



FEBRUARY 2016

Investor Update – February 2016

Welcome to the February Edition of the Investor Update. This month we have an article by Brian Herd about how much you can rely on your adult children, Chris Brycki shares his thoughts on why bonds belong in your portfolio and Bill Dodd looks at the Australian secular bear market. We hope you enjoy.

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The triple guilt trip

Brian Herd: CRH Law

Have you ever sat down and thought about how much you can rely (willingly or unwillingly) on your adult children in later life?

This came home to me recently when I was perusing a report which was a spreadsheet summary of details of all Sales Inspections conducted in a Retirement Village for the month of January 2016. What initially struck me was one of the columns in the report which was headed "With Family". It required the sales person to note whether a prospective resident who came to inspect the village, did so with a member of their family. What was even more revealing was that, of the 22 prospective residents who inspected the village that month, 14 of them were noted as being there with a member of their family.

Upcoming Events

AIA Annual Investors Conference
Volatility, Risk & Reward –
Strategies for an uncertain world
Save the dates:
August 7 – 10, 2016.

Featuring some of the most respected names in the financial industry, this conference is not to be missed. Full details will be available shortly and we hope to see you at the Marriott Resort and Spa Surfers Paradise.

Perth Information Meeting
Clinton Reid –SMSF's: A New Hope
1st March 2016 7.30pm

Brisbane Information Meeting
Rob Hay & Tim Rocks
2nd March 2016 1.30pm

Sydney Seminar
Riding the stock market roller coaster
4th March 2016 9.00am

Sydney North Shore Group
Peter Hogan – Bullet proof your SMSF Investment Strategy
9th March 2016 7.30pm

Adelaide Information Meeting
David White
21st March 2016

[ALL MEETINGS](#)

What does it tell you? Probably a few things we already knew such as:

Sales people appreciate that, in the retirement living and aged care space, family members are just as important to target in the sales pitch as their respective mums or dads

Older people, particularly if they are single, will naturally rely on, and resort to, their children for advice and usually before anybody else (it's free advice)

Not only that, older people often feel that it is just as important for their family to support their decision as it is to make their own decision. This can lead to trouble for example, where the children don't agree on mum or dad's proposed decision

Having to make formative decisions in later life can be a regular event and the decisions themselves are often complex. Relying on our family is entirely natural and understandable. The family becomes a bit like a corporation with collective decision making at the family 'board of directors' meetings.

Can you feel a 'BUT' coming on?

You're right and here it is. Initially, you might expect me to say that not even family members should advise their mum or dad on complex decision making without obtaining professional advice. That should be the first piece of family advice they give to their mum or dad – let's go and get some advice. As I bang on about the importance of this all the time, you will probably brush over this paragraph.

But here's another BUT. We're starting to discern another effect of not following our mantra – we call it the 'triple guilt trip'. It goes like this:

Guilt 1

Most children feel a real remorse or guilt about, as they say, 'having to put' mum or dad into an aged care facility. This guilt can be even worse where it is mum, for example, having to put dad (her husband) into aged care. As with most families, they don't obtain good professional advice about the decision, the transition and its implications (apart perhaps from Centrelink)

Guilt 2

They proceed along their chosen pathway of blissful ignorance until one day, they are hit by a clanger. A letter arrives from some authority advising that, for

example, as mum's house has been sold, the proceeds of sale will now be an assessable asset and her aged care fees will increase substantially

The family now faces the second regret, the consequences of which are mum will have to pay more in aged care fees than they had bargained for because the family didn't realise what the implications would be in selling her home

Guilt 3

It's at this point it gets personal

The regret festers to resentment because the adult children now realise their expected inheritance is going to be reduced by the substantial aged care fees

This guilt trip is played out every day in our nation. It's usually because families focus on the price of doing something (getting advice), as opposed to the cost of doing nothing (not getting advice). Even more significant than the financial consequences, is the effect on relationships. As you can imagine, when the proverbial hits the fan, many families engage in the blame game – whose fault was it that we are now in this situation? The culprit culture leads almost inevitably to the implosion of the family.

