OUTLOOK FOR FINANCIAL MARKETS as at 31/1/2016

The Australian and World economic and investment markets environment at present can best be described as "Uncertain":

- Is the US Federal Reserve going to continue to raise interest rates?
- Is China's conversion from focusing on large construction projects to a more consumer driven economy actually progressing well or is this irrelevant as sections of the financial media seem to be ignoring this factor?
- Will Europe's and Japan's extremely low interest rates and quantitative easing programs finally gain some traction, resulting in improving economic growth outlooks?
- Even though lower energy prices are beneficial to all but oil and gas producers, at present they are causing share price falls because the major oil producing countries (*such as the Saudi's*) are selling many $ Billions of shares from their sovereign wealth funds in order to balance their budgets and maintain sufficient foreign reserves (*currencies*).
- What's happening with and are there any financial consequences of various military conflicts around the world. E.g. Syria, ISIL, Ukraine, various African countries?
- Is Australia heading towards a recession or extended low growth period?

This uncertainty has manifested itself during 2015 and early 2016 in more volatile share and currency markets.

What does this mean for our ideal investment strategies moving forward? In my mind it places even more importance on remaining genuinely diversified across your entire investment portfolios, whilst at the same time being very selective in the underlying investments chosen.

In what follows I have picked out a couple of sectors to make comments on, which hopefully you may find of interest.

AUSTRALIAN SHARES

As I have often stressed in the past when selecting share fund managers or selecting stocks for a direct share portfolio it is important to attempt to pick the best shares, avoid the poor performers and not just simply follow the Index, which is dominated by the larger companies – the top 20 make up 62% of the S & P / ASX 300 (*a size weighted index of the largest 300 companies which doesn't include the other 2,000 odd listed stocks available to choose from*). No one gets their picks right all of the time, but if you get more right than wrong you should end up with above average performance. Over the last 9 months (30/4/15 to 31/1/16) only 5 of the 20 largest Australian listed companies finished in front and only 3 of these made what I would suggest was a respectable return (more than 4%) – CSL, Scentre Group and Westfield. The other 15 of these companies all went backwards, including:

	Not Annualised
Origin Energy	-62.02%
BHP Billiton	-46.00%
Rio Tinto	-28.79%
ANZ Bank	-22.30%
QBE Insurance	-20.58%
Woodside Petroleum	-16.87%
NAB	-16.64%
Woolworths	-14.29%
AMP	-13.80%

The S & P / ASX 20 Index (*Accumulation – including dividends*) generated a return of **-14.45%** over the last 9 months and the S & P ASX 200's return was **-10.61%.** From the Australian share funds we recommend for clients, results over the same period for some of our more widely used funds are:

	Return for 30/4/15 to 31/1/16 (*Not Annualised*)
Ausbil Microcap Fund	+20.20%
Perpetual Pure Microcap Fund	+14.95%
The Montgomery Fund	+3.41%
Pengana Emerging Companies Fund	+3.39%
Bennelong Kardinia Absolute Return Fund	+1.26%
Pengana Australian Equities Fund	+1.09%
SGH20 Fund	-(1.18)%
Perpetual Share Plus Long Short Fund	-(3.20)%
Perpetual Concentrated Equity Fund	-(9.61)%
Allan Gray Australian Equity Fund	-(13.37)%

Some may argue that if you select different periods you will get different results and that is certainly true. However, the long term track record for all of these funds is better than the index (*although you could no doubt find some periods where they underperformed the index*) and I have included this information merely to illustrate a point that we as advisers feel strongly about, which is we don't like managed share funds that closely follow the index in determining the shares they hold:

- The index is the average which contains all the good performing shares together with all the rubbish. By following the index, after management fees you end up with an automatic below average performance (*relative to the index*). Why wouldn't you try to pick the better performers and avoid the losers?

- Following the index means that as a share becomes relatively more expensive you are forced to buy more of it and as it becomes relatively cheaper you get forced to sell more of it, which makes no sense at all to me.

- This is why we select fund managers who we believe have the ability, the right philosophy and resources to be good "stock pickers".

AUSTRALIAN GOVERNMENT BONDS

The following table shows Australian 10 year Government Bond Capital Market Yields (*as at 30th November each year*) for the last 45 years i.e. the interest rates determined by the Bond Markets. To put things in perspective for example if the Government is offering 6.5% p.a. for 10 years but market forces determine that a year later a more appropriate rate is 9.5% p.a. then $10,000 worth of bonds would theoretically fall in value to $8,237 which is technically what $650 p.a. in interest plus a $10,000 payout after another 9 years is worth when current market rates are 9.5% p.a. Rising interest rates are a result of falling Bond prices – because the interest payable on a Government Bond is fixed then the price has to fall to generate a higher interest return. The reverse is also true, falling interest rates equate to higher Bond prices.

Australian 10 year Gov't Bonds Capital Market Rates (*as at 30th November 2015)*

1971	6.38%	1986	13.60%	2001	5.46%
1972	5.76%	1987	13.30%	2002	5.50%
1973	8.35%	1988	12.35%	2003	5.87%
1974	9.50%	1989	13.10%	2004	5.40%
1975	10.00%	1990	12.23%	2005	5.44%
1976	10.00%	1991	9.78%	2006	5.60%
1977	9.79%	1992	9.14%	2007	6.03%
1978	8.80%	1993	6.81%	2008	4.94%
1979	10.08%	1994	10.47%	2009	5.47%
1980	12.42%	1995	8.50%	2010	5.38%
1981	15.00%	1996	7.16%	2011	4.08%
1982	14.60%	1997	6.03%	2012	3.09%
1983	13.20%	1998	5.13%	2013	4.24%
1984	13.25%	1999	6.56%	2014	2.83%
1985	15.05%	2000	5.99%	2015	2.89%

Since 30/11/15 the Australian Government 10 year bond yield has fallen to 2.4% p.a. *(close to the record all time low*). Whilst I'm not going to suggest that long term interest rates in Australia are going to rise much in the near future I do believe they can't fall much lower and will eventually rise, provided we don't suffer a bout of severe deflation which I think is very unlikely. So a decision to invest in these Bonds now is confining yourself to 10 years of a fully taxable return (*if you pay tax*) at around 2.4% p.a. or 2.4% p.a. minus a capital loss if you decide to sell them before the 10 years is up which is a fairly ordinary return in my opinion. Note much the same thing can also be said about most other Developed Countries Bond Markets. It is true that if you look at the average performance over the last 25 years or so of Bond Funds that invest in Australian or Developed Country Government Bonds, that their performance has been mostly quite good. But that is because interest rates have fallen from around 13% to currently 2.4%. A fall of more than 10%, translates into good capital gains not to mention much higher average interest payments over the period than are available now. For past performance to repeat itself Bond rates would have to fall to say -7% i.e. you pay the Government 7% to keep your money. My conclusion therefore is that unless you think we are headed for a sustained period of significant deflation then steer clear of any exposure to Australian and other Developed Countries' long term Government Bond investments.