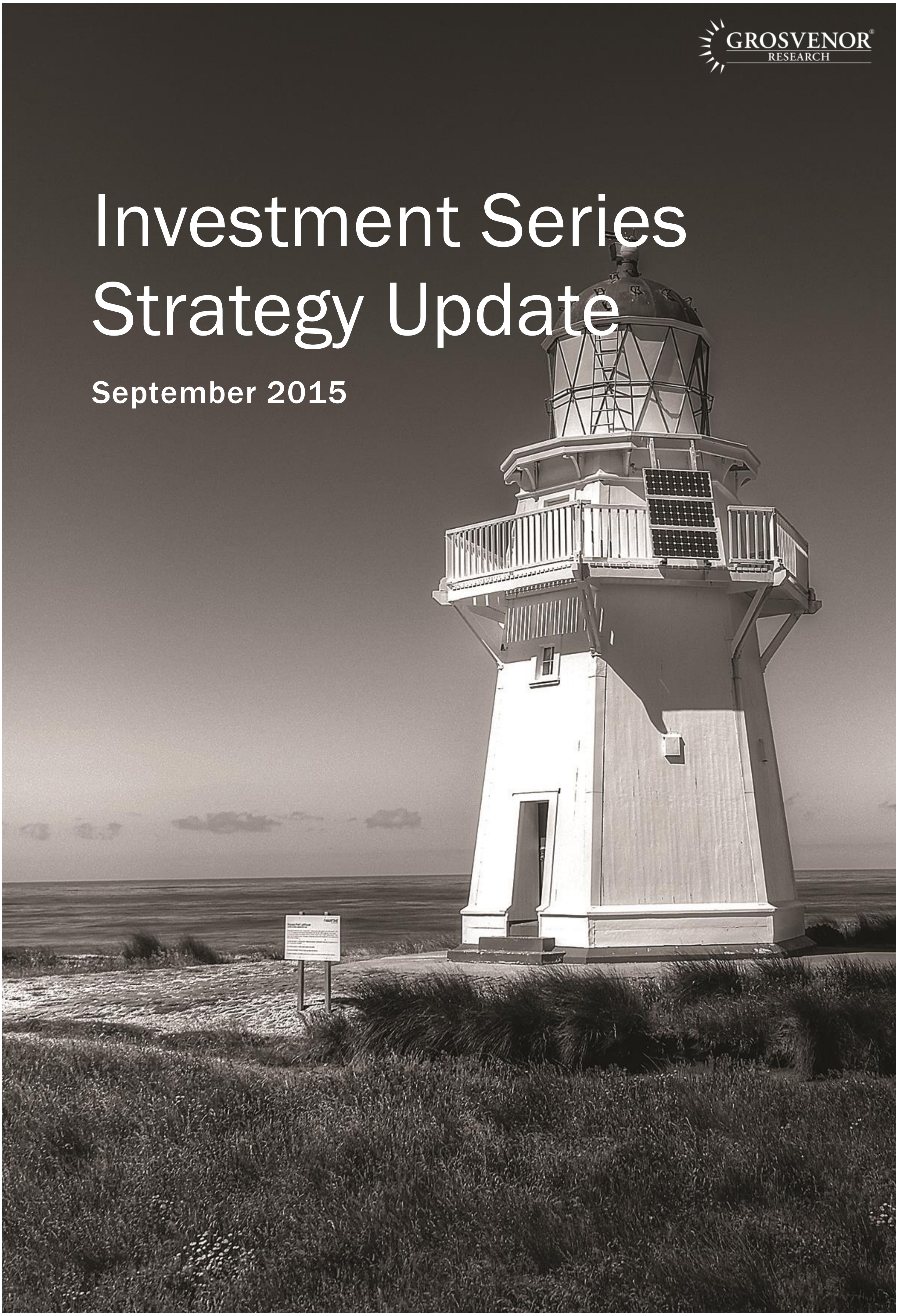
GROSVENOR® RESEARCH

Investment Series Strategy Update

September 2015



Strategy overview: Introduction

This quarterly update aims to provide an overview and rationale of "cyclical" portfolio positioning. It supplements our annual Strategic Asset Allocation Review, which sets the base-line levels for long-term portfolio allocations.

A pickup in market volatility over the quarter highlights that the relatively smooth gains in investment markets over the past couple of years should not be taken for granted. History has consistently shown that markets work in cycles, and the recent rear-view mirror is a fickle guide to future outcomes. Pleasingly, multi-sector portfolios have benefitted from the strong returns on both shares and bonds over the past 3-5 years, even if the pace of underlying gains has tailed off during 2015. Economic growth has generally been favourable around the world, and lower interest rates have supported returns by setting a lower bar for expectations across all asset classes. Recently, the level of divergence in returns within asset classes also seems to have been reinforced: the industry a company operates in, the region they are based in, or the level of income they provide, matters more than it used to several years ago, while some of the "typical" links between different types of investments have broken down. While each creating their own challenges, these factors also give more opportunity for a level of active management in client portfolios, and reinforce the value of combining active overlays with an index-based core in client portfolios.

Whilst adopting a wider range of active measures over the past year, these have nevertheless been implemented within a closely monitored risk budgeting framework relative to peers. The overall risk budget for MIA portfolios has been progressively increased following 2014's tighter focus, and is expected to continue to do so over time. However, this will occur within a tightly managed process, where potential sources of value-add are continually assessed to justify their place within portfolios. The current risk budget is illustrated below with contributions from active ETF tilts, stock and manager selection within the global shares sector, as well as options protection, and active asset allocation positioning.

Key Active Overlays - MIA Balanced Fund

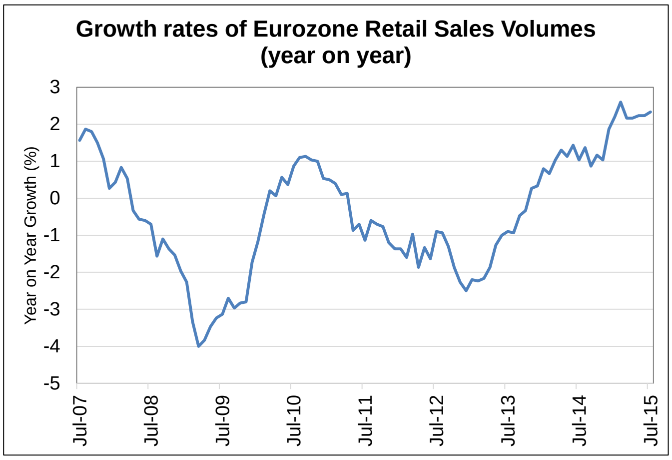
Sector	Overlay	Quantity	Tracking Error	Contribution to Risk Budget	
Asset Allocations					
NZ Dollars (Hedging)	Overweight	**5.00%**	12.0%	0.18%	
NZ Fixed Interest	Neutral	0.00%		0.00%	
Global Fixed Interest	Options	**-0.25%**	4.0%	**0.02%**	
Global Shares	Options	**-2.90%**	14.0%	**0.41%**	
Australian Shares	Overweight	**1.50%**	12.0%	**0.09%**	
NZ Shares	Underweight	**-1.50%**	12.0%	**0.09%**	
Property	Neutral	0.00%		0.00%	**0.78%**
Within Sector					
NZ Fixed Interest	Short duration	-0.25	0.8%	0.03%	
Global Credit Risk	Neutral	0.00%	3.0%	0.00%	
Global Shares	Active stocks/thematics	29.00%	2.1%	0.62%	
NZ Shares	Active stocks	8.50%	2.1%	0.18%	
Australian Shares	Active stocks	8.50%	2.4%	0.20%	**1.48%**
Global Opportunities	Active cycles	3.00%	15.0%	0.45%	
					2.26%
	Ex ante tracking error net of diversification across active positions:				**1.49%**

