

financially speaking

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Economic outlook

International share markets experienced major fluctuations during the June quarter owing to ongoing trade-tariff tensions. The Australian economy grew strongly, driven by strong Government spending on infrastructure and increased demand for Australian mining exports.

International shares

International shares swung between strength and weakness owing to ongoing trade tensions between the US and its trading partners, particularly China. The US has used harsher rhetoric surrounding trade tariffs with the EU, Canada and Mexico and tensions rose. This weighed on business sentiment, particularly in the manufacturing industry, which is more exposed to direct tariffs. The US dollar continued to rise during the quarter, appreciating against major trading partners. This can be linked to the underlying strength of the US economy and the growing gap between interest rates in the US and other developed nations. The US Federal Reserve hiked interest rates a further 0.25 per cent to two per cent at the end of June.

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Economic outlook continued

Despite these issues, the underlying economic backdrop has remained positive during the quarter. This was led by the US, where strong GDP growth is expected for the June quarter as jobs growth continues at high levels. Global manufacturing and service indexes continue to remain in expansionary territory. However, points of softness can be found. In Europe, the economic momentum visible in January has tapered off and inflation remains subdued despite stimulatory monetary policy.

The Chinese economy showed some signs of slowing as industrial production and retail sales data fell below market expectations. Surveys of businesses have highlighted that trade tensions have negatively affected sentiment and this could cause China's economy to slow. China's economy continues to grow strongly – with the latest Gross Domestic Product (GDP) showing growth of 6.7 per cent – which is a positive sign for continued strong demand for Australian exports, particularly mining and education.

Australian economy

The Australian economy grew strongly, up 3.1 per cent in the year to March 2018, driven by strong Government spending on infrastructure as well as demand for Australian mining exports. Despite this, the outlook looks weaker for growth in the future owing to stagnant consumer incomes.

Wage data highlighted this situation with annual growth of only 2.1 per cent, in line with inflation at 2.1 per cent. This means individual incomes are just keeping up with general inflation leaving less capacity for additional spending. The Reserve Bank of Australia (RBA) is optimistic this situation will change given strong demand for workers and high business confidence. The demand for workers has not yet turned into sustained wage increases indicating there is a lot of 'slack' in the labour market. Underemployment, which is a measure of the amount of people that would work more hours if they could, remains at elevated levels. This points to a surplus of manpower that

businesses can still use without having to offer more money to attract new hires, thereby keeping wages lower for longer. The RBA has said it expects any shift towards higher wages to be gradual, taking place over years rather than immediately.

Low wage growth does not necessarily mean low mortgage rates as banks need to borrow from overseas markets to fund their lending in Australia. In recent weeks, the cost of overseas funding has risen and this has flowed onto Australian borrowers. Several banks have raised mortgage rates in response to their higher funding costs.

The Australian dollar has depreciated substantially over the last three months. A few factors are responsible – the strength of the US economy relative to our own, the growing interest rate gap with US rates, currently 0.5 per cent, and concerns over trade tariff disputes and the negative implications for our major trading partner, China.

Source: IOOF



More benchmarks in the world than stocks – how it can affect you

The number of indices benchmarking portfolio performance in the world now far exceeds the actual number of stocks in the world. This is patently absurd. Benchmarks and indices were first created to collate and measure the performance of a basket of securities. Now, you could have one basket for every security and still have too many.

This raises the question of what benchmarking is meant to achieve, and the effects of the proliferation of benchmarks on how capital is invested.

A value for the major US stock market index, the Standard & Poor's 500, was first published in 1923 with a small number of stocks, expanding to 90 stocks in 1926 and then in 1957 to its current 500 companies. The number of benchmarks has blossomed since then, across virtually all asset classes and investment types.

Benchmarks and indices are largely two ways to refer to the same thing – a basket of securities that have a common thread and can therefore be combined and tracked. For example, the S&P 500 combines the performances of 500 publicly traded US domestic companies listed on the New York Stock Exchange or the high-tech NASDAQ index, using weightings determined by the index's owner. A similar process is used for the Australian stock market's benchmark Standard & Poor's/ASX 200 index.

