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Are bonds failing us as a warning signal?

Roger Montgomery

The Montgomery team has written extensively about the stunning decline in bond yields. This is occurring despite terrorist attacks, political turmoil in the UK, violence in the US and the prospect of 'last resort' helicopter money in Japan. Life isn't changing, which makes one wonder, are investors frogs in a pot full of gradually heating water?

Confusing and ambiguous signals

Since the US Federal Reserve raised rates in December 2015, usually a sign that the economy is strengthening, US 10-year government bond yields have fallen from 2.3% to 1.47%.

Traditionally, a rising stock market signalled an improving economy while falling bond yields signalled deflation or disinflation, implying the virtual certainty of a recession. We have both. Tradition doesn't apply when the source of the declining bond yields aren't regular investors but massive, globally coordinated central banks. This then begs the question, are the signals we, as equity investors, are used to seeing being obscured by 'official' central bank activity?

In others words, perhaps the recent new highs in the S&P500 are anything but a sign of a strengthening economy. The reality is that the rally has been confined to 'minimum volatility' or defensive stocks, those that might be seen as a substitute for bonds like utilities, telcos and REITs. The same is true in Australia, with the likes of Transurban and Sydney Airport benefiting the most from investor affection. In the past, such behaviour has presaged a fall in aggregate corporate profits and a recession.

Putting aside the probability that declining bond yields will continue to fuel equity price appreciation as capital continues to pursue higher yields, it is worth considering the deeper issues that may, like rust, be now emerging through the paint on the surface of equity markets.

Some commentators took delight from the recent US jobs numbers with one TV personality writing, *"the pessimists on the US economy have been proved wrong"*. Such responses are simplistic. While the payroll gains of 287,000 jobs beat economists' expectations, the trend numbers remain firmly negative. Monthly payrolls in the second quarter averaged 25% less than the first quarter and were half the average number for the fourth quarter of 2015. More importantly, the one million new jobs created in 2016 is still 33% below the total increase in working age people. In the past six-and-a-half years, the total number of new US jobs created has lagged the growth in the working age population by 1.6 million.

According to a report by Deutsche bank, $US15 trillion or 40.5% of the $US37 trillion in developed market sovereign bonds are carrying negative yields and 80% are carrying yields of less than 1%.

Think about that for a moment. If you lend CHF100,000 to Switzerland for 30 years by purchasing a 30-year Swiss bond, you will receive CHF96,172 in three decades' time. The same thing happens if you lend money to the governments of Germany and Japan for 10 years, and the list over five years includes The Netherlands, Finland, Austria, Denmark, Belgium, France, Sweden and over two years you can add Ireland, Spain and Italy to the list. Italy's banking system is in crisis and in need of a bailout. It is estimated it is harbouring $US400 billion of problem loans or 25% of the country's GDP. Yet despite this, Italy can borrow at lower rates than when times were good.

All of this has been driven by heavy-handed central banks, not the weighing scales of the market's price discovery process. The combined central bank balance sheets of Switzerland, the UK, the European Central Bank, the US and Japan have grown from $US3.5 trillion in 2007 to $US12.5 trillion today.

Faulty price signalling

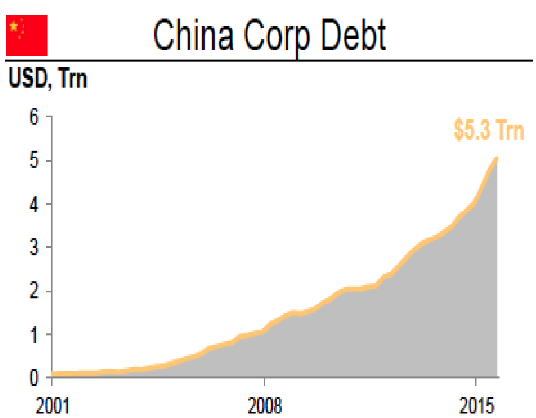
The justification for many equity investors to be fully invested is that the earnings yield – the inverse of the price to earnings ratio – on equities is more attractive than bond yields. But if bond yields are an artifice created by central bank buying, should they be the benchmark against which we measure the attractiveness of stocks?

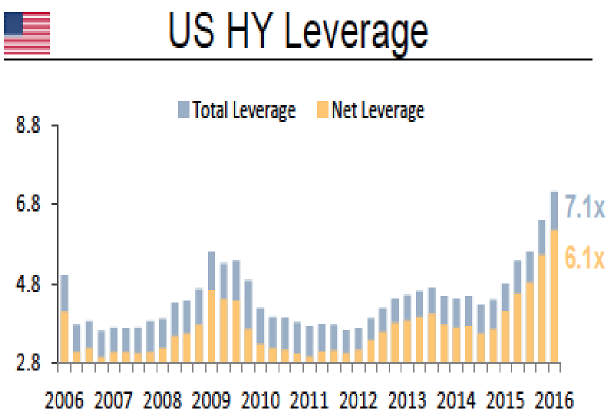
Where would bond yields really be if not for central bank buying? Where would they be if the market were allowed to adjust for risk and uncertainty, without central bank intervention? Would earnings yields of stocks trading on 25, 35 or 55 times earnings look attractive?

Corporate debt has expanded to epochal levels, used to drive shareholder returns through share buybacks and dividends and to fund mergers and acquisitions.

In the first half of 2016 alone, US corporates issued a record $US700 billion. As the following two charts demonstrate, the level of corporate debt puts us in unchartered territory. And don't forget, it's the level of gearing that ultimately determines the toxicity of a burst bubble.

