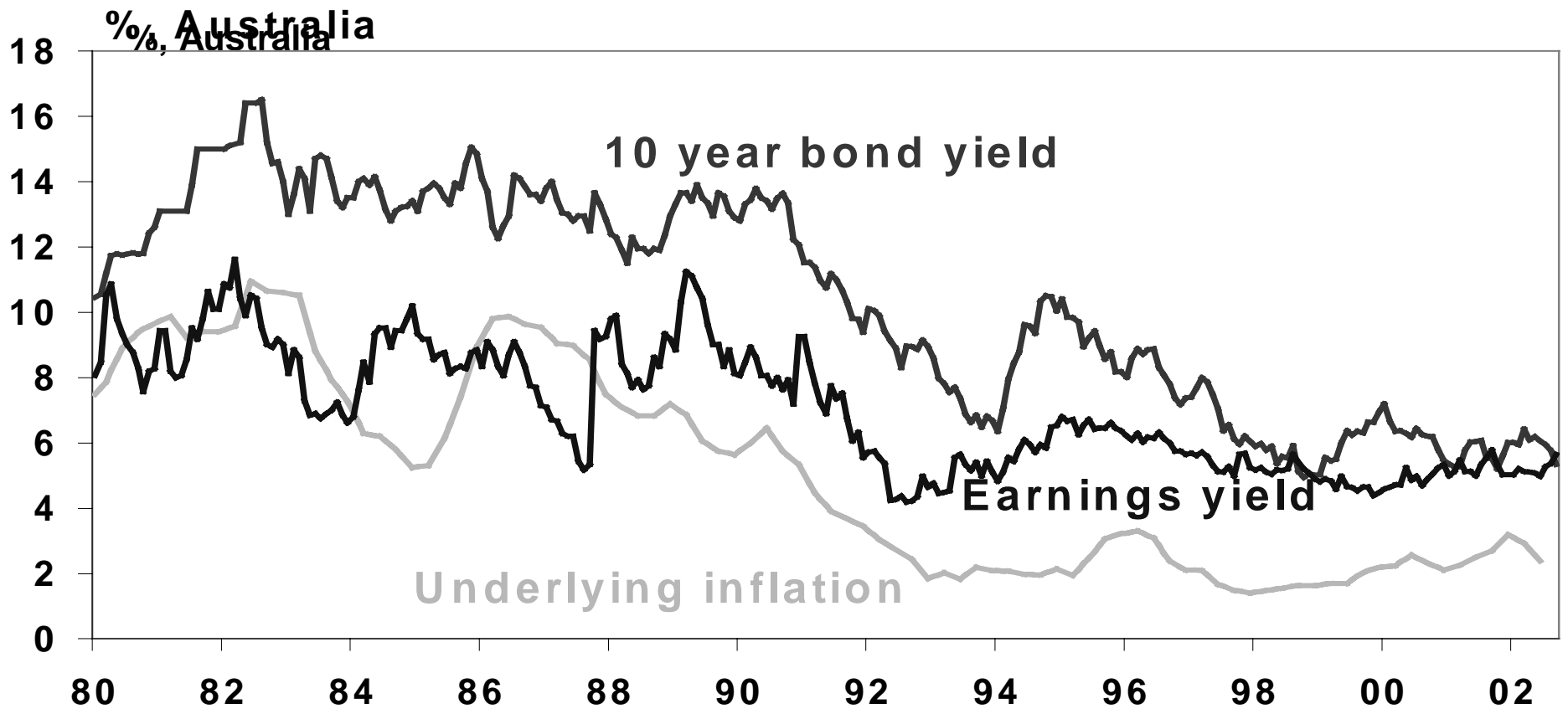
PE based on 10 yr trailing avg of earnings



Inflation: have we seen the best?



