Personal Wealth

Spring 2017

A Quarterly Newsletter for **Lifespan Clients**

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Investment Markets

Recent Events

Hurricanes in the US and the belligerence of North Korea initially lead to some volatility in markets but that did not last long. Most Global equities markets are well up in 2017 while the major US equities indices are still hovering around record highs. Global equities are in fact performing much better than Australian equities in local currency terms.

The rise of the Australian dollar from 72 US cents to around 80 cents has somewhat masked the underperformance of domestic equities in 2017. The (Bloomberg) US dollar index, which measures the US dollar against a basket of currencies is down about 10% in 2017, this is almost a 3 year low.

Year to date, in local currency (to September 18), Global equities have returned 13.0% (MSCI AC World), US equities have returned 13.3% (S&P 500), while Australian shares have returned 4.1% (ASX 200). The standout performer has been Emerging markets which have returned 25%.

While resources, particularly iron ore have rallied, Australian large Caps have been held back by the troubles of CBA and the lower dividend policy of Telstra. Another feature has been Australian Small Cap equities which have returned 5.6% year to date, reversing their recent underperformance versus large Caps. Over the 3 months to the end of August, Small Caps have returned 5.1% while large Caps are up just 0.9%. Over the same period, Global equities were down -2.7% as a result of a strongly rising Australian dollar.

The Australian 10 year bond yield has risen from around 2.4% in June to 2.8%, mainly on the back of stronger employment numbers. Higher bond yields did not help Australian listed property (AREITS) which returned -3.7% over 3 months. .

Economy

The global economy is doing quite well with practically all OECD economies exhibiting positive growth. Global GDP growth is projected to increase to 3.5% in 2017 and 3.7% in 2018 from 3% in 2016 according to the OECD. In the US, second quarter GDP was upwardly revised to a 3.0% annualised growth rate. However inflation data remained sluggish with core personal consumption expenditure for July of 1.4% year-on-year (the US Fed preferred measure of inflation). European GDP growth came in at 0.6% in the second quarter, up from 0.5% in the first quarter. Meanwhile, annual inflation was estimated to pick up to 1.5% in August from 1.3% in July.

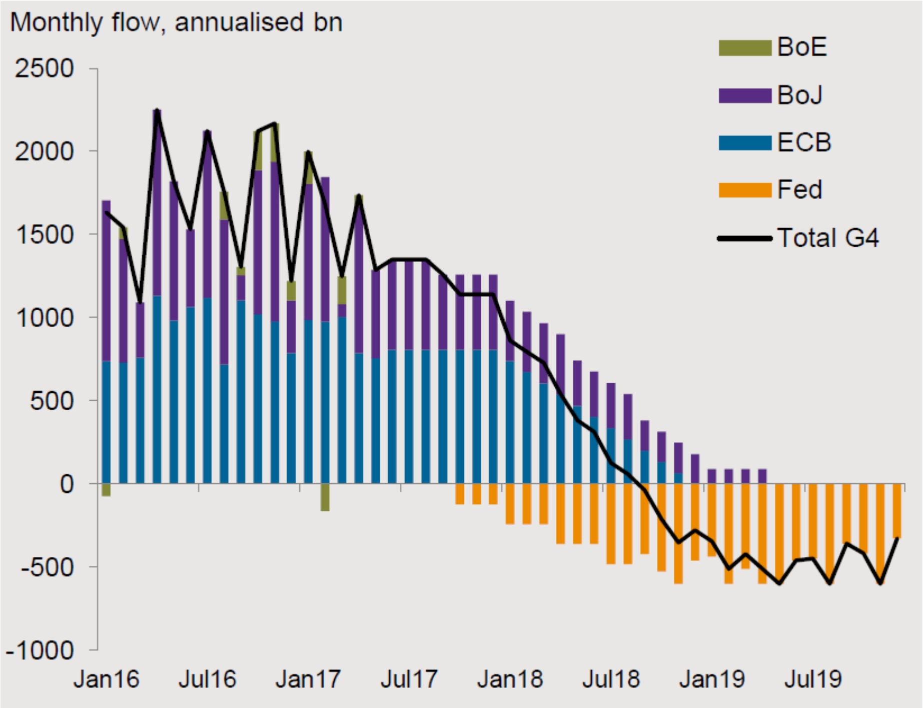
Australian employment rose by 54,200 in August, the biggest jump since October 2015 and way above forecasts of 15,000 to 20,000. That was the 11th straight month of gains and the longest streak in 23 years. Employment is growing at an annual rate of 2.7%in Australia compared with 1.4%in the US. According to CommSec, more than a quarter of a million jobs have been created in the past 6 months, “you have to go back 17 years to find a stronger result," The strength in the jobs numbers partly explains the recent rise in local bond yields and the Australian dollar .

