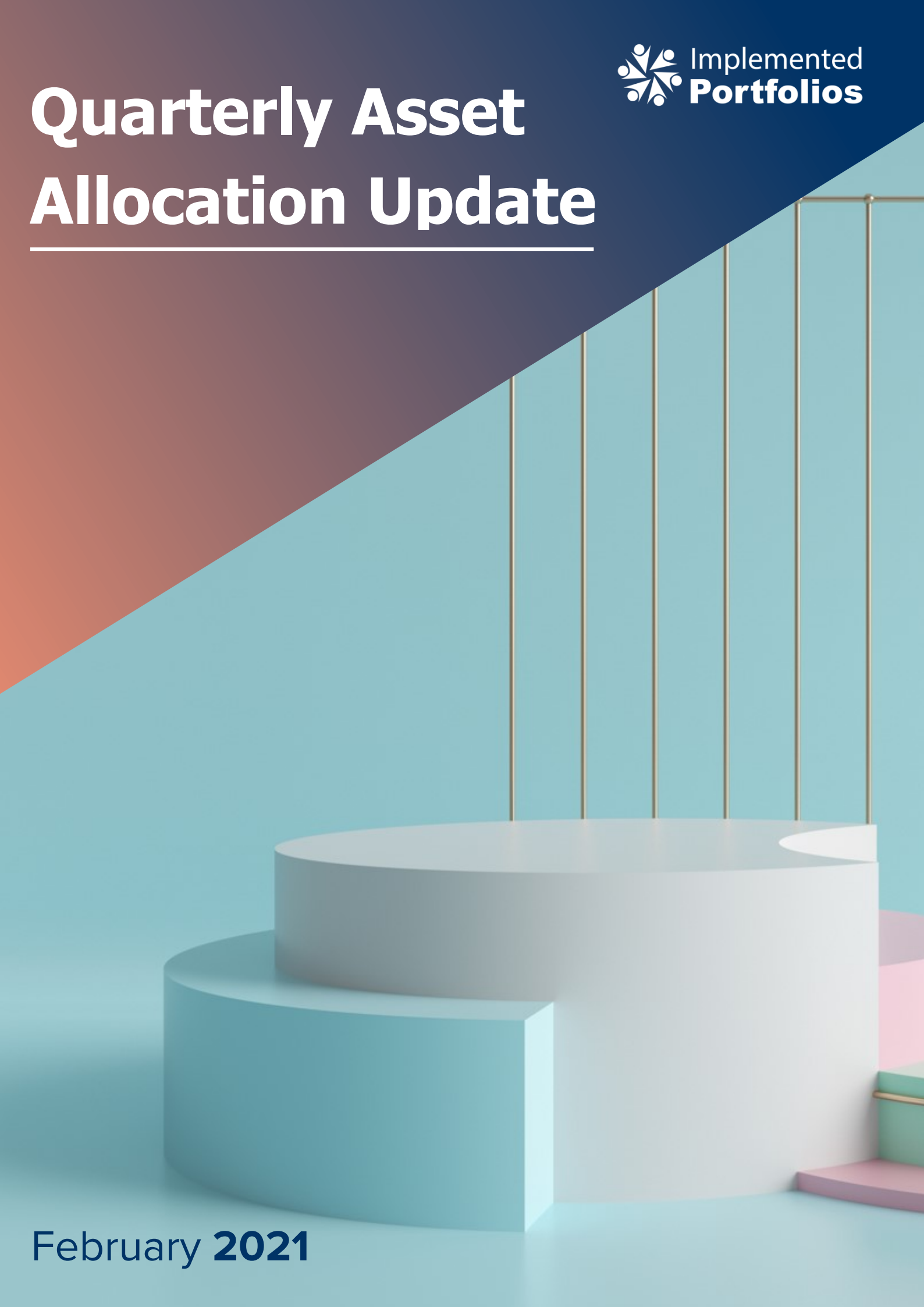
Implemented Portfolios

Quarterly Asset Allocation Update



February **2021**

ALLIEDWEALTH

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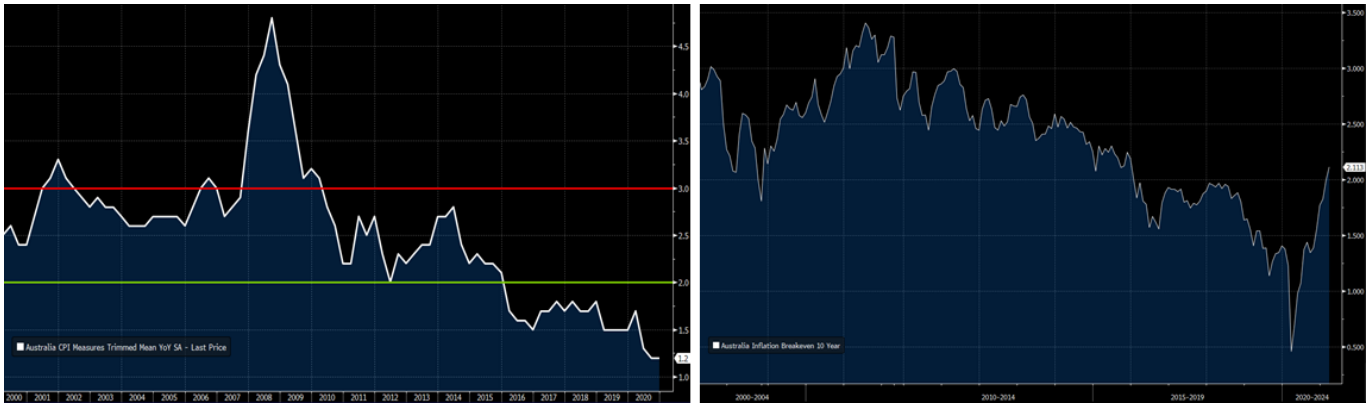
It is not unusual for the investment world to fall into two camps, but in the last few weeks there has been an especially important version of this unfolding. The current divide centres around the strength of the economic recovery underway, and more specifically if the policies from central banks and governments designed to support that recovery will prove too much, and will lead to the long dormant inflation data heading much higher. Were that to actually occur, the flow on effects across a range of markets and asset classes are incredibly consequential for portfolio management.

So, we start the discussion by using an Australian context to look at the issue, and initially by sharing again the chart on the left which tracks the Reserve Bank of Australia's preferred measure of inflation. It is important to note that that the most recent reading of 1.2% is from December 2020, and that we will not get the reading for the March quarter until the end of April. Also, it is clear that recent inflation data continues to be well below the bottom of the bank's target band of between 2% and 3%. In fact, inflation has been less than 2% for the last five years, which of course pre-dates the coronavirus induced recession.



