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Investment Insight

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There are some moments in time where courage lacks wisdom and others where wisdom lacks courage. As the world ventures deeper into unchartered economic waters, risks of all types, increasingly rise. Investing today requires us to make many choices and decisions where the outcomes are far from certain, but the financial stakes are high. As we write this edition of Investing Insight, we are confronted by both extremely favourable and extremely troubling economic signals. In a very mature bull market, where most global asset prices have been inflated by the snake oil of borrowed money, our quandary is to determine just how much courage remains wise.

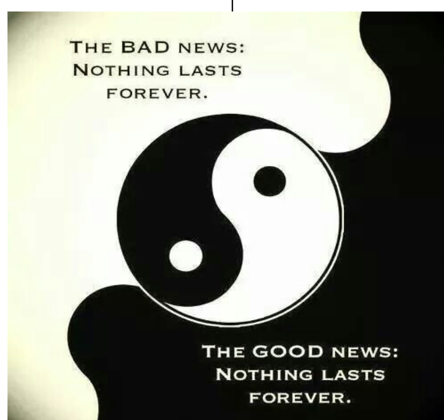
The Good, The Bad & The Not So Ugly

Risk Tolerance is Personal not Public

Most readers will know that investing is more an art than a science. Although the results may be measured or measurable by empirical returns, the process leading to those results is not so definable and the skills of the manager are not so readily apparent. The objective of all investment managers (including DIY managers) is to meet the goals of investors. Yet this task is not so easily achieved should the goals change over time.

Investors see results from a very subjective and personal perspective. No two people are alike. Extended periods of favourable market conditions (as we have recently enjoyed) lead investors once fearful of losses to become more and more "courageous". Over time, many are progressively ***drawn to invest more than they should, and fear risk less than they should.*** This response follows classic behavioural finance theory driven largely by human emotion and manifesting itself in a form of FOMO.

This behavioural type is more common than most expect. Often, **these very investors do not consider themselves as risk takers,** yet by their actions, are undeniably so. Almost to a person, these people gradually develop an expectation of **higher than market gains but lower than market losses**.



Although this sounds unrealistic, it is demonstrably the most common failing of investors over the centuries. "Keeping up with the Joneses" has contributed to nearly every boom and bust in history. It seems imprinted in the DNA of most people. It is also the reason why so few seem aware or prepared for changes in market conditions.

If the Yin and Yang graphic on this page attracted your eye, it is now time to understand the meaning of "The Bad News". Prepare for it before it becomes front page news.

Know Your Required Rate of Return

Returning to our primary theme, we must investigate why ***intelligent people appear unable to sustain intelligent behaviour***. We hope that this brief discussion is of value to readers.

As financial advisers, one of our most important tasks is to determine what rate of return on capital is required for our clients' long term goals to be met and reconcile this figure with the investment risk tolerance (volatility) each client is prepared to accept. By its very nature, this apparently simple task becomes mired in subjective judgements and projections of unknowable outcomes. If it were easy, we'd be out of a job.

Knowing your rate of return allows each investor to be aware of the difference between the **risks they may be drawn to take** and the **risks they can afford to take**. This determination is first made at the time of the investment but reviewed at least annually taking into consideration both prevailing and future economic and investment circumstances.

By way of example, given a person's capital resources and risk tolerance, if a working client with a balanced investment risk profile needs a return of CPI+5% (currently 7%) in order to meet their retirement or investment objectives, they must naturally accept market risk and volatility to be a part of their investment strategy and have planned for it.

Since "risk free" investments such as bonds and term deposits are only likely to yield 2.5% - 3%, achieving a target of 7% demands investment in higher yielding assets such as shares, property and infrastructure assets. The mix between defensive and growth assets is then constructed and implemented. These investments will likely generate the desired rate of return **BUT ONLY** if the investor is able to resist buying too much risk in high markets and selling down in low markets. Here lies the problem.

If this person were the average, no advice (DIY) 40 something, currently they will have accumulated more growth (risk) assets than intended and got used to annual returns well over their target rate. This will have most likely caused them to ***raise their expected return to say 10% p.a.*** without any awareness that they were assuming higher risk. Thus, in the event of a market correction, they suffer greater losses than they were prepared for.

Under stress, the risk of making poor decisions is high and the likelihood of reaching their 7% return is dashed. Worse still, if they have borrowed money in the last couple of years for investment, whether it be in property or shares, losses may be magnified.

Right now, they are still invested boots and all.

What they should be doing is rebalancing their portfolios, reducing both risk and debt, locking in profits and considering sensible dollar cost averaging (DCA) strategies. Employing these ideas, may well make future goals become achievable realities.

Notice in our example, the expectations of this investor, almost unconsciously, change over time in the absence of any significant market corrections. Perhaps unwittingly, his/her portfolio has assumed that of an **aggressive investor with a diminished fear of capital loss**.

Insidiously, we observe similar changes in the behaviours of retirees. Clients who were living on investment returns of say 5% p.a. have **increased their discretionary spending as investment returns have increased**. Demographically, these are the people who are most vulnerable to falls and have the least capacity to recover. Baby boomers please be watchful.

At this point of the investment cycle, we respectfully advise clients look into yourself, identify your underlying investment risk tolerance. Older clients expecting gains over 6% p.a. are reminded returns go both ways.

It is not an illicit behaviour to seek to maximise growth by riding investments waves from deep waters all the way to the shore. However, **if you cannot handle investment losses do not chase investment risk (returns).**

Clients who are retired or near retirement, do not under estimate the present risks in investment markets. **Recently recurring returns of 7% p.a. - 10% p.a. represent the "sweet spot" of the cycle not the new normal**. In our view, well managed conservative portfolios are more likely to average 3% - 6% over the next 5 years and there will be some negative years.

Higher risk investors should be prepared for a roller coaster over the next 12-24 months. We expect market volatility to ratchet up significantly as investors either leave the table or double up. The tail wind of low interest rates and QE has led to investor complacency. Expect that to change.

What We Like Right Now

Our July 2017 Insight had a cautious investment tenor speaking as it did about Australia's construction boom. Nevertheless, we outlined the extreme contrast in outcomes between investing in Australia or overseas (5% p.a. versus 17% p.a.). We continue to favour overseas assets.

Since July 2017, President Trump has quashed his doubters and delivered on many milestone economic promises. His capacity to execute fiscal change is now irrefutable, with game changing reforms to domestic tax policy, infrastructure spending and controversial trade policies. Many of these policies may be fiscally expensive and economically destabilising. However, they are inherently US centric and US jobs and growth oriented . Previous administrations, by their inaction, have overseen the US merchandise trade deficit with China grow from $US100bn p.a to US$375bn p.a. since 2001. In addressing this serious imbalance, Trump aims to end 20 years of lop-sided Eastern trade and subsidy policies.

Political and economic purists may disagree with Trump's methods, but the swashbuckling speed and breadth of change in the US has translated directly into positive global economic sentiment including Australia.

For the first time in over a decade, US fiscal policy is driving growth NOT loose monetary policy. This positive message has empowered overseas governments to act by legislature rather than funny money.

The convergence of fiscal change, positive sentiment, investment momentum and low interest rates has driven strong US GDP, employment growth and spending growth revitalising domestic confidence.

Contrary to expectations, the US dollar has weakened against the Euro and most trading partners driving strong US corporate earnings underpinning the continuing equities **bull market** (which as of 9th March 2018) is now 9 years old and **2nd longest (without a 20% correction) in history.**

In every respect we would do well to recognise the return of US economic leadership in the world and not underestimate it. On the basis of what is currently evident, the pre-conditions for a US market pull back or economic recession simply do not exist and we do not expect one in 2018.

In Australia, the February 2018 NAB Business Survey recorded its best business conditions since 1994 with the aggregate of trading conditions, profitability and employment all at record survey levels. GDP is expected to rise from 2.4% to 2.8% reinforcing the positive feedback loop.

Global GDP has been revised upwards from 3.6% to 3.8% with US and Japanese growth driving the revision. With the global economy building up a strong head of steam there seems to be little likely to stand in the way of this train. We expect any **bad economic news will be swamped by positive news,** subject only to concerns about FED interest rate hikes.

What We Don't Like Right Now

With the US government re-claiming ownership of the US economy, it is time for accommodative monetary policy to take a back seat. After a 30 year super-cycle of falling interest rates, the tide might just have turned. US markets are pricing in 3 or possibly 4 rate hikes in 2018. This could significantly change both the cost and flow of money and precipitate a downward revision in the relative pricing of all assets. That is, in most circumstances, **interest rate rises lead to price falls in bonds, property and shares**. After all, it is an economic cooling measure. Incidentally, a 1% rise these days is huge. It is sobering to consider that a full 1% rate hike in Australia, would effectively wipe out the equity of the bottom 20% of all home borrowers. RBA inertia recognises this but realistically, interest rates must eventually rise and painfully so. **Normalising interest rates** and avoiding economic mayhem in Australia **will be like walking on egg shells**.

The February 2018 "flash crash" in equity markets was the first fearful response that 10 year bond (interest) rates were rising and that long lost wages growth and inflation may return. **We do not see Jay Powell delivering the number of interest rate rises expected** by the market. Both he and the FED are well aware of the fragility of the financial system and the possibly temporary economic euphoria circulating the globe.

Not only do we not know the ultimate success of the recent US fiscal policies, newly introduced trade tensions and geo-political tensions across many borders and territories could change sentiment very quickly.

Another factor that remains on our radar is that historically, rising Merger & Acquisition activity (M&A), is typically the last stage of every bull market. It is in full force right now and ominously, usually precedes rising interest rates, **capitalising on the last leg of excess liquidity and cheap money**. We hope to wipe the dust off our old Investment Clock in our June/July Insight, to add some context to this discussion.

A symptom of all investment booms is speculation. This time around it is not tulips, or gold, or even apartments. It is the **crypto-currency mania** in all of its incarnations, bitcoin, ripple, ethereum etc.

Without challenging the anti-intermediary basis of crypto-currencies, we comment only on its meteoric price rise (and fall). It has been an "asset" of simple speculation promising the lure of easy money, but it is also an indicator of investor euphoria and risk mis-management. 21st century technology has given new life to the old "pump and dump" strategies used by shysters in the 19th century but proving yet again that **a naïve person, a smart phone and their money, remain easily parted**. Punters in this highly sophisticated algorithmic chain have both made and lost fortunes in less than a year. Investors take note.

Domestically, we remain concerned about the underlying health of our debt laden Australian economy. Large equity gains across the world have not translated to large equity gains in Australia. This points to a domestic problem. The December, 2017 National Accounts show sluggish GDP growth, deteriorating terms of trade and negative productivity countering an employment and spending "rush". Rising wages income is a welcome sight, but being spent rather than saved is a borrowing nation's dilemma.

Internationally, we are disturbed by China's Xi Jinping's move to essentially install himself as a de facto Emperor. China is not without its own monumental economic challenges and its posturing to engage in both trade and/or military conflicts is a constant threat to the status quo.

Finally, we cannot speak of our modern world and leave out the "Old World" of Europe. Having been propped up by a most unlikely US and China alliance, Europe will soon be asked to take care of itself. US tariff concessions are over, as is the growth inducing fall in the Euro. As for Brexit, there are now only 12 short months to untangle the web without both sides getting sticky fingers. Enough said.

So What Is Our Current Position?

The extraordinary political and economic actions of President Trump have shifted our compass. Despite the many deep and unresolved matters that trouble us, we are decidedly of the view that investment markets will continue to rise over the course of calendar 2018 albeit with volatility.

Although synchronised growth may already be built into current elevated asset prices, the weight of money being attracted to growth assets seems destined to propel markets higher. Amidst the continuous stream of positive data, we suspect bad economic news will be dismissed. This market cycle, known as "**climbing the wall of worry**" is well documented.

We are not so confident that mid to late 2019 will meet expectations.

At our best guess, 2018 will not be as strong as 2017. However, **we do not expect the usual decade ending calamity**. Well not just yet any way. Most likely, that is another Presidential election campaign away.

Until then, we remain cautiously optimistic that 2018 will provide more conservative investors with a reasonable exit point to reweight portfolios more defensively and safely get onto the investment shoreline.

Although sounding like a broken record (for those who remember such things) our repeated concerns about our unabated Australian appetite for debt, now 200% of income levels, remain. Extraordinary debt casts a constant shadow over Australia's ever diminishing window of good fortune.

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