Quarterly Asset Allocation Update

Implemented Portfolios

August 2021

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While most of us on the east coast remain under stay-at-home orders of some description, collectively the Australian share market has been able to look through that and see the brighter future that lays ahead.

The chart above is taken from the most recent quarterly briefing provided to your Adviser, during which we noted that the pre-coronavirus peak in February 2020 was being challenged around the time of the previous update provided in May. Since then, it can clearly be seen that the local market has gone on to regularly set new all-time highs, and that has provided an ideal environment to continue to slowly reduce your portfolio's exposure to Australian Equities.

It has been very pleasing to note that recent portfolio performance reflects the significant Overweight stance to Australian Equities held all the way through April of this year. This validates the importance of decisions informed by the long-term forecasts, and more broadly the dynamic asset allocation process. That process to move towards Neutral is close to being completed, and will be achieved over about the six-month period indicated when we initially communicated the decision.

The S&P/ASX200 index is shown above over three years, so around the time when we published the August 2018 Quarterly Update. In that note we outlined that our forecast return for Australian Equities was in the mid 7% range - on average, per annum, over the subsequent ten years. However, when prices got cheaper just a few months later we were buyers of Australian Equities into the end of 2018. Then when markets recovered, we started to lighten off on that exposure through the second half of 2019. The flexibility to lean in towards assets as they get cheaper, and then start to lean away as markets rally and they get more expensive, is the essence of our dynamic asset allocation process.

Whilst we did not immediately see the precipitous drop from late February to March 2020, our process did lead us to make modest additions to the Australian Equities exposure on the way down. This seems a much more obvious move now, with the benefit of hindsight, but it was certainly challenging to do so at the time amidst the incredible uncertainty of those few weeks. What prevented us from doing more buying at those lows was simply the speed of the recovery.

While it can now only be a hypothetical point, the historical record we have accumulated in portfolio management supports the view that we would have completed more buying had the market stayed down for longer than just that one month. Just as we are doing now in taking several months to regularly adjust a few percent of your portfolio at a time, only in the opposite direction and after a strong recovery.

You may recall during the early stages of that recovery, through April and May and June of last year, there was no shortage of pundits saying the right thing to do was to sell into any recovery. Such confident short-term predictions are the stock-in-trade of many in the investment industry, but rarely are such calls evaluated after an appropriate period of time has elapsed. Many fund managers did in fact do just that, and sold into rallies, accumulating high levels of cash within portfolios, and have effectively been underinvested through the much of the recovery.

By contrast, we are pleased that our long-term forecasts led to maintaining an overweight stance to Australian Equities up until recent months, and that your portfolio performance has reflected the strong performance shown in the earlier chart.

Government Bonds

In a recent weekly commentary we discussed the most recent addition to the defensive Income Securities asset class, an ETF that invests in Australian Government Bonds. The important feature of this fund is that its price moves in the opposite direction to the yield payable on government debt (a relationship shown clearly on the following chart).

Imagine someone bought a government bond a year ago when it was paying 1%, but today the market has changed and a new bond issued by the government now pays 2%. If we have money to invest in government bonds today, we will clearly prefer to receive the one paying double the amount of income, which means that the original investor would need to discount their price if they wanted to sell their bond only paying 1%. This phenomenon gets reflected in aggregate across the bond market, and in funds such as the one added to your portfolio in early March. That is, as bond yields go up their prices go down, and if bond yields fall then the earlier bonds have better rates of income and therefore command higher prices.

This is a 1-year chart showing the price of the government bond ETF in the top panel, and the inverse relationship to bond yields, shown in the bottom panel. Around early November last year, upon the announcement of effective vaccines against the coronavirus, the prospect of a strong recovery started to be considered by investors, which implied that emergency support policies that kept interest rates low would be unwound. The red line shows that the yield on 10-Year Australian Government Bonds went from around 0.8% to more than 1.8% quite quickly. As expected, the price of the government bond ETF fell by about 7%, and that provided the attractive opportunity to add this fund to your portfolio in early March.

The spread of the delta variant has caused some investors to question the strength of the recovery, or to at least expect that it is likely to take longer to play out. As such, we have seen the yield on government bonds drift back towards 1%, which has provided a boost to the price of the government bond ETF of about 4.5% to the recent high at about $52.50 in late August. The committee has reached an agreement to sell the exposure to Australian Government Bonds if we see prices just a bit better than they are currently. Also, it is worth noting that our experience informs us that rather than the incremental approach used in adjusting equities exposures, it is beneficial to be more definitive in any such move within the defensive asset classes. If we see the target price for this fund is available, you should expect we will move quickly to capture those gains for your portfolio.

