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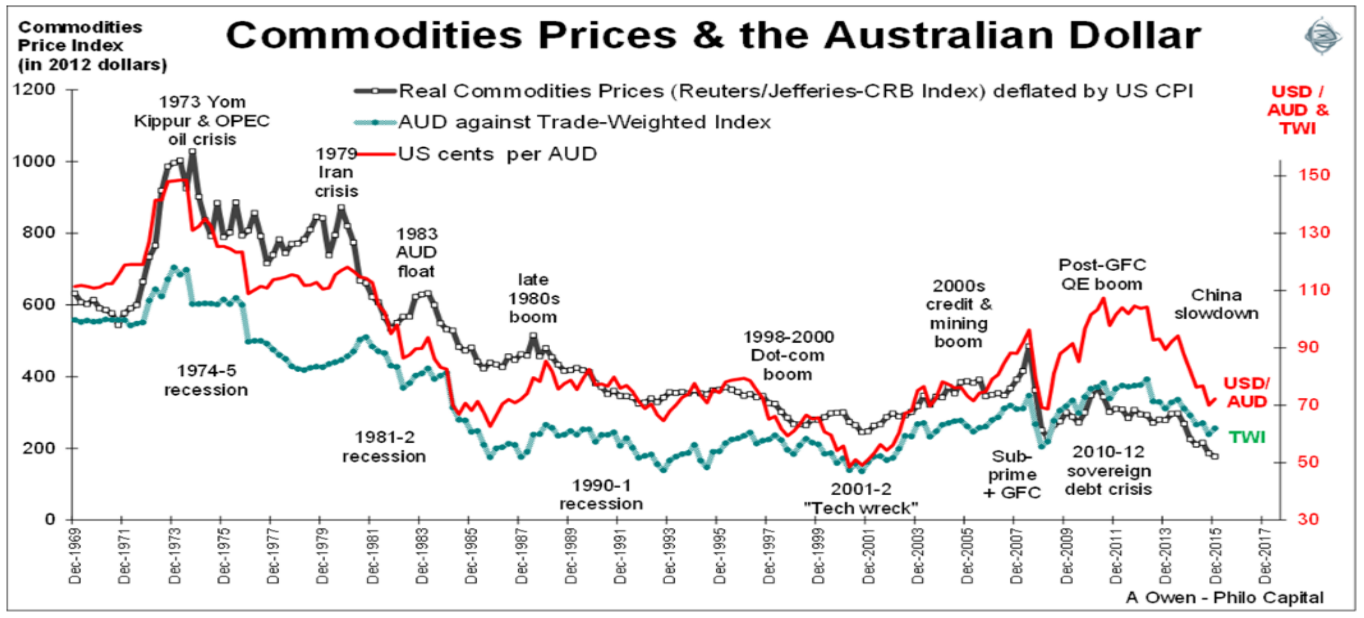
Australian dollar follows commodity prices

Ashley Owen

Investors need to take a view on exchange rates in order to make currency hedging decisions on foreign assets in their portfolios. This makes a big difference to portfolio returns. It is possible for even small investors to make currency hedging decisions using Exchange Traded Funds listed on the ASX.

One crucial factor we look at is commodities prices (other factors include relative purchasing power, current account balances, foreign reserves and interest rates differences).

Australia exports rocks and other basic materials to foreigners who use them to make useful things that we then re-import back as manufactured goods at astronomical price mark-ups in terms of dollars per tonne. This is one of the many ways in which Australia is more like an 'emerging' market economy rather than a 'developed' one. (Australia did once make things out of our rocks – but only while



protected from global competition behind high tariff barriers erected after World War 1 and dismantled since the 1980s).

As a result, the AUD has tended to follow the path of commodities prices.

The chart shows a broad commodities price index adjusted for inflation (black line), the USD/AUD foreign exchange rate (red) and the AUD Trade Weighted Index (green) since the late 1960s, when the gold standard started to break down.

The AUD has risen and fallen with all of the major ups and downs in commodities prices over the period. The dollar was at its lowest levels during the 'dot com' boom and subsequent 'tech wreck' when commodities were considered so out of fashion and so cheap that you almost couldn't give them away.

