CIO MONTHLY / MAY 2019

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How have our clients responded to *recent volatility?*

This month we provide an update on how our high and ultra-high-net-worth, family office and not-for-profit clients are invested. Importantly, we also take a look at how they have managed their portfolios through recent volatility—in particular, through the sharp correction in risk at the end of 2018 and the subsequent recovery we have witnessed through Q1 2019.

We find that, collectively, our funds under advice (FUA) are well diversified and align increasingly to our recommended 'growth' rather than 'balanced' strategic asset allocation (SAA). This has a correlation of almost 90%, up from about 80% two years ago. About 60% of client assets are invested in equities, with another 20% allocated to fixed income assets (mostly in Australia).

Over the past six months, despite volatility in global markets, our clients have continued to increase their allocations to international equities. Of interest, in contrast to a year ago (and for some time before that, we suspect), our clients international equity positions collectively now exceed domestic equity positions, in line with our recent strategic and tactical decisions.

Clients have continued to increase their allocations to international equities…

…a long-standing Australian equity 'home bias' is being reduced.

Client portfolios have also embraced our strong strategic and tactical commitment to alternative assets, which have increased by more than 50% over the past year from 6% to 10% of FUA. These assets typically exhibit low correlation to traditional equity and fixed income assets and can provide significant portfolio diversification benefits as the macro cycle matures.

But first…it's time to contemplate a better growth outlook

As we highlighted in a *Special report* to clients in mid-April, it is time to start contemplating a better global growth outlook over the remainder of 2019—and maybe also a better outlook for Australia. 'Have you not seen the data?' we hear you say. 'What about the unrelenting slashing of growth forecasts over recent months?' Heightened market volatility has also dented sentiment.

The global economy slowed sharply in late 2018, much more than analysts expected, and remained weak in early 2019. The longevity of the current cycle, and the perception it must be closer to its end than its beginning, also contributed to the speed with which the market embarked on a sharp equity rout and bond rally. Indeed, it was the worst December for equity markets since the 1929-1939 Great Depression.

Clients have embraced our strategic and tactical tilt to alternative assets…

…allocations to these assets have increased more than 50% over the past year.

If inflation and interest rates were to keep rising as they did through 2018, the expectation that economies and risk markets would continue ever-lower in 2019 to an inevitable cycle-end is a conclusion well founded in history. Rising inflation accompanied by central banks actively tightening policy—taking the punch bowl away, as it is referred to—is one of the more frequent paths to a downturn that refreshes the risk cycle, particularly since the 1970s.

Inflation, however, is no longer rising. We flagged the risk of this in late September 2018 when we shifted underweight equities. We then became more confident of this when we returned to a more neutral stance in December and are now becoming increasingly confident that inflation risks for this year have all but dissipated. Indeed, as we wrote in February this year, central banks are in retreat, seemingly 'benched' for the rest of this year.

Global activity indicators point to a moderate reacceleration in growth in mid-2019…

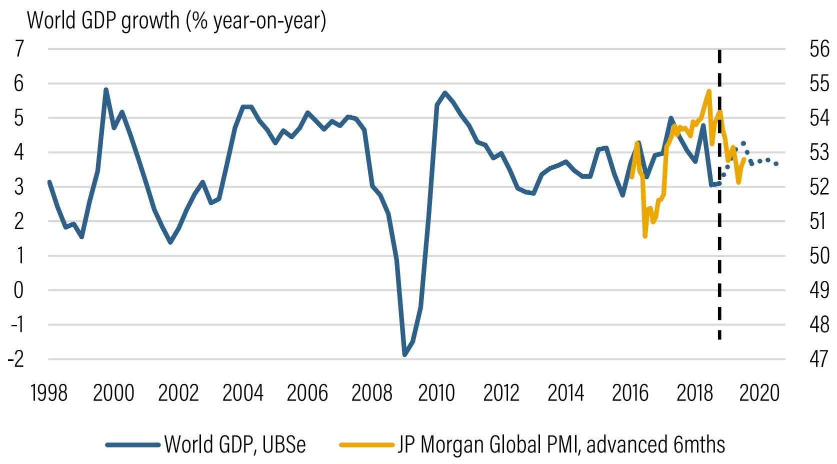
…Australia's activity data has also stabilised over recent weeks.

Moreover, we have seen the data…and it's getting better!

Globally, industrial activity, trade and consumer spending has improved across the US, Europe, the UK and China. As reflected in the chart on the following page, the JP Morgan composite Purchasing Managers Index (PMI) has now recovered to its September 2018 level.

