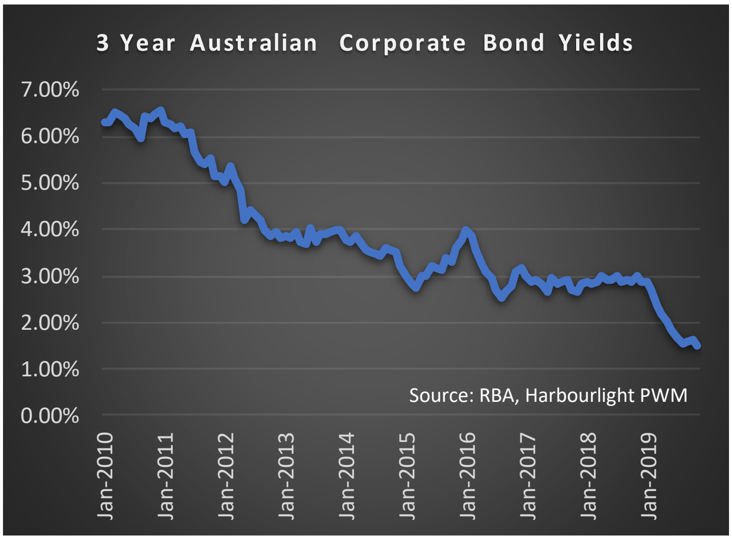
A brief review of investment markets and broader factors affecting clients. **January 2020**

Macro-Economic and Asset Class

As we welcome in a new decade, asset prices continue to rise lowering investment running returns (current earnings or interest compared to an investments price).



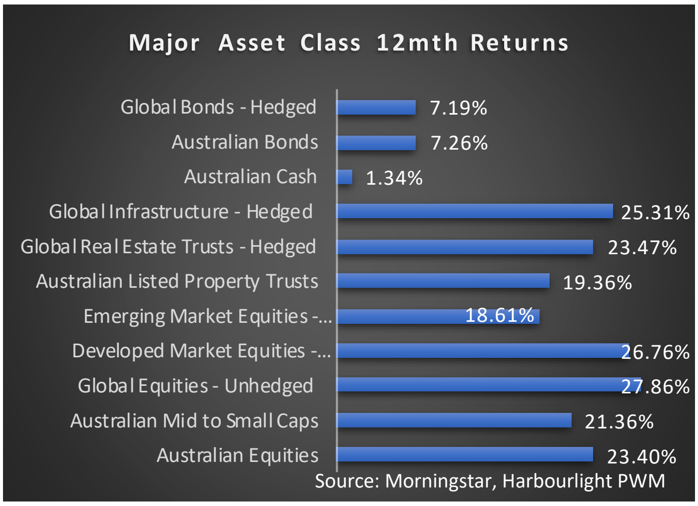
Falling interest rates are driving a large part of this phenomenon. For example, the yield on a safe 3-year Australian bond portfolio is now 1.49% down from 6.33% at the start of 2010. Adjusted for the current rate of inflation (1.7%) these safe portfolios now look likely to provide negative real returns.

This presents investors with a difficult environment to navigate. At the start of the last decade an investor with $1 million to invest in a safe bond portfolio could expect an income of $63,300, as we end the decade, the return on the same portfolio has reduced to $14,900. With other asset prices elevated, living off portfolio earnings has become significantly harder.

Using alternative investments to boost returns has become more important, yet this comes with its own risks. We continue to support portfolios that are very well diversified, resilient to unforeseen surprises and capable of deriving good investment returns without taking excessive amounts of risk. More defensive growth assets such as quality direct property, alternative fixed income and derivative overlays in equity portfolios will play an important part in helping investors manage their way through this period.

The year 2019 started with asset prices under pressure from political headlines including a trade war, Brexit and interest rates that had started rising in Northern America and parts of Europe.

As the year progressed, local elections resulted in a rebound in Australian house prices, China and the US agreed terms for a partial easing in the trade war and Boris Johnson was voted in as Prime Minister of the UK providing more certainty that Britain would leave the European Union on the 31st of January this year.

