POINTS OF **INTEREST**

Issue 29

Summer 2020

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we review the major economic and financial events of the past year and look ahead to what 2020 may bring investors.

EXECUTIVE **SUMMARY**

- **Despite a weak performance in the final three months of 2019, the stock market performed strongly over the past year, with the benchmark ASX 200 Index increasing by 20.27% over the 12 months ended 31 December 2019.**
- **Despite ongoing geo-political concerns, equity markets around the world remain buoyed by supportive monetary policy and a diminishing lack of alternatives for investors.**
- **We expect 2020 to remain susceptible to geo-political issues, although monetary policy is likely to continue to push investors toward higher risk assets.**

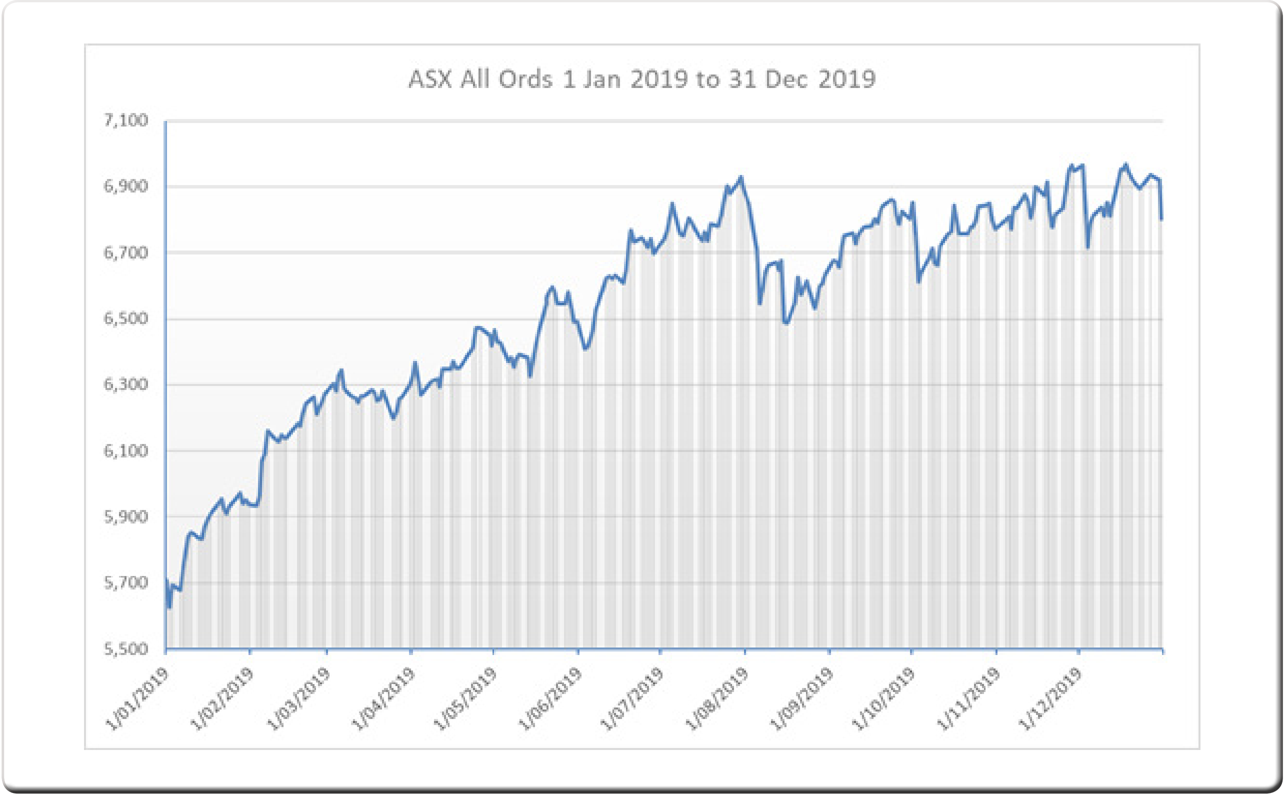
The best year since 2009

Despite a weak final quarter, 2019 saw the Australian stock market generate the highest annual return since 2009, no doubt a very pleasing outcome for investors.

