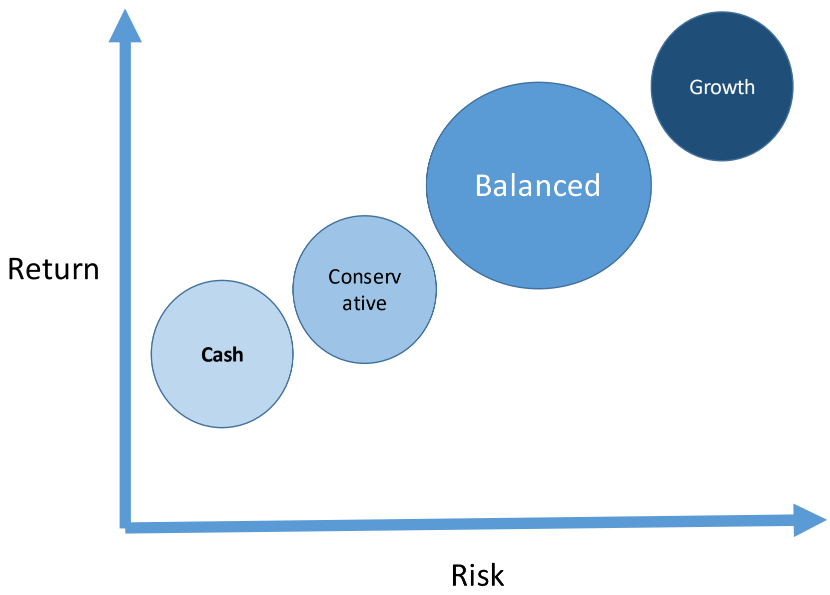
Is it time to rethink the asset allocation of conservative member investment choices?

Most Australian superannuation funds offer members a range of member investment choices (MIC). While the menu of options varies across funds, a common structure for the design of the suite, centres around the 'default' balanced choice, with other options offering different risk/return profiles relative to this default option.



The balanced choice typically has the greatest number of members and is the focus of performance surveys. A key risk with this choice is that it becomes the primary focus of attention, to the detriment of other choices/members.

The current investment environment (i.e. low base rates) raises particular challenges for the traditional approach to conservative member investment choices. It is important to review whether these options will deliver on member expectations.

Context

Members who choose conservative investment choices have made an active decision not to invest in the default balanced option. They want lower investment risk as they typically have a shorter investment horizon (typically around 3 years vs 7+ years). However, their investment horizon is not so short that they invest purely in cash. Conservative members want to earn more than cash, but take significantly less risk than balanced.

Table 1: Conservative versus balanced objectives

	Conservative	Balanced
Asset allocation (defensive/growth)	30-35%/65-70%	70%/30%
Return target	CPI + 1.5-2%	CPI + 3-4%
Negative return every 20 years	2-3 years	5 years
Minimum investment horizon	3 years	7+ years

Asset Class Building Block Approach to MIC Asset Allocation

Most funds use an asset class building block approach to constructing MIC asset allocations. That is, different MICs have different allocations to different asset classes, but within each asset class, the manager configurations are identical. For example, the fixed income bucket will contain the same fixed income fund managers in both balanced and conservative options – the only difference will be the proportion allocated to fixed income.

For the most part, this approach makes a lot of sense, it maximises the economies of scale of managing the fund, allowing individual MICs benefit from the scale of the overall fund.

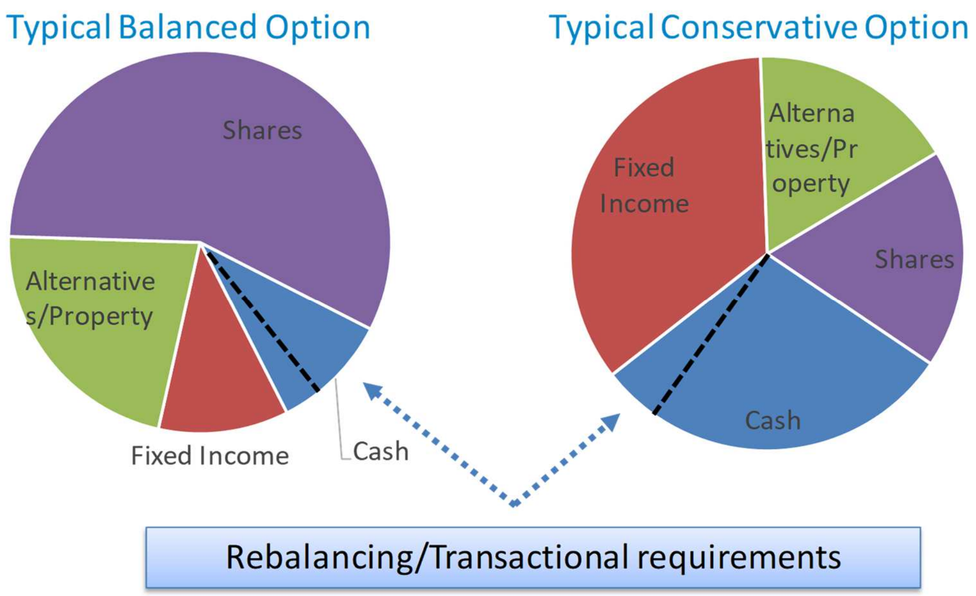
One potential drawback, as noted above, is that the balanced option tends to receive the most attention. This leads to asset classes, such as the defensive asset classes of cash and fixed income, being designed in the context of balanced option asset allocations.