Chinese corporate debt and US leverage





Source: DB Global Markets Research

Perhaps because the accumulating debt has been used for 'financial engineering' rather than productivity or productive capacity improvements, US business capital expenditure is at six-year lows and corporate earnings have not grown.

Since 2011, dividend payout ratios in the US have increased from about 25% to 37% today. In Australia, the payout ratio since 2010 has increased from 55% to approaching 80%, as shown below.

Australian payout ratio increase at expense of earnings growth

August 2005 to August 2015. Source: FactSet.

When companies don't retain earnings to reinvest in earnings growth, the only other avenue to grow is to borrow money or raise capital. Given companies are borrowing record amounts to buy back their shares, it effectively rules out borrowing more money or issuing new shares.

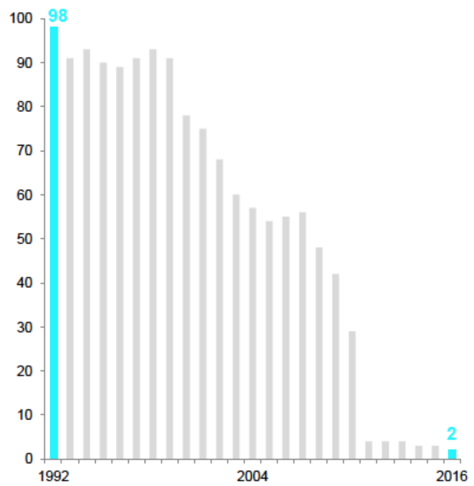
Depressed earnings growth becoming entrenched

In the US, S&P500 companies have, in aggregate, posted negative earnings growth for six consecutive quarters. The S&P500's peak earnings was in 2014, and earnings stand at 18% less today, although the fall is not as great as the 36% slumps registered in the four worst recessions. The decline is more concentrated among commodity companies, but excluding them reveals earnings growth since 2014 of just 0.2%.

Margins will come under further pressure. Wages are rising in the US, and when combined with full employment and declining productivity, it becomes very hard to maintain profit margins.

Low growth, pressure on prospects and high debt unsurprisingly has reduced the credit ratings of many companies. In the US, the number of S&P AAA-rated companies has fallen from 98 in 1992 to just two today – Microsoft and Johnson & Johnson.

Number of S&P AAA rated companies.



Source: S&P, Deutsche Bank

If credit quality is low, the risks for equity investors are high. But if risks are high, why are bond rates at record lows? It doesn't make sense and it means that bond markets have lost their ability to provide appropriate signals to investors.

Any serious break in confidence, the emergence of inflation, or even the flight to safety of US company pension funds, whose aggregate liabilities trounce their assets, could cause apathetic investors to dump their now highly profitable bond positions.

Of course equities would not be immune to such an exodus. As John Authers wrote in the *Australian Financial Review* on 18 July 2016,

"There is no enthusiasm, but ever-pricier bonds leave no choice but to buy stocks … Is this a secure basis on which to invest? No … anyone trying to make money or preserve capital must be calm and relaxed."

Bill Gross the founder of the Janus Global Unconstrained Bond Fund perhaps summed it up best:

"Global yields lowest in 500 years of recorded history and $10 trillion of negative rate bonds. This is a supernova that will explode one day."

It may be some years before there is any sign of panic by investors and in the long run, you will do best being invested in businesses able to retain profits and generate high returns on that incremental equity. In other words, you will do well if you can hold your best quality assets through thick and thin.

However, when the primary justification for the rally in most asset prices is a bond price signal that is broken, holding some cash and perhaps taking some profits on the most highly geared and overpriced assets (Australian apartments anyone?), may well turn out to be a good strategy.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is for general educational purposes and does not consider the specific circumstances of any individual.

Seniors living is becoming a mainstream investment

Adrian Harrington

Australia's population is ageing. The number of people over 65 has more than doubled in 20 years from 1.6 million in 1995 to 3.6 million in 2015, and is forecast to reach 5.6 million by 2030. The seniors living industry is also undergoing significant change due to this ageing population, industry consolidation, changing expectations, and a shortage of quality accommodation.

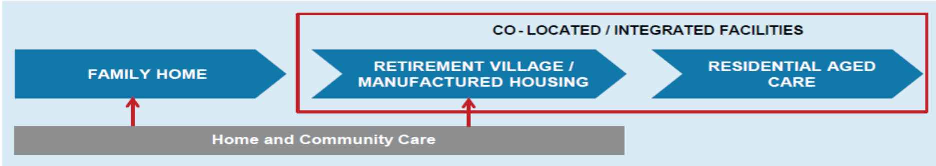
The seniors living industry has three key accommodation components:

- manufactured housing estates (MHEs) – operate under a ground lease agreement in which the resident owns the relocatable home and leases the right to occupy the site from the village owner or operator
- retirement living communities and villages – facilities comprising apartments or villas in which the residents do not own the unit but live in it subject to a lease or licence to occupy. Retirement villages typically operate under a deferred management fee (DMF) structure
- aged care – a special-purpose facility that provides accommodation and other support ranging from assistance with day-to-day living to intensive nursing care to frail and aged residents.

Increasing degrees of care

Older Australians are moving along the spectrum of seniors housing, from independent living at home, to accessing low-level support services in a retirement living community or manufactured housing estate, to ongoing nursing care in a residential aged care facility (as shown in Figure 1). There is also a growing move toward integrated facilities, offering a 'continuum of care', through the integration of an aged care facility and/or provision of home care services within, or adjacent to, an MHE or retirement living community.