On the right-hand side we show an indicator[1] of how the market collectively thinks the outlook for inflation has changed over time. We can see at the bottom right of the chart that during the depths of the crisis early last year, sentiment was understandably very poor and confusion and pessimism about the economic outlook was the understandable order of the day. This is reflected by there being at that time only an expectation for inflation to average around 0.5% for the ten years ahead. Since then, and with the recovery now underway, the collective view has changed appreciably to now be an expectation for inflation to a little more than 2% over the next ten years.

Which, if we return to the left-hand chart, we can see equates to the bottom end of the RBA's target band, not even the mid-point, and certainly not the upper limit of the target. Many are now predicting that pent-up demand, high household savings and large ongoing policy support measures will mean we see much

higher inflation ahead, and that central banks will have to start hiking interest rates long before they have told us they intend to, though this is not the view of the Asset Allocation and Investment Committee.

One critical impact we need to consider from a portfolio management perspective is in the defensive part of your portfolio. Here we switch to a chart that shows the rate of income (yield) that has historically been earned by investors holding 10-Year Australian Government Bonds, and consistent with the charts above we start back in January 2000. Debt issued by the government is traditionally considered a risk-free investment, and we can see for most of the time leading into what became the Global Financial Crisis in 2008/09, the risk-free return available to investors was between about 5% and 6.5%.

