2 steps forward, 2 steps back

31 December 2015

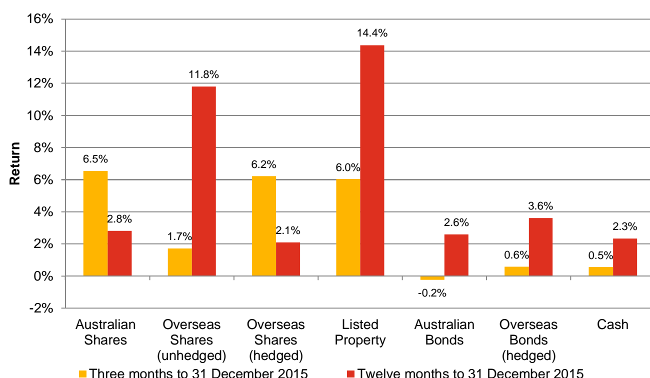
December 2015 Quarter

The December quarter saw a recovery in the markets after falls in the September quarter. The median growth fund returned 3% and the median conservative fund returned 1.2% for the quarter, according to Morningstar data. Over the 2015 calendar year the median growth fund returned 4.7% and the median conservative fund 2.6%.

The most significant event of the quarter was the US Federal Reserve deciding to raise interest rates for the first time in nearly a decade, despite relatively low inflation figures. Meanwhile in an effort to pursue +7% growth, the People's Bank of China made its 6th rate cut since November 2014.

The Australian equity market was strong in October following some over-selling in the September quarter. November and the first half of December saw a retraction before a welcome 8% rally in the last two weeks of 2015. The ASX300 index returned +6.5% for the quarter, which countered the -6.5% loss in the September quarter.

The positive sentiment however did not continue into 2016, with all of the gains from the last two weeks of 2015 given up in the first two weeks of 2016. Market sentiment continues to be weak, and it really feels like 2 steps forward 2 steps back.



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.*

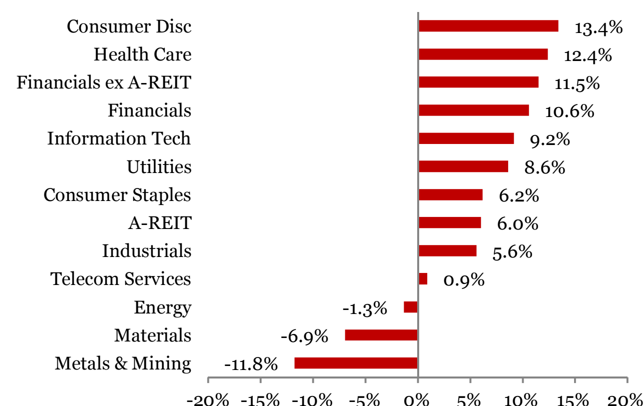
Overseas shares had a strong quarter, but the strengthening of the Australian Dollar from around $US0.70 at the start of the quarter to $US0.73 at the end detracted from returns for unhedged exposures. Overseas shares returned +6.2% on a $A hedged basis and +1.7% unhedged over the quarter.

US equities gained 7% over the quarter. The Federal Reserve increased its main policy rate from 0% to 0.25% in December following strong domestic economic data.

The Japanese market performed strongly, returning +9.8% over the quarter. Europe returned +5.9%, while the UK market returned +3.5%. Emerging market equities returned 1.5% (MSCI EM Index) in the fourth quarter; although a stronger US dollar, concerns over slowing growth in China, and falling commodity prices, served to weigh on returns.

China's equity market (based on the MSCI China Index) posted a 4% return over the quarter after an extremely volatile 6 months, largely due to various moves from the People's Bank of China to support the economy, including an interest rate cut.

ASX Sector Returns – December quarter



Within the Australian equity market, the sectors that have done well over the last few years continued to do well. Consumer Discretionary (+13.4%) led the market, followed by the Health Care (+12.4%), Financials ex A-REIT (+11.5%) and Financials (+10.6%) sectors. The sectors that are exposed to commodity prices continued to struggle, for example the Energy (-1.3%), Materials (-6.9%), and Metals & Mining (-11.8%) sectors.