Figure 1: Continuum of care for seniors living



Accommodation Type	**Home or Unit**	**Manufactured Housing**	**Retirement Living Communities/Villages**	**Residential Aged Care Facility**
Services Offered	Home based aged care for eligible people	Basic services from providers; can access home care	Varies by village, and some offer extensive services; can also access home care	Ongoing care
Access to Gov't Funded Home Modifications	Yes, subject to eligibility and waiting times	Yes, subject to eligibility and waiting times	Not applicable	Not applicable
Legal Ownership Status/ Tenure	Own land and dwelling	Own the dwelling and lease the land	Long-term license to occupy the dwelling	Not applicable
Regulation	Supply of care controlled by Commonwealth	Varies by jurisdiction	Varies by jurisdiction	Supply controlled by Commonwealth
Fee Structure	Not applicable	Purchase price of home & ongoing rental fees (some also pay at departure)	Ongoing fees & refundable lump sum at entry & departure lump sum	Subsidised ongoing fees. Can choose to pay refundable lump sum for accommodation
Interaction with Tax/ Transfer System	Home exempt from the Age Pension asset test. Only part of the value included in residential aged care asset test	Age pensioners eligible for Commonwealth Rent Assistance. Value of dwelling exempt from Age Pension means test	Mostly ineligible for Commonwealth Rent Assistance. Entry contribution exempt from the Age Pension asset test	Means testing determines the fees payable. The value of the principal residence included up to a capped amount

Source: Folkestone and the Productivity Commission

Industry consolidation

Ownership across all three components of the seniors living industry is highly fragmented and the quality of facilities varies widely.

In the retirement living sector, the top six operators represent only 29% of the number of operators in the sector, according to Colliers International. However, approximately 60% of the facilities are currently accounted for by the for-profit operators such as Lend Lease, AVEO, Stockland, Retire Australia, Living Choice, and Australian Unity and 40% by the not-for-profit operators.

The aged care sector is a similar story. As at June 2014, approximately 63% of operators operated a single facility, accounting for 24% of all operational aged care places, while 29% operated between two and six facilities. Conversely, large providers with more than 20 homes comprised only 2% of all providers but 22% of operational places.

Increased participation from the private sector and institutional investors is leading the move from a boutique cottage industry to one of growing sophistication and scale. A flurry of ASX listings in recent years by both specialist aged care operators such as Japara, Regis and Estia, and listed A-REITs such as Gateway Lifestyles, Ingenia, and Lifestyle Communities, have shone the spotlight on the sector. AVEO (the former FKP) is transforming into a specialist retirement and aged care operator. We expect more opportunities for investors to access the sector through the unlisted space via both private equity and unlisted real estate funds.

Changing consumer expectations

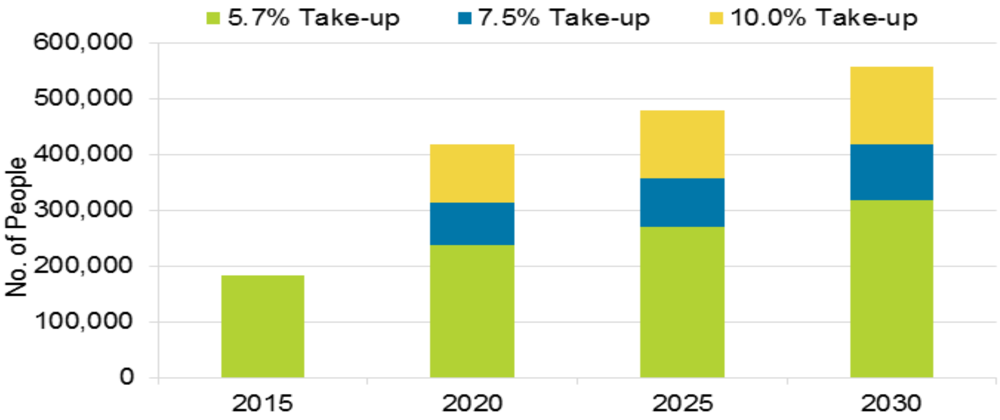
Large numbers of affluent baby boomers are expected to bolster the sector's numbers over the next 10-20 years. These customers will pay more for facilities and services but they will also expect high standards. There will be a greater emphasis on quality service, brand recognition and the reputation of service providers.

The Federal Government wants more people to age in their own home, with a commitment to increase funding for home care packages. MHEs and retirement villages will offer additional services including home care packages within their communities as a way to enhance their overall profitability.

Shortage of quality accommodation

There are approximately 2,300 retirement living communities and villages in Australia, comprising more than 140,000 dwellings and housing approximately 184,000 people, according to the PwC/Property Council Retirement Census for 2015. The average age of a retirement living facility is 23 years, with many of the earlier ones heading towards obsolescence. Folkestone estimates that if the penetration rate of retirement living communities and villages was to increase from just under 6% to 7.5% of the over 65s population, the population of retirement living facilities would more than double to 419,000 by 2030 (see Figure 2). If penetration rates were to increase to 10% (in the US it's currently around 12%), approximately 560,000 people would be living in retirement living communities by 2030.