Yields then dropped sharply during the GFC but quickly recovered, before resuming their path lower. As the line in this chart moves from top left to bottom right, that boosts the returns from fixed-rate bonds. Lower yields means that investors earn an additional capital return on top of the rate of income that the bonds were paying when they were purchased.

Imagine you bought a bond back in 2018 that was paying interest of 2.75%, and then in late 2020 newly issued bonds are only paying 0.75%. If you decided to sell your bond rather than hold it to maturity, the higher rate of income means the person you sold it to would pay you a premium over the original face value of the bond. Now consider this imaginary scenario, but in reverse. You bought a bond in 2020 that pays 0.75%, but newly issued bonds are now paying 2%. In order to sell your bond with the lower yield, or indeed to value your bond investments in today's environment, the face value must now be discounted. When rates rise as sharply as they just have, your bond ETF or fund will show an appreciable loss.

This was the scenario that we anticipated back in late 2019, when we switched out of fixed rate bonds, though the investments in your portfolio at that time were actually in investment-grade corporate bonds rather than in government debt. Taking on the extra risk at the time of investing in bonds issued by companies rather than by governments provided better returns, with a still acceptable level of risk. When we made this switch, we did so in contemplation of eventually heading back to those existing funds (CRED/PLUS) when the circumstances were more favourable, i.e. when yields had started to normalise.

You will be aware however that the changes we have recently enacted have added a new fund, which owns Australian Government Bonds. We chose this over the former investments that hold corporate bonds as the extra return for the corporate risk has shrunk significantly, and our judgement was that there was no longer sufficient compensation for those risks being taken on in your portfolio. As rates have risen the government bond fund that we have added (AGVT) declined by about 7% over the few months since late November, consistent with the explanation above. The committee believes this discount represents an attractive opportunity to adjust the composition of the defensive Income Securities asset class.

At this stage however, we have only made a partial move by selling down the floating rate funds (FLOT/QPON) by half to fund the investment in the government debt ETF (AGVT). Which begs the question, what happens next? In simple terms, time will tell which of the camps was right.

If inflation does head much higher, and bond yields follow it up, then central banks will likely be forced to move on interest rates. The new investment in the Australian Government Bond ETF will fall further than the 7% mentioned above, and trade lower than the prices just paid. However, we will have the opportunity to move the remainder of the floating rate investments into what would then be bonds paying 2.5%, or maybe even 3%. To reiterate, that is not what we expect to happen, but it is not impossible.

Our outlook for the Australian economy aligns much more closely with the consensus of private economic forecasters described below, and indeed with what the central banks tell us they expect to occur. Note that this is quite distinct from the collective view expressed by investors in the bond markets. Highlighted below in the red boxes are economic growth and inflation, and self-evidently there is a strong rebound in activity already underway, and there will be a temporary spike in the inflation readings. Note that the Consumer Price Index is forecast to peak in the June Quarter this year at a reading of 2.9%, still within the RBA's target band, but also that it then quickly falls back below 2% in the subsequent quarter.

Australia | Browse | Private | Official

Actual / Forecasts | Probability of Recession 10.0%

Indicator	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22
Economic Activity										
Real GDP (QoQ%)	-0.3	-7.0	3.4	3.1	1.0	1.1	1.1	0.9	0.8	0.7
Real GDP (YoY%)	1.4	-6.3	-3.7	-1.1	-0.8	7.6	5.3	4.1	3.8	3.6
Household Consumpti...	-1.4	-12.3	7.9	4.3	-0.8	14.4	7.1	4.5	4.0	3.8
Government Consum...	2.0	2.9	1.5	0.8	6.2	3.6	2.6	1.9	2.5	2.6
Gross Fixed Capital F...	-0.2	-4.6	0.5	3.6	-3.5	3.0	4.7	5.0	5.7	5.7
Exports (YoY%)	-4.2	-7.6	-4.0	3.8	-6.8	2.3	7.0	5.1	6.5	6.1
Imports (YoY%)	-7.2	-12.3	5.9	4.9	-0.9	14.9	10.0	6.9	6.3	5.4
Price Indices										
CPI (YoY%)	2.2	-0.3	0.7	0.9	0.9	2.9	1.9	1.6	1.6	1.6
Labor Market										
Unemployment (%)	5.2	7.0	7.1	6.8	6.5	6.4	6.3	6.2	5.9	5.6

