Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

In share investing, perception is reality

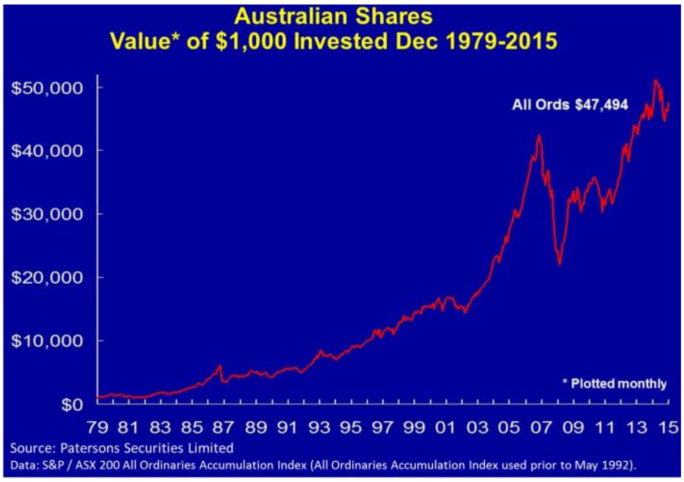
Peter Thornhill

Some years ago, as my wife and I contemplated the transition to full retirement, we decided to take charge of our future and opted to manage our own super. One of the primary reasons was to ensure that the assets reflected our conservative nature; that is 100% shares. This may sound contradictory to many but after more than 45 years in the financial services industry, I had learnt some important lessons.

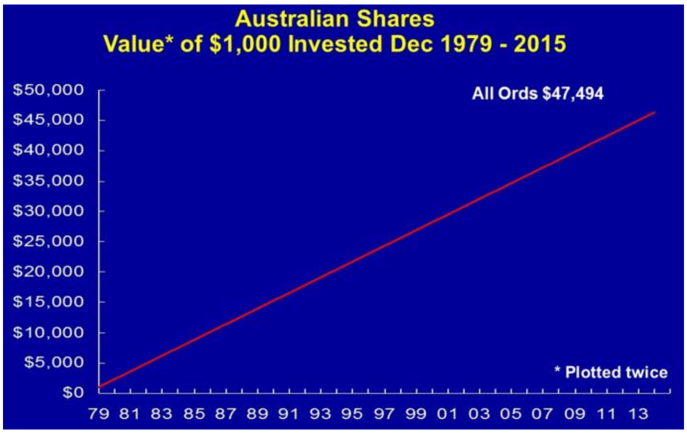
What does risk really mean?

The word 'risk' is bandied about but many do not understand the investment risks associated with retirement. Still today, the definition of investment risk remains the volatility of share prices. So, leaving our future hostage to an industry still wedded to this outdated dogma did not appeal to us. We refuse to accept volatility as a problem. Our primary risk is not losing money but outliving it.

In many presentations I have tried to curb this unhealthy focus on prices by offering an alternative view. The chart below is the All Ordinaries Accumulation Index plotted monthly over 35 years. One can see the constant volatility which gives mindless speculators, day traders, hedge funds, computer traders etc. and the media, a fertile environment for spreading their germs.



As 'perception is reality', consider my perception of this same picture.



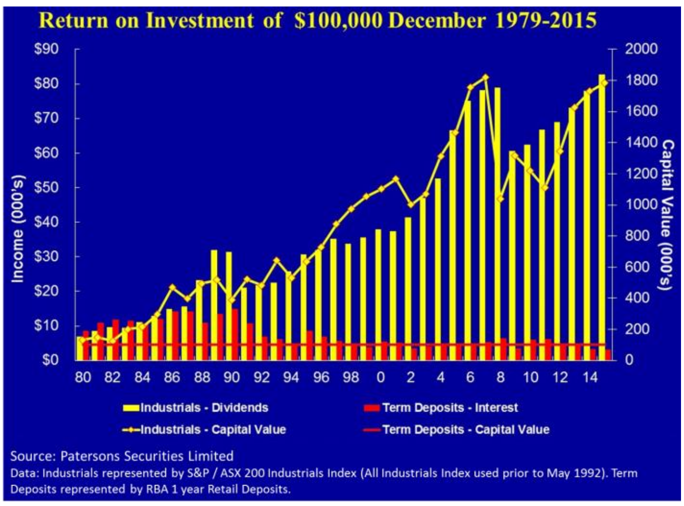
You will note that in both cases we arrived at exactly the same point. I have simply chosen to ignore all the dead ends, shortcuts and deviations along the way! I know what I paid for the shares and I know what they are worth at the end of each day as every one of them is publicly 'auctioned'. The revelation for me, some years ago, was that all the noise in between purchase and today was just useless chatter. Unless of course you are a 'chartist'. It is difficult to draw trend lines on my chart and identify the 'double tops' and 'head and shoulders'!

In retirement, it's income that matters most

When discussing whether we could afford my ceasing full-time work, the consideration was not how much money we had but how much income we needed. We looked at the three assets available (cash, property and shares), considered their income prospects both present and future, and opted for shares.

The income they generated would meet our immediate needs without having to rely on selling, thus maintaining the integrity of our asset base. Also, over the long term I knew that the dividends from a diversified portfolio of shares had and would grow in a relatively stable way and being linked to the productive efforts of the nation, they would be superior to the income from other sources.

The chart below is worth a thousand words. This shows the Industrial Share Index and cash broken into their two separate elements, income and capital. The income streams (the vertical bars) have been available to every one of us for the last 35 years and beyond. It is regrettable that those people who required the most income often chose the asset (cash) that produced the least income because shares were classified as risky due to their price fluctuations.