One of our other abiding mantras is – live life with no regrets. It sounds trite to say but making decisions based on good advice will significantly reduce the potential for regret. It may even keep your family together as they confront the later life demands and needs of parents.

Brian Herd - *Recognised as one of the leading experts in Australia on elder law, aged care, retirement, estate planning and disability and a regular author, broadcaster and popular presenter on many elder law subjects and issues.*

Why bonds belong in your portfolio

Chris Brycki, Stockspot

What are bonds?

A bond is a piece of debt sold to investors usually by a company or the government. Bondholders "lend" money to the bond issuer for an agreed period (until "maturity") and in return for that, they are paid a regular income in the form of interest.

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Investors in bonds can earn a return in 2 ways:

- From the income received through the bond interest payments.
- By selling the bond. If you hold a bond to maturity, you will get face value of the bond back, which is usually \$100. However it is possible get more (or less) back by selling a bond before it matures. This is because bonds, like shares, trade on a secondary market and their prices are always changing.

What are bond ETFs?

Similar to Exchange Traded Funds (ETFs) for shares, bond ETFs include a portfolio of many bonds which track an index. The most commonly used bond index in Australia is the UBS Composite Bond Index. This index invests in investment-grade bonds issued by Australian Treasury, state governments and companies.

In our [2015 Australian ETF Report](#) we profiled the 10 different bond ETFs listed on the ASX. Since we published the report, several new bond ETFs have listed, including a few that invest in international bonds to give Australian bond investors global diversification.

New bond ETF	Invests in
iShares Global Corporate Bond ETF (IHCB)	Investment-grade corporate fixed rate bonds issued by companies in emerging and developed markets worldwide.
iShares Global High Yield Bond ETF (IHXY)	High-yield corporate bonds from developed markets.
iShares JP Morgan US Dollar Emerging Markets Bond ETF (IHCB)	US-dollar-denominated emerging market bonds.
Vanguard International Credit Securities ETF (VCF)	Income-generating securities issued by government-owned entities, government-guaranteed entities and investment-grade corporate issuers from around the world.
Vanguard International Fixed Interest Index (VIF)	Income-generating securities issued by governments from around the world.

Currently the Stockspot portfolios invest in the iShares Composite Bond ETF (IAF) which tracks the UBS Composite Bond Index. We believe that this ETF offers a good mix of Australian government, semi-government and company bonds. In addition, its relatively short average bond payback period of 4.6 years (also known as duration) reduces our clients' exposure to long-term interest rate changes – as we will discuss below.

What causes bonds to rise or fall in value?

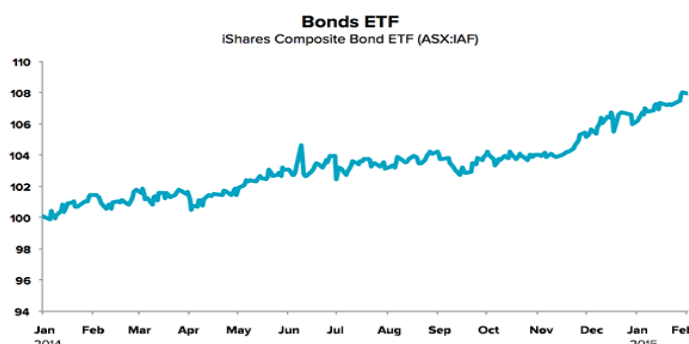
There are a few factors that influence bond prices between when they are issued and when they mature.

The 2 most influential factors are changes in interest rates and credit risk.

Changes in interest rates

Bonds are an alternative to leaving your money in the bank, so as interest rates rise investors demand higher returns, and demand for bonds falls. On the other hand, falling interest rates cause bonds to rise. The longer-dated bonds are, the more sensitive they are to interest rate changes since any changes compound over many years. This is why we prefer shorter-dated bonds for our clients to reduce the impact of any changes in long-term interest rates.

Bonds that have already been issued and are trading must continually re-adjust their prices and yields to stay in line with current interest rates. When [interest rates fall](#), as they have been in Australia over the past couple of years, investors can benefit from capital appreciation in addition to interest. In 2014, IAF returned 9.6%, which was made up of a 3.3% coupon (interest) and 6.3% capital gain as interest rates fell in Australia. Bond prices move inversely to interest rates, so when rates fall, bond prices tend to rise.

