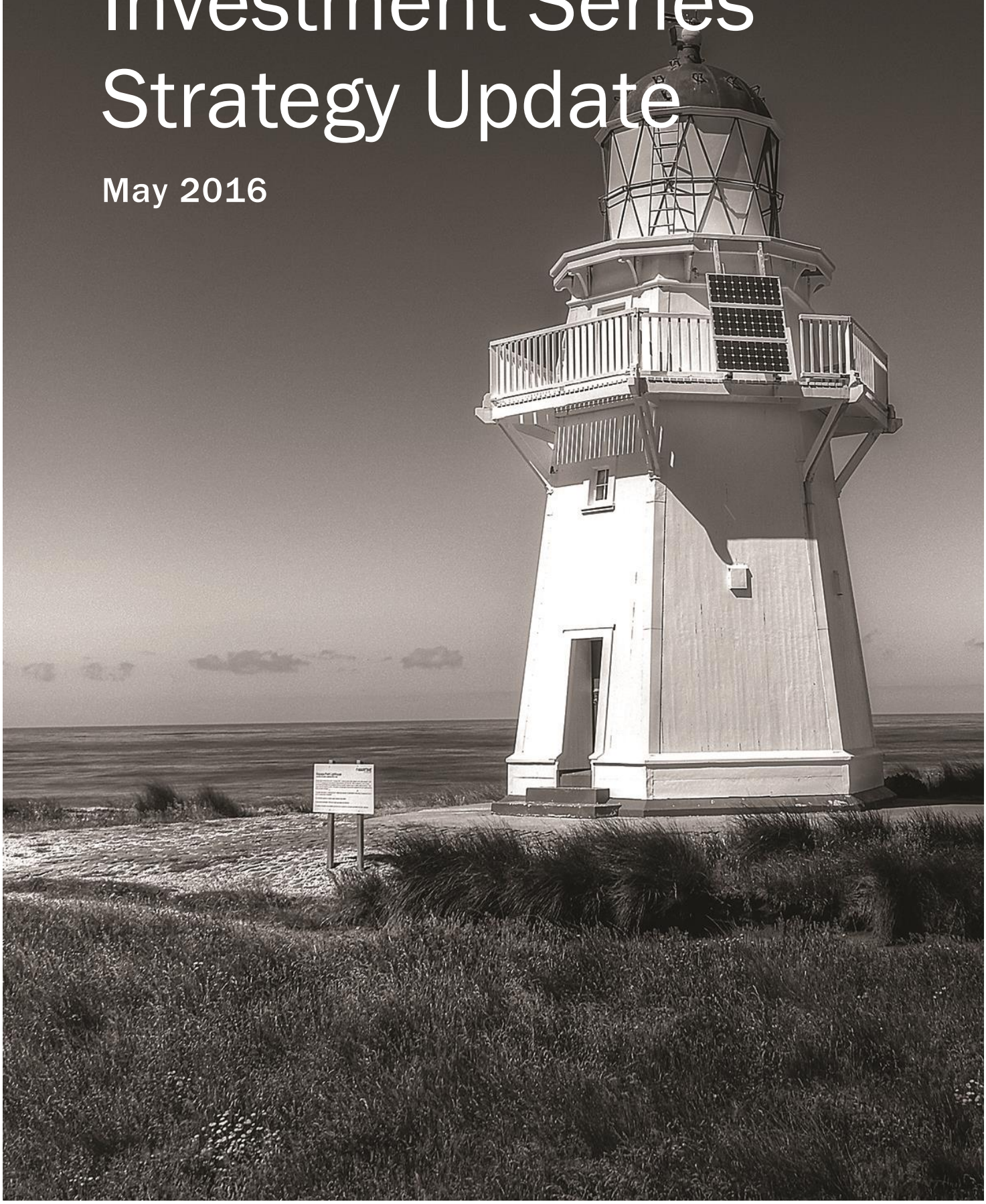
GROSVENOR RESEARCH

Investment Series Strategy Update

May 2016



GROSVENOR RESEARCH

Strategy overview: Introduction

This publication 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.

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 moderated during 2015-16. 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. A gradual move towards a tightening in global monetary policy (starting in the United States) poses some challenge to this looking forward, and is likely to reinforce the level of divergence in returns between asset classes and industry sectors. While this sets a challenging backdrop, these factors also give more opportunity for a level of active management in client portfolios, and reinforce the value of combining active overlays with a strategic, index-based core.

Executive Summary

Key changes since the previous update include:

- Expectations remain for moderate growth for the world as a whole, despite some concerns at times during 2016. Growth in China is benefitting from further government stimulus.
- Options protection over global shares remains in place, but at a lower level following two market corrections over the past 6-9 months;
- Currency hedging increased to 60% in the global shares sector, as the NZ Dollar has fallen;
- NZ Fixed Interest duration increased slightly to be in line with the benchmark index, in response to a steeper yield curve as short-term rates fell.

As well as covering the current strategies in place, this update outlines key positions under close ongoing monitoring, where valuations have drifted significantly from medium-term "fair value". In each case, monitoring is focussed on a patient approach to confirming that the medium-term cycle has turned before reflecting more fully in portfolio allocations. The key positions include:

- An increased allocation to global value shares;
- A bias to emerging market shares over developed markets, where valuations have risen;
- A further bias to Australian shares over New Zealand;
- A reduction in New Zealand listed property shares, where the attractiveness of income yields has fallen amid the global "search for yield".

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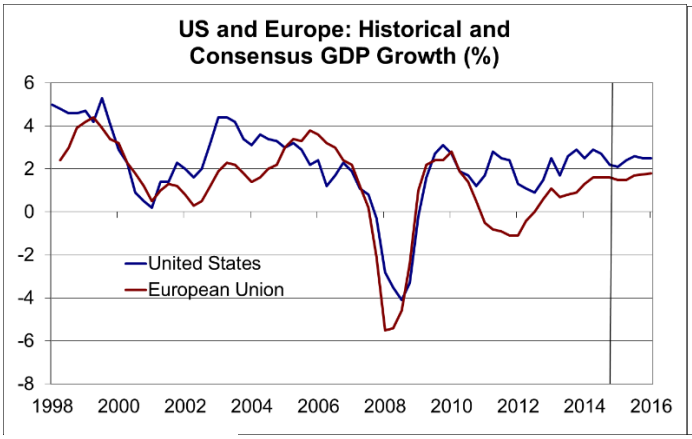
Global backdrop

Moderate growth in the west, helped by lower oil prices. For companies, profit margins a watchword as economic slack falls.