The dividends, during the 80's and 90's whilst I was still working, were being reinvested. When I quit the industry and wound down my business in 2007/2008 it was simply a matter of redirecting the dividend stream from reinvestment to pension mode.

A real time test of the strategy

With nearly a decade behind us now and the GFC to add some spice, we can now look at our strategy being tested in real time. As painful as it was to watch our portfolio almost halve in value, the income only dropped by 20%. However, as we held enough in cash to cover two years' worth of pension withdrawals, we simply followed our parents example who, when times were tough, tightened their belts.

Today, too many retire with too little, too early and leave themselves exposed to the disaster that is cashing assets to produce income when prices have retreated. As we drew down on our cash buffer the dividends replenished the account which avoided us having to cash any of the holdings. In fact, with cash available, we were able to take advantage of the turmoil generated by the GFC to modestly enhance our future income.

During the GFC, our biggest bank, CBA, fell from $64.00 to below $30.00. Credit markets had frozen so the only way companies could raise capital to bolster balance sheets was through a rights issue, usually new shares pro rata to existing shareholders, or a share purchase plan. CBA did this at $26.00 per share. Similarly, one of Australia's larger conglomerates, Wesfarmers, fell from around $40.00 and issued shares at $13.50. This was repeated with all of the major banks and many of the country's leading companies.

The following table shows the current situation with those share parcels that were purchased.

CBA – Return from GFC	Wesfarmers – Return from GFC
Purchase price in 2008: $26.00 Total dividends paid = $21.29	Purchase price in 2008: $13.50 Total dividends paid = $10.19
80% of the purchase price has been returned PLUS Shares are worth over three times amount paid	75% of the purchase price has been returned PLUS Shares are worth over three times amount paid
Last annual dividend is $4.16 which equates to a current yield of 16%	Last annual dividend is $2.04 which equates to a current yield of 15.1%

Those and other new share issues that we were able to take up have paid off handsomely with their cash flow and continue to do so. These figures do not include the recently announced dividends.

Bearing in mind that we were able to purchase shares at the lowest point in the market, our personal portfolio benefitted substantially when compared to the cash versus shares comparison chart above. It is now seven years later and our income is above where it was and the portfolio value has more than fully recovered. The importance of never having to rely on cashing your asset base to provide income cannot be overstated.

Focus on the dividend flows

I can think of no better 'longevity' insurance than that indicated by the yellow bars above. How do we get people to stop following daily share prices and, more importantly, paying heed to mindless media commentary? By focussing only on the income and not the prices of our shares, we have avoided much of the angst associated with the GFC. Also, as longevity appears to be a potential genetic advantage that we enjoy I need to be sure that the asset base remains intact and the income stream will continue to grow for decades to come.

I have watched as my parents, in-laws and many of their peers were reduced to living totally on the old age pension because they had initially relied on bank deposits in what they thought was the 'safe' option. The nail in the coffin (no pun intended) as far as I was concerned was watching as the two respective family homes were sold as neither widow (the husbands having pre-deceased their spouses) could afford to maintain them.

As the probability is that my wife will outlive me, we will continue to invest solely in shares, the conservative option, as I am determined that she will continue to live with dignity.

Peter Thornhill is a financial commentator, public speaker and Principal of Motivated Money. This article is general in nature only and does not constitute or convey specific or professional advice. Formal advice should be sought before acting in any of the areas discussed. This article is reproduced with permission of the author.

Google's driverless cars: welcome to the world of investing

Graham Hand

It started out as a news story about cars, not investing:

"When a Google self-driving car edged into the middle of a lane at just a bit over 3km/h on St Valentine's Day and hit the side of a passing bus, it was a scrape heard around the world."

Although the incident was big news in the car industry and at Google, it has no apparent connection to investing. But then the story took a delightful twist:

"The accident illustrates that computers and people make an imperfect combination on the roads. Robots are extremely good at following rules … but they are no better at divining how humans will behave than other humans are."

Starting to sound familiar? Rather like markets and behavioural economics? Here's the punch line:

"Google's car calculated that the bus would stop, while the bus driver thought the car would. Google plans to program its vehicles to more deeply understand ***the behaviour of bus drivers****."*

You gotta laugh. Good luck with that one, Mr Google. Will you be programming the driver (any driver!) who is texting, or the one who drank too many beers last night, or the one who just had a fight with his wife, or the one onto her fifth coffee?

Welcome to the world of investing and human behaviour which is anything but rational.

Behavioural finance and the struggle for explanations

Every human emotion plays out when investing, making financial markets unpredictable and struggling for a theory based on scientific evidence. We have covered the subject of behavioural finance many times in Cuffelinks, such as here and here. Often, investment decisions are driven by emotions rather than facts, with common behaviours such as:

- Loss aversion – the desire to avoid the pain of loss
- Anchoring – holding fast to past prices or decisions
- Herding – the tendency to follow the crowd in bursts of optimism or pessimism

- Availability bias – the most recent statistic or trend is the most relevant
- Mental accounting – the value of money varies with the circumstance.

