Welcome to the political circus

30 June 2016

June 2016 Quarter

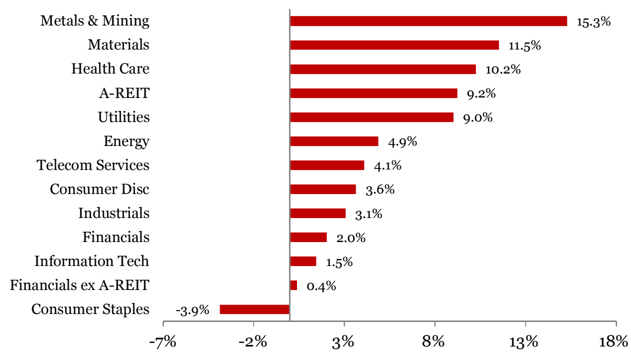
The June quarter saw shares recover from the losses in the March quarter as commodity prices rebounded in April and market sentiment improved. However, global markets were hit in the second half of June when Britain narrowly voted in a referendum to leave the European Union. The markets initially panicked based on fears of a recession in the UK and a downgrade to the UK's credit rating, but have since recovered.

The median untaxed growth fund returned 2.8% and the median untaxed conservative fund returned 2.1% for the quarter, according to Morningstar data. Over the financial year to 30 June 2016 the median growth fund returned 1.8% and the median conservative fund 3.7%.

The Australian shares market performed strongly during April and May, returning 3.3% and 3.1% respectively. However, political uncertainty during June, both in the US and Europe, weighed on the economic outlook to finish the month -2.4%, and 4.0% for the quarter.

Within the Australian shares market, the Metals & Mining (+15.3%) and Materials (+11.5%) sectors delivered strong returns, reversing the trend from 2015. The Health Care (+10.2%) and A-REIT (+9.2%) sectors also performed well over the quarter. The Consumer Staples (-3.9%) sector trailed the market due to concerns around price deflation and weaker fresh food prices.

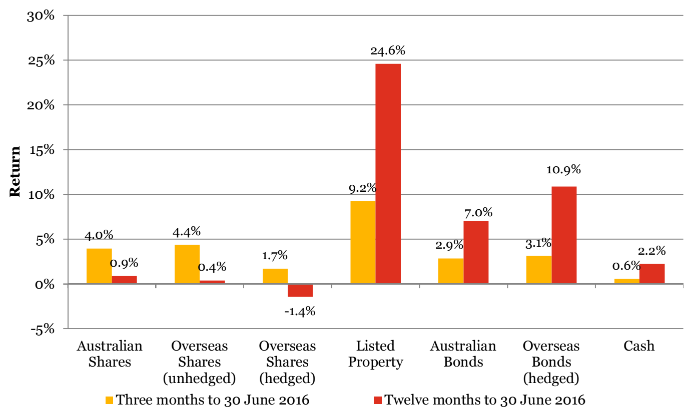
ASX Sector Returns – June quarter



Overseas shares started the quarter strongly, posting returns of +2.4% and +6.0% for April and May respectively. However, markets fell in June, returning -3.8% for the month and 4.4% on an unhedged basis for the quarter.

US shares gained 2.4% over the quarter in anticipation of better than expected jobs growth announcement in June after a disappointing payroll report in May. The renewed confidence in the US economy has led to more optimism that the Federal Reserve would increase interest rates again despite ongoing concerns surrounding Britain's decision to leave the EU in June. Confidence was also boosted by positive results from stress tests carried out on US banks that indicated that most banks were well-capitalised and financially stable.

Asset Class Returns – June quarter



1. *All market returns shown above are before tax and before investment costs.*
2. *Indices used are outlined in the Disclaimer section of this newsletter.*

The Japanese equity market fell again this quarter, returning -7.8%. The yen has strengthened almost 20% against the US dollar this year, hurting exports and forcing the Bank of Japan to consider additional rounds of stimulus.

The European equity market returned -1.1%, while the UK market returned +6.7%, with most of the gains made in June. European markets were weighed down by bad loans particularly in the Italian banking sector, and the fall-out from Britain's decision to leave the EU. Emerging market equities returned +0.7% (MSCI EM Index) for the quarter.

