

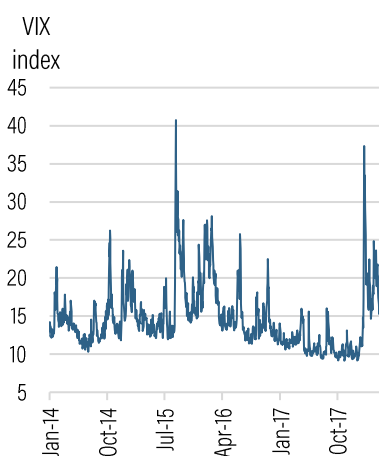


SCOTT HASLEM

*Higher volatility has been the stand-out for markets so far in 2018...*

*...our clients have been accumulating more international equities and alternative assets.*

**Volatility lifted in 2018, though it is now arguably 'more normal'**



Source: Crestone Wealth Management and Bloomberg

## How have our clients responded to rising volatility?

Higher volatility has been the stand-out for markets so far in 2018. Initially, its return was driven by fears of faster-than-expected inflation in the US, to be replaced relatively promptly thereafter by fears of an escalation in global trade tensions. Reflecting this, markets have had a difficult start to the year, with bond yields moving noticeably higher and equity markets only starting to deliver solid returns in April (after correcting sharply in the first quarter).

Through early 2018 we have been recommending to our clients to 'stay cautiously engaged' with risk and to start looking to increase allocations to alternative assets. These have low correlations to bonds and equities and can increase diversification at more uncertain points in the macro cycle.

This month, we take a look at how our high and ultra-high net worth clients, family offices and not-for-profit organisations are invested, and how they have managed their portfolios through this period of rising volatility.

We find that, collectively, our funds under advice (FUA) are well diversified and align increasingly closely to our recommended growth (rather than balanced) strategic asset allocation (with a correlation of over 85%).

Moreover, broadly paralleling our early-year assessment, we find that during Q1 2018, our clients have been reducing some of their precautionary cash holdings to both accumulate more attractively-valued international equities and lift their allocation to more market-neutral alternative assets.

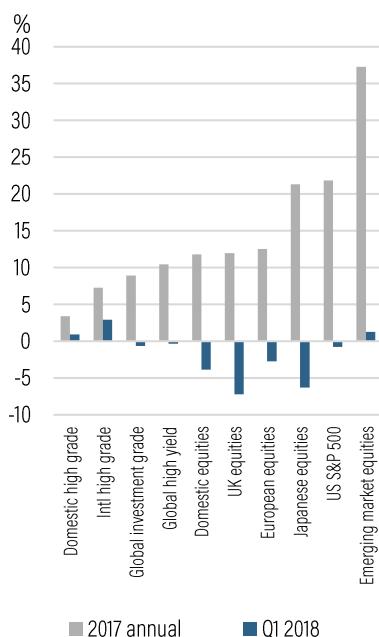
### A return to volatility delivers a tough start for 2018...

Volatility returned in early 2018 after a two-year respite. As the chart opposite reveals, 'the Vix'—the most familiar measure of market volatility—more than trebled in late January 2018 and has remained relatively high since. Of course, our sensitivity to higher uncertainty and volatility has been heightened by its absence over the past couple of years, with the current level not of itself absolutely high in an historic context (see again the chart opposite).

The catalysts for the end of calm were late-January's higher-than-expected US wage data and February's higher US inflation outcomes. As we noted last month, with valuations elevated, the US equity market entered its first correction since early 2016. By late April, US 10-year bond yields had risen through 3% to their highest level in over six years.

Yet, by the end of Q1 2018, wage and inflation data in the US had stepped back, and there was little evidence of a more rapid inflation uplift elsewhere in the world. But markets have continued to be volatile on fears of a dramatic escalation in global trade tensions as US President Trump and China's President Xi Jinping announced protective tariffs. These threatened to reverse some of the past benefits of a vibrantly-trading global economy. For now, we expect the impact to be limited, a view supported by Credit Suisse who recently flagged the announced measures as having only a "very small" impact on global growth.

## 2018 asset returns are more dispersed than in 2017



Source: Crestone Wealth Management and Bloomberg

*Our clients continue to globally diversify their portfolios...*

*...with around 60% allocated to equities and 20% to fixed income, and a rising allocation to 'alternatives'.*

## Our clients' collective funds under advice

Percentage of Crestone FUA	Sep 2017	Dec 2017	Mar 2018
Cash and liquidity	13.8	12.2	11.3
Domestic fixed income	15.3	15.3	14.9
International fixed income	4.2	4.1	4.5
Domestic equities	32.6	33.2	32.6
International equities	28.2	28.8	29.8
Alternatives	6.0	6.3	6.8

Source: Crestone Wealth Management

## Asset returns have been more dispersed than in 2017

Rising investor concerns have been reflected in far more muted and dispersed asset returns during Q1 2018. This follows 2017, where all major asset classes delivered, on average, stellar returns (see chart opposite).

Taking a look at Q1 2018, we find equity returns were weak. This was particularly for the UK and Australia (both underweights in our tactical positioning), with Q1 total returns in local currency negative 7% and 4% respectively, while Japan returns also declined 6%. The US (neutral) and Europe (overweight) performed relatively better at -1% and -3%, as did emerging market equities (neutral) at 1%. Year to date, reflecting a solid rebound through April, US and European total returns have moved to be positive, while Australian and UK returns have also become less negative.