A new book to be published soon, written by Meir Statman, called *Finance for Normal People,* argues that the four foundation blocks of standard finance theory need rewriting, as follows:

Standard finance theory	Behavioural finance alternative theory
1. People are rational	1. People are normal
2. People should design portfolios based on 'mean-variance' portfolio theory	2. People should design portfolios based on behavioural portfolio theory
3. Differences in expected returns are determined by the amount of risk	3. Expected returns are influenced by many factors such as emotions and behaviours
4. Markets are efficient since price equals value	4. Markets are not efficient because price does not equal value

The unfortunate truth is that if an investor went to ten different financial advisers, it's likely they would end up with ten different investment portfolios. Investors have their own views on issues such as diversification, risk, active versus passive, efficiency, short run versus long run, etc, and often settle for 'rules of thumb' as a guide to investing. The bestselling book, *Nudge*, by distinguished professors, Richard Thaler and Cass Sunstein, quotes the father of modern portfolio theory and Nobel Laureate, Harry Markowitz, confessing about his personal retirement account,

"I should have computed the historic covariance of the asset classes and drawn an efficient frontier. Instead, I split my contributions fifty-fifty between bonds and equities." (page 133)

That's it! One of the greatest investment minds of the twentieth century simply goes 50/50. This is all the industry has achieved despite decades of research, complicated theories and multi-million dollar salaries paid to the sharpest minds from the best universities.

Economics as a 'social science'

Why is investing so imprecise, replete with emotions and strategies with little supporting evidence, when other 'sciences' have unified theories? Why does a physicist know how gravity works, an arborist knows how a tree grows and a doctor can treat a patient with cancer, while fund managers around the world have different view on markets, stocks and bonds?

Consider Newton's third law of motion:

"When one body exerts a force on a second body, the second body simultaneously exerts a force equal in magnitude and opposite in direction on the first body."

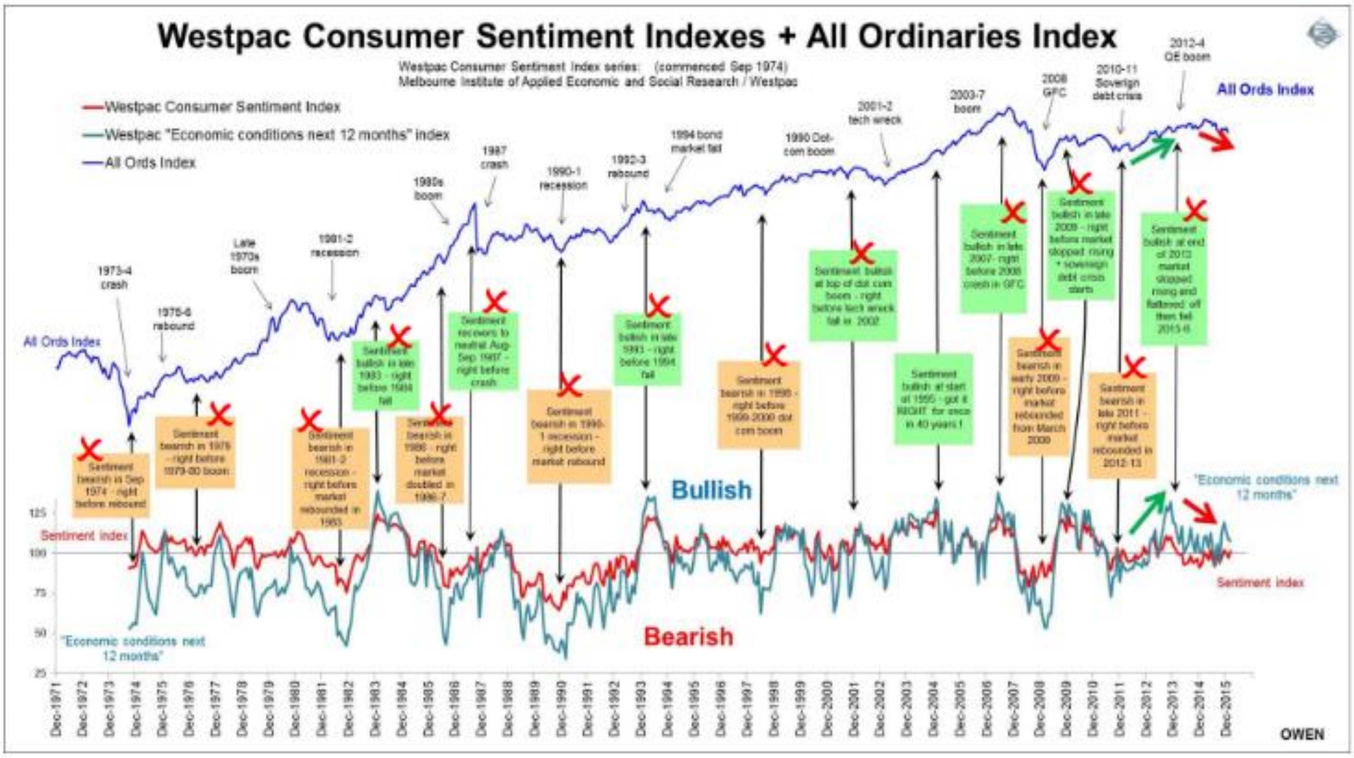
There is no equivalent of this certainty in economics. For example, we do not know how the market will react when a central bank reduces interest rates. Maybe it happened because the economy is slowing, which is bad for the markets, and the hoped-for stimulus does not occur. And so the central bank plunges into unproven QE and even negative interest rates as it runs out of ideas.

Although economics pretends to be a 'science', it is a social science of politics, society, culture and human emotions.

It is often said that economics suffers from 'physics envy'. Economists cannot test a theory in a controlled laboratory-style experiment in the way a physicist or chemist can. Ironically, economists usually earn a lot more than physicists, and are called upon as the experts in almost everything. Economists don't even need empirical validation of their theories.

