



INVESTMENT MANAGEMENT INSIGHTS FOR PROFESSIONAL FINANCIAL ADVISERS AND THEIR CLIENTS

WHERE TO GENERATE RETURNS WHEN VALUATIONS ARE STRETCHED

Traditional asset classes are set to post their lowest long-term gains in history, ending years of booming returns underpinned by the accommodative actions of central banks.

But that doesn't mean investors need to settle for anaemic results.

A more nuanced approach that exploits the better risk-return potential of non-traditional asset classes, specific sub-sectors, and factor strategies is a key part of the solution.

That's not to mention the extra tailwind that an active asset allocation can provide to take advantage of short-term mispricing opportunities.

But the challenge remains, with 10-year forecast returns for traditional asset classes at historic low levels, as seen in the table below.

FORECAST 10-YEAR RETURNS

Cash	1.00%	Global REITS	2.90%
Australian Equities	3.61%	Global Infrastructure	2.90%
International Equities	1.38%	Global High Yield Bond	0.00%
European Equities	3.20%	Australian Treasury Bond	1.70%
Asia Pacific Ex Japan Equities	4.56%	Australian Corporate Bond	2.30%
Japanese Equities	5.52%	Barclays Global Aggregate	0.00%
Emerging Market Equities	5.50%	Managed Futures	4.00%
Australian REITS	1.70%	Gold	4.00%

While no-one can know the future with absolute certainty, our forecasts don't make pleasant reading. Cash returns are likely to be more than halved compared to the previous decade. The fall in returns across many growth asset classes (such as international equities and Australian REITs) is even worse, with annualised double-digit returns over the last decade falling low single-digit gains.

Combining these forecast asset classes into a traditional 60:40 balanced style portfolio produces a 10-year forecast nominal return of just 2.2% a year¹.

Taking on more risk via traditional asset classes will clearly no longer deliver the returns of past years.

There are several reasons. Since the global financial crisis (GFC) of 2008-09, central banks have cut interest rates to near-zero or even negative to encourage borrowing and business investment. They have also snapped up an ever-widening range of assets to help stimulate their economies.

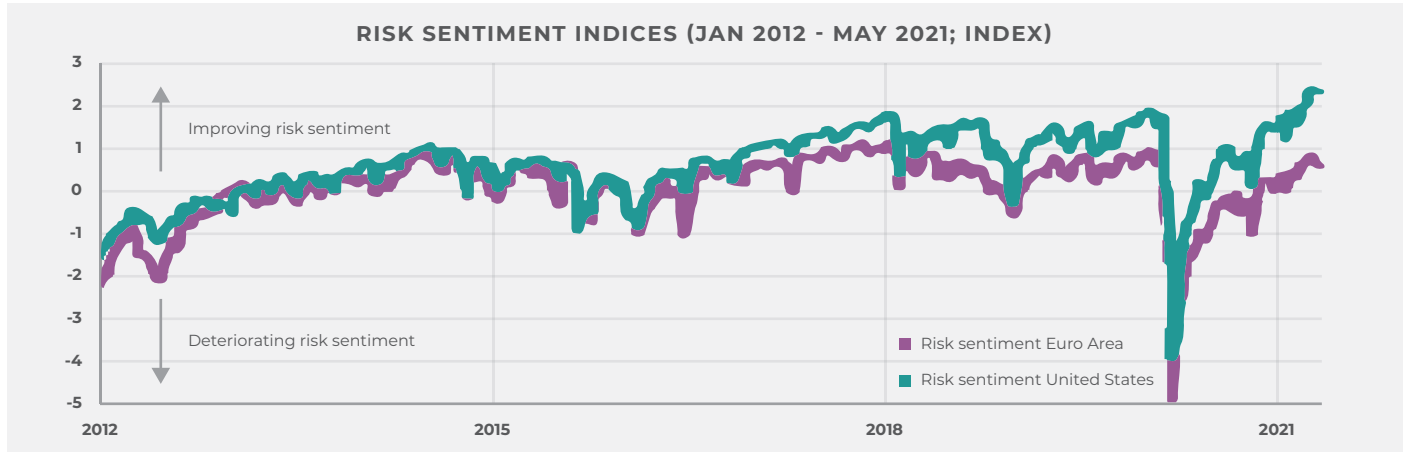
Rather than spur economic growth, their actions have put a rising floor under asset prices. The result is that surging asset prices have regularly become divorced from the underlying fundamentals.

Source: Innova

¹ We compared our forecast returns to Research Affiliates for traditional asset classes and built a 60:40 portfolio using their methodology.

Central banks know it. The **European Central Bank warned** that equity markets recently exhibited “remarkable exuberance”, rallying higher even as US

benchmark bond yields rose in response to higher expectations for long-term inflation².



Source: European Central Bank. (2021). *Financial Stability Review*, May 2021.

But **valuation still matters**³.

For example, even with improving corporate earnings, the US share market is trading at valuation ranges we last saw in the tech bubble more than two decades ago. With such a high starting point, our annualised 10-year forecast for international equities (the US makes up about half of the index) is just 1.38%.

But with no room left to cut interest rates, and the spectre of long-term inflation returning as governments continue to spend big in the wake of COVID, central banks' no longer have the same firepower.

VALUE CAN STILL BE FOUND IN NON-TRADITIONAL ASSET CLASSES

Navigating this landscape requires a closer look at the asset classes on offer.

Traditional asset classes such as Australian shares are set to deliver less than half the returns they did over

the last decade (3.61% versus 8.4%) but taking a more granular approach can produce more promising results. For example, most investors are aware of growth versus value style, but many more potential factors can produce a long-term premium. Taking this active approach boosts our forecast Australian equity return to 5.30%.