Commodities price cycles are more about supply than demand. Demand drifts upward over time as global population and living standards rise steadily, interrupted briefly by recessions. The problem is on the supply side and in particular the long lead times between exploration, mine development and new production (supply) of commodities. These supply cycles usually take a decade or more.

Falling commodities prices during the 1980s and 1990s meant that exploration, mine development and new production came to a grinding halt for a couple of decades.

Demand for commodities was drifting up slowly and then suddenly picked up with the Chinese manufacturing export and urbanisation boom that accelerated with China's entry into the World Trade Organisation in 2001. The increase in demand from China plus the supply constraints from two decades of little new supply caused commodities prices to sky-rocket, lifting the Australian dollar as well.

Commodities prices and the AUD collapsed briefly in the 2008-09 sub-prime collapse and global financial crisis but then quickly rebounded in 2010. The peak of the commodities/AUD cycle was in April 2011 after the Japanese tsunami.

But every mining boom contains the seeds of its subsequent bust. Rising commodities prices in the 2000s triggered an explosion in exploration, mine development and production. Due to the long-time lags, new supply is only coming on stream now at a time when Chinese and global demand growth is weakening. The huge amount of new supply is crippling commodities prices.

The result is the same as it has been in every past mining boom cycle – prices fall, mining companies collapse, and most of the new holes in the ground are abandoned. It is happening now with iron ore, coal and non-ferrous metals, and we are about to see it in oil and LNG.

(Every boom/bust cycle is different in the details of course. This time around we have two additional negative elements. The first is the huge piles of ultra-cheap debt in many mining companies that will soon need to be refinanced at higher rates. The second is the blow-out in current account and budget deficits resulting from the collapse in commodities prices).

We have been bearish on the AUD (and unhedged on foreign shares in portfolios) since 2011. This has added 30% to returns on global shares since then. Because of the long lags involved in the supply side of mining we are still bearish on the AUD (and unhedged on global shares) as the current global over-production and over-supply of commodities is likely to swamp the modest demand growth for many years to come.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is for general education only, not personal financial advice.

5 factors to look for when assessing management

Chris Stott

While financial statements provide detailed insights into a company's prospects, future performance is significantly impacted by the business's management – regardless of size, structure or industry. The quality of the Chief Executive and senior managers is critical to assessing the overall value of an enterprise and is one of the most important factors informing our investment decisions.

Our investment approach is based on a detailed rating system for measuring a company's intrinsic value and determining if it is a viable investment proposition. We rate both quantitative aspects of the company, such as forecast Earnings per Share (EPS) growth, and qualitative attributes, such as management. So how do you measure the value of a company's management team?

1. Verbal and non-verbal communication

We seek out information about a company's management from a range of sources including ASX announcements, company reports, media articles, analyst research and industry sources. But we gather some of our most valuable data from face-to-face meetings and briefings. As an investment manager, we invest in more than 90 companies at any one time and over the course of a year, our investment team has more than 1,000 meetings with the individuals who run these businesses.

Meetings provide us with the opportunity to gain an immediate and potent impression of the people who run a company. Observing their body language and overall demeanour can be incredibly insightful. For example, a lack of eye contact or crossed arms may signal that what they are telling us is inconsistent with reality. We may meet with the same managers many times over several years. This allows us to develop a rapport and understand nuances in their body language, tone and demeanour and, when we detect changes, this can be an important indicator.

2. Track record of success

As the saying goes, "past success is the best predictor of future success" and this holds true when evaluating a company's CEO and management. In fact, when a board appoints a new CEO (and management team) with a track record of strong performance, this can be a catalyst for us to invest. In our experience, when a company is underperforming, management is by far the most important factor in achieving a turnaround in its fortunes.

When Simon Baker was Managing Director and CEO of REA Group Ltd (ASX: REA), owner of online real estate advertising portal realestate.com.au, he achieved great success with the company. During his tenure, REA's share price rose from an IPO price of 50 cents to around $3.80 a share. In 2009, Simon joined Malaysia-based iProperty Group Limited (ASX: IPP), servicing the burgeoning Southeast Asian property market. We had great faith in his ability and factored this into our decision to invest in the company. While iProperty shares listed in September 2007 at 25 cents each, in recent weeks the company received a bid by REA offering shareholders $4.00 a share.