Since 31 December 2015

There has been a very poor start to 2016 for markets, with some commentators calling it the "worst start in history". The markets are being driven at the moment by negative sentiment rather than economic fundamentals. After the first two weeks of January, equity markets are down around 8% on average. The Australian dollar has also fallen back below $US0.70 which will cushion the blow to some extent for unhedged investors.

While markets are certainly jittery at the moment, our view is that some of this is overblown and investors should not be rushing to sell assets or change their long term investment strategy at this time.

Some longer term themes

Some key issues going forward include:

- **Impact of Fed rate rise** – The US is the first major economy to increase interest rates at a time when many countries are still considering cutting rates further.
- **Commodity prices remain depressed**– low prices look to persist well into 2016. Excess supply is a major factor, combined with lacklustre demand.
- **Negative sentiment** – when the markets go into a downward spiral it is difficult to predict the end point, but history tells us that these periods do end and the market will recover in time.

Market behaviour during periods of increasing interest rates

December 2015 saw the US Federal Reserve (Fed) increase interest rates for the first time in almost a decade. The world had been watching and waiting for many months for the Fed to make its move.

There was uncertainty around the timing given US inflation figures were still relatively low and forecasted inflation figures were only marginally higher. In past rate rise cycles, GDP growth has been above 5% prior to implementing a tightening policy, far higher than the current rate. The Fed's stated intention is to gradually increase rates to avoid disrupting the fragile world economy and a repeat of the 2013 taper tantrum, when investors reacted negatively to the prospect of a wind-back of quantitative easing. The cautious approach of the Fed in the end meant that the increase was a bit of a non-event.

Equity investments are less attractive as interest rates rise because valuations reduce due to a higher discount rate on future earnings, and debt financing becomes more expensive reducing profits and future capital expenditure.

On the other hand, interest rates are going up because of the underlying strength in the economy and it reflects a vote of confidence from the Fed in the economic recovery. These factors should be positive for equities. Pessimists will lament the removal of economic stimulus but optimists will rejoice that the stimulus is no longer required.

The weakness in markets at the start of 2016 may cause a rethink, and the Fed may not proceed with further interest rate increases, but only time will tell. It is even possible that rates will go back down, but the chance of this is slight. The European Central Bank and the Swedish central bank raised rates in 2011 only to later reverse the decision as their economies weakened significantly.

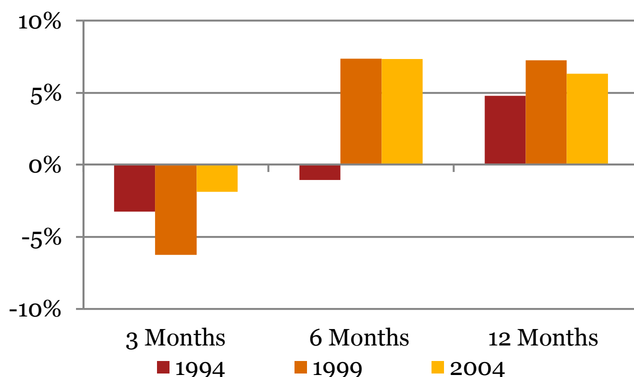
Looking at historical situations when the Fed has begun tightening interest rates i.e. 1994, 1999 and 2004, we can see how equity performance in the US has fared.

1994 – 7 rate raises over a 12 month period, increasing rates by 3.00%, from 3.00% to 6.00%

1999 – 6 rate rises over a 12 month period, increasing rates by 1.75%, from 4.75% to 6.50%

2004 – 17 rate rises over a 24 month period, increasing rates by 4.25%, from 1.00% to 5.25%

The chart below shows the total return on the S&P500 index at three, six and twelve months after the initial increase. In the first three months after each rate increase the market has fallen. However, if you look out six or twelve months the markets have generally moved upwards by 5% or more.