Markets and Outlook

One of the big issues facing markets is the tightening of liquidity as Central bank quantitative easing (QE) programs begin to be unwound. As we write this we are one day away from a US Federal Reserve meeting which could announce the shrinking its $US4.2 trillion balance sheet. Right now we expect this be a gradual process and it is well anticipated by the market. However given the stronger recent economic data in Europe, we also expect the European Central Bank's (ECB) to announce tapering its QE programme in the near future (Chart 1).

Chart 1.

Central Bank Balance sheets will likely start to contract in late 2018 (USD Bn)



Source: Bloomberg, JPMAM, Assumptions: The Fed ends reinvestments starting in Q4 17. The BoJ taper to zero by early 2019; the BoE do not make any additional purchases; The ECB begin a 12 month taper in January 2018.

If this eventuates then we would expect that Central Bank balance sheet would be contracting in the second half of 2018. This would provide a headwind to both bonds and equities as debt would become more expensive. One thing that may moderate this rise in interest rates is the fact that inflation has stayed stubbornly low despite the efforts of Central Banks. For instance the US has had 5 CPI misses in a row. This has led to a lowering of expectations for interest rate hikes and has resulted in a weaker US dollar.

The benign global economy and a weaker US dollar has helped Emerging market equities to outperform other markets. Many managers now see Emerging markets as the best global equity bet. Historically this can change quite quickly as Emerging markets tend to attract hot money, much of it through ETFs.

Emerging market bond markets have also done very well lately as nominal bond yields averaging around 6% provide a significant positive yield above inflation. This is not the case for developed market bonds where many 'real' yields are negative. Bond yields have risen lately but we are still cautious about fixed interest, particularly in credit markets which have rallied a lot lately. We would remain underweight in fixed interest as longer term rates are likely to move higher from here. While we do not believe equities are cheap, they do provide your best risk/reward opportunity in current markets. There is still a chance that US tax cuts get passed which would be positive for equities.

The direction of the Australian dollar is difficult to predict from here. The US is only one rate rise away from having the same Cash rate as Australia which is negative for our dollar. However given how strong employment growth has been here it is possible the RBA could raise interest rates one or two times next year, obviously bullish for the local dollar.

Despite this we will continue to maintain our overweight allocation to Global equities if only for diversification purposes. The two sectors that tend to drive our market are resources and Financials. While resources look OK, it is a coin toss on the outlook for China. Financials or more specifically banks, look like they will struggle to generate much earnings growth from here given their large dependence on housing loans. Returns have been very good over the last year but we would expect returns to be lower going forward than we have experienced in the recent past given current valuations.

Investment Returns to 31 August 2017 (% p.a.)

Asset Class	1 month	3 months	1 Year	3 Years	5 Years
Australian Shares	0.71	0.87	9.79	5.13	10.56
Global Shares	1.04	-2.71	10.97	11.55	16.46
Listed Property	1.28	-3.67	-7.43	10.00	13.19
Fixed Interest	-0.01	-0.66	-0.66	3.90	4.16

Source: Mercer

Understanding Diversification

"Don't put all your eggs in one basket"

Diversification is a key investment principle used to manage some investment risk within a portfolio.

It is often described as "Don't put all your eggs in one basket".

To diversify an investment portfolio means to invest in a variety of assets and investments that perform differently to each other over time. It is often described as "don't put all your eggs in one basket".

You can diversify your portfolio in different ways. Examples of diversification include investing:

- Across a range of asset classes including 'growth assets" like shares and property and 'defensive' assets like fixed interest (bonds) and cash.
- Across different countries such as Australian and international assets.
- Across different securities that provide you access to a range of companies and sectors

The value of diversification

Diversification allows you to participate in the growth and performance of financial markets while reducing risk in your portfolio by moderating the ups and downs in returns over time. This means that you avoid taking big bets in one asset class and/or a few investments that may adversely affect your returns if it underperforms.

Diversification avoids having your investment fortunes tied to the performance of a small number of securities or assets. It also allows you to have an exposure to a spread of assets and securities including both 'growth' and 'defensive' assets.

Diversification provides a greater chance that your portfolio will experience smoother returns over time, particularly over shorter periods.

How diversification works

The key to diversification is to invest in assets that have different ups and downs in their returns from each other.

History has shown that no one asset class has consistently out-performed year after year. This is illustrated in the table below which shows the one year (to end December) returns from the various asset classes over the last 10 years.

The table below demonstrates that the underperforming asset class one year may be the better performing in the following year. For example, in 2015 (end December 2015) Australian shares underperformed the other growth asset classes but the next year (end December 2016) they were the second best performing asset class. This shows the risks of trying to invest in line with historical returns and demonstrates the value of diversification.

Having a mix of assets such as demonstrated by the balanced portfolio (shown in green) has historically allowed an investor to perform around the middle of the table in most years. That is, it shows that historically, a diversified portfolio of assets has allowed an investor to participate in good performing asset classes while reducing the risk of performing at the bottom of the table.

Effectiveness of diversification

Diversification can reduce the risk in your portfolio but it will not eliminate the risks.