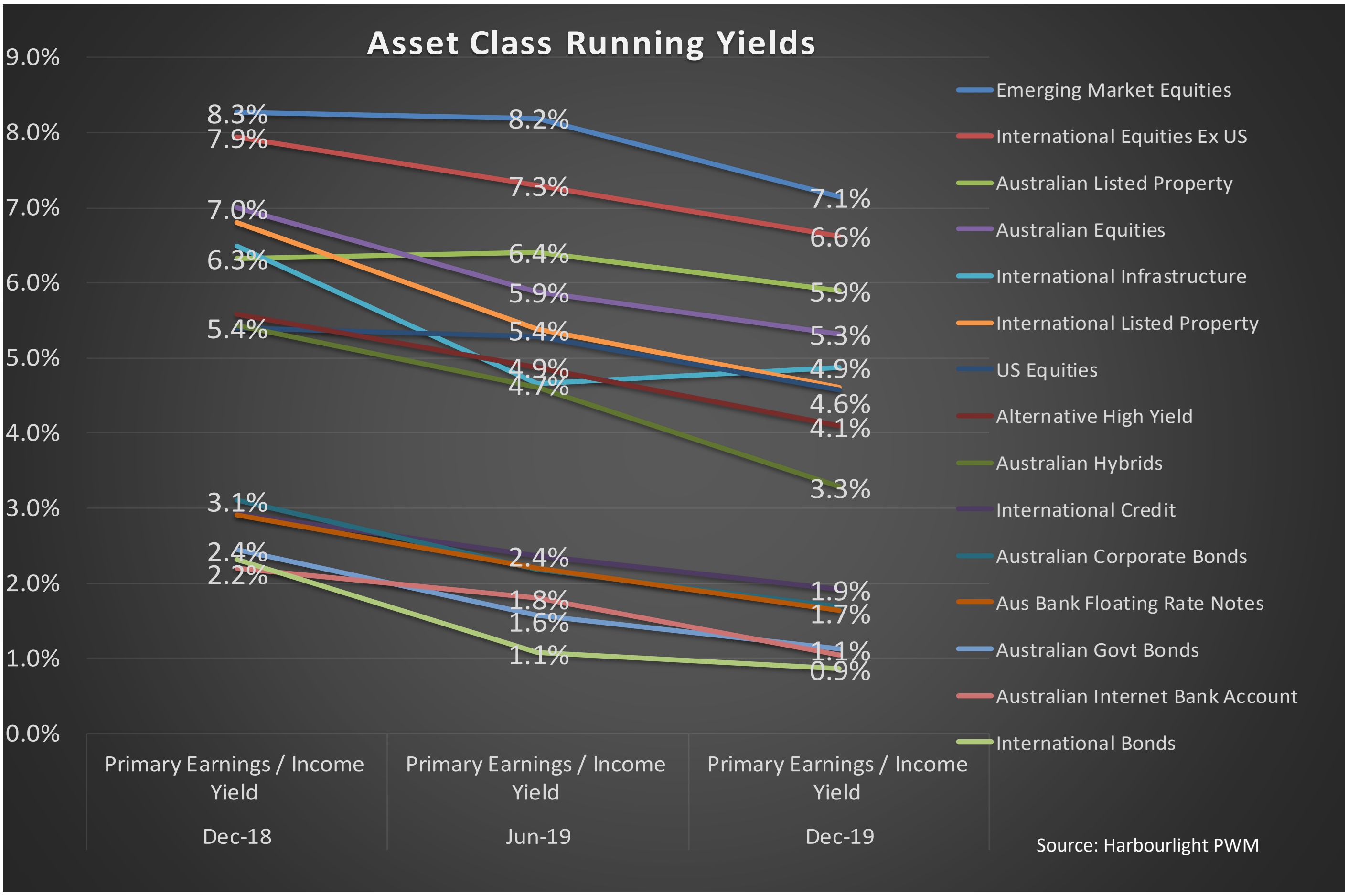


With markets starting the year from lower levels, a change in the direction of US interest rates and reduced political uncertainty saw very strong returns for 2019. These ranged from 18.61% to 27.86% for growth assets with the majority of these returns made in the first six months.

As we start our way through 2020, it's important to note these rising asset prices are making valuations look pretty stretched by historical standards.

While historical returns shouldn't guide expectations for future returns, we believe it's good time to be conscious of what is around us. The political environment is still tense, the Sino-American trade wars are likely to be a longer-term issue, Iranian tensions are escalating and we have a US election this year.

Looking further at running returns on various investment classes in the chart below, it can be seen that these returns dropped meaningfully by 1-2% this year. As previously mentioned, this has been mainly as a consequence of strong asset price appreciation and falling investor return expectations. Australian hybrids and international listed property trusts showed the strongest drop in running return in 2019 making local listed property and global alternative fixed income a more interesting proposition comparatively.



We also saw some interesting companies attempt to list or list and achieve sub optimal outcomes in 2019. Shares in Uber, the ride hailing company for example listed in May 2019 at a price of $45 a share and lost 34% over the year. WeWork, a provider of shared office workspaces attempted a failed listing, as did the Australian company Latitude Financial a provider of business and consumer financing. These actions show signs of indigestion and differing company valuations between investors and sellers of private businesses.

Our views for 2020

In a world of slowing growth, continuing political tension, labour transformation, low interest rates and high levels of debt we continue to support portfolios that are well invested, highly diversified, value conscious and cognoscente of the fact that we are well progressed (approaching 13 years) into this financial cycle.

Whilst it appears that interest rates will remain low, stimulating the world through its current difficulties, we have not seen interest rates this low before and as each year passes the chance of a turn in the cycle increases. We believe the risk of an event that causes a sharp downturn to growth assets as a result of interest rate increases or other unforeseen factors currently sits at 20 to 30%.

From a portfolio construction perspective using cash and fixed income assets that return low to negative inflation adjusted returns becomes more difficult, making defensive mid risk growth assets more attractive. We also continue to believe investments in emerging markets equities will help add long-term value to client investment portfolios.

Other Regulative Matters

- Previously mentioned legislation that would remove primary residence capital gains tax exclusions for foreign residents was passed in December 2019. This means expatriates who sell their homes whilst offshore will not be able to access the primary residence CGT exclusion post Jun 2020.
- Income tax bands will remain the same this financial year in line with the Government's *Personal Income Tax Plan* legislated in 2018. Personal income tax bands will remain at current levels until 2022 where the next round of tax cut will commence.
- The maximum level of annual superannuation contributions remains at $25,000 for concessional and $100,000 non-concessional contributions.
- The transfer balance cap applying to commencing retirement income streams remains at $1.6m.
- Incentives continue to be provided for those who have had less time to contribute to super, with the largest being a $300,000 non-concessional allowance for those aged over 65 who are downsizing their home if held for over 10 years.
- Superannuation guarantee contributions remain at 9.5% with a scheduled increase to 10% in 2021
- From 1 January 2020, salary sacrifice contributions cannot be used to reduce an employer's minimum superannuation guarantee contributions.

Please feel free to contact us if you wish to discuss any of these matters.

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