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IMFG Investment Insights

End of Financial Year 2017 – 'Strength in Diversity'

Contents

By Angus Dockrill, Director and Wealth Specialist, IMFG (written on 1 August 2017)

Information contained within this report is to 30 June 2017 and has been sourced and collated by IMFG from a variety of sources including: AMP, Datastream, DFA, FE Analytics, Iress, JANA Investment Consulting, Morgans, MSCI, RBA, Standard & Poors, Thomson Reuters. Refer to our disclaimer at the end of this document.

Summary – The year in review

Our clients have enjoyed good returns on their investments over the last financial year, with performance across diversified portfolios delivering returns above expectation and above long-term averages.

This may be surprising to some. For many, it doesn't *feel* like we live in prosperous times. Particularly if you make investment decisions by reading news headlines. And yet share markets have delivered returns of more than 13% over the last year. And property values have appreciated, particularly in Sydney and Melbourne.

Recent strong investment performance is pleasing. However, IMFG remain focused on 'risk' as much as, if not more than, 'return'. The last period has delivered relatively high returns with relatively low volatility. It can be expected that, at some stage, a period of lower returns and increased volatility will permeate various economies, industries and investment markets.

IMFG believe there remains strength in retaining a diverse portfolio, designed to achieve your defined life goals.

> *"What's most important is not investment performance over any isolated period, but achieving your goals over your lifetime."* Angus Dockrill, Director, IMFG

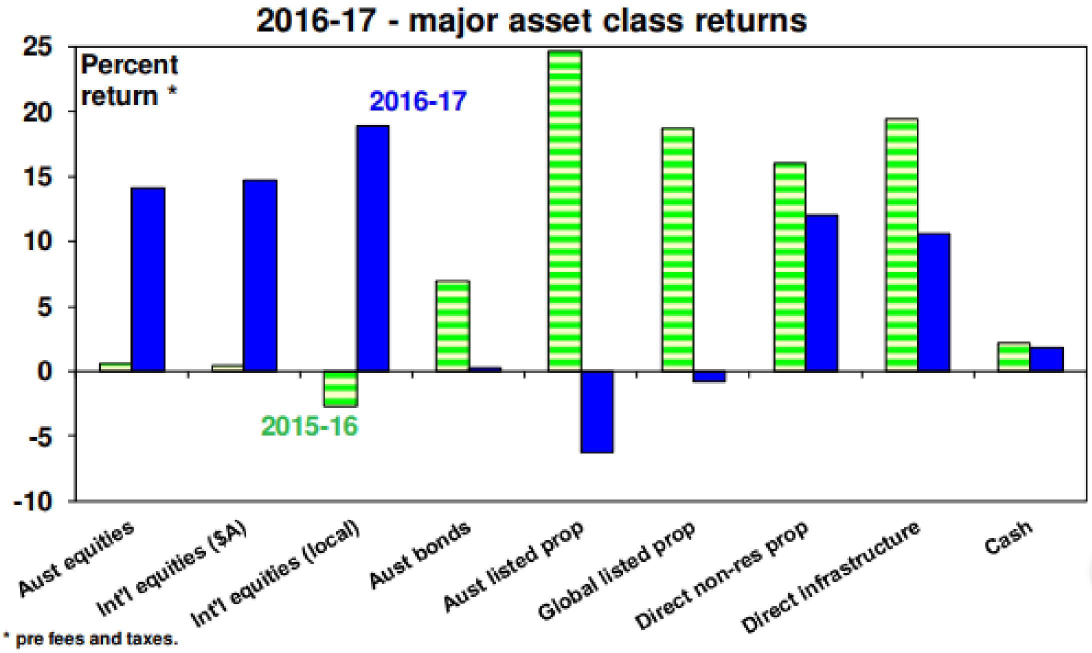
Reflecting the IMFG promise to our clients, we promise to understand you and your dreams, be on your side, help you avoid 'the big mistake' and to help find answers to your challenges.

The IMFG End of Financial Year review draws on research and insights from a variety of sources to provide:

1. an **update** on the financial news shaping market dynamics;
2. a considered view of what markets are expected to deliver in the **future**, and;
3. a focus on some of the factors you control that should continue to help you have a **successful investment experience**.

What did markets deliver?

The below graph outlines what each major market delivered for the 12 months to 30 June 2017 (in blue), compared with the previous 12 months (in green). We then take a 'deeper dive' to provide more insights on the sources of return over the last year and a framework for the future.



Source: Thomson Reuters, AMP Capital

Key insights:

- Last financial year's 'winners' (listed property and direct infrastructure) were different to this financial year's 'winners' (International equities and Australian equities).
- Interestingly, last years 'winner' was this years 'loser' (Australian listed property). And last years 'loser' was this years 'winner' (International equities). Put another way, those who chased past performance did not have a good year. Those investors, including IMFG Private Clients, who remained broadly diversified and rebalanced their portfolios with monotonous discipline had a successful year and were rewarded with above average investment performance.
- Cash is not king – cash and bank term deposit rates remain low. Even considering the low interest rate environment, banks do not appear very generous. The banks have reduced savings interest rates more than the RBA with out of cycle rate changes. This is good news for bank shareholders and bad news for savers – particularly retirees who rely on interest income to fund their lifestyle.
- Performance across share equity markets was *above* long-term expectations. International equities performed strongly – led by the *developing* world with emerging markets delivering returns of more than 20% for the year (think Korea, China, India and Brazil et al). All this in spite of news headlines.
- Property values increased. However, the market price of listed property trusts *fell* by more than 7%. Does this indicate fear of imminent property falls, future increases in the cost of debt or simply the 'animal spirits' of investors? Who is right - the listed property market or the unlisted property market? Or neither?
- Fixed interest bonds achieved a relatively low return.
- Overall, a diversified portfolio delivered an improved outcome when compared with picking last year's winners, with a smoother ride.

Financial year performance across asset classes

WORLD INDICES WRAP UP

FIXED INTEREST	QTR	1 Year
Bloomberg AusBond Bank Bill Index	0.44%	1.82%
Bloomberg AusBond Composite 0+ Yr Index	1.01%	0.25%
Bloomberg Barclays Global Aggregate Bond Index (hedged to AUD)	1.17%	0.47%

AUSTRALIAN EQUITIES	QTR	1 Year
S&P/ASX 300 Index (Total Return)	-1.57%	13.82%
S&P/ASX Small Ordinaries Index (Total Return)	-0.35%	7.01%
S&P Australia BMI Value Index (AUD, gross div.)	-4.06%	18.35%
S&P Australia BMI Growth Index (gross div.)	0.74%	10.34%

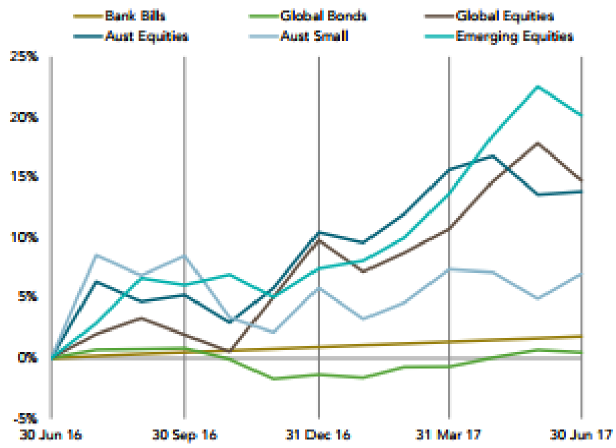
GLOBAL EQUITIES	QTR	1 Year
MSCI World ex Australia Index (net div., AUD)	3.62%	14.73%
MSCI World ex Australia Index (net div., hedged to AUD)	3.16%	20.54%
Hedging Premium	-0.46%	5.81%
MSCI World ex Australia Small Cap Index (net div., AUD)	3.75%	17.52%
MSCI World ex Australia Value Index (net div., AUD)	2.48%	15.06%
MSCI Emerging Markets Index (net div., AUD)	5.69%	20.12%

REAL ESTATE	QTR	1 Year
S&P/ASX 300 A-REIT Index (Total Return)	-3.05%	-5.64%
S&P Developed REIT Index (AUD, net div.)	1.05%	-5.42%

WORLD MARKETS	QTR	1 Year
S&P 500 Index	2.47%	14.40%
MSCI UK Index (net div.)	4.10%	9.99%
MSCI Europe ex UK Index (net div.)	7.75%	20.68%
Japan Nikkei 225 Average Index (price-only)	4.24%	14.58%
Shanghai Stock Exchange Composite Index	0.10%	3.62%

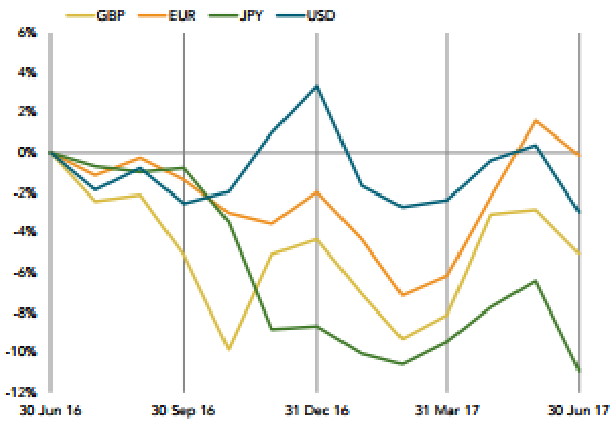
CURRENCIES (RELATIVE TO AUD)	QTR	1 Year
British Pound	3.33%	-5.07%
Euro	6.42%	-0.13%
Japanese Yen	-1.61%	-10.91%
United States Dollar	-0.60%	-2.97%

MARKET RETURNS



Source: Bank Bills – Bloomberg AusBond Bank Bill Index, Global Bonds – Bloomberg Barclays Global Aggregate Bond Index (hedged to AUD), Global Equities – MSCI World ex Australia Index (net div., AUD), Aust Equities – S&P/ASX 300 Index (Total Return), Aust Small – S&P/ASX Small Ordinaries Index (Total Return), Emerging Equities – MSCI Emerging Markets Index (net div., AUD).

CURRENCY RETURNS (Relative to AUD)



Performance is shown in AUD. Bloomberg indices copyright Bloomberg 2017. The S&P data are provided by Standard & Poor's Index Services Group. MSCI data copyright MSCI 2017, all rights reserved. Individual country stock exchange indices provided by Datastream. Currency data provided by WM/Reuters

Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

Hedging premium – MSCI World ex Australia Index (net div., hedged to AUD) minus MSCI World ex Australia Index (net div., AUD).

Market returns – a deeper dive

A closer look at the factors that have driven market returns reveals a high level of divergence between the areas that have outperformed and underperformed.

Australian share market

Interestingly in the Australian share market, it has been the 'value' companies that have outperformed over the last year. 'Value' stocks tend to be relatively unloved assets whose future expected dividends are cheaper to buy compared with the broader market. 'Growth' stocks are those that are expected to grow at a higher rate than the market and are relatively expensive to buy given their higher future growth potential.

- The broader Australian share market appreciated 13.82% - as reflected in the S&P ASX300 Index.
- The S&P Australia BMI Value index achieved a *positive* investment return of 18.35%. This is significantly more than the broader market index.
- Comparatively, the S&P Australia BMI Growth Index appreciated *only* 10.34%.
- The spread between the return delivered by 'value' businesses compared with 'growth' businesses is unusually high, but not beyond the range of outcomes one can expect. What was remarkable was the *speed* with which the value index outperformed the broader market and growth index during the year. The shift of investment returns from growth to value occurred over a couple of weeks in late 2016.
- In early 2016 we wrote about the relative underperformance of 'value' businesses when compared with 'growth' businesses in the previous years and how history shows performance in different investment styles and markets changes regularly and often quicker than one may think.
- The moral of the story? Patience is a virtue. The last 12 months have proven this again.

Global share markets

Global share markets – often approached with some trepidation by Australian investors, particularly Self Managed Super Funds – delivered a higher performance than Australian shares. In what may surprise some, Global share markets even delivered a higher return than Australian investment grade property.

It wasn't just the US share market and the developed world (North America, Japan, the UK and Europe) that delivered strong returns. Emerging markets delivered the strongest investment performance across markets for the year.

In previous years, the emerging markets of the *developing* world have lagged the Western markets. In last years end of financial year update, we posed the question of when, not if, would the emerging markets of the developing world outperform those of the 'Developed' markets?

Despite news headlines delivering news of geo-political risks in the South China Sea, ongoing concerns over North Korea as well as the potential impact of a Trump-led America reducing trade to the developing world, we did not have to ponder for long.

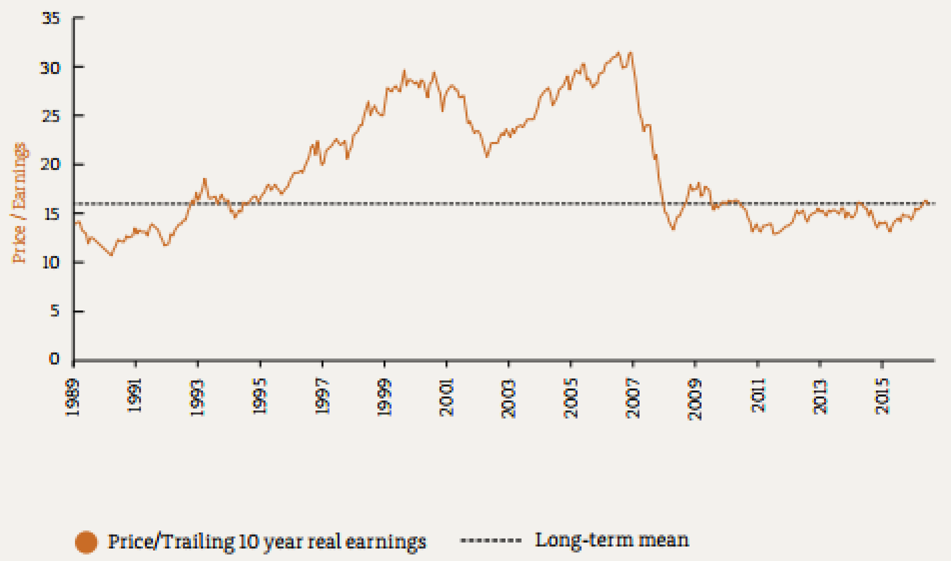
Is the stock market overvalued?

A commonly used barometer for whether a share market is “undervalued” or “overvalued” is to measure the price the market is currently demanding you pay for the promise of future earnings (ie, the Price to Earnings ratio) and compare this with history. The below chart reflects the Australian share market’s Price to Earnings ratio since 1989, using 10 year trailing real earnings. Using this measure, some investment analysts hypothesise that the market is;

- ‘cheap’ when the market is lower than the long term mean (ie, when the orange line is lower than the black dashed-line);
- ‘expensive’ when the market is higher than the long term mean (ie, when the orange line is above the black dashed-line).

The below chart reveals two interesting things. Firstly, using this barometer of value, the share market does not appear to be overly expensive. The market is trading at close to the long-term average. Secondly, we do not recommend basing your investment decisions solely on this chart. By way of example, in 1996 had the long-term investor chosen not to invest at that point because they feared the market was getting too ‘expensive’ to invest, they would have had to wait a long time – twelve years – before the chart indicated the share market was ‘cheap’ enough to invest. During those intervening years the ASX200 Accumulation Index rose 317%.

CHART 6: AUSTRALIAN SHARES
Market indicator *S&P/ASX 200*



Source: Global Financial Data.

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A better approach is to let the market do the worrying for you and build a diversified portfolio around the long-term drivers of return.

But this is not based on a forecast about what might happen with geopolitics, economics, commodities, interest rates, currencies and shares in the year ahead, but on what is going on in your life and how you are tracking relative to your pre-defined goals.

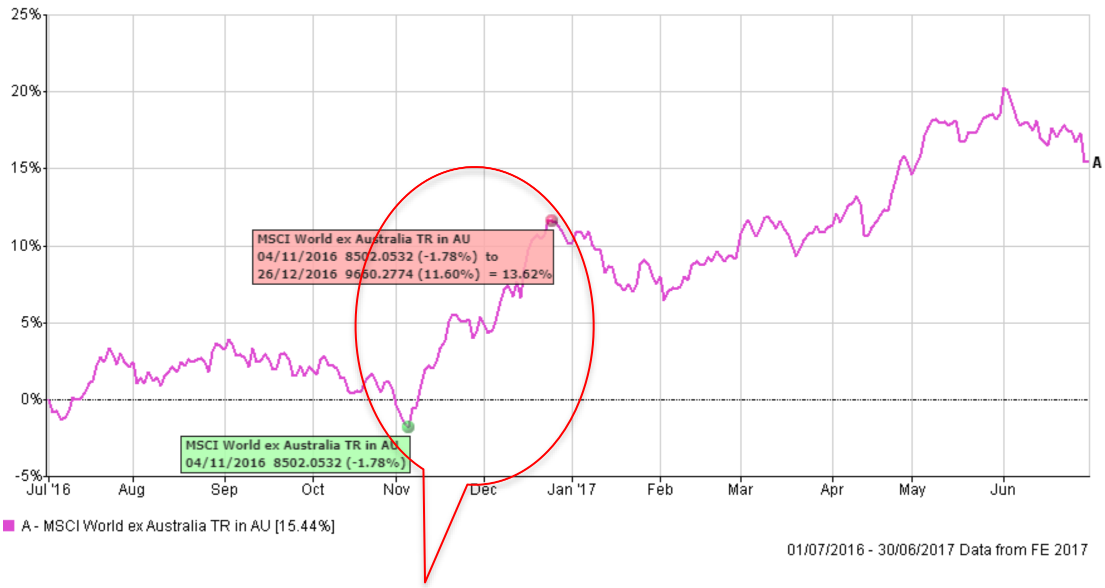
Key lesson – concentrated nature of investment returns

You never know which market segments will outperform from year to year. By holding a globally diversified portfolio, investors are well positioned to capture returns wherever they occur.

When you look at the long-term history of investment markets, what you discover is that a lot of the positive returns that are delivered by investment markets happens in a short period of time. That is, you must be present to win.

Some investors miss out on a significant amount of investment return by not remaining invested through a market cycle. 2017 was no different in this regard. The following two graphs show the investment journey of the global share market and the Australian share market for the 2016/2017 financial year. As noted in each graph, most of the year's investment return occurred in a what was only a few weeks of the year.

Global share market performance (MSCI World Index ex Australia in Australian dollars)



In a year when the global share market appreciated around 15% (in Australian dollars), interestingly markets appreciated more than 13% in only a seven week period from 4 November 2016. At the time news headlines were alarmist and reflecting a highly uncertain future. Donald Trump was elected President of the USA on 8 November 2016 (9 November Australian time).

Australian share market performance (ASX300 Index)

The Australian stock market also delivered most of its 12-month gains in just a two month period. The 8 weeks from 9 November 2016 to 9 January 2017 delivered performance of more than 13% - the majority of the investment return experienced over the year.

"Over the past financial year, the more successful investor remained invested and was 'in the seat' to capture the returns on offer – even when it may have felt uncomfortable to remain invested" Scott Douglas, Director, IMFG

A look ahead

Investment markets are dynamic with many moving parts. And there are plenty of forecasts that will be delivered to you via the media, financial services industry and friends and family – many of which will be alarming and may cause you to question the wisdom of your long-term investment portfolio and plan.

One of the hardest things to do, and yet what is typically one of the most beneficial things to do, is not to change your game plan because of what the markets are doing, or what the forecast is saying markets are going to do.

Low volatility – is it here to stay?

The high returns of the last period have been achieved with a remarkably low level of volatility.

We expect volatility in asset prices to increase and uncertainty to remain. Both are normal ingredients of investment markets. In fact, they are **required** for the investment market eco-system to continue to process an investment return which remains inextricably linked to the inherent risks one is prepared to accept.

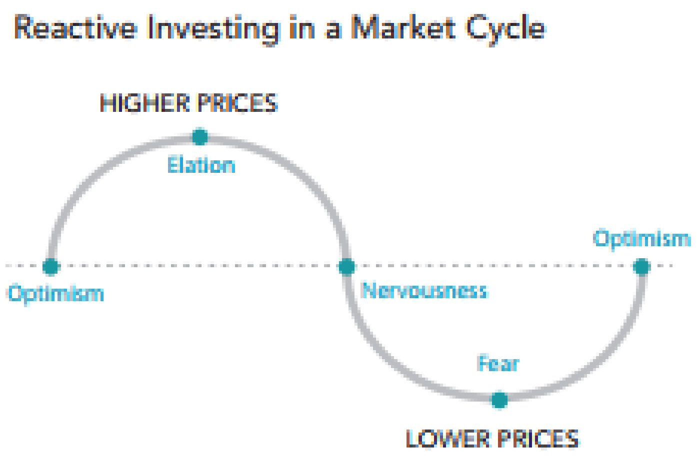
In that sense, IMFG believe volatility is a good thing that should be embraced. However, volatility can conversely become a bad thing if it encourages emotional decision making at the expense of your long-term strategy.

As noted earlier, IMFG are just as, if not more, focused on risk as return. Particularly in recent times where relatively high returns have been achieved with relative low volatility. Within investment markets, periods of low volatility and high returns are generally followed by periods of higher volatility and lower investment return. There is strength in diversity.

The real challenge - managing your emotions

Planning and having a plan is good. However, sticking to your plan when things get tough is when your fortitude will be tested.

Many people struggle to separate their emotions from investing. Markets go up and down.



Fear and greed are the two things that typically derail investment strategies. Succumbing to those urges is the difficult piece in sticking to your well considered and robust investment plan - but this is exactly what will prevent you from making the wrong change at the wrong time.

IMFG Private Clients can rest in the knowledge that your financial plan is focused on elements you *can* control—for example, savings, retirement date, personal spending, asset allocation, reducing fees and taxes, and applying discipline. Everything else is not worth worrying too much about.

IMFG stand ready to help our Private Clients make smarter financial decisions in their long term interest. We remain confident and committed to our diversified investment portfolio approach to capture the returns on offer with patience and discipline.

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Investing involves risk, including the possible loss of capital. Past performance is not a reliable guide to future returns.

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