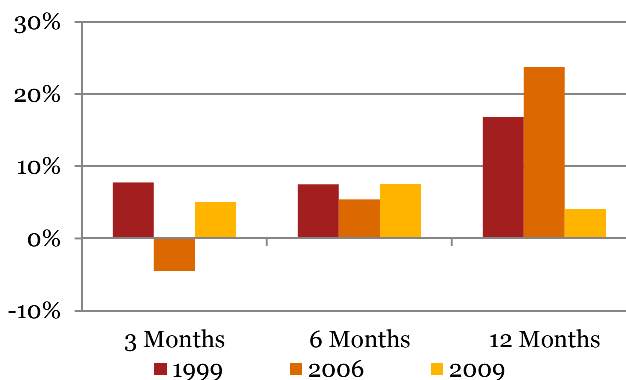
This reflects the theory that initially markets focus on the pessimistic aspect of the interest rate rise, but longer term the focus moves to the strength in the underlying economy.

Looking at the Australian share market we can see a similar pattern as to what is seen in the US, in that returns are typically more subdued in the first 3 months compared to 6 and 12 months after the rate rise.

1999 – 5 rate raises over a 9 month period, increasing rates by 1.50%, from 4.75% to 6.25%

2006 – 7 rate rises over a 22 month period, increasing rates by 1.75%, from 5.50% to 7.25%

2009 – 7 rate rises over a 13 month period, increasing rates by 1.75%, from 3.00% to 4.75%



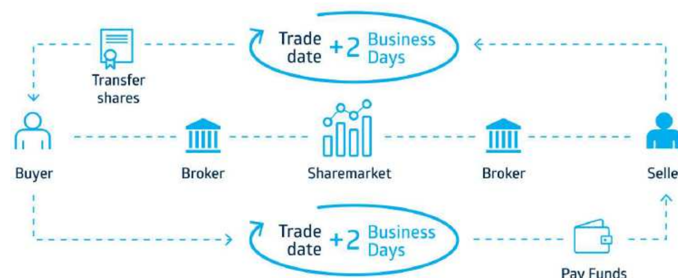
Although we must note that this time round the situation is different from the past three rises, and there are many other factors influencing the market. Commodity prices remain very low, the US dollar is likely to strengthen, and many other countries are still reducing interest rates.

However, overall we feel the US interest rate increase is good news for the global economy. Despite initial uncertainty, and apprehension, markets are likely to focus on the underlying fundamentals in the longer term, as has happened in the past.

T + 2 settlements

The ASX announced in December that settlement dates for Australian financial products will move to trade date plus two days, from the current trade date plus three days (T + 3), effective Monday 7 March 2016. Some of the financial products covered are those traded on licensed Australian securities markets including shares, units, bonds, hybrids, exchange traded government bonds, ETFs, warrants and instalments.

The Clearing House Electronic Subregister System (CHESS) is the system which performs the sharemarket settlements, which has been improved to ensure the Australian market remains globally competitive. The last improvement was in 1999, where the settlement cycle moved from T + 5 to T + 3.



Source: "The transition to T+2 settlement"

The change will also affect the date between corporate actions (such as dividends). The difference between the ex-date and the record date will now become 2 days rather than 3 days - inclusive of the ex-date and the record date.

The ex-date is the date on which shares change from being quoted "cum" (or entitled) to 'ex' (or not entitled) for a corporate action. The record date is the date used in determining who is entitled to a dividend or other entitlement associated with a share i.e. those on the register on the record date are eligible for the entitlement.

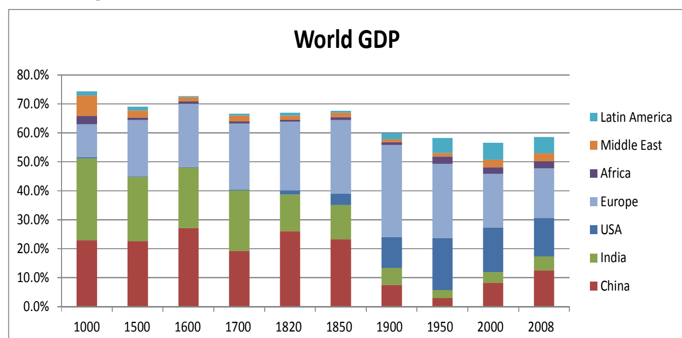
The image below shows a sample process for a share purchase on the day before the ex-dividend date relative to the corporate action timeline.