From the perspective of a conservative MIC member, this can lead to sub-optimal cash and fixed income asset allocations including:

1. Excessive focus on liquidity within the cash and fixed income asset classes;
2. Over allocation to Government bonds/duration risk;
3. Over reliance on equities/alternatives to deliver the conservative options 1.5%-2% real return objectives; and
4. Higher risks of negative returns given today's low interest rate environments.

Excessive Focus on Liquidity

Most funds seek much higher levels of liquidity for their defensive assets relative to their growth asset classes. This makes sense from a balanced centric perspective. Cash is often a very small asset class, say 3 to 5%, and so what is a modest rebalancing transaction at a whole of balanced option level (say a shift in asset allocation of 2% or 3%) would be a large proportion of the cash asset class. This same approach doesn't make sense for conservative choices, where 30% allocations to cash are typical, and you are never going to rebalance 30% at once.

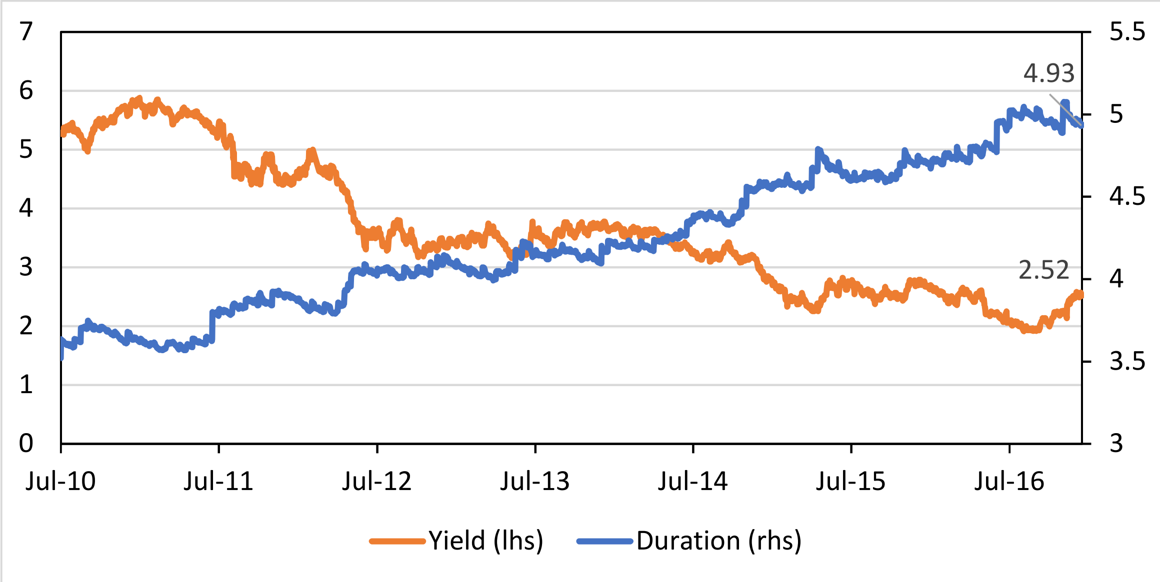


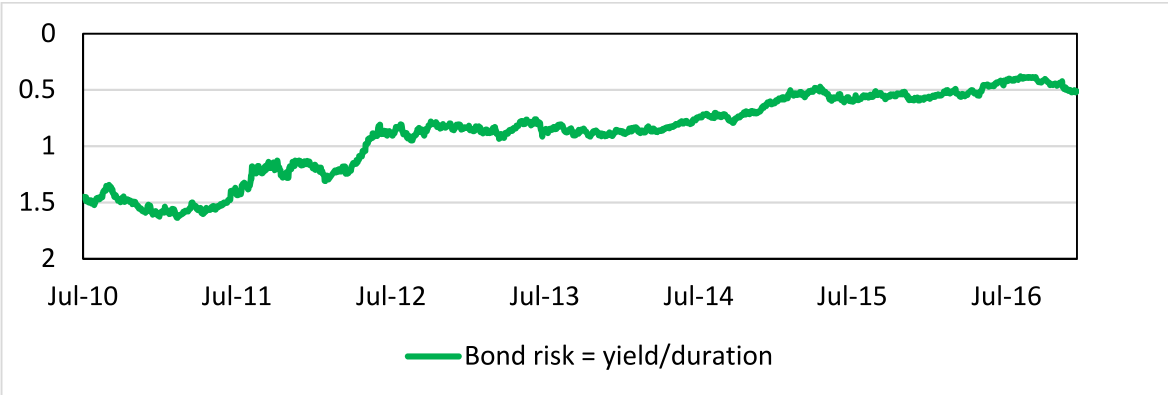
In effect, this means conservative members are sacrificing returns on their cash and fixed income investment allocations to provide liquidity they don't really need.

Over allocation to Government bonds/Duration Risk

Most fund's fixed income portfolios are dominated by long-duration government bonds. For example, in the popular Bloomberg Composite index around 90% consists of government and government related bonds.

Chart 1: Bloomberg Ausbond Composite 0+Yr Index