There will be a few months at least before we really start to see which camp has their views backed up by the data, and a lot of potential contingencies to consider over that time. Not least among these will be how effectively we distribute vaccines, and the extent to which our lives get back to some sense of the old normal. As we have recently demonstrated, the Asset Allocation and Investment Committee is prepared to move quickly, as we think that there may be relatively short time frames in which to capture the opportunities ahead.

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	3.6%	1.8%	1.8%	4.5%	6.1%	2.6%
+ Currency Impact		1.0%	-2.2%			
+ EPS Growth (10 Yrs)	3.8%	4.1%	7.7%	1.4%*		
+ Valuation Effect	-1.7%	-2.5%	-2.4%	-0.2%	-2.0%	
Index Return (Pre-Tax)	5.7%	4.4%	5.0%	5.7%	4.1%	2.6%

* Forecast Distribution Growth

The table above shows an important dynamic between the elements of our long-term forecast, and one which we expect to play out over the balance of the year, and perhaps a bit beyond that. In the third row we have quite strong forecasts for Earnings Per Share (EPS) Growth across all the range of equities, and this reflects the two main elements that comprise our overall forecast for earnings.

We first determine what we think Core EPS is likely to be, considering elements such as current valuations, expected inflation, dividend payout ratios and an allowance for inefficient investments. Then we assess where today's earnings are relative to where a long-term trend would have them, as we know that there is a strong pattern of cyclicality in earnings over time. Given the global shutdown of 2020, earnings across the board collapsed in fairly dramatic fashion, though not to the extent that we expected they might.

The second part of this dynamic is shown in the fourth row above, where the negative numbers indicate that we consider current valuations to be high. In the case of Australian Equities, the current Price/Earnings ratio is a bit more than 21x, which is ahead of our target of 18x and equates with the 1.7% reduction each year in our ten-year forecast. However, in the recently completed company reporting season we have seen strong growth from depressed 2020 earnings, and in many cases reasonably optimistic assessments about short-term future earnings as the global economy reopens.

In essence, the market is looking for earnings to catch up with where valuations are already, and this interplay will be reflected in how these two critical elements of our forecast evolve over time.

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*	14.0%	20.8%	27.4%	36.4%	50.9%

Looking back twelve months, all of the funds that comprise this asset class have posted positive returns, an outcome that we would have welcomed as the depths of the coronavirus crisis were becoming clearer. There is though widely differing performance between the sectors and companies of different sizes though, with Resources (+37.9%) sector making a particularly strong contribution, supported by sustained highs in key commodity prices. Medium sized companies also had a strong contribution from the Technology sector and returned 20.2%, leading the smaller companies ETF which added a still respectable +8.7%.

There is no doubt that the banking sector was at the epicentre of the crisis with a significant amount of business loan and mortgage deferrals, extra provisioning required by the regulator and restrictions on their ability to return capital to investors in the form of dividends. Pleasingly though, that has proved to be an overly cautious approach as we have dealt with both the health and economic crises more effectively than was expected. So, while it was a modest total return for Financials of just 1.8% for the year ended February, we remain optimistic that there will be a solid contribution to future performance from this sector. It is often useful to take a longer-term perspective, and we note that the Financials ETF has provided a 7.9% annualised return for the five years ended February 2021, despite the various banking scandals, a lengthy Royal Commission and of course the unprecedented impact of a global pandemic.

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*	5.4%	10.6%	15.7%	23.8%	33.9%

Our explicit target on this asset class was set at Neutral, but as you will see positive performance over the last few months, even as other asset classes have also done well, has seen the actual target float higher. Whilst we have held steady at the overall asset class level, you will be aware from previous commentaries that we have been quite active within this asset class.