We begin this newsletter with a review of the exceptional growth of the Australian stock market during 2019, which saw the benchmark ASX 200 Index increase by 20.27% over the year. For historians, only 2009 bettered last year's return and that was largely based on the recovery from the steep losses incurred during the Global Financial Crisis.

2019 was a year in which a rising tide lifted (nearly) all boats. With one notable exception (the much maligned and much discredited banking sector), strong returns were generated across all sectors of the economy, ranging from healthcare to mining to telecommunications and even the struggling retail sector. To be fair, a significant proportion of 2019's growth simply reflects the recovery from the sharp falls experienced during the last quarter of 2018, however there was still substantial growth over and above the losses recovered from the previous year.

The chart below shows the growth of the ASX All Ordinaries Index over the course of 2019, with a significant increase in the seven months leading up to the end of July. The second half of the year was more subdued, with a minor fall in the last few trading days of the year, which capped off a weak final quarter, with the ASX 200 Index in fact falling 4 points over the three months ended 31 December.



To provide an illustration of the magnitude of investment returns, as well as the wide range of sectors which enjoyed strong returns, the table below lists a number of the most commonly held shares, showing their total return (capital growth plus dividends) for 2019:

Company	Total return 2019
CSL Limited	50.72%
Wesfarmers Ltd	39.42%
Resmed Inc.	38.95%
QBE Insurance Group	33.79%
Telstra Corporation	30.81%
Ramsay Healthcare	28.63%
Woolworths Ltd	26.87%
BHP Group Ltd	25.15%

From an investment manager's perspective, it has been many years since we have witnessed such strong growth across so many varied companies and sectors. It is seldom the case that one could expect large companies such as CSL, BHP or Woolworths to generate annual returns over 25%. Conventional wisdom says that such large companies, operating in mature industries, are not expected to generate the rates of return achieved during 2019; after all, did CSL's profits increase by 50% during 2019? Did Woolworths increase its sales by 26%? In both cases, the answer is a resounding no. Despite both companies being examples of well-run businesses (if we conveniently forget the Woolworths' management-led disaster with the Masters hardware foray), with robust business models, there is little relationship between the share price growth and the companies' operating performance during 2019. Which naturally leads to the question, why were returns so high during 2019, particularly for those larger companies with mature business models?

Central banks and interest rates

The answer to that question leads us to what is certainly the most talked about issue in financial circles, the role of central banks and the existing environment of ultra-low interest rates. The two go hand in hand of course, as it is central banks which set the level of interest rates in most economies, and certainly in those which matter. It is the direct outcome of policy decisions by central banks around the world to which stock market investors owe their good fortune. Savers and self-funded retirees in particular, would be keenly aware of the direction of interest rates over the past decade, with the RBA cash rate falling from a decade high of 4.75% in October 2011, to the current historical low rate of just 0.75% (and expected to go lower still).

The impact on the traditional approach to managing one's savings, term deposits, has been as expected, with the average 12-month term deposit rate falling from 6.15% in January 2011, to a very miserly 1.25% in December 2019. To put those figures into perspective, nine years ago a retiree with a million dollars in a 12-month term deposit was earning $61,500 per year in interest. That same retiree is now earning just $12,500 per year. That equates to a reduction in income of nearly 80%. Imagine an employee being asked to accept an 80% wage cut and still being able to meet their living costs. That is effectively the arrangement which the Reserve Bank expects savers and self-funded retirees to accept.