Similarly, in 2013, the team leading Flexigroup Limited (ASX: FXL) departed after growing the company and driving the share price from 31c a share to above $4.85 per share. They joined Eclipx Group Limited (ASX: ECX) and have had similar success, with the company's share price increasing from a listing price of $2.30 a share in April 2015 to around $3.40 today.

3. Alignment of remuneration and incentives

It is absolutely paramount that management's interests are aligned with those of its shareholders. This is achieved through incentive structures that motivate managers to make prudent decisions that benefit the company and not themselves. The appropriate base salary, bonus structure and performance hurdles are required to ensure the business's leaders successfully manage the company to achieve sustainable growth. Ideally, performance targets should be a mixture of EPS, which focuses on driving profit, and Total Shareholder Return (TSR), which is related to share price performance. In our experience, over 17 years of investing, the wrong incentive structure can have dire outcomes for the company's investors.

It is also important to ensure good quality managers are incentivised to remain in the business. If management has some serious 'skin in the game' through equity in the company, it further aligns their interests with those of its shareholders. Good examples of this are Jamie Pherous, Managing Director at Corporate Travel Management Limited (ASX: CTD), and Adrian Di Marco, Executive Chairman at TechnologyOne Limited (ASX: TNE).

4. Leadership style

We assess management by evaluating the leadership style of the CEO and individual managers, looking at their ability to layer management, reduce costs and importantly how they cultivate a positive culture and empower their team.

Numerous research studies have shown there is a correlation between corporate culture and a company's financial performance. For example, in 2001, Eric Flamholtz from the University of California at Los Angeles found organisational culture had an impact on both a company's effectiveness and the 'bottom line'. In addition, Hewitt Associates and Barrett Values Centre conducted a study of 163 companies as part of the 2008 Best Employer study and found that "… employee engagement significantly influences organisational and financial performance."

We can assess the culture based on small but insightful details. For example, observing during a site tour whether the manager knows their employees by name and how they interact.

5. Consistency of 'story' over time

We have meetings with the management team of the companies we invest in at least once every six months and we ask some of the same questions every time. If the company's script changes it raises a concern that they are not on the same path and have altered their strategic point of view.

A disciplined approach to executing the company's strategy over time and consistency of approach are important factors to measuring management's ability and gauging if they're trustworthy.

Chris Stott is Chief Investment Officer at Wilson Asset Management. Disclaimer: Listed Investment Companies managed by Wilson Asset Management invest in IPP, ECX and FXL. This article is general education and does not address the needs of any individual.

Chasing dividend yields often overlooks growth

Roger Montgomery

A year ago in Cuffelinks, we wrote about the bubble in stocks (and inevitably property) inflated by the baby boomer's desperate search for yield. We described the pursuit of yield as a fad. We were not surprised to watch investors rushing into higher yielding banks and Telstra but we were shocked to hear of investors buying BHP for its 'progressive' dividend.

The bubble has burst but the fad lives on, and banks have wiped billions from retirees' wealth while BHP has backed away from its 'progressive' dividend position. We wrote:

"The pursuit of yields through dividend-paying shares is analogous to a mindless heard of bison stampeding towards a cliff. Wall Street will sell what Wall Street can sell. Right now selling yield and income is the easiest game in town. Investors are predisposed to hearing the siren song of income and advisers and product issuers are rushing to feed the hoards. There are only a few who are willing to question the conventional thinking about pursuing yield at all costs.

My belief is that the pendulum will swing back and this time is no different to other periods of unbridled optimism…"

Of course much has changed. BHP has fallen 35%, CBA declined 26% from its interim peak to trough, NAB 28% and Telstra 23%. What has not changed is retirees' need for income. But is there a better way to generate income that suffers less from the massive tides associated with mass investor hype and hysteria?

High payouts may generate income but limit growth

I believe there is and some basic arithmetic can demonstrate a superior choice even for those requiring income.