China's equity market (based on the MSCI China Index) posted a +0.1% return over the quarter. Slowing manufacturing activity weighed on the Chinese economy due to weaker demand and industrial overcapacity.

June 2016 Financial Year

Commodity prices have been on a rollercoaster ride since mid-2014 reaching levels as low as US$30 a barrel of oil earlier this year. They have since recovered to aboutUS$48 a barrel at the end of June indicating that we may be on the way up from the bottom of the cycle for commodity prices.

US equities posted returns of +2.5% over the financial year while commodity price volatility had a greater impact on Australian equities which returned +0.9% for the year.

Within the Australian equity market, Energy was the worst performing sector returning -21.8% over the year, with most of the losses suffered in the first quarter to September, while A-REIT performed strongly, returning +24.6% over the same period.

Looking overseas, the Chinese and Japanese equity markets returned -23.3% and -23.7% respectively. Despite the turmoil of Brexit late June, European and UK equities fared much better, returning -9.6% and 3.4% respectively.

Since 30 June 2016

Equity markets and commodity prices have continued their recovery from the Brexit decision in June and commodity price lows earlier this year. Australian equities returned +2.4% over the first two weeks into July, while overseas equities returned -0.1%. Within the Australian equity market, Metals & Mining was the strongest sector, returning 11.1% to July 12.

Outlook

We believe that the major asset classes are broadly at fair value, and on this basis we do not see a need for clients to deviate from their long term asset allocations.

Some key issues going forward include:

- **Brexit** – 52% of British voters voted in a referendum to leave the EU in June. The results came as a surprise to most, and financial markets were thrown into turmoil in the days following the decision. The process of exiting the EU is likely to take several years to negotiate and finalise.
- **US Election** – The 2016 Presidential Election is going to be a showdown between Hillary Clinton and Donald Trump. Both Clinton and Trump have struggled to gain support within their own parties. However, whoever gets elected to the White House will be a first for the United States, whether it be the first female or the first person who hasn't previously held public office or a senior military position.
- **Australian Election** – After almost a week of counting votes, the Liberal/National coalition narrowly defeated the Labor opposition in the national elections. Prime Minister Malcolm Turnbull now faces challenging times ahead as smaller parties and independents who saw greater voter support in the elections could cause gridlock in Canberra.

So your asset consultant became an investment manager, what now?

Over the last few years, implemented consulting products have become a lot more popular. Most of the major asset consultants now offer these products and they are rapidly gathering significant funds under management. Traditionally, an asset consultant would provide independent advice to organisations on investment strategy and asset allocations, and assist the organisation in appointing appropriate external investment managers. The asset consultant would also monitor the performance of the investment managers and the overall Fund, and report to the Trustee.

Many asset owners are becoming less willing to devote resources and money to managing their investments, so a single packaged solution that requires minimal Board involvement looks very attractive. The implemented consultants also offer specialised solutions like ESG, tax-effective investing and smart-beta, plus access to asset classes like unlisted property, infrastructure and other alternatives that are not normally available to small investors. Finally, the implemented consultants are reducing prices as they get bigger and as competition for new business increases. We see this trend continuing as other players (e.g. wealth managers) come into the implemented consulting market.

The Board sets the overall investment strategy and is invested with only one organisation, the implemented consultant. The implemented consultant can appoint, monitor and terminate investment managers within unit trust structures. The implemented consultant also assists the Board by providing ongoing strategy and asset allocation advice.

There are many benefits to this structure, but there are also a couple of potential conflicts. The first is that the implemented consultant generally charges an all-inclusive fee that includes the cost of the underlying managers plus the profit margin of the implemented consultant. Therefore, the implemented consultant can face a trade-off between a more complex and higher-cost investment program that would benefit the client in the long term, at the expense of its own profits. There is also an issue when some of the assets are managed in-house, and the decision to include or retain that asset needs to be done in the best interests of the clients and independently of the financial considerations for the parent organisation.

The second potential issue relates to governance and the fact that the implemented consultant is no longer an independent advisor.

