Portfolio Perspectives

Insights from the CIO Office
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Key Messages for Investors

- Release of our updated Strategic Asset Allocation (SAA) with a more granular asset class taxonomy
- More dynamic Growth and High Growth risk profiles to improve upside capture
- Directionally, the new SAA broadly aligns with our recent Dynamic Asset Allocation (DAA) positioning
- We remain constructive on the global economy and are putting risk assets to work
- Amongst Growth Assets, we favour Global Equities and Global Listed Property over Australian and Emerging Market Equities
- Amongst Defensive Assets, we favour Australian Bonds over Global Bonds, Diversified Income and Cash

Updated SAA

Lonsec has just completed its latest review of its Strategic Asset Allocations (SAA) framework. Lonsec considers strategic asset allocation to be a critical element of an investment strategy in setting the foundations for any investment policy. Strategic asset allocation drives the bulk of an investor's risk and return outcome over their investment time horizon. Therefore, having a rigorous asset allocation review process is considered important in ensuring that investors remain on target to achieving their investment objectives in a risk-controlled manner.

The objective of this review was to ensure that the Lonsec strategic asset allocation framework remains robust and continues to be effective in achieving the stated investment objectives of the respective risk profiles in the long term.

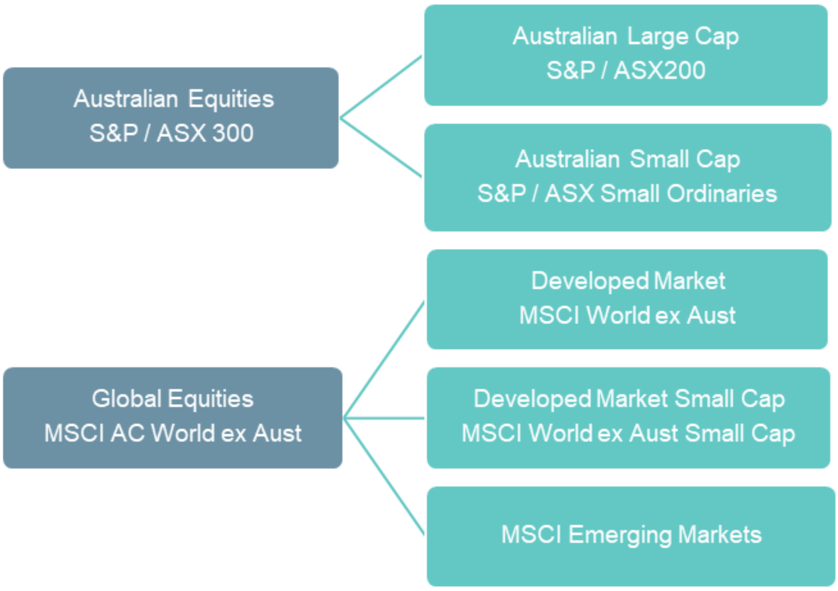
Key changes in the 2024 review:

- A new asset class taxonomy, with explicit allocations made to smaller capitalisation stocks (small caps) within both Australian and global equities
- The removal of Australian Listed Property (AREITs)
- More risk added to the Growth and High Growth risk profiles.

A new Asset Class taxonomy

This year Lonsec has introduced a new asset class taxonomy, adopting a more granular approach to asset class selection, notably within the Australian and global equity sectors. Explicit allocations have been made to small caps within both Australian and global equities, along with changes to the assigned benchmarks within the Australian and global equity asset classes.

Benchmark Changes 2024



Capital has been reallocated away from the broader benchmarks and divided across large cap equities and small cap equities, both domestically and globally. While it may appear a meaningful change in approach, Lonsec has been allocating to small caps via our dynamic asset allocation and underlying manager selection to varying degrees for a number of years now. The new taxonomy better reflects how we have been managing capital for some time now.

Adopting a more granular asset class taxonomy provides greater flexibility for portfolio construction, particularly given the extended starting valuations and increased concentration we are observing in the large cap end of these respective markets.

The Magnificent Seven (NVIDIA, Apple, Microsoft, Amazon, Meta, Alphabet and Tesla) now account for over 20% of the MSCI ACWI World ex Aust Index. That weight has more than doubled since the end of 2019 when the same companies accounted for less than 10% of the index. At the time of writing, NVIDIA is the world's largest company at 4.5% of the MSCI ACWI World ex Aust Index. In terms of market capitalisation, NVIDIA is now larger than the total market cap of Britain (3.3%), China (2.9%), Canada (2.8%) and France (2.5%). Only Japan (4.8%) and the US (66.3%) are currently larger in size than this one company.