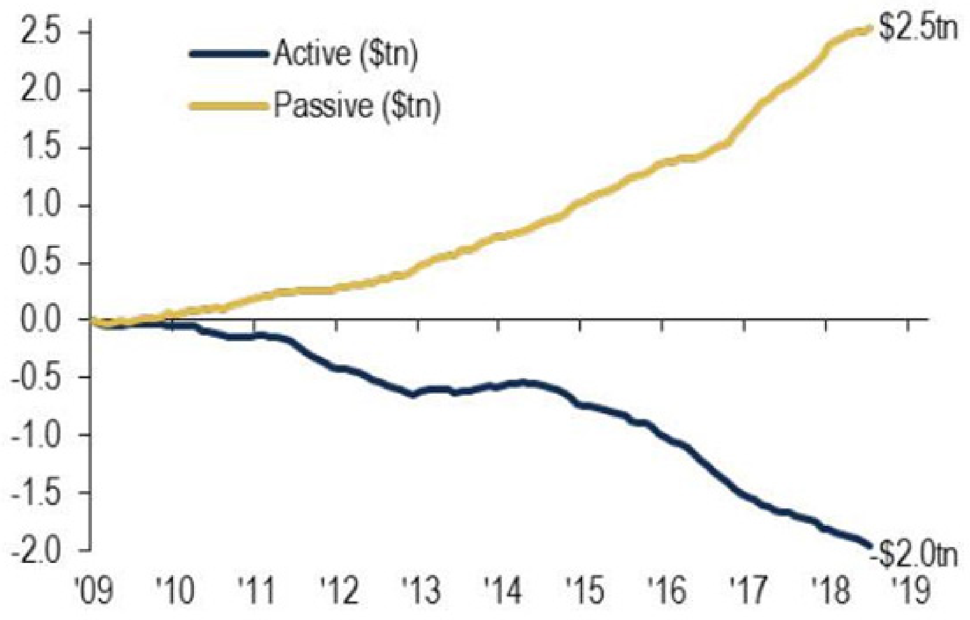
In the face of such unacceptably low returns, the normal (and wholly justifiable) response of people in that situation has been to look for higher returns elsewhere. And in many cases, a significant proportion of that money looking for a new home has ended up in the stock market. The stock market being what it is, simply a measure of supply and demand, additional money flowing into the market has a positive impact on share prices – when there are more buyers than sellers, prices must go up. At this stage another factor comes into play – the trend towards passive index investing.

The rise of passive investing

At its simplest, passive investing involves allocating money to those investments which simply aim to track a particular index or benchmark, with little or no consideration given to selecting specific investments. For example, an investor might invest in an ASX 200 Index Exchange Traded Fund, which replicates the return of the entire index. Effectively the investor owns a little bit of every company listed on the exchange, the large ones, the small ones, the good ones and the bad ones. The opposite of this approach is active investing, where the investor (or their adviser or a fund manager) exercises their discretion in choosing which specific investments they wish to own. For example, rather than invest in a product which replicates the entire stock market, you might choose 20 or 30 companies which you believe to have superior prospects when compared to the many other listed companies. Or, you might prefer to avoid companies which run businesses that do not fit your ethical views, such as gaming or tobacco companies, in which case you would adopt an active approach to avoiding those investments.

The chart below shows the increasing role that passive investing has had on global stock markets over the past ten years, with a net $2.5 trillion dollars (US) being invested through passive products, as compared to the withdrawal of around $2 trillion dollars from active products (largely represented by your typical equities fund manager) over the same time.

Chart 3: Active vs. Passive equity flows since 2009



Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

The relative merits of passive vs. active investing have been hotly debated for many years and we will not relive that discussion here. That said, an important flaw in passive investing is that it has a tendency to add fuel to the fire in a rising market. This stems from the characteristic of passive investments to invest regardless of price. That is, if a company's share price is increasing, it will tend to attract additional investment as more money is contributed through passive investments. The fact that the share price may have reached extreme levels, where most rational investors would consider it to be significantly overvalued, is not taken into consideration in passive investing and an even greater proportion of future funds invested through passive investing will be allocated to the investment. This compares to a fund manager, for example, who would recognise that a particular share might have reached an overvalued level and would refrain from making further investments until the share price returned to a level which was justified by the fundamentals (such as revenue, profits and other measurable variables). While this is a serious flaw, passive investing has increased in popularity for a number of reasons, chiefly being its low cost (there's no need to employ expensive fund managers or analysts, a computer can do all of their jobs) and the fact that many fund managers do not produce returns which justify their fees. As a result, the use of passive investing is expected to continue, particularly if markets continue to rise (there is an argument that passive investors will disproportionately suffer in the next market crash, which will of course be known only in hindsight).