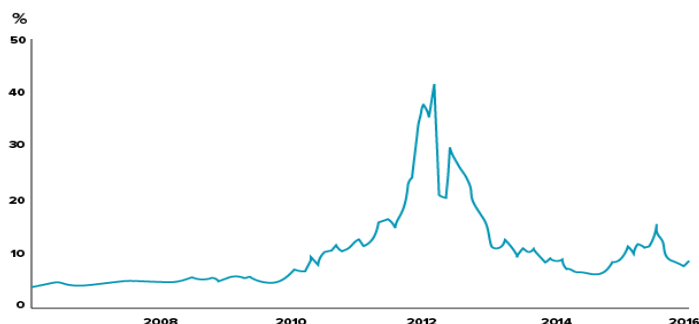


Creditworthiness

Credit risk also contributes to a bond's price since it influences the likelihood of a company being able to pay back bondholders. When companies (or governments) are facing financial struggles or take on a lot of debt, their bond prices often fall to reflect the higher possibility of the company (or government) going bust.

During the Greek financial crisis, Greek bond yields rose to 46.8%. This means investors were so concerned with Greece's ability to pay back debt that they required a 46.8% return to compensate for that risk.

Greece Government Bond Yield



In general however, bonds tend to be less risky than shares since they have a set repayment date and repayment amount. Also, in the event of the company being liquidated, bondholders are paid before shareholders.

How do bonds compliment shares?

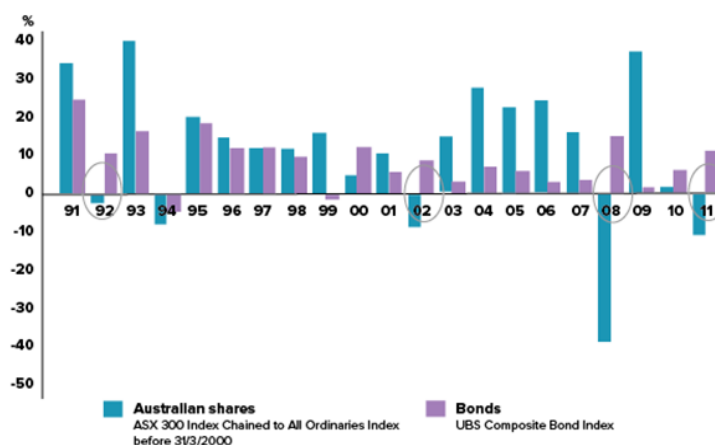
Bonds and shares work together well in a portfolio for a few key reasons:

Diversification

Bonds are counter-cyclical. That means when the economy is in recession and interest rates are falling, bond prices tend to rise. On the other hand, when the economy is expanding or at its peak, bonds become less attractive.

Bonds usually move in the opposite direction to shares, which is why they often described as a defensive asset. We can see in the chart below, bond returns have tended to be positive when returns on shares have been negative. It is this movement in opposite directions that help to smooth the ups and downs in an overall portfolio.

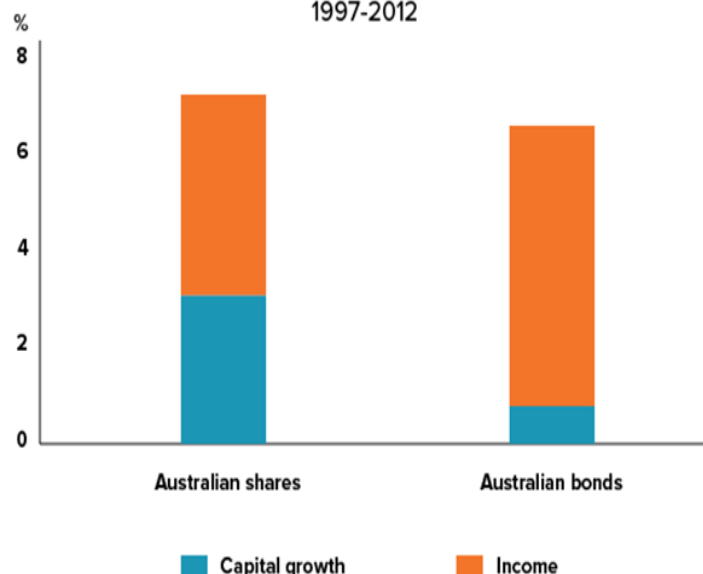
Calendar year returns for Australian shares and bonds



Source: UBS, IRESS, Vanguard calculations.