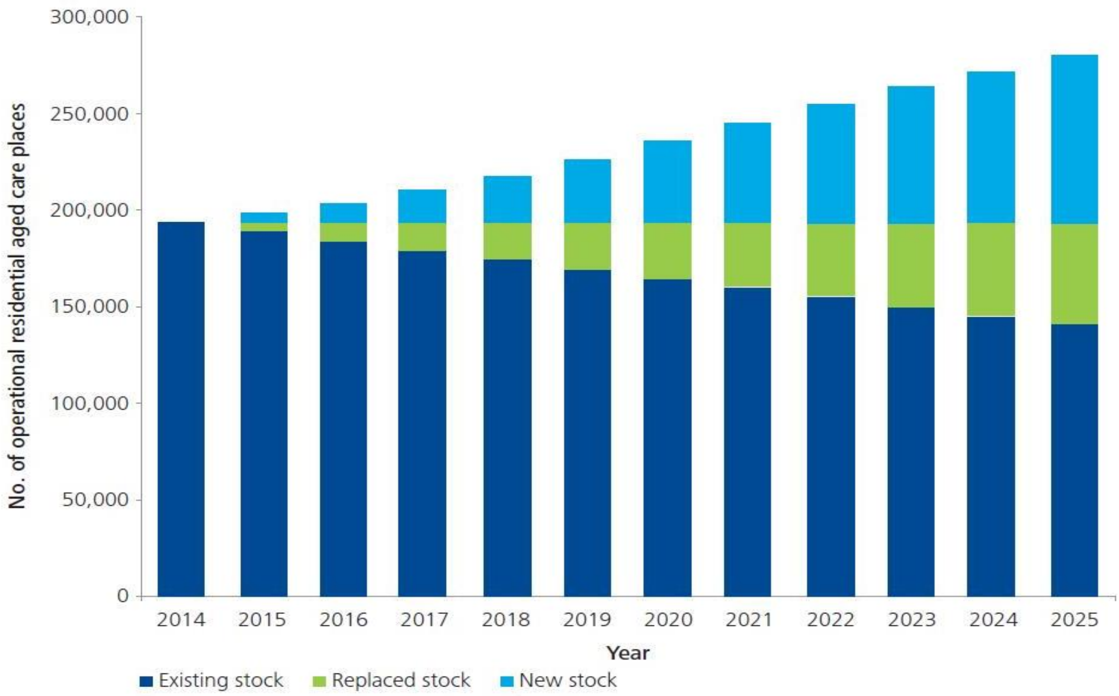
Figure 2: Implied demand, retirement living community residents: 2015 – 2030



Source: Folkestone/ABS

The Aged Care Financing Authority estimated in 2015 that the residential aged care sector will need to build approximately 82,000 additional places over the next decade compared with 36,778 new places created in the decade leading up to June 2014. At the same time, the sector will need to rebuild a substantial number of current facilities which are old, inefficient and don't meet the standards of the government and the community. Assuming that the cost of construction continues to grow at the current rate, and that a quarter of the current stock of buildings is rebuilt at an even rate over the next decade, the Federal Government estimates the sector will require about $33 billion of investment over the next decade.

Figure 3: Number of operational residential aged care places required: 2014 - 2025



Source: Aged Care Financing Authority

An attractive asset class

We believe all three components of the seniors living sector – manufactured housing estates, retirement villages and aged care – will continue to professionalise, consolidate and become more attractive as an investment asset class.

This will require a substantial amount of capital, and we see significant opportunities for investors taking a long term investment view to participate in the evolution and growth of this important sector either through investing in the operations or the underlying real estate via both the ASX and unlisted funds.

Adrian Harrington in Head of Funds Management at Folkestone Limited (ASX:FLK). This article is general information and does not consider the investment needs of any individual. Future articles by Adrian will explain the fees and funding of various retirement sector facilities.

Estate planning and meeting your wishes after death

Gemma Dale

Part 1 of this series on estate planning looked at the decision-making processes involved in preparing an effective plan. Part 2 outlined the documentation required to ensure that your strategy is effectively executed, starting with your will.

In this final part, we look at areas that are easy to overlook in the overall estate-planning process but are vitally important for ensuring that your funds go to those you intended them to and that your house is in order way before that time arrives.

Powers of Attorney

An Enduring Power of Attorney is a legal document where you appoint a person of your choice to manage your assets and financial affairs if you are unable to do so due to illness, accident or absence (such as being overseas). It also applies in the event that you lose mental capacity to make decisions, and may therefore apply for many years in the event of dementia or other cognitive illness.

A medical power of attorney allows you to appoint someone to make decisions about your medical treatment if you become mentally or physically incapable of deciding for yourself.

These two documents give your chosen attorney or attorneys almost limitless power, and therefore require careful consideration and great trust. While the Power of Attorney can be challenged and an alternative Guardian appointed in the event that your attorney is behaving unscrupulously, there is no guarantee of success and a publicly appointed Guardian may be less cognisant of your personal wishes than a close family member or friend.

To guard against unscrupulous behaviour, many solicitors will advise that two or more attorneys be appointed jointly. While this can cause conflict, it creates a system of checks and balances. In the event that you have no preferred loved one or professional to appoint, you can appoint the Public Trustee in your state. Often, however, a close acquaintance will take a more personal interest and therefore be more likely to look after your wishes, and many solicitors will recommend this option.

Superannuation death benefits

Superannuation death benefits are often an individual's largest asset, particularly if the family home is held in joint names. These are not automatically captured by your estate, and therefore you should take steps to ensure that benefits are distributed according to your wishes.

