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Asset allocation: don't build on shifting sands

In one crucial aspect, investing is like building a palatial manor on foundations of shifting sand. No matter how much the owner renovates or decorates, cracks will appear and the edifice may well crumble entirely. In investing terms, the solid foundations are built around the prudent selection of asset classes in the first place. The practice, known as asset allocation, can mean the eventual difference between retiring to a suburban Taj Mahal or the kids' cubby house.

At its heart, asset allocation is about ensuring an investor's portfolio consists of suitably diverse assets and with risk settings commensurate with the preferences of the individual. Most investors would be surprised about the importance of asset allocation in driving long-term portfolio returns. As a plethora of research suggests, getting the balance right in the first place is more productive than trying to pick whether Woolworths shares will outperform Wesfarmers stock.

One respected study concluded that 91.5 per cent of investment variability (measured by either volatility or returns) is attributable to the original asset allocation decision.

"The asset allocation decision is one of the most important an investor will make and it is a key determinant on how your investment portfolio will perform," says Citi's head of investment specialists, Danica Hampton.

A suitable portfolio is not just about returns, but also about risk mitigation when the market turns sour. Typically, the mix should include both growth assets (such as listed equities, commodities and some property classes) and defensive assets (such as fixed interest, cash and infrastructure).

Hampton stresses that asset allocation should not be a set-and-forget affair and thus should be subject to periodic review.

The other reason for an active approach is that as the asset classes won't perform uniformly, the asset weighting will become skewed to the assets increasing in value.

Hampton cites a portfolio starting with a balance of 70 per cent shares and 30 per cent bonds. If the shares increase in value by 20 per cent in a year — which is quite possible — the investor would need to sell shares to maintain the desired 70-30 balance.

While there are varying ways of handling such imbalances, the common approach is to nominate a regular period (say each year) or target level (overweight or underweight) at which a rebalance is triggered.

Long-running Australian Bureau of Statistics data gives us a glimpse of the asset exposure of a typical Australian, insofar as they are invested through a managed fund (including super funds).

According to the stats, 31 per cent of collective investments are in equities, slightly above the ten-year average of 28 per cent. Bond and short-term security exposures are in line with the decade-long trend at 11 per cent.

The real mover is offshore investments, which at 22 per cent is higher than at any time since the ABS first compiled the data in 1988.

"Most investment goals are fairly straightforward, such as saving for retirement or preserving and growing wealth," Hampton says. "However, constraints can be complex."

These include the investor's tolerance for market risk, which is influenced by the investment time horizon. "Other constraints can include taxes, the need for liquidity or individual preferences."

What's more, some individuals may have ethical values they want to express, such as not investing in companies related to gambling or tobacco.

It's also easy to overlook some of your risk exposures. Many Australians have a large allocation to the property sector, whether through an investment property or the family home. Long-term employees are often heavily invested in their employer's industry without realising it. For instance, a bank worker of several decades' standing may well have sizeable bonus allocations of the bank's shares.

Superannuation is another factor, in that the investor's broader portfolio should dovetail with their super fund's risk settings. A fund member ticking the "growth" option is choosing to build a portfolio with a heavy weighting to listed equities.

Overseas assets should also be part and parcel of the allocation process, whether they are shares, bonds or fixed interest. There may also be a place for so-called 'alternative assets', like infrastructure, private equity and perhaps 'real' assets (such as water rights).

Hampton warns it's easy to get caught up in the desire to invest in the next "hot" thing, whether it is an exotic high-yielding bond or a medical cannabis or lithium float.

"Without a total portfolio approach, an investment portfolio may end up within an unintended concentration in a certain market sector or it may stray from target strategic asset allocation."

The line frequently pushed by active fund managers is that building growth is all about picking winners in a particular asset category.

But as the screeds of research suggests, the best fund manager in the world won't save you from a poor return if the portfolio is built on shifting sands.

This information was prepared without taking into account the financial situation of readers. Consider the advice in regard to your personal situation before acting. All opinions constitute Citigroup (Citibank) judgment as of the date of this article and are subject to change.

