Active management will remain key

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The past few years have seen heightened volatility as markets recover from the Global Financial Crisis, and deleveraging takes place in developed countries. While market volatility can be unsettling for investors, it also brings exciting opportunities for those who actively manage their investments. It’s important to remember that markets are constantly changing, so the ability to actively manage at both the asset allocation and stock level will continue to benefit investors. It’s also important not to forget another fundamental principle of investment – that it pays to stay in the market and allow your investments sufficient time to perform. These principles are tested by markets periodically, but they have stood the test of time.

Asset allocation was so important in 2013

Share markets went up

At the beginning of 2013, we recognised that the greater threats to share market performance had receded, and that the ‘less risky’ economic backdrop was leaving room for the market to focus on fundamentals. As shares were very cheap and poised to deliver good returns for the year, those investors who allocated an overweight position to this part of the market stood to benefit. By the end of the year, the share market had, indeed, performed very well as predicted. Australian shares returned 20% (as measured by the S&P/ASX 200 Accumulation index), and international shares delivered a very strong 29% in local currency terms, or 48% on an unhedged basis when adding the currency effect (MSCI World ex Australia Accumulation Index).

Bonds had a poor year

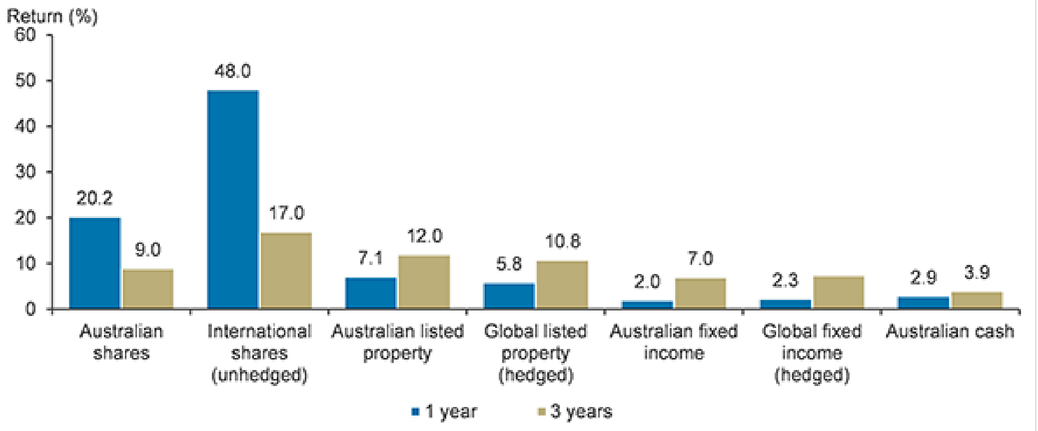
Conversely, we expected low returns from bonds at the outset of the year. With this in mind, it made sense to hold an underweight position in fixed income. Yields in core government bond markets were at record lows, suggesting that they would rise in the future (i.e. prices would fall) as global growth improved. This was indeed what eventuated in 2013, and we saw, for example, the Australian 10-year government bond yield rise over the year by almost 1%. All in all, the UBS Government Bond index managed only a 1.3% return for the year.

The Australian dollar fell

The decline in the Australian dollar was another notable event of 2013. The currency fell around 14% versus the US dollar as the Reserve Bank of Australia cut rates.

This provided opportunities for active asset allocation

These examples demonstrate the value of active management at the asset allocation level. Considering the returns these different markets generated over the year, it clearly paid off for investors if they were able to benefit from increased exposure to markets that did well, and reduce exposure to those sectors that had a lacklustre year. Indeed, asset allocation is the main source of performance over the long-term, so it pays to get the right mix of assets within portfolios*.



Source: Australian shares: S&P/ASX 200 Accumulation index in AUD; International shares (unhedged): MSCI World ex Australia net index in AUD; Australian listed property: S&P/ASX 200 A-REIT Accumulation index; Global listed property: UBS Global Investors ex Australia; Australian fixed income: UBS Composite All Maturities index; Global fixed income: Barclays Global Aggregate Index Hedged AUD; Australian cash: UBS 90 Day Bank Bill index. Data as of 31 December 2013.