Table 1. High ROE company paying out 100% of earnings

	Year 1	Year 2	Year 3
Equity(b)	$10.00	$10.00	$10.00
ROE	20%	20%	20%
EPS	$2.00	$2.00	$2.00
POR	100%	100%	100%
DPS	$2.00	$2.00	$2.00
Equity(e)	$10.00	$10.00	$10.00
P/E	10	10	10
Share Price	$20.00		$20.00
Cash Flows	-$20.00	$2.00	$22.00
IRR			10%

Let's start with the company described in Table 1 by making some minor assumptions. First, we assume the business is able to generate a return on equity (ROE) of 20% sustainably. Second, we can buy and sell the shares on an unchanged price earnings (P/E) ratio of 10 times. The final assumption is a payout ratio of 100%.

We have assumed no increases in debt (which increases the risks) and no dilutionary share issues. The company's only source of growing equity is retained profits.

Table 1 demonstrates that an investor who purchases and sells shares in a company with an attractive rate of return on equity, a constant P/E and a payout of 100% will receive as their return an internal rate equivalent to the dividend yield at the time the shares are purchased. This represents the upper bound of their return – the dividend yield is the best outcome, unless they speculate successfully on an expansion of the P/E ratio. For that to occur, sentiment or popularity towards the company's shares would have to change and be correctly predicted.

In more simple terms, if you chase a high yield and the company pays all of its earnings out as a

dividend, the high yield is about all you should expect. Perhaps that is what investors who chased the banks, Telstra and BHP are now finding out.

Lower payout ratios can improve total returns

In Table 2, the only item that has changed is the payout ratio, which is now zero. Of course this has a major impact on everything else.

Table 2. High ROE company paying out 0% of earnings

	Year 1	Year 2	Year 3
Equity(b)	$10.00	$12.00	$14.40
ROE	20%	20%	20%
EPS	$2.00	$2.40	$2.88
POR	0%	0%	0%
DPS	$0.00	$0.00	$0.00
Equity(e)	$12.00	$14.40	$17.28
P/E	10	10	10
Share Price	-$24.00		$34.56
Cash Flows	-$24.00	$0.00	$34.56
IRR			20%

Yield = 0%

This company pays none of its earnings out as a dividend. An investor who buys and sells the shares on the same P/E ratio will experience capital and earnings growing by the rate of the retained ROE. The constant P/E ratio means the IRR to the investor will equal the return on equity of 20%.

My proposal is that investors who chase higher yields, especially from companies that pay the bulk of their earnings out as dividends, are missing out on major financial benefits. The corollary is that company boards who acquiesce to shareholder demands for higher dividend payout ratios – especially where they are able to employ retained earnings at high rates of return – are ultimately doing their shareholders and their share price a disservice, as shown in Table 3.

Table 3. Power of true blue-chips (not Telstra)

2005	m2		CSL
Investment	$100,000	$100,000	$100,000
Price	$0.32	$4.69	$9.09
Dividend	$0.01	$0.28	$0.47 *
Yield	3.91%	5.97%	5.17%
Total Income	$3,910	$5,970	$5,171
2015			
Price	$9.63	$5.52	$92.44
Investment	$3,006,250	$117,697	$1,016,942
Dividend	$0.32	$0.31	$1.69
Yield	3.32%	5.53%	1.83%
Total Income	$99,807.50	$6,508.66	$18,591.86

*excludes special

It's not only about dividend yields

Investors in 2005 who invested $100,000 in the higher, 5.9%-yielding Telstra shares could have invested $100,000 in the M2 Group. The major difference between these two companies was not just their yield. Telstra's management elected to pay the bulk of the company's earnings out as a dividend. Indeed, under Solomon Dennis Trujillo, Telstra's dividend exceeded earnings over a number of years. While Telstra's payout ratio was near 100%, M2 Group's payout ratio was much lower. Table 2 revealed the desirable impact on returns from investing in a company that can retain earnings and reinvest those earnings at a high ROE. Table 3 puts that into practice.

Investing $100,000 in Telstra in 2005 for ten years has produced an investment of about $117,000 or an average annual compounded capital return of 1.5% p.a. Many of you will jump to the defence of Telstra and point out that I have excluded the dividends from the calculations. But this article is about retirees who have been chasing income to spend on food and clothing and other essentials like BMWs and annual overseas holidays, so I have not assumed a reinvestment of dividends.