Which leaves markets prone to irrational bursts of optimism and pessimism, as we have seen in the last month. January and February 2016 started off with dire predictions on oil, other commodities and China and the market fell heavily, and then in early March, it staged a strong rally as the banks and resource companies recovered some of their losses. Prices were higher despite no apparent improvement in underlying fundamentals. Morgan Stanley analyst Adam Parker advised clients:

"If the consensus is right that we will chop up and down, then by the time we feel a little better, we should take off risk, not add some. Maybe you should do the opposite of what you think you should do. That's the new risk management."



Do the opposite of what you think you should do

That's the advice! Maybe it's not as crazy as it sounds.

Consider the chart above, courtesy of Ashley Owen. It compares the Westpac Consumer Sentiment Index with the All Ordinaries Index. It shows that bearish sentiment (the blue line for economic conditions in the next 12 months) is usually followed a rising share market. Bullish consumer sentiment is followed by a falling market. It's why people tend to buy high and sell low, and empirical evidence is that investors usually underperform the index by poorly timing the market.

Let's leave the final words to Jack Bogle, Founder of the Vanguard Group:

"The idea that a bell rings to signal when investors should get into or out of the market is simply not credible. After nearly 50 years in the business, I do not know of anyone who has done it successfully and consistently."

Good luck with that, Google

I can imagine the scientists and engineers doing what we all do to start a new project, and Googling about human behaviour as they start to model how bus drivers might behave. They could do worse than study a good book on behavioural finance.

Graham Hand is Editor of Cuffelinks and confesses his own SMSF has a growth/defensive allocation of about 50/50. If it's good enough for a Nobel prize winner …

Multi-manager diversification or tax efficiency or both?

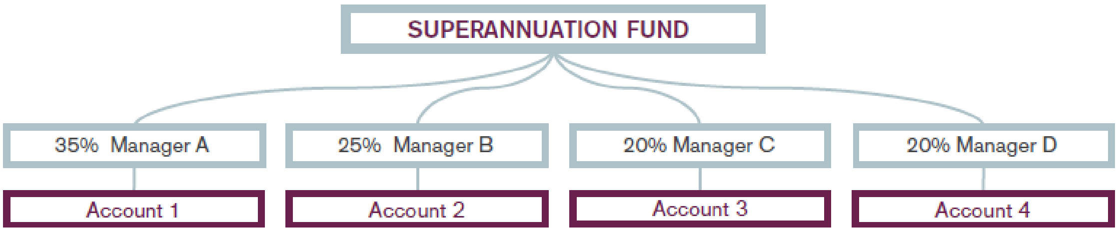
Raewyn Williams

The taxation structure of superannuation funds in Australia is curious by world standards. Most countries follow the 'EET' taxation structure (Exempt contributions, Exempt investments, Taxable benefits). Australia, unusually, follows the 'TTE' structure (Taxable contributions, Taxable investments, Exempt benefits), though the 'T' is levied at concessional rates. It will be fascinating to see what will change as the Government moves through its tax reform agenda this year.

Taxation in the accumulation and pension phase

Management of the 'middle T' taxation of the investment earnings of superannuation funds is therefore a particularly Australian challenge, and appears alien to our US and UK counterparts. Finding reliable research, expertise and solutions in the area of managing institutional superannuation

Traditional Fund Structure:



portfolios after tax is quite challenging, yet the task is an important one. This is true not only for superannuation members in the taxable accumulation (pre-retirement) phase but also for pension phase members who care about that other Australian tax peculiarity, franking credits, along with foreign withholding taxes.

An early challenge large funds face as they move to an after-tax investing focus for their equity portfolios is how this fits within a multi-manager framework. Funds typically spread their portfolios across a range of managers to access different styles and achieve an optimal blend of diversity – an application of the more familiar theme of diversifying across asset classes to reduce risks and increase returns to further improve the overall risk/return profile of the fund's equity portfolio. This results in the equity portfolio of a large superannuation fund having an architecture that looks something like the diagram above.

Multi-manager structure tax inefficiencies

Naturally, each manager is unaware of the other managers' portfolio holdings, trading and investment insights. This protects each manager's intellectual property and the diversity of the structure as a whole. But here's the rub: it is a very inefficient, possibly damaging way to manage the fund's overall capital gains tax (CGT) liabilities from equity trading. Each manager can, at best, manage the CGT on their own portfolio, but still have no knowledge of the tax positions of other managers or of the portfolio as a whole. This can generate dysfunctional decision-making.

For example, Table 1 below illustrates three types of potentially sub-optimal behaviour by equity managers:

1. trading which looks value-accretive but in fact reduces value post-tax
2. not trading, hence forgoing active returns, because of an illusory tax hurdle
3. delaying the timing of a trade, hence increasing tracking error risk, because of an illusory CGT discount benefit.

Effective CGT management requires centralisation or line-of-sight across the whole portfolio. Superannuation funds may think they are doing the right thing for their members by asking their equity managers to concentrate on after-tax returns, but actually it makes little sense to hold those managers accountable for the fund's overall CGT liability.