Disinflation saw yields fall



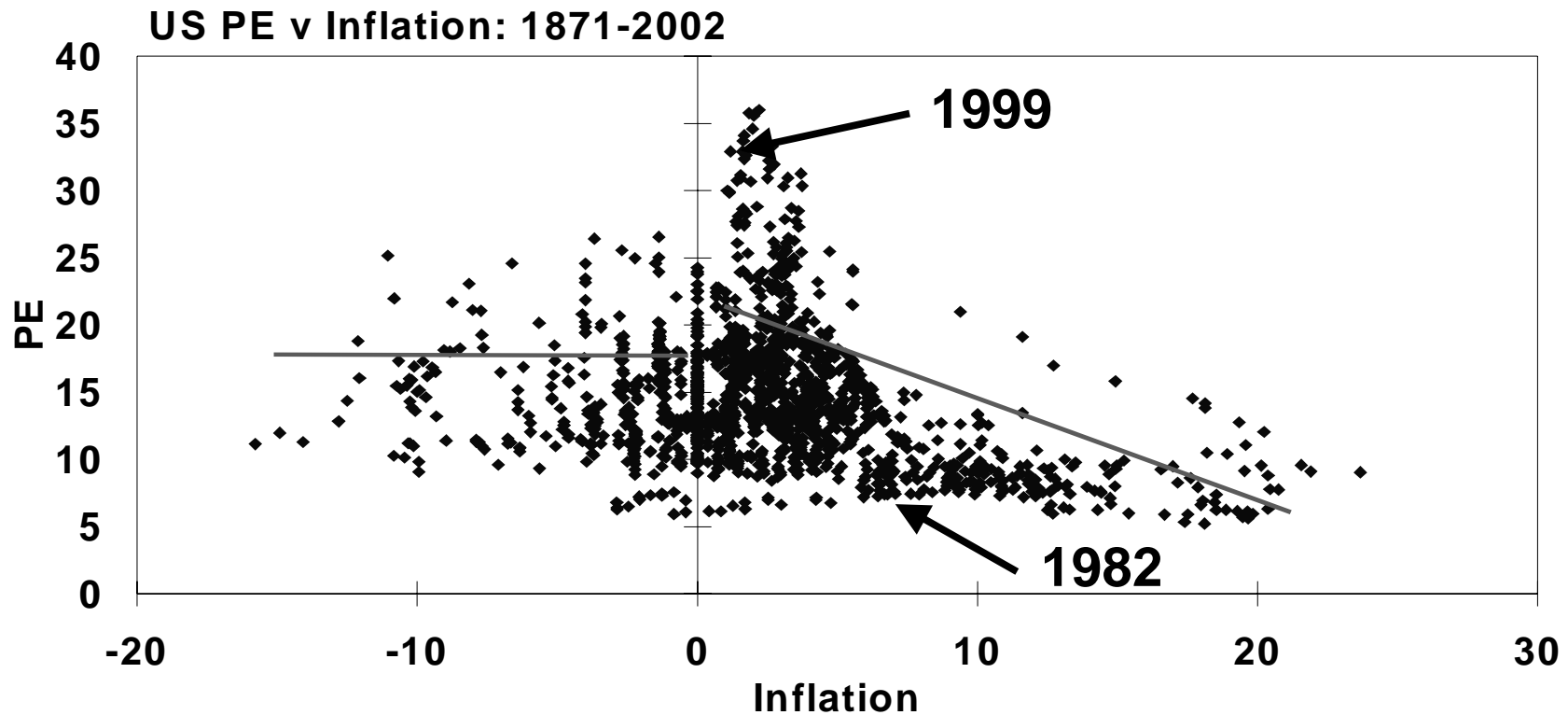
The impact of falling inflation/rising valuations on domestic equity returns

Australia (% pa)	1981-2001
Total return	= 13.6
• Dividends	4.6
• Capital growth	+ 9.0
➤ earnings	6.4
➤ change in valuations	+ 2.6
Underlying return	11.0

The impact of falling inflation/rising valuations on US equity returns

US (% pa)	1981-2001
Total return	= 15.3
• Dividends	3.5
• Capital growth	+ 11.8
➤ earnings	4.4
➤ change in valuations	+ 7.4
Underlying return	7.9