Income

Most of the investment return from bonds comes in the form of interest income. Since Bond ETFs include broad portfolio of bonds, these interest payments provide a reliable stream of income. The chart below shows that unlike shares, which have historically focused on capital returns, bond returns have largely come from interest income.

Components of total return
1997-2012

Source: Vanguard

A note on cash

We sometimes get asked why we include bond ETFs in our portfolios and not cash. Cash and term deposits can be better described as savings instruments rather than an investment. They are better used for paying short-term expenses or meeting near term financial goals. This is why we encourage all of our clients to keep enough cash and short-term deposits to be able to cover their immediate cash needs.

Cash and term deposits offer relatively low interest since they don't carry much risk. In contrast, bonds will offer higher expected returns over the long term for investors willing to take on slightly more risk. These higher returns are compensation for investors taking on higher amounts of interest rate and credit exposure. Therefore bonds generally suit an investor with a longer investment time horizon.

Why bonds belong in your portfolio

By combining shares and bonds in a portfolio, investors are able to better manage their risk to generate predictable long-term returns. In his 2014 investors

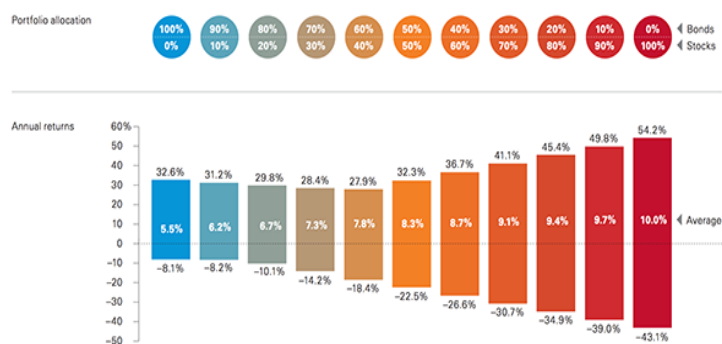
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letter to shareholders, famed investor Warren Buffett said:

My advice [to my trustee] could not be more simple... put 10% in short-term government bonds and 90% in a very low cost [S&P 500] index fund. I believe the long term results from this policy will be superior to those attained by most investors... whether pension funds, institutions or individuals.

Just as Buffett has described, share and bond ETFs form the building blocks of our portfolios. We aim to combine them in a way that gives our clients the best chance of reaching their goals. For clients with a shorter investment horizon this typically means more bonds, and for those like Buffett, with a long time-frame, they can afford to invest a majority in shares.

This chart shows the best, worst and average annual returns between 1926 and 2012 based on different combinations of bonds and shares in the US. As you can see, the higher your allocation to shares (red side), the better your average long-term returns would have been, but with more down years along the way. On the other hand, by focusing a portfolio in bonds (blue side), investors could reduce the chance of down years, at the cost of lower returns



Source: Vanguard

By finding out about our clients' investment horizon, risk propensity and cashflow needs, we're able to recommend the ideal combination of shares and bonds to suit their personal goals.

Chris Brycki - Stockspot

States and China as well as the continued falling price of oil there is little likelihood of respite from a continuing bear market in the near future.

In the present economic circumstances this should be of little surprise to experienced investors because November 2007 was the start of a secular bear market in Australia. This current secular bear market is now in its eighth year and is still incomplete. Secular bear markets are periods of falling valuations and can be expected to be protracted by the effects of deflation and low economic growth. Both are evident in the current economic environment where markets will be driven lower by falling corporate profits and returns from equities for perhaps the next few years.