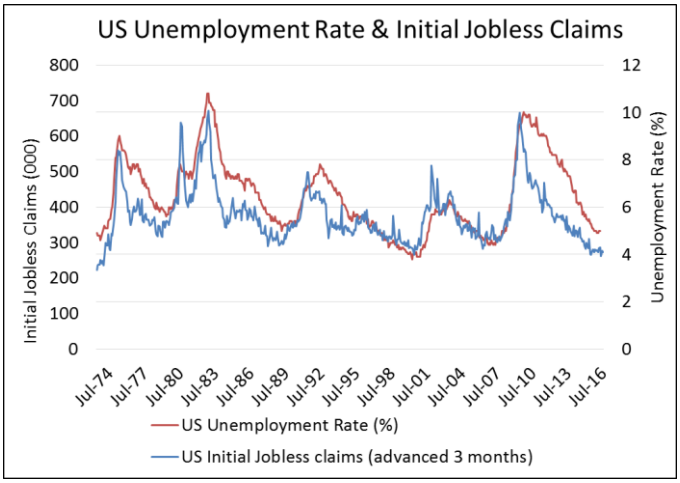
The key United States economy has continued to grow at a moderate pace. Confidence levels suggest this should be ongoing, with some of the head wind from a higher US Dollar (which hurt exports and manufacturing activity over the past year) starting to fade, and despite a hit to growth from oil exploration being curtailed. Employment growth and consumer optimism are still in relatively good shape (helped by the fall in oil prices over 2014-15). This has also spurred moderate growth in Europe, where bank lending has started to grow again after five years of retrenchment.



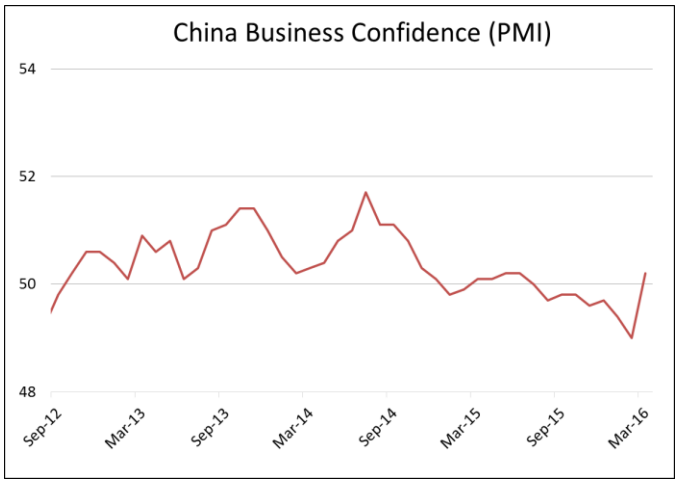
Source: Bloomberg

Source: Bloomberg

Growth in the United States continues to gradually eat into the economic "slack" that has built up since 2008, with unemployment down substantially. However, 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: China Federation of Logistics and Purchasing

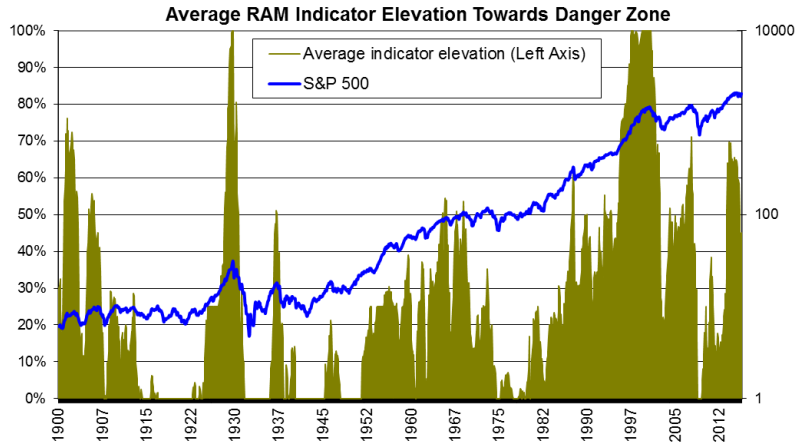
Further afield, China continues to transition away from manufacturing-led growth, but indicators suggest that a "hard landing" is unlikely. Growth indicators have improved since mid-2015, with increased government support playing a role and signs of life in the property market, previously a source of weakness. Looking further ahead, across much of Asia a combination of gradual market-based reform, technological convergence and relatively young populations should help support growth over the medium term.

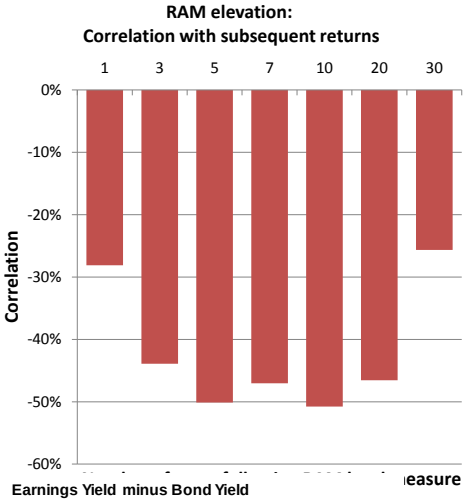
Multiple expansion raises the bar for future returns

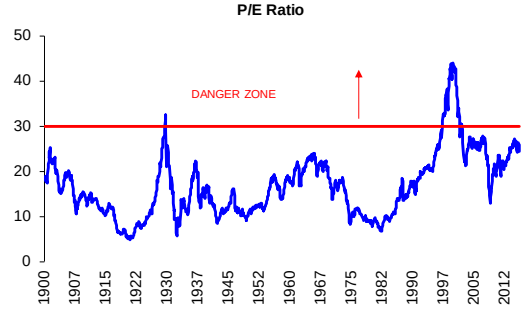
Fully invested, but with options protection in place

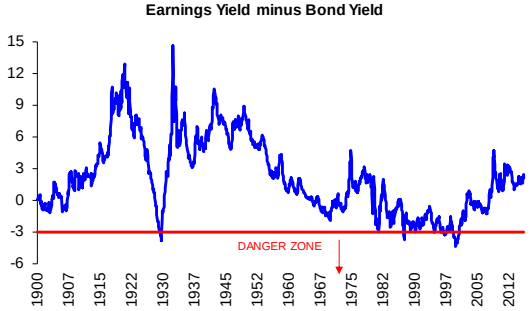
Despite moderate overall economic expansion, strong share market returns over the past five years (but particularly since 2012) have been driven by higher price-earnings multiples, more than underlying earnings growth. This sets the bar higher for future returns and has been reflected in Grosvenor's key Risk Alert Monitor (RAM) indicators – with P/E ratios and Price/net asset backing ratios rising, and equity returns having been sustained at elevated levels.