Global Shares	Weight	Contribution to balanced
Vanguard	43%	
Value Tilt	10.0%	0.06%
Europe Tilt	7.5%	0.09%
Direct Shares (Rothschilds)	15.0%	0.13%
Platinum	15.0%	0.17%
Magellan	15.0%	0.17%
	100.0%	0.62%

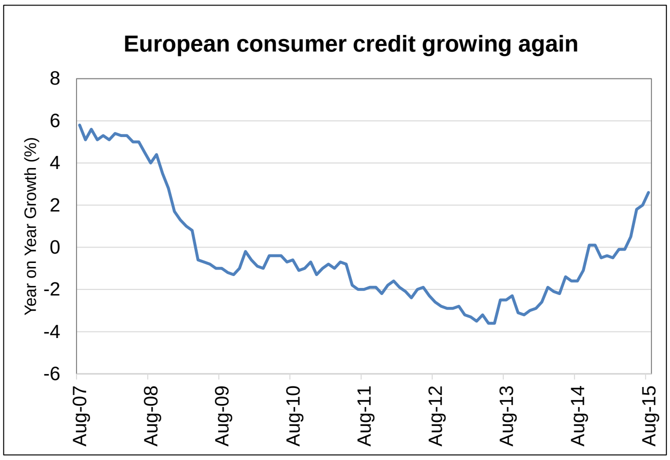
Global backdrop

Moderate growth in the west, with central banks still very supportive. For companies, profit margins a watchword as economic slack falls.

While markets have been rattled recently, economic growth prospects in developed economies do not appear to have been much affected. Growth in the United States economy continues at a fairly moderate pace, with steady employment growth and consumer optimism. A similar theme applies in Europe, albeit with growth tracking at a lower speed: Unemployment is steadily falling, and combined with sharply lower energy costs (thanks to lower oil prices) has led to a good rise in consumer spending. After five years of retrenchment, bank lending has started to grow again, and higher incomes and confidence should reinforce this over time.

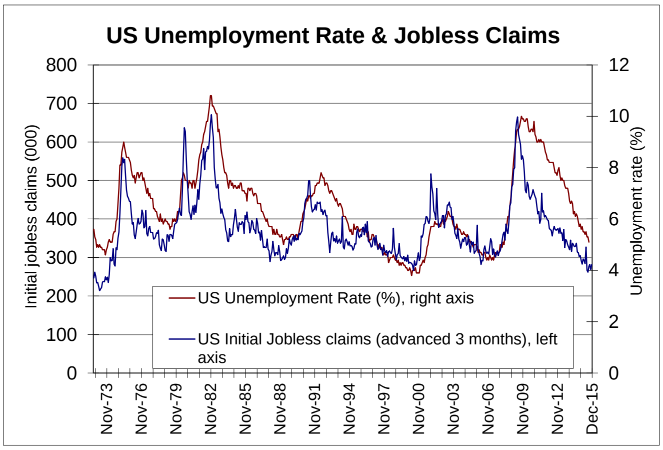


Source: Eurostat

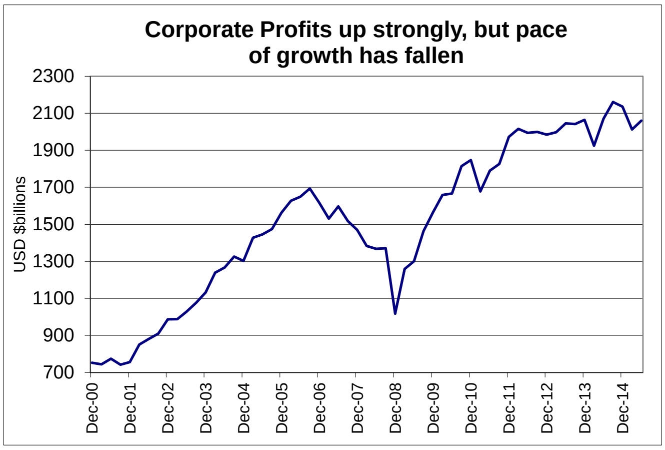


Source: European Central Bank

While growth in the United States continues to gradually eat into the economic "slack" that has built up since 2008, this is not all good news for companies. A side-effect of plentiful labour supply has been low pressure to increase wages, and some catch-up appears likely (some early signs can already be seen in rising labour costs). Even as the economy continues to expand, this could head-off some of the corporate earnings growth that might otherwise be expected.



Source: Department of Labor



Source: Bureau of Economic Analysis

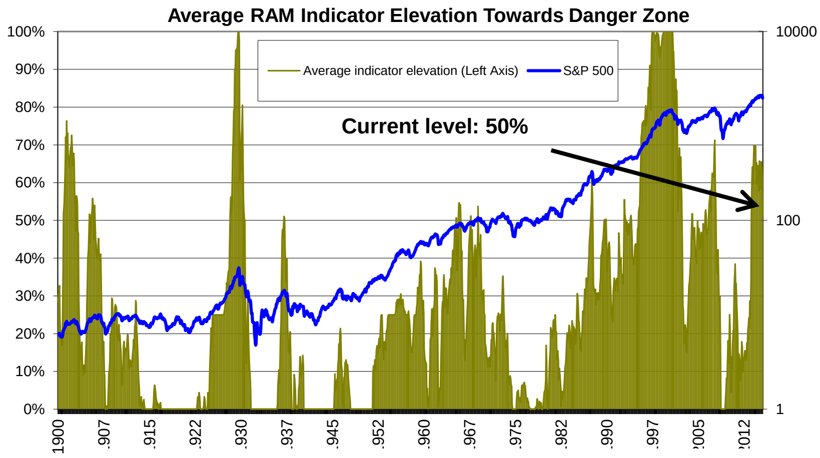
Further afield, China continues to transition away from manufacturing-led growth, but indicators suggest that a "hard landing" is unlikely. Manufacturing sector confidence has fallen lately, but actual activity levels have held up relatively well and the services sector has continued to expand. Some positive contribution from stimulus should come through over the remainder of the year. China's long-term outlook remains driven by its gradual opening up of markets, ranging from state-owned business reform, to banking and exchange rate liberalisation.