Source: "The transition to T+2 settlement",

This change helps investors manage liquidity requirements by being able to access cash one day sooner, and reduces time out of the market involved when transferring assets.

The rise and fall of nations[1]

Over the last 150 years, the world's economy and culture has been dominated by a small proportion of the human population in Europe and North America. The rapid development of countries like China and India in recent years has generated concern about the impact of economic and political influence shifting from the developed West to the developing East. While these changes appear to be exciting and unchartered territory, if we look back over the last thousand years, the world is actually reverting back to its historical norm.



Source: Angus Maddison, The Maddison Project.

A thousand years ago, the Muslim civilisations were leaders in mathematics, medicine and the sciences; the largest and most affluent cities were in China, and India was a land of diverse empires and religions. Europe, by contrast, was largely rural, medieval and agricultural.

Baghdad was positioned along trade routes that linked the Middle East to Asia. It was revered as the "centre of the world" because of its scholarship and learning.

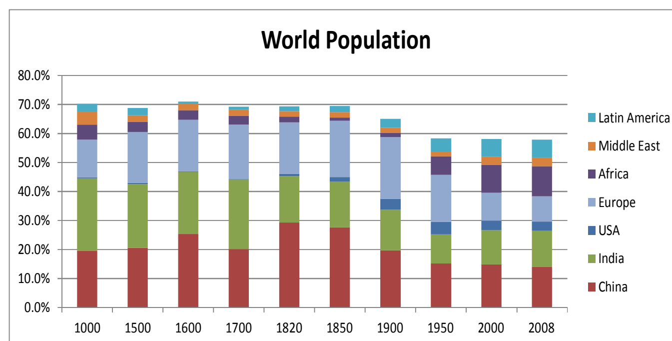
Why was the East so dominant?

Before the industrial and technology revolutions, economic strength was closely tied to population size. China is one of the oldest surviving civilisations and, combined with India, made up over 40% of the world's population up until the mid-1800s.

This was before the arrival of Europeans in the US, Canada, and many other countries including Australia.

Therefore, up until 1900 the split of world GDP resembled the distribution of the population (see charts) but in the 20th century the GDP for Europe and North America grew at a much faster rate than its population.

[1] The idea and much of the material for this article was taken from "An unusual couple of centuries" by Julian McCormack, Investment Specialist, Platinum Asset Management.



Source: Angus Maddison, The Maddison-Project.

Why did the West overtake the East?

1. In 1258 Baghdad was sacked by the Mongols who massacred most of the city's inhabitants and destroyed large sections of the city. It was later conquered by the Ottoman Turks and never regained its former status.

2. The Industrial Revolution of the 1800s introduced technological advancements that sent productivity skyrocketing at an unprecedented pace. Per capita output growth in Europe and America increased rapidly and meant that economic strength became more closely tied to productivity rather than population size.

3. The loss of American colonies in the late 1700s turned British and European attention to the East. Through colonization, the West was able to lay claim to the rich resources of the East and take advantage of strategic trading ports across the world.

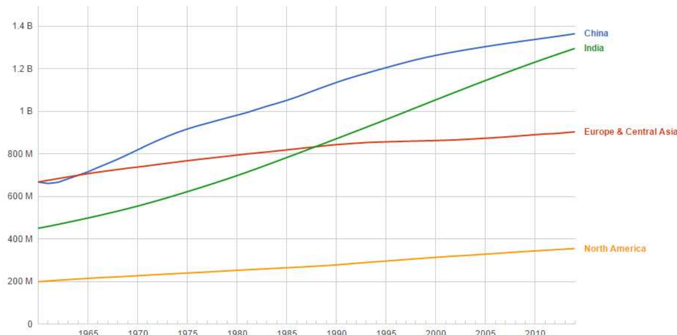
4. Years of political and military turmoil hampered economic growth in the East. China suffered a severe decline in living standards and population size as a result of the Taiping Rebellion from 1850-1864. Civil and world wars that followed led to losses of major trading ports and territories to foreign powers like the British and the French. War also brought about huge financial losses; China had to rely on foreign borrowing to pay Japan a sum approximately a third of the Japanese GDP at the time, to withdraw from its territory. After World War II, communist rule sent China backwards economically and socially as political agendas overtook economic progress and intellectual advancements. As a result, China and the Middle East fell far behind the West.

