AUSTRALIAN INVESTORS ASSOCIATION

Investor Update
Monthly updates on investment issues for AIA members

JANUARY 2016

Investor Update – January 2016

Happy New Year and welcome to our first Investor Update for 2016. This issue contains an article on the US Economy by Craig Swanger, Paul Resnick tells us the challenges for robo-advisers, Julie Dolan comments on the importance of your SMSF trust deed and Roger Montgomery gives his opinion on what to do with your equity portfolio in 2016. We hope you enjoy.

In this issue

Notes from the US – A challenging year for equity holders

Craig Swanger – FIIG

I've spent the past week in the US, writing this update in New York. This week has been very challenging for anyone holding equities, albeit offset by gains on bonds, so it's timely to share some views on the US economy and the source of the concerns.

Last year we explained that we thought US equities would need to fall 20-30% in order to see PE ratios better reflect the world economy's mediocre growth rate. Unless earnings increased (they fell in 2015), US equities would need to fall to around 1,600-1,700 points on the S&P 500 Index. That's still more than 10% below the current market level. While Australian equities had a poorer year than the US last year, we are still not immune to falling US markets in 2016. Even CBA's share price has fallen 8% in 2016, exactly the same as the S&P500 in the US.

Upcoming Events

AIA Annual Investors Conference

Volatility, Risk & Reward –
Strategies for an uncertain world
Save the date: August 7 – 10, 2016.
Featuring some of the most respected names in the financial industry, this conference is not to be missed. Details will be available early next year and we hope to see you at the Marriott Resort and Spa Surfers Paradise.

Perth Information Meeting

Wembley Downs Tennis Club, 2nd February @7.30pm

Blackburn Local Discussion Group

Naturalist Club Blackburn, 3rd February @7.30pm

Hills District Discussion Group

Suite 17, 35 Old Northern Rd Baulkham Hills 3rd February @7.00pm

Brisbane Information Meeting

Wesley House, 140 Ann St Brisbane
3rd February @ 1.30pm
ALL MEETINGS

Notes from the US – (continued)

Much of the past week's falls have been blamed on concerns about the Chinese markets and economy. But it's much broader than that. The concerns are about China and specifically concerns that China isn't likely to be strong enough for the world to achieve the growth that equity markets have built in. Valuations, for example price/earnings ratios, are simply too high if one applies realistic growth assumptions. Dividends won't be growing as fast as equity markets are assuming, and so prices of shares need to fall.

What triggered the correction in the past two weeks is a little bit more interesting.

Trigger #1: China's ban on large shareholders selling was due to expire Friday 8 January

The ban was imposed in July 2015 when Chinese equities first tumbled. The problem with any such ban is that eventually it must end and if conditions worsen in the meantime, all it does is create large volume selling on the day the ban ends. That was exactly the scenario the world feared on Friday 8 January. The ban was extended indefinitely while new rules are drafted. Citigroup has estimated that when the ban does end, there will be an additional USD15bn per day in selling pressure. Given that Chinese equity markets have fallen despite the ban, this additional selling pressure is a serious problem for world equity markets.

Trigger #2: US GDP growth rate in the 4Q2015 was around 0.6%pa

Markets had been assuming around 2% p.a. growth in Q4, but several indicators now point to a much lower growth rate:

- Retail sales grew at their slowest pace since 2009
- Inflation remains weak
- Wage growth isn't climbing despite (perceived) high employment
- manufacturing is in a recession
- Exports remain weak due to the high dollar

Consumer spending is particularly worrying. Confidence is up and energy prices are down so spending should be stronger. Retail spending is partly depressed by the accelerating use of online shopping and this won't change for years yet, but the impact on the older parts of the economy is significant. Walmart announced it would be closing 25% of its major stores this year laying off 16,000 employees, for example.

Trigger #3: Oil

Lower oil prices are taken by markets to be a sign of weak demand for oil, which in turn is an indication of weaker economic conditions. News of rising inventories (the amount of oil or oil products in storage) spooked markets, and rightly so. The only excuse for rising inventories is the unusually warm northern hemisphere winter meaning there is less oil needed for heating. On the other hand, the UN just announced that they have issued the final certification that Iran has complied with its requirements under the nuclear arms deal, meaning that sanctions will be lifted. Iran will commence oil production immediately and in fact can now start selling the oil they have in storage. If this sales and production process is faster than expected, oil could fall even further.