Within the balanced investment choice, the allocation to fixed income is motivated by low/negative correlation between bond yields and equity returns. Bonds act as a 'hedge' of equities risk in a balanced portfolio (see below).

Table 2: Correlation coefficients

	S&P/ASX 200 Accumulation	S&P/ASX Govt. Bond Index	Cash
S&P/ASX 200 Accumulation	1.0	-0.2	-0.2
S&P/ASX Govt. Bond Index	-0.2	1.0	0.2
Cash	-0.2	0.2	1.0

From the perspective of the balanced investment choice, it makes sense for fixed income allocations to include quite long duration bonds (i.e. high sensitivity to movements in interest rates). Long duration bonds might have a poor risk return trade off on a stand-alone basis (see below), but they are an efficient hedge of larger equity exposures because the fixed income allocation is small (10-20%) relative to the listed equity allocation (40-50%).

Table 3: Risk adjusted returns

	Modified duration	YTM	Excess return over cash	10-year std. dev.	Sharpe Ratio
Cash	0.00	1.81%	-	0.51%	-
S&P/ASX Govt. Bond Index	5.75	2.37%	0.57%	4.23%	0.13
S&P/ASX Corp. Bond Index	3.37	3.19%	1.39%	2.20%	0.63

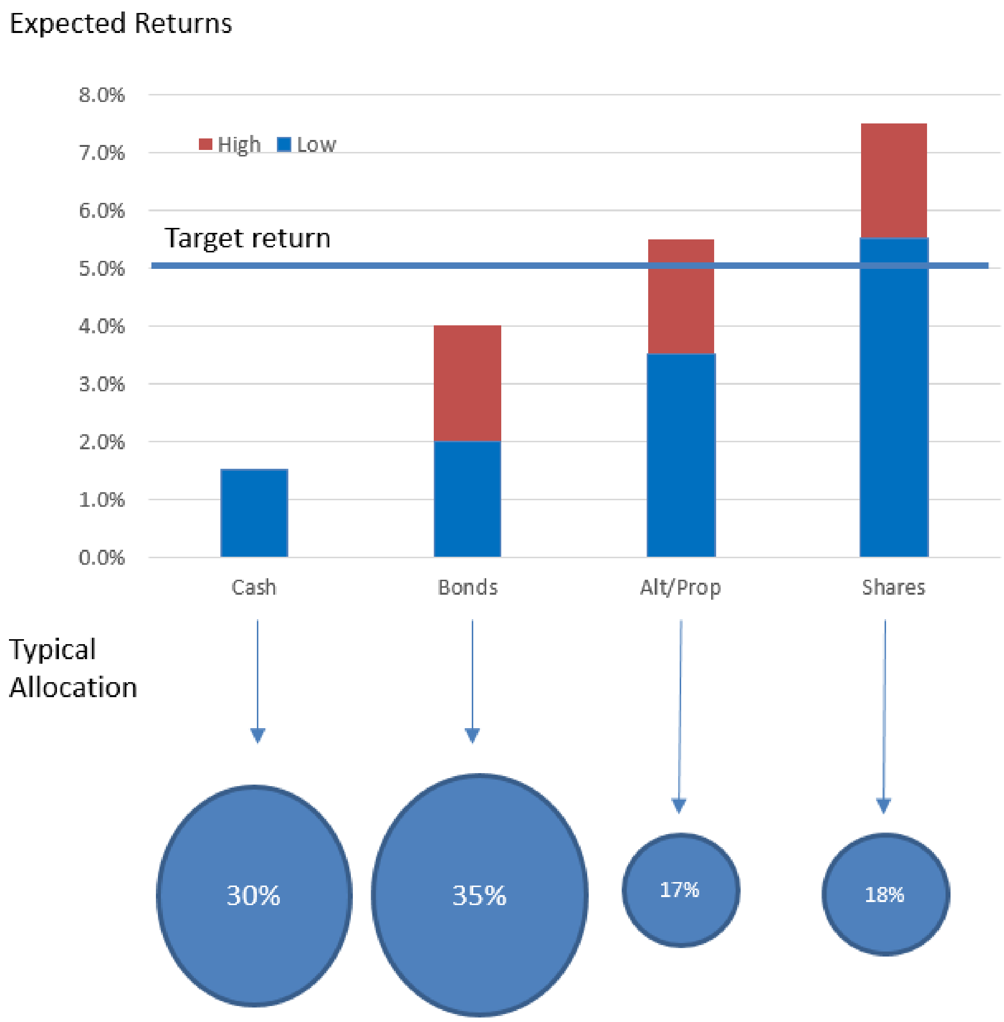
This approach to fixed income, makes sense for balanced, but does it make sense for conservative members where the fixed income allocation is doubled and the equity allocation is halved? The duration exposure is contrary to conservative member's investment return objective (capital stability). Conservative members would be much better served by a fixed income allocation that puts greater focus on yield/income (whilst maintaining desired defensive characteristics), and less focus on long-dated government bonds/liquidity.