Low interest rates and passive investing

To return to the discussion of the interaction of interest rates and passive investing: in essence, low interest rates have contrived to push a wall of money towards the stock market as savers withdraw their cash from the banks in search of higher returns. A significant proportion of this money ends up invested through various passive investment products and voila, stock markets go up, regardless of the underlying fundamentals, both on a whole of economy basis, and on the individual company level. That is how, in an economy which is growing at only around 3.00% per year, and with grocery and liquor sales increasing by only around the same level, Woolworths' share price managed to increase by nearly 23% last year.

The issue confronting investors is that neither of these influences, low interest rates and the rise of passive investing, are expected to reverse course any time soon. Both factors can be expected to support share prices (i.e. push them higher) for some time to come. Investors that chose to remain on the sidelines, fully aware of the artificial nature of current stock market returns, risk missing out on potentially many years of positive returns. In the words of former Citigroup CEO Chuck Prince, '…as long as the music is playing, you've got to get up and dance'. At the moment the music is playing loud and clear, when will it stop is anyone's guess.

> ***"…as long as the music is playing, you've got to get up and dance."***

Looking ahead to 2020

If 2019 was the year of low interest rates, passive investing and geo-political events, it is hard to see 2020 being any different. Certainly, there is little expectation that interest rates will return to levels which provide savers with a reasonable return on their investment. The general consensus is that interest rates will remain at current levels, with some even holding the view that additional cuts are likely through 2020. Such an action would only exacerbate the flow of money seeking refuge in the higher yielding (but higher risk) stock market. The key indicator to watch in regard to interest rates is the inflation rate, which in turn is highly susceptible to wages growth. At the moment, with a relatively weak labour market, growth in wages remains subdued, with employers not compelled to compete for willing staff. Low wage growth in turn tends to have a deflationary effect on prices as households either have little free funds for spending or direct their excess savings toward debt reduction.

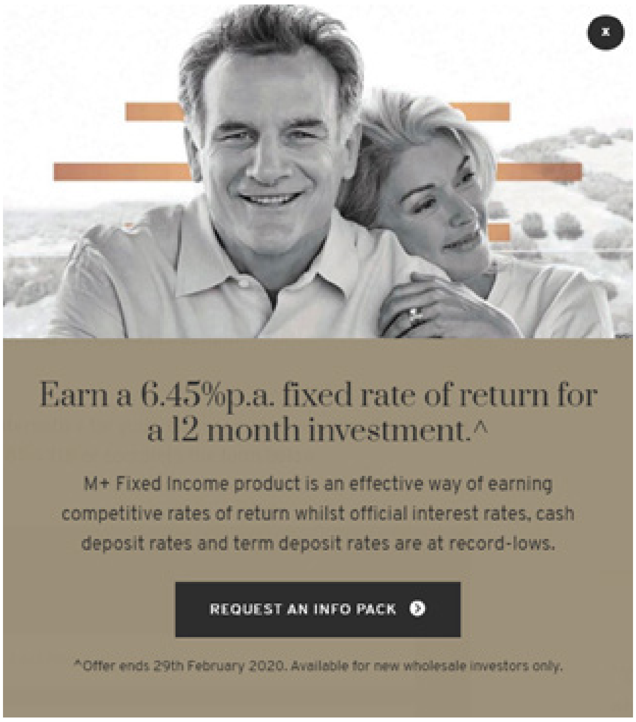
Without a meaningful increase in inflation, the Reserve Bank can be expected to keep interest rates at their current low levels, which will continue to provide support for the stock market. That is not to say that a stock market correction cannot occur – at current levels the stock market is undeniably expensive and is vulnerable to a change in sentiment, low interest rates and the 'search for yield' notwithstanding. Over the longer term however, current monetary settings should continue to encourage cash inflows into stock market investments.

