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IMFG Investment Insights
End of Financial Year Review 2017/18

‘Managing Turbulent Times’

“How do the year end numbers look?”

Contents

Angus Dockrill, Director and Wealth Specialist, IMFG, July 2018

Information contained within this report is to 30 June 2018 and has been sourced and collated by IMFG from a variety of sources including: Blackrock, Datastream, DFA, Fairfax, FE Analytics, Iress, JANA Investment Consulting, Morgans, MSCI, RBA, Shane Oliver, Standard & Poors and Thomson Reuters. Refer to our disclaimer at the end of this document.

Investment Insights Summary

- *Strong investment performance in FY 2017 / 2018, driven by share markets*
- *Expect turbulence ahead*
- *Diversification will mitigate the prospect of permanent loss*

The year in review

It has been said we live in turbulent times.

And yet, the investment market returns for the year ending 30 June 2018 were strong for all except those who invested in cash and some of the more conservative areas across investment markets, like bonds.

For the diversified investor with approximately 70% of their portfolio in growth asset classes (ie, shares and property) the market investment return was around 9%. On balance, a very good investment result in what felt like a complex year.

We expect turbulence and uncertainty in geopolitics, economies and investment markets to continue. We contend it will be your *behaviour* and *reaction* to the market, rather than the market itself, that will be the dominant factor in whether you continue to have a successful investment experience and achieve the level of financial security with the peace of mind that you want. As much as it is valuable to reflect on the progress across investment markets, we remain more focused on your progress towards your wants, dreams and goals.

IMFG believes there is strength in retaining a diverse portfolio. We continue to trust a structured approach that, at its core, believes that the return you demand will be directly related to the inherent risks in your portfolio. In capturing a high investment return you should not lose sight of the fact that it will be achieved with periods of increased turbulence and periods of sustained negative investment return.

"Turbulence is not a problem for the plane nor the pilots, safety, nor does it signal a safety problem. Turbulence is a natural phenomenon in which every plane is built to fly" www.fearofflying.com

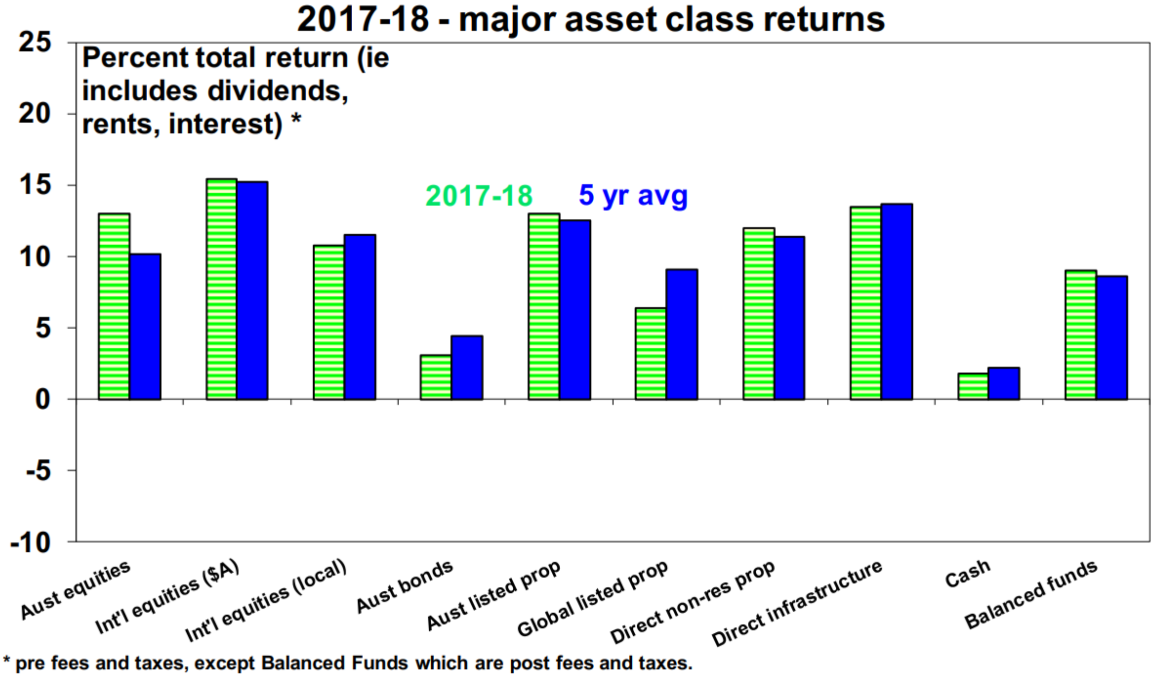
The IMFG 2018 End of Financial Year Review draws on research and insights from a variety of sources to provide:

1. An **update** on the investment markets in FY 2017/2018
2. Key **lessons** to prepare for the year ahead
3. A **glossary** of the financial terms used

We hope you enjoy reading IMFG's Investment Insights and would be happy to answer any questions you may have.