We can take a similar factor approach to other traditional markets such as international, European, emerging markets and Asia-Pacific equities. We can also judiciously replace some low-yielding fixed income asset classes with higher-yielding (but with a similar risk profile) bonds.

This approach is not easy – it must be evidence-based and requires extensive research beyond traditional asset classes and regions.

However, it pays off. A more active asset allocation approach improves our forecast returns, as shown in the table below.

FORECAST 10-YEAR RETURNS : PASSIVE VERSUS ACTIVE ASSET ALLOCATION

INDEX RETURN	
Cash	1.00%
Australian Equities	3.61%
International Equities	1.38%
European Equities	3.20%
Asia Pacific Ex Japan Equities	4.56%
Japanese Equities	5.52%
Emerging Market Equities	5.50%
Australian REITS	1.70%
Global REITS	2.90%
Global Infrastructure	2.90%
Global High Yield Bond	0.00%
Australian Treasury Bond	1.70%
Australian Corporate Bond	2.30%
Barclays Global Aggregate	0.00%
Managed Futures	4.00%
Gold	4.00%

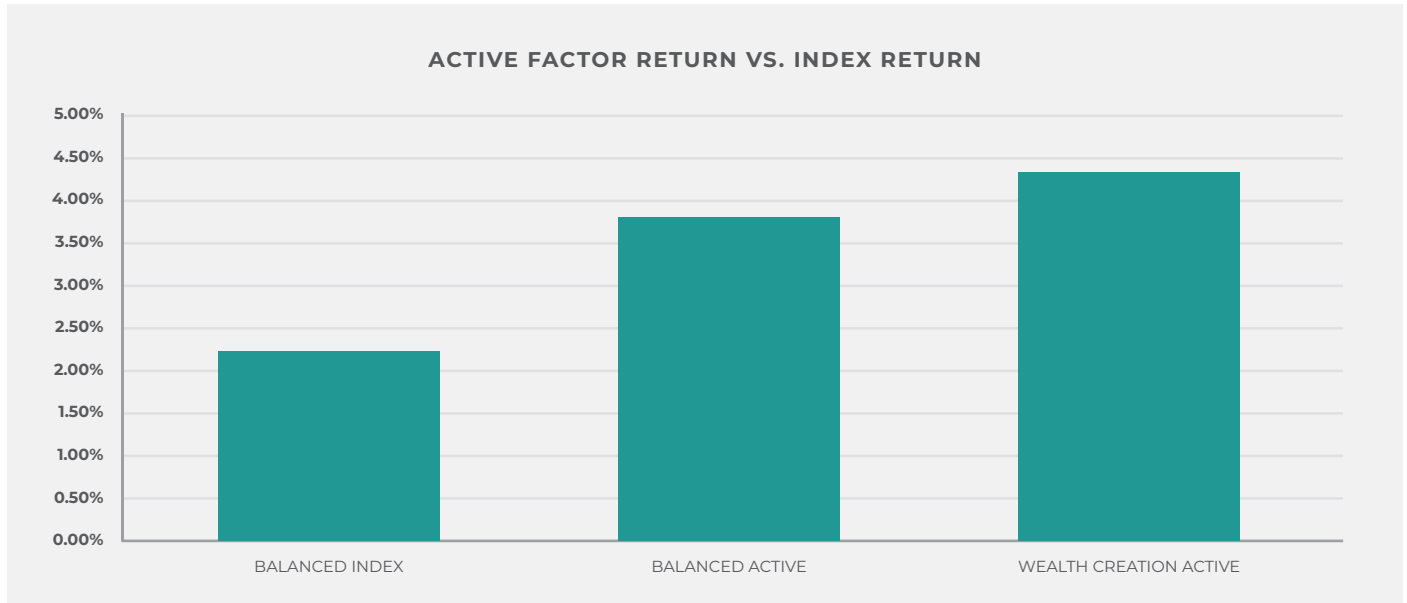
ACTIVE/RETURN	
Cash	1.00%
Australian Equities	5.30%
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Japanese Equities	5.52%
Emerging Market Equities	7.50%
Australian REITS	1.70%
Global REITS	2.90%
Global Infrastructure	2.90%
Global High Yield Bond	0.00%
Australian Treasury Bond	2.50%
Australian Corporate Bond	4.00%
Barclays Global Aggregate	0.00%
Managed Futures	4.00%
Gold	4.00%

Source: Innova

²European Central Bank. (2021). *Financial Stability Review*, May 2021. European Central Bank, (1). Retrieved from <https://www.ecb.europa.eu/pub/financial-stability/fsr/html/ecb.fsr202105-757f727fe4.en.html> ³Portfolio Insights May 2021 – Valuation matters | Innova Asset Management. (2021, June 01). Retrieved from <https://www.innovaam.com.au/portfolio-insights-may-2021-valuation-matters>

At first glance, this doesn't look like a dramatic difference, particularly given some asset classes are delivering the same returns. However, it makes a dramatic difference

when we compare forecast simulated portfolio returns using a more active approach against the original balanced index.



Source: Innova

It is important to note that no asset allocation or factor/strategy changes have been made in the above simulations. This is an important source of value add (something we will explore in next month's Insight).

When markets are challenging, it requires a closer look to uncover strong returns. Searching in non-traditional

pockets of the market and applying an active asset allocation strategy can more than offset historic low returns.



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Dan Miles is the Managing Director & Co-Chief Investment Officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios for 8 years. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.

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