Improving Economies – Improving Markets

March Quarter 2017

pwc

March 2017 Quarter

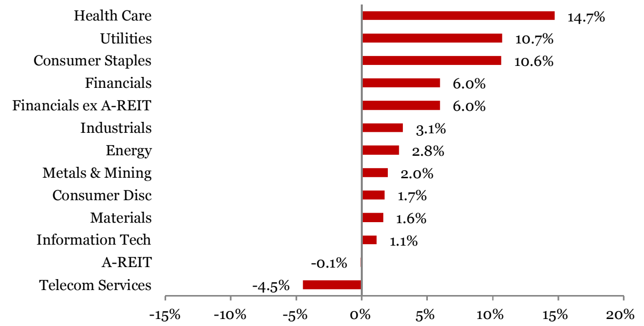
The March quarter continued the positive sentiment from the December quarter, driven by the continued positive economic data in the US, growing optimism within China due to better than expected economic data and a stabilizing yuan, and an improving outlook within the EU. Government bond rates fell slightly over the quarter and the Australian dollar strengthened against most major currencies.

The median untaxed growth fund returned 2.4% for the quarter and the median untaxed conservative fund returned 1.4%, according to Morningstar.

The Australian share market gained 4.7% over the quarter. The strong performance was led by the defensive sectors (Healthcare, Utilities and Consumer Staples) which saw a modest reversal of the rotation from 'expensive defensives' into cyclicals in the December quarter.

Australia has had 25 years without a recession and the positive economic growth is expected to continue. The A-REIT sector fell slightly (-0.1%) driven by the concerns over property price bubbles and increases in interest rates.

ASX Sector Returns – March Quarter



The RBA has indicated that it is concerned about the impact of increasing interest rates given the large level of private debt in Australia. APRA has called into question the level of interest-only loans and has announced tougher new rules on interest-only loans.

Global equities markets have continued to perform well propped up by the continued positive economic data from the US and the improved economic situation in China. Increasing interest rates have signalled a movement away from unusual monetary policy improving investor confidence. For Australian investors, gains made by global markets were largely offset by the strengthening Australian dollar, which started the quarter at $US0.72 and finished the quarter at $US0.76.

US shares continue to show positive results as the market remains optimistic about the Trump administration's plans for tax cuts, infrastructure spending and deregulation.

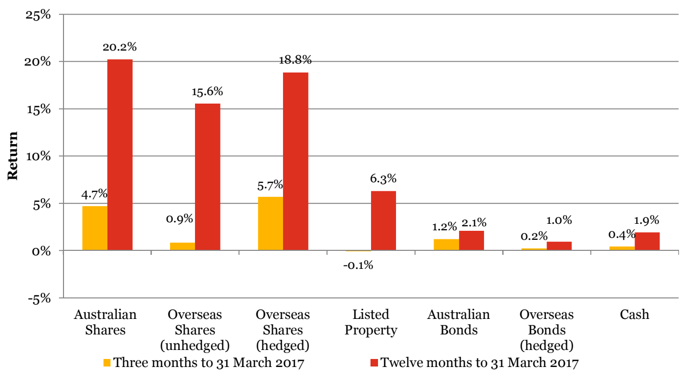
The positive growth was also supported by the Federal Reserve's increase to the Fed funds rate, from 0.75% to 1.00% due to the improved growth and inflation outlook for the US. However, the Trump administration did not manage to get its health care reforms through Congress, which has led to some doubt as to how much of Trump's growth agenda will be implemented.

The EU region markets had a positive quarter, driven by largely positive economic data and key EU elections showing a movement away from anti-EU parties. While the EU has had positive economic data through the quarter, the ECB has indicated that it will maintain the current quantitative easing policies until the end of 2017.

The UK share market proved more resilient than expected, with the Bank of England upgrading the growth forecast for the UK in 2017 from 1.4% to 2% due to stronger than expected consumer spending. Towards the end of the quarter the UK triggered article 50 initiating the process of leaving the EU, but it remains unclear how leaving the EU will impact the UK.

Asia ex Japan equities rebounded strongly and returned 13.4% in the March quarter as measured by the MSCI AC Asia ex Japan Index in USD. The positive performance was driven by better than expected economic data from China and a stabilizing yuan improving investor confidence. Further, the lack of any follow through on the protectionist policies mentioned by the Trump administration has eased concerns.

Asset Class Returns to 31 March 2017



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.*

Asset class returns for equities have been strong, returning 15-20% over the year to March, reflecting a turnaround in global sentiment. Fixed interest and cash returns have been much more subdued.

Since 31 March 2017

Share markets have remained buoyant in April, despite tensions relating to Korea and a US missile strike on Syria. Global share markets are up by 3.9% in Australian dollar terms and the Australian share market is up by 0.8% (as at 26 April).

A balanced portfolio would have returned around 1.5% in April (so far).

Outlook

The US Federal Reserve increased rates at the March meeting following the positive economic data in the US. Global interest rates are now expected to increase as central banks move slowly back towards more traditional monetary policy.

As a result the expectations for increased interest rates have become more widespread. Thus, we are seeing a reduction in fixed interest, property and infrastructure returns.