New silk roads lure investors

China isn't just a big player; it's the biggest player in history

ROGER MONTGOMERY

Some of the most successful investments in recent times have been investments in Chinese companies such as Tencent and Alibaba. Global investors who focus only on the US may be missing very profitable opportunities. But first, a few crucial observations.

Recently in his investor memo, legendary US value investor Howard Marks of Oaktree Capital wrote: "Uncertainties are unusual in terms of number, scale and insolubility."

An adviser to one of the analysts we follow reflected similar sentiments when he said: "What is scary about the current situation is the 'perfect storm' confronting the United States. It currently faces an external threat from the increasing economic power of China and the growing alignment of many nations with China."

"On top of that," he added, "several nations are beginning to behave more belligerently (Russian election meddling, Chinese threatening war over US provocation, North Korea's nuclear threat)."

"Internally, America elected a president who is unpredictable and who many don't trust to act rationally (we are closer than most would think to a constitutional crisis) and a population which doesn't trust institutions, or more importantly, other Americans, all of which is being driven by inequality and a disconnection from the population ..."

AFP

Guangzhou New City on the outskirts of Kashgar in China's western Xinjiang province

Now while all that has been going on the US, an investor might note that China has been investing aggressively by expanding its maritime power under the One Belt, One Road strategy.

In the past year more than half of all international port acquisitions have been made by Chinese buyers despite — or perhaps because — global shipping is enduring a material downturn and traditional or typical buyers are cautious. (The port of Darwin has been leased for 99 years to China's Landbridge conglomerate.)

In July Chinese state-owned Cosco offered to buy Hong Kong's Orient Overseas Container line for more than $US6 billion ($7.5bn). In the same month a 99-year agreement to majority-own and operate the Sri Lankan Hambantota port, which fronts the main shipping route between Asia and Europe, was purchased by China Merchants Port for $US1.1bn.

According to *The Financial Times* of Britain, for the 2017 financial year, Chinese entities have invested more than $US20bn in overseas ports across 68 countries linked to the One Belt, One Road initiative — double the $9.97bn invested in FY16. Geoff Wade from the Department of Foreign Affairs defines the One Belt, One Road initiative as a Chinese economic and strategic agenda by which two ends of Eurasia as well as Africa and Oceania are being more closely tied.

Some analysts suggest China is driven to duplicate its dominance in global trade and simultaneously break Europe's dominance in container shipping by controlling ports from Nairobi to Darwin.

China is the largest disrupter the world has ever seen. And the error of treating China as merely another big player was highlighted by three-decade Singaporean prime minister Lee Kuan Yew when he observed that the world will have to find a new balance because China is not just another big player but "the biggest player in the history of the world".

As China displaces the old guard in commerce and geopolitics, it creates new poles that destabilise the Earth's very axis.

In 2009 China displaced Germany as the world's largest exporter and in 2013 it replaced the US as the world's largest trading nation.

Danger and chance

In the book *Destined for War: Can China and America Escape Thucydides's Trap?* author Graham Allison observes: "Today, an irresistible rising China is on course to collide with an immovable America. The likely result of this competition was identified by the great historian Thucydides, who wrote: "It was the rise of Athens and the fear that this instilled in Sparta that made war inevitable."

Allison goes on to observe that any Hollywood producer making a film about China and the US on the path to war could cast no better lead that Donald Trump.

Allison described the trap as the 21st Century's defining challenge and one of history's deadliest patterns: "When a rising power threatens to displace a ruling one, the most likely outcome is war. Twelve of 16 cases in which this occurred in the past 500 years ended violently."

China's rise to prominence has caught many investors and policymakers off-guard. This is understandable given the country's GDP has grown from just $US300bn in 1980 to $US11 trillion in 2015.

To put it another way, for every two-year period since 2008, China's GDP growth has been larger than the entire Indian economy.