Over reliance on equities and risk assets to generate target returns.

Conservative MICs typically target a return of around CPI + 1.5-2%. Assuming the RBA achieves its target of inflation at 2.5% this is an all-in return of 4.0%, or a pre-tax return of around 5-6%.

In today's return environment cash is earning 1.5% and Government bonds 2-3%. To achieve the 1.5 2% overall return objective – funds are relying on the relatively small growth allocation to deliver overall return objectives as shown in Chart 1 below.

Chart 2: Expected asset allocation returns



Is there an alternative solution to achieving the target returns for conservative members? One option is an allocation to floating rate credit which is an asset class that delivers the 1.5%-2% real return objective without the high volatility of listed equities.

Increased exposure to negative return events in low base rate environments

As interest rates have fallen, so has the natural yield provided on the defensive portion of conservative MIC options. This means there is less of a buffer to protect against negative returns, particularly compared to the period prior to the GFC where cash and bond yields were north of 5%.

To illustrate, Table 4 below looks at the breakeven position. If we assume the typical asset allocation of 65% in cash/bonds, 17% in alternatives and 18% in equities. For a range of cash/bond returns we calculate the largest loss on equities before the overall portfolio return is negative (and in the second row of the table we show the largest loss across equities and alternatives).

Table 4: Implied breakeven of equities and alternatives

Cash and bond return	**5.0%**	**4.0%**	**3.0%**	**2.0%**	**1.5%**	**1.0%**
Equities (Alternatives earn 0%)	-18.1%	-14.4%	-10.8%	-7.2%	-5.4%	-3.6%
Equities and alternatives	-9.3%	-7.4%	-5.6%	-3.7%	-2.8%	-1.9%

For example, at cash and bond yields of 5%, a conservative option could suffer a near 20% loss on its equities and still have a positive return. At today's yields that loss is now only 5%-7%. This highlights how the decline in base rates has increased the risk (particularly as measured by the standard risk measure concept of the number of negative returns) of conservative MIC asset allocations.

There is no easy fix to this – that negative returns are 'closer' when you start from 1.5-2% risk free rates is a law of arithmetic that is hard to avoid. That said, strategies that boost the yield of defensive assets while maintaining credit quality provide a way to mitigate some of the consequences of lower base rates.

Conclusion

2016-17 represents an extremely challenging investment environment with the low level of interest rates creating real challenges in meeting member real return expectations. In this situation, it is too easy to focus on the balanced investment choice, with the specific issues for other investment options, such as conservative, easily overlooked.

It is important to remember that conservative members have made an active choice (and often have high balances). They are likely to be highly engaged members and will not be happy if their investments don't perform to their expectations. For this reason, we would encourage investors to evaluate the composition of the defensive portions of their conservative investment choices.