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financiallyspeaking

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Economic outlook

Global economy

The trade war between the United States (US) and China continued during the September 2019 quarter as the US imposed new tariffs on goods imported from China. In other trade news, the World Trade Organisation found that subsidies provided by the European Union (EU) to Airbus, a leading European global aerospace organisation, disadvantaged the aerospace industry in the US. This led to new US tariffs on European goods, contributing to weaker global business confidence and concern for global economic growth.

Across a number of countries, monetary policy was eased further with cuts to interest rates. Fiscal policy (taxation and spending) also featured in public debate (Germany) and was implemented in certain cases (India). The US and the EU reduced interest rates in an attempt to boost economic growth. The rate of economic growth slowed slightly in China, the US and Europe.

The Markit Global Manufacturing Purchasing Managers Index (PMI), which provides a forward-looking measure of global manufacturing activity, remained in contractionary territory. Similar surveys in the US and China remained positive and improved slightly compared to last quarter. The European economic outlook continued to weaken, which was led by the poor performance of Germany.

In this issue

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Economic outlook continued

Weakness in the EU's services sector prompted a restart of the European Central Bank's asset purchasing program, also known as 'quantitative easing', which aims to increase the money supply and encourage lending and investment.

Australia

In Australia, economic data was disappointing. Economic growth in the June 2019 quarter was 0.5%, which, while in line with expectations, resulted in economic growth of only 1.4% for the 12-month period. This is a decline from the 3.1% growth rate reported in the 2017/18 financial year.

The annual inflation rate was 1.6% for the year-ended 30 June 2019. This is below the Reserve Bank of Australia's (RBA) target of between 2% and 3%.

Both the NAB Monthly Business Survey and the Westpac Melbourne Institute Index of Consumer Sentiment pointed to subdued confidence among businesses and consumers. This has occurred despite the anticipated stimulus driven by the RBA's sequence of interest rate cuts and the Government's tax offsets for lower income earners. The Government may need to do more to reinvigorate economic growth.

The relatively weak economic data may see the RBA make further reductions to interest rates before the end of the year.

Shares

In Australia, during the September 2019 quarter, many companies reported their results for the 2019 financial year. Companies with surprising results, that were above market expectations, had significant share price gains. For instance, model portfolio stock James Hardie's (ASX: JHX) share price rose from $18.70 to $24.86 during the quarter, a gain of 32.9%.

Smaller companies performed well, with small capitalised companies (small caps) and micro caps, which generally have a market capitalisation of under $500 million, outperforming the broader share market by 0.7% and 11.3% respectively.

Globally, unhedged large caps performed strongly. This was due to a falling Australian dollar and strong demand for 'bond proxies' (higher-yielding shares) such as utilities and listed property trusts.

Fixed income and currencies

Interest rate cuts contributed to the positive performance of bonds during the quarter. As interest rates fall, bond prices typically appreciate because they offer a higher yield than the cash rate. This enhances short-term returns and increases potential capital gains.

However, this comes at the cost of lower future returns. The Australian 10-year Government Bond is now offering a yield of only approximately 1%. This suggests the possibility of investors receiving lower long-term returns from bond portfolios.

The Australian dollar fell as a result of weaker global growth, RBA interest rate cuts and weaker iron ore prices following increased production in Brazil by Vale, a major iron ore producer.

The impact of the Reserve Bank of Australia's rate cuts

This year the RBA cut rates by 0.25% in June, July and October. This was for several reasons. The RBA was responding to a weaker global economy and was concerned about how this would impact the Australian economy. It also hoped that by cutting interest rates it would lower unemployment without increasing inflation substantially. And a third reason was to stop the Australian dollar rising too much, which would impact our exporting businesses against countries such as New Zealand which had already cut interest rates substantially.

RBA rate cuts have different impacts across the economy. Some groups and areas benefit while others are disadvantaged. These include:

- **Borrowers:** The majority of bank lending is for housing. Lower interest rates, provided they are passed on by banks to borrowers, reduce mortgage repayments and improve borrower spending capacity. The hope is for increased consumer spending to support economic growth.
- **Savers:** Savers are penalised by lower interest rates because they receive less interest income. This disadvantages retirees and people with large amounts of cash held in bank accounts or conservative investment portfolios.
- **Property market:** Lower interest rates increase potential borrowing power and help to increase property prices. They also make property, with its potential for higher returns, more attractive than other safer investments such as cash. As a result, following the rate cuts, we have seen price rises in the Sydney and Melbourne property markets.

Economic outlook continued

- **Consumer spending and sentiment:** If consumers feel confident about their future prospects, rate cuts can help encourage further spending. Or, interest rate cuts can have the opposite impact where too many cuts make consumers feel concerned about economic growth. Recently this has occurred with consumer sentiment falling to below-average levels after the three rate cuts.
- **Business investment:** Rate cuts make it easier for businesses to borrow at lower rates of interest or to issue bonds with lower yields. While this can encourage business spending this is typically only true if businesses are already struggling from a high cost of capital. If that is not the case then any impact on business investment is likely to be minimal.
- **Economic growth:** To grow the economy, rate cuts can be seen as a supply-side solution by making borrowing easier. If access to credit is not a major issue for consumers or businesses then the impact is limited. This may mean the Government needs to implement demand-side solutions, such as investing in transport and other infrastructure, that directly encourage more spending within the economy.

Source: IOOF

Why decisions made during your ‘transition to retirement’ are life changing

The decisions you make when you are transitioning into retirement can be the most telling for financial security throughout your golden years. Why? Your accumulated savings pool is likely to be highest in the years nearing retirement – and just after you retire. Investment decisions made at this time can greatly impact your income down the track.

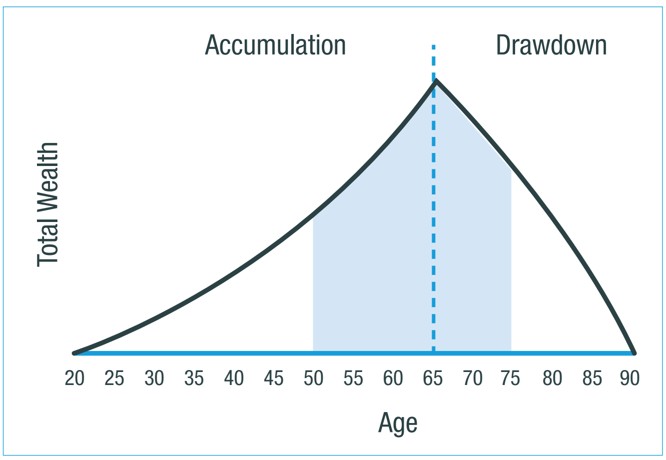
The risk they don’t talk about in the papers

When it comes to investing we are all familiar with the most common definition of risk; investment returns can and will vary. But risk needs to be considered in context of not achieving your objectives – and how a lesser known risk called ‘sequencing risk’ impacts whether or not you meet your goals.

Returns matter the most when you have the most capital at risk. Sequencing risk relates to the order in which returns occur.

Rather than just assessing how assets go up or down over a given time horizon, the path of the return also needs to be assessed. This is because your outcome will be a function of both the investment returns achieved and the size of your investment savings. Let me show you with an example.

Critical investment period near retirement and just post retirement

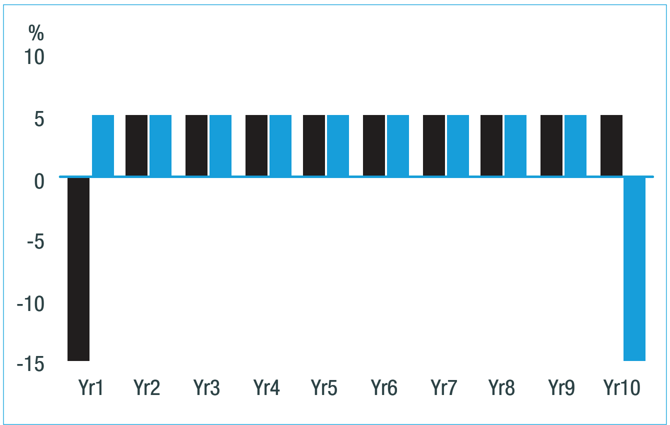


A poor investment outcome at the wrong time can be very costly

Consider an investor in their accumulation phase who saves $10,000 each year for 10 years. In the below two scenarios, the investor experiences a large negative loss over the course of that decade. In Scenario 1, the investor experiences the loss in the first year, while in Scenario 2, the loss occurs in the final year of their investment.

Both scenarios have the same compounded annualised return and volatility. If you were to read about these returns in the newspaper at the end of the decade, the returns would be the same under either scenario. But the dollar outcomes for the investor are vastly different.

Timing Matters: different outcomes due to different timing of returns



	Market return outcome	Client portfolio outcome
Scenario 1	31.9%	$128,965
Scenario 2	31.9%	$106,912
Difference	**0%**	**-17.1%**

In Scenario 1, the market decline occurred early and impacted savings when the accumulated investment balance was low. In Scenario 2, ten years of savings contributions and years of steady market gains were impacted by the poor returns in the last year.

The difference for the investor who experienced a draw down in the last year was -17.1%. A poor investment outcome at the wrong time can be very costly.

The value of seeking expert advice

Why haven't you read about sequencing risk more often? *Financial markets* don't experience sequencing risk, only *investors* do. It relates to where you are in your own working/retirement journey and the savings balance you are accumulating ahead of retirement.

Investment strategies are available that aim to improve the outcomes during this important 'transition to retirement' phase. These strategies aim to reduce volatility and improve the stability of returns.

This highlights the benefit of seeking expert financial advice to assist with these challenges. Your financial planning adviser can tailor an investment strategy that matches your personal circumstances and seeks to address your multiple objectives. They have required skills and experience to determine if strategies designed for the transition to retirement may be appropriate for you in terms of achieving your long-term financial goals.

Taking the time to plan your 'transition to retirement' can be well worth the effort.

Source: First Sentier

How to be a human be-ing, not a human do-ing

We are so busy in our lives today. Decisions are made instantaneously, but knee-jerk reactions are often the wrong course of action. Taking the time to evaluate a situation can lead to a more informed decision and a better result in the long term. We are human be-ings not human do-ings; we don't always need to be active and taking immediate action.

Quick decisions are often made because of fear. We are scared of failing, or losing control. Switching away from a poorly performing investment is a case in point, as it is human instinct to not want to suffer through poor performance.

It is very difficult to not look at short-term investment returns. During these periods many investors may be tempted to take swift action and switch out of a poorly-performing fund into a fund that has performed better. Although this may appear to be a sensible way to generate better returns, switching funds during periods of poor performance can destroy the value of your investment.

You have to sell your units, which will usually incur 'friction costs' (all the direct and indirect costs associated with a financial transaction, such as transaction fees and taxes). It also locks in the underperformance of the fund that you are switching from. Simultaneously, there are no guarantees that the fund that you switch into will be able to repeat its recent strong performance. By switching you are often selling and buying at exactly the wrong time.

Managing the urge to switch

There are many reasons why we switch. Next time before we do it, it is worthwhile considering the following three factors to judge how much of a role they play in the decision making.

1. Our emotions

You would not be human if market volatility didn't create a sense of fear, or at least make you uncomfortable. These emotions often lead to taking action that will permanently lock in losses, or missing the best time to invest.

Your role as an investor is to pick a managed fund on the basis that it suits your needs and objectives and that you trust the fund manager – not solely on account of recent performance.

2. Forecasting

Various studies have shown there is no correlation between economic growth and share returns, but investors often study macroeconomics to attempt to predict market returns.

In the end, what determines the success of your investment is the price that you pay for an asset, and how much return it generates.

3. Rare events

Sometimes events occur that are incredibly rare and extremely difficult to predict. These can have a major effect on markets and investments, for example the September 11 attacks and Brexit. The impact on your portfolio can be significant, but these events are highly unpredictable. It is not a good idea to base your investment decisions on what could 'possibly' happen.

To benefit when switching funds, you have to be able to choose the best times to leave and enter the market. This is nearly impossible because markets can swing wildly from day to day in response to a variety of unpredictable factors.

Remaining invested when faced with poor performance will take strong nerves. But if you can steady your emotions, and keep in mind the reasons why you invested in the first place, you can ride out a difficult period and hopefully enjoy good returns in the future. It would have been tempting to switch your investments in the final quarter of 2018, but since the start of 2019 the ASX 300 Index is up almost 23% (to 30 September 2019).

Sometimes there are good reasons to switch. For example, if your, or the fund's, objectives, change then your investment may no longer be suitable. You may have lost faith in the fund manager, or maybe you simply need to rebalance your portfolio.

Before making any decision, investing or otherwise, it's important to slow down, take time to re-evaluate the situation and focus on your long-term priorities. In today's world the urge to take immediate action can be overwhelming, but sometimes the best course of action is to do nothing at all.

Source: Allan Gray

Protecting your super – further changes to insurance in super now law

Did you know that superannuation fund members under the age of 25 and members with balances below $6,000 risk losing their insurance cover unless they actively opt in to retain their cover?

Background

These recently enacted changes were the remaining "Protecting your super package" (PYS) measures that did not pass through parliament when the federal election was called in May this year. This second tranche of measures is known as 'Putting Members' Interests First' or PMIF changes.

Originally announced in the 2018 Federal Budget, the measures aim to address concerns that superannuation balances are being eroded by premiums for insurance that members may not need or may not be aware of.

The changes add to the already enacted PYS legislation which requires trustees to switch off insurance cover for members if their superannuation account has been inactive (i.e. no contributions or rollovers received into the account) for 16 months or more, unless they opt in to maintain their cover.

The PMIF changes – what it means for superannuation fund members

From 1 April 2020, a superannuation trustee cannot provide insurance to a member where:

- the member is under the age of 25 and begins to hold the product on or after 1 February 2020, or
- the balance of the product is less than $6,000 and it has not been $6,000 or more since 1 November 2019, unless the member has elected to maintain their insurance.

Tip – A written direction to retain insurance cover by a member who is either under 25 or who has a balance of less than $6,000 will be valid indefinitely unless their account becomes inactive. Additionally, an election to opt in by a member who is under 25 will be taken to satisfy the opt-in requirement for low balance products, and vice versa.

Exemptions from the PMIF changes

Some individuals will not be impacted by the PMIF changes, including:

- existing superannuation fund members who have opted in or elected to take out or maintain insurance (i.e. had underwritten policies) before 1 November 2019.
- members of self-managed superannuation funds (SMSFs) or small APRA funds
- members whose employer makes contributions to a fund on their behalf which cover the full costs of the member's insurance premiums (on top of superannuation guarantee obligations)
- defined benefit fund members
- Australian Defence Force (ADF) Superannuation members (or a person who would have been an ADF Super member if they had not exercised a choice not to), and
- superannuation fund members engaged in dangerous occupations (see below).

The PMIF legislation includes a 'dangerous occupation' exemption that applies to:

- emergency services workers, including members of the police force or service, fire service or ambulance service, and
- fund members who are employed in an occupation considered to be in the riskiest quintile of occupations in Australia (as certified by an actuary based on rates of death, or death and total permanent disability).

What superannuation trustees will be doing

Trustees will need to determine whether a member has elected to take out insurance through the fund (i.e. applied for a personally underwritten policy) before 1 November 2019. If so, the member will be deemed to have opted-in.

Other fund members with account balances below $6,000 on 1 November 2019 will be notified by 1 December 2019 that they will lose their cover on 1 April 2020 if their balance remains below $6,000. Note that cover can be maintained if member elects to retain it, and the trustee communication will set out the opt-in method that may be used (i.e. opt-in via paper-based form, web-based form submitted online, email to trustee, etc).

What superannuation fund members need to do

Members impacted by the PMIF changes who wish to retain their cover can do so by submitting a valid election in writing (an opt-in notification) to their superannuation fund prior to 1 April 2020 to maintain their insurance cover.

Alternatively, impacted members can also choose to do nothing if they do not want their insurance to continue.

Source: AIA

Using diversification to combat risk

One of the most important principles of investing is to ensure that you have a diversified portfolio. Diversification — spreading your money among many different investments — attempts to take a middle road through the highs and lows of market performance, allowing your money the opportunity to grow regularly with fewer fluctuations along the way.

What are some of the benefits of diversification?

The reason for diversification is simple: By including a variety of investments in your portfolio, your risk is less than if you put all your money in one type of investment. Three key advantages include:

1. Minimising risk of loss

If one investment performs poorly over a certain period, other investments may perform better over that same period, reducing the potential losses of your investment portfolio from concentrating all your capital under one type of investment.

2. Preserving capital

Not all investors are in the accumulation phase of life; some who are close to retirement have goals oriented towards preservation of capital, and diversification can help protect your savings.

3. Generating returns

Sometimes investments don't always perform as expected, by diversifying you're not merely relying upon one source of income.

Choosing a mix of investments

What goes up usually comes down

All securities behave differently from one another, going up and down in separate cycles and to varying degrees. An individual stock is affected by a combination of different elements, including the overall stock market, health of the industry the company does business in, and the company's own performance. Though stocks generally vary more than fixed-income investments (such as bonds), fixed-income prices can be affected by changes in interest rates and the overall fixed-income market.

Diversification within and across asset classes

Diversification can be achieved in many ways, for example:

- **Across different asset classes** including growth and defensive assets. Growth assets generally provide longer term capital gains, but typically have a higher level of risk e.g. shares or property. Defensive assets generally provide a lower return over the long term, but also generally a lower level of volatility and risk e.g. cash or fixed interest.
- **Within asset classes** such as purchasing shares across different industry sectors.
- **Across different fund managers** if investing in managed funds.

The risk or variability of different markets are impacted by: domestic/international developments and economic factors - such as production, employment, monetary policy, and levels of investment. How you diversify across asset classes, therefore, has a direct effect on the amount of risk, or variability of returns, you are likely to have.

For example, during periods of increased share market volatility, your share portfolio may suffer losses. If you also hold investments in other asset classes such as fixed interest or direct property that may perform better over the same period, the returns from these investments can help smooth the returns of your overall investment portfolio.

Practicing diversification in your savings plan

Mutual funds that invest in both stocks and fixed-income investments (balanced funds) offer one way of diversifying both across and within asset classes.

Another way of diversifying is to choose your own mix of investments, rather than invest in a fund where the mix is determined by someone else. However, if you take this route, you need to be more diligent about evaluating your choices and may want to get assistance from a professional adviser.

Two simple rules