In a so-called "enlightened" world that only measures success through the lens of money, the balance of power always rests with the richest. China is the largest trading partner to more than 130 countries, and is not only the world's largest producer of steel, aluminium, furniture, textiles, mobile phones, ships and computers, it is also the largest consumer of everything from oil and solar power to vehicles and mobile gaming.

For investors it should not be forgotten that (Warren Buffett's long-time investing partner) and value investor Charlie Munger remarked at this year's Berkshire Hathaway annual meeting: "I do think the Chinese stockmarket is cheaper than the American stockmarket. And I do think China has a bright future."

How policymakers respond to China will determine the future for everyone.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund.

www.montinvest.com

Picking your peer-to-peer platform provider to invest

ELIZABETH MORAN

Disruption is not just happening to retail, hospitality and taxis. It's also happening in financial services, especially banks, where borrowers and lenders are finding ways to engage, cutting traditional players out of the picture.

At best, in this scenario, both investors and borrowers can end up winning, with better lending rates and higher returns. This sector is worth investigating for investors comfortable with debt, but be prepared to do your homework.

The sector is expanding rapidly with a range of new businesses, offering differing features. But for most investors the field can be split into peer-to-peer lenders and corporate bonds.

The lenders

Funds are available for personal commitments such as car and housing loans and refinancing existing debts as well as those seeking small business loans. Borrowers and investors can trawl the online market place and find peer-to-peer lenders, negating the need to go to a bank. The company acts as an intermediary and brings both groups together in much the same way as a bank would, but its business is online, without the costs of physical branches and staff, enabling cheaper delivery.

Investors can decide how much they want to lend, the term, and in some cases be involved in assessing the lending risk. The company checks creditworthiness and administers repayments.

One of the largest companies in the market is SocietyOne. It offer consumer loans from $5000 up to $50,000 for up to five years with principal and interest repayments fortnightly or monthly. It also lends to the agricultural sector. SocietyOne does not pool loans like some industry rivals; rather investors can select individual loans in which to invest. In operation since 2012, the company (which is part-owned by News Corp, owner of *The Australian*) has orchestrated $300 million worth of loans. Comparison loan rates at SocietyOne compared to the major banks (as at July this year) were showing SocietyOne at 9.92 per cent against 14-18 per cent at the nation's biggest lenders.

At RateSetter, supply and demand for products determine the rates of return. Minimum investment is just $10, for terms of 1 month out to five years. As at August 31, current indicative rates of return ranged from 3.9 per cent for one month out to 8.9 per cent for five years net of fees. RateSetter has an attractive "provision fund", where part of the charges to borrowers are set aside to compensate lenders in the event of a default. Although it doesn't provide a guarantee, and it is not insurance, the collective value provides some comfort to lenders.

The website details the value of outstanding loans at about $97 million, money in the provision fund of $5.5m current estimates of bad debts of $3.2m, with coverage against bad debts of 172 per cent.

Bigstone targets small businesses and offers funding up to $250,000 for up to 24 months. The company makes the loan based on financials and credit performance of the company and its directors. Revenue must be at least $10,000 per month. Returns range from 7 to 23 per cent and the company advertises low fees of 1 per cent, and only collected when the funds are paid to investors.

ThinCats Australia deals in secured business loans for Australian companies. Lenders bid for amounts for fixed rate loans, with a minimum bid of $1000, the maximum being the value of the loan. Investors can make multiple bids with at different rates and amounts, and more than one bid can be accepted, providing multiple loans at different rates of return. To invest via ThinCats you must be a sophisticated investor.

One point to note, in many cases investors commit for the term of the loan. If liquidity is important to you, these investments may not be suitable, or you need to invest in the shortest dated loans.

The top end of town

While peer-to-peer lenders get a lot of the media attention, investors in corporate bonds have been providing a similar service for many years ... that is, they have been lending directly to companies. Banks have provided much of the debt to mid-sized companies, but new avenues are opening.

Larger companies are adding other sources of funding by issuing corporate bonds. There have been fewer, larger deals worth $30m to $300m, offering investors 6-10 per cent per annum returns.

The bonds can be secured or unsecured, fixed or floating rate and importantly, are tradeable.