In 2005, the 5.9% yield on Telstra shares equated to $5,900 of fully franked income. Telstra has increased the dividend since then from 28 cents to 30 cents per share and the low increase reflects that fact that profits have not grown markedly. In any event, the income on the $117,000 investment would be about $6,500.

Contrast this with M2 where the ability to generate high returns on large amounts of capital have turned $100,000 into $3 million and importantly for those desperate for income, turned $3,900 of dividends in 2005 into almost $100,000 of fully franked dividends in 2015.

M2 is not an isolated example of the power of high rates of return on equity and the ability to retain profits. For example, CSL also displayed a less attractive dividend yield than Telstra in 2005, but was able to retain capital and compound it at an attractive rate, ultimately producing more wealth and more income.

Investors chasing the highest yielding blue chip shares are missing out on the returns and income available from true blue chips – the type that we prefer to fill our portfolios with. Investors are making an expensive mistake by eschewing those companies with lower yields today but are able to grow their income. Go for growing income, not the highest yield.

*Roger Montgomery is CIO at The Montgomery Fund and author of '*Value.able – how to value the best stocks and buy them for less than they're worth.*' As a special Cuffelinks offer for Christmas, go to rogermontgomery.com/valueable-book/ for a two-for-one book promotion until December 13th. The coupon code is TWO4ONE. This article is for general information purposes only.*

Looking deeper than the home page of roboadvice

Graham Hand

It's fashionable to be enthralled by the glamour of financial technology, or 'fintech', and in particular, 'roboadvice'. It's the cheap disrupter, replacing those nasty and expensive financial advisers. Easy to access via the colourful home page, it's the investment solution for millions who would never pay to see an adviser.

The recent announcements by both Macquarie and National Bank have taken roboadvice out of the realm of the startup struggling for resources, to the mainstream where IT budgets run into billions.

How much of it is form over substance, more about the presentation, the so-called 'customer experience', than it is about offering appropriate advice and a good investment outcome?

It will improve over time, but it's not there yet

Speculating about whether roboadvice will attract money and fill the role of financial advisers is like cogitating about driverless cars. There seems obvious potential, but neither the technology nor the public are ready at the moment. But most new technologies start that way, with incumbents failing to see the full potential, then Amazon destroys Borders, Netflix kills Blockbuster and Kodak ignores its own invention, the digital camera.

The definition of roboadvice is evolving, covering automated financial advice with some formulaic investment solution. In most cases, it works by the customer answering questions online, usually about risk appetite, age, income and assets, and rules are applied to find the optimal allocation of investments. It aims to fill the gap between what the public is willing to pay for financial advice (not much) and what full professional services cost (a lot).

A software developer in Australia recently told me he has a list of 41 roboadvice businesses either in the market or under development. Globally, companies like Wealthfront, Betterment and Nutmeg have raised hundreds of millions of venture capital dollars, and major businesses like Charles Schwab, Vanguard and Fidelity are already in the market.

Two major developments called 'roboadvice'

While there will be an unlimited variety of robo offerings, it's important to distinguish between the two emerging types:

1. The 'Business-to-Consumer' (B2C) robo, which takes the client all the way from risk profiling through an 'algorithm' to an investment outcome, invariably leading to an asset allocation among different Exchange Traded Funds (ETFs) to reduce the cost. The robo's revenue comes from an advice or subscription fee, or a percentage of assets under management following an investment.
2. The 'Business-to-Business' (B2B) robo, where an existing superannuation fund offers an online planning tool, a type of retirement outcomes forecaster that simulates a range of retirement incomes based on different market conditions, savings patterns and time horizons. The robo's revenue comes from a licence or usage fee paid by the superannuation fund, or the fund may take equity or own the robo.

Neither presents a serious threat to full service financial advisers at the moment. Roboadvice cannot handle complex issues like estate planning, social security impacts or selecting aged care facilities. At best, it is limited advice for the masses, the 80% of people who don't see an adviser.

The B2B tools are useful for member engagement to help people to think better about their future super balances. A member who believes $500,000 will fund 30 years in retirement may not bother putting more into super until they realise it will not last their life expectancy based on an acceptable living standard. Further enhancement will provide 'whole of wealth' outcomes, not limited to superannuation.