Firstly, understand how your super fund trustee deals with death benefits. Some automatically pay all death benefits to the deceased's estate and do not distribute benefits directly. Others distribute according to their discretion, which generally favours a spouse and minor children over other potential beneficiaries such as adult children. Some offer binding (and even non-lapsing) death benefit nominations which allow you to direct to whom your funds are paid.

An SMSF generally allows all of these options, however the trust deed must explicitly provide for binding nominations. Only certain individuals can receive a superannuation death benefit directly, including your spouse (which could be de facto and same sex partners), children (including step, adopted and adult children), any tax dependants and a person who is in an interdependent relationship with you. The tax treatment of your benefit differs depending on these relationships. Others, such as parents or siblings, can only receive your superannuation benefit via your estate.

Once you know what options are available to you, choose your preferred option and document it. Some solicitors will advise to have all proceeds paid to the estate, so the will can deal with distribution. This is often the case where a testamentary trust has been incorporated into the will. In this case, make a binding nomination to your estate if this option is offered by your fund. Other specialists believe the tax benefits and flexibility of paying a death benefit pension (generally only available to a spouse, minor child or disabled child) make this a better option. Again, ensure this is documented in a binding nomination or consider a reversionary pension, while being mindful of social security and other potential considerations.

SMSFs are a particularly important area of estate planning, as the surviving trustees of the fund have full discretion as to how your death benefits are paid in the event that you have not documented your wishes in a valid binding nomination. This has led to some high-profile court cases and adverse outcomes for potential beneficiaries, which cannot be overturned, despite the clearly valid claim (in principle if not in law) of the wronged beneficiary. Ensure your solicitor has experience in this area, and ensure your trust deed and nominations are carefully prepared; inadequate documentation has caused much grief and expense.

Insurance

Non-superannuation insurance policies should have clearly specified, up-to-date beneficiaries nominated. Check these each time you receive your annual statement to ensure nothing has changed. This includes total and permanent disablement and trauma/critical illness policies that may have life cover attached. The proceeds of these policies will be paid directly to the nominated beneficiary and bypass your estate entirely, so can be an effective way of equalising an otherwise unequal distribution or ensuring your loved ones have access to funds that may otherwise take some time to become available.

Insurance policies held inside superannuation are treated as super death benefits as per the above (albeit with different tax treatment, but that's for another article).

Ultimately, ensuring your wishes will be met after your death or in the event of your illness or incapacity can be expensive and time-consuming. However, it may be the greatest gift you leave your loved ones, making their lives a little easier in a time of grief. The complexity of these issues illustrates why a well-qualified professional is imperative in ensuring the right outcome for you and those you care about.

Gemma Dale is the Head of SMSF Solutions at National Australia Bank. This information is general only and does not take into account the personal circumstances or financial objectives of any reader. Readers should consider consulting an estate planning professional before making any decision.

Investing conservatively vs conventionally: is there a difference?

Tim Carleton

In the 2015/2016 financial year, the average investor performed poorly, despite typically being invested conventionally. The All Ordinaries Accumulation Index masked the significantly worse performance of the top 20 stocks in the market – the S&P/ASX20 Accumulation Index returned negative 7.0% for the year (including dividends). This is noteworthy because of the market capitalisation dominance of those top 20 companies, which at the time of writing constituted over 51% of the All Ordinaries Index. The names are very familiar and dominate most retail investors' portfolios, but many of the individual stocks did significantly worse than the index.

2015/2016 performance of largest 20 companies on ASX

Company	FY16 Performance	Company	FY16 Performance
AMP	– 9.8%	Rio Tinto	– 9.8%
Australia and New Zealand Banking Group	– 19.8%	Scentre Group	+ 38.0%
BHP Billiton	– 27.7%	Suncorp Group	– 3.5%
Brambles	+ 19.9%	Transurban Group	+ 34.7%
Commonwealth Bank	– 7.2%	Telstra	– 4.2%
CSL	+ 32.1%	Westpac Banking Corporation	– 2.2%
Insurance Australia Group	+ 5.4%	Wesfarmers	+ 8.1%
Macquarie Group	– 10.8%	Westfield Corporation	+ 21.0%
National Australia Bank	– 15.4%	Woolworths	– 18.7%
QBE Insurance Group	– 20.4%	Woodside Petroleum	– 17.5%

Investing in large, familiar companies

These companies constitute the most conventional of stock holdings and it begs the question, just because someone is invested conventionally, does that mean that they are being conservative? Most investors who hold large positions in these companies believe that because they are household names they must also be the least risky stocks to hold. But the connection between company size or familiarity and risk is a tenuous one.

The most important determinant of investment risk is the price paid for the asset. A poor asset purchased well under liquidation value can still be a great investment, just as a great asset bought at too high a price can prove a lousy one.

In his book *Common Stocks and Uncommon Profits*, first published in 1958, famed investor Philip Fisher, said:

"Unfortunately, often there is so much confusion between acting conservatively and acting conventionally that for those truly determined to conserve their assets, this whole subject needs considerable untangling."

He highlighted what he thought were the four important characteristics of conservative assets:

1. Superior operating performance, defined as being a 'very low cost producer or operator in its field, [with] outstanding marketing and financial ability and a demonstrated above-average skill on the complex managerial problem of attaining worthwhile results from its research or technological organisation'.

2. Outstanding, high quality people, employees who are responsive to change and enjoy their workplace, and management who are disciplined in building long-range profits (and not solely focused on short-term results).

3. Inherent characteristics that demonstrate above-average profitability – 'what can the company do that others would not be able to do about as well?' – typically demonstrated by a superior return on invested assets and/or profit margin on sales.