PE rises as inflation falls, but not in deflation



EMH under challenge - current thinking on market efficiency and predictability

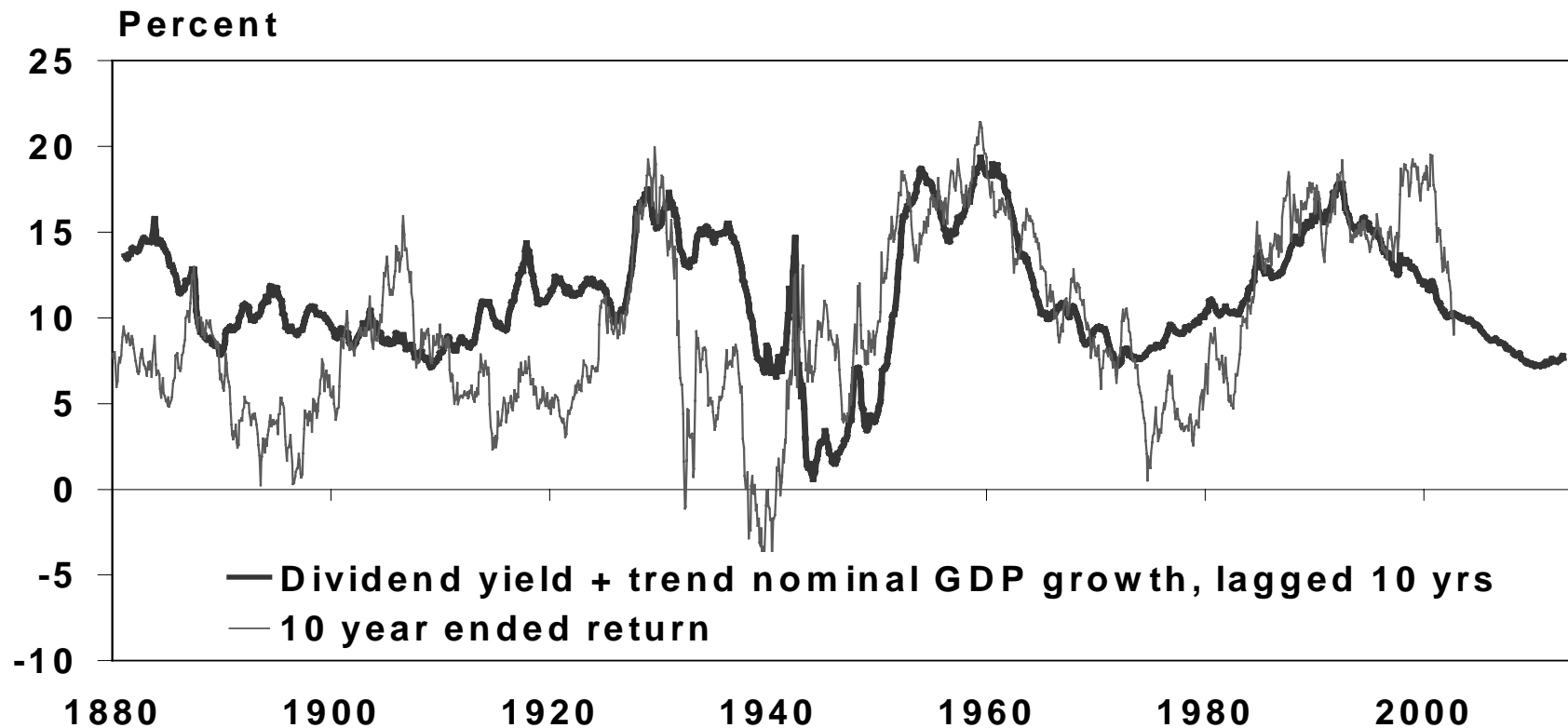
- Market returns close to random in the short term
- ...but are partly predictable over long term horizons
- Markets tend to overshoot such that future returns are dependent on current market prices (ie valuations)
- Predictability is greatest at 5-10 year horizons
- Yields (whether earnings yields, dividend yields or bond yields) are good guides to subsequent long horizon returns

Long term returns

Expected equity return

$$\begin{aligned} &= \text{dividend yield} \\ &+ \text{anticipated growth (= nominal GDP growth)} \\ &+ \text{valuation change} \end{aligned}$$

US - forecast and actual 10 Year Returns



Asset class returns - next 10 years, %pa

	Nominal GDP	Div Yield	+ Growth (=nominal GDP)	+ Valuation Change	= Return
US	2.3 + 3.0	1.7	5.3	0.0	7.0
UK	2.5 + 2.5	3.8	5.0	0.0	9.0
Europe	2.0 + 2.5	2.9	4.5	0.0	8.0
Japan	1.0 + 2.0	1.1	3.0	0.0	4.0 ??
Asia	3.0 + 5.0	2.0	8.0	0.0	10.0
Australia	2.5 + 3.5	3.8	6.0	0.0	9.5
Direct Property		7.0	2.5	0.0	9.5
Listed Property		7.1	2.5	0.0	9.5
Aust Bonds		5.5	0.0	0.0	5.5
Aust Cash		5.0	0.0	0.0	5.0