Regulator focus on the investment outcomes

It is the B2C robos that will come under greater scrutiny from regulators. They face the added complication of recommending and implementing an actual portfolio as part of a product sale, not simply hypothesising about what might happen a few decades hence. This requires a compliant auto-generated Statement of Advice and a tougher test of whether the recommendation is really right for the client, often based on flimsy profiling.

While the industry regulator, ASIC, is keen to engage with this new digital world, it will not be doing any favours to the upstarts. Louise Macaulay, ASIC's Senior Executive Leader in the financial services team, told the recent Financial Planning Association (FPA) Conference:

"Our view is that the legislation is tech neutral. The same standards will apply whether it's technology-based advice, or face to face ... They (roboadvisers) need to make sure that clients understand what they are buying; and that they are not just clicking from one screen to another."

Although the B2C roboadvisers claim to be offering personal advice, the simple questions currently generate only superficial information resulting in standardised asset allocations. Some robos ask only a few basic questions about risk appetite, time horizon and capacity for loss.

Louise Macaulay went on to say:

"The sector needs to improve the compliance and record keeping. There is also the potential for large scale loss if there is a flaw in the algorithm."

In May 2015, the United States' Securities and Exchange Commission (SEC) issued a caution about roboadvice:

"An automated investment tool may not assess all of your particular circumstances, such as your age, financial situation and needs, investment experience, other holdings, tax situation, willingness to risk losing your investment money for potentially higher investment returns, time horizon for investing, need for cash, and investment goals. Consequently, some tools may suggest investments (including asset-allocation models) that may not be right for you."

The robo investment experience

I completed the online application process of an Australian roboadviser, expecting a growth-oriented portfolio based on my responses. It allocated for me 44% into Australian government bonds, 10% into gold and 11% in emerging markets equities. That is 65% of nothing I want, such as Australian shares, developed country shares, corporate bonds and property. Anyone given such a portfolio should carefully scrutinise whether it is right for them, especially when government bond ETFs yield less than 2%.

And the total cost on a $20,000 investment with this low cost disrupter'? It was 1.6%, including management fee, administration fee and investment fee, far more than the standard MySuper fund from retail and industry fund incumbents of below 1%.

Gaining a consumer foothold will be tough

Most startups without links to existing clients will not succeed in their own right in gaining a strong enough investor base. The cost of acquiring customers will be too great and the competition at low or no margins will become intense from the big names. Many startups will turn into B2B players and sell out to large impatient superannuation funds who want the intellectual property and a few smart resources on the team.

It's only a matter of time before large wealth players use robo to transition customers to their more complete services. Global names like Charles Schwab have no existing Australian business to cannibalise, and a company like Blackrock can drive demand for its ETFs. Expect these companies to have sophisticated offers at price points no new startup can match.

As a result, consumers who currently receive no financial advice will benefit. With sophisticated graphics, enticing modelling of outcomes and cheap investments, robo offers will increase in sophistication and attract thousands who would never visit a financial adviser. Roboadvice will gradually improve in ways we can only speculate on, much like we could not foresee the extraordinary ways other technologies have changed our lives.

And the full service, personal adviser? Many will embrace robo to service the disengaged or less wealthy, and there will always be a role for person-to-person contact. Regardless of how good the website is, it will never put an arm around the worried investor and explain market events with an intimate knowledge of the client experience and goals.

Graham Hand is Editor of Cuffelinks.

Is Australia in trouble?

Sam Churchill

Now is a time for investors to be cautious about prospects for the Australian economy. With China's economy slowing, our biggest mining boom since the 1850s ending, and the US Federal Reserve (Fed) entering an interest rate hiking cycle, Australia might be facing a challenging period ahead. Major commodity economies such as Canada, Brazil and Russia are already in recession. The risk of an Australian recession in the next few years remains elevated, and global events could exacerbate domestic economic challenges.

Key challenges for the Australian economy

Let's first look at the headwinds facing the economy:

1. China's credit and property bubble

China's rapid growth may be taking a significant turn. As Australia's largest trading partner, its slowdown presents a major risk to the economy.