What did markets deliver?

Most investment markets had a particularly strong year. Indeed, the last five years have seen markets deliver performances that are above long term averages. The below graph outlines what each major asset class delivered for the 12 months to 30 June 2018 (in green) compared with the 5 year average of annual returns (in blue).



Source: Thomson Reuters, AMP Capital

Key insights:

- Overall, a diversified portfolio delivered a positive outcome above long term averages.
- Last financial year's 'winners' (Australian equities and International equities) continued their strong performance remaining at the top of the leaderboard.
- Performance across equity markets was *above* long-term expectations with the Australian share market delivering more than 13% total return and the developed world share markets delivering more than 11%. This rises to 15% taking into account the fall in the Australian dollar over the year.
- Property markets experienced a mixed bag. The listed property sector delivered more than 13% total return (i.e. investment grade property and property development activities in commercial, industrial and shopping sectors). However, residential property showed signs of weakness with reported falls in values across the Sydney and Melbourne residential markets.
- Cash is not king – cash and bank term deposit rates remain low. The RBA continues to hold the official cash rate at 1.5%pa, a rate that has remained unchanged since August 2016. This is bad news for savers, particularly retirees who rely on interest income to fund their lifestyle.
- Investments in fixed interest securities and bonds experienced low returns. As a conservative asset class, changing expectations on the direction of interest rates across various markets, uncertainty relating to the prospect of Trump led trade wars and increased fear that some borrowers may not pay all of their debts back to bond holders have negatively impacted returns.

- As a reminder of how difficult it is to forecast future returns with accuracy, Fairfax Media surveyed 26 economists in July 2017 to provide their view on what the Australian share market would deliver in the 2018 financial year. The consensus forecast was a meagre rise for the year of less than 2%. The most pessimistic forecast foresaw a fall of 12%. In fact, the Australian share market gained 8% in price terms, or a little over 13% on a total return basis including dividend income. This strong return was delivered despite weakness in traditional 'leaders' like Telstra and the major banks.
- Investors who continued with a concentrated portfolio of bank term deposits complemented with a significant exposure to the four banks and Telstra did not have a good year.
- Conversely those investors, including IMFG Private Clients, who remained broadly diversified and rebalanced their portfolios with rigorous discipline had a successful year and were rewarded with above average investment performance relative to the risks inherent in their portfolio.

We take a 'deeper dive' into the financial performance of different markets in the following four pages. For those not interested fast forward to page nine for 'Key Lessons for 2019'.

Financial year performance across asset classes

WORLD INDICES WRAP UP

FIXED INTEREST	QTR	1 Year
Bloomberg AusBond Bank Bill Index	0.49%	1.78%
Bloomberg AusBond Composite 0+ Yr Index	0.82%	3.09%
Bloomberg Barclays Global Aggregate Bond Index (hedged to AUD)	0.15%	1.85%

AUSTRALIAN EQUITIES	QTR	1 Year
S&P/ASX 300 Index (Total Return)	8.36%	13.24%
S&P/ASX Small Ordinaries Index (Total Return)	7.67%	24.25%
S&P Australia BMI Value Index (gross div., AUD)	8.74%	11.91%
S&P Australia BMI Growth Index (gross div.)	9.14%	17.06%