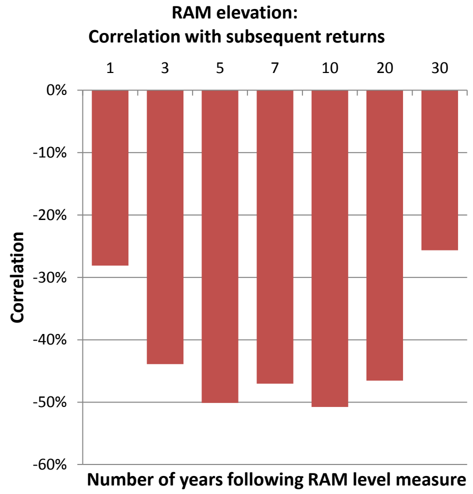
Multiple expansion raises the bar for future returns

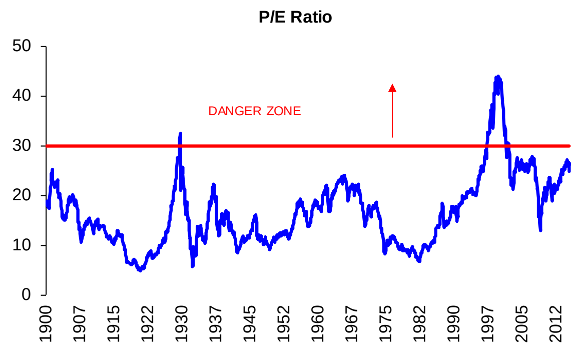
Fully invested, but with options protection in place

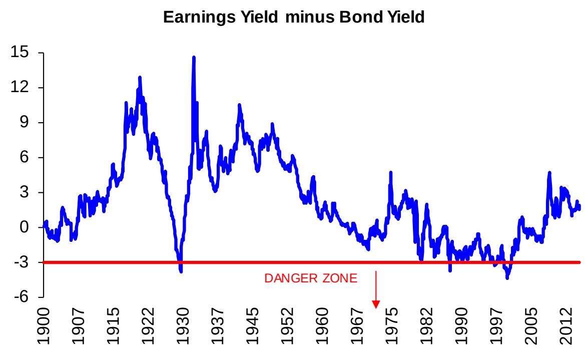
Despite the pullback in share markets over the past 3-6 months, global share markets are not far from their levels of a year ago, and valuations remain somewhat elevated on traditional measures. Solid medium-term returns have seen price-earnings multiples rise more than underlying earnings have expanded, even as economic growth has maintained a moderate track. Within the key Risk Alert Monitor (RAM) indicators, Price-Earnings ratios and Price/net asset backing ratios are relatively high, even if not within their "danger zones". Real (inflation-adjusted) equity returns over the past 5 years have also been around twice their average level, even if this measure has slightly moderated lately.

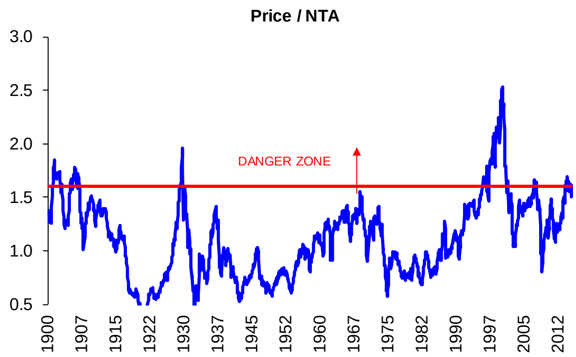
The key support to equity markets has clearly been via low returns on offer elsewhere: The difference between the "earnings yield" on shares and the 10-year US bond rate is only just at its long-run average. Looking forward, some moderation here is likely, as yields gradually rise. Overall, while the current RAM score is zero, the <u>average</u> elevation across the RAM suite (top left chart) gives some pause for caution. Historical analysis suggests that while valuations can remain away from averages for some time, they do tend to mean revert, and have the strongest link to subsequent returns starting from a 3-year time horizon. Within this in mind, we have continued to maintain some insurance protection over around 40% of the global shares sector (as well as some protection over global bonds), to mitigate any <u>material</u> market weakness at a minor level of cost.

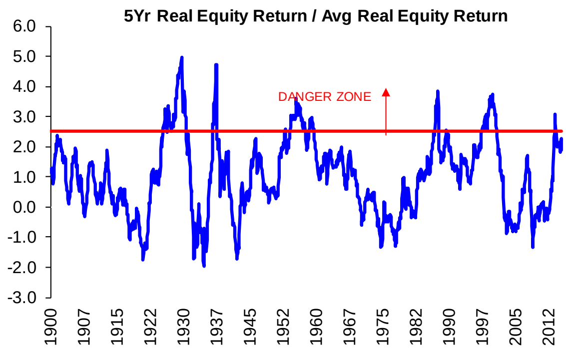










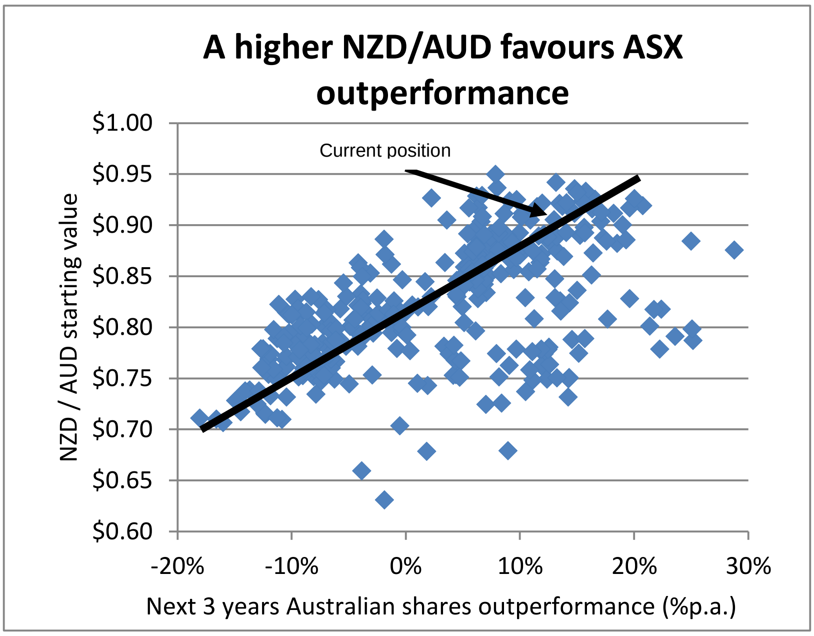


Sources: Bloomberg, Federal Reserve, Standard & Poors

Rock star reversal?