If you are interested in learning more, a great place to start is the ASIC MoneySmart website at www.moneysmart.gov.au which covers peer to peer lending and corporate bonds as well as other investments.

Elizabeth Moran is a director of education and research at FIIG Fixed Income Specialists.

FLOAT WATCH

Security solution provider tries again

RightCrowd Limited

ASX code: RCW
Shares on offer: 33.3m
Listing price: $0.30
Market capitalisation: $40m
Listing date: September 14

SIMON HERRMANN

RightCrowd Limited, a Brisbane-based enterprise software company that is focused on security and compliance solutions, is seeking to raise $10 million to list on the Australian Securities Exchange later this month in a fully underwritten deal by Morgans.

RightCrowd has developed software applications designed to automate and monitor security and compliance-related business processes, targeting large enterprise clients in a number of industries including the resources, oil and gas and utilities sectors.

RightCrowd says it has ASX 10 and Fortune 50 clients, including one of the "world's top producers of major commodities".

Founder Peter Hill will retain a 40 per cent interest in the company and take on the role as chief executive.

The IPO isn't the first attempt to go public.

In October, ASX-listed Omni Market Tide Limited (ASX: OMT) announced the intended acquisition of RightCrowd and proposed a $35m capital raising that would have valued the combined entity at more than $85m.

However, the backdoor listing failed after the stock exchange did not grant the necessary approvals for the merger.

Now valued at about half of the initial amount, RightCrowd has decided to list via a conventional IPO in order to ramp up sales and marketing activity, fund research and development capabilities and repay debt.

The market will ask questions about RightCrowd's lumpy financials as total revenues for financial year 2017 dipped to just $4m from about $7m last year.

The company's ability to retain existing clients and sign up new clients will be a critical value driver.

The major risk as we have witnessed at numerous software companies may be to grow the top line in a sustainable manner.

The fact that the offer is fully underwritten sends a strong signal to the market.

However, listing at a pre-money valuation of 7 to 8 times revenue, RightCrowd is required to deliver a substantial degree of sales growth in order to support the valuation.

Simon Herrmann is an analyst at wise-owl.com

Rewards to revel in

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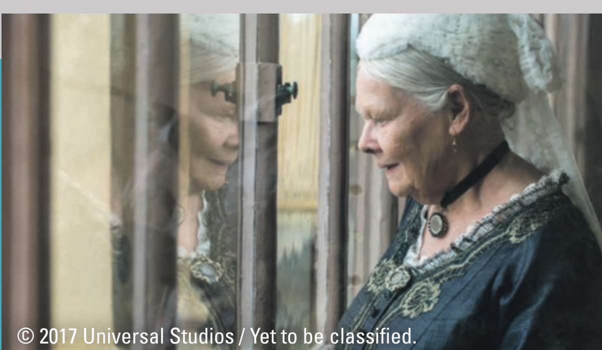

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Limit one entry per member. Australian residents aged 18 years and over only. Entries open at 9.00am on Tuesday 1 August 2017 and close at 12:00am on Monday 25 September 2017. Winner determined at 11am on Monday 25 September 2017 at Nationwide News Pty Ltd, 2 Holt Street, Surry Hills NSW 2010. Total prize pool valued at $3,645. Entries open at 9.00am on Friday 4 August 2017 and close at 12:00am on Friday 1 September 2017. Winner determined at 11am on Friday 1 September 2017 at Nationwide News Pty Ltd, 2 Holt Street, Surry Hills NSW 2010. Total prize pool valued at $1,960. Entries open at 9.00am AEST on Tuesday 8 August 2017 and close at 12:00am AEST on Thursday 7 September 2017. Winner drawn at 11am on Thursday 7 September 2017 by random computer selection at Pinpoint Pty Ltd 34 James Craig Road, NSW 2039. Winner's name published on Monday 11 September 2017 on The Australian Plus website. Total prize pool valued at $6,000. Limit one redemption per member. Tickets are strictly limited. Full terms and conditions available at theaustralianplus.com.au.