In our view the Australian equity market is fair value to slightly overvalued. Property and infrastructure assets are expensive, cash is returning a very low rate, and fixed interest is vulnerable to rising interest rates. We maintain our view from last quarter that equities is the 'least bad' option.

Some key issues going forward include:

- **How fast will Interest Rates rise?** – The level of debt in the world continues to be very high, which means that even small increases in interest rates can have a significant impact. We expect interest rates to rise, but at a slow pace
- **Will Trump Succeed?** – Global markets have been buoyed by optimism over Trump's growth-oriented policy. However, the failure of the Trump administration to push through the health care reforms brings into question what will happen if Trump fails to push through the tax cuts, infrastructure spend or deregulation promised. It appears that the benefits from these policies have been partially priced into markets, thus there may be a correction in the market if these policies fail to pass.
- **Korean Tensions** –North Korea has conducted missile tests, the US has sent ships, and a war of words has erupted over North Korea. The rest of the world is hoping that cool heads will prevail.

Bank Loans

Facing ever increasing regulatory requirements, banks are under increasing pressures to de-risk or increase their levels of capital. A natural reaction to the stricter requirements is for the bank to ensure that they are getting the best return on their capital, and to not use up precious capital on lower returning activities.

At the same time, institutional investors like superannuation funds are finding it increasingly difficult to find attractive yields without taking on excessive levels of risk. A few years ago cash or term deposits were paying 5% or higher, but cash rates have since fallen to below 2%.

Unlike the banks, investors like pension funds and insurance companies have the capacity to take on private debt, whether it be straight off the bank's books or originating the loans themselves.

A global survey of 500 managers of public and corporate pensions, foundations, endowments, insurance funds and sovereign wealth funds by Natixis Global Asset Management found that 44% were considering increasing direct lending in the next 12 months. The global private debt market has quadrupled in size since 2006, reaching assets under management of US$595 billion as at June 2016.

A number of asset managers have already taken advantage of the opportunity, taking on the role of the middlemen between institutional investors seeking higher returns, and companies seeking financing.

The investment risks are ensuring liquidity, assessing the credit worthiness of the borrower, and achieving a diversified portfolio of loans. There is also a perception issue from the GFC where portfolios of securities were marketed as being much lower risk than they actually were.

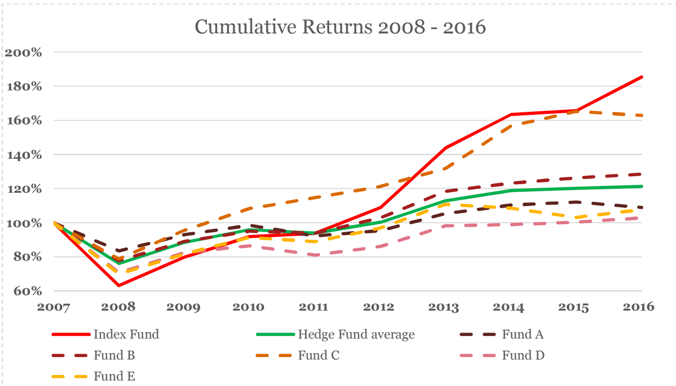
Here in Australia, the direct lending market is still very much in its infancy. At the moment, only the largest of funds, the likes of AustralianSuper, Cbus and the Future Fund, have the appetite and resources to manage direct lending investments. Large funds are able to draw on the expertise of their internal teams and relationships with the banks to identify opportunities in the market.

Direct lending is still predominately the bank's domain, but given the current regulatory environment and low returns from traditional defensive assets, we would expect that long term, patient investors will become more interested in direct lending.

The Buffett Bet

In 2008, Warren Buffett bet a million dollars (to be donated to charity) that an index fund picked by him could outperform a portfolio of any five hedge funds over a ten year period. The other side of the bet was taken by a firm called Protégé Partners.

Nine years later, Buffet's index fund, the Vanguard S&P's 500 Admiral Fund, has appreciated by 85.4%, while Protégé's portfolio of hedge funds has only gained 22.0%. With only eight months left until the bet expires, chances are very slim for Protégé unless there is a major turnaround.



Source: Warren Buffett's December 2016 letter to investors

The answer starts with the hedge fund industry's fees, typically 2% plus an incentive of 20% of the profits. The Vanguard Fund, in contrast, charges expenses of only 0.05% a year. That means the hedge funds have to do far better than the index fund just to break even.

It gets even worse, because funds of hedge funds often charge fees on top of those charged by the underlying hedge funds. Most hedge funds would also trade more actively than the index fund, which adds an additional layer of transaction costs.

The active manager therefore faced a hurdle of 3% per year or possibly higher, just to overcome the effect of the fees.

Not only did the hedge fund manager have to find one hedge fund that would outperform by 3%, it had to find five of them that would on average outperform by 3%.

Timing also plays a factor in this wager. Active management and hedge funds typically outperform during downturns in markets. This was evident in the Global Financial Crisis, when Buffet's fund lost 37.0% of its value, while Protégé lost 23.9%. Fortunately for Buffett, markets recovered and Buffett's fund outperformed Protégé's every year since 2008.