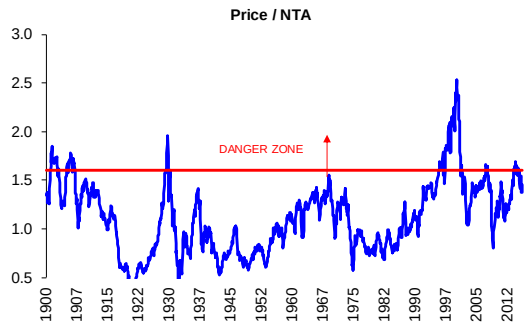
The key support to equity markets has clearly been via low returns on offer elsewhere: The difference between the "earnings yield" on shares and the 10-year US bond rate is not far off its long-run average. Looking forward, some moderation here is likely, as yields gradually rise. Overall, while the current RAM score is zero, the average 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, with the effect on returns strongest from a 3-year time horizon onwards. With this in mind, we have continued to maintain some insurance protection over 20% of the global shares sector, as well as some protection over global bonds, to mitigate any material market weakness at a minor level of cost. Within global shares, this level of protection has been moderated compared to that maintained during 2015, with two recent market dips of over 10% having taken some of the steam out of potential market complacency.

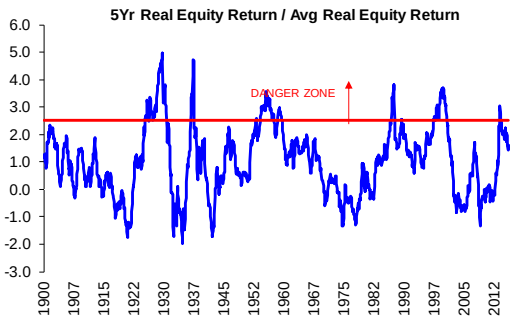










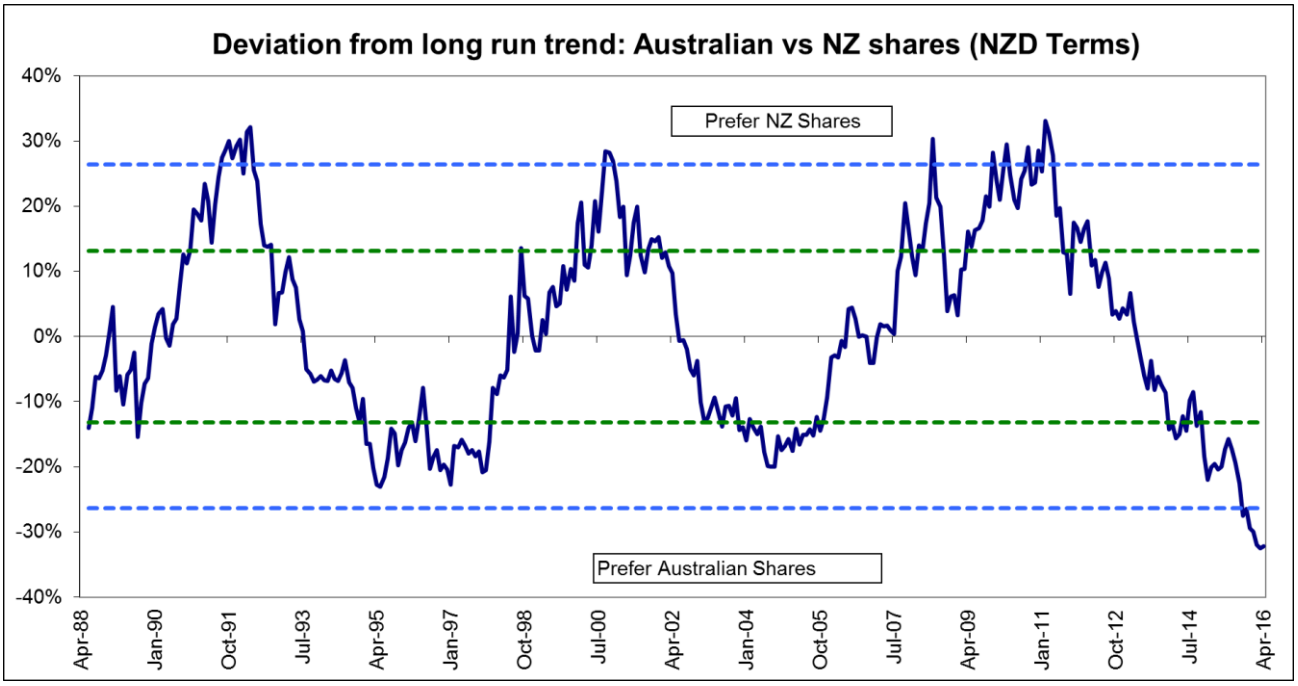


Sources: Bloomberg, Federal Reserve, Standard & Poors

New Zealand and Australian share markets out of sync

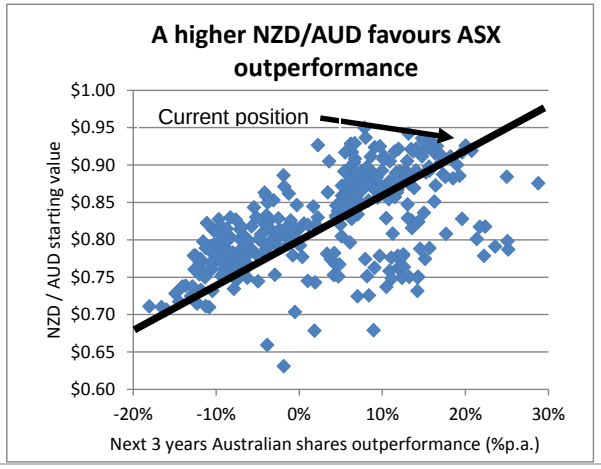
Overweight Australian shares compared to New Zealand, with favourable relative valuations as New Zealand shares have risen substantially.