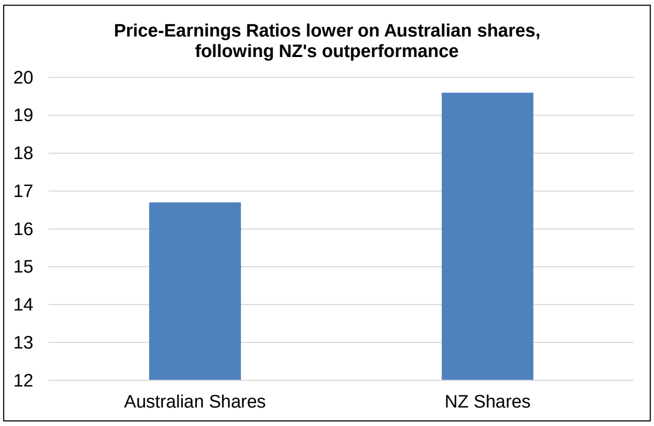
Overweight Australian shares compared to New Zealand, with the local economy moderating while New Zealand shares have risen substantially.

Portfolios continue to maintain an equal weight between NZ and Australian shares, despite a moderate preference for NZ shares on a long-run strategic basis (driven largely by NZ's dividend imputation regime). This overweight on Australian shares directly reflects the difference in valuations that has resulted from Australian shares' lower performance since 2011, with NZ shares now well above trend compared to Australia (in NZD terms). Exchange rates have driven some (but not all) of the difference, and looking forward, this outlook is consistent with the two markets' typical relationship to currencies: A higher starting point for the NZD/AUD exchange rate has historically been followed by Australian shares outperforming NZ over the following three years (and vice versa).

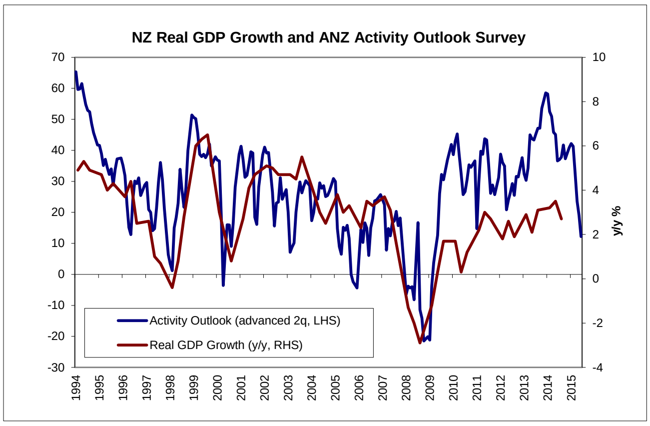


Source: Bloomberg, Grosvenor Research

Lower relative returns have also led to a lesser premium placed on earnings of Australian companies. Based on the ASX 50 and NZX 50 market indices, Australian forward-looking Price-Earnings ratios are some 15% below New Zealand, where the average forward Price-Earnings ratio remains close to 20. Economically, this comes at a time where the Australian economy has been working through an extended transition away from the mining sector, while New Zealand's dairy export base initially remained strong for around two years after the Australian slowdown began. New Zealand's economic profile appears now in the process of moderating (albeit from strong levels), with growth more reliant on Auckland's property market as general business confidence and the agricultural sector have softened.



Source: Bloomberg

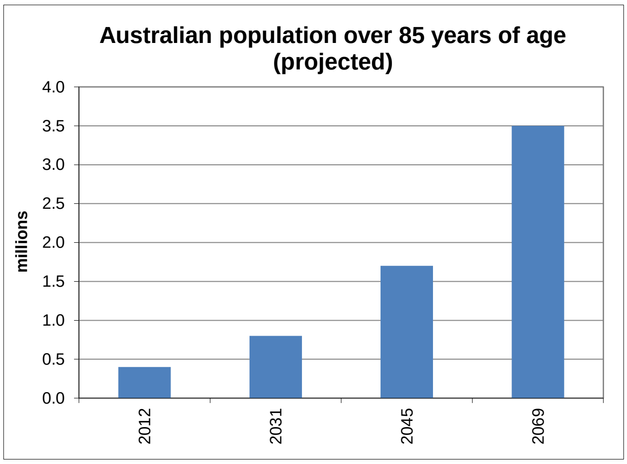


Sources: ANZ, Statistics NZ, Bloomberg

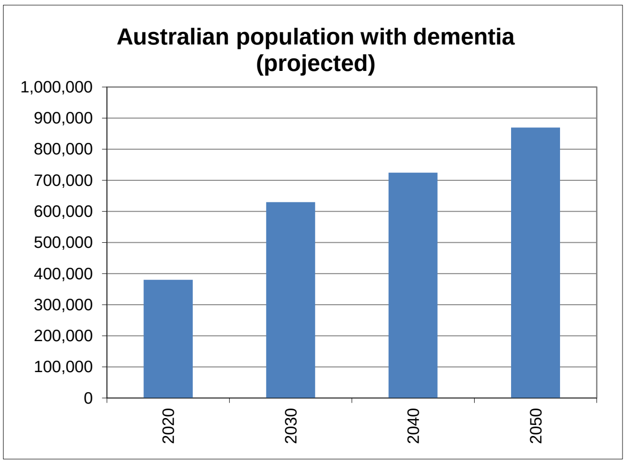
Key sector themes

Healthcare's 21st century tailwind not abating, while slightly defensive in New Zealand shares. Cyclical positioning still favouring global value over growth, while also tilted away from US towards European shares.

An increasingly varied mix of performance across global markets provides a good level of opportunity within individual companies and sectors, despite the generally higher level of valuations. Within the directly-held components of client portfolios (including NZ, Australian and Global Direct shares) the healthcare sector remains a key long-term focus, building on the needs of ageing populations across the western world and higher spending in the east. In New Zealand, relatively integrated aged-care companies provide an attractive way to capture this theme, while Australian and global markets provide alternatives across a range of hospital, pathology and pharmaceutical providers.



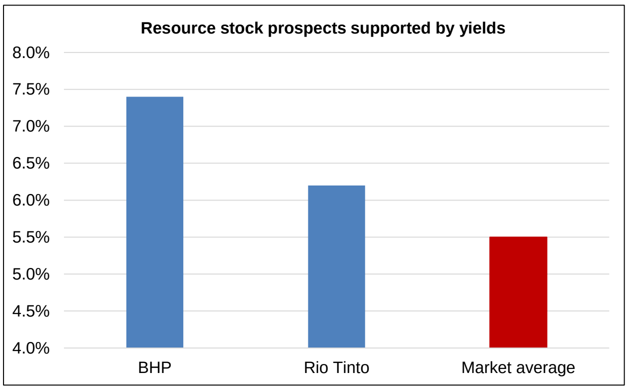
Source: Australian Bureau of Statistics



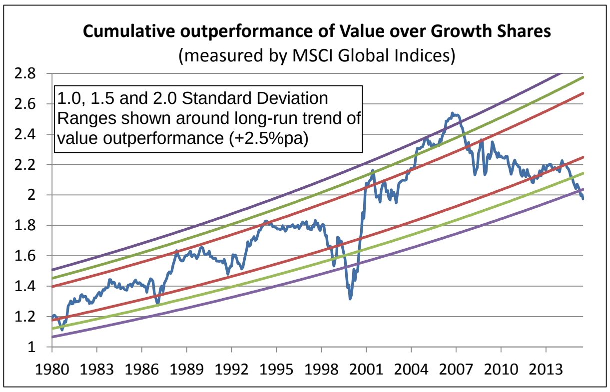
Source: Australian Institute of Health and Welfare