'Funny' money

Related to interest rates is another issue which may become more prominent during 2020. This is the proliferation of investments which are both opaque and complex, yet also cleverly marketed and deceptively promoted. What we refer to as 'funny money', this represents a wide range of investments which purport to offer investors a safe and attractive return, but provide very little detail (to the uninitiated) as to exactly how this 'safe' return would be achieved. Invariably, further investigations reveal that the money would be invested in an esoteric range of 'investments': private loans to related companies; unsecured funding for unspecific operational activities (usually code for paying the directors and management over-inflated salaries); mezzanine financing; high risk unsecured low-doc mortgage loans; complex leveraged investment vehicles and even outright Ponzi schemes.

As an example, readers may have seen one of the many advertisements placed by a particular investment firm, promising returns which seem very attractive. The image on the right is just one of the numerous advertisements which flooded national newspapers, major websites and social media in recent months.

Sounds enticing, doesn't it? An annual return of 6.45% for a 12-month investment, when a term deposit at your local bank branch might be offered at just 1.25%.



The difference is that the term deposit is government-guaranteed, with no risk of loss (barring the unlikely collapse of the government), while the seemingly attractive 6.45% product provides little detail on how the funds are invested and relies on slick marketing to convince investors to buy in. As it happens, money invested in this particular product is then on-lent to the managing company, where it has been used to make somewhat questionable investments into a range of related private companies, assets such as Dunk Island in northern Queensland and a host of businesses apparently involved in some form of cryptocurrency activities. Rather than being an alternative to term deposits and bank accounts, what we have is a highly speculative, high risk investment with almost no transparency, which will almost certainly end in significant losses for investors. And this particular product is really just the tip of the iceberg as regards the proliferation of overly complex products which are unfortunately attracting significant investment from people who most likely have little idea of the true risks involved.

Elections, trade wars and other events (again)

The other issues we expect to dominate financial markets are the usual suspects: the US Presidential election in November; the ongoing trade spat between the United States and much of the rest of the world, but principally China; the resolution (maybe) of Brexit, one way or another; and the usual list of domestic political issues (it has been nearly a year since the election of Australia's current Prime Minister, so going by recent history we should expect a new one sometime towards the end of 2020).

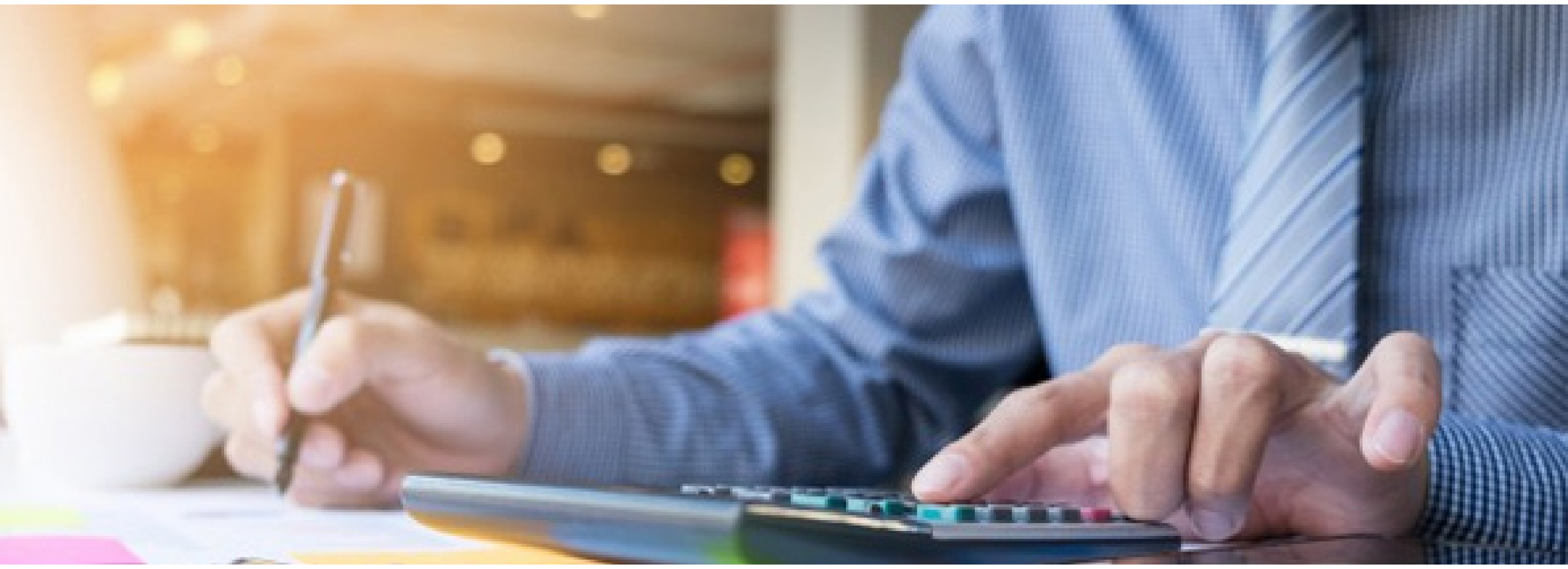
These issues can be expected to impact markets all through the year, with potentially both positive and negative results. As investment managers we take note and certainly consider the impact of such events on markets and ultimately portfolio returns, however we recognise that accurately predicting the outcome is in most cases impossible. A robust investment strategy which adheres to the principles of diversification and risk management is the most useful tool when faced with such uncertainty.

