OUTLOOK FOR FINANCIAL MARKETS as at 7/6/2017

I think we are living in a time of much change and some things "as we know them" are changing. Some aspects of this change are referred to as "creative destruction" where by all sorts of things are replaced by new technologies.

Examples from history are cars & trucks replacing horses & carriages, digital photography replacing cameras that required film, telephone going mobile, electricity coming from solar and wind sources (*still in its infancy*). Examples of changes happening now involve robotics to do all sorts of things (*even surgery*), electric driverless cars / trucks, 3D printing, new medicines being developed, the growth in on-line shopping, the coming emergence of block-chain technology and digital currencies, new building materials and foods being discovered. It is all around us. Over time all these changes will have a profound effect on our lives via the functioning of countries / economies, businesses and organisations. Those that adapt to the changes will do well and those that don't will fall behind.

From an investment perspective, this means that in the not too distant future it will be super critical to be very selective in the investments you make within all categories – shares, property, fixed interest and other alternatives, both Australian and Global.

Over the last 12 months or so there has been a massive trend for investors to invest via lower cost passive index driven options such as Exchange Traded Funds (*ETF's*) and other index funds. Following an index means investors will have exposure to all the largest components of the index (*both the good and the bad*) weighted heavily towards the larger components. For example, a fixed interest strategy that follows the main global fixed interest index would have very high exposure to US, European and Japanese Government Bonds at a time when these Bonds are paying next to nothing – 10-year Government Bonds in the US are paying 2.16% p.a., the UK is paying 1.04% p.a., Germany is paying 0.27% p.a., Japan is paying 0.05% p.a. and some like the Swiss have negative rates. Note Australian 10-year Government Bonds are only paying 2.41% p.a. and our Reserve Bank's official cash rate is still at its historical low of 1.5% p.a. and not looking like changing any time soon.

As another example, one of the main indices for Australian shares is the S & P / ASX200 which covers the top 200 (*by size*) listed Australian Companies (*out of over 2,000 listed companies*), heavily weighted towards the 10 largest companies (*CBA, Westpac, BHP, ANZ, NAB, CSL, Telstra, Wesfarmers, Woolworths & Macquarie*) who together are more than 50% of the index. That is a lot of concentration in a handful of companies, well over half of which are banks.

With the recent trend towards lower cost index funds / ETF's the flow of money has been into these larger bond markets for fixed interest and the biggest companies for share markets meaning the prices of these assets being purchased, relative to other investment options, is being forced up making these assets more expensive. Over time the prices of investment assets will ultimately graduate towards their true value and expensive assets will fall in price and the price of cheap assets will rise.

I can't tell you when the current fashion towards all things index will finish but it will happen (*maybe soon*) and once again common sense / logic will prevail and other cheaper good quality investments will come to the fore.

So, our approach to investing is to rely on managers who are very selective with the investments they make, don't follow indices, look to buy good quality assets without overpaying for anything and are actually good at implementing these strategies.

As always, the best way to control risk and obtain good longer-term returns is to remain genuinely well diversified.