Re-emergence of the East?

1. After decades of political turmoil, economic reforms began in the 1980s that opened up the Chinese economy to international markets. With a massive supply of cheap labour, China quickly became the world's factory.

2. Population growth in Asia overtook the West.

Population 1960-2014



Source: World Bank, Google

3. Asian economies began to adopt the technological advancements developed in the West and in recent times, have led in innovation and technology again. While Europe and the US led the Global Innovation Index released in 2015, countries like Korea and Singapore are catching up.
4. Intellectual property and technology advances moved quickly around the world. Most of the technology successes in the West have Chinese equivalents like Alibaba (eBay), Tencent (Facebook) and Baidu (Google).

It seems inevitable that over time there will be some form of equalisation of the world's wealth and power. GDP per capita in the US is currently around 4 times that of China. At current growth rates it will take 40-50 years for GDP per capita to equalise.

Challenges for the future

The turbulent times of history serve as a reminder that political and economic stability, individual freedom, and stable institutions are essential for progress.

The relative wealth and development of nations has changed dramatically over time, and can be expected to change in the future. The current world order has only been around for 100-150 years and over longer periods of history the Middle East and Asia have played much bigger roles in world affairs.

The current trajectory of India and China should see them playing a much bigger role in the future, as they have done for much of history.

Robo-advice and Technology – wealth management's big disrupter?

Internet banking substantially changed the banking industry in the 2000's and Uber has derailed the taxi industry. It is now looking likely that Robo-advice and technology will disrupt the wealth management industry.

Robo-advice is basically an automated advisory tool that can assist with financial advice and portfolio management, either in conjunction with or instead of a financial advisor. On-line platforms that combine financial advice, implementation, direct equity investment, cashflow management, reporting, and tax management could become a one-stop shop for all an investor's needs. If it links seamlessly to your bank account, the ATO, an on-line broker and the underlying investment managers, all financial transactions could be made with the press of a button or a swipe of your phone.

A robo-advisor will take you through the same process you would with your financial advisor, understanding your risk profile, investment objectives, tax position and lifestyle.

Using historical data and leading portfolio management tools, the robo-advisor will suggest suitable investments to provide a balanced and diversified portfolio to meet your investment needs, tailored to your own objectives.

Impact on financial advisors

The big question is will robo-advisors completely replace the financial advisor – unlikely. The most likely course of action is that robo-advice will support financial advisors and help educate the user on investing. Traditional wealth managers are investing large sums of money into robo technologies and investment platforms, and a new category of 'robo-advisory hybrid' is emerging. Under this model clients are serviced by a seamless combination of algorithmic advice and personal contact with an advisor.

Quality of advice

Advisor led robo-advice tools could help to close the gap around perceived quality of advice. An ASIC report on the quality of financial advice found that 39% of advice examples were poor, and failed to meet the requirement under the Corporations Law to have a reasonable basis for the advice. The robo-advisor can test the advice against any number of parameters and stop many cases of poor advice.

Most Australians do not get financial advice for many of the key decisions in their lives, and one of the key reasons for this is the cost and accessibility of financial advice. Robo-advice reduces the cost of advice which will make advice more available, which is a good thing even if the advice is limited.

Impact on investment managers

Interestingly, technology advances are leading to the growth of simple and efficient investment options, like index funds and exchange traded funds (ETF). There will always be a demand for quality investment management, but investors are going to be less willing to pay fees for 'average' investment management.

The large platforms will negotiate directly with investment managers for wholesale fees, and the automation will allow them to pass that on for a small additional fee. The days of 2% investment fees with commissions paid to an advisor are likely to be long gone. Platform and administration fees should be driven down by the new technology and the 'disruption'.

Benefits for investors

The big advantages for investors will be lower fees (smaller investors will have access to wholesale fees through the platforms), reduced administrative hassle through direct links to the bank, investment manager and ATO, and greater access to information/advice for much lower fees.

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All reasonable care has been taken to provide performance and investment data that are accurate. However, we have relied on a range of external sources for data. As a result, we are unable to guarantee the accuracy of the data contained in this document.

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

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