Kind regards,
Asset Allocation and Investment Committee

TEN YEAR FORECAST RETURNS

	Australian Equities	Inter Eq - Dev Mkts	Inter Eq – Emerg Mkts	Listed Property	HY Income Securities	Income Securities
Current Yield	4.6%	1.6%	2.2%	4.2%	4.8%	2.7%
+ Currency Impact		0.4%	-3.0%			
+ EPS Growth (10 Yrs)	0.8%	1.8%	4.6%	1.4%*		
+ Valuation Effect	-0.2%	-1.3%	1.3%	0.8%	-1.5%	
Index Return (Pre-Tax)	5.2%	2.5%	5.1%	6.4%	3.3%	2.7%

* Forecast Distribution Growth

Please note that the active asset allocation targets mentioned below apply to both the Exchange Traded Fund portfolios managed by Implemented Portfolios and the portfolios that own direct shares which are managed by Joseph Palmer & Sons. However, commentary below about individual investments is in relation to the ETF portfolios only.

AUSTRALIAN EQUITIES

Australian Equities	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	10.0%	15.0%	20.0%	27.0%	40.0%
Target*	10.0%	15.0%	20.1%	27.1%	40.1%

The portfolio management team have continued to enact the move to Neutral by reducing the investments in medium and smaller sized Australian companies. The investments in these funds have performed strongly though the recovery, and as such our forecasts at around 3.5% for each are materially lower than the broad Australian Equities forecast shown above, and even further behind our expectations for the Financials sector where we continue to maintain a meaningful overweight sector allocation. The recent company reporting season confirmed generally quite strong results for the year ending June, though of course we are in the midst of a much more challenging quarter. The consensus view though is that the economy will return to it's growth trajectory by the end of the year, and for now that has been sufficient to placate any fears about the impact of current shutdowns in New South Wales and Victoria.

INTERNATIONAL EQUITIES

International Equities	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	5.0%	10.0%	15.0%	23.0%	35.0%
Target*	5.7%	11.1%	16.1%	23.9%	34.7%

We continue to monitor the trends in Covid-19 cases and vaccinations for a range of countries, and especially for Europe and the United Kingdom where your portfolio has key exposures. Whilst there has been a surge related to the delta variant, the relatively high vaccination rates do seem to have provided enough protection to enable the respective economies to remain open. Performance over recent months from both investments has been very pleasing, with some assistance provided more recently from the weaker Australian dollar. Around the end of August, the announcement of a change in leadership in Japan has proved to be a catalyst for a very strong couple of weeks for Japanese equities, which is comfortably the largest country exposure in this asset class.

Listed Property

Listed Property	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	5.0%	5.0%	10.0%	10.0%	10.0%
Target*	5.5%	5.5%	11.0%	11.0%	11.0%

The committee agreed to retain the modest Overweight stance to the Listed Property fund, noting that there remain short-term challenges to key sectors, particularly office and retail. We've continued to observe an inverse relationship between interest rates and the performance of listed property trusts, and so the recent decline in bond yields which saw 10 Year Australian Government Bonds back down close to 1% has been accompanied by quite strong recent performance in the Australian Property ETF. There is still quite a bit of uncertainty about what the return to work and shopping looks like, but we are comfortable that this fund will provide an important contribution to overall portfolio performance.

High Yield Income Securities

HY Income Secs	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	10.0%	15.0%	15.0%	15.0%	10.0%
Target*	0.0%	0.0%	0.0%	0.0%	0.0%

We remain 100% underweight in this asset class for now, though the committee has undertaken extensive research over recent months to evaluate opportunities in this asset class. We are close to finalising that work and expect to be able to update you on any decisions that are reached in the near future.

Income Securities & Cash

Income Securities	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	40.0%	40.0%	30.0%	20.0%	0.0%
Target*	56.1%	55.4%	43.6%	34.2%	10.4%

Cash	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	30.0%	15.0%	10.0%	5.0%	5.0%
Target*	22.7%	13.0%	9.3%	3.8%	3.8%

Exposure to these two defensive asset classes has been growing in recent times, notably as we have been reducing other parts of the portfolio for the last several months. As with High Yield Income Securities above, we have been evaluating a wide range of potential investments that can provide better returns than Cash, but still with an acceptable level of risk. That is still quite a challenging exercise in the current market with historically very low interest rates set to be maintained for the next couple of years. Again, we are close to finalising due diligence on a number of possible inclusions, and of course any decisions to adjust this asset class will be communicated to you in a timely manner.

** The Target weights outlined above reflect both the active asset allocation stance as determined by the committee and also the impact of market price changes as portfolios use a floating weight regime for securities within an asset class, and asset classes within each of the respective Investment Programs.*

Asset Class Tipping Points

Through the month and into September, regular modest selling in Australian Equities continues to migrate portfolios towards the target Neutral allocation, consistent with the Fair Value indicated below. We have though also maintained the additional sector allocation to Financials, supported by the better forecast and the Cheap valuation. The holdings in International Equities have been maintained and recently bolstered by the weaker Australian dollar. A pull back in the Asia-Pacific region has improved that forecast, however we remain comfortable with the current allocation which has been significantly reduced prior to the recent weakness. Listed Property has enjoyed the lower bond yields of late and has provided a solid contribution to performance in recent months.