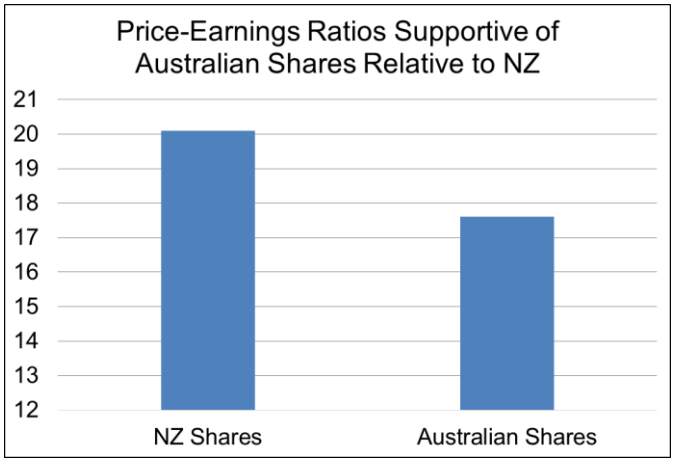
Portfolios continue to maintain an equal weight between NZ and Australian shares, despite a moderate preference for NZ shares on a long-run strategic basis (driven largely by NZ's dividend imputation regime). This overweight on Australian shares directly reflects the difference in valuations that has 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 has increased towards 20. (In New Zealand, the higher Price-Earnings ratio has driven substantially all of the strong recent gains). Economically, this comes at a time where the Australian economy has been working through an extended transition away from the mining sector, but supported by solid overall employment growth. New Zealand's economic profile has likewise moderated from its "rock star" peak, with growth more reliant on Auckland's property market as general business confidence and the agricultural sector have softened.



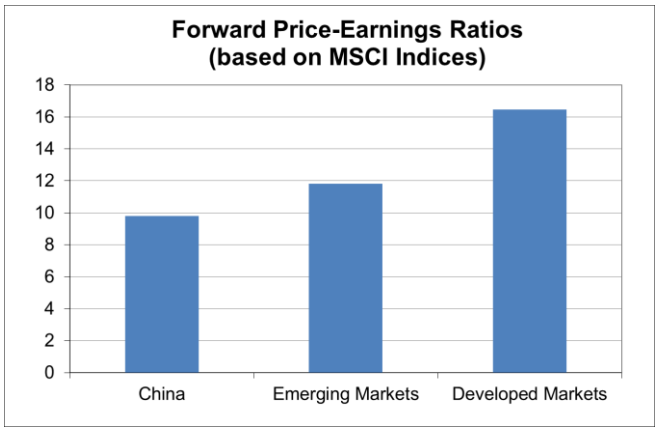


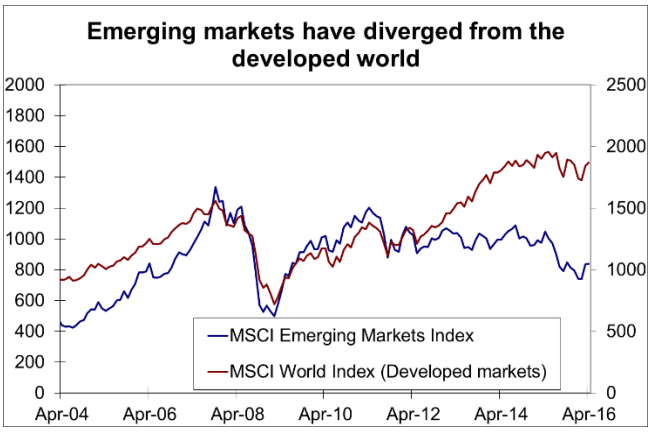
Source: Bloomberg

Divergence in Developing Markets

Bias to favouring emerging markets, with favourable valuations compared to the west.

Emerging markets have been the weak point in global share markets since 2012, lagging behind the rise in developed markets by 40%. Lower 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 as the most likely scenario, as part of its ongoing transition to lower, broader growth. On a wider 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 almost 30% 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. Key monitoring factors before moving to a greater portfolio allocation include seeing evidence of continued reform in the Chinese government's approach to managing credit growth, as well as returns more indicative of a turn in the market cycle.



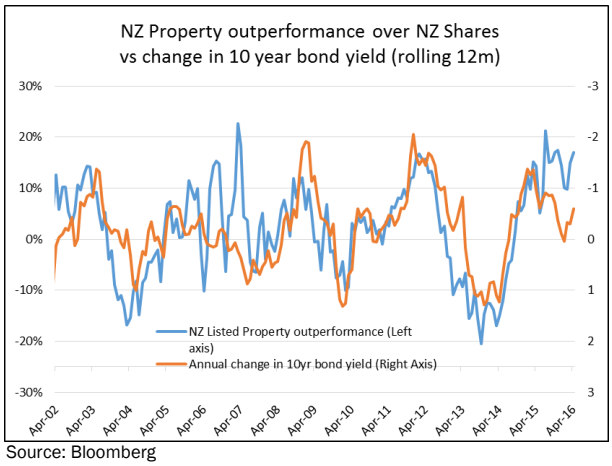


Sources: Bloomberg, MSCI

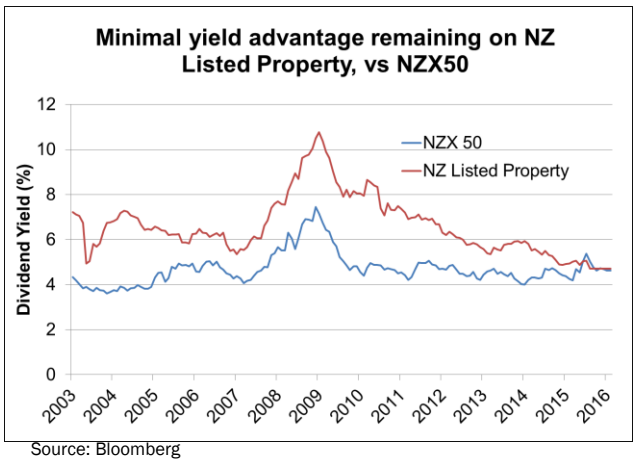
Listed Property – reaching for yield?

Bias to move away from Listed Property, from the global search for yield.

In a global environment of lower yields, the property sector has been a key beneficiary. Such results are well in keeping with the typical historical relationship, with listed property tending to outperform shares when bond yields fall (and vice versa). Although central bank policy remains stimulatory overall, future support for Listed Property returns (relative to shares) is likely to diminish. With property stocks' traditional yield advantage also having diminished amid strong investor demand, the changed risk-reward dynamics justify some caution and a bias to move to an allocation below the long-run strategic level, once clearer evidence of a change in the OCR reduction cycle is in place.