4. The price paid for the investment.

Focus on the price paid

The fourth characteristic is often the most significant factor when determining the expected return on an investment. We focus on finding investments that are priced in a way where we expect an attractive total return with a sufficient margin of safety should business conditions or company circumstances prove to be worse than our initial expectation.

Most of the businesses we are attracted to have the following characteristics that are commonly sought after (as highlighted by the similarity between this list and Philip Fisher's four dimensions):

- a simple business model selling products and/or services we are familiar with
- a sustainable competitive advantage
- an attractive return on invested capital
- significant cash flow generation
- a strong balance sheet, and
- competent, disciplined management.

Many of the large Australian businesses listed in the table above we would characterise as good businesses. But a good business bought at too high a price will still generally make a poor investment, especially from a risk-adjusted return perspective. Our view a year ago was that many of these businesses were priced well above our estimate of fair value. They may have appeared to be conservative investments, but in reality they were more conventional investments, and somewhat expensive conventional investments at that.

We are reminded of the Warren Buffett adage, *"Price is what you pay, value is what you get."* Investors should ensure they receive more value than they pay for when purchasing securities. If they do so over time, investors should earn an adequate return on their capital.

Tim Carleton is Principal and Portfolio Manager at [Auscap Asset Management](), a boutique Australian equities-focussed long/short investment manager. This article is general information and does not consider the needs of any individual.

Australia's other boom exports

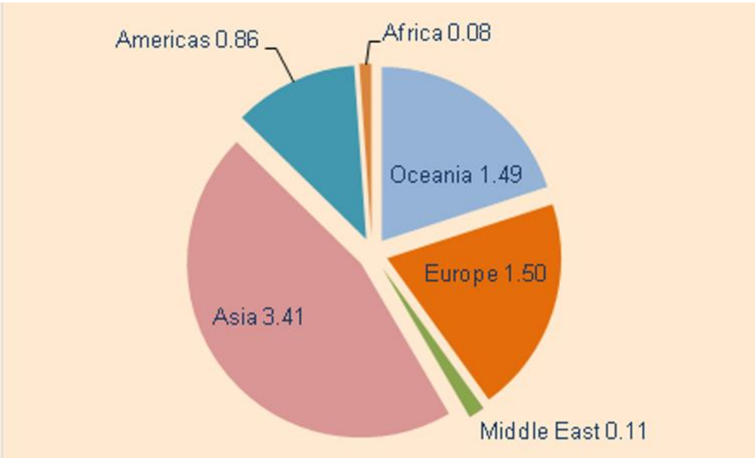
John O'Connell

Australia has some important and resilient industries which have taken up some of the slack in the wind down of the construction-led commodities boom. Record tourist numbers from China, educating international students, strong food exports and a resurgent wine export industry have been sectors which have not only been performing well but have been creating new records in the process. Australia's economy grew 3.1% year on year to the first quarter of 2016 on the back of a better than expected services sector.

Increasing arrivals to Australia, especially from Asia

Short-term arrivals from Asia into Australia make up the largest share of any region. In 2015, as shown in Chart 1, 3.4 million visitors from Asia came to these shores. For the first five months of this year, 3.3 million people have arrived on short-term stays, almost one million more than for the same period five years ago.

Chart 1: Short-term arrivals into Australia in millions, 2015



Source: ABS, Owners Advisory, July 2016

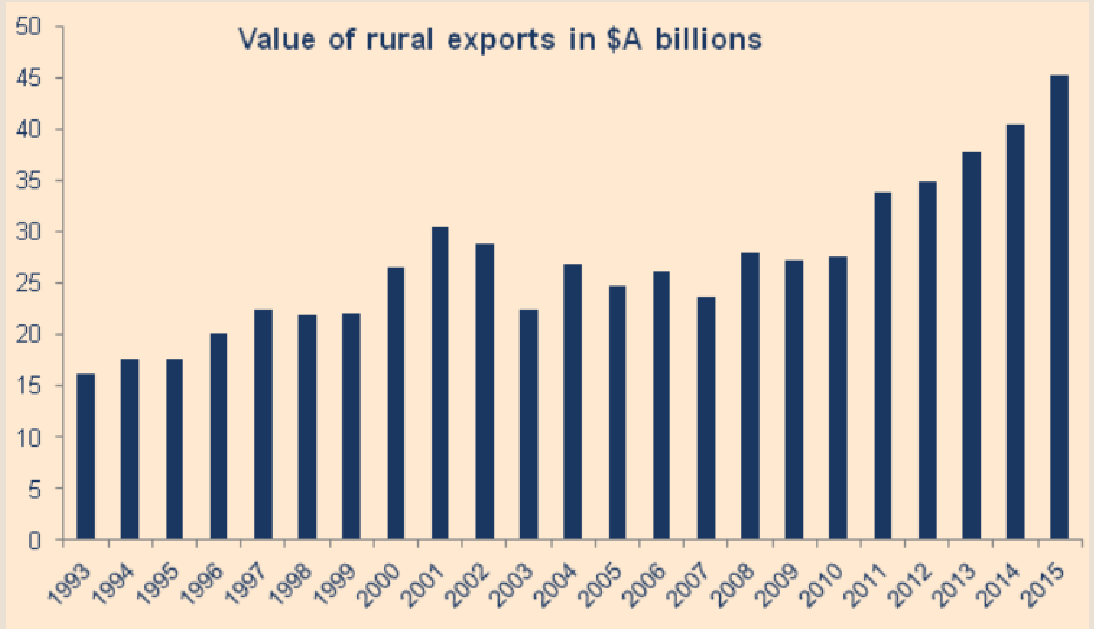
Australia is one of the biggest beneficiaries of the rising consumer in Asia where the region is expected to account for more than two-thirds of the global middle class by 2031. The tourism numbers have boomed from China with 1.4 million short-term arrivals from the mainland and Hong Kong in the past 12 months. This number has now surpassed New Zealand as the country where most short-term arrivals originate.

