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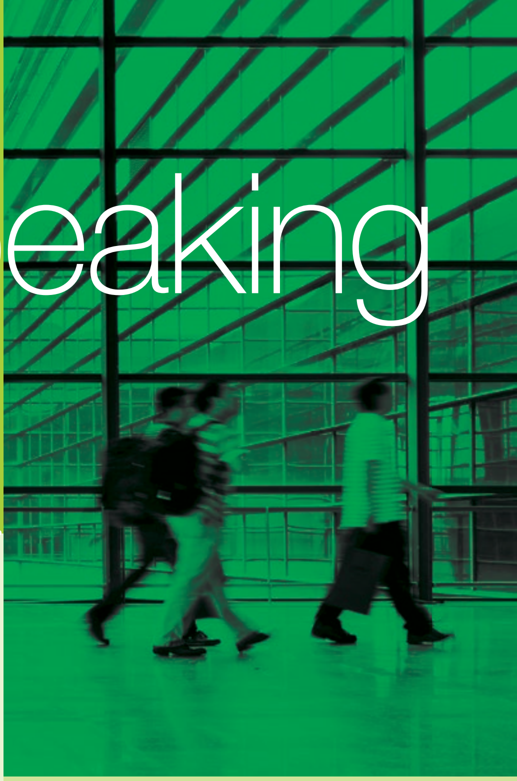

Balancing portfolios in an unbalanced world

Investors are constantly challenged to navigate through uncertainty. In the near-to-medium term, asset markets are keenly focused on the path of monetary policy and the potential headwinds that a reversal of unprecedented monetary easing could bring. At the same time, instability in Europe and the potential for a 'hard landing' in China cannot be ignored. We remain cautious around the outlook for share markets over the next few years given the macroeconomic backdrop.

Unwinding monetary distortion

G7 central banks have massively expanded their balance sheets and now collectively hold over US$17 trillion of assets – US$12 trillion of which is sovereign debt with negative yields. These unprecedented policy actions have created massive distortions in fixed income markets. These distortions have impacted all risk assets, including shares, by lowering yield and return expectations.

The process of unwinding global monetary stimulus is being led by the US Federal Reserve (Fed). The Fed started this process in October 2014 when it ended quantitative easing, followed by the first hike in US interest rates in December 2015. Macroeconomic conditions in the US are supportive of increases in US interest rates,

Inside this edition

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with inflation expected to move closer to its 2 per cent target. By contrast, the Bank of England and the European Central Bank have maintained their respective quantitative easing actions.

Tightening of monetary policy presents the greatest medium-term risk to asset markets. The unprecedented scale of monetary easing means the impact on share markets from policy reversal could be significant.

Complexities in Europe

The European economy continues to face significant challenges, ranging from political and social issues to systemic risks within the financial sector. The potential for major shocks in Europe presents a risk to world growth and asset markets.

The Brexit vote is likely to result in an extended period of uncertainty in the UK. The path to Brexit and the timing remain uncertain. A 'hard' Brexit scenario, where the UK leaves the single market, could trigger a sharp recession in the UK.

Risks of further political destabilisation in Europe are also on the horizon. People of The Netherlands are scheduled to go to the polls in March 2017, followed by the French in April/May and the Germans in September/October, all at a time when there is considerable angst among voters. Growing support for euro-sceptic parties leads to questions around European Union (EU) membership which could potentially destabilise the region. At present, it appears unlikely these parties will prevail in elections, but risks remain.

Systemic risks are centred on the Italian banking system. The country's book of non-performing loans is over €360 billion, or around 25 per cent of GDP. EU rules on bail outs make government-led bank recapitalisations problematic.

Risks of a hard landing in China

A hard landing in China poses a risk to global growth and could export deflationary pressures throughout the world economy. The key risks to China are the potential for a financial crisis or a rapid run on the renminbi. China has experienced a multi-year credit boom which has facilitated a massive oversupply in the property market. However, China's financial system is not dependent on external creditors and the central government has the capacity to deal with bad banking debts. Chinese authorities appear to have stabilised capital outflows which makes a collapse in the renminbi appear unlikely. A hard landing or financial crisis spawned out of China appears unlikely at present.