Source: Bloomberg

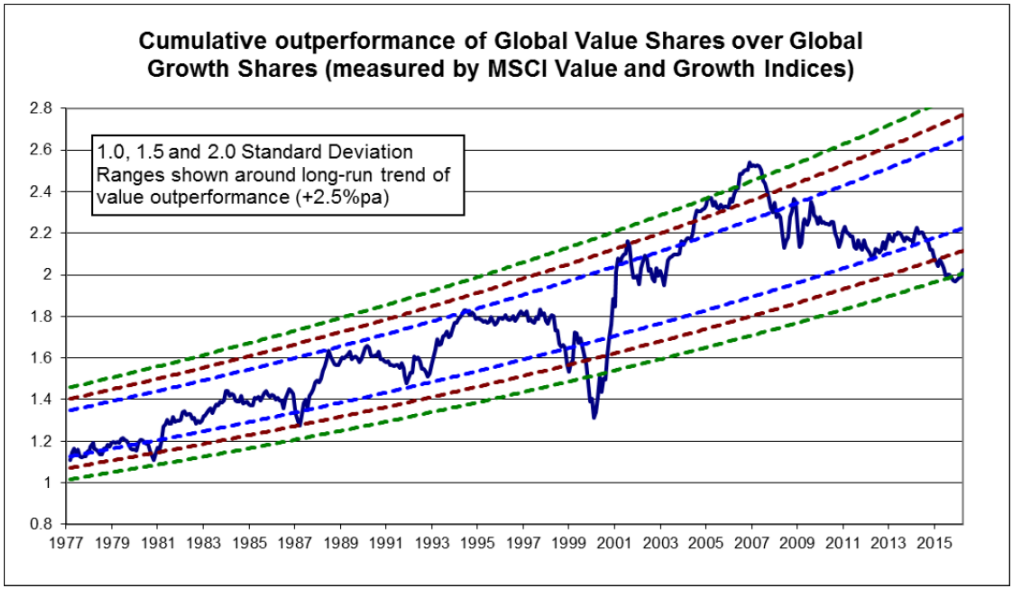


Source: Bloomberg

Key sector themes

Value shares favoured globally, given substantial "growth" outperformance. A 21st century tailwind for healthcare, while favouring Australia's building materials sector.

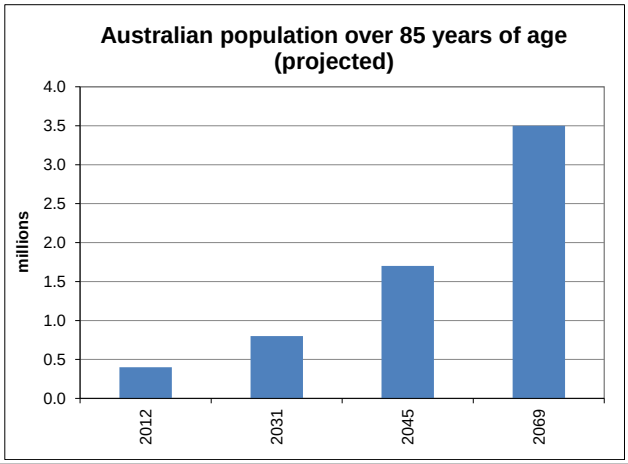
While global share market valuations have risen, areas of relative opportunity exist. On a broad style basis, a 10% tilt towards global value-share ETFs, carved out of the Vanguard index allocation, follows an extended period of underperformance by value shares compared to their growth counterparts: Growth shares have driven the past few years' market gains. Long-run proponents of value shares are likely to have been disappointed on a global level, with value having contributed no additional return since the turn of the century, based on MSCI index data. However, such periods are not uncommon as markets move in cycles (see the period 1994 through to 1999, for instance, when value shares underperformed growth by 25%).

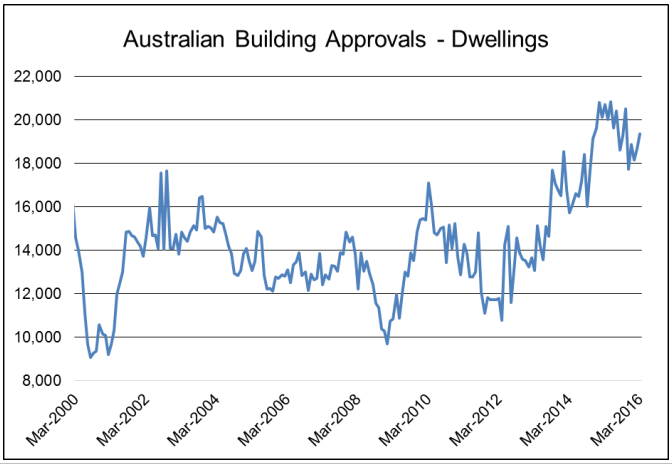


Source: MSCI, Grosvenor Research

Within the NZ, Australian and global share portfolios, company allocations are positioned to capture structural growth in demand for healthcare services. The Australian Bureau of Statistics projects a quadrupling in the number of people aged over 85 within the coming 30 years, just one example within the developed world. In New Zealand, aged care facility operators provide a good focussed allocation to this theme.

In conjunction with the wider tilt from New Zealand to Australian shares, company allocations within each sector also reflect the relative opportunities of the two markets. In Australian shares, holdings in providers of building materials reflect the catch-up that Australia is seeing from years of under-investment in housing. Despite lower commodity prices, cash flow levels of the key miners provide a dividend yield comparable to the traditionally favoured banking sector. While within New Zealand, an overweight allocation to utilities reflects a preference for earnings consistency given the general level of valuations.