This long-term theme complements the tailoring of allocations within NZ and Australian shares to capture the relative opportunities of each market. Australia's building materials sector has continued to be a bright spot as activity catches up with a historical construction shortfall, although is subject to close monitoring as company valuations have risen. While commodity prices have declined, the allocation to Australian resource companies has been maintained at the same level as the wider market. Despite lower output prices, the larger providers (such as BHP and Rio Tinto) are benefitting from expanded production over recent years, while their need for future expansion investment has fallen. As a result, their dividend yields have quietly risen to more attractive levels. Similar opportunity is emerging in the Australian energy sector, where dividend yields have almost reached double digits (in the case of Woodside Petroleum). Within New Zealand shares, a moderate defensive bias is consistent with our tilt away from the local market, reflected in an overweight allocation to utility businesses as regulatory risks have subsided.

On a broad global basis, growth shares have driven market gains in recent years, in stark contrast to the long-run record of "value" shares outperforming. The reality has been that like all investment classes, the performance of value shares has moved in cycles, with value currently two standard deviations below trend vs growth. Current cycle positioning therefore continues to favour a tilt towards global value-shares ETFs (covering 10% of the global shares sector).



Source: Bloomberg

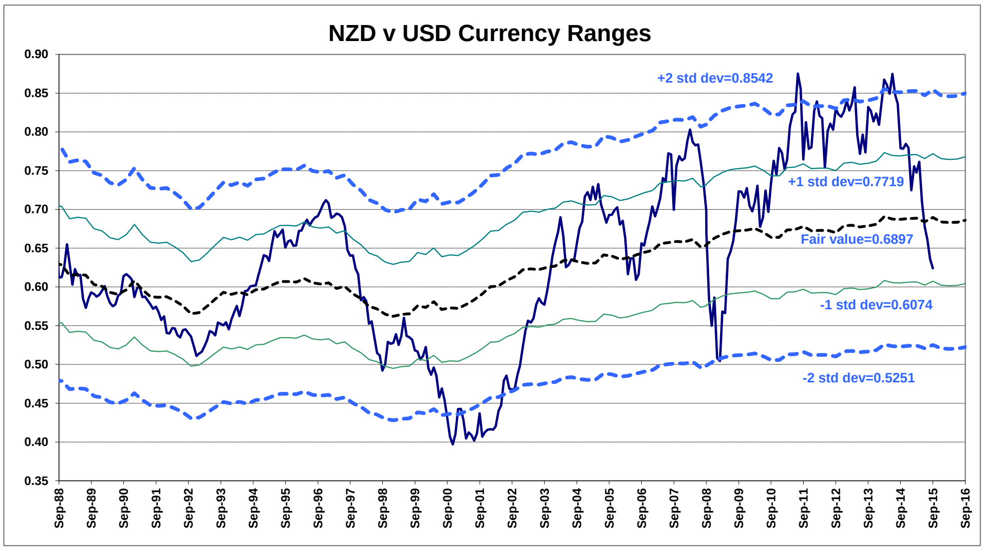


Source: MSCI, Grosvenor Research

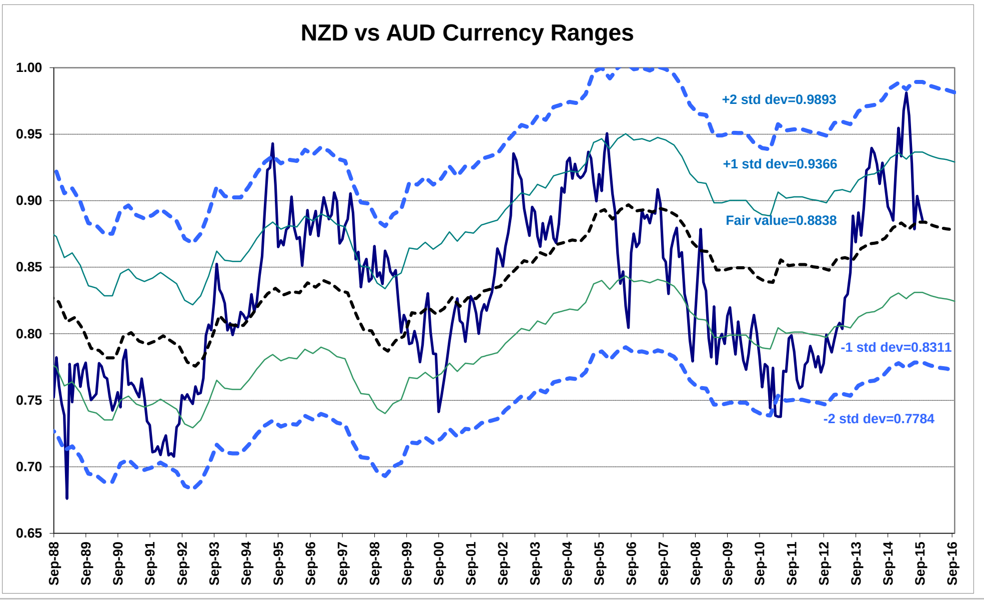
Currencies

Global currency hedging increased to 55% as the New Zealand Dollar has fallen, while 20% hedged within Australian Shares. The relative interest rate outlook has been the key driver of exchange rates, ahead of anticipating hiking in the United States.

Further declines have led the New Zealand Dollar to almost one standard deviation below long-run fair value, as the Reserve Bank has continued on a lower cash rate path following the earlier declines in export commodity prices. In contrast the Federal Reserve has moved gradually closer to raising interest rates, from effectively zero. New Zealand dollar weakness has also reflected broad US Dollar strength: The USD is now up 20% against a wide basket of other currencies over the past year. Looking forward from here, this substantial move may well anticipate a meaningful degree of future interest rate changes. Indeed, analysis of Fed tightening cycles since 1970 suggests that the US Dollar typically weakens as the Fed raises rates – falling by 6% to 8% on average. Combined with a NZD level below long run fair value and ongoing hedge premia of around 2.5%p.a., this has supported a move to a higher 55% hedge ratio within global shares, incrementally increased from 45% over the past quarter.



Compared to the Australian Dollar, similar themes have driven both currencies (lower commodity prices and interest rates). However, with New Zealand's dairy price falls having come later than Australia's lower iron ore prices, the NZD-AUD exchange rate has returned closer to fair value from its brief flirtation with parity. Against this backdrop, a 20% hedge ratio within the Australian Shares sector allows returns to benefit from hedge premia of almost 1% p.a – a direct result from New Zealand's higher interest rates compared to Australia..