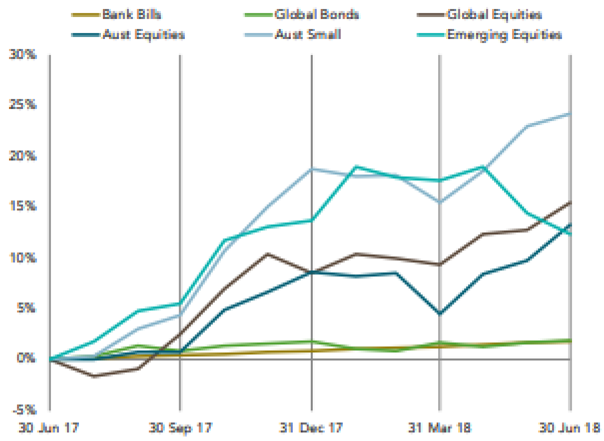
GLOBAL EQUITIES	QTR	1 Year
MSCI World ex Australia Index (net div., AUD)	5.53%	15.39%
MSCI World ex Australia Index (net div., hedged to AUD)	3.62%	11.48%
Hedging Premium	-1.91%	-3.92%
MSCI World ex Australia Small Cap Index (net div., AUD)	7.22%	19.19%
MSCI World ex Australia Value Index (net div., AUD)	3.61%	9.81%
MSCI Emerging Markets Index (net div., AUD)	-4.45%	12.33%

REAL ESTATE	QTR	1 Year
S&P/ASX 300 A-REIT Index (Total Return)	9.82%	13.20%
S&P Developed REIT Index (net div., AUD)	10.69%	8.44%

WORLD MARKETS	QTR	1 Year
S&P 500 Index	7.38%	18.74%
MSCI United Kingdom Index (net div.)	6.88%	14.22%
MSCI Europe ex UK Index (net div.)	0.84%	7.46%
Japan Nikkei 225 Average Index (price-only)	3.63%	17.25%
Shanghai Stock Exchange Composite Index	-11.41%	-5.25%

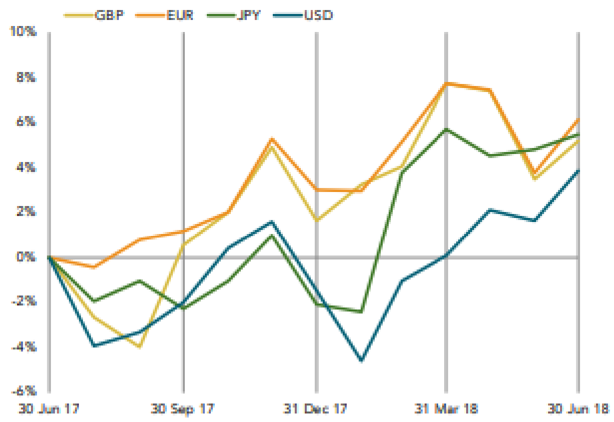
CURRENCIES (RELATIVE TO AUD)	QTR	1 Year
British Pound	-2.34%	5.20%
Euro	-1.47%	6.15%
Japanese Yen	-0.22%	5.47%
United States Dollar	3.78%	3.86%

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)



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 was 'smaller' companies that outperformed over the last year. The broader Australian share market returned 13.24% and yet the Smaller Companies Index achieved 24.25%.

Further, those companies that are expected to grow at a higher rate than the market and are relatively expensive to buy (reflecting their higher future growth potential) have also outperformed in the year. The S&P Australia BMI Growth index achieved an investment return of 17.06%. This is significantly more than the broader market index. Comparatively, the S&P Australia BMI Value Index appreciated *only* 11.91%. The spread between the return delivered by 'growth' businesses compared with 'value' businesses is high, but not beyond the range of outcomes one can expect.

- It was a good year for sectors like Healthcare (+27% return) and Resources (+40% return) and a bad year for the Banks (flat) and Telecommunications (-34%).
- More than half of the investment return delivered by the Australian share market occurred in the last 3 months to end of June 2018.
- Listed property markets delivered strong returns of more than 13%. Most of this return was also delivered in the last quarter to end of June.

The moral of the story? Patience remains a virtue. While turbulence continues to be a constant, a diversified approach structured around the key drivers of long term returns remains a sound strategy.

Global share markets

Global share markets delivered another year of strong performance with the US market and the Japanese market leading the way across the larger markets. Within these markets it was sectors including Information Technology (+36%) that drove out performance. US Banks delivered a return of 14.07%. That is lower than the overall US share market but a higher return than the overall Australian share market and considerably more than the Australian banking industry.

One area that we continue to monitor is the impact – which can be both positive and negative – of changing currency values. In the last year the Australian dollar has fallen against the major currencies (i.e. US Dollar, British Pound, Japanese Yen and the Euro). Whilst this may mean your next overseas holiday is more expensive, your portfolio has benefited from this fall to the extent that you have global shares without currency hedging in your portfolio.