Your portfolio is still likely to experience ups and downs in returns over time but with a lower level of variability. Your portfolio may have exposure to specific investments that perform poorly at times and you are unlikely to avoid investing in poor performing investments. When reviewing the effectiveness of diversification, you should consider the overall performance of your total portfolio.

The benefits of diversification will vary over different time periods. Historically in some periods when the broad financial markets decline, the effectiveness of diversification has reduced. Diversification should therefore be measured over medium to long term periods

Best annual returns

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Aust shares	Aust bonds	Aust shares	Global bonds	Aust bonds	Aust REITs	Global shares	Aust REITs	Aust REITs	Aust REITs
Cash	Global bonds	Balanced	Aust bonds	Global bonds	Aust shares	Balanced	Global shares	Global shares	Aust shares
Global bonds	Cash	Aust REITs	Cash	Cash	Balanced	Aust shares	Balanced	Balanced	Balanced
Balanced	Balanced	Global bonds	Balanced	Aust REITs	Global shares	Aust REITs	Global bonds	Global bonds	Global shares
Aust bonds		Cash	Aust shares	Balanced	Global bonds	Cash	Aust bonds	Aust shares	Global bonds
Global shares	Aust shares	Aust bonds	Aust REITs	Global shares	Aust bonds	Global bonds	Aust shares	Aust bonds	Aust bonds
Aust REITs	Aust REITs	Global shares	Global shares	Aust shares	Cash	Aust bonds	Cash	Cash	Cash

Worst annual returns

Note: Balanced fund assumed asset allocation is as follows: Australian shares (36%), A-REITs (7%), global shares (27%), Australian bonds (15%), global binds (10%), Cash (5%).

Indices used are as follows: Australian shares (S&P/ASX 300 Accumulation index), global shares (MSCI World ex Australia - unhedged Accumulation index, A-REITs (S&P/ASX 300 A-REIT Accumulation index), Australian bonds (Bloomberg AusBond Composite Index Yr +0 Accumulation index), global bonds (Barclays Global Aggregate Accumulation index - hedged), Cash (RBA Bank Accepted Bills 90 Days)

The importance of planning for aged care

Did you know...?

- At age 65, a person's chance of needing aged care during their lifetime is 68% for women and 48% for men
- Accommodation payments in regional areas and capital cities are not uncommon at $350,000-$550,000
- Planning before you need aged care can improve your financial situation and give you more choices and control

All too often we procrastinate over financial decisions and panic when the event occurs. Unfortunately, this procrastination can limit our financial planning opportunities.

This is an all too common scenario for aged care. A move into aged care usually happens in a hurry and with emotional turmoil but planning ahead can help to improve your situation and help to avoid family conflict.

You might be thinking about your own future needs, or you may be faced with making decisions for a parent or other elderly relative. Advice is a key element of these decisions. Aged care is a growing issue for many Australians and financial advice is important.

The costs for aged care are increasing and with an ageing population we all need to think more carefully about how we will be affected and how to access the help we need. Currently, more than two million people in Australia are aged 70 and over and approximately 45% of these will use aged care services.

The cost for Government is estimated to double by 2049/50 as a percentage of our economy (as measured by our Gross Domestic Product - GDP). This will be more money than the Government's budget for defence or education. The increasing cost of aged care is shown in graph 1.

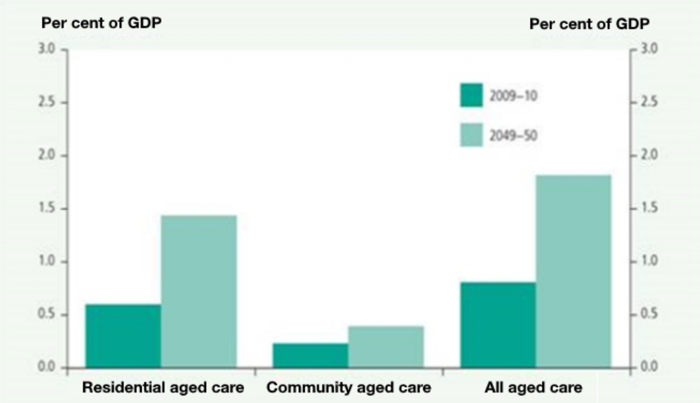
How you plan for aged care and the decisions made can have a significant impact on your lifestyle and comfort, your entitlement to the age pension and the fees paid to access aged care services.

Planning for aged care should commence early and continue throughout your retirement. The fees to enter a residential aged care service tend to be significant amounts that require careful planning ahead of time.

Thinking ahead can give you (or older relatives) lifestyle choices including:

- The chance to live in your own home to maintain your independence
- Strategies to reduce ongoing fees
- Options for funding the entry costs
- Strategies to invest other assets, and
- An understanding of the impact of decisions on age pension entitlements.

Graph 1



Source: Intergenerational Report, 2010

If planning your retirement or helping a family member deal with the challenges as they age, we can help you to navigate through the fees for aged care and the strategies to meet your family and estate planning circumstances.

For further information on aged care planning or any other planning issues, please contact your adviser.

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