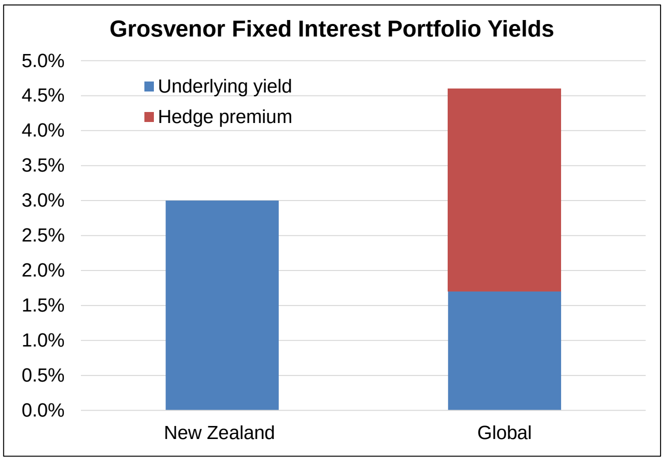


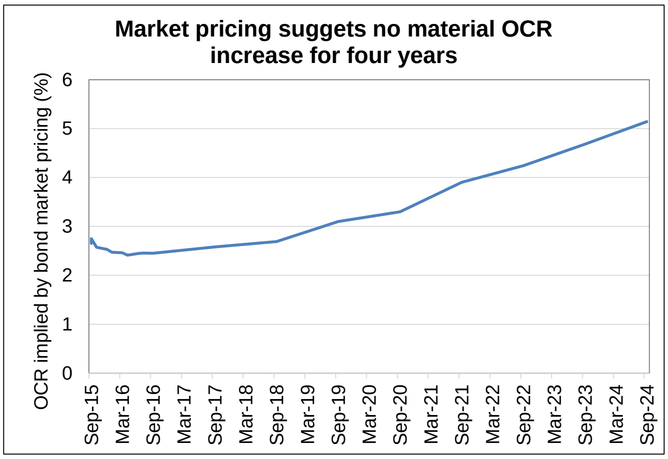
Sources: Bureau of Economic Analysis, Statistics New Zealand, ABS

Fixed Interest

Slightly short duration in New Zealand Fixed Interest, with some options protection over global bonds. Federal Reserve taking a patient approach to rate rises, while market expectations for eventual NZ OCR increases appear overly modest.

Central bank policy should remain supportive around the world, even as the US Federal Reserve moves closer to raising interest rates. Likely to occur later this year, this will shine the spotlight on divergence vs Japan and vs Europe, where Quantitative Easing may well be expanded with no real inflation pressure on the horizon - potentially magnifying the effectiveness of both programs. Importantly, the yield on global bonds remains strongly enhanced by a near 3% premium received by hedging returns into NZD. In New Zealand, a market focussed on OCR cuts has pushed the implied timing of any increases out to at least 2019. Despite the moderation in local economic growth, this appears over-done (especially relative to likely increases in the United States) and has been reflected in a slight reduction to the average bond maturity in the New Zealand Fixed Interest sector, anticipating better investment rates if yields rise.

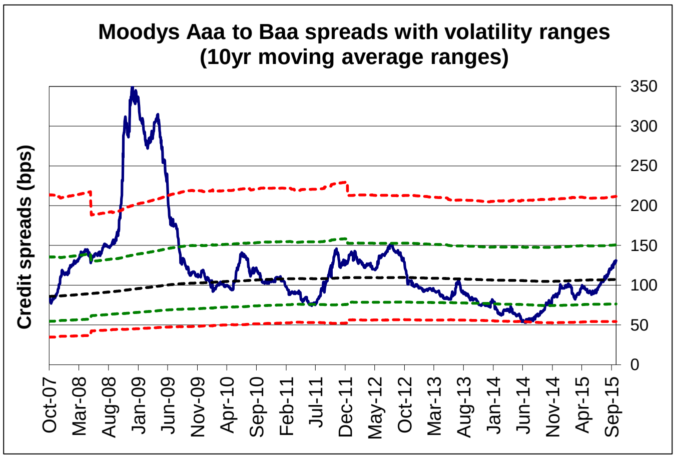


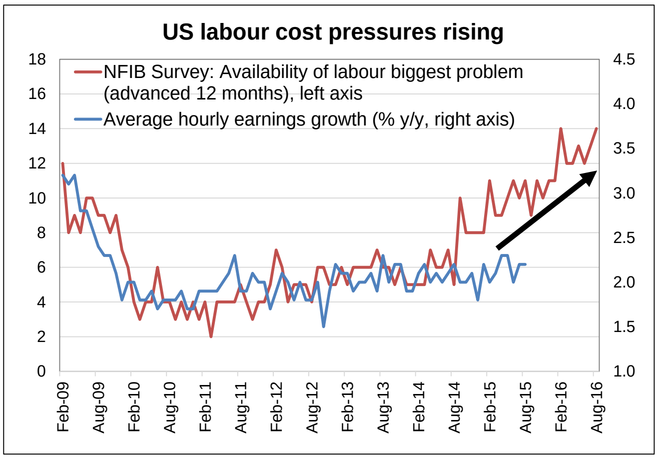


Source: Bloomberg, Grosvenor Research

Underlying inflation pressures in the United States continue to show signs of building, but not (quite) eventuating. An improving jobs market is the clearest source of pressure, with some indicators of wage levels starting to move upwards. If this continues then in time it will become a source of greater concern for the Federal Reserve. However a patient approach is likely to continue to be the key element of Fed policy – with rates rising only gradually once increases commence unless inflation really takes off. Our purchase of some options protection over global bonds should help moderate this tail risk, but remains under close watch for its ongoing merits.

Yields on global corporate bonds relative to government bonds (aka "credit spreads") have widened markedly since early 2014. For the time being, this supports a neutral 50/50 allocation between government and corporate bonds within the Global Fixed Interest sector, as credit spreads are only slightly higher than normal. However should the rise continue, a reallocation in favour of corporate bonds may well be justified.



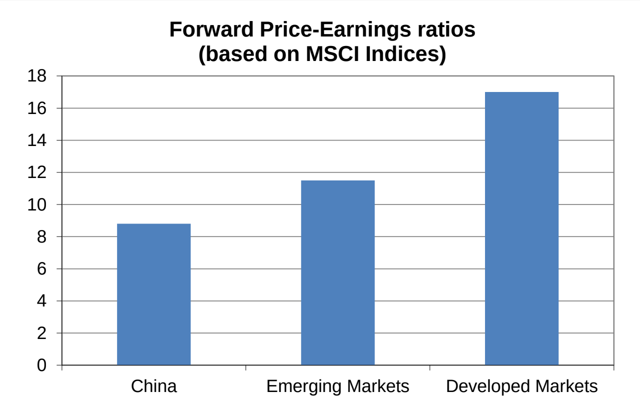


Sources: NFIB, US Bureau of Labor Statistics

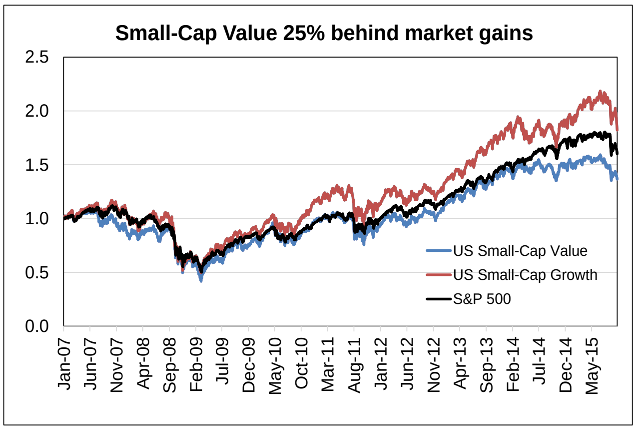
Global Opportunities

Focus on contrarian opportunities including emerging markets, value-based smaller companies and integrated oil producers.

