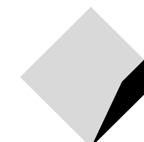
# Quarterly Investment Strategy Q4 2020.

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# Contents


| | |
|---|---|
| Summary | 3 |
| Commonwealth Private House View – November 2020 | 4 |
| Summary of Asset Allocation Themes | 5 |
| International Equities | 6 |
| Australian Equities | 7 |
| Fixed Income | 8 |
| Alternatives | 9 |

**About the author**

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**The Investments and Research Team**

The Investments and Research team specialises in investments, strategy and portfolio recommendations to support Commonwealth Private's Private Wealth Managers. The team researches investment markets and produces a range of publications to help clients deepen their understanding of investing. The team also constructs multi-asset portfolios to help our clients manage and grow their wealth.

All portfolio changes and product recommendations are overseen by the Commonwealth Private Investment Committee.

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# Summary

The US Federal Election is upon us, and irrespective of the final result, the stockmarket picked a preferred candidate in the lead up to voting day. Biden. How might we conclude this?

Well, you can try to correlate market movements with election polling odds, or market betting odds if that's your thing. For example, if Biden moves up in the polls, and the market rallies, you notice the correlation and make some sort of statement about causality.

You can do event studies, which are conceptually similar. In this instance, you'd take a significant event (like the debates) and attribute market movements to the narrative that emerged. For example: "it was clear that A decisively won."

You can be a bit more granular and look at the stocks and sectors the candidate has indicated a proposed change for. If housing was "on the nose" due to proposed changes in legislation to negative gearing and Capital Gains Tax, you can infer something about the magnitude of the impact and its probability of occurring.

Lastly, you can just ask people – good old surveys. Much of Wall Street has settled on Biden as the most probable winner.

Equally, Hilary Clinton was the candidate that most would win the 2016 election. Equally, most thought BREXIT was unlikely to occur, and, equally, most thought coronavirus would be much more contained than it has been.

Even at face value, Donald Trump's chances are still at 1/3rd, which means we shouldn't really be stunned no matter what happens.

Both candidates have flagged material fiscal stimulus if they win. The numbers are large, in the trillions, which is fine, because the US economy is also measured in the trillions.

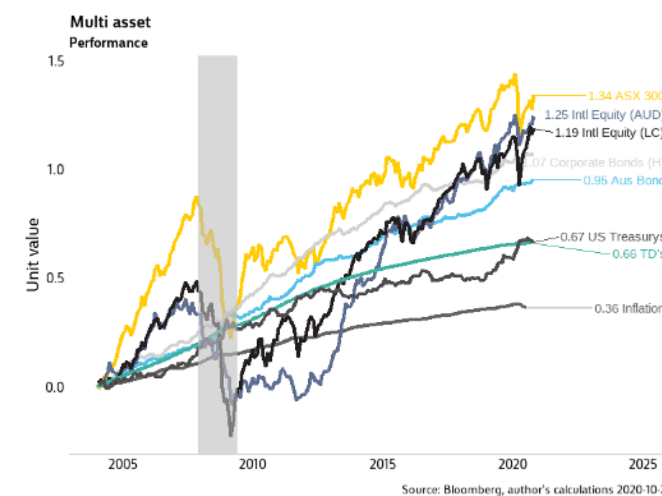
There's no issue around the quantum of the debt, and recessions, which the US is assuredly in. Recessions require deficits to keep things ticking along until whatever caused the recession eases off. In this case, the virus.

In our view, fiscal stimulus is priced in. The election risk creates volatility risk, but not meaningful economic risk over and above what we've already got.

Monetary policy is also accommodative (well, as much as it can get without going into uncharted territory) and these negative real rates, which remain negative out to 2025, are very equity-market friendly.

Again, this also likely priced in, and so we're sitting, in our Dynamic Asset Allocation portfolios, a touch under our Strategic Asset Allocation weights; meaning a modestly defensive tilt.

Remember asset allocation is the weighting framework to achieve our long-run goals (return and risk objectives). Dynamic is simply where we bump those weights up or down to reflect where we are in the cycle. Things are broadly balanced, and so, for the moment, are our funds.



# Commonwealth Private House View – November 2020

| View | Asset class | Sub sector | Over the cycle (strategic asset allocation) | Current (dynamic asset allocation) |
|---|---|---|---|---|
| ▼ | Australian equities | Large cap | 17% | 17.0% |
| | | Small cap | 1.5% | 1.5% |
| ▼ | International shares | FX hedging level | 50% | 50% |
| | | Developed markets | 22% | 24.0% |
| | | Emerging market | 4% | 2.0% |
| = | Property | Global REITs (hedged) | 1.9% | 1.0% |
| | | Australian REITs | 1.9% | 1.0% |
| | | Australian direct property | 3.8% | 2.0% |
| ▼ | Fixed income | Australian government bonds | 5.5% | 6.5% |
| | | Global government bonds | 5.5% | 2.7% |
| | | Investment grade credit | 9.0% | 3.0% |
| | | Securitized (CLO, ABS) & Derivatives | 0.0% | 2.1% |
| | | Cash / Money market | 0.0% | 3.8% |
| ▲ | Alternatives | Infrastructure | 3.8% | 4.5% |
| | | Hedge funds | 11.2% | 13.5% |
| | | Commodities | 0.0% | 2.0% |
| ▲ | Cash | Cash | 10.0% | 14.0% |
| ▼ | Growth - Tilt | Growth assets | 62.0% | 61% |

**Things you should know:**

Above, we illustrate our views by asset class. We outline our 'House View' on each asset class, and whether we recommend adding or reducing exposure to an asset class. These weightings relate to our Balanced asset allocation profile and are made with a medium term (one-to-three year) investment horizon. The percentage terms are indicative only and may vary depending on your objectives, financial situation and needs. This information is based on information available at the time of publishing, information which we believe is correct and any opinions, conclusions or forecasts are reasonably held or made as at the time of its compilation, but no warranty is made as to its accuracy, reliability or completeness. To the extent permitted by law, neither Commonwealth Private nor any of its related entities accept liability to any person for loss or damage arising from the use of the information herein. This document has been prepared without taking into account your objectives, financial situation or needs, so before acting on the information herein, you should consider its appropriateness, having regard to your objectives, financial situation and needs and, if necessary, seek professional advice.

# Summary of Asset Allocation Themes

| Asset class | Themes | Strategies |
| --- | --- | --- |
| **Australian equities** | ▸ Coronavirus dominates, although Australia has responded very well (vastly better outcomes on total case rates, deaths) and very large, well-targeted stimulus. Nonetheless, we viewed the economy as troubled prior to coronavirus | ▸ Quality defensive names have performed well, driving material portfolio outperformance. We are locking in some gains<br>▸ Value has beaten up, we are selectively adding exposures |
| **International equities** | ▸ Emerging Markets remain structurally challenged. They have lower growth, and are not as well able to cope with coronavirus. US dollar shortages abound for many Emerging Markets | ▸ European equities remain affected by ongoing EU integration issues. Similar story to the last 12 years. Nonetheless, equity risk premia everywhere are high, and attractive |
| **Currency** | ▸ On our models, the AUD is now sitting at fair value. These models are bog-standard rate and Terms of Trade models. Using risk-off models, AUD has a slight downside risk tilt | ▸ Hedge ratio set to 50/50. However, with AUD sitting at the upper end of our value range, and with risk-off models present, we are inching towards a shift in the hedge ratio to the old 20% H level |
| **Fixed income sovereigns** | ▸ Coronavirus is essentially a deflationary shock<br>▸ Monetary policy has deemphasised the old Phillips curve<br>▸ Expect low rates for the foreseeable future | ▸ We have moved underweight in Fixed Income<br>▸ Average Inflation Targeting, combined with Quantitative Easing, will likely prove a modest negative for bonds on a medium view |
| **Fixed income credit** | ▸ Spreads are mostly still too tight. We anticipate higher defaults, which are not captured in spreads | ▸ Prefer investment-grade credit to high yield<br>▸ Prefer Australian government bonds to investment-grade credit |
| **Cash** | ▸ Term deposit returns are too low after inflation and tax<br>▸ We're maintaining around 10% cash (in our Balanced Portfolio) | ▸ Overweight cash, given our defensive tilts, with negative real returns on offer in fixed income meaning we prefer to hold cash |
| **Alternatives** | ▸ Alternatives will provide another source of growth and diversification for portfolios outside of equities, which is valuable in this lower-return environment | ▸ We have expanded our Alternatives mix of infrastructure and hedge funds to include diversified oil and gas markets |
| **Property** | ▸ Property is seeing large impacts from store closures, and tenants seeking rental waivers. Working from home likely to weigh on Commercial property, particularly Office and Retail | ▸ Prime or premium-grade properties<br>▸ Avoid Office, Retail, prefer long Logistics<br>▸ Maintain minimal exposure to developers and constructors |

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# International Equities

You hear a lot that “the stockmarket is NOT the economy”. That, as a barometer for how the economy is performing, the stockmarket is not particularly useful or relevant.

We disagree, subject to a few notable caveats. There’s obvious stuff where what’s good for the market may not be good for the economy.

A race to the bottom in corporate tax cuts can raise corporate profits. This is great for share prices, but can result in material cutbacks in other government services, such that the overall impact is higher unemployment. There’s a sweet spot, and you can clearly go beyond it.

Similarly, industry concentration (excessive mergers and acquisition) can result in firms choosing to ration supply (lowering investment relative to what it would have been) and simply raise prices. Cosy oligopolies across many sectors can be wonderful for markets but not so good for consumers.

However, in the coronavirus context, where many ask “how can the market be up by so much, when there is so much unemployment”, the whole stockmarket-not-the-economy analogy breaks down.

The winners over the past year have been the coronavirus beneficiaries. Firms that can conduct most of their business online benefitted from a huge wave of new customers. The FAANGMN stocks (Facebook, Amazon, Apple, Netflix, Google, Microsoft etc) clearly fit that bill.

Retailers (to use some familiar local examples, like JB Hi-Fi or Harvey Norman) found themselves with customers that could no longer spend on services (everything from haircuts to massages to sports events to tourism), so substituted their spending on homewares and fitting out their home office.

Stocks and sectors that could no longer safely provide such services, were hammered. In other words, stocks with increasing sales and earnings went up, and stocks with decreasing sales and earnings went down.

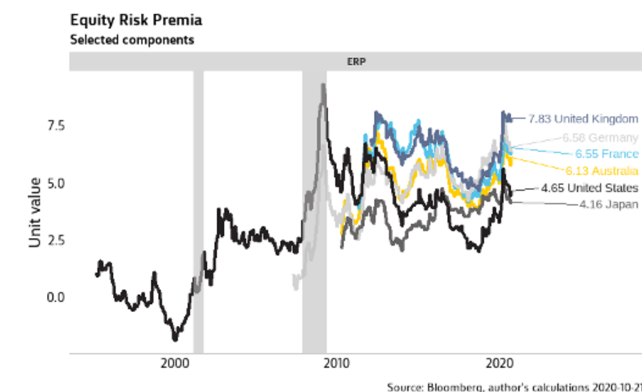
There was no dichotomy between the two. But perhaps here’s the rub. The weightings of the stocks that suffered from coronavirus are not especially large. The weightings of the coronavirus beneficiaries are.

The poor performers were too small to make much of an impact on the overall value of the S&P500. And that’s where you can make the case that the stockmarket, as constructed, is not a particularly good barometer for what’s happening in the broader economy.

You can make the point that FAANGMN stocks don’t employ nearly as many people as their market capitalisations might lead you to believe.

Now, risk premia in the US are back to what we’d broadly term ‘mid-cycle’. They aren’t cheap. On other models that calculate this premia, they are in fact slightly expensive.

But the rest of world’s Equity Risk Premia look pretty good, and so with a slight underweight to US equities and a slight underweight to Equities more broadly, we feel we’re well positioned for this stage of the cycle.



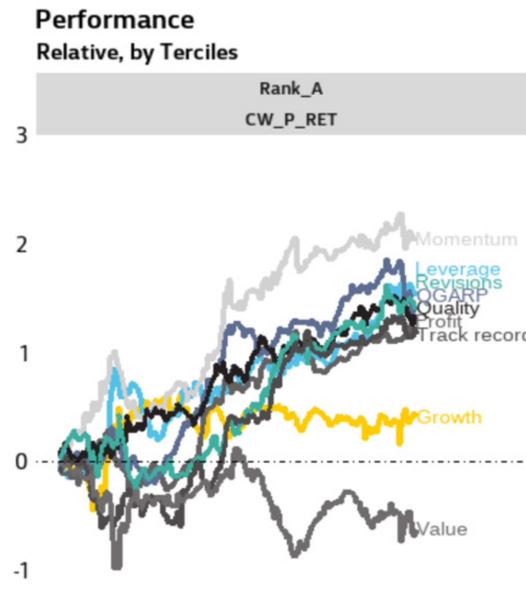
# Australian Equities

Casting around for value in the local market is actually quite easy, would you believe?

Value itself is "a thing". A specific investment strategy borne out of the realisation that investors (people, and the people behind the machines that program them) make specific errors when parsing the world. They often underreact to some new information (which gives rise to a strategy called Momentum) or overreact, extrapolating whatever has happened in the recent past and assuming it will remain that way indefinitely.

The recent extrapolation of "new paradigm" is evident in technology stocks. Particularly where new technology can intersect with other popular market narratives (like healthcare, predicated on ageing populations, or financials, where people believe Fintec will supplant/replace/disrupt incumbent financials).

What makes it complex is that some will! There are some legitimately good business models in there. But not all. And the market caps of many names that straddle the nexus between information technology, financials and health are trading on triple-digit price-earnings ratios.



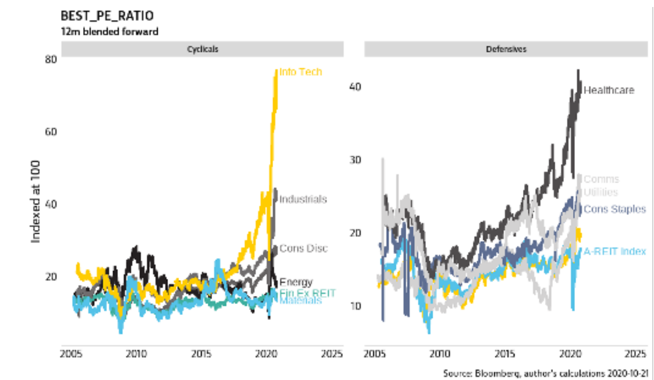

Now Value as a thing hasn't worked well for much of the past 10 years.

Ranking stocks on an absolute basis (i.e. not accounting for sectoral composition or relativities), we see Value as an investment style that has been trounced by everything. Buying cheap stocks, and selling expensive ones based on the behavioural foundations we outlined above, hasn't worked.

Good for us I suppose, in that our style is Quality Growth. So the past 10 years have been very strong for our chosen investment style.

But, the reason a strategy works in the first place is because if it was a) easy to do and b) easy to stick with, everyone would do it. There'd be no return to the factor.

Thus, we recognise every strategy will have long periods of underperformance, and that's okay. For us, on a market-timing basis, at a time when we think some markets, and some investment styles are expensive, making a modest allocation to Value makes a good deal of sense. This is at the overall portfolio level, and the stock selection level.



# Fixed Income

Every now and again, I feel compelled to revisit fixed income – to explain why rates are low, and why they're likely to stay low. Let's posit a bunch of stuff, and then see if that seems to ring true.

Economic theory suggests a relationship between growth rates and interest rates. If you're expecting future growth in your income, you're more likely to borrow and spend now, putting upward pressure on rates.

If you're young, you likely don't have much savings and to smooth out your consumption, you borrow (for cars, homes, travel etc), putting upwards pressure on rates.

Economic growth itself comes from productivity (ideas dispersion throughout the economy to produce more with less) and from growth in the labour force, in turn, growth in population.

Rates should also be a function of inflation. If the market expects higher inflation, it will pass that through in the form of higher nominal rates to ensure the purchasing power of capital remains the same (i.e. not eroded by inflation).

What else is there to mention? Well, long rates are an average of expected future short rates, and short rates are reflective of monetary policy. In turn, this is reflective of things like output gaps or unemployment gaps.

Lastly, uncertainty about future interest rates should show up there somewhere (as a form of term premium) that we could proxy by looking at rate volatility over time.

Great, we have some ideas. Let's look at that in a time series model (I put the graph in below for those that wanted to see what such output looks like. It does need explaining to do it justice, detail that can't easily squeeze into this report).

```
Call:
conLM.lm(object = object, constraints = constraints)

Restriktor: restricted linear model:

Residuals:
     Min       1Q   Median       3Q      Max
-1.69592 -0.38877  0.03521  0.41584  1.35345

Coefficients:
                         Estimate Std. Error  t value  Pr(>|t|)
(Intercept)             0.1231373  0.1369781   0.8990 0.3692023
Short_rate              0.3045174  0.0249773  12.1917 < 2.2e-16 ***
Expected_inflation      0.6954826  0.0249773  27.8445 < 2.2e-16 ***
Expected_growth        -0.0737238  0.0399122  -1.8471 0.0654440 .
Inf_spread              0.3395752  0.0972789   3.4907 0.0005339 ***
Risk_premium            8.5205412  0.5117589  16.6495 < 2.2e-16 ***
TWD                     0.0331501  0.0046317   7.1573 3.813e-12 ***
Foreign_holding_change -0.1925664  0.0301366  -6.3898 4.508e-10 ***
Proportion_65_change   -3.3873292  0.2526022 -13.4097 < 2.2e-16 ***
Fed_debt_stock_change   0.0821077  0.0185486   4.4266 1.228e-05 ***
---
Signif. codes:  0 ‘***’ 0.001 ‘**’ 0.01 ‘*’ 0.05 ‘.’ 0.1 ‘ ’ 1
```

Source: Bloomberg, author's calculations, 2020-10-13

We see lots of statistically significant coefficients in our model. All those ideas seemed to be detectable in the data, which regressed long bond rates (10 years) against those economic fundamentals.

If you're interested in what that model meant more specifically, let us know! But the main point for having it is to say that rates are about where we expect them to be.

There is no central bank repression happening. Central banks everywhere are following rates down, driven by the fundamentals. The Fed went from all-powerful hero, to sidekick in the space of three columns and a graph.

Doesn't it mean fixed income is now suddenly wildly attractive? No, it doesn't. The negative real yields aren't great. But given bonds still have a role to play in generating a) reliable income streams and b) portfolio diversification benefits, we should absolutely still include them in our diversified investment portfolios.

Which is why we do.

# Alternatives

I wrote the section on fixed income to kind of set the scene for Alternatives. We've got quite a decent exposure to Alternatives, but I suppose people still feel a bit unsure of them as an asset class. So, here goes.

There are well-known bog-standard risk premia we employ in portfolio construction.

Bonds have term premia, liquidity premia and credit risk (i.e. prospect of defaults) embedded in their yields and expected returns. The reason you get a return is because you're exposed to risk in these things, and in return for "shouldering" those risks, you get some yield.

Equities are the same. The risks are higher, there are less capital structure protections, and so you get a bit of extra premia, called the equity risk premium.

These are basic Strategic Asset Allocation building blocks. Over long periods of time, if we expose capital against them, we'll probably make some money.

At times, those premia can be a bit cheap, or, a bit expensive, and so we dynamically oscillate between them (just moderately, in our Dynamic approach).

We talked earlier about Value and Momentum as valid investment strategies, akin to risk premia.

Quality, Low vol, betting against beta, carry (high yield payers) are all eligible risk premia. These have been observed in many different asset classes, in many different markets, over many different years.

But there are other premia out there, that don't require you take on the market risk associated with the equity risk premia.

For example, Merger arbitrage. You see a proposed acquisition of XYZ at $25. The market isn't sure the deal will go through, and prices it at $24.50. The difference is time, value of money and deal shortfall risk.

You decide that most deals do succeed, and you'll take that risk. More particularly, you decide to go long the acquired, and short the acquirer. And, because the total return you'll get from doing this isn't especially large, you decide to leverage the trade.

Now you decide to do this for many deals. Perhaps you have 100s in front of you.

Now you've created a risk premia (merger arbitrage) that is uncorrelated to what's happening in the broader economy or market. At least that's the idea. Using the same phrases as I've been using throughout this report, this is a valid investment strategy.

It has the potential of making money even if stocks go up or down. Combining this sort of approach, with many other "alternative" risk premia, is the essence of Alternatives. You can generate a positive expected return for an improved sharp ratio (risk adjusted return measure).

Given how low the returns to traditional premia are (for example, the negative term premia, the low credit premia) Alternatives are an important way to meet return objectives. People are often thinking of "cash +" investment outcomes, in a search for yields.

Alternatives can certainly be part of that consideration.

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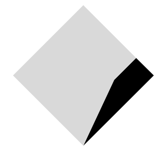

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