While being more concentrated is not in itself overly concerning (the S&P / ASX300 Index has long been concentrated in the financials (32%) and materials sectors (20%)), our 2024 capital market assumptions point to high starting valuations in both the Magnificent Seven and domestically, in the financials sector. This presents as less attractive forward-looking returns in the large cap end of these respective markets.

Removal of Australian Listed Property (AREITs)

Within the real assets sector, Australian Listed Property (AREITs) has been removed across all risk profiles. The concentration in the sector has become problematic from a diversification perspective. The S&P/ASX 300 A-REIT Total

Return Index consists of just 31 securities. Goodman Group, the largest security in the index, now accounts for 36% of the index, while the top 10 securities account for 83% of the index. With the sector's performance increasingly reliant on the performance of just one security (Goodman Group), Lonsec sees better diversification opportunities in global REITs.

Australian investors will also typically have an allocation to AREITs within their broader Australian equity allocation. Goodman forms close to a 3% weight in the S&P / ASX200 Index making it a top 10 holding in that index also.

We retain the ability to actively allocate to the AREIT sector via our Dynamic Asset Allocation positioning when market conditions dictate.

Adding risk to the Growth and High Growth risk profiles

At the higher risk profiles (growth and high growth) we have reduced the overall exposure to real assets (including the aforementioned reduction in the AREIT sector) in favour of equities (namely small caps and emerging markets) to ensure we are making the most out of the available risk budget available. Structural changes in markets have led to shifts in capital market assumptions and correlations, key inputs into the optimisation process. A review of the portfolios found we were no longer taking enough risk in the higher risk profiles to meet investor risk tolerance levels.

Emerging markets, for example, have evolved substantially over the last decade having spent years improving their policy frameworks to mitigate external pressures. They have built additional currency reserves and moved towards exchange-rate flexibility. The structure of public debt has also become more resilient, and both domestic savers and domestic investors have become more confident investing in local-currency assets, reducing reliance on foreign capital. Major emerging markets have enhanced central bank independence, improved policy frameworks, and gained progressively more credibility. As a result of these changes, benchmark indices have become more stable, with risk measures such as volatility and drawdowns now similar to those observed in developed markets.

While the beta within the portfolios has increased given the higher allocation to emerging markets and small caps, we remain comfortably within the Standard Risk Measure (SRM) bands and risk profile tolerance ranges for the respective portfolios, ensuring we remain true to our long-standing investment philosophy.

Updated DAA

Following the release of our updated Strategic Asset Allocation (SAA) framework, we simultaneously update our Dynamic Asset Allocation (DAA) positioning. Notably, our updated SAA defaults into asset classes previously favoured by our DAA tilts as we seek additional sources of return generation. This necessitates a resetting of our active tilts.

Australian Equities vs Developed Market Equities

Absent a catalyst, we continue to expect Australian Equities to underperform Developed Market Equities, with about half of the Australian market expected to report either near-zero or negative earnings growth in FY25. Supply-side focused stimulus measures in China unlikely to drive economic growth materially and, by extension, reignite their appetite for Australian natural resources. Until we see a decisive turn in Chinese consumer sentiment, we struggle to see a catalyst for corporate profits in Australia. Additionally, with the introduction of a permanent Small Cap Australian Equity allocation with our SAA framework, we apply our Slight Underweight here to reflect the larger portion of unprofitable miners who should continue to struggle absent strong commodity demand from China.

Emerging Market Equities vs Developed Market Equities

Continuing our concerns with Chinese supply-side-focused policies, we also move to Slightly Underweight Emerging Market Equities. The recent rally in Chinese equities has not closed the discount this market trades versus other major markets, suggesting it is prudent not to shun this exposure completely. We are watching for further policy changes and the outcome of the US elections for further direction in both consumer and market sentiment. If estimates are correct, Chinese earnings growth is some of the strongest in the world, yet market participants are not rewarding this bullish outlook.

Developed Market Equities

Our new SAA splits our Developed Market Equity allocation into explicit Large and Small Cap allocations. The new SAA also reflects our strong preference for Small Caps, suggesting no further need to increase this allocation. Instead, we move to Overweight our Large Cap exposure as we size our relative preferences while being mindful of current client portfolio positions. We also take this opportunity to remove our preference for Europe as earnings and economic conditions have turned decided lower, and the conflict in Ukraine drags on.

Global Listed Property

We continue to be Slightly Overweight Global Listed Property as a beneficiary of the current easing cycle and favour the non-Office sector in any allocations.