With ongoing tension relating to 'Trade Wars' one can expect the value of emerging stock markets, and their currencies, to fluctuate in value reflecting the risk that there will be 'winners' and 'losers' in different economies and industries. With history as a guide higher risk across capital markets is likely, but by no means guaranteed, to deliver higher expected returns over the long term.

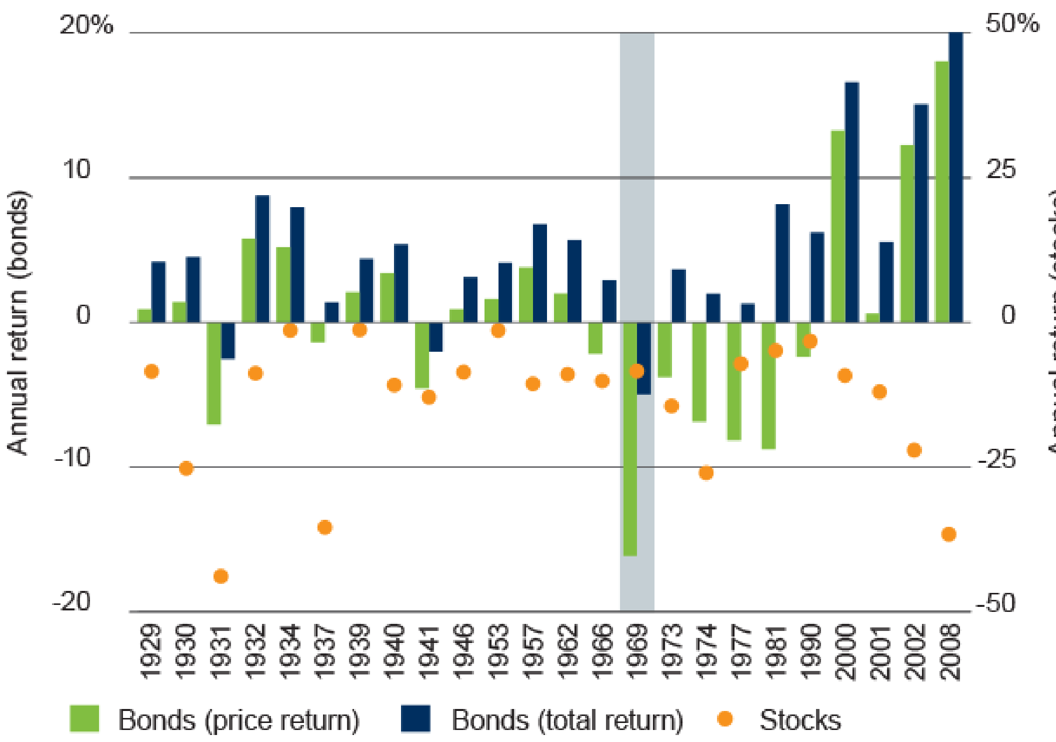
Fixed interest markets – an inflexion point?

Fixed interest markets delivered low returns in the last year.

The conventional wisdom is that when share markets fall, bond markets go up. This can be valuable when share markets fall. Of the 24 years with negative equity returns in the United States since 1929, U.S. 10-year Treasuries generated positive returns in all but three. As outlined in the chart below, history shows that there can be periods when both markets fall at *the same time*, albeit in a minority of occasions. It is possible that this may occur again in the near future.

Bonds hedge growth, not inflation risks

U.S. stock vs. bond returns in years with negative stock returns, 1929-2017



Past performance is not a reliable indicator of future results. Source: BlackRock Investment Institute, with data from Bloomberg, May 2018. Notes: The price and total return of bonds are based on the annual return of 10-year U.S. Treasury bonds. Stocks are represented by the S&P 500 Index. Price returns are estimated based on the duration of bonds and the movement of the 10-year rate over the year.

We are alert but not alarmed to this downside risk and believe any exposure to fixed interest should be very diversified with a dogged focus on:

1. quality of credit and;
2. the loan term.

It turns out the market has worried about this too, evidenced by the meagre returns in bond markets over the last 12 months.

Of more concern is how investors will ***react*** in the event of fixed interest markets falling significantly *at the same time* as a fall in share and property markets. Put another way, it is possible bond holders will fear turbulent times before share market investors, as they may fear they are not going to receive all their money back or expectations can change rapidly on what interest a bond holder will receive in continuing to lend money to governments and corporates.

If the fixed interest market is the ‘canary in the coal mine’, we think the canary should have a gas mask. History shows diversification with a focus on quality is an effective gas mask. If one invests in this manner, they are better placed to endure any abnormal shock to markets in the future.

We believe bonds have a role to play in a diversified portfolio. We also believe any exposure to fixed interest securities markets should remain diversified in line with the long term drivers of return (ie, focus on quality of the borrower and the term of the bond, or loan).

Key lessons for 2019

1. Tune out the white noise

Have you read the news today? Chances are there is something happening in the world with the potential to keep you awake at night.

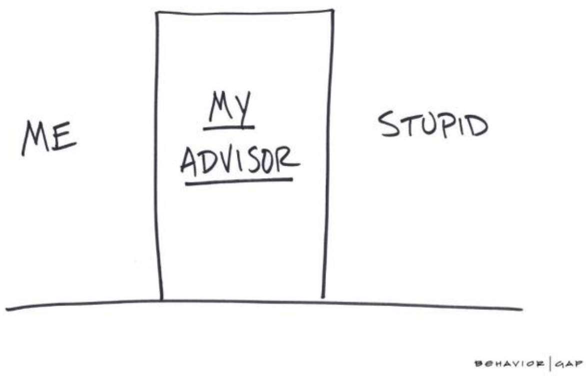
We live in a world where President Trump could permanently change the fortunes of an industry or an economy with a tweet. Or the value of a 'trusted' institution that generations of Australians have relied on since 1849 could fall more than one third in a short period because of shocking findings at a Royal Commission.

But while it is one thing to follow the news, it's another to act on it in a way that can backfire on you as an investor.

Investment markets are dynamic with many moving parts. And there are plenty of forecasts (about geopolitics, economics, commodities, interest rates, currencies and more) that will be delivered to you via the media, the financial services industry, 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.

These events can be scary in isolation, but responding to this 'news' and making investment decision in isolation (against your well thought out financial plan) is even scarier.

Don't let fear derail your investment strategy. Tune out the white noise. Be disciplined and do not react. Trust in the strength of the market and the diversified financial plan that we have created together. Remain calm. This patience is exactly what will prevent you from making the wrong change at the wrong time.



2. Fight the desire to concentrate

One very human response to uncertain times is to develop your own investment hypothesis on future markets and act accordingly.

Often this hypothesis is concentrated in an area in which you specialise or feel most comfortable. A Construction Manager may be more inclined to invest in property (particularly in the market segment that funds his or her salary). A Doctor may be more inclined to invest

in the medical device company or pharmaceutical business that many clients use. An IT engineer may be more inclined to invest in Bitcoin or Facebook.

This concentrated approach to investment may make you rich. On the other hand, it may make you less financially secure if only one investment idea fails.

We believe in the power of a diversified approach – particularly in an interconnected world full of complexity and turbulence. There is a way to use the market forces driving capitalist markets to your advantage without speculation. IMFG is confident and committed to our diversified investment portfolio approach to capture the returns on offer. Effective diversification across the spectrum of investment possibilities, aligned with your desired cash flow, remains the most reliable strategy to manage these type of risks – particularly when your goal is ongoing financial security for you and your loved ones.

3. Keep it simple (& stay disciplined)

Having a successful investment experience should not be exciting and quick, but slow and boring. Keeping your investment discipline when markets turn is one of the more effective aspects to continuing to have a successful investment experience.

One aspect worthy of consideration is to rebalance your portfolio. It has been said rebalancing is the only near-perfect investment strategy. Rebalancing your portfolio a couple of times a year means you automatically sell some of your short term 'winners' and, in the same move, buy some of your short term 'losers' at a lower price. The result, if followed with discipline, is improved returns with lower risk.

"We all wish we had a little genie who could reliably tell us to 'buy low and sell high.' Systematic rebalancing is the closest analogue we have." Burt Malkiel, Princeton Professor and author of 'A Random Walk Down Wall Street'

IMFG Private Clients can rest in the knowledge that your financial plan is focused on elements you *can* control - for example, your savings, retirement date, personal spending, asset allocation, tax plan, and cost-effective implementation strategy. Everything else is not worth worrying too much about.

And if it's too hard to tune out the noise (which is understandable in this turbulent environment) ask for our help and we can develop strategies to stop you worrying.

Glossary

Source: www.moneysmart.gov.au

Asset Class *– A group of securities that exhibit similar characteristics, behave similarly in the marketplace, and are subject to the same laws and regulations. The main asset classes are equities (stocks or shares), property, fixed-income (bonds) and cash equivalents (money market instruments).*

Australian equities *– Common shares of businesses listed on an Australian stock exchange. The dominant stock exchange in Australia is the Australian Stock Exchange.*

Bank term deposit *– An account with a financial institution where money is deposited for a set period of time. The interest rate is usually fixed for the term of the deposit and is generally higher than a transaction account but not always higher than some other at-call high interest savings accounts. Also known as a fixed deposit*

Cash *– Money invested in short-term, interest-paying investments. Having money in a bank account is an example of a cash investment.*

Concentrated portfolio – *A portfolio that holds a small number of different securities in order to achieve an expected investment return. Unlike higher levels of diversification, which could involve purchasing a large number of different securities in order to mitigate risk, a concentrated portfolio might have fewer than twenty assets. It may also concentrate its investment in one or two asset classes, markets, industries or economies.*

Conservative asset class *– Investment asset classes where the investor typically lends capital for an expected investment return. Examples include cash and fixed interest. Not without some controversy, some large superannuation funds also include long dated assets, including types of infrastructure, as a conservative asset class. Conservative asset classes deliver a lower expected investment return with less risk to the investor of loss of capital.*

Currency hedging *– In very simple terms, currency hedging is the act of entering into a financial contract in order to protect against unexpected, expected or anticipated changes in currency exchange rates.*

Diversified Portfolio *– A portfolio that has spread its investments across a variety of different asset classes to reduce risk. Further, within each asset class the investor has exposure to a wide range of investments. There is a range of views on an appropriate level of diversification. An active fund manager typically believes a portfolio of 20 to 40 assets is an appropriate level of diversification in each asset class, whereas, more passive fund managers believe holding a portfolio of hundreds if not thousands of assets in each asset class is an appropriate level of diversification.*

Fixed Interest Security / Fixed Interest Bonds *– Commonly known as bonds, these securities are a fixed income investment in which an investor loans money to governments and corporates in Australia and around the world on the promise of their capital being repaid in time with the potential to earn higher interest than that offered by a bank term deposit during the period they hold the bond. Investors in fixed interest securities are generally more conservative than share and property market investors. Interestingly, fixed interest markets are generally more liquid and more heavily traded than share and listed property markets.*

Fixed interest markets - *Covers a broad range of investments, with varying degrees of risk, such as term deposits, government bonds, corporate bonds, capital notes, debentures and income securities.*

Growth asset classes – *Investment asset classes where the investor invests to own a part of the investment for an expected investment return. Examples include shares and property. Growth asset classes expect to deliver a higher expected investment return with higher risk to the investor of loss of capital.*

Idiosyncratic Risk *– Also referred to as 'unsystematic risk', is the risk that is endemic to a particular asset such as a stock and not a whole investment portfolio. Being the opposite of systematic risk (the overall risk that affects all assets, like fluctuations in the stock market or interest rates), Idiosyncratic risk can be mitigated through diversification in an investment portfolio. Since idiosyncratic risk is by definition generally unpredictable, investors seek to minimize its negative impact on an investment portfolio by diversification or hedging.*

International equities *– Common shares of businesses listed on stock exchanges outside of Australia.*

Investment grade property *– a term used to describe property felt to be of sufficient size and quality to be an attractive purchase target by one of the large institutional portfolios, such as retirement funds or insurance companies.*

Listed property *– Trust funds listed on a securities exchange and managed by an investment manager (also known as real estate investment trusts (REITs). May invest in a specific type of property such as residential, industrial, office buildings, shopping centres or hotels, or in a diversified portfolio of real estate assets either in Australia or overseas.*

Rebalancing *– Rebalancing is the process of realigning the weightings of a portfolio of assets. Rebalancing involves periodically buying or selling assets in a portfolio to maintain an original desired level of asset allocation*.

S&P Australia BMI Growth Index *– Seek to measure growth stocks using three factors: sales growth, the ratio of earnings change to price, and momentum. Growth stocks are shares in a company whose earnings are expected to grow at an above-average rate relative to the market.*

S&P Australia BMI Value Index *– Seek to measure value stocks using three factors: the ratios of book value, earnings, and sales to price. A value stock is a stock that tends to trade at a lower price relative to its fundamentals, such as dividends, earnings and sales, making them appealing to value investors.*

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