Risks of an exciting future

Macroeconomic drivers are highly relevant for markets over the medium term; however, over the longer term, technological change can have a profound effect on businesses. It is worth reflecting on the differing fortunes of Kodak, Nokia, Google and Apple as contrasting examples of the success and disruption that technological change can bring to individual businesses. We need to question whether we are entering a new technological and machine age over the next 10-25 years that may be more important than the industrial revolution. Prudent investors should keep one eye on central bankers and an even closer eye on how their portfolios are positioned for fundamental and disruptive change over the longer term.

Source: Magellan Asset Management Limited

To find out more about balancing your portfolio, please speak to your financial planner.

Learning the (investment) lessons from history

"History, is just one damned thing after another" said one sceptic. For investors, it's something else altogether. Studying history is a great way to learn to be a successful investor – and so improve your lifestyle.

Investment experts will remind you that past performance is no guarantee of future performance – and they're right. But the past does have lessons to teach. Looking back at the last 50 years of the Australian share market history, many important lessons can be learned.

Lesson:

'Chaos isn't the pit, chaos is the ladder'*

Over the past five decades the world has seen its share of chaos – wars, terrorism, economic crises, world-changing innovations and epochal elections.

However, it's important to look beyond the emotions surrounding such events – crises like the 1987 crash or September 11, or bonanzas like the 90s dot-com revolution and the resources boom of earlier this decade.

People become irrationally negative just as they become irrationally euphoric. If you take a long-term view when others are panicking, you can buy a business which is selling for well below its fundamental value.

*Game of Thrones

Lesson:

Bank on the balance sheet, not the banks

The balance sheet is the thing that stands between you and disaster. When times are good, markets throw caution to the wind and chase companies that have a lot of debt and so a lot of risk. You're better off future proofing your portfolio by buying companies with a good balance sheet.

You want to be holding businesses that have cash on their books and aren't dependent on the banks when things turn ugly. Banks are great at lending you an umbrella when it's dry. As soon as it starts raining they want it back again.

Lesson:

Be born in Australia

Warren Buffett famously said two of the big reasons for his success were compound returns and being born in the US. You can make the same argument for Australia.

Australia has been a great place to buy shares. Credit Suisse's Global Investment Yearbook tracks share market performance as far back as 1900. According to their research, Australia has been the world's second best source of real share market returns – generating an average, after-inflation return of 6.7 per cent a year over 116 years.

Source: Perpetual Investment Management Limited

To find out more about investment opportunities, please speak to your financial planner.

Trust your strategic plan but keep some powder dry

Oliver Cromwell, in the opening battle of the English civil war in 1642, is reported to have told his Roundhead troops, "Put your trust in God, my boys, but keep your powder dry." Or in today's common application, "Keep calm and take precautions so you can 'let rip' when the opportunity presents itself."

