

AUSfund

Quarterly Dynamic Asset Allocation (DAA) Review

May 2017

1 Executive Summary

- Frontier has published its June 2017 Quarterly Market Outlook (QMO), which should be read in conjunction with this paper to help explain reasons for our Dynamic Asset Allocation (DAA¹) recommendations. The Executive will manage cash flows based on the DAAs with assistance from Frontier if needed.
- Our current views relevant for AUSfund include:
 - A High Conviction Underweight to sovereign bonds (Australian and International);
 - A Neutral View on Floating Rate Debt (FRD) and Equities (Australian and International);
 - A Positive View on Foreign Currency; and
 - A Negative View on Investment Grade Credit (IG Credit), High Yield Bonds (HYBs) and Cash (on investment grounds).
- There has been no change in views from the March 2017 QMO. However, given the recent strong returns in equities, the QMO suggest taking some profits and we are comfortable with accumulating some cash balances. Emerging market equities is also preferred over Australian equities given attractive relative valuations. With foreign currency, there is an increasingly Positive View given deteriorating interest rate differentials (AUD vs USD), less optimistic outlook for commodity prices, and increasing desire for downside protection.
- We have proposed the following changes to the DAAs:
 - Reducing the DAA for Equities (equal allocation from Australian and International unhedged) by 1.0%, reflecting stretched equities valuations after last quarter's strong performance. This will contribute to the funding of the Liquid Alternatives sector and will result in a reduction in the Portfolio's overall "Growth Assets" overweight tilt to 5.0% (from 5.5%). This lower "Growth" overweight tilt will reduce the downside risk from an equities market downturn, and as a result we believe a slight reduction to the foreign currency's overweight tilt to 3.5% (reduction in the unhedged component of International Equities) remains appropriate and is in line with the Portfolio's overall Growth profile. We do note that we continue to maintain a Positive View on foreign

¹ DAAs incorporate current market pricing and fundamentals to reflect short to medium-term market views. The QMO expresses strong conviction under or overweight recommendations and views (positive, neutral or negative) by asset class.

currency, driven primarily by its role in providing downside protection and therefore the overweight (albeit less) to unhedged equities remains appropriate; and

- Instead of rotating the equities reduction into cash, we propose increasing the DAA for Liquid Alternatives by 1.0% to 6.0%. This allows the portfolio to retain some growth allocation should equities continues to rally.
- The Proposed AUSfund DAA positions are consistent with our QMO views and tilts including: an overweight to growth assets implemented through a slight overweight to international equities; an overweight to unhedged international equities (albeit reduced) given our Positive View on foreign currency and its role in downside protection and a large underweight to fixed interest. Liquid Alternatives has been increased to an Overweight (from Neutral) to retain the ability to capture upside from an equity rally. We have retained an overweight to alternative debt reflecting our view that FRD plays an important role in managing duration risk within the Portfolio. Additionally to this, yields remain attractive relative to cash. Whilst we have a Negative View on cash on investment grounds, we retain our overweight in our DAA given the need for liquidity and as a margin of safety given the limited diversification from other asset classes. With High Yield Bonds and Investment Grade Credit, as AUSfund holds limited exposure to these assets, this is largely irrelevant to Portfolio and as such, we do not propose any changes.

2 Summary of Recommendations

We recommend that the Board:

- Approve the proposed DAAs for AUSfund (provided in Table 2); and
- Note Frontier's June 2017 QMO.

3 Frontier's DAA Recommendations

Frontier's DAA recommendations are provided in the QMO and reproduced below in Table 1. For a detailed rationale for "tilts" and "views" of each asset class, please see the QMO.

4 AUSfund DAA Recommendations

4.1 Reduce DAA to Equities, whilst maintaining a slight Overweight tilt

Equities markets have experienced a strong run in the recent quarter and despite a markedly improved earnings growth outlook, valuations seem stretched and as a result we recommend taking some profits. However, we recommend maintaining a slight overweight tilt to equities. Although the equities yield spread to government bonds has contracted, we note that it is still materially above historic average levels. That is to say relative to debt, equities continue to remain attractive relative to bonds. Secondly, we are comfortable with a slight overweight to International Equities as it is being used to implement a modest pro-growth bias.