The use of Centralised Portfolio Management

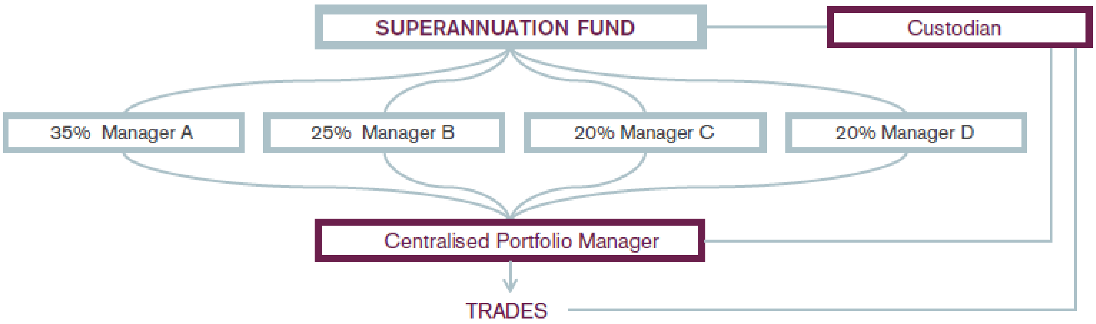
There is a solution, well-established in the US and gaining traction in Australia, which can help superannuation funds with multi-manager equity portfolios solve this problem. 'Tax-managed Centralised Portfolio Management' (CPM) combines each manager's investment insights with a central implementation manager with the job of ensuring

Table 1: The Capital Gains Tax Inefficiency Problem for Multi Manager Funds

	Equity manager's sleeve view						Whole-of-portfolio view					
Gain/loss on proposed trade	Holding period	Short gains available?	Long gains available?	Losses available?	Expected CGT impact	**Expected after-tax return**	Short gains available?	Long gains available?	Losses available?	Real CGT impact	**Real after-tax return**	**Manager's return misstatement**
$1,000	10 months			Y	0	**$1,000**			N	$150	**$850**	**$150**
$1,000	10 months			N	$150	**$850**			Y	$0	**$1,000**	**($150)**
$1,000	3 years			Y	$0	**$1,000**			N	$100	**$900**	**$100**
$1,000	3 years			N	$100	**$900**			Y	0	**$1,000**	**($100)**
($1,000)	10 months	N	Y		($100)	**($900)**	Y	N		($150)	**($850)**	**($50)**
($1,000)	3 years	Y	N		($150)	**($850)**	N	Y		($100)	**($900)**	**$50**

Source: Parametric 2014, excerpted from 'What Should Managers Manage?", Parametric Research 2014.

Fund Structure with CPM:



trades are tax-optimised at the whole-of-portfolio level as shown in the diagram above.

In this solution, a large superannuation fund can continue to appoint managers based on the fund's own objectives, style preferences, and risk and fee budgets. This preserves the multi-manager blending and diversification benefits the fund is seeking. But instead of each manager routing trades separately through their own set of brokers, the execution of these collective manager insights is centralised. Daily, the managers' recommended trade lists are received and offsetting 'redundant' trades identified and eliminated by a single implementation manager (e.g. where Manager A buys BHP shares as Manager B sells BHP shares). The implementation manager, viewing the entire portfolio, can then address tax inefficiencies; for example, by identifying the same stock in a different manager's portfolio with lower embedded CGT; or by choosing to hold off on a proposed trade so that it qualifies for the CGT discount. There are also numerous other (non-tax) benefits of centralising implementation in this way.

CPM as a dedicated, sophisticated after-tax focused investment solution shows how funds need not be forced to choose between multi-manager diversification and tax efficiency – both important objectives. With a little innovation, a fund really can have both.

Raewyn Williams is Director of Research & After-Tax Solutions at Parametric, a US-based investment advisor. Parametric is exempt from the requirement to hold an AFSL under the Corporations Act 2001 (Cth) (the "Act") in respect of the provision of financial services to wholesale clients as defined in the Act and is regulated by the SEC under US laws, which may differ from Australian laws. This information is not intended for retail clients, as defined in the Act. Parametric is not a licensed tax agent or advisor in Australia and this does not represent tax advice. Additional information is available at www.parametricportfolio.com/au.

Taking the good times with The Bard

Nader Naeimi

In the midst of heightened anxiety over the possibility of another financial crisis and market turmoil, 2016 marks the 400th anniversary of Shakespeare's death. While most people don't pick up Shakespeare's plays when they're looking for investment advice, Shakespeare did write frequently about money matters.

"How poor are they that have not patience! What wound did ever heal but by degrees?" – Iago in Othello in Act 2, Scene 3. Or in plain English: **patience pays off.**

"Neither a borrower nor a lender be; For loan oft loses both itself and friend, And borrowing dulls the edge of husbandry." – Polonius in Hamlet Act I, Scene 3. In other words, **don't spend money you don't have**.

"Foul-cankering rust the hidden treasure frets, But gold that's put to use more gold begets." – Venus and Adonis, a poem. Or more simply: **Don't put your money under the mattress.**

Where the Bard and markets meet

Shakespeare's plays often turn on the idea of fate. Controlling one's fate seemed to have become part of the human consciousness by Shakespeare's time but not yet the competencies to achieve that end. Instead, those who tested fate usually ended up dead. These themes are explored most vividly in The Tragedy of Julius Caesar. Caesar receives all sorts of apparent warning signs, which he ignores, proudly insisting that they point to someone else's death. Then Caesar is assassinated.

Given the rough start to the year, you may wonder if we made the same mistake as Caesar by ignoring the warning signs. After all, our expectation for a better 2016 (compared to 2015) did not get off to a good start.