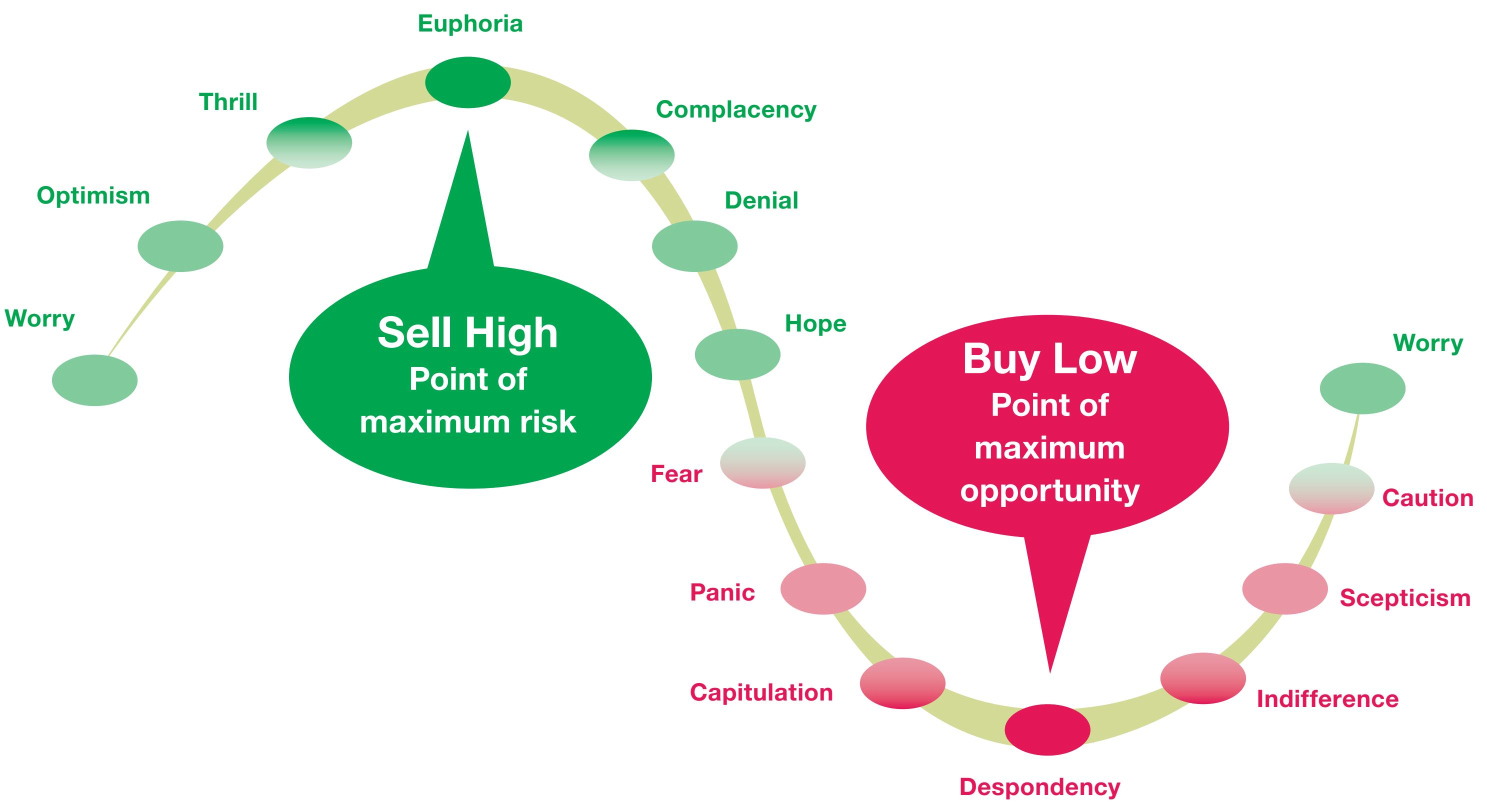
While today we are unlikely to be jumpy about the chances of being confronted by hordes of pike men, cannon balls and musketeers screaming toward us, in times of volatility, the principle remains generally the same. Keep your head, stay disciplined, address the bigger risks and get ready to act when needed.

Volatility is both a blessing and a curse. While very few enjoy a stomach-churning ride chasing returns, it is a fact of life that volatility also allows significant long term opportunities (or 'bargains') to be captured.

Of course, no-one would be so silly as to buy high and sell low, right? Especially because we know about a thing called the 'cycle of investor emotions'. However, the actual evidence of investor behaviour, both here and overseas, clearly shows the opposite – buying when the market is high and selling low.

The key problem with volatility is it pokes the emotional response mechanisms in human nature. Often this takes the form of "don't just stand there, do something!" The problem is, when markets have wild gyrations in very large ranges, without a clear overall trend direction, it is very easy to give in to your emotions, take big bets, and end up whip-sawed (a term used to mean getting 'run over' by a market reversal in a short period of time, before getting 'backed over' again as you exit just before the market finally moves your way).

In the present market, traditional asset classes look expensive, cash yields are low and getting lower, and the more you look around to generate returns the more you can be excused for feeling like one of Cromwell's Roundhead troops – under siege.