Emerging markets have been the weak point in global share markets for three years, lagging behind the rise in developed markets by 30% since 2012. Commodity prices have played a part (around 25% of the MSCI Emerging Markets Index is made up of countries reliant on commodity exports), as has the gradual moderation of growth in China. Looking forward, China looks set for growth of around 5%-6% over the next few years, while on a broader basis the long-run fundamentals driving emerging economies remain intact: Market-based reform is becoming more widespread throughout Asia (with particular potential in India), and middle-class expansion and urbanisation continues. Favourable valuations also provide a buffer to future prospects, with Price-Earnings Ratios 35% cheaper than the west. Although a stronger US Dollar has weighed on market performance comparisons, particularly compared to US shares, to a degree this reflects the more robust floating exchange rates typically now used compared to the relatively fragile fixed rate regimes before 1998. As noted above, US Dollar weakness might also see this effect reverse going forward.

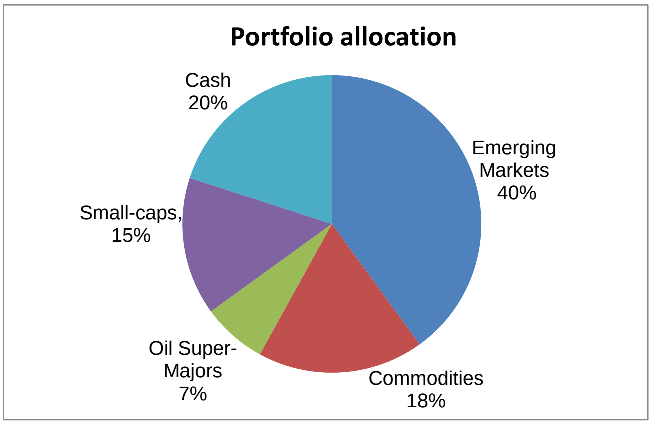


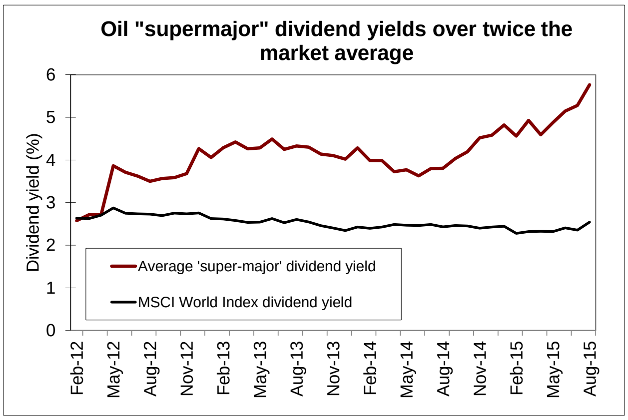
Source: Bloomberg



Sources: Bloomberg, Russell Small-Cap Indices, Standard & Poors

While maintaining an allocation to global smaller company shares, the value-growth cycle is also clearly evident here: In the United States, small-cap value shares have fallen behind even the broader S&P 500 Index over the past 5 years, let alone their small-cap "growth" counterparts, and provide a good opportunity for a contrarian investment approach, complementing a continued allocation to oil "super major" producers where dividend yields have expanded as share prices have fallen. Against a general picture of higher than average market valuations, and a bias towards favouring absolute returns within the portfolio, a 20% cash allocation continues to provide further room to add opportunistically to holdings should markets decline further.





Source: Bloomberg

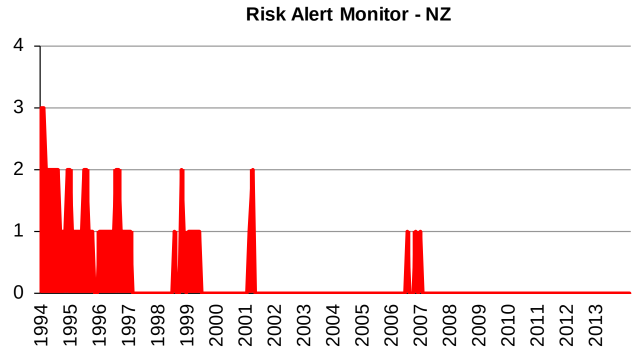
Appendix: New Zealand and Australia Risk Alert Monitors

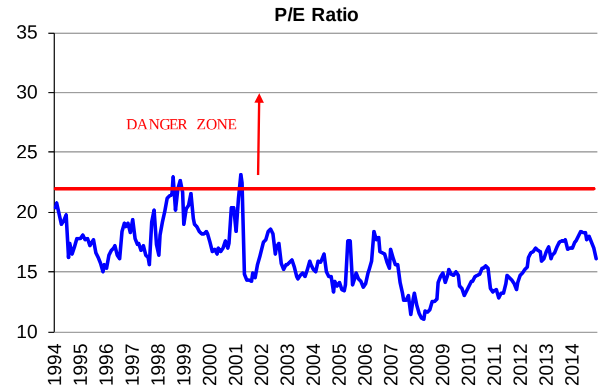
Included below are the New Zealand and Australian share market equivalents of the Risk Alert Monitors. While broadly consistent with the broad approach taken over the S&P 500 (included above), a shorter and narrower data history is a drawback within Australasian markets, which limits the ability to provide a long-term "cyclically adjusted" price-earnings ratio consistent with the United States.

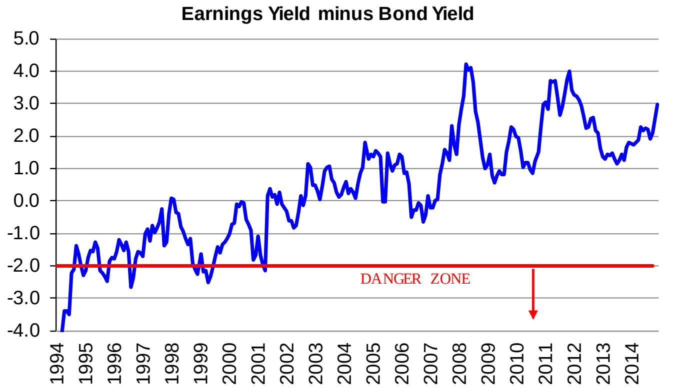
The overall RAM score for New Zealand and Australian share markets is zero; however some higher level of elevation in the case of New Zealand shares is consistent with the tilt towards the Australian market in client portfolios.