Asset Class Tipping Points - August 2021

Australian Equities

All Ords	10 Year Forecast	Valuation	31-Aug
10,600	1.0%	Overpriced	
10,300	1.4%	Fully Priced	
10,000	1.8%	Fully Priced	
9,700	2.2%	Fully Priced	
9,400	2.6%	Fully Priced	
9,100	3.1%	Fully Priced	
8,800	3.5%	Fully Priced	
8,500	4.0%	Fair Value	
8,200	4.5%	Fair Value	
7,900	5.1%	Fair Value	Aust 5.2%
7,600	5.6%	Fair Value	
7,300	6.2%	Cheap	
7,000	6.9%	Cheap	Fin'l 7.1%
6,700	7.5%	Cheap	
6,400	8.3%	Cheap	
6,100	9.0%	Cheap	
5,800	9.9%	Cheap	

Income	4.6%	p.a.
Earnings	0.8%	p.a.
Valuation	-0.2%	p.a.
Forecast	**5.2%**	**p.a.**

International Equities - Developed

World ExAust	10 Year Forecast	Valuation	31-Aug
3,600	1.2%	Overpriced	
3,500	1.5%	Fully Priced	
3,400	1.8%	Fully Priced	
3,300	2.2%	Fully Priced	
3,200	2.5%	Fully Priced	
3,100	2.9%	Fully Priced	Dev 2.5%
3,000	3.3%	Fully Priced	
2,900	3.7%	Fully Priced	
2,800	4.1%	Fair Value	
2,700	4.5%	Fair Value	
2,600	5.0%	Fair Value	
2,500	5.5%	Fair Value	
2,400	6.0%	Fair Value	EU 5.8%
2,300	6.5%	Cheap	UK 6.7% Japan 6.7%
2,200	7.0%	Cheap	
2,100	7.6%	Cheap	
2,000	8.3%	Cheap	

Income*	2.0%	p.a.
Earnings	1.8%	p.a.
Valuation	-1.3%	p.a.
Forecast	**2.5%**	**p.a.**

International Equities - Emerging

Emerging Markets	10 Year Forecast	Valuation	31-Aug
1,850	1.0%	Overpriced	
1,800	1.3%	Fully Priced	
1,750	1.7%	Fully Priced	
1,700	2.0%	Fully Priced	
1,650	2.4%	Fully Priced	
1,600	2.7%	Fully Priced	
1,550	3.1%	Fully Priced	
1,500	3.5%	Fully Priced	
1,450	3.9%	Fair Value	
1,400	4.3%	Fair Value	
1,350	4.7%	Fair Value	
1,300	5.2%	Fair Value	EM 5.1%
1,250	5.7%	Fair Value	Asia-P 5.8%
1,200	6.2%	Cheap	
1,150	6.8%	Cheap	
1,100	7.3%	Cheap	
1,050	7.9%	Cheap	

Income*	-0.8%	p.a.
Earnings	4.6%	p.a.
Valuation	1.3%	p.a.
Forecast	**5.1%**	**p.a.**

Listed Property

ASX200 Property	10 Year Forecast	Valuation	31-Aug
2,500	0.9%	Overpriced	
2,425	1.3%	Fully Priced	
2,350	1.6%	Fully Priced	
2,275	2.1%	Fully Priced	
2,200	2.5%	Fully Priced	
2,125	2.9%	Fully Priced	
2,050	3.4%	Fully Priced	
1,975	3.9%	Fair Value	
1,900	4.4%	Fair Value	
1,825	5.0%	Fair Value	
1,750	5.6%	Fair Value	
1,675	6.2%	Fair Value	
1,600	6.9%	Cheap	A-REITs 6.4%
1,525	7.6%	Cheap	
1,450	8.3%	Cheap	
1,375	9.1%	Cheap	
1,300	10.0%	Cheap	

Income	4.2%	p.a.
Dist Grwth	1.4%	p.a.
Valuation	0.8%	p.a.
Forecast	**6.4%**	**p.a.**

** Income for International Equities includes dividends and forecast currency impact.*

NOTE: It is important to note that each portfolio is managed to its own mandate, which can mean that activity mentioned above is not reflected in your own portfolio. This may be because it is more beneficial to your portfolios after tax performance to complete the trading at a different time or may be due to individual customisation that you have requested. This flexibility is an integral part of the investment process. If you would like to discuss the tailoring of your portfolio please contact your Adviser.