What was the trigger for such a panic in January? China, oil and Fed worries were nothing new. The same worries led us to take out portfolio hedges and reduce growth exposure from the second half of 2015 when market complacency was high. While these tail hedging strategies paid off, they were not enough to offset the negative contribution from the exposures to commodities and Asian shares.

As 2015 drew to a close, many of our sentiment and valuation indicators had made a significant positive adjustment (mostly during the August-October correction), macro indicators were showing signs of steady improvement and financial conditions in China were looking up. Then a few people got back to work in early January and listened to interviews by some hedge fund gurus on how China is about to implode and that central banks are out of ammunition. Panic buttons were hit despite the fact these gurus have been making the same predictions ever since the GFC. With markets down sharply, the next group of sellers showed up and decided to sell based on the idea that 'maybe the market is telling us something'.

Reasons not to join the panic

For now, major equity indices have found support at key support areas, as the market now focuses on:

- Little or no signs of credit crunch even as global banks came under fire.
- Easing financial conditions in China, and after a year of monetary easing, real yields are falling and loan growth is picking up steam.
- Significant improvement in valuation measures. Of course, valuations are not great timing indicators and just because valuations are cheap doesn't mean markets can't fall further. However, when valuation signals move to historical extremes, it pays to take notice.

History shows time and time again that strong positive returns can be achieved by investing in the share market when the economic news is negative, and bad news is well covered and reflected in valuation measures. However, investors as a group fail to exploit valuation anomalies. Why? Because there is a price to pay and that's accepting short-term volatility.

While downside selling pressure has shown signs of easing, evidence of buying pressure will need to emerge. Improved earnings prospects against much pessimistic expectations and further policy support from Europe, China, Japan and US (through delayed further rate hikes) should lead to reduced short-term volatility and a re-rating of equities. The most significant risk to market stability, however, continues to be the US dollar.

What if China implodes?

For Chinese H shares, valuations (extremely cheap), cycle (leading indicators of growth are turning up), monetary policy (significant improvement in monetary conditions), technicals (waning downside participation across individual stocks) and sentiment indicators (extreme pessimism) are all green. Rarely do we find an asset class that gets a tick across so many drivers.

Of course, none of this matters if the predictions of some US hedge fund gurus are right and Chinese banks collapse. Their calls on financial Armageddon in China have gained widespread coverage (so much that we received several emails from some worried clients).

In our view, as with all things in China, the spectre of a financial crisis is an intensely political concern. Should a financial crisis occur in China, it will be because all options to prevent such a profound dislocation have been tried and failed. Indeed, China is one of the very few countries in the world with the ability to boost fiscal support, and that's what we have seen in recent months.

In summary, despite the intense market weakness since the start of the year, increasing calls of an imminent global recession and financial meltdown, our focus was and is to remain objective. We continue to expect market turbulence to settle down soon. Further breakdown in emerging market currencies, another bout of underperformance by cyclically-sensitive sectors and falling inflation expectations (pushing real yields higher) will be examples of such dynamics that will warrant a shift in allocation towards a more defensive stance.

Nader Naeimi is Head of Dynamic Markets at AMP Capital. This article is a general view and does not address the specific circumstances of any investor.

Reporting season was not all doom and gloom

Sebastian Evans

February's 'reporting season' took place whilst global equity markets were in free fall. As at the end of February 2016, the Australian All Ordinaries Accumulation Index had posted a negative return year-to-date of -6.78%. We are not alone in our pain however, with similar sentiment across many other international (developed) equity markets. The two major US indices, the Dow Jones Industrial Average and S&P 500 kick-started the year with the worst opening week performance in history, and the story was much the same across most European exchanges.

Whilst volatility in equity markets was driven by continued oil price weakness and fears surrounding the extent of China's 'hard landing', according to those responsible for setting Australia's monetary policy, the picture doesn't look that bad. Economic growth continues to track within an acceptable range and there are no unanticipated signs of structural decline in any areas of the economy. In this seemingly contradictory environment, it is worth delving into the challenges and tailwinds facing businesses as reported by them during February's reporting season.

What do we like to see?

The stock market is likely to reward companies that could:

- grow revenue in a sustainable manner and
- increase earnings through a combination of revenue and margin growth, rather than only cost-cutting.

Indeed, in an environment where earnings remain elusive and growth even more scarce (as evidenced by the high multiples paid for stocks that provide even a hint of this, such as Blackmores, Bellamy's, Burson, IPH Limited), many analysts feared the worst in the reporting window. What resulted, however, surprised many, with Goldman Sachs stating, 'Relative to expectations, this earnings season is on track to be one of the stronger post GFC period.'

According to Goldman Sachs' research, at the close of the second week of reporting season (22 February), of the 54% of all companies that reported (the remaining falling into the final week of the month), 46% of these beat expectations by greater than 2%. Whilst this may not seem such a stunning result, the same research claimed that only twice in the past 15 earnings seasons have more than 40% of firms beaten expectations.

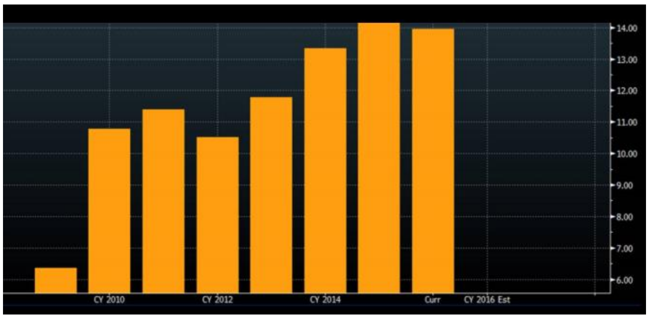
Those that performed the best, in line with the broader economic picture, operated in the consumer discretionary sector and relied on growth in domestic demand to increase revenue and earnings. While the consensus trade in February was from growth/momentum stocks to those in the resources sector (which also didn't disappoint but mainly as a result of cost-cutting initiatives being delivered on time), it was momentum stocks that also produced some of the strongest 'consensus beating' results as at the time the research was undertaken.