Sentiment in the US remains strong, despite all of this. The real economy, as opposed to Wall Street's assumptions about the economy, continues to be good but not great. Consumer debt is around 30% lower now than it was in 2008 and banks are carrying 45% more capital buffer, meaning the banking system is far less likely to seize up like in 2008/09.

What needs to happen though is that Wall Street needs to come to terms with the weak growth rate and adjust their forecasts accordingly. This year will be a very challenging year for equity holders. And once again, we expect bond yields to finish the year lower than the market anticipates.

Government bond yields in both Australia and the US fell steeply, meaning prices rose. US yields are now around our forecast levels of 2.0% p.a. (closed at 2.0347% on Friday). Australia's 10 year bond yield is still higher than we believe represents a realistic outlook for rates in Australia. It closed Friday at 2.69%, which is down 17bps since December but still up on this time last year.

This doesn't accurately reflect the weakening outlook for China and the impact on the Australian economy.

Implications

Take a very cautious approach towards equities and if you see opportunities to sell on rebounds, consider the option of Australian bonds with duration, preferably in investment grade (lower risk) and ideally in infrastructure to avoid any further decline in economic conditions. Look for opportunities to hold duration in US bonds if market yields rise above 2.10% again.

Six challenges for robo-advisers

Paul Resnick – Co Founder FinaMetrica
Courtesy of Cuffelinks

We believe robo-advisers will be paradigm-changing, but that doesn't mean they have a free pass to success. They must overcome six significant challenges if they are to evolve into profitable financial services businesses:

1. Changing perceptions of financial advice
For a large group of consumers, investment advisers are self-interested and greedy, financial markets are rigged and corrupt and their money is better off being self-invested into real estate, gold and other real assets. This widely-held perception of the finance industry is deserved.

There have been far too many financial services scandals that prove these theories, from an outright fraud like Bernie Madoff through to a local adviser churning an unsophisticated client through a procession of high brokerage-fee products. Meanwhile, the global markets collapse of 2008 left many investors wary and untrusting of the entire financial market framework. They would rather buy real estate that they can see and touch.

The financial advice industry has failed to make a convincing argument to justify its value to consumers. The industry has struggled with the intangibility of advice, the potential uncertainties of outcomes should markets crash and perceptions of greed among the people running the 'system'. The impact is that most people don't want to pay for financial advice.

2. Establishing trust
In financial planning, human interaction has traditionally been vitally important. As many a salesperson knows, selling something that is intangible requires the establishment of trust. This is problematic, because trust in the planning industry is low.

Trust is defined as "a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behaviours of another" (Rousseau, Sitkin, Burt, & Camerer, 1998).

Repeated surveys around the world show financial advisers sit towards the bottom of the trust ladder. How do robo-advisers show they are trustworthy? To show you are trustworthy, you must display the behaviours that will lead people to trust you.

Three important requirements are:

- Competence in the matters in which competence is claimed and required
- Reliability, by doing the things as expected and promised, and
- Honesty and transparency in dealings with customers.

To convince the broad public that it can be trusted, a robo-adviser will be required to invest in processes and marketing to tell the story of how and why they are trustworthy.

Established brands and the large end of town already have customer bases into which to market to achieve scale while also having the marketing budgets and communication channels needed to attract new business to a robo-adviser.

3. Advice and guidance gaps
'Advice gaps' arise when people who could benefit from financial advice do not receive it because:

- Their level of assets is too low to viably warrant the attention of a financial adviser, or
- They are not prepared to pay a fee to receive advice.

In the US, the desire to maximise planner profits makes accessing a financial planner high compared with the rest of the world. US advisers focus almost exclusively on what would be regarded as high wealth clients in the rest of the world.

In the UK, financial advice is generally more readily available to the middle classes – what might be termed the 'mass affluent'. The dollar figure required to access a basic service is driven significantly by the regulatory framework. Ironically, rules that were introduced to protect consumers now deny many of those people any service at all as the costs of regulatory compliance are too high to make them financially viable clients.

It is, perhaps, a logical conclusion to see robo-advisers as the solution to the advice gap as they have scalability and can service customers at low cost. Some people see robo-advisers 'democratising' financial advice, making it available to all.

By definition, those in advice gaps have lower investable asset balances, which means, per customer, lower income for the robo operator. Robo-advisers need profitable clients, but to acquire them as clients they

need to invest serious marketing money, which is why existing big players have advantages over new entrant start-ups no matter how well funded. The exception is perhaps those providing a B2B robo white-label platform for existing distributors.