Mean reversion rules

Real returns % pa avg	US	Germany	Japan	Australia
Last 100 years	6.5	3.3	4.3	7.5
1900-09	7.8	3.6	11.8	11.8
1910-19	-2.6	-12.7	7.0	3.9
1920-29	14.4	5.8	2.5	16.3
1930-39	1.9	6.5	10.4	9.5
1940-49	4.0	-10.3	-25.7	3.2
1950-59	15.7	24.6	27.5	8.9
1960-69	5.6	3.9	8.5	10.5
1970-79	-0.7	-2.5	3.4	-4.6
1980-89	11.0	14.0	18.2	8.6
1990-99	14.2	9.6	-5.2	8.7

Source: Triumph of the Optimists, 2002

Asset class returns to be low

	Actual		Indicative
	1981-2001 (%pa)	1991-2001 (%pa)	2001-2011 (%pa)
Australian shares	13.6	11.7	9.0
International shares	16.8	12.5	8.0
Australian fixed interest	12.1	8.8	5.5
International fixed interest	na	9.1	5.0
Cash	10.5	6.1	5.0
Direct property	9.6	6.6	9.0
Listed property	13.5	11.9	9.0
Typical 70/30 Balanced Fund	na	10.7	7.5
Inflation	4.8	2.3	2.5

Key issue - will the US ERP be enough for investors?

Historic	1820 - 1900	0.8%
	1900 - 2000	5.8%
Expected = required	Fund Managers	4% (Merrill Lynch Survey)
	Actuaries	c. 5% (9% Total Return)
	Retail Investors	6%+ (based on 10% TR)
	Arnott and Bernstein	2-3%
Projected	Arnott and Bernstein	0% (5% TR)
	Bank Credit Analyst	0 - 2% (4-6% TR)
	Goldman Sachs	2.5 - 3.5%
	AMP Henderson	2 - 3%

The 5 -10 year outlook for US Equities - three scenarios

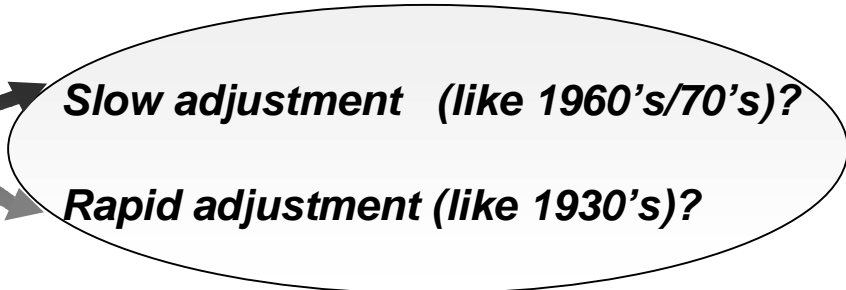
Central

- returns around/just below trend
- more volatility
- like late 1960's
- better returns elsewhere
 - Asia
 - Small and mid cap
 - High yield
 - Emerging market debt
 - Property
 - Australia



Secular Bear

- returns well below 6.0% real
- equities out of favour/revulsion
- Historic PE's fall to below 15x



Secular Bull

- returns well above 6.5% real
- triumph of new economy

5-10 year scenarios - indicative returns, % pa

	Central	Mild bear	Severe bear	Bull
US equities	7	3	1	12
Aust equities	9	5	3	10
Aust fixed	5	6	7	3
Direct prop	9	9	3	9
US corp bonds	6	5	2	6
Cash	5	4	3	6

Asset class implications

- Japanese (?), Asian, emerging markets, small caps may do better than the large cap Western markets
- More diversified mix with property, corporate bonds and alternative investments the main beneficiaries
- With low return outlook & higher chance of negative returns (& progressively, demographics), focus will increasingly be on yield
- Equity markets with high relative dividend yields & defensive exposures eg Australia, may be in favour