Primarily that has been in the form of reducing the long-held and formerly significantly overweight stance to the Asia-Pacific region. Using a similar five-year review period, the Asia (ex-Japan) fund has provided a total return of 14.6% per annum, and even with the headwind of a stronger Australian dollar, the performance over the least year has been a robust 17.4%. Both those figures are well in excess of our

previous forecast, and a long way ahead of what we are now predicting for future performance. This is the reason we have been completing some quite significant reductions in exposure to the region, and any further gains will very likely see us continue to reduce this exposure.

The proceeds from reducing Asia Pacific (ex-Japan) have been reinvested primarily in Japan, where we see a good alignment between the sector exposures of the Japanese equity market and the global re-opening narrative, and importantly this comes at a more attractive price. Here we also see the impact of the stronger dollar against the Japanese Yen, and while that has hurt performance over the last year, a longer-term view is again helpful, with five-year currency hedged and unhedged returns almost identical.

We did also redeploy some funds to the existing Developed Europe (ex-UK) investment, but more recently have just added a standalone investment in the United Kingdom, through their benchmark FTSE 100 index. The UK equity market has been quite a laggard of late, with the total return since January 2020 (in A$) more than 10% behind one of the main European indices, and these cheaper prices are reflected in a reasonably attractive long-term expected return.

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%	5.6%	11.1%	11.2%	11.2%

A fair amount of uncertainty still exists about this asset class, and whilst we can hope that there are no more short-term city or state-wide lockdowns, it would be imprudent to rule that out at this stage. These obviously have a bigger impact on the office and retail sectors than they do for industrial and warehouses, as reflected in the recent office occupancy statistics which showed for February that the Sydney CBD was at 48% occupancy and Melbourne at just 24%.

Pleasingly, the recently completed buying to re-establish the 10% Overweight stance to this asset class proved to be quite timely, and prices are currently close to 4% above the buy price of late February. With vaccines now being distributed, we think it is reasonable to expect that people will start to return in greater numbers to their offices and to shopping centres, and we expect a solid contribution to overall portfolio performance from Listed Property in the months and years ahead.

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 here as the forecast return is not sufficient to compensate for the risks.

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*	51.5%	49.4%	35.8%	23.4%	0.0%

Cash	No. 1	No. 2	No. 3	No. 4	No. 5
Neutral	30.0%	15.0%	10.0%	5.0%	5.0%
Target*	23.5%	13.6%	9.9%	5.3%	4.1%

Given the discussion above, we will provide just a brief comment here that focuses on the investments in this asset class not already mentioned. As the outlook for the major banks has improved with the economic recovery, the preference shares issued by them have traded quite strongly. We are seeking opportunities to potentially rotate to alternative preference shares with a longer time before they are called, as the income tends to be better for the same level of risk. This is a good example of where the flexibility of the Individually Managed Account structure allows the portfolio management team to consider the circumstances of each portfolio and then agree targeted portfolio adjustments.

The other fund owned in this asset class, the Australian Subordinated Debt fund (SUBD) has shown pleasing recent performance, with a total return of just under 3% p.a. since the fund was incepted in October 2019. More recently, and after recovering from the dip in the first part of last year, SUBD has returned 4.1% for the Financial Year to Date, equivalent to an annualised return of 6.0%.

** 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

These charts will be a useful way of tracking how the earnings recovery unfolds, and as discussed above, how this may start to ease some of the pressure on elevated valuations. The Australian Equities forecasts are now comfortably into Fair Value and we are in the early stages of considering the current overweight stance. We continue to see good long-term potential in Japan and Europe, and have our UK forecast currently in line with that for Europe. Strong performance from Asia-Pacific means a lower forecast which has been the catalyst for us to continue to reduce exposure. As mentioned, Listed Property has bounced recently after the additional buying was completed, moving the valuation from Cheap back to Fair Value.