The message for investors is clear – fees matter!

This is not an argument against active management, and PwC believes in active management. However, investors need to have a reasonable expectation that the net of fees excess return achieved by the active investment manager is greater than the net of fees return for a passive manager. If not, it may make more sense to use a lower cost, less active manager.

Hedge fund managers also diversify risk away from listed market exposures, and in some cases try to 'pick' or 'time' markets. This is very hard to do, and this story also highlights the importance of staying exposed to growth assets when investing over the long term.

The Fearless Girl

US fund manager, State Street Global Advisors (SSgA), has placed a statue of a 'fearless girl' in front of the bronze charging bull in Lower Manhattan. The statue is part of the fund manager's campaign to get more women into board roles.

The girl is standing facing the charging bull, hands on hip, a defiant expression carved into her face. SSgA notes that companies with more diverse boards of directors tend to perform better.

The campaign is also backed up by an actual threat from the money manager, which has over A$3.3 trillion in assets under management. If companies aren't making tangible progress toward adding women to their board, they'll vote their substantial shareholding against them.

Investment Manager Operational Due Diligence

Since the SPS prudential standards were introduced, APRA has on a number of occasions publicly communicated its expectations that RSEs should be considering both investment and operational risks when appointing external investment managers.

Traditionally, RSEs have focussed on investment capability, usually with the assistance of an asset consultant. The ability of the investment manager to deliver on its investment strategy, and to manage the associated trading and operational risks, has been given less attention. However, operational issues at an investment manager can significantly impact clients. The nature and extent of operational due diligence performed over the operations of investment managers has also varied considerably across the industry. Typically, the due diligence has been commissioned by the fund that is planning to invest, leading to the same or similar due diligence being performed multiple times over the same investment manager.

In 2016, AIST released a guidance note calling for the industry to adopt a consistent framework for the operational due diligence over investment managers leading to a more cost-effective and streamlined process, and for the investment managers to be able to provide the report to clients, thus making the process more efficient for the investment managers.

PwC is in the process of developing a framework for performing Operational Due Diligence on investment managers. We expect that it will include a 'design' phase where feedback is provided on the operating procedures and environment to enable the investment manager to document them, and a 'testing' phase which will provide assurance around the operating effectiveness of the controls specified in the design phase. This process will provide a level of assurance as to whether the investment manager has met a minimum standard of operational capability.

RG 97 – Enhanced Fee Disclosure update

In last quarter's newsletter we outlined ASIC's release of RG 97, which requires enhanced fee disclosure for superannuation and retail managed investment products. Under RG 97, amongst other things, issuers will be required to provide a greater degree of disclosure regarding fees.

The intention of the standard is to capture all investment fees, including those contained in 'interposed vehicles' (i.e. where a fund invests into a vehicle which then invests into other vehicles) and operational transactional costs to provide a better estimate of the total fees and costs.

RG97 comes into effect in PDS' from 30 September 2017. However, product issuers have provided ASIC with updated fees and costs by 1 March 2017. The results are not yet publicly disclosed, but from a sample of funds we have identified that disclosed fees will increase for many funds under RG97, most notably in relation to the incorporation of:

- Transactional and operational costs, which added to the fees for most funds sampled, by between 0.05% and 0.40%;

- Indirect costs were most notable for unlisted property funds where costs of managing properties were required to be included under the RG97 definition. These costs can be significant for unlisted property funds, adding as much as 2.5% to disclosed fees; and
- Borrowing costs also applied to some funds, adding as much as 0.30% to fees.

The impact on funds will be different depending on the circumstances of each. Funds with complex structures, and high exposures to illiquid, unlisted or private assets are likely to be the most impacted.

Overall, we expect the disclosed fees for many funds and superannuation options to increase from RG97. It is important to note that this is a change to the disclosure of fees, but these are not additional or new costs incurred by funds, so the after fee performance of funds would still have been the same regardless of how the fees were disclosed.

Productivity Commission Superannuation Report

The Productivity Commission has released its draft report "*Superannuation: Alternative Default Models*" on the 29th of March 2017. The report was primarily commissioned to review alternative methods for the allocation of default funds with an emphasis on promoting a competitive environment. The report argues for workers to have a single default superannuation and for that default to follow the worker when they move jobs.

The Commission states that the reduction in the proliferation of accounts every time an employee changes jobs, will reduce the administrative costs of superannuation funds, which will lead to lower fees. The Commission estimates approximately $150 million will be saved. In addition, the Commission recommends the reduction of the number of scheme, arguing that underperforming schemes should be absorbed into better performing schemes to increase the overall efficiency and competitiveness of the Superannuation Industry.

The final report is due in August 2017, with responses to the draft report due before 28 April 2017. It is unclear whether the report will change materially. However, it is clear that the Commission is of the opinion that significant structural changes are required in the Superannuation Industry.

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

Su Song – 03 8603 1398

Tyrone Louw – 09 8603 0730

PricewaterhouseCoopers Securities Ltd ACN 003 311 617 ABN 54 003 311 617 Holder of Australian Financial Services Licence No 244572