When demand for Chinese exports deteriorated in the GFC, Chinese banks responded by lending to state-owned enterprises, local governments, private businesses, households and other Chinese entities. It resulted in a credit-fuelled investment boom, much of which found its way into the Chinese property market.

Now, China has to deal with the credit overhang, a massive property oversupply and excess industrial capacity. As China's property market adjusts to lower rates of construction and the economy rebalances towards consumption and away from investment and heavy industry, Australian exports could contract. Given the strong linkages between other Asian economies and China, any slowdown in China will likely spill-over to Australia's other key export partners in the region.

2. US interest rate normalisation

The ongoing recovery of the US economy poses both opportunity and risk for Australia. As the world's largest economy (one quarter of global GDP), a growing US economy will provide an important economic stimulus to many of Australia's major trading partners.

With the US approaching full employment, the Fed is entering an interest rate hiking cycle that will put pressure on economies with asynchronous economic cycles and large foreign debts such as Australia. Australian households, banks and businesses have benefited from ultra-low global interest rates since the GFC, which enabled large debt burdens to be sustained. A normalisation in lending rates and risk premia poses a risk to economies like Australia dependent on foreign capital inflows. As the foreign debt matures and is refinanced, borrowers may face higher interest rates. With the cash rate already at a historic low of 2%, the RBA may have limited scope to offset further weakness in the domestic economy or tighter global financial conditions.

3. Domestic vulnerabilities

Following one of the largest terms of trade booms in Australia's history, a number of imbalances have developed in the economy, making Australia vulnerable to economic shocks.

- High household debt: Australian household finances are stretched and most of this debt is tied to the property market. An increase in unemployment or a general tightening of global financial conditions could lead to defaults and forced sales, with consequences for the property market and financial system.
- Labour market: A normalisation of economic conditions and a fall in employment, most likely in the construction and mining industry, could trigger broader job losses and credit events among highly geared households.
- Mining investment: With the mining and terms of trade boom unwinding, capital expenditure has begun to decline and may still have some way left to fall. A sharp fall in capex could cause a recession, particularly if investment overshoots on the downside and if there are significant multipliers and linkages to other sectors.
- Property market excesses: With Australia's population growth slowing in recent years, the increased quantity of homes under construction appears unsustainable.

Do opportunities exist for Australian businesses?

The headwinds are, as always, balanced to some extent by tailwinds:

1. Depreciation of the Australian dollar

Trade-exposed businesses such as manufacturing, agriculture, tourism and tertiary education will see an improvement in their competitive positions from the significant depreciation of the Australian dollar. Due to the strong wage growth during the

commodities boom and its impact on international competitiveness, it is possible that the Australian dollar still has further to fall, adding further impetus.

2. Domestic population growth

Australia's population growth rate of 1.4% p.a. currently exceeds that of all other major advanced economies. While this will not generate higher per capita incomes, it will help stimulate the economy and create opportunities for Australian businesses. The benefits of population growth are mitigated to some extent by the impact of population ageing, however Australia's working age population (15-64 year olds) continues to grow in aggregate.

3. Productivity growth

Productivity growth is a key long term driver of real GDP. Although relatively weak in recent years, global technological progress has continued. Australian businesses will have the opportunity to modernise and harness this innovation in the years ahead. New jobs will be created in as yet unknown industries as creative destruction takes its course and the economy evolves.

4. Growth in Asia

With Asia accounting for three quarters of Australian goods exports, the region is likely to present significant growth opportunities for Australian businesses. In addition, 50% of the world's population growth in the next 10 years (380 million people) is expected to come from Asia.

What this means for investors

The challenges facing the Australian economy serve as a reminder to investors of the importance of achieving meaningful portfolio diversification. Substantial home bias still exists among Australian investors, including many professionally-managed portfolios in the superannuation industry. Tax structures typically favour domestic assets, while investor and manager preferences are often skewed towards areas of familiarity.

Australia is of course just one of about 200 countries in the world. By investing most of our assets in the same economy in which we live and work, Australians run the risk of having all our eggs in one basket. This approach worked sufficiently while the Australian economy was the beneficiary of significant tailwinds starting with the global economic boom in the 1990s and followed by the China-driven mining boom of the 2000s. However, it would be foolish to assume that Australia's recent economic good fortune is a function of our own good management, and will continue unchecked into future.

