PROACTIVE PORTFOLIOS

Listed Security SMA Portfolio Update

1 December 2021

Summary

In July we made several changes to improve overall portfolio structure and have made slight portfolio changes since then. We believe that the most important consideration for all portfolios is to ensure that they are well diversified and are positioned for the favourable growth environment where we expect growth assets to outperform defensive assets.

Our Strategic Asset Allocation (SAA) Process

The Proactive Portfolios SAA process utilises Mercer's forward-looking Capital Market Assumptions (CMA) to ensure that the portfolios are structurally aligned to the current market environment. The recommended SAA represents the long-term neutral position of the portfolio. A Dynamic Asset Allocation (DAA) overlay is then applied to ensure that the portfolios are positioned to capture the "medium" term (1-3 year) outlook and to minimise transaction costs.

Dynamic Asset Allocation Views

Across the DAA time horizon of 1 to 3 years, we are expecting the environment to be positive for growth assets compared to defensive assets and anticipate higher policy risks due to greater inflation persistence. This may result in periods of rising volatility in markets.

International/global equities

Globally we expect economies to grow strongly over the next few quarters, however, we believe that growth is adjusting towards a lower trend. Unemployment is likely to continue to fall over the next few years. The biggest risk to this outlook comes from the possibility of much tighter monetary policy, which could happen if inflation stays within central bank's desired targets. We anticipate a more aggressive tightening path in monetary policy by the US Federal Reserve to put downward pressure on the Australian dollar over the coming year. This suggests that taking an unhedged position for international equities would be desirable.

From a macro perspective, economic growth remains supported by financial conditions. The loss of momentum over Q3, 2021 shows an uneven growth trajectory. Global central banks have shared the pathway out of ultra-accommodative monetary policy which is expected to weigh on sentiment. Inflation pressures are also rising as cost-push and demand-pull factors come together as a result of pandemic related economic activity. Higher inflation could become a headwind for equities, especially if it forces central banks to increase rates earlier than expected. For this reason, we have dialled down our global equities outlook.

Source: Mercer

Australian Equities

In contrast to the increasing risks in global markets, the Reserve Bank of Australia (RBA) has maintained a dovish policy stance by maintaining its yield curve control policy out to April 2024 at a rate of 0.1% whilst also tapering bond purchases. The RBA is expected to be more patient in normalising interest rates given domestic growth has lagged, providing a slightly more positive environment for domestic equities versus international equities. This dovish bias will likely put downward pressure on the Australian dollar which will be key for economic rebalance.

Cash and Fixed Interest

We continue to favour a high allocation to non-core fixed income assets such as corporate bonds and other credit securities within portfolios. Strong investor demand, continued supportive monetary and fiscal policies, vaccine-led macro progressions, and improving corporate fundamentals have contributed to a strong macro picture for global investment grade credit.

The recent rise in energy prices is expected to lead to stronger inflationary pressures especially in the United States, which can lead to a further selloff in US treasuries. This is likely to take Australian bond yields higher. We continue to see the prospect for bond yields to diverge between Australia and the United States as the RBA's dovish policy stance relative to the Federal Reserve would support lower bond yields domestically. Similarly, for global government bond yields, we believe that the balance of risk is tilted towards higher yields as output gaps[1] close and central banks across developed markets look to taper asset purchase programs. Taken together, yields are now priced slightly more attractively following the late-September selloff.

The portfolios continue to be positioned for this favourable growth environment where we expect growth assets to outperform defensive assets. This is expressed as moving to an **overweight in domestic equities** position relative to **global government bonds**.

Portfolio changes

Growth assets:

- **Overweight growth assets** (all portfolios).
- **Australian Equities** allocation increased (all portfolios).
- **Hedged Global Equities** decreased in favour of **Unhedged Global Equities**.

Defensive Assets

- **Global Fixed Interest** allocation decreased (Conservative and Balanced).
- **Cash** allocation decreased (Growth and High Growth).

The portfolio changes are effective **1 December 2021**. The updated holdings reports will be available on the Proactive Portfolios website shortly thereafter.

The recommended asset allocation changes including relevant DAA positioning is summarised in Appendix 1.

[1] Investopedia – output gap: difference between the actual output of an economy versus the maximum potential output of an economy expressed as a percentage of gross domestic product

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Appendix 1

Recommended AA changes including relevant DAA positioning

	Conservative (P Class)			Balanced (P Class)			Growth (P Class)			High Growth (P Class)		
	SAA	Change	DAA	SAA	Change	DAA	SAA	Change	DAA	SAA	Change	DAA
Australian Equity	**16.0%**	2.0%	**18.0%**	**32.0%**	3.0%	**35.0%**	**39.0%**	2.0%	**41.0%**	**45.0%**	1.0%	**46.0%**
Australian Large Caps	16.0%	2.0%	18.0%	32.0%	3.0%	35.0%	39.0%	2.0%	41.0%	45.0%	1.0%	46.0%
International Equity	**8.0%**	-	**8.0%**	**28.0%**	-	**28.0%**	**34.0%**	-	**34.0%**	**40.0%**	-	**40.0%**
Developed Markets Equity (uh)	5.0%	-	5.0%	14.0%	2.0%	16.0%	17.0%	2.0%	19.0%	20.0%	2.0%	22.0%
Developed Markets Equity (h)	3.0%	-	3.0%	9.0%	-2.0%	7.0%	11.0%	-2.0%	9.0%	12.0%	-2.0%	10.0%
HiEmerging Markets Equity (uh)	-	-	-	5.0%	-	5.0%	6.0%	-	6.0%	8.0%	-	8.0%
Property & Infrastructure	**6.0%**	-	**6.0%**	**10.0%**	-	**10.0%**	**12.0%**	-	**12.0%**	**12.0%**	-	**12.0%**
GREITs (h)	3.0%	-	3.0%	5.0%	-	5.0%	6.0%	-	6.0%	6.0%	-	6.0%
Global Listed Infrastructure	3.0%	-	3.0%	5.0%	-	5.0%	6.0%	-	6.0%	6.0%	-	6.0%
Fixed Interest	**62.5%**	-2.0%	**60.5%**	**25.0%**	-3.0%	**22.0%**	**11.0%**	-	**11.0%**	**0.0%**	-	**0.0%**
Australian Fixed Interest Composite	25.0%	-	25.0%	10.0%	-	2.0%	3.0%	-	3.0%	-	-	-
Global Fixed Interest	20.0%	-2.0%	18.0%	8.0%	-3.0%	5.0%	4.0%	-	4.0%	-	-	-
Short Duration Absolute Return	17.5%	-	17.5%	7.0%	-	8.0%	4.0%	-	4.0%	-	-	-
Cash	**7.5%**	-	**7.5%**	**5.0%**	-	**5.0%**	**4.0%**	-2.0%	**2.0%**	**3.0%**	-1.0%	**2.0%**
Cash (Bank Bills)	7.5%	-	7.5%	5.0%	-	5.0%	4.0%	-2.0%	2.0%	3.0%	-1.0%	2.0%
Total	100.0%	-	100.0%	100.0%	-	100.0%	100.0%	-	100.0%	100.0%	-	100.0%
Growth Assets	30.0%	2.0%	32.0%	70.0%	3.0%	73.0%	85.0%	2.0%	87.0%	97.0%	1.0%	98.0%
Defensive Assets	70.0%	-2.0%	68.0%	30.0%	-3.0%	27.0%	15.0%	-2.0%	13.0%	3.0%	-1.0%	2.0%