So let's take some sage advice from Mr. Cromwell
(on this point anyway... as he did, after all, end up being executed for high treason):

- **Keep your head and stay disciplined** – if a strategic investment plan has been well constructed, appropriately diversified, and built to survive through the ups and down of a full cycle, then trust it. If your strategy isn't like this, then fix it. Don't give in to emotional triggers for investment decisions, especially in times like the present.
- **Address the 'bigger' risks** – ensure your strategic portfolio is diversified, don't pay too much for assets and allow enough flexibility to make adjustments, capture emerging opportunities and address emerging risks.
- **Get ready to take action** – many traditional asset classes appear expensive at present, but this does not mean everything is expensive. Even in traditional asset classes like shares and fixed income, there are significant pockets where valuations are more reasonable, if not cheap. This is where it pays to keep a little powder dry, so you can put some money to work to capture long term opportunities if good assets get caught up in a broader sentiment-driven sell-off.

The bottom line – trust in a strategic investment plan.

If it's seen you through challenges before, it will likely do so again. To avoid getting whip-sawed, **stay reasonably close to your strategic asset allocation** – volatility increases uncertainty and, when most things are expensive and sentiment driven, don't stick your neck out too far. Finally, **stay flexible enough to capture value opportunities** when presented by market over-reactions.

This combination of strategic discipline and 'measured' opportunism is what is needed to keep on track for meeting long term goals.

Source: Russell Investments

Please speak to your financial planner about your investment strategies.

The case for industrial shares

The first question most people ask about investing in industrial shares is: why limit yourself to industrial shares in a country like Australia, one of the world's great resource producers? The answer is simple – industrial shares may provide higher levels of income, strong capital appreciation and lower volatility.

INDUSTRIALS VS RESOURCES

The choice between resources and industrials will depend upon your individual circumstances, goals, income needs, and so on.

Generally, resources can suit investors looking for higher growth exposure. Over the past decade, resource shares have exhibited more of what fund managers call 'growth characteristics' – simply put, the rise in their share price has been greater than that for industrials. However, those higher returns have come at the expense of increased volatility.

In fact, over the past 20 years, resources experienced volatility of 22% per annum1 compared to 13% per annum2 for industrials. Industrial shares have historically generated more consistent growth in capital and income.

If you are looking at industrial shares as an investment option, consider the following these four main factors:

1. Capital growth

Capital growth occurs when the value of an investment increases over time. Under normal conditions, movements in a company's share price should reflect changing expectations of its profits. When you invest in shares with growth characteristics you may be better able to protect the value of your capital.

The tendency of industrial shares to grow in value over time is one of their key attractions. Over the past 20 years, industrial shares returned 5.0 per cent per annum in capital growth alone (excluding dividend payments). The ability of industrial shares to grow their share price is linked to the successful growth strategies they pursue within their business – new product development, international expansion, entrance to new markets, and so on. These strategies underpin the sustainable capital growth of successful industrial companies.

2. Investing for income

The income you receive from direct shares is in the form of dividends. Dividends are paid out of a company's earnings. Dividends generally increase as a company grows.

Industrial companies have historically paid strong dividends, with a sector average yield of 5.1 per cent per annum. As industrials tend to operate in more predictable business sectors – banking, retail, manufacturing, etc. – their earnings are less cyclical and operations more flexible. This means they can prudently pay out a large portion of their earnings as dividends – particularly in comparison to resources.

Resource companies typically have very high capital expenses, such as equipment and machinery, and their profitability relies heavily upon the changing market price of the commodities they sell or use. As a result they are required to retain a large portion of earnings to provide a cushion against volatile market conditions. This naturally means they have less cash to pay out to shareholders.

CHART 1: HISTORICALLY INDUSTRIAL SHARES HAVE PAID STRONG DIVIDENDS
Historical dividend yields, June 2001 – June 2016

Source: FactSet

3. Tax-effective income

Not only are industrial shares a good source of income, they can also be very tax effective. This is because Australian share income is taxed favourably through what is called 'dividend imputation', also known as 'franking credits'. This means that if the company has already paid tax on its income, you may be eligible to receive a tax benefit for dividends received from that company. This is so tax isn't paid twice on the same income.