In terms of underperformers, importers were hit especially hard by falls in the Australian dollar, particularly those whose currency hedging positions rolled off. The key challenge for these businesses is how best to pass on price increases to highly sensitive consumers without damaging demand - a fine balance to find.

Where is growth in earnings per share coming from?

In terms of overarching trends, perhaps one of the most interesting has been Earnings Per Share (EPS) overtaking Dividend Per Share (DPS) in certain sectors such as Industrials and Banks. EPS, simply speaking, is the proportion of a company's profits allocated to issued capital (common shares). Growth in EPS is positively viewed by investors as it shows how much money the company is making for its shareholders, not only due to changes in profit, but also after all the effects of issuance of new shares.

As the picture for earnings remains elusive, where is the growth in EPS coming from? Previously, we had seen the delivery of cost-cutting initiatives and low interest cover charges to boost profit margins. Looking at the EBITDA operating margins, we can see that profit margins have now stopped increasing suggesting that benefits from these inputs have diminished and any future growth in earnings will need to come solely through revenue growth, particularly for those companies in the Industrials sector. The chart below shows the operating margins of the ASX-100 Industrials since 2010.



Source: Bloomberg

Volatility is disguising economic health

Tying together company performance and key indicators of Australia's economic health, we conclude that the picture is not as bleak as the recent volatility in equity markets suggests. Looking at the underlying reasons for the recent market fall (before the March 2016 rally):

1. **Oil price weakness**: Positive for net importers of this commodity as it represents, as per Howard Marks of Oaktree, a "multi-hundred-billion-dollar tax cut, adding to consumers' disposable income. It can also increase an importer nation's cost competiveness", and

2. **Growth headwinds in China**: Whilst growth levels have fallen, they still remain attractive relative to other global economies. Further, areas within China are experiencing strong growth, such as consumer spending, particularly in retail sales and travel. Retail sales in China are up almost 11.5% versus this time last year and the latest statistics relating to inbound tourism from China to Australia show growth of almost 11% from this time last year. Further, in relation to China's impact on US growth, according to US national income accounts, only 0.7% of US profits are generated in China. Goldman Sachs' research estimates that a 1% drop in China's GDP growth will have a 0.1% impact on US GDP from direct and indirect exposure. If you compare that to the GFC, the banking system in the US had a 39% exposure to US mortgages, hence why the shock was so great. Yes, there is always a risk of financial contagion from China to other countries, but we think this risk is being overplayed.

What is the key criteria for successful investing through this period of equity market volatility?

As a value-driven investor, we look for companies that have the ability to leverage the 'quality' aspects of their business, such as strong brands, people, balance sheets and the ability to move quickly and efficiently to implement changes to position them as leaders. Whilst profitability is, of course, important to assess, it presents the market with a value to ascribe to a company's stock 'at a given point in time'. As such, inefficiencies can be created and therefore opportunity can present for those with a longer-term horizon.

Sebastian Evans is Chief Investment Officer and Managing Director of [NAOS Asset Management](). This information is general only and does not take into consideration the investment objectives, financial situation or particular needs of any reader. Readers should consider consulting a financial adviser before making any investment decision.