In addition to tourism, Chinese and Indian students are taking education opportunities in Australia. Education sits behind iron ore and coal as the country's third largest export. In 2014–15 export income from education was estimated at $18.1 billion. Education is also a pathway to settlement for students who opt to remain in the country as skilled participants.

Food glorious food

Demand for a bit of 'Australia' in the form of food and wine has seen both export classes touch record highs in the past three years. Grain and meat sales have garnered a lot of the attention as Asian consumers change to a more protein-based diet. Agricultural and fisheries exports for the last financial year reached about $46 billion, as shown in Chart 2, or about 25% of Australia's overall commodity exports of $205 billion.

Chart 2: Australia exported over $45 billion of rural products in 2015



Source: ABS, Owners Advisory, July 2016

Australian wine rises again on strong Chinese demand

The Australian Bureau of Agricultural Sciences reports that annual wine exports grew over 10% in 2015, and is forecast to generate sales of $2.2 billion in the coming year.

Source: Department of Foreign Affairs and Trade, Owners Advisory, July 2016

Austrade points to the Chinese middle class as the primary driver of interest in Australian wine, which is regarded as a stable, consistent and high-quality product. China is now the second largest export destination for Australian sparkling, red and white wines after taking over from the United Kingdom earlier this year.

Achieving exposure to these export sectors

There are many ways for investors to gain exposure to these sectors. Without going into much detail here, Sydney Airport is one of the main gateways into Australia, and while shares are not cheap, the medium- to long-term returns should persist into the future.

Navitas is a global education provider offering a range of educational services including university programmes, resettlement assistance and language training. Navitas scores well on a number of key metrics of profitability, quality of earning and a management team delivering on its mandate.

Treasury Wines is one of the world's largest wine companies with brands including Penfolds, Wolfblass and Rosemount, and the outlook for growth of underlying sales and earnings looks strong.

John O'Connell is Chief Investment Officer of Macquarie's Wealth Management group, and Founder of the bank's roboadvice division, OwnersAdvisory. This article is general information and does not consider the investment needs of any individual.

Investing is a balancing act

Robin Bowerman

Balance is something most of us aspire to in many parts of our life, be it work and family time, diet or exercise. Likewise, as the past 20 years has shown us, a balanced approach to investing can help navigate turbulent market times.

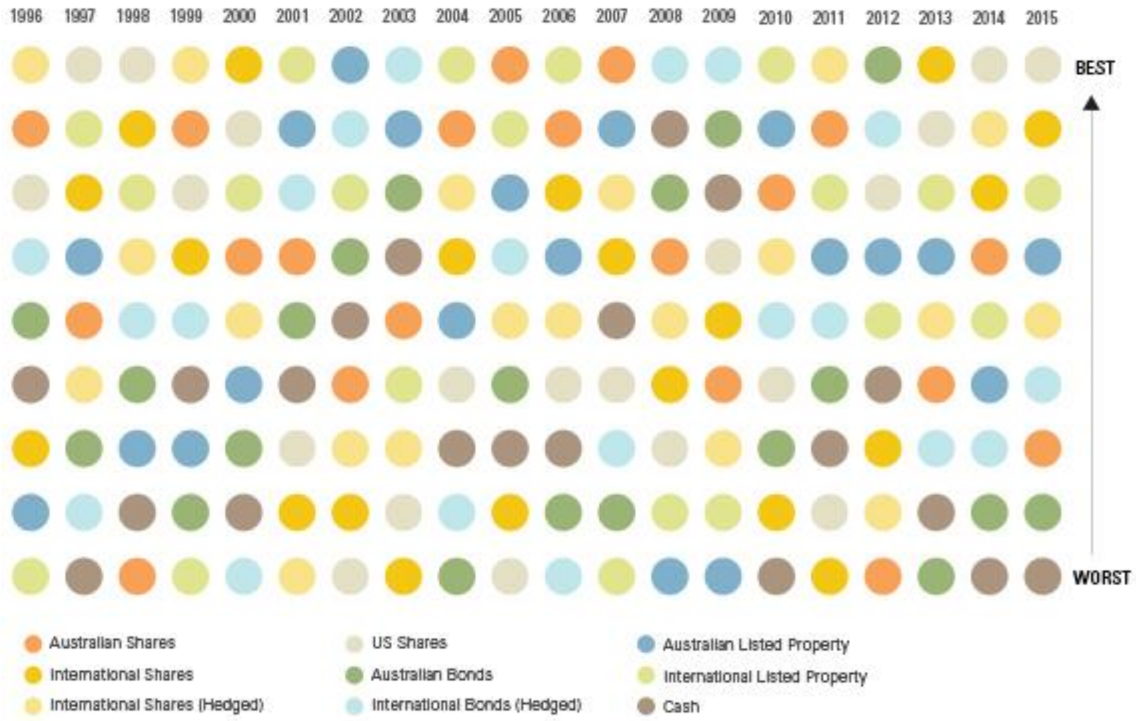
A strong body of research (including the 2013 Vanguard paper, *The global case for strategic asset allocation*) shows that the most important decision any investor makes is setting their asset allocation. However, it is almost impossible to pick which asset class will be next year's winner, or in any subsequent year.