Australian data has recently shown some stabilisation. Retail sales, residential building approvals, consumer confidence and car sales have all recently rebounded, and the pace of housing price declines has slowed.

The JP Morgan Global PMI now points to a pickup in growth into Q2



Source: UBS, JP Morgan, Crestone.

We are not advocating an absolute 'risk-on' stance…

We are still in the later stages of the cycle and there is a confronting list of potential geo-political flashpoints…

…moreover, equity valuations are at best fair.

This is not about calling a sharp reacceleration in global growth that shifts activity back to its synchronised above-trend pace of 2016 and 2017. It is about a **relative** improvement in activity. It is still best viewed as a mid-cycle stabilisation—but this is a much better alternative than the global recession being contemplated by some at the start of this year.

Nor is it about returning to an **absolute** 'risk-on' stance. We are in the later stages of an extended macro and market cycle. There is still a confronting list of potential geo-political flashpoints that could short-circuit an improving risk environment. This includes failed US-China trade talks, stalled Brexit talks, and risks currently on the periphery, such as a European break-up.

Moreover, valuations in equity markets are at best fair. The Q1 US reporting season is delivering positive signals—according to Factset, of the 46% of companies that have reported, about 77% have reported a positive earnings surprise. But the forward 12-month price-to-earnings (P/E) ratio of 16.8 for the S&P 500 index is above the five-year average of 16.4. Valuations in Europe are fair, cheap in the UK and a little above average in emerging markets.

Still, a number of factors now look likely to support risk markets ahead:

- A pick-up in global growth into Q2 accompanied by a lift in global manufacturing and export growth could stabilise activity near trend.
- An end to downwards company earnings revisions may lead to modest upgrades into mid-year and support credit markets.
- A rally in global bonds, particularly in Europe, has taken yields to expensive positions adding relative value to risk markets.
- Inflation is now trending lower, reinforcing expectations that global central banks are on hold or moving more stimulatory.

…but we are more confident investors should stay engaged

Recent developments leave us more confident that a global or US recession is beyond the near-term horizon. While we continue for now to 'sit on the fence'

There is now heightened risk associated with remaining disengaged with markets in anticipation of a long-awaited correction!

regarding risk, staying tactically neutral equities in the later stages of this cycle, we continue to advocate being overweight equities relative to bonds. A recovery in non-US global growth could be quite powerful for European markets. This has the potential to weaken the US dollar, supporting emerging economies, which is our largest global equities overweight. A more risk-orientated equity position could evolve if consensus global growth forecast and company earnings estimates started to drift higher ahead.

Most importantly, recent developments increase our confidence that cash is unlikely to be the asset class of choice in 2019. A longer-than-expected period of steady growth, inflation and interest rates argues strongly for continuing to implement portfolios in a strategic manner in the wake of liquidity events.

How are our clients invested?

Our investment process is centred on providing globally-diversified investment portfolios. 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 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 with our recommended balanced or growth-focused SAA portfolios?

Our clients' collective funds under advice

	CRESTONE SAA (%)		CLIENTS' COLLECTIVE FUA (%)				
	BALANCED	GROWTH	SEP-17	SEP-18	DEC-18	MAR-19	LATEST
Cash / liquidity	5	5	13.8	13.5	13.3	13.2	12.6
Fixed income	33	17	19.5	18.2	19.4	18.6	18.5
Domestic	19	9	15.3	13.8	14.9	14.2	14.1
International	14	8	4.2	4.4	4.5	4.4	4.4
Equities	42	62	60.8	59.8	57.7	58.9	59.1
Domestic	20	30	32.6	29.1	28.3	28.1	28.0
International	22	32	28.2	30.7	29.4	30.8	31.1
Alternatives	20	16	6.0	8.5	9.5	9.3	9.8

Source: Crestone.

The table above shows our collective asset allocation. From this we can draw a number of conclusions about our clients' holdings:

Our collective portfolio suggests our clients align more with a growth-focused investor…

…60% of client portfolios are allocated to equities and 20% to fixed income.