The Australian economy may be in trouble. The end of the mining boom poses a major challenge to income growth and our standard of living. Global risks are complicating the adjustment process and could lead to slower growth or a recession in the years ahead. Although Australia has a number of opportunities to generate sustained economic growth, investors should be cautious about prospects for the Australian economy.

Sam Churchill is the Head of Macro Research at Magellan Asset Management. This article provides general information for educational purposes and does not address the personal circumstances of any individual.

Diversification is the foundation of a solid portfolio

Peter Gee

It is well recognised that avoiding large losses is a key element in building wealth. The focus on capital preservation is warranted as heavy losses require very high rates of return to restore the original capital. For example, a 100% gain is required to recoup a 50% loss.

Exhibit 1 shows the annual returns of each of the four major asset classes over a 40-year period. The asset classes are arranged in descending order of return so that the best performing asset class is at the top and the poorest performing asset class is at the bottom. It is clear from the 'gameboard' that no single asset class either outperforms or underperforms consistently. The largest recorded annual fall in the 40-year period was property with 55.3%.

So how do we avoid the extreme losses to capital?

Diversifying or spreading investments across multiple asset classes reduces an investment portfolio's overall risk. This is because losses made in one asset class can be offset by gains in others. The benefits of diversification can be seen in Exhibit 2. It illustrates how a diversified multi-asset portfolio (60% growth assets) has performed compared to individual asset classes in the same 40-year period. In 34 years, the diversified portfolio has

achieved a return in the top 3 asset classes and in only six periods, the portfolio has produced a return in the second-last ranking asset class. The diversified portfolio is neither the best- nor, more importantly, the worst-performing investment in any given year. The risk of a large loss to capital has been significantly reduced and the overall return is less volatile.

Peter Gee is Research Products Manager with Morningstar Australasia. Information provided is for general information only, and individuals should seek personal advice before making investment decisions. The objectives of any individual have not been considered in this article.

Exhibit 1: Gameboard Chart Featuring Asset Class Returns Over a 40-Year Period

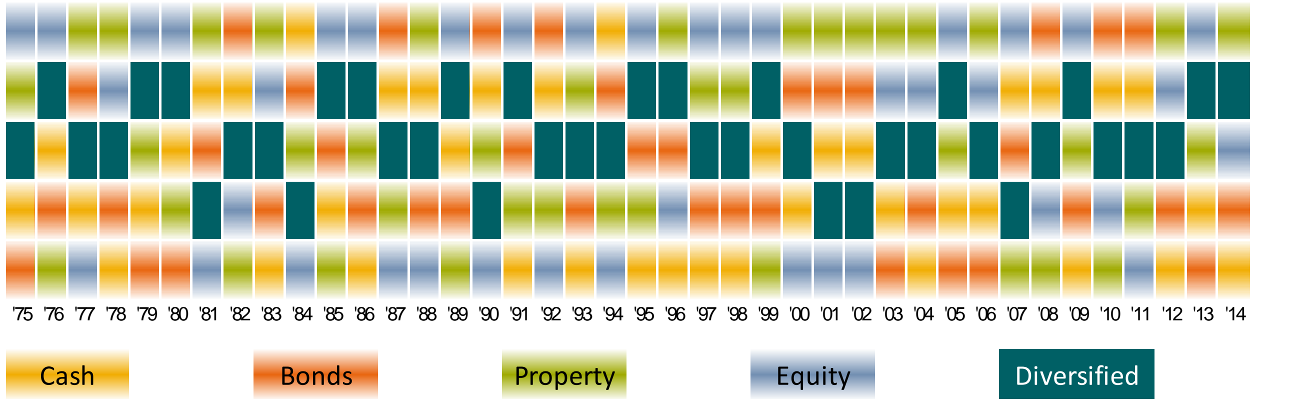
'75 '76 '77 '78 '79 '80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14

'75 '76 '77 '78 '79 '80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14

Cash Bonds Property Equity

Source: Morningstar Direct

Exhibit 2: Gameboard Chart Featuring Asset Class Returns and a Diversified Portfolio Over a 40-Year Period



Source: Morningstar Direct

Disclaimer

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