Helen Rowell, Deputy Chairman of APRA, noted at the AFR Banking & Wealth Summit in April 2015 that while many trustees proactively look at ways to enhance their investment governance practices, some are "over-reliant on service providers or have significant weaknesses in their investment governance and investment risk management frameworks." APRA requires that the person measuring the performance is operationally independent of the person generating the performance. In an implemented consulting arrangement, the separation of duties is not so clear cut. The implemented consultant has delegated authority in appointing managers, and is also responsible for monitoring the performance of the underlying managers and reporting these results to the Trustee.

The risk, as pointed out by Helen Rowell, is that organisations have delegated too much authority to their implemented consultants and without another layer of independent oversight, cannot be sure that they are receiving unbiased and independent advice.

As part of good investment governance, organisations should at the very least set up a process to review their implemented consultants on a periodic basis to ensure that the advice provided is independent and objective.

Brexit – Better trade for Australia

No doubt by now you've seen many articles relating to the British Referendum, where the British public made the momentous decision to leave the European Union.

It would seem some British politicians took "leave" quite literally. Prime Minister David Cameron resigned from his role, stating "the country requires fresh leadership to take it in this direction." Boris Johnson, the Mayor of London and pro-leave campaigner, who seemed to be a suitable replacement, surprised the British public by saying he will not put himself forward for the PM role. Nigel Farage, leader of the United Kingdom Independence Party (UKIP), after spending 10 years pushing for the UK to leave the EU, resigned as leader of UKIP, stating his "political ambition has been achieved".

There is a clear reluctance by the country's leaders to be the person that triggers Article 50 (clause within the Treaty of Lisbon stating how a country can leave the union) without having a well thought out plan. This clause has never been triggered before in the EU's 59 years history, and as such the process for exiting the union is likely to be a long and drawn out process.

A clear issue for the British public and pro-leave voters was immigration and the free movement of people within the EU. Mr Gove (UK MP) would like to have a points-based immigration system, similar to what is currently operating in Australia.

Being a member of the EU comes with many trade agreements which are aimed to benefit those within Europe, and can hinder trade with non-European countries. For example, during the 1960's and early 1970's the UK and Australia had strong trade relartionships, particularly around farm produce such as Tasmanian apples. However, after joining the EU common market the UK imported apples mainly from Europe.

Brexit has the potential to reopen bilateral trade agreements with Australia, but also other countries which Britain previously had strong ties with e.g. India, and the opportunity to increase trading with developing economies outside of the EU. Australia has recently started negotiations on a Free Trade Agreement with the EU. Free Trade Agreements with both the EU and England will be a boost for Australian exporters in the future.

The rise of the angry voter

The following article is an opinion piece and does not reflect the views of PwC. Credit is due to Leigh Sales, ABC journalist, for many of the original ideas.

A number of events recently have seen the 'average' voter start to fight back against the mainstream parties and the political elites. The average voter feels abandoned by the economic and political class, and wants his or her opinions to be heard. Populist politicians are taking votes from the mainstream parties, with a rejection of some of the key policies of the last twenty years – like globalisation, free-trade, immigration and economic rationalism.

The successes of Donald Trump and Bernie Sanders, the results of the Australian election, the re-emergence of Pauline Hanson, Nick Xenophon, and the 'Brexit' vote are all examples of voters rebelling against the political mainstream.

Donald Trump talks of building a wall between the US and Mexico and he gets roundly criticised. Despite the obvious impracticalities, these types of comments resonate with an American middle class that has lost a lot of jobs to cheaper emerging markets and whose wages have not increased in real terms for the past 20 years.

According to Bernard Salt, a commentator on demographic issues, Generation X is becoming the pissed-off generation - "Boomers got the Pill, free love, free education and easy jobs. Generation X got AIDS, HECS and the GFC."

Meanwhile, house prices have risen 140% in the last ten years and many young Australians either have large mortgages or have been unable to enter the property market. Demographers tell us that we are all going to live longer and will need to save more for retirement. Most young people now believe that they will not be able to rely on the pension in retirement as their parents and grandparents did, and they will have to save for their own retirement. Job security is declining and large companies think nothing of 'right-sizing' (i.e. getting rid of a few hundred workers) at the drop of a hat.