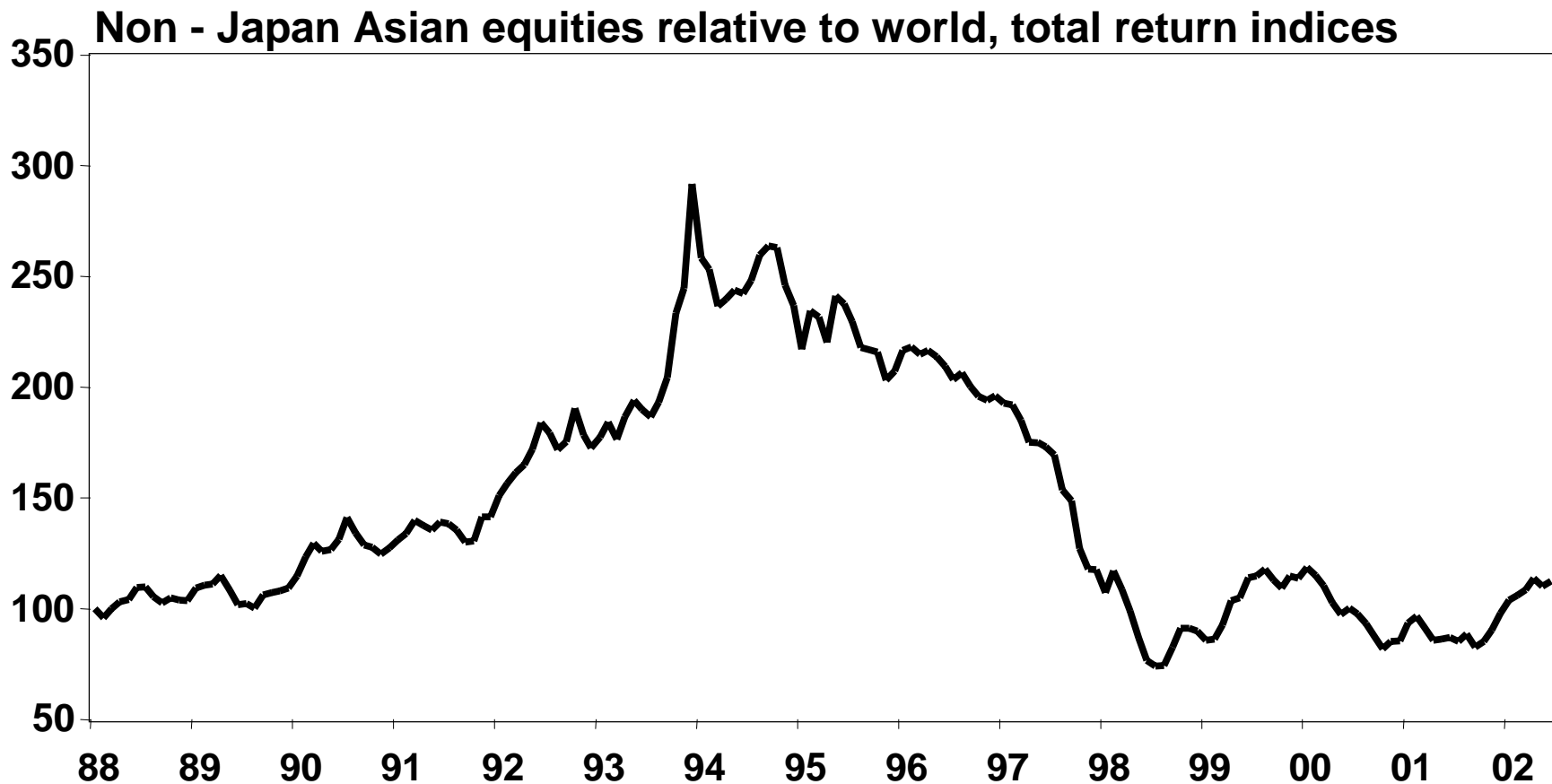
Implications for strategic asset allocation

- Maintain a bias towards Australian equities

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- Maintain a bias towards Australian equities
- Increase exposure to non-US markets within global equities