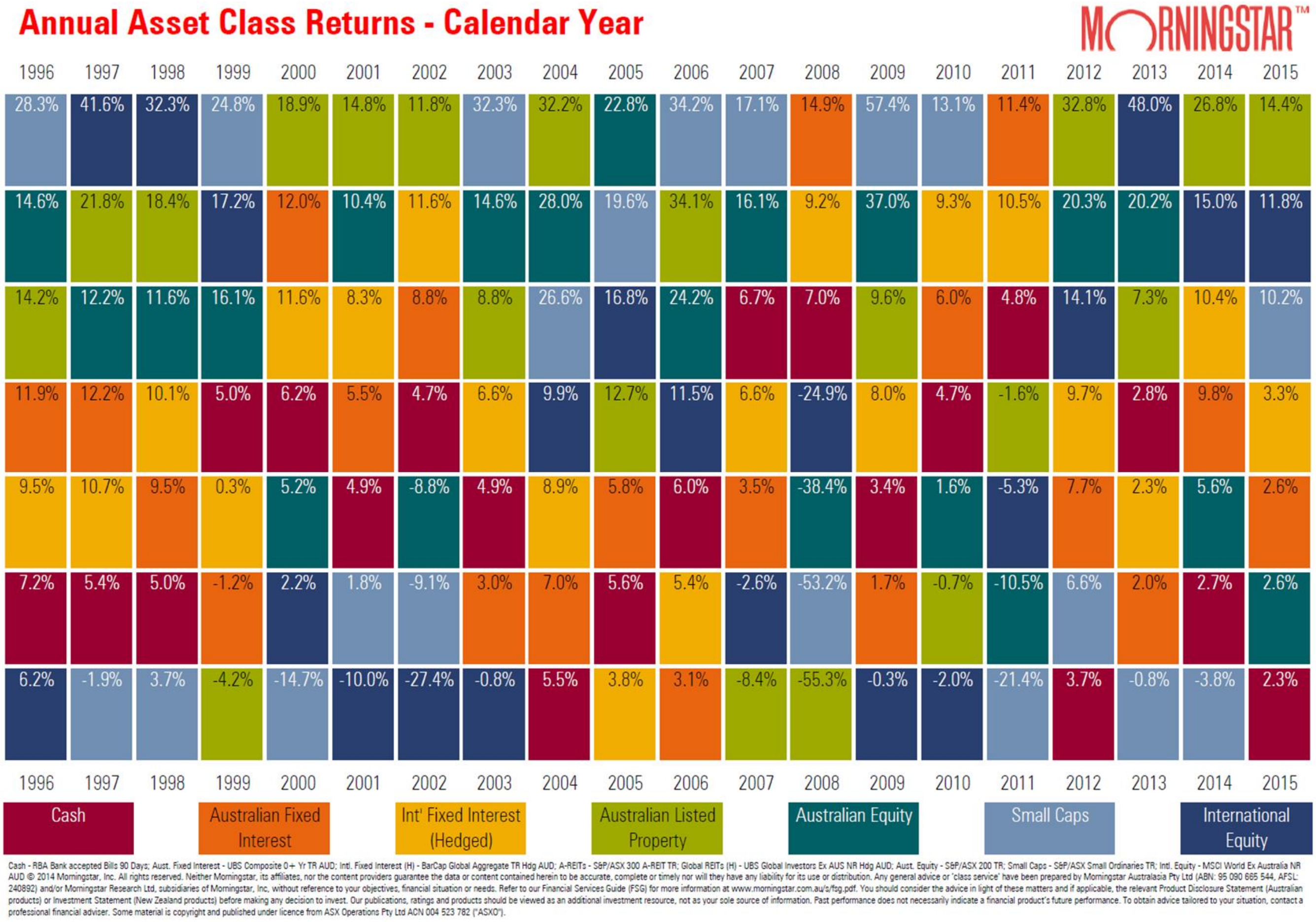
Asset class gameboard 1996-2015

Morningstar

Morningstar's asset class 'gameboard' for 2015 (on the next page) is an excellent visual summary of how each asset class has performed over the last 20 years, and shows that no single asset class consistently outperforms the others. It also gives no hint into how the previous year's winners or losers will perform in the following year as the pattern appears random.

In case the fine print is a little too fine, here are the underlying data sources for each asset class:

- Cash - RBA Bank accepted Bills 90 Days
- Aust. Fixed Interest - UBS Composite 0+ Yr Total Return (TR) AUD
- Intl. Fixed Interest (Hedged) - BarCap Global Aggregate TR Hedged AUD
- A-REITs - S&P/ASX 300 A-REIT TR
- Aust. Equity - S&P/ASX 200 TR
- Small Caps - S&P/ASX Small Ordinaries TR
- Intl. Equity - MSCI World Ex Australia NR


Annual Asset Class Returns - Calendar Year
MORNINGSTAR
1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
28.3% 41.6% 32.3% 24.8% 18.9% 14.8% 11.8% 32.3% 32.2% 22.8% 34.2% 17.1% 14.9% 57.4% 13.1% 11.4% 32.8% 48.0% 26.8% 14.4%
14.6% 21.8% 18.4% 17.2% 12.0% 10.4% 11.6% 14.6% 28.0% 19.6% 34.1% 16.1% 9.2% 37.0% 9.3% 10.5% 20.3% 20.2% 15.0% 11.8%
14.2% 12.2% 11.6% 16.1% 11.6% 8.3% 8.8% 8.8% 26.6% 16.8% 24.2% 6.7% 7.0% 9.6% 6.0% 4.8% 14.1% 7.3% 10.4% 10.2%
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9.5% 10.7% 9.5% 0.3% 5.2% 4.9% -8.8% 4.9% 8.9% 5.8% 6.0% 3.5% -38.4% 3.4% 1.6% -5.3% 7.7% 2.3% 5.6% 2.6%
7.2% 5.4% 5.0% -1.2% 2.2% 1.8% -9.1% 3.0% 7.0% 5.6% 5.4% -2.6% -53.2% 1.7% -0.7% -10.5% 6.6% 2.0% 2.7% 2.6%
6.2% -1.9% 3.7% -4.2% -14.7% -10.0% -27.4% -0.8% 5.5% 3.8% 3.1% -8.4% -55.3% -0.3% -2.0% -21.4% 3.7% -0.8% -3.8% 2.3%
1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015
Cash
Australian Fixed Interest
Int' Fixed Interest (Hedged)
Australian Listed Property
Australian Equity
Small Caps
International Equity
Cash - RBA Bank accepted Bills 90 Days; Aust. Fixed Interest - UBS Composite 0+ Yr TR AUD; Intl. Fixed Interest (H) - BarCap Global Aggregate TR Hdg AUD; A-REITs - S&P/ASX 300 A-REIT TR; Global REITs (H) - UBS Global Investors Ex AUS NR Hdg AUD; Aust. Equity - S&P/ASX 200 TR; Small Caps - S&P/ASX Small Ordinaries TR; Intl. Equity - MSCI World Ex Australia NR AUD © 2014 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement (Australian products) or Investment Statement (New Zealand products) before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Past performance does not necessarily indicate a financial product's future performance. To obtain advice tailored to your situation, contact a professional financial adviser. Some material is copyright and published under licence from ASX Operations Pty Ltd ACN 004 523 782 ("ASXO").