According to broker Alliance Bernstein, there are already over a million indices in the world and the number is growing exponentially due to lack of barriers to index creation and a perception of high demand. The total number of stocks in the world, by contrast, is approximately 43,000 though with the number of liquid ones closer to just 3000.

The establishment of benchmarks provides two major functions – the ability to track the performance of one set of securities versus itself and versus other indices over time, and to benchmark an investment manager's performance versus their agreed index.

The acceptance of benchmarking over the past few decades as the way to measure investment performance has turbocharged the development of more indices that cut the pie in more ways. At the same time, market players can also use indices as the basis of their investment products. You can't actually invest in an index itself, but companies do offer index-based products that synthetically track the performance of a particular index and give investors the returns produced by the index, less a fee. It is also this factor that has produced the constellation of new index-based products.

For investment managers that are active (ie do not passively look to recreate the performance of an index), each period, either short or longer term, they check their investment returns – what was their performance in raw terms as a percentage? Did they make money or lose money for their investors?

With that information digested, some managers will move on to checking their relative performance versus their identified index. In the language of the industry, did they beat the benchmark's performance or did their benchmark beat them? This is an indicator of how much value the manager has added over the benchmark over a given period of time.

But this post-period checking can turn into pre-period portfolio adjustments. Instead of the manager looking at returns versus the relevant index produced as a result of their portfolio construction, managers – cogniscent of how damaging it can be to their business to underperform the index – can construct their portfolios prior to the investment period in question in such a way that there is less risk that they

will underperform. Managers can 'hug' an index, buying stocks to weightings similar to the index, apart from some exceptions, to reduce the chance of underperformance.

As long as investors know what they are getting is an 'index plus' portfolio, we don't think that is necessarily a bad thing. However, our view is that if a manager describes themselves as active then that is what they should be.

We describe ourselves as a benchmark-unaware, unrestricted, long term active manager that finds market anomalies around the world. Our exposure to industry sectors, geographic regions or market capitalisation is determined solely by our conviction in the risk/reward opportunities that we identify within portfolio guidelines. Rather than invest in hundreds of securities, our global equities fund typically holds 25-45 businesses, centred on six to eight core investment propositions, as we think that is the best way to achieve acceptable returns on our clients' capital.

Although you will see mentions of a benchmark in some reporting of our performance, this is a descriptive tool only for our clients, and the constituents of an index or their weightings do not play a role in how our portfolios are constructed.

We believe that long term blended investment returns produced by markets alone are going to be lower than they have in the past so many people saving for retirement or other significant goals are not going to meet their objectives. That is why we believe investors need credible, high-conviction managers that don't rely on an index to satisfy their long-term goals.

Source: PM Capital

Where are we now?

The cycle of market emotions

“Just like investment cycles, where markets move and investment options go up and down, it’s important to know about the cycle of our emotions”



Stage 1: Optimism, thrill and euphoria

Investors all start with optimism. We commonly expect things to go our way, or we tend to expect a return for the risk of investing.

As expectations are met, it is common to get excited about the possibility of even greater returns and the excitement becomes thrilling as the returns exceed expectations.

At the top of the cycle is when investors experience euphoria. But it is here where investors are at the point of maximum financial risk. When we believe everything we touch turns to gold, we fool ourselves into believing we can beat the market, we cannot make mistakes, that excessive returns are common place and that we can tolerate higher levels of risk.



Stage 2: Complacency, denial, hope

The second phase of the cycle occurs when the market stops meeting our new lofty expectations and begins to turn. At first, we anxiously watch the market for any signs of direction. Anxiety turns to denial and then quickly to fear, as the value of the investments decline. Many people will then start to act defensively and may think about switching out of riskier assets to more defensive shares or other asset classes such as bonds.

What are the consequences of this emotional roller-coaster?

Emotions turn rational investors into irrational investors. So, it is important to remember that markets move and investments will always go in and out of favour.

Developed, diversified long-term financial plans are placed in jeopardy when investors are confronted by extraordinary events because we are guided by our emotions.

You can avoid the emotional roller coaster by being aware of the emotions you are likely to experience. The five most common behavioural pitfalls are:

- 1. Overconfidence** – when investors over-rate their ability to select winning shares or investment managers.
- 2. Loss aversion** – research indicates a loss causes about twice as much pain as a gain causes pleasure. During periods of market volatility investors experience the sense of loss more acutely.
- 3. Chasing past performance** – we see this time and time again, but unfortunately, individual investors who are abandoning a well-diversified portfolio for bonds, or even cash, may be jeopardising their future financial security.
- 4. Timing the market** – research shows that no-one can accurately time the market.
- 5. Failure to rebalance** – the risk/return characteristics of an investor’s portfolio should be independent of what’s happening in the market and this means selling high and buying low.



Stage 3: Panic, capitulation, despondency

In the third phase of the cycle, the realities of a bear market come to the fore and an investor may become desperate. Many panic and withdraw from the market altogether – afraid of further losses. Those who persevere become despondent and wonder whether the markets are ever going to recover and whether they should be there at all.

Ironically, at these times, an investor will commonly fail to recognise they are actually at the point of maximum financial opportunity.



Stage 4: Scepticism, caution, worry

In the fourth stage of the cycle, investors may experience some scepticism when markets start to rise. They often have a sense of caution or worry, wondering if market growth will last – and may be reluctant to invest money in the market at a point when prices are still relatively low, and opportunities are attractive.

The temptation to fall into one of these traps can be resisted by developing and committing to a well-defined, long-term investment plan. This is the best way to protect yourself from your emotions.

Where is the market right now on the emotional roller-coaster?

It's late in the market cycle, with evidence of thrill and euphoria and potentially signs of complacency and denial as markets corrected early February. While there is uncertainty about whether this is the peak of the cycle, we believe the risks investors face are asymmetric – the downswing is inevitable. One thing is for sure – we're nearer to the point of maximum risk than the point of maximum opportunity.

Without a solid process, there is the very real risk of being drawn into fear as markets peak and capitulating with despondency at the cycle bottom. Investors can't afford these mistakes.

Source: Russell Investments



Redefining risk for income investors

An equity-based investment fund that aims to deliver dependable income is likely to deviate significantly from the Australian share market index. It requires an active approach to manage a set of very different risks.

For a typical return-seeking equity fund aiming to outperform the index, the main risk is 'relative risk' associated with the portfolio deviating from the index and underperforming this benchmark. But what really matters for income investors is the risk that the fund does not deliver a sustainable and growing income stream.

A different set of risks requires a different approach.

Risks specific to the income investor

Income investors face several unique risks that are often not acknowledged in traditional investment literature:



1) Income level risk

Typically, income investors aim to generate an income stream that enables them to maintain their standard of living. This is a critical issue for retirees, and to achieve this goal they must tackle income level risk – the danger that the income paid by an investment falls in response to interest rate changes and other factors.

In today's lower interest rate world, term deposit investors need to invest larger sums of capital than historically to achieve the same dollar return. Additionally, these lower rates impact the level of return available from annuity type products and create significant challenges to overcome.

2) Inflation risk

Inflation risk refers to the risk that the real value of an income stream declines as the cost of living rises. For investors to be able to maintain their spending power and to protect, as well as maintain, their living standards they must ensure their income stream grows at least in line with inflation. This is particularly important for people in retirement as they are likely to incur increased costs in areas such as healthcare and aged care services.

To illustrate inflation risk, imagine investing in a term deposit that has an interest rate of 2% p.a., when inflation is compounding at 2.5% annually. In this scenario, even though an investor is earning a nominal return of 2% a year, inflation is eroding 2.5% of that, leaving the investor with a real (inflation adjusted) return of negative 0.5%.

Given retirees will usually have a relatively fixed capital base, inflation protection has to be a central consideration in any medium to long-term income oriented financial plan.

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Source: Legg Mason and Martin Currie Australia

The real risk/return trade-off for income investors

For the reasons outlined, investors seeking income need to focus on specific income solutions that can generate a yield high enough to meet their requirements today, that is sustainable over the long-term, that can be expected to grow at least in line with inflation, whilst also protecting their hard-earned capital base.



3) Income volatility risk

Investors worry about movements in the capital value of their investments but for income investors, we believe it is more important to focus on the volatility of the income stream. Putting this a different way – what matters most for income investors is that their investments deliver a sustainable and growing income stream – and the main risk they face is that it does not.

For income-oriented investment solutions, reducing the volatility of the income stream in search of reliable income delivery should be a primary consideration.

Data suggests that the actual volatility of the income stream from term deposits is more than double the volatility of the dividend stream from Australian equities. In addition, the income from dividends has been materially higher¹.



4) Longevity risk

Australians are living longer. The average life expectancy of Australian men and women is now over 90 years, having increased by an average of around 20 years since 1960. So, the probability (risk) that we outlive our savings is growing – this is known as longevity risk.

And not only are we living longer but more and more of us are entering retirement.

Over the next 40 years Australia's population will experience a major shift – a far greater proportion of the population will be older – as the dominant baby-boomer generation moves into retirement, and these older Australians will be living longer. This combination will significantly increase the nation's pension expenses and upset the balance between retirees and the working age people who are funding the pension system. Currently, for every person aged 65 and over there are 4.5 people of workforce age (15 to 64) contributing their taxes to help fund pensions. This is forecast to decrease to around 2.7 people per retiree by 2055, putting an increased strain on the entire system².

¹ Source: Martin Currie Australia, Factset, as at 30 June 2018

² Australian Department of Treasury, 2015 Intergenerational Report, Chapter 1

What crowdfunding means for the wealth industry

Many family owned businesses across Australia are not pre-IPO candidates nor are they willing to hand over management to venture capital or private equity firms.

In the absence of any obvious transition to their children or other family members these businesses are often left with little option but to sell to a competitor or entrust the sale of their business to a business broker – many of whom are not sufficiently experienced.

As such they struggle to monetise and achieve value. This means that after 30 to 40 years of hard work, they are not enjoying the returns they deserve.

The wealth industry and equity crowdfunding (called crowd-sourced funding “CSF” in Australia) may seem, at first pass, like odd partners but at FinEx Wealth we see a material and beneficial linkage between the two.

Under the CSF rules businesses with up to \$25 million revenue or less than \$25 million in net tangible assets can raise up to \$5 million dollars per year.

As an example, this means a \$15 million family business can monetise over a three-year period. This also represents the perfect opportunity to transition the business from a family operation to a professional managed entity with likely incremental increases in value along the way.

A few weeks ago, one of our team members suggested to me that CSF had a ‘convoluted identity’ and I have been struggling to find a more apt description since. The reasons for this identity struggle are obvious and, at this stage, numerous.

Some of these elements include:

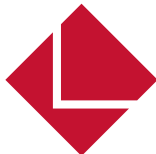
- The legislation is new (it came into effect in September 2017)
- Licenses, of which there are only a handful, were granted in January 2018
- The number of completed transactions in Australia can be counted on one hand
- Its heavily associated with ‘start ups’ and ‘tech’ businesses

In reality the legal and commercial spine of CSF addresses one of the greatest areas of equity capital market failure in Australia.

This is the area of ‘post venture capital but pre-IPO’.

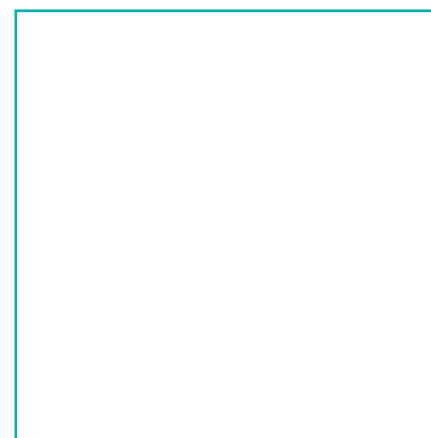
The wealth industry in Australia is best placed to identify who these businesses are and is therefore best placed to help them access this exciting new legislative change.





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1 Australian Department of Treasury, 2015 Intergenerational Report, Chapter 1. Source: FinEx Wealth