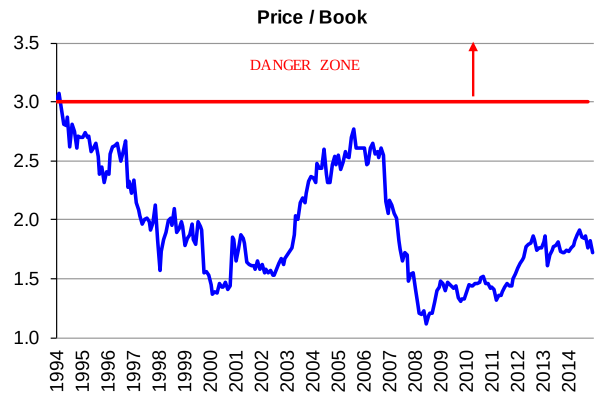
Risk Alert Monitor - NZX50

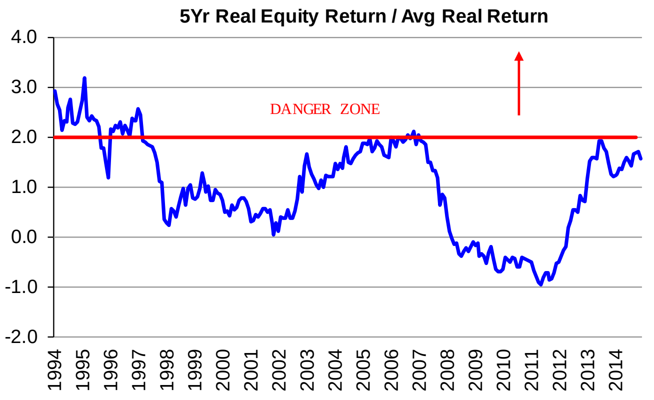
Indicator	Danger Zone	Current Aug15	1M Ago Jul15	1Yr Ago Aug14
P/E Ratio (adjusted)	> 22.0	16.1	17.0	17.0
Earnings - Bond Yield	< -2.0%	**3.0%**	2.5%	1.8%
Price / Book	> 3.0	**1.7**	1.8	1.7
5Yr Real Equity Return / Avg	> 2.0	**1.6**	1.7	1.2
RAM level		0	0	0



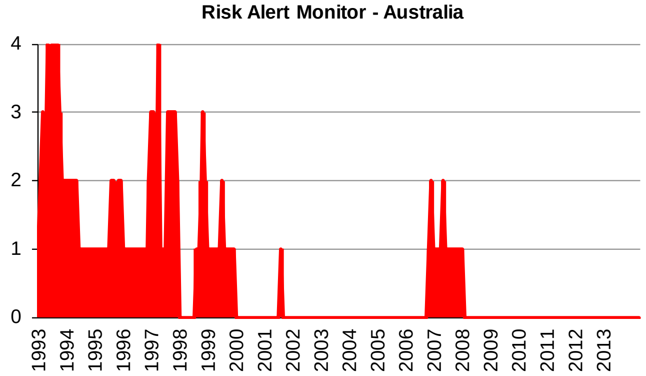


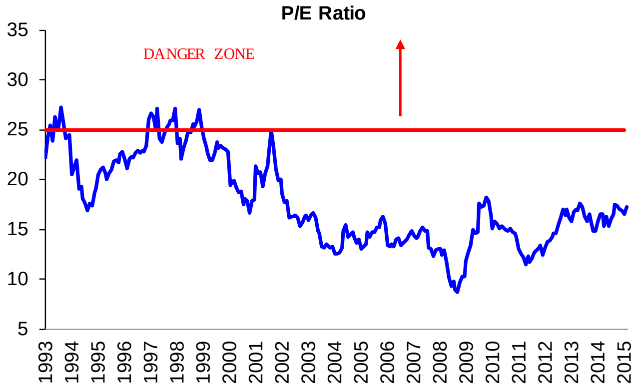


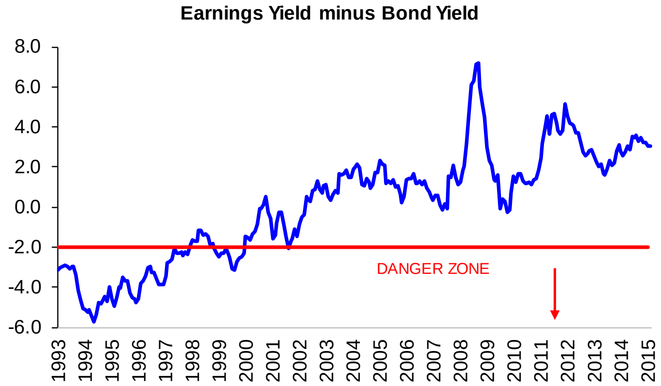


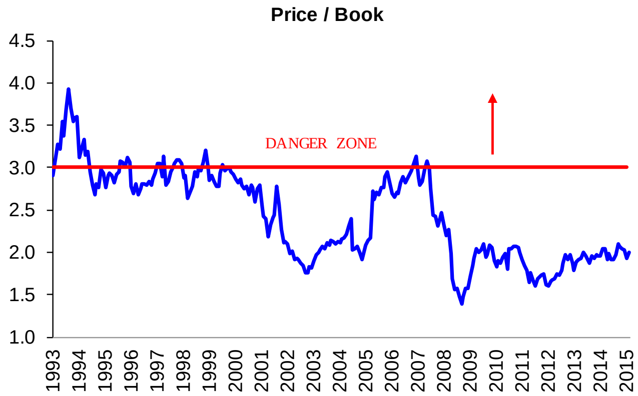


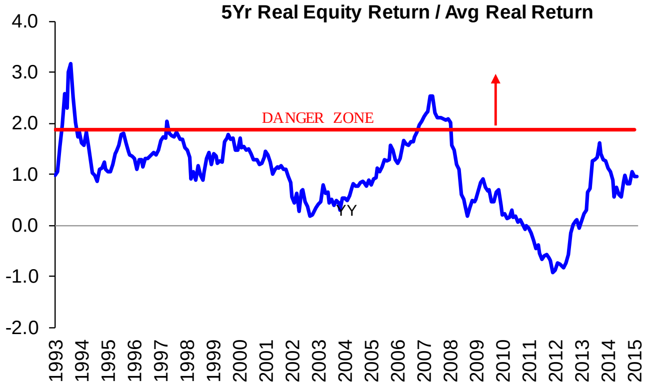
Risk Alert Monitor - Australia ASX200				
Indicator	**Danger Zone**	**Current** Aug15	**1M Ago** Jul15	**1Yr Ago** Aug14
P/E Ratio (adjusted)	> 25.0	**15.9**	17.2	16.6
Earnings - Bond Yield	< -2.0%	**3.6%**	3.0%	2.7%
Price / Book	> 3.0	**1.8**	2.0	2.0
5Yr Real Equity Return / Avg	> 2.0	**0.8**	1.0	0.9
RAM level		**0**	0	0











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