As the chart opposite also shows, total returns in domestic and global high-grade government bonds and corporate credit markets (investment grade and high yield) have also been limited, and significantly below that of 2017. We have been progressively moving more underweight international fixed income as interest rates look likely to continue to rise ahead.

## How are our clients invested?

Our investment process is centred on providing globally-diversified investment portfolios. Strategic asset allocation (SAA) is an important part of portfolio construction as it structures portfolios at the asset class level to match an investor's specific investment objectives and risk tolerance. Furthermore, history has shown that a disciplined SAA is responsible for around 80% of overall investment performance over the long term.

Looking collectively across our FUA, how diversified are our clients' portfolios? To what extent do they have a global focus? And to what extent do they align more with our balanced or growth-focused SAA recommended portfolios?

The table below shows our collective asset allocation as at the end of March 2018. We can draw a number of conclusions. Our clients:

- **Currently hold more cash** at 11% than our SAAs recommend (5%). However, this is not inconsistent with our current tactical asset allocation (TAA) to be overweight liquidity (7%) given more 'mid-cycle' markets.
- **Hold significantly less alternatives** (such as hedge funds, global macro funds or private equity) at 7% compared with our 16-20% recommended SAA across our balanced and growth portfolios. We have also recently recommended a tactical overweight position to the alternatives asset class.
- **Have fixed income allocations (19%) closer to our growth (17%) than balanced (33%) SAA model portfolios.** However, allocations are skewed to domestic fixed income (at 15% where we have included hybrids for this analysis). This contrasts international fixed income (5%), which is below our recommended SAAs for both growth and balanced portfolios (8-13%).
- **Hold 62% of their assets in equities in line with our growth SAA.** The domestic/international split (50/50) also roughly matches our SAAs, though our clients currently have slightly more domestic equities (33%) than international (30%), contrasting our slight preference to international.

Overall, our FUA is allocated with a correlation of about 87% to our recommended growth SAA (up from less than 80% a year ago), compared with 51% correlation to our balanced SAA. Our clients' portfolios have significant diversification into international equities, with modest diversification into international fixed income. Our clients' lower alternatives allocation is partly offset by a higher allocation to cash, albeit both provide diversification relative to traditional bonds and equities.

## How have our clients responded to rising volatility?

Over recent months, we have been advocating that investors consider cautiously engaging risk in equity markets, despite higher volatility, via a slightly overweight tactical position in international equities. Also, as detailed in last month's *Core Offerings*, we have been suggesting clients consider the potential diversification benefits of alternative investments (such as hedge funds, private equity and global macro funds). These typically exhibit a low correlation to traditional asset classes, such as bonds and equities, and can provide portfolio diversification in maturing

*Despite the rise in uncertainty during Q1 2018...*

*...our clients have continued to cautiously engage risk as advised.*

growth cycles, where asset market returns can be lower, more volatile and more dispersed.

Looking across our FUA, how have they responded to the weakness in equities in Q1 2018, rising bond yields and uplift in volatility? Looking again at the earlier table, we find that, collectively, our clients have:

- **Utilised a part of their (overweight) precautionary cash holdings to increase their non-cash investments.** Between the end of December 2017 and the end of March 2018, cash weightings fell almost a percentage point from 12% to 11%.
- **Increased offshore equity positions, despite weak markets.** Our FUA in international equities rose 1% (from 29% to 30%), despite offshore markets falling on average (though the Australian dollar's weakness in Q1 2018 would have mitigated some of that valuation impact for unhedged positions). This move was broadly consistent with our tactical overweight to international equities.
- **Increased allocations to alternative assets.** Our FUA in alternatives rose in Q1 2018, to be up almost 1% since September 2017 (from 6% to 7%). We expect a further rise in the share of alternatives during Q2, broadly consistent with our recent move to tactically overweight this asset class.
- **Reduced allocations to domestic equities marginally** (from a little over to a little under 33%). This could have been mostly passive given the 4% fall in the return of domestic equities during Q1. Overall, a reduction in exposure to domestic equities is consistent with our slight tactical underweight.
- **Made little change to total fixed income holdings** (which was unchanged at 19% of FUA in Q1). There was a small shift from domestic to international exposures (compared with our preference for domestic fixed income relative to international fixed income). The modestly- reduced share of domestic fixed income may reflect a widening of the spread on hybrid investments during the quarter.

### **In summary**

Despite the rise in volatility and uncertainty during Q1 2018, as well as a more difficult start to investment markets this year, our clients have continued to cautiously engage risk as advised. Overweight precautionary cash balances have collectively been used to fund higher positions in international equities and alternative asset classes, broadly consistent with both our strategic and tactical asset allocation recommendations.

We also find that our clients are increasingly diversified, with strong allocations to overseas markets, which we believe present a greater opportunity set than investment portfolios concentrated in Australia. The rising correlation of our FUA towards a strategic asset allocation reflecting a growth strategy highlights the importance of long-term, through-the-cycle investment returns for our high and ultra-high net worth clients, family offices and not-for-profit organisations.

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