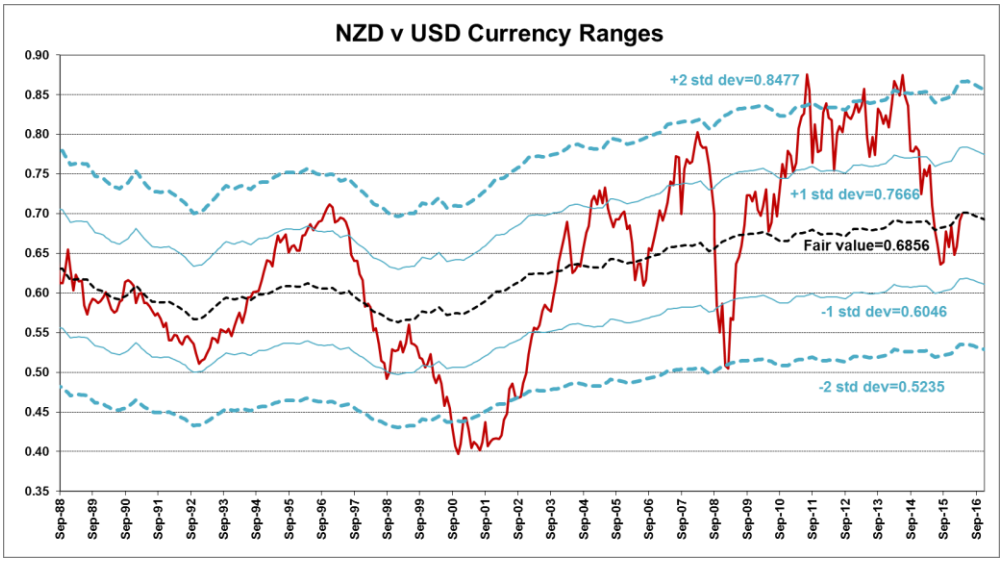




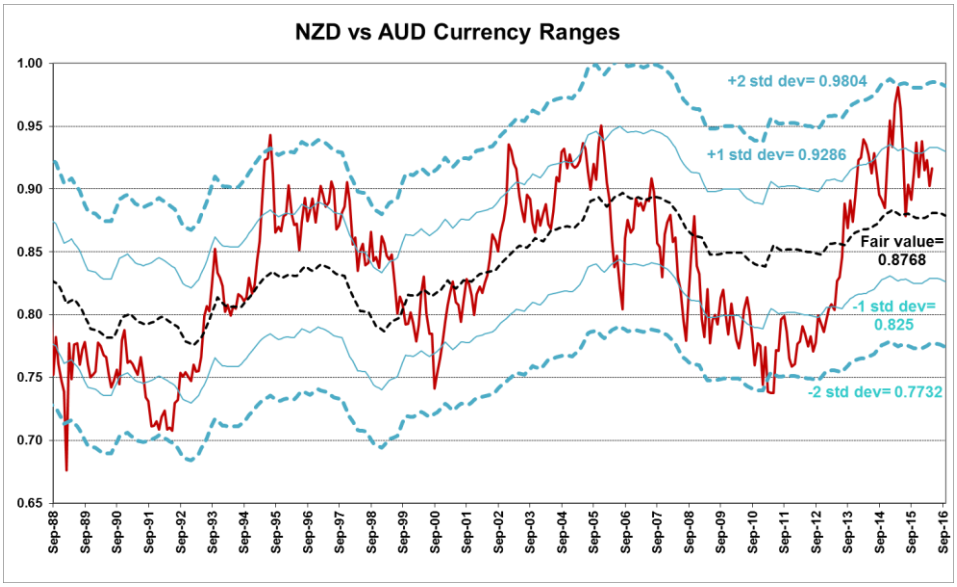
Currencies

Global currency hedging increased to 60% as the New Zealand Dollar has fallen, now in line with strategic level. 30% hedged within Australian Shares (underweight vs 50% strategic level) with NZD/AUD rate above fair value.

Following a sharp decline from its peak during 2014, the New Zealand Dollar has recovered towards its long-run fair value. The decline provided the opportunity to gradually increase hedging over global shares to the sector's 60% strategic level. Looking forward, expectations of a fall in the NZD with the US Federal Reserve commencing interest rate increases may be overstated. The USD is already up 20% against a wide basket of other currencies over the past two years, a move that anticipates 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. However from a starting point at current levels, any further changes to hedging levels will take into account any differences that develop compared to assessed long-run fair value.



Relative to the Australian Dollar, the NZD has fluctuated moderately above fair value over the past two years although remains down from its brief flirtation with parity. Relative changes in interest rates (Reserve Bank of NZ vs Reserve Bank of Australia) and commodity prices (dairy vs iron ore) have been key drivers, with some recent recovery in dairy prices. However with the exchange rate a moderate 7% above assessed fair value, portfolio positioning is in keeping with leaving the overweight allocation to Australian Shares unhedged.

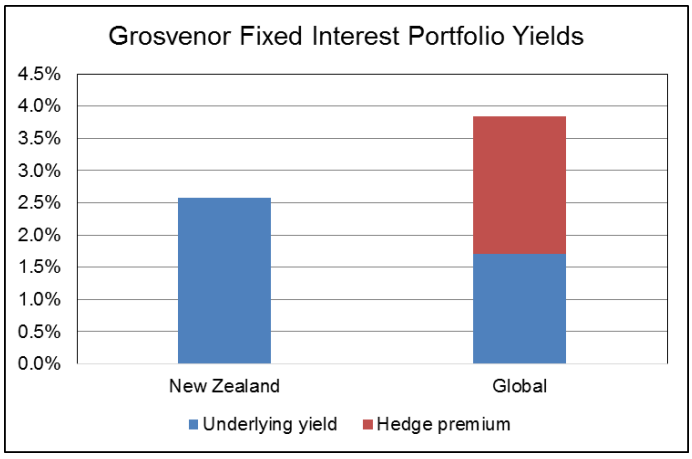


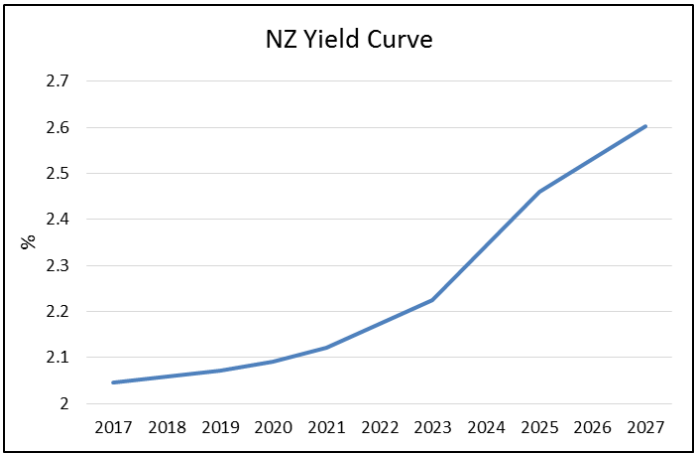
Sources: Bureau of Economic Analysis, Statistics New Zealand, ABS

Fixed Interest

Neutral duration in New Zealand Fixed Interest, while holding cash via the Enhanced Cash Portfolio. Some options protection over global bonds.