4. Economic influences

Around the world, wealth is being squeezed into upper economic groups, with corresponding falls in income and wealth for the middle and lower economic groups.

The loss of the middle range investor means that an increasing number of service providers are marketing to a shrinking pool of affluent investors, albeit that each of those customers comes bearing a larger pool of assets.

At the same time, there might be increased demand for robo-advisers that focus on providing budgeting tools and cash-flow forecasting, as these issues are of more significance to lower economic groups than questions of investment.

5. Cost of acquiring clients

Robo-advisers need clients to operate and the cost of acquiring (CAC) clients in financial services is high.

To us, this is the elephant in the robo-adviser room that is seldom discussed – which we believe is a strategic failure of the highest order.

Acquisition costs include the costs of initially finding a prospect and then converting those prospects into clients, with the inevitable attrition rate that those conversions incur. When total costs are compared to clients gained the results can be surprisingly high. Lucian Camp calculates the cost of acquiring a client in the UK to be around £200 (US$312).

This cost is beyond the means of many advisory firms, which is why they grow slowly – largely through word-of-mouth referral. In the past, they might have relied on product manufacturers and distributors to provide them with marketing support. Under new regulations in the UK, such supports are now largely no longer possible. But they continue to thrive in the US marketplace. In a world where former specialties have become commoditised, being able to make a financial product or service no longer makes you special as it once did.

Where, in the past, you may have been able to extract an economic rent because you occupied a position of advantage, market forces have now equalised you. Today, the ability (knowledge) and capacity (cash-flow) to quickly market financial products to scale is what separates successful financial services businesses from the 'also-rans'.

It does not matter if you arrive at the marketplace with a better mousetrap if that trap is hidden where the mice cannot find it. Cheese – in the form of marketing, advertising and promotion – will help to attract them. But cheese isn't cheap. Robo-advisers are very good at servicing customers, but do nothing to attract customers.

6. Behavioural biases

It is human nature to want it now. But it is also human nature to make plans for the future, including saving money. Of course, the two natures quickly come into conflict. You want a holiday now – but spending the money will reduce your pension in 30 years' time.

More often than not your 'present' self will defeat your 'future' self. The future loss is so far away that it is diminished, but the present benefit is NOW! "Pack your swimsuit, honey, we are going to the beach."

There is good reason to believe that robo-advice systems might do a much better job than human systems at helping people confront and manage this 'present-day' bias, by allowing them to visualise the impact of financial decisions made now projected into the future.

As ever when there are challenges, those who are successful will find new solutions and build the scale critical for success, while many others will fall by the side.

Paul Resnik is a co-founder of FinaMetrica, which provides psychometric risk tolerance testing tools and investment suitability methodologies to financial advisers in 23 countries.

The Holy Grail of your SMSF

Julie Dolon – CEO SMSF Consulting

The Holy Grail of your SMSF.
You might just think that the Trust Deed to your SMSF is another document that you keep safe and bring out every now and then for your accountant, auditor or bank manager. In reality this document is one of if not the most important documents supporting your SMSF.
As trustees of your SMSF, you are ultimately responsible for the prudential management and decision making of the fund. In fact as part of the ATO Trustee Declaration that you would have signed, it states that you are required to not only 'keep yourself informed of changes in the legislation relevant to the operation of your fund

but to ensure that your trust deed is kept up to date in accordance with the law and the needs of the members'. The trust deed is the 'instruction manual' of your fund and along with the rules and regulations that govern SMSF's it forms part of the governing rules of the fund. The SMSF laws are regulatory in nature and hence stipulate what cannot be done whereas the trust deed states what the Trustee of the fund can do. Therefore, even though the legislation may allow for a certain function or strategy i.e. reversionary pensions or BDBN's, if the Trust Deed does not allow for then the Trustee(s) cannot put in place for the members of the fund. This is particularly important in relation to estate planning and unfortunately we are starting to see more and more court cases coming through highlighting the angst that this can cause remaining family members to the deceased member.

As you are aware, SMSF rules and regulations constantly change so it is critical that your fund is kept up to date. Besides the risk of breaching the rules of the Trust Deed, having an out dated trust deed places you in a position of not being able to adopt strategies that could increase your wealth as your deed may not permit them. Therefore, the quality of the deed can determine the level of strategic ability of the fund. These strategies are endless, but could be as simple as accepting contributions and making benefit payments through to allowing the ability for the fund to borrow or putting in place tailored estate planning strategies.
The trust deed is the Holy Grail to your SMSF. So please nurture and keep up to date so that not only are you keeping to your trustee obligations but allowing you to maximise the strategic ability of your fund. It is prudent to review and update at least every 2 to 3 years.