Asset Class Tipping Points - February 2021

Australian Equities

All Ords	10 Year Forecast	Valuation	28-Feb
9,900	1.2%	Overpriced	
9,600	1.6%	Fully Priced	
9,300	2.0%	Fully Priced	
9,000	2.4%	Fully Priced	
8,700	2.8%	Fully Priced	
8,400	3.2%	Fully Priced	
8,100	3.7%	Fully Priced	
7,800	4.2%	Fair Value	
7,500	4.7%	Fair Value	
7,200	5.2%	Fair Value	
6,900	5.8%	Fair Value	Aust 5.7%
6,600	6.4%	Fair Value	Fin'l 6.1%
6,300	7.0%	Cheap	
6,000	7.7%	Cheap	
5,700	8.4%	Cheap	
5,400	9.2%	Cheap	
5,100	10.1%	Cheap	

Income	3.6%	p.a.
Earnings	3.8%	p.a.
Valuation	-1.7%	p.a.
Forecast	**5.7%**	**p.a.**

International Equities - Developed

World ExAust	10 Year Forecast	Valuation	28-Feb
3,700	1.3%	Overpriced	USA 1.0%
3,600	1.6%	Fully Priced	
3,500	1.9%	Fully Priced	
3,400	2.2%	Fully Priced	
3,300	2.5%	Fully Priced	
3,200	2.9%	Fully Priced	
3,100	3.2%	Fully Priced	
3,000	3.6%	Fully Priced	
2,900	4.0%	Fair Value	
2,800	4.4%	Fair Value	Dev 4.4%
2,700	4.8%	Fair Value	
2,600	5.3%	Fair Value	
2,500	5.7%	Fair Value	
2,400	6.2%	Fair Value	
2,300	6.7%	Cheap	
2,200	7.3%	Cheap	Japan 7.4%
2,100	7.8%	Cheap	Euro 7.9%

Income*	2.8%	p.a.
Earnings	4.1%	p.a.
Valuation	-2.5%	p.a.
Forecast	**4.4%**	**p.a.**

International Equities - Emerging

Emerging Markets	10 Year Forecast	Valuation	28-Feb
1,850	1.4%	Overpriced	
1,800	1.7%	Fully Priced	
1,750	2.0%	Fully Priced	
1,700	2.3%	Fully Priced	
1,650	2.6%	Fully Priced	
1,600	3.0%	Fully Priced	
1,550	3.3%	Fully Priced	
1,500	3.7%	Fully Priced	
1,450	4.1%	Fair Value	
1,400	4.5%	Fair Value	
1,350	4.9%	Fair Value	EM 5.0%
1,300	5.4%	Fair Value	A-P 5.2%
1,250	5.8%	Fair Value	
1,200	6.3%	Fair Value	
1,150	6.8%	Cheap	
1,100	7.4%	Cheap	
1,050	7.9%	Cheap	

Income*	-0.3%	p.a.
Earnings	7.7%	p.a.
Valuation	-2.4%	p.a.
Forecast	**5.0%**	**p.a.**

Listed Property

ASX200 Property	10 Year Forecast	Valuation	28-Feb
1,850	1.3%	Overpriced	
1,800	1.6%	Fully Priced	
1,750	2.0%	Fully Priced	
1,700	2.4%	Fully Priced	
1,650	2.8%	Fully Priced	
1,600	3.2%	Fully Priced	
1,550	3.6%	Fully Priced	
1,500	4.1%	Fair Value	
1,450	4.6%	Fair Value	
1,400	5.1%	Fair Value	
1,350	5.6%	Fair Value	A-REITs 5.7%
1,300	6.1%	Fair Value	
1,250	6.7%	Cheap	
1,200	7.3%	Cheap	
1,150	8.0%	Cheap	
1,100	8.7%	Cheap	
1,050	9.4%	Cheap	

Income	4.5%	p.a.
Dist Grwth	1.4%	p.a.
Valuation	-0.2%	p.a.
Forecast	**5.7%**	**p.a.**

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

Sources/Notes:

1. The Generic Australian Breakeven rates are calculated using the closest nominal government bond to the inflation-linked bonds. The yield on nominal bonds minus the inflation-linked bond provides the breakeven, or the expected rate of future inflation. Data and charts are sourced from Bloomberg, as at 8-Mar-21.

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.