- **59% of their assets are in equities**, which is broadly in line with our growth SAA of 62% compared with 42% for a balanced SAA. There is a preference for international (31%) over domestic (28%) equities, which closely matches our embedded growth SAA tilt of 32% international versus 30% domestic. This contrasts with a year ago when portfolios favoured domestic equities.
- **19% of their assets are in fixed income**, also closer to our growth SAA of 17% compared with 33% for a balanced SAA. However, allocations are significantly skewed to domestic fixed income (14%, where hybrids are included), which contrasts with only a slight preference for domestic fixed income in our SAAs. International fixed income (4%) is below our recommended SAAs for both growth (8%) and balanced (14%) portfolios.
- **10% of their assets are in alternatives** (such as equity hedge funds, global macro funds or private equity), which is below our 16-20% recommended SAAs across balanced and growth portfolios. However, compared with a year or so ago, allocations have risen from 6% to 10%, a rise of more than 50%.
- **cash assets at 13%** are above our recommended SAAs 5%. However, this has been a consistently high allocation over the past few years, likely reflecting investors' preference for liquidity as the cycle matures. The growth in our FUA, and the time taken to implement new investments, may also bias this percentage higher.

Allocations to global equities, alternatives and emerging markets are rising, while the share of investments in Australian hybrid securities has fallen over the past year.

Another couple of features bear mentioning:

Within equities, allocations to **emerging markets** at a little under 2% of FUA are below our SAAs (3% for balanced, 6% for growth). But since engaging a tactically overweight position in late September 2018, the allocation of investments to emerging markets has risen from closer to just 1%.

Within domestic fixed income, in contrast, allocations to **hybrid securities** have been drifting lower, from over 7% a year ago to around 6% currently.

Overall, our FUA is allocated with a correlation of about 89% to our recommended growth SAA (up from 87% a year ago and less than 80% a year before that). This compares with 48% correlation to our balanced SAA (down from 51% a year ago). Our clients' portfolios are significantly diversified into international equities and modestly diversified into international fixed income. Our clients' lower alternatives allocation relative to SAAs is partly offset by a higher allocation to cash, albeit both provide diversification benefits relative to traditional bonds and equities.

How have our clients responded to recent volatility?

In our 2019 outlook *Staying Cautious, staying engaged*, which was published in early December 2018, we argued for moving our tactical underweight risk position (held through most of Q4 2018) to a more neutral level. This more optimistic positioning (which included an overweight to international equities) reflected our assessment that global growth would stabilise in 2019 and a global recession would be avoided. At the same time, inflation would fail to challenge central bank targets, which would likely stall the rise in interest rates seen in 2018.

This tactical position added value by the end of Q1 2019—but markets experienced heightened volatility in December as a calamitous 'risk-off' period unfolded before a sharp reversal delivered one of the strongest starts to a calendar year for equity markets. By mid-April, US equity markets were just reaching prior record levels. During this period, bonds rallied strongly, while credit markets weakened sharply before recovering.

During the volatility of the past six months, allocations to alternatives have increased significantly.

Looking across our FUA, how have investors responded to this period of heightened volatility through Q4 2018 and Q1 2019?

- **Clients continue to significantly allocate to international equities**. As a share of FUA, international equities have edged higher from 30.7% to 31.1% over the past six months (though this may largely reflect the impact of the Australian dollar's small decline on unhedged portfolio positions). However, relative to two years ago, the percentage of our FUA in international equities has risen meaningfully from 28% to 31%. This is consistent with our tactical overweight and recent strategic increase.
- **Home country bias in domestic equities is reducing**. In late 2017, domestic equities accounted for around 33% of FUA. This has fallen almost 5% to 28%, below the 31% allocation to international. This is consistent with our recent decision to move our strategic positioning in favour of international equities, as well as our recent decision to increase our tactical underweight to domestic equities, reflecting elevated economic and political risks.
- **Clients are significantly lifting their allocation to alternative assets**. As the cycle matures, we continue to recommend a tactical overweight to alternative assets, particularly defensive alternatives. Alternatives have now risen from 6% in Q3 2017 to almost 10% in Q2 2019. We continue to believe that alternative assets offer attractive risk-adjusted returns in the current environment of relatively low expected returns and high volatility for traditional asset classes.

Overall, during the volatility of the past six months, allocations to alternatives have increased significantly—funded particularly from trimming domestic equity positions and some cash holdings. The allocation to international equity markets has proved resilient. Given a maturing cycle and lower expected returns in traditional assets from here, the growth in allocations to alternative assets is consistent with strategies increasingly employed by larger family offices and large wholesale superannuation funds. While our FUA shows a near doubling in alternatives from 6% to 10%, global family offices and Australia's own sovereign wealth fund, The Future Fund, continue to allocate 40-50% of their portfolios to alternative assets.

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