No discernible pattern of returns

When you plot the performance of all the major asset classes over the past 20 years, from domestic and international shares, domestic and international fixed income, domestic and global property and emerging markets, there is no discernible pattern.

It certainly adds weight to the argument that past performance is not a reliable indicator of future returns. Indeed, when you plot the various asset classes in different colour squares it looks more like a random patchwork quilt than a tool for making investment decisions.

The next "winning" asset class is impossible to predict



This is not to say investment markets have not rewarded investors over the past two decades. If an investor had placed $10,000 in a broad Australian share index fund 20 years ago, it would have grown to around $51,480 by 2016. However, investors in international and domestic shares have had to endure a wild ride. Think of the 'tech wreck' of 2000 and 2008's GFC. By comparison, investors in fixed income or cash have had a much smoother journey but have also missed out on the higher returns from other asset classes. A conservative Australian fixed income portfolio would have grown more sedately to $37,606 over the last 20 years.

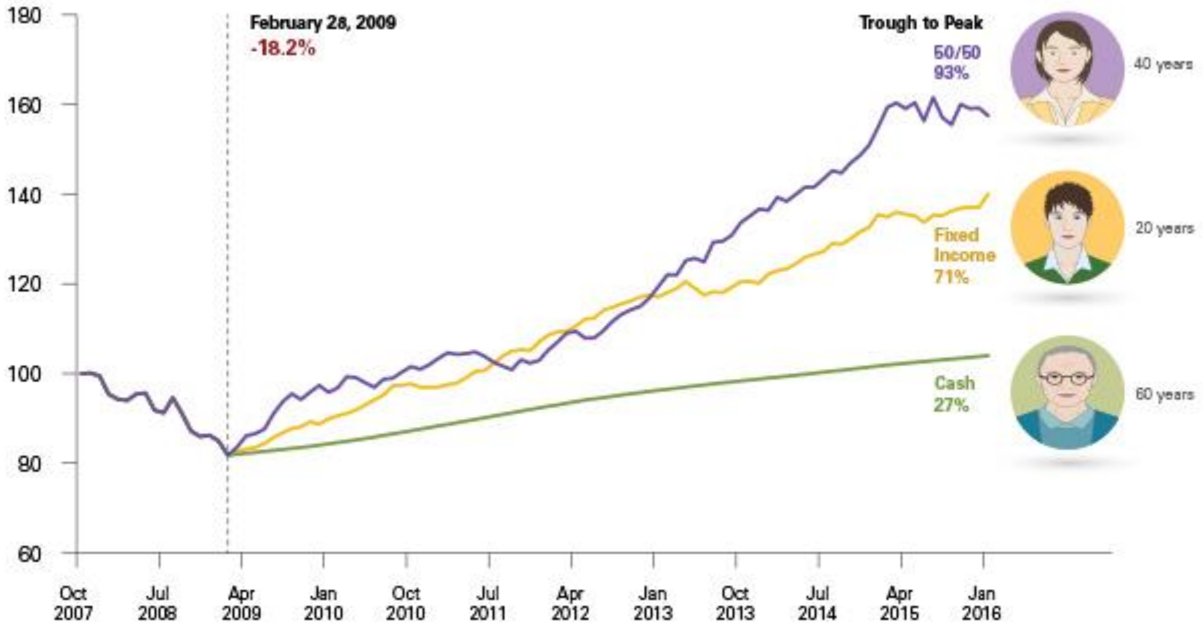
In the real world, investors have to decide where on the risk spectrum, with cash/fixed income at the conservative end and shares at the higher end, they want to sit. Another lesson of the past 20 years is that market shocks can and do appear from unforeseen sources such as the US residential housing market and its influence on the GFC.

Tolerance for risk in asset allocation

Investor need to clearly understand how much risk they can tolerate before deciding which assets to allocate money to. Setting an asset allocation is the first thing, but sticking to it is another thing entirely.

Let's take the example of three investors who each had the same balanced portfolio (50% growth assets and 50% fixed income) back in 2008 before the GFC hit. By February 2009 their respective portfolios had all fallen 18% in value.

The impact of rebalancing



One investor decides it's all too much and switches the make-up of their portfolio entirely to cash to stop the losses. The second investor is also worried about the dramatic decline in the portfolio's value and opts to switch to a more defensive asset allocation, shifting the portfolio entirely into fixed income. The third investor, while concerned by the global market gyrations, decides to stick with the 50/50 asset allocation of their balanced fund.

Not surprisingly, these changes resulted in quite different portfolio performances. If we move forward from February 2009 to February 2016, the portfolio of the investor who shifted to cash grew by 27%, the fixed income approach grew by a healthy 71%, but the portfolio of the investor who changed nothing and stayed the course with a 50/50 asset allocation grew by a 93% from the trough of the GFC.

The asset allocation decision has been shown to drive about 90% of a portfolio's performance, but it is not a once-off static decision. The asset allocation for a 30-year-old, given their investment time horizon, may well be more aggressive with growth assets than a 60-year-old approaching retirement may feel comfortable with. And as the 30-year-old moves through different life stages the asset allocation should rebalance.

The biggest lesson from the past 20 years is that we should expect different asset classes to regularly change positions on the annual performance rankings. The investor's quest is keeping the balance right between the various asset classes to give the best chance of reaching an investment goal.

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