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welcome to brighter

five key

investment considerations

for Australian wealth management firms in 2021

2020 proved to be a year for the history books as COVID-19 increased the speed of some of the structural trends, like the decline in yields, the rise in public debt and the increased importance of the virtual world.

2020 has created the foundations for potentially more unprecedented surprises in 2021. Looking forward, advisors and their clients may find it more difficult to navigate the markets to build durable portfolios required to meet clients' investment goals.

Mercer has identified the following five areas that we deem critical for advisors to consider for long-term success.

1

Forward-looking returns: Revisiting the balanced portfolio

While the traditional global balanced portfolio of 60% equities and 40% fixed income outpaced more diversified portfolios since the Global Financial Crisis (GFC), sustained low interest rates and high equity valuations have greatly reduced return expectations for this type of portfolio.

Based on an average of the rolling ten-year returns, a typical Australian balanced portfolio (60% equities / 40% bonds) would have returned around 7-8% per annum over the past decade with strong returns from equities and bonds benefitting from continued falling yields. However, with the current low/negative bond yield environment in many countries and the Reserve Bank of Australia (RBA) keeping cash rates close to zero for at least the next three years, the balanced portfolio is expected to return closer to 4-5% over the next ten-year period.

We believe that intermediaries will need to seek opportunities outside of the traditional balanced portfolio framework to enhance client returns; this includes both determining what investments to allocate to and educating clients about the potential risks and opportunities.

Actions to consider:

- Explore alternatives strategies that have historically only been accessible by institutional investors and may provide higher risk adjusted portfolio returns over a market cycle.
- Revisit clients' liquidity needs to identify appetite for investments in alternative strategies and discuss the relevant risk, such as liquidity and fees.
- Ensure the proper level of investment and operational due diligence within the manager selection process; whether that be performed by an internal team or with an outside professional firm.

2

The fixed income dilemma: from fixed income to no income?

With historically low interest rates and elevated global risk, advisors fear that fixed income may no longer be able to provide diversification (especially in down markets) or income in client portfolios.

The past few years have proven to be a challenge, as many investors have sacrificed quality, ignoring certain risks, in order to seek higher yielding investments for client portfolios. As such we have seen both duration extend and credit quality decline in traditional bond benchmarks. Looking forward, we encourage advisors to be mindful regarding fixed income in client portfolios.

Questions to consider:

- What role should fixed income play in your client portfolios?
- How should advisors think about the risk reduction bucket of the overall portfolio?
- Is increased yield worth the risk of potential loss if credit markets deteriorate?
- Are the diversification benefits of fixed income, particularly sovereign bonds, still intact given the current low rate environment?
- Are other sources of income/yield worth considering (distressed credit, convertible bonds, hybrids, private debt, high yield, and emerging markets debt)?

3

Governance is key for market crisis readiness

Market crises are by their very nature a surprise and generally unprecedented. However, for the prepared and patient investor, they can also create opportunity.

Fiduciaries overseeing client portfolios should be thoughtful and well prepared with the proper planning and governance structure in place for addressing priorities with their clients ahead of time. This can allow them to capture the opportunities as they arise and not succumb to panic.

Actions to consider:

- Revisit core investment beliefs and ensure they are reflected in the client's portfolio positioning.
- Understand risk exposures and stress test portfolios.
- Re-educate clients about long-term goals and objectives and the importance of being prepared to take action in future volatile market environments; such as rebalancing in market drawdowns.
- Maintain an opportunistic bucket – have dry powder ready to implement when/if opportunities arise.
- Consider possible regulatory and tax changes and how they may affect future investment returns.

4

Managing inflation: The devil is in the detail

As central banks across the globe continue to demonstrate a commitment to expansionary monetary policy, investors are increasingly worried about the threat of inflation.

This is not a new phenomenon; inflation concerns last surfaced after the GFC, but did not materialise. The question is whether the typical inflation protection playbook will be relevant today or is something different required given the amount of fiscal and monetary stimulus this time, as well as the impact of accelerated trends related to COVID-19 on certain market segments such as real estate.

Questions to consider:

- Does the combination of fiscal and monetary policy change how we view the future?
- Are there new asset classes (i.e. cryptocurrency) that should be evaluated as part of the toolkit?
- Are there any existing portfolio allocations (i.e. equities, credit or real assets) that can help combat inflation over the long term?
- Is there a hypothesis for more tactical asset classes (i.e. gold or currency overlays) to be included in investors' strategic allocations?
- Should investors aim to hedge or outpace inflation?

5

Responsible investment: Understand the evolution

Responsible Investment (RI) is an umbrella term for economic, social and corporate governance (ESG) investing, impact investing, screened investing and active ownership. It has become clear that RI cannot be ignored and Mercer believes it will be the path to better investment results over the long run. An advisory firm's ability to offer flexible approaches and show measurable impact can be appealing to clients and prospects, particularly the next generation.

Actions to consider:

- Focus on advisor education and training so they can effectively establish an RI approach with their clients.
- Understand and overcome implementation challenges – technology, reporting, lack of high quality investment products.
- Consider firm-level beliefs to differentiate your practice to help guide clients, since ignoring ESG factors could be a risk to your business.

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