The three legs of the secular bear market are highlighted in the monthly chart of the ASX200 below. Elliot wave analysis would suggest that the final leg of this secular bear market which is now confirmed will continue for some time, falling at least to the 2008 bear market low of about 3050 but possibly much lower.



The question that investors will now be asking is, when will this secular bear market end? Current world economic conditions are quite ugly and will be exacerbated by the effects of the wars in the Middle East, so it is not likely that a market recovery will be rapid. Investors should be aware that in the 1930s and the 1960s the markets showed no growth and went sideways for about 20 years on each occasion. Despite recent efforts by central banks, a world with continued low growth and deflation seems inevitable, so **market behaviour of the 1930s seems to be a likely model for equity markets over the next few years.**

Bill Dodd: The Independent Investor. www.aust-investor.com

The Australian secular bear market

Bill Dodd (Published February 10, 2016)

With the ASX200 index now falling below the 4800 level, Australia now is technically in a bear market. With significant challenging economic concerns in the United

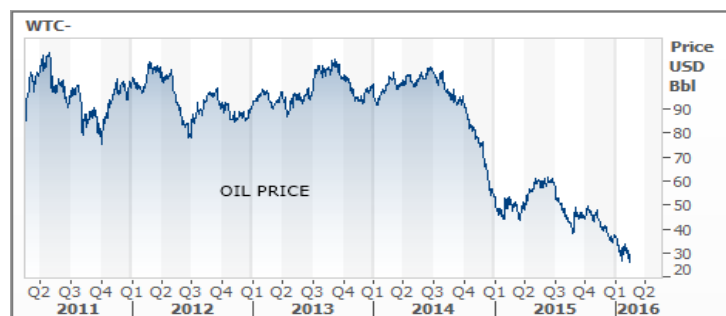
Seeing Value

Marcus Padley – Marcis Today, 17 Feb 2016

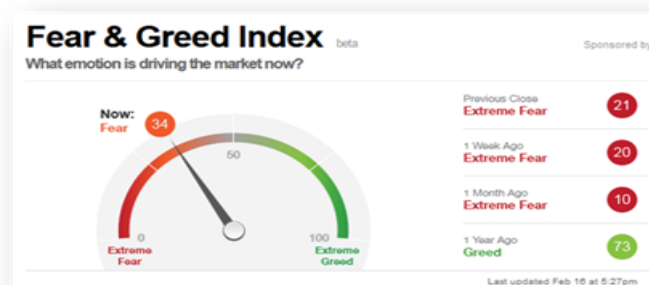


For a few reasons I'm beginning to think that we should be buying something. Technically we shouldn't, so we won't, the charts are still ugly, but there are a few things going on which suggest there is value to be had in select industrial stocks. Notably:

- The "Yield Gap", the 10 year bond yield minus the equity yield, is as high (good for equities) as it's been since the GFC. There is value in the equity market now assuming the dividend forecasts are right.
- The average yield on the ASX 200 is very close to 5% plus franking. This compares to a longer term average of 3.5% to 4%. This is again a level of yield we haven't seen since the GFC.
- Some large industrials have had big jumps on results. The market is clearly not interested in fundamentals unless they are waved in its face.
- Some of the banks have higher yields than their PEs. Some yield more than 11%. If the banks were perceived as 'safe' some could rally 40% and still be on an 8% gross yield. In the GFC the bank sector fell 56% on fear alone and then rallied 171% in the years after, massively outstripping the rest of the market.
- Term deposit yields have dropped below 3%. At some point, as soon as the perceived risk of a capital loss in equities has diminished, there will be a rush by income seeking retirees to take advantage of equity market yields, particularly bank yields, before they drop again.
- It is obvious from the correlation on the way down that for the market to bottom will require commodity prices to stop falling. It is probably too optimistic to expect them to rally but we have certainly seen some recent consolidation in the oil and iron ore prices, the root of all evil. The bulk of the damage may well have been done. Consolidation alone will significantly reduce the market risk.



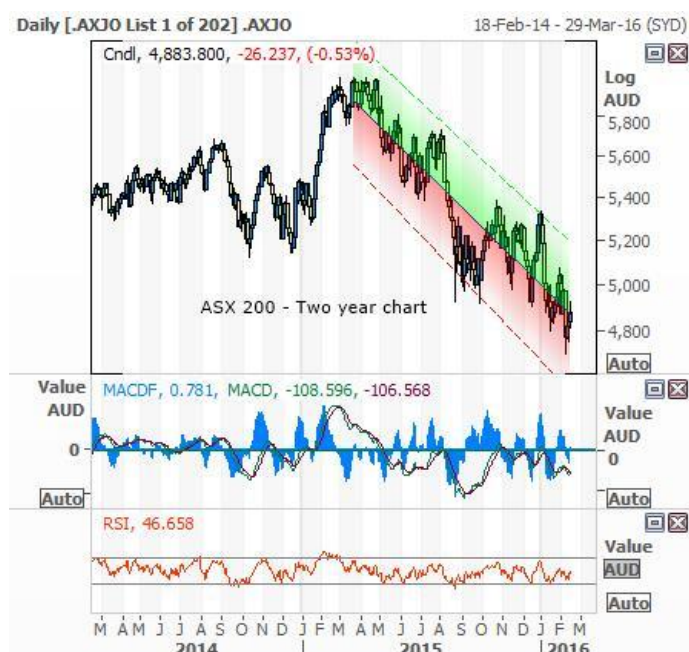
- Credit Suisse commented this week about grizzly bear markets and gummy bear markets. The grizzly bear market is when it falls 20% and then falls another 20%. A gummy bear market is when it falls 20% providing a sweet buying opportunity ahead of it rallying 20%. They think we are in a gummy bear market.
- The doom and gloom merchants are in full flight. Gold bulls are pouring fuel on the fire at every opportunity. It is a frenzy, short term and a sign of a bottom not a top.
- Sentiment rules. We are not quite in blind panic mode but we are close. The CNN fear and greed index which recently hit "extreme fear" at 10 out of 100, suggests people are beginning to fear 'fear itself', doing 200 miles an hour with their hair on fire. This fear is lacking a parallel destruction in fundamental value except in the resources sector (which is now a dead horse - no point beating it any more).



- Not to buy the market now requires a belief in an Armageddon event. The ingredients for that are not apparent and will be heavily resisted by Central Banks. "Fearing fear itself" is not enough.

- Any rally is likely to be quick. To take the equity market yield from 4.9% to 4.0% would require a 20% rise in the market and to take it to 3.5% would require a 30% rise in the market. If the market stops worrying and starts buying the value will be quickly snatched up.

So why don't we buy the market? Because the market is firmly in downtrend. We all know you don't catch the knife and, truthfully, no-one is buying because the risk of a capital loss is still more important than the mild attraction of a potential profit.



To remove the risk we need the energy sector debt issue laid bare and the confidence to believe that banks globally are not hiding some unstated exposures that would melt the financial system again.

That may take some time. The energy and the iron ore companies are perpetually bullish and are going to leave it to the last possible moment before admitting any debt issues because debt is a function of confidence and a declaration that they are struggling destroys that confidence and becomes self-fulfilling, lenders simply back-off, the company is starved, debt costs rise and the problem compounds.

"No confessions" is the rule. So we may struggle to find confidence for a while, until the energy sector impact is laid bare. We are either going to get some watershed event (big resources company going bust) or some fundamental reassurance, but unfortunately energy and resources companies won't tell us the extent of their pain until they have to. They are constantly buying time before confession, they are all living in hope that the oil

price and iron ore price will rally to rescue them. So we may stay in the dark, fearing the unknown for a while longer.

Whilst we do we are ignoring value.

The problem of course is that we are unlikely to ever get that clarity and by the time we do the opportunity will be gone. So you have to go early, you have to gamble, but most of us won't until prices stop going down and start going up. But on that day, there will be plenty to buy, and that's the point.

Crisis What Crisis

I saw a chart on Bloomberg which rather amused me - so I have recreated it for you - this is a chart that shows the bear markets in the MSCI world index since 1990. Interestingly we can name them all (see legend on chart) and the reasons they happened including; US recession, Asian financial crisis, the tech wreck, the global financial crisis, the Greek crisis.



Then there is 2016, our market is down 21% and the MSCI world index is down 13.9% but no one has a name for it, or an excuse really. What are we going to call this bear market? The commodities rout maybe. Or the Chinese growth crisis. The quantitative easing headache we had to have.

Or, as Supertramp fans might call it, the "Crisis what Crisis" bear market. It's just begging the question, is there really a crisis? Do we have an excuse for an Armageddon event because as Credit Suisse described it, if this is a grizzly bear market (falls 20% then falls another 20%) you need a reason. Otherwise it's just a great buying opportunity.

The problem of course is that niggling in the back of many of our brains is the understanding that in the GFC it took quite a while to work out just how important someone not paying their mortgage in Florida was going to be.

Similarly an energy company not paying its debts could have consequences beyond our imagination as well - you might have noticed Woodside's results today, a 98% fall in profit, they made just \$26 million out of \$5.03 billion worth of sales. Pitiful. Others results follow this week. (By the way, I see one broker suggesting you buy Woodside for its 5.5% fully franked yield. I wouldn't touch Woodside ahead of the Origin and Santos results, it could be a very rough week for the sector.)

Companies in pain always spend some period of time in denial; until forced to confess, they won't. So we may still find new depths because the chances are we haven't heard the worst of it yet from the resources sector. The damage done by an oil price that has fallen from \$107 to \$26 (-75%) in less than 2 years and an iron ore price that is down from \$130 to \$45 (-58%) is only appearing in the results now.

What I am beginning to think, thanks to the 'cheap' looking industrials being ignored, is that we do now need this Armageddon event to justify selling the market further or buying gold. Both are a bet on Armageddon happening which means that for the market to really bottom we need to dismiss this Armageddon fear.



IN SUMMARY:

- There is value in the market.
- No one will buy it because they are still more concerned about a capital loss than making a profit.
- To continue to sell the market (or buy gold) we need an Armageddon event.
- That could come from energy companies - watch the Santos and Origin results this week.

- Resources are still not a buy. Why take the risk?
- Gold is not a buy - don't believe the impassioned gold stories - it's only a momentary trade and there is nothing predictable about it.
- Without an Armageddon event I would be buying select Australian industrials and the Australian financial sector.
- Stock picking (not blanket buying) continues to be the game (as always) as you can tell from today's results - some fabulous performances from individual stocks that have reasserted their fundamental attractions after being sold down on 'market' fear rather than a fundamental deterioration.
- Most of us won't buy anything until the trend turns up, at the moment the market is still firmly in downtrend.
- The catalyst for a market turnaround will be a commodity price rally.
- When we get over the fear there is every reason to buy some stocks - the rally will be rapid.

The best use of your time at the moment is deciding what to buy when the time is right and it's not buying rubbish stocks in crap sectors for a bounce, look at Domino's Pizza recent results. It's about buying the quality stocks we wanted to but wouldn't buy at the top of the market...at the bottom of the market.

Marcus Padley: Marcus Today



DEFINITELY NOT TO BE MISSED AND WORTH BOOKING EARLY.

We hope to see you there.



**2016 National Conference @ Marriott Resort & Spa
7th August - 10th August 2016**

Special offer for early registrations:

Book by 31st May and pay a non refundable \$100 deposit and pay the balance by 5th July and you are entitled to attend the Monday Evening Light Supper & Master Class FREE.

You will also go into the draw to WIN 3 NIGHTS ACCOMMODATION at the Marriott during the conference.

Other delegates not fitting this criteria will need to pay an additional \$33 to attend the Master Class and are not entitled to go into the accommodation draw.

This year, the focus is on **Volatility, Risk & Reward...**
Strategies for an uncertain world.

We have a great line up of speakers including Dr Shane Oliver, Noel Whittaker, Don Stammers & Paul Bloxham. Your favourites are also back including Alan Hull, Marcus Padley Colin Nicholson & Roger Montgomery, just to name a few.

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