Similar themes call for more active management

Further gains are expected for shares

As we look forward into 2014, we expect to see a continuation of many of the same themes as last year. Improving economic growth, with low inflation and interest rates, provide a positive backdrop for growth assets. Despite the fact that the Federal Reserve has commenced tapering of its asset purchase program (which will gradually withdraw liquidity from markets), this should be seen as good news. Essentially, it indicates that the US economic recovery is becoming more sustainable. Furthermore, the Federal Reserve has reinforced that any increase in interest rates is still some time off, so policy remains very supportive of shares.

Yes, shares have had a strong run for the past 18 months – but they have not reached 'expensive' levels. We still believe that valuations look fair in an absolute sense. That said, we feel the market will need to see evidence of earnings growth from companies in order to move higher. Therefore, the ability to dynamically allocate between asset classes will remain critical as we monitor how the market evolves in 2014. Likewise, the ability to identify companies with strong management and decent cash-flows will be more important than ever.

At a regional level, US shares currently appear to be one of the more expensive markets, and European stocks are more attractive on a relative basis. From a valuation perspective, the Chinese share market looks as cheap as it did immediately post the Financial Crisis. We feel that the market's concern over a Chinese economic slowdown and fiscal tightening has been largely priced into valuations. This should leave room for an up-tick in share prices at some point in the future.

Another year of low returns from bonds

We expect another year of low returns from bonds. That said, the rise in yields on sovereign bonds in 2013 indicates that bonds have become ‘less unattractive’. Consequently, the next move from a portfolio construction perspective could be to increase exposure to this asset class. But, for now, a relative underweight exposure to sovereign bonds is appropriate for the current environment.

* Based on three year performance of AMP Balanced Growth Option net of fees and taxes, more than 94% of the fund’s total return came from the strategic asset allocation mix. Past performance is not a reliable indicator of future performance.

A stock-picker’s market

In addition to active asset allocation opportunities, there are exciting opportunities for active management at the stock level. This is because there is a high level of dispersion between the performance of different companies in the market. This is in contrast to share market dynamics of recent years where stock prices tended to move in tandem with each other. We saw this begin to reverse in 2013 when the market began focussing more on company fundamentals than macro-economic news. This environment is ripe for active stock pickers, offering plenty of scope to add value over the market return.

In the December quarter alone, the best performing stock in the MSCI Emerging Markets index returned more than 100%, compared to a -40% return from the worst performing company.

Domestically, one example of a company which has performed particularly well in 2013 is Ramsay Hospitals, which operates throughout Australia, the UK and France. The company delivered a staggering 43.5% return above the S&P/ASX 200 index in 2013. This was on the back of consistently positive earnings per share revisions, and an expansion in its price-earnings ratio.

This demonstrates how conditions in both Australian and offshore markets have created opportunities for active stock selection. We believe that throughout 2014 the market will continue to reward companies with strong management, consistent earnings delivery and relatively low earnings risk.

Keep your focus on what really matters

Contrarian investment views may arise from time to time, but it’s important to remain focussed on the long-term objective of your investments, and not be sidelined by daily headlines. In 2014, we may see short-term corrections in share prices or falling bond yields for periods of time. Identifying the most appropriate long-term mix of assets continues to be the foundation of portfolio construction, as it’s this decision that will drive the bulk of returns for diversified portfolios. Actively managing portfolios around the strategic asset mix will also be important in 2014 as it was in 2013, as this provides the opportunity to benefit from changing market conditions and expectations of future returns.

About the Author

Debbie Allison is the Head of Portfolio Management within the Multi-Asset Group. Debbie is responsible for overseeing the Group’s multi-asset investment capability which specialises in the management of diversified portfolios. This includes portfolio construction and asset allocation, monitoring and risk management.