Australian Bonds

We continue to favour Australian Bonds, especially at current levels, where they represent attractive levels for building duration in portfolios. We are close to reviewing this position in light of the upcoming US Presidential elections. Our relative preferences between Global and Australian Bonds will be re-assessed in light of the policy direction taken by the new US President.

Australian Bonds - Floating Rate and Cash

Our constructive view on risk and belief that the Reserve Bank of Australia will eventually lower its key policy rate next year sees us shift allocations to other parts of the portfolios, as noted above.

Outlook and Positioning

Overall, we are now Slightly Overweight Growth Assets as the start of the interest rate easing cycle should create a tailwind for risk and valuations for long-duration assets.

The coming US Presidential and Congressional elections will be consequential for portfolios, but not necessarily on November 5, A dividend government, one where neither the Republications or Democratics hold both the Presidency and Congress would likely lead to policy grid lock and modest economic impacts. After reviewing a synthesis of consensus opinions, the market believes a Republication sweep would be net positive for the economy as corporate tax cuts would offset the harm from universal tariffs. A Democrat sweep would also be net positive for the economy but would be led by increased household consumption offsetting corporate tax increases.

While our analysis would imply either a neutral or upside risk to the economy regardless of the outcome, the road from political victory to policy implementation is long and winding making it challenging to take high-conviction positions even once all the votes are counted. Our primary recommendation to deal with uncertainty is to have a well-diversified portfolio that aligns with your financial objectives and reflects your risk tolerance.

Growth Assets	Underweight			N	Overweight		
Australian Equities – Large Cap				●			
Australia Equities - Small Caps			●				
Developed Market Equities – Large Caps						●	
Developed Market Equities - Small Caps				●			
Emerging Market Equities			●				
Global Listed Property					●		
Global Listed Infrastructure				●			
Growth Alternatives				●			
Defensive Assets	**Underweight**			**N**	**Overweight**		
Australian Bonds					●		
Global Bonds				●			
Diversified Income			●				
Defensive Alternatives				●			
Cash			●				

Growth Assets

Asset Class	Position	Rationale
Australian Equities – Large Caps	Neutral	Australian equity valuations look stretched and require a re-rating in bank and resource earnings which does not seem forthcoming. Population growth and a resilient consumer continues to support the economy but inflation looks to be more than just sticky. Recent China stimulus must translate to improve business and consumer sentiment before we will get constructive on the Resource sector.
Australian Equities – Small Caps	Slight Underweight	Supply-side focused stimulus measures in China are not likely to drive economic growth materially and, by extension, resume their appetite for Australian natural resources. This should disproportionately impact junior miners with make up a large portion of the Small Caps sector vs Large Caps.
Developed Market Equities – Large Caps	Overweight	The start of the interest rate easing cycle by major Developed Market Central Banks should be a tailwind for equities. We remove our preference for Europe as earnings and economic conditions have turned decided lower, and the conflict in Ukraine drags on.
Developed Market Equities – Small Caps	Neutral	DM Small Caps typically move ahead of the turn in the economic cycle, and US Small Caps, in particular, have responded positively to the Fed starting its easing cycle. This leads to a preference for US over ex-US Small Caps.
Emerging Market Equities	Slight Underweight	While valuations look attractive on a relative bases, emerging market currently look to be fairly priced, with main valuation metrics sitting in line with their long-term average. But with so much uncertainty around China and its growth outlook, risks continue to be slightly elevated.
Global Listed Property	Slight Overweight	Attractive subsector valuations warrant an active approach to this sector. Office sector remaining structurally challenged but rental growth and healthy fundamentals are appearing in other areas of the sector (age care, data management, supply chains).
Global Listed Infrastructure	Neutral	As major developed market Central Banks have started cutting their key policy rates, a key headwind to the sector is gone. Valuations are attractive versus long term averages.
Growth Alternatives	Neutral	Prefer liquid multi-strategy hedge funds over private market exposures where prices remain elevated. We maintain FX hedges within our global exposures as the AUD continues to trade at levels we consider cheap.

Defensive Assets

Asset Class	Position	Rationale
Australian Bonds	Slight Overweight	Bond yields are now offering good value and bonds can once again play a defensive role in diversified portfolios.
Global Bonds	Neutral	Supply/demand imbalances in the US and the end of yield curve control policy in Japan may see yields move higher offshore.
Diversified Income	Slight Underweight	Our constructive view on risk and belief that the Reserve Bank of Australia will eventually lower its key policy rate next year sees us shift allocations to other parts of the portfolios.
Conservative Alternatives	Neutral	Gold acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.
Cash	Slight Underweight	With cycle risks declining, we believe cash can be put to work in riskier asset classes.