Inequality is also rising. Over the last 20 years the economic gains from rising productivity have largely gone to high income earners and corporate profits, and not to the ordinary worker.

Is it any wonder that voters are angry?

Anger

There is increasing anger towards politicians and a view that government is letting us down. The electorate sees politicians making poor decisions and breaking promises, economic reform is held up by the Senate, and the party leaders seem more interested in political point scoring than meaningful reform or budget repair.

Kevin Rudd campaigned on climate change as the great moral issue of our time and then walked away from his emissions trading scheme. Julia Gillard vowed there would be no carbon tax under any government she led, only to implement one when she got into government. Tony Abbott promised to lead a grown-up government with no surprises, only to startle the nation with his first budget that was seen to be unfair and unduly harsh. Malcolm Turnbull disappointed voters by not doing very much, floating ideas and then walking away from them, and failing to live up to people's fairly high expectations.

In Australia we like to think that everyone votes because it is compulsory, but the AEC has revealed that almost 3 million eligible Australians did not vote in the 2013 election. In other words, only around 81% of eligible voters cast a valid vote. Approximately 1.2 million people were not enrolled, 900,000 people were enrolled but did not vote, and over 800,000 people cast an informal vote. We don't have these numbers yet for the 2016 election, but they would be expected to be similar. It is impossible to tell exactly but some of the informal or missing votes are mistakes, some are the result of apathy and a large part of it must relate to disengagement or a protest. That is a lot of angry voters.

Anxiety

Our economy and job market is rapidly changing. Jobs in traditional areas like making cars and the steel industry have already largely gone, and almost daily we are told that robots and other automation will replace our current jobs. Researchers at Oxford University believe that 35 per cent of jobs in the United Kingdom will disappear during the next 20 years, and the same will probably happen here.

Malcolm Turnbull says that it's never been a more exciting time to be an Australian. But, for many people, it's also a time of great uncertainty and anxiety, and therefore his catch-cry failed to resonate with voters.

Betrayal

Many Australians now believe that life in the future will involve harder work, less secure jobs and less government support. The ideals of a secure job, a house to live in, and a pension in retirement seem less attainable. The government tells us we will have to work for longer and provide for ourselves. Australian households now carry more debt relative to the size of the national economy than any other country in the world.

Ordinary people feel angry about what they regard as a betrayal by the intellectuals and political class. They have stopped listening to the 'experts' and are sending a message at the ballot box.

Angry voters

In the US, Trump and Sanders are offering broad brush and populist "solutions" to Americans' concerns. Yet the reality is, for most people there will be no fix, only adaptation. Populist and protectionist policies worked well in the Australian election as well, with Nick Xenophon and Pauline Hanson picking up votes. Support for economic rationalist policies has fallen. Over the last twenty years there has been broad-based support for globalisation, free trade, economic reform, and immigration – but we may be entering a period where economic reform is much harder to achieve, and a move back to policies which protect Australian companies and jobs.

Indices Used:

Australian Shares: S&P/ASX300 Accumulation Index

Overseas Shares (unhedged): MSCI World(Ex Australia) Index in Australian dollars

Overseas Shares (hedged): MSCI World(Ex Australia) Index (hedged)

Listed Property: S&P/ASX300 Property Trust Accumulation Index

Australian Bonds: Bloomberg AusBond Composite Bond Index (All Maturities)

Overseas Bonds (hedged): Citigroup World Government Bond (Ex-Australia) Index (Hedged)

Cash: Bloomberg AusBond Bank Bill Index

Contacts:

For further information on any of these topics please contact one of the members of our investment team.

Stephen Jackman – 03 8603 1498

Catherine Nance – 03 8603 3919

David St. John – 03 8603 1259

Janice Jones – 08 9238 3445

Matt Johnston – 03 8603 5978

Daniel Zhang – 03 8603 5329

Shaun Eldred – 03 8603 1607

Su Song – 03 8603 1398

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