A note on current portfolio holdings

Clients may have noticed that in certain situations, the cash component of their portfolios have increased considerably in recent months. There are a number of explanations for this increase in cash. Firstly, the end of 2019 saw the redemption of a number of fixed interest securities which had been held in many portfolios for a considerable number of years. In this instance, the issuing entities always held the option to redeem the investments for their full face value, with the proceeds paid back to investors as cash.

The other source of increased cash is related to the mortgage investments which we have used in many portfolios for nearly two decades. Late last year the company which manages the mortgage investments, Australian Securities Limited, notified us that as a result of an internal business decision, they would no longer accept any mortgage investment which was less than $50,000. This was a significant change from the previous arrangement, where there was no minimum investment amount. From our perspective, the change to a $50,000 minimum investment was problematic, as there were few circumstances where we would be comfortable with individual mortgage investments of such magnitude, given our emphasis on maintaining an adequate level of diversification in client portfolios and our focus on risk management. As such, in nearly all cases, existing mortgage investments will be repaid over the remainder of the year, with the proceeds credited to the portfolio Cash Management Accounts.

In both instances, the fixed interest securities and the mortgage investments, we are actively reviewing our investment options. We are acutely aware of the low returns offered on cash, yet we recognise that, as discussed earlier, in attempting to generate higher returns one must be careful of not taking on excessive risks. We are in discussions with a large financial organisation who offer a similar mortgage investment product, which may suit our desire for a non-market linked investment with reasonable security and an appropriate return. We are also actively reviewing a number of other investments which seem likely to meet our stringent investment criteria and we hope to convey our recommendations, where appropriate, in due course. Of course, as always, should you have any queries regarding the composition of your investment portfolios or our intentions in regard to individual assets or securities, please do not hesitate to contact us.



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We hope you have enjoyed this edition of our quarterly newsletter and wish all of our clients and their families a happy, safe and prosperous New Year. As always, should you have any queries, questions or feedback, please do not hesitate to contact us.

With kind regards,

Justin, Ray & Michelle

FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate (annual)	1.6% (Jun)	+0.3%
Australian unemployment rate	5.2% (Nov)	-0.1%
RBA Cash rate	0.75% (Dec meeting)	-0.25%
ASX 200 Index	6,684	-4 points
Australian $ vs. US $	$0.7006	+2.57c
Australian $ vs. UK £	$0.5340	-1.48c
Australian $ vs. Euro €	$0.6254	+0.83c

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