What to do with your equity portfolio in 2016

Roger Montgomery – Founder and CEO at The Montgomery Fund – Courtesy Cuffelinks

During the holiday break, if you didn't completely turn off from finance and investing, you may have read one, two or a dozen columns about where the markets are heading in 2016, 'how to make money in 2016' and where the best returns will come from in 2016.

Most are simply a waste of your time and you would have been better off ditching the articles and jumping in the water or heading down the slopes with your kids, partner or friends.

Forecasting doesn't work

The sagest advice I have received on forecasting is that if I wanted to be successful at predicting markets, I should simply do it often. As investing professionals, we are regularly asked for insights that stem from our crystal ball gazing and for many it pays to participate. Those that get it right are lauded as if they have an omnipotent connection to the future, and such is the brevity of our memories, those who get it wrong are forgotten.

And such is the ability of some self-proclaimed prophets to spin their incorrect predictions into divine prophesy that they see no diminution in their monthly newsletter sales. I recall one magniloquent and high profile commentator stating with almost daily certainty that the Australian equity market would end 2016 above 6000 points. At the time the prediction was made the market was indeed close to that level. Of course, the market ended significantly below 6000 and traded below 5000 points after the prognostication was made. But in early 2016, the commentator slipped in that he got the call right (emphasis added):

"… the return of stock buyers whenever we hover around 5000 or just below tells us that the majority of stock players don't see our market worthy of being at 6000, which we missed by five lousy points on March 23."

Desist from forecasting altogether

Long-term investing success has nothing to do with forecasting share prices, politics or economics and everything to do with buying businesses whose intrinsic values rise over the long run. The share price will look after itself if the value of the business is rising steadily over the years. To offer any forecast of where the stock market will be, demonstrates a lack of understanding of this basic investing principle. A forecast tells you a great deal about the forecaster but nothing about what is to come.

Those who presume to understand the machinations of the economy and the markets and then offer their 'insights' simply haven't learned that 1) they will never do better than 50/50 with their forecasts and 2) their forecasts aren't required by you for you to be a successful investor.

There's a constant temptation however to believe the facts one has collected amount to some undeniable insight about the future that one can bet the farm. To save ourselves at Montgomery from falling into this trap, with 50/50 outcomes, we developed a process. And much

as one does when marrying – vowing to have and to hold for better or worse – we publicly committed to our investors, their advisers and the ratings houses to follow the process come what may.

At the beginning of 2015, I was asked whether I thought the market was expensive or cheap and I argued that the market seemed expensive because value did not abound, and that it would be difficult to generate meaningful returns.

It isn't wise for fund managers to say such things because rather than appearing knowledgeable, it risks influencing investors to zip up their wallets. Of course, while we may have been right (50/50 remember!) with our prognostications – for the year to 31 December 2015 the Australian All Ordinaries Index declined by 0.8%, add in dividends and the return was just 2.8% – the Montgomery Fund returned significantly outperformed after all fees and expenses. If I had accurately predicted a 2.8% return for the market and decided the risks outweighed the benefits, so listening to myself, put all of my money into a term deposit, I would have missed the strong return.

Invest in strong businesses and be patient

And that's the point. The stock market index is not where you should be investing (my piece on the problems of index investing is here). You should be investing at rational prices in businesses you are reasonably confident, if not virtually certain, will be materially larger and at least equally profitable in many years hence. General stock market and economic forecasts are largely irrelevant over the timeframe I am contemplating.

When we observed early in 2015 that the market was expensive, we also noted that banks and mining companies, at the highs, were unsafe investments, but this was not a prediction about the direction of the share prices of these stocks or what would happen next. What we simply observed is that investors were behaving dangerously and without regard to risk when they were chasing high yields and ignoring whether those dividends they were chasing were being supported by growth. We were simply saying that it was a mistake to chase yield at the expense of growth.

A business adds value by retaining profits and redeploying that incremental capital at attractive rates of return. It's that simple. To maximize your returns, you have to fill your portfolio with companies able to retain large amounts of capital and generate large returns on that capital. The share prices of these companies will look after themselves over the long run.

The short run is merely the period over which stock prices for these companies overreact on both the upside and downside and therefore it is the period over which you can take advantage of the market's manic moods.

Ignore everything else in 2016 and you should do well over the long run.

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 needs of any individual.

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