This proposed reduction of 1% will come equally from both International (unhedged) and Australian equities:

- **Australian Equities (0.5% reduction which brings it to Neutral relative to SAA)**
 - Although earnings revisions have continued to improve, the market seems to have priced in a large part of this expected earnings growth which increases the vulnerability of a market downturn should future earnings disappoint. Also, the price to earnings ratio of Australian banks has moved from below to above the historical long term average, while the rebound in commodity prices seems to have reached a peak of late and a moderation in commodity prices will be a challenge to earnings over the near term.
 - The QMO also favours developed and emerging markets more positively relative to Australian equities due to the potential downside risks domestically:
 - Elevated level of household debt which increases the vulnerability of the housing market
 - Limited upside to commodity prices considering how much it has recovered, in addition to China's declining investment and move to a less capital intensive growth phase
- **International Equities (0.5% reduction to unhedged portion, retain Overweight)**
 - The reduction in Equities will result in a lower Portfolio "growth" overweight tilt and this lessens the downside risk from an equities market downturn. As a result, we believe a slight reduction to the foreign currency's overweight tilt to 3.5% (from 4%) from a reduction in the unhedged component remains appropriate and is in line with the Portfolio's overall growth profile.
 - International Equities continue to remain attractive to bonds (yield spread relative to government bonds is still well above historic average levels), and this overweight position is being used to implement a modest pro-growth bias.

The QMO has an increasingly Positive View on Foreign Currency given deteriorating interest rate differentials (AUD vs USD), less optimistic outlook for commodity prices, and increasing desire for downside protection. We propose reducing the foreign currency overweight to reflect the slight reduction in the growth profile.

4.2 Recommend Overweight Position to Liquid Alternatives

Given the sector's return objective and the portfolio completion role it plays, we recommend increasing allocation to Liquid Alternatives (funded from equities) which brings it from a Neutral to an Overweight position.

We believe this reallocation to Liquid Alternatives is appropriate given we are Neutral on equities and there are limited diversification and downside protection levers for the Portfolio given the challenges faced by sovereign bonds (high conviction underweight) and foreign currency (there is already a large overweight tilt relative to Portfolio's Growth profile). These strategies provide some diversification against interest rate risk from the bond allocation in the portfolio, have the potential to provide reasonable returns during normal markets, participate in market rallies but more importantly, experience relatively smaller falls (and even profits) relative to equities during volatile markets. As such, we believe an overweight position to Liquid Alternatives remains appropriate.

4.3 Retain Underweight to Bonds

We continue to support an underweight to sovereign bonds given that bond yields are at historic lows. Despite the high conviction Underweight View, we do not recommend any further reduction as we continue to believe that bonds play a key defensive role (i.e. providing a stable source of return and portfolio diversification benefits) during market downturns. For these reasons we continue to support a large underweight to bonds.

4.4 Retain Overweight to Alternative Debt

We recommend retaining the current overweight for Alternative Debt as it continues to provide a key role in assisting with managing duration risk in the portfolio. Although credit spreads have contracted over the quarter, Floating Rate Debt (FRD) spreads still provide some premium over high yield credit spreads and this is in addition to FRD being higher in the capital structure as well as providing some benefits in a rising interest rate environment. We also have a more positive outlook on FRD than sovereign bonds.

In addition, we note that the current overweight to Alternative Debt is not large, nor does it represent a significant part of the debt Portfolio (17% of total debt and 6% of total Portfolio). Any reduction in the allocation to alternative debt would reduce the sector's ability to mitigate duration risk in the portfolio as IFM Specialised Credit and T Rowe Price strategies are the only active managers in the debt portfolio. Therefore, from a risk perspective, we believe the current overweight to Alternative Debt remains appropriate.

4.5 Retain Underweight to Private Equity

Given the illiquidity of private equity investments, we have not proposed any changes to the allocation despite the Negative and Neutral Views for International and Australian Private Equity asset classes respectively.

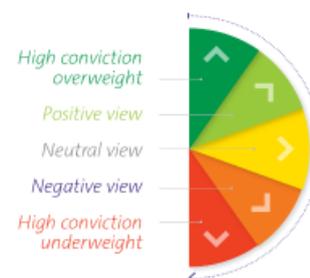
We note that the allocation to private equity is the main driver behind the growth bias within the Portfolio. As these assets continue to wind-down, the overweight growth exposure in the Portfolio will reduce. We note that Frontier and the Executive continues to take an opportunistic approach to selling these assets.

4.6 Retain Overweight to Cash

Whilst we have a Negative View on Cash on investment grounds, we continue to retain our overweight in our DAA given the need for liquidity and as a margin of safety given the limited diversification from other asset classes in the AUSfund's portfolio.

Table 1: DAA Tilts and Views

DAA Views



No change to views, although recommend taking profits, and more positive on emerging markets relative to Australian equities

DAA Tilts	Previous	Current
	Qtr	Qtr
Australian Govt. Bonds	⬇️	⬇️
International Govt. Bonds	⬇️	⬇️
DAA Views		
Foreign Currency	↔️	↔️
UK Unlisted Property	⬇️	⬇️
Australian Listed Property	⬇️	⬇️
International Private Equity	⬇️	⬇️
Cash	⬇️	⬇️
Inflation Linked Bonds	⬇️	⬇️
Investment Grade Credit	⬇️	⬇️
High Yield Bonds	⬇️	⬇️
Neutral Recommendations		
International Equities	➡️	➡️
Australian Equities	➡️	➡️
Emerging Market Equities	➡️	➡️
Floating Rate Debt	➡️	➡️
Australian Private Equity	➡️	➡️
Unlisted Property	➡️	➡️
Unlisted Infrastructure	➡️	➡️
Global Listed Property	➡️	➡️
Global Listed Infrastructure	➡️	➡️
Portfolio Construction		
Downside Protection	↔️	↔️

Table 2: AUSfund SAA, DAA and Actual Asset Allocation (as at March 2017)

Asset Class	Actual Asset Allocation*	SAA	DAA	Proposed DAA	Variance (Proposed DAA – SAA)	Ranges
	(%)	(%)	(%)	(%)	(%)	(%)
Australian Equities	21.4	20.5	21.0	20.5	0.0	10 - 40
International Equities	18.0	17.0	18.0	17.5	0.5	10 - 40
<i>International Equities (unhedged)</i>	12.4	8.5	12.5	12.0	3.5	5 - 20
<i>Int'l Equities (hedged)</i>	5.5	8.5	5.5	5.5	-3.0	5 - 20
Liquid Alternatives	5.1	5.0	5.0	6.0	1.0	0 – 10
Private Equity	4.1	0.0	4.0	4.0	4.0	0 - 8
Australian Fixed Interest	15.07	22.75	15.0	15.0	-7.75	5 - 35
International Fixed Interest	15.10	22.75	15.0	15.0	-7.75	5 - 35
Alternative Debt	6.0	4.0	6.0	6.0	2.0	0 - 10
Cash	15.3	8.0	16.0	16.0	8.0	5 - 20
Total	100.0	100.0	100.0	100.0	0.0	
Growth Assets	46.0	40.0	45.5	45.0	5.0	20 - 60
Defensive Assets	54.0	60.0	54.5	55.0	(5.0)	40 - 80
Currency Exposure	12.4	8.5	12.5	12.0	3.5	5 – 15
Illiquids	7.1	2.0	7.0	7.0	5.0	
Ratio of Australian equities to total equities	54.3	54.7	53.8	53.9	(0.7)	

*Subject to rounding

5 Recommendations

We recommend that the Board:

- Approve the proposed DAAs for AUSfund (provided in Table 2); and,
- Note Frontier's June 2017 QMO.

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Attachment 1: Frontier Quarterly Market Outlook