Central bank policy should remain supportive around the world, even as the US Federal Reserve gradually increases interest rates. While the US Fed Funds Rate is likely to increase towards 0.5%-0.75% over the coming year, this will shine the spotlight on divergence compared to Japan and Europe. Quantitative Easing remains firmly on the agenda of the European and Japanese central banks, 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 2% premium received by hedging returns into NZD. In New Zealand, expectations are for the OCR to rise only gradually (in keeping within the low global interest rate environment), and even for that to take place only after at least one more reduction. With the resulting lower yields on government bonds, this leads to a focus on short-term corporate bonds as a source of additional portfolio yield.

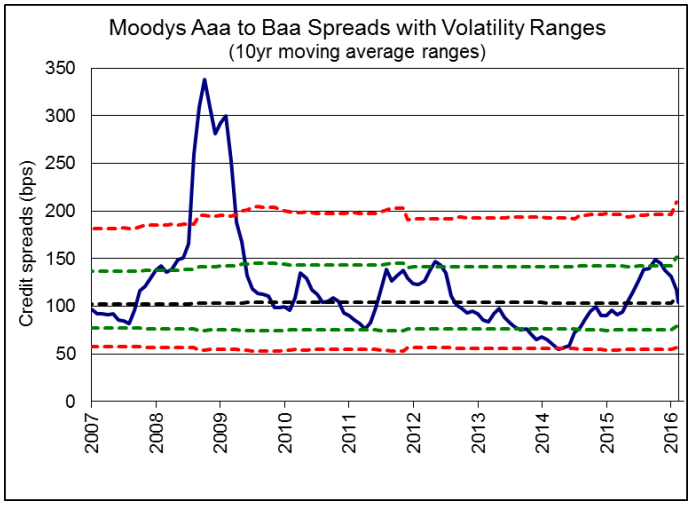




Source: Bloomberg, Grosvenor Research

Underlying inflation pressures in the United States continue to show signs of building. An improving jobs market (see chart on page 3) 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 increasing at a very moderate pace unless inflation really takes off. Our purchase of some options protection over global bonds is aimed to help moderate this tail risk, but remains under close watch for its ongoing merits.

Within global fixed interest, the additional yield available on global corporate bonds relative to government bonds (aka "credit spreads") is supportive of maintaining a 50-50 allocation between government bonds and corporate bonds. The chart to the left shows the average level of credit spreads (blue line) relative to levels one standard deviation and two standard deviations away from normal. 2015 saw some widening in spreads, but not to the level at which we would look to materially adjust portfolio allocations. The rise in credit spreads was driven both by general market volatility and the effects of lower oil prices on borrowers in the energy sector. The latter point added an element of structural concern, with credit quality materially lowered for a range of businesses. Having briefly touched one standard deviation above long run average, spreads have since fallen back to more normal levels as general market volatility has fallen and oil prices have recovered.



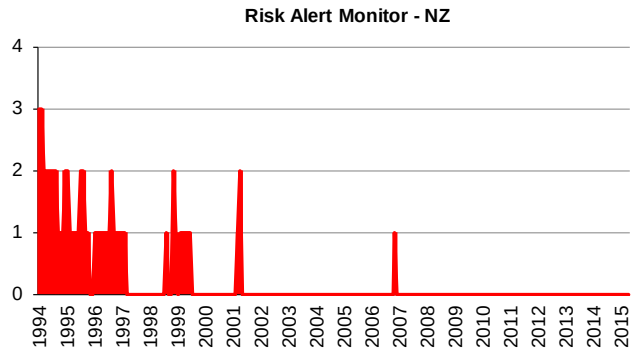
Appendix: New Zealand and Australia Risk Alert Monitors

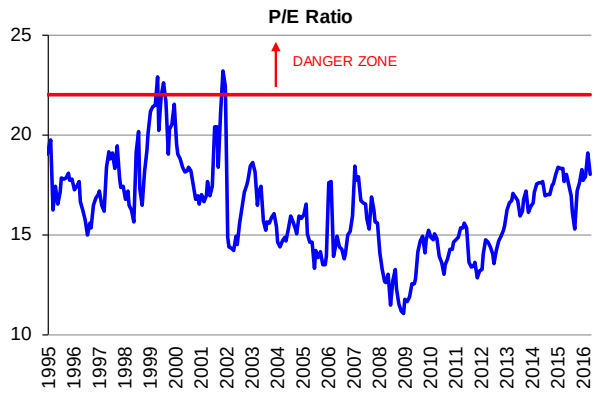
Included below are the New Zealand and Australian share market equivalents of the Risk Alert Monitors. While broadly consistent with the broad approach taken over the S&P 500 (included above), a shorter and narrower data history is a drawback within Australasian markets, which limits the ability to provide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

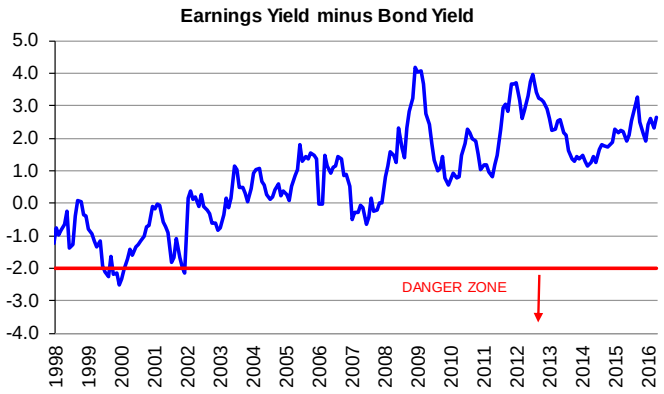
The overall RAM score for New Zealand and Australian share markets is zero; however some higher level of elevation in the case of New Zealand shares is consistent with the tilt towards the Australian market in client portfolios.

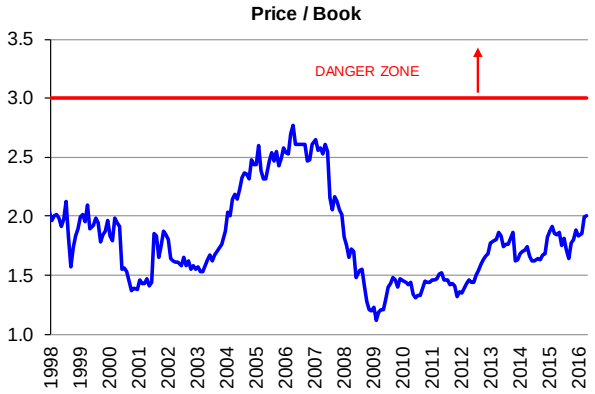
Risk Alert Monitor - NZX50

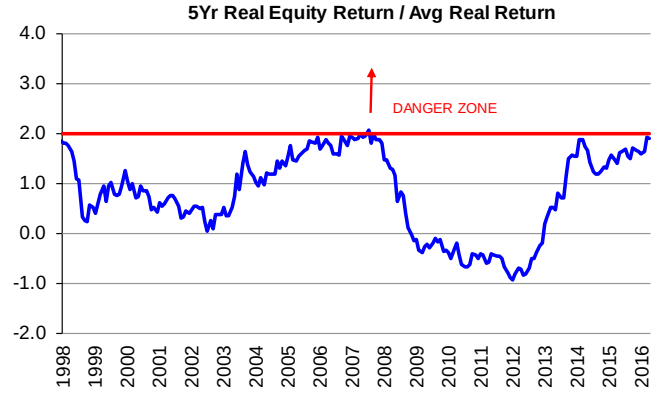
Indicator	Danger Zone	Current Apr16	1M Ago Mar16	1Yr Ago Apr15
P/E Ratio (adjusted)	> 22.0	18.0	19.1	17.7
Earnings - Bond Yield	< -2.0%	**2.6%**	2.3%	2.2%
Price / Book	> 3.0	**2.0**	2.0	1.8
5Yr Real Equity Return / Avg	> 2.0	**1.9**	1.9	1.4
RAM level		**0**	0	0





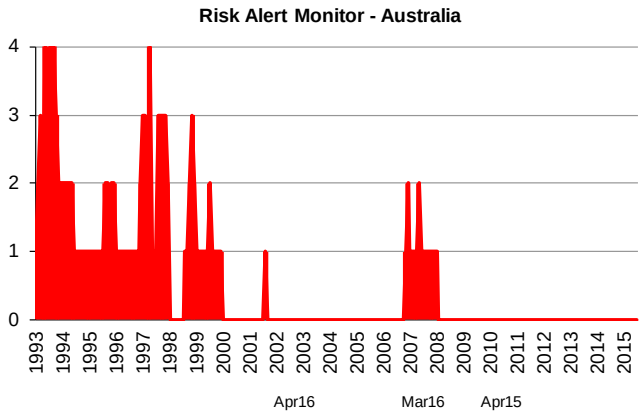


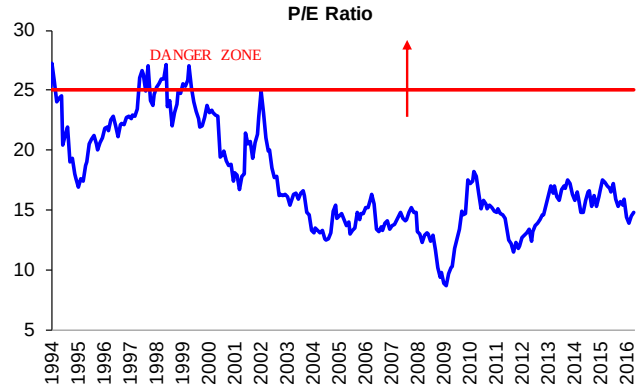


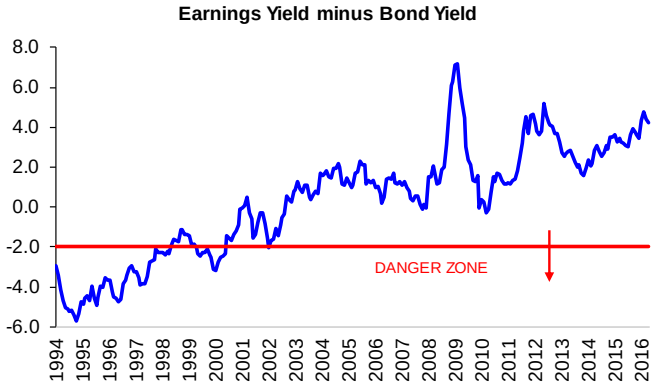


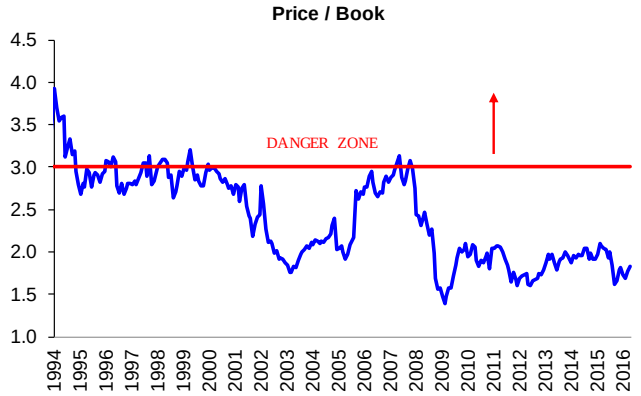
Risk Alert Monitor - Australia ASX200

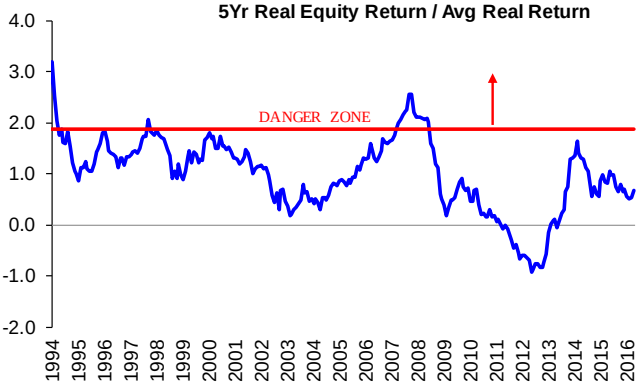
Indicator	Danger Zone	Current Apr16	1M Ago Mar16	1Yr Ago Apr15
P/E Ratio (adjusted)	> 25.0	**14.8**	14.5	17.0
Earnings - Bond Yield	< -2.0%	**4.2%**	4.4%	3.2%
Price / Book	> 3.0	**1.8**	1.8	2.0
5Yr Real Equity Return / Avg	> 2.0	**0.7**	0.5	0.8
RAM level		**0**	0	0











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