4. Protection against inflation

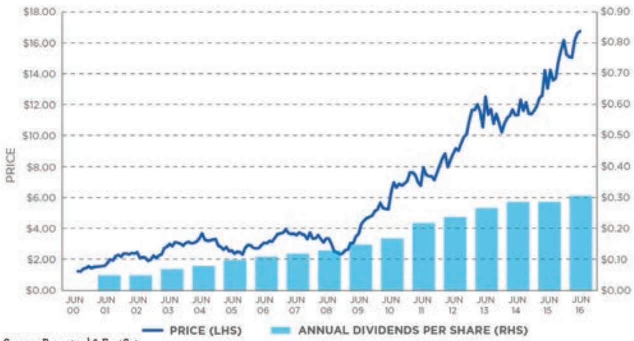
Inflation erodes your purchasing power and diminishes your real investment returns. So it's important that your investments provide protection against inflation.

Over the past 20 years, industrial shares have consistently generated both income and capital growth above the rate of inflation. This protection against inflation is one of the reasons industrial shares are often highly valuable to long-term investors – including those looking to fund their retirement.

Case Study 1 – ARB Corporation

ARB Corporation is Australia's largest manufacturer and distributor of 4x4 accessories. Having grown from a family garage in Melbourne, the company now has a large international presence and distributes its products to more than 100 countries around the globe. Management's unwavering focus on quality, product innovation and cost control has allowed the business to continually expand at a steady pace over time, maintaining consistently strong profit margins, earnings and cash flow.

CHART 2: ARB CORPORATION HAS PROVIDED STRONG EARNINGS AND DIVIDENDS GROWTH
Share price vs dividends per share, June 2000 – June 2016



Source: Perpetual & FactSet

Case Study 2 – Reece Australia

Harold Reece opened the first Reece plumbing hardware store in 1920. Today, the company has over 570 branches throughout Australia and New Zealand and has become a household name in bathroom supplies. The company has a long history of successful store roll-outs and expansion into new product lines.

Supported by a strong brand name and a reputation for quality, Reece have built a dominant position in their market. As evidence of this, Reece has delivered earnings growth of 15 per cent per annum since 1996. This earnings growth is reflected in the long-term rise in its share price, as reflected in the chart below.

CHART 3: REECE INVESTORS HAVE ENJOYED SHARE PRICE RISE OVER THE LONG TERM
Share price vs dividends per share, June 1996 to June 2016

Source: Perpetual & FactSet

How does an industrial share fund fit into a balanced portfolio?

Over the past 20 years, Australian industrial shares have delivered income and capital growth at levels that have comfortably beat inflation at a level of volatility or risk that is lower than both resource shares and the overall Australian market.

Every investor has different needs for income and growth, a unique tax situation, and a personal risk tolerance. When making investment decisions, these factors need to be considered.

1 Annualised volatility of historical monthly returns of the S&P/ASX 300 Resources Price Index from 30 June 1996 to 30 June 2016.

2 Annualised volatility of historical monthly returns of the S&P/ASX 300 Industrials Price Index from 30 June 1996 to 30 June 2016.

3 Annualised return of the S&P/ASX 300 Industrials Price Index from 30 June 1996 to 30 June 2016.

4 Average dividend yield of S&P/ASX 300 Industrials Accumulation Index from June 2001 to June 2016.

Source: Perpetual

To find out more about the benefits that industrial share funds can offer, talk to your financial planner.

What is global listed infrastructure?

Amidst the current climate of bond yields at historic lows and unpredictable share markets, there is a growing interest in the return profile and investment characteristics of infrastructure assets. As a separate asset class, infrastructure can offer an attractive income stream with long-term capital appreciation from monopolistic assets.

Infrastructure assets provide essential services that serve communities around the world. These include assets such as airports, rail, roads, electricity transmission and gas pipelines. All of these assets are required for economies to function and prosper. Irrespective of whether markets are in a boom or a bust phase, the revenues of many of these assets remain relatively stable. People interact with these services every day, as their demand for water, gas and electricity remains relatively constant. Importantly for investors, infrastructure assets are mostly long-dated, monopolistic assets that have historically provided stable and inflation-protected returns.

Infrastructure assets are either regulated or user-pay, based on long-term concession agreements. All have the common characteristics of long duration assets - high capital costs, high barriers to entry and provide an essential service to society. As a relatively new asset class, indices for infrastructure are fairly rudimentary which has created an opportunity for specialist managers to add value through active management.

Types of infrastructure assets

Regulated infrastructure assets

Some infrastructure assets, namely water, gas, and electricity, are regulated, usually by an independent government body. The role of the regulator is to provide a balance between protecting the users of these assets (the public) and the return a company can earn. The regulator must allow the company enough return to maintain the assets and compensate investors for making capital available. For instance, if the costs of maintaining the asset increases, such as due to inflation or a rising cost of capital, the regulator will generally allow a company to pass on these costs to users. This mechanism can lead to stable cash flows for a business, which is reasonably predictable, well into the future. These assets, therefore, can offer investors consistent growing yields over time and protection against long-term inflation. Spark Infrastructure, an Australian company that owns regulated electricity networks, is a prime example of a company who owns and operates regulated electricity assets.

User-pay infrastructure assets

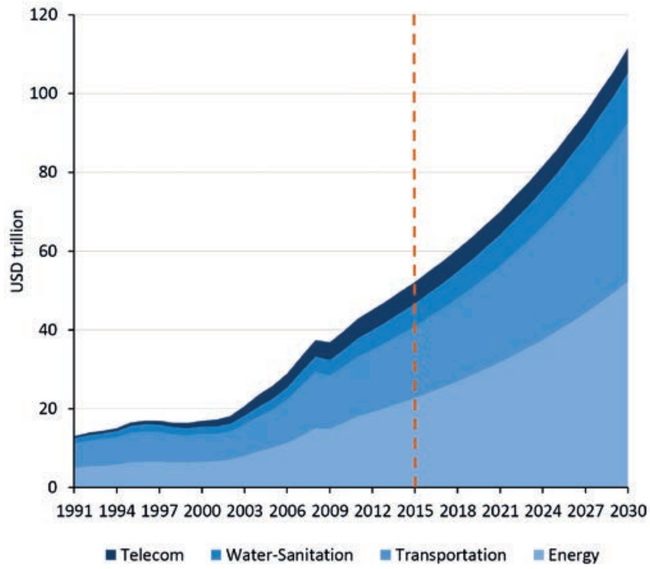
User-pay assets are where the revenues depend on how many people use the asset. Examples of user-pay assets are toll roads, seaports, rail and communication assets. The majority of user-pay assets have long-dated contractual arrangements, usually with local or national governments. As revenue from these assets often closely correlate to the economic activity of a particular region. As economies grow, so does the demand for additional infrastructure services. For instance, this demand directly affects the usage of road networks as trucks and cars increase their usage of toll roads and rail networks as additional freight is transported around the economy.

Expected growth of infrastructure assets

The opportunity for investors is that the global infrastructure market is estimated to grow by 124 per cent, to US$110 trillion by 2030 as per the table opposite.

In the developed markets, investment in existing and aging infrastructure is required to meet the future needs of these communities. In emerging markets, the need is quite different as new infrastructure is required to meet the demand of major structural drivers culminating from strong growing

Value of Global Infratructure Assets by Sector



Source: David Hale Global Economics (2014) and RARE

economies. This stuctural shift may present significant opportunities for investors to capture additional value. The majority of global infrastructure assets, however, remains within public ownership and as such is not available to private investors. With pressure on government fiscal spending increasing, infrastructure assets are increasingly transferring into private ownership through unlisted or listed markets providing opportunities to expand the universe of investments available in this asset class.

Source: RARE Infrastructure

Ask your financial planner about investing in infrastructure assets.

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