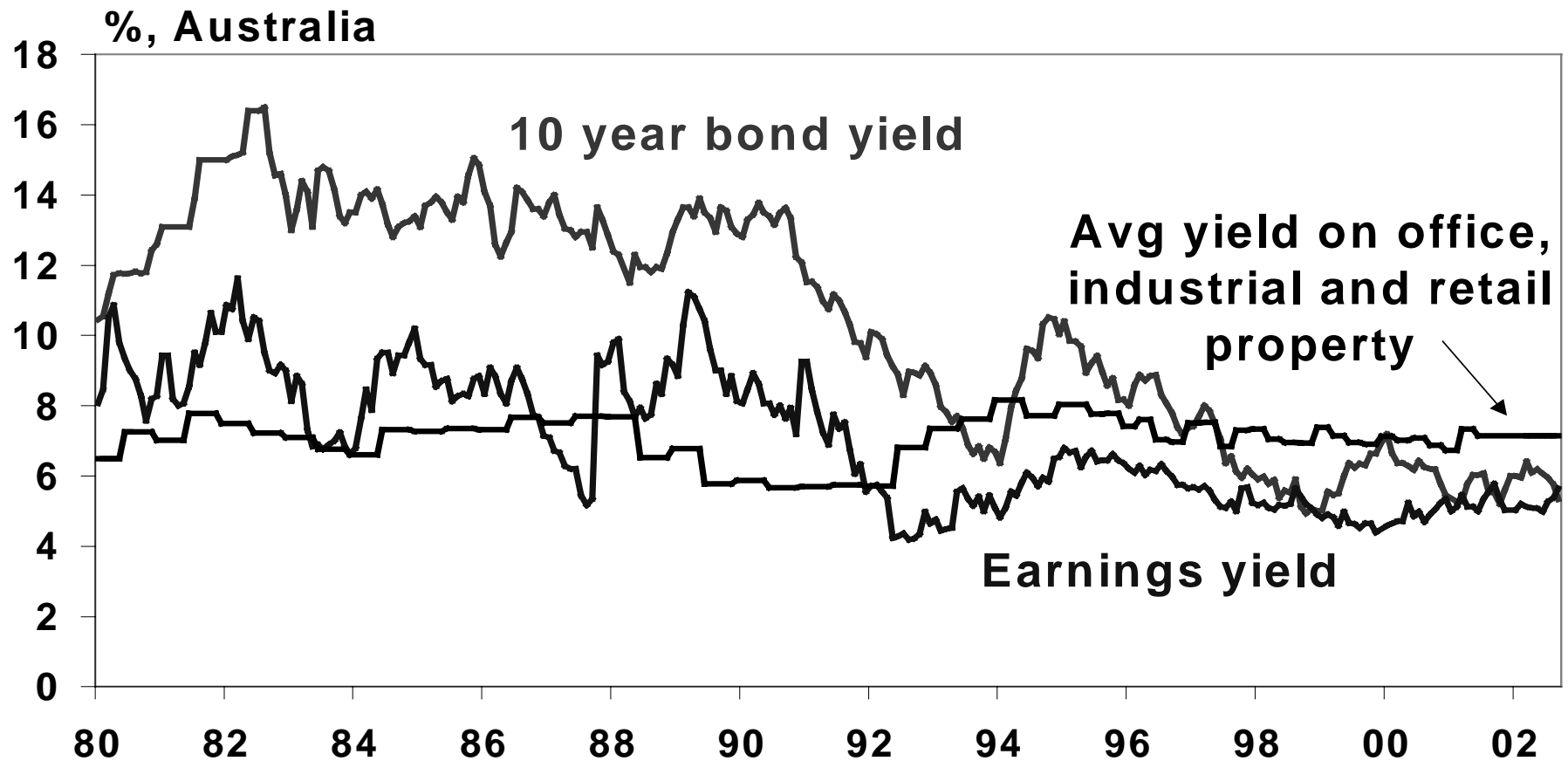
Asia looks attractive



Implications for strategic asset allocation

- Maintain a bias towards Australian equities
- Increase exposure to non-US markets within global equities
- Increase exposure to property

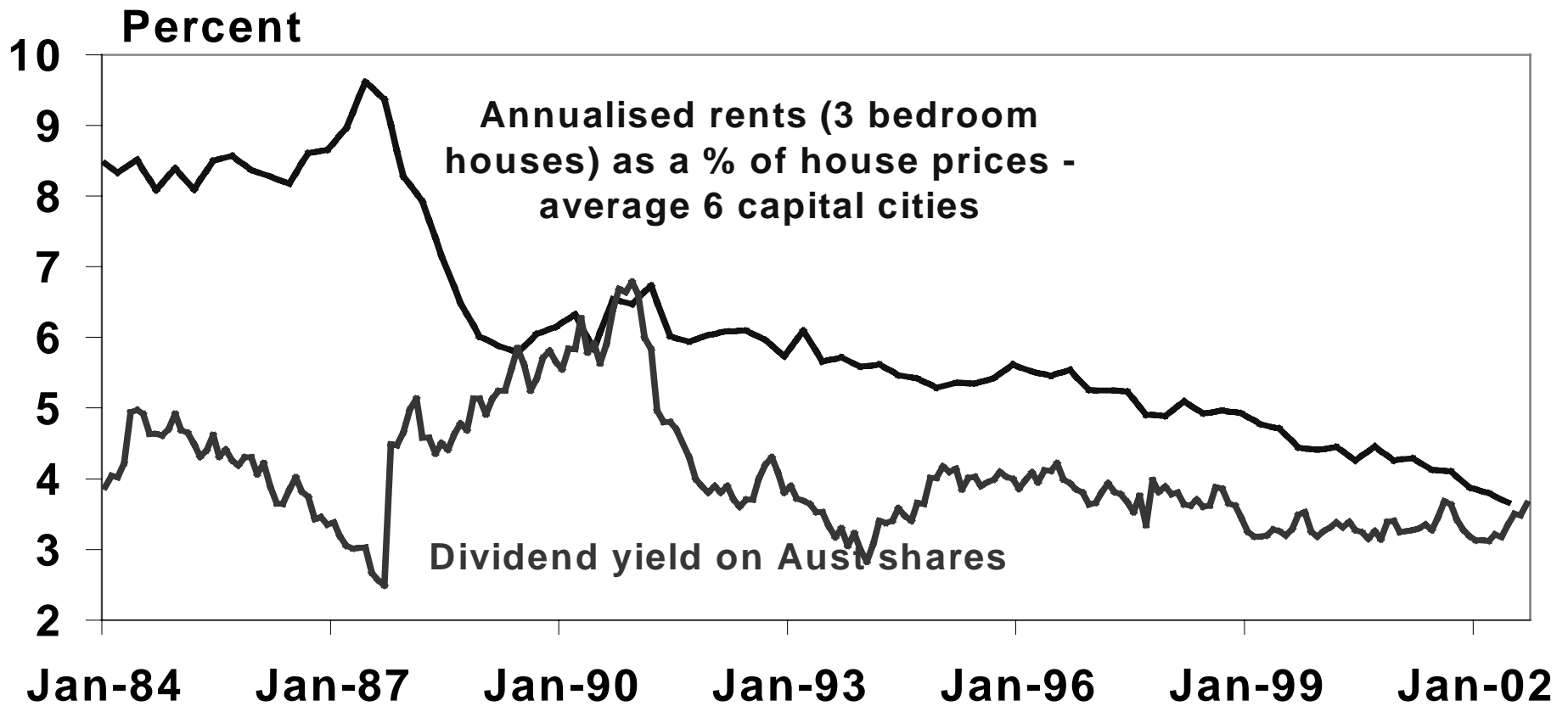
Commercial property yields are attractive



Listed property is also attractive

- Preference for direct property, but
- Listed is a viable alternative
- Yield play versus equities and will benefit from aging population
- Global listed property (provides diversification benefits) or local listed property

...but residential property is not



Implications for strategic asset allocation

- Maintain a bias towards Australian equities
- Increase exposure to non-US markets within global equities
- Increase exposure to property
- Reduce exposure to traditional fixed interest in favour of property/corporate debt and cash

Changing nature of fixed interest

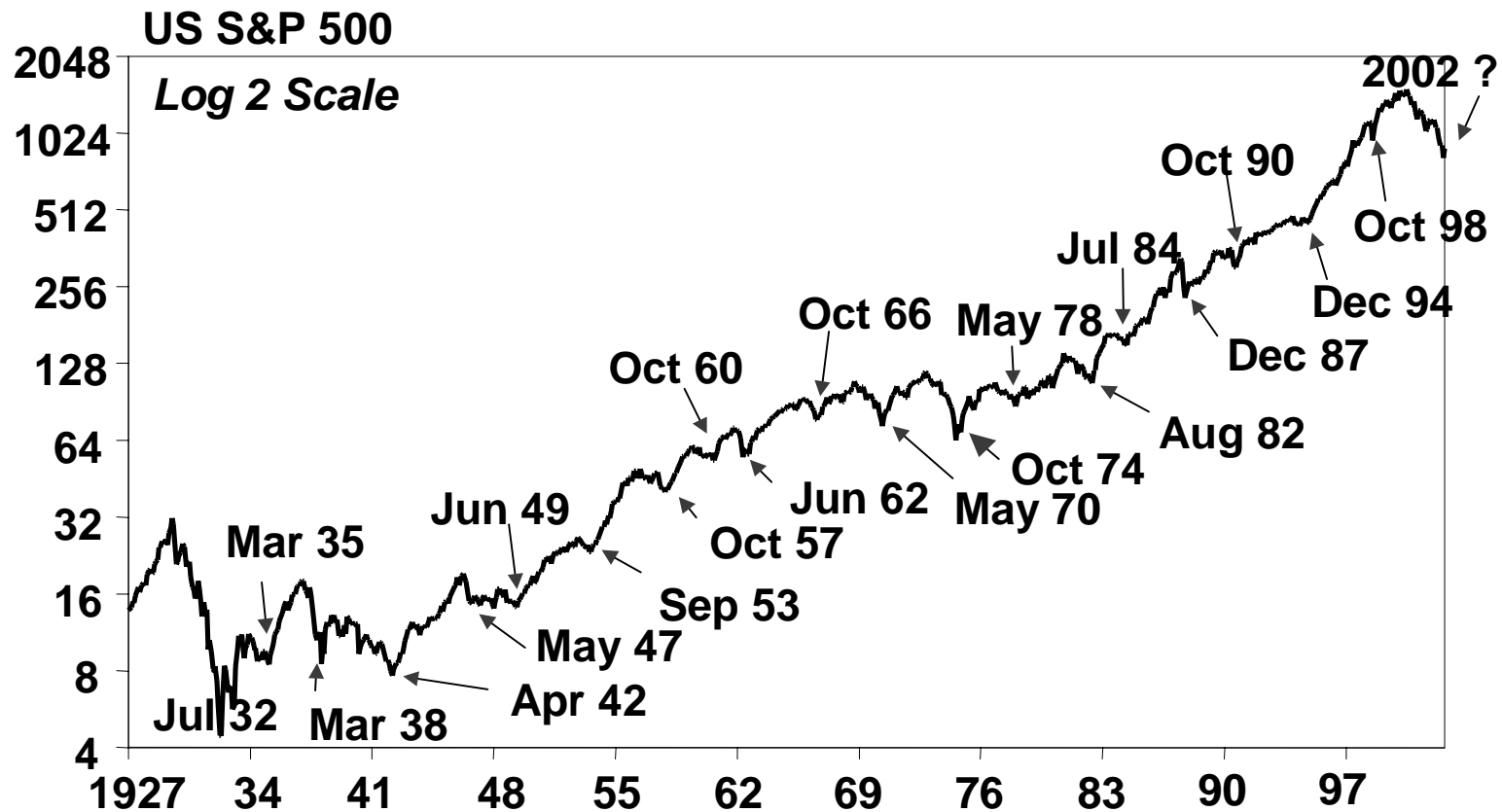
- **Argument for increasing cash at expense of sovereign debt**
 - Reduced return relativities
 - Complements increased property weights - helps liquidity
 - Maintains risk characteristics if corporate debt exposure increased
- **Increased corporate debt at expense of sovereign**
- **Some fixed interest assets really more growth assets**
Eg, emerging market debt, high yield credit, etc
 - Good return attributes but not defensive
 - Greater correlation with equities

Implications for strategic asset allocation

- Maintain a bias towards Australian equities
- Increase exposure to non-US markets within global equities
- Increase exposure to property
- Reduce exposure to traditional fixed interest in favour of property/corporate debt and cash
- Increase exposure to alternative investments - private capital, infrastructure, etc

Tactical (6-12 month) view

But don't forget - there is still a cycle



Conclusion

- Base case - low returns from traditional asset classes
 - average returns to be single digit
 - cycle lives on - more negative return years/increased volatility
 - smaller differential between asset classes
- Risk case
 - sustained secular bear market in the US comparable to the 1966/82 downswing.
- Strategic asset allocation to favour: commercial property, corporate debt, Asian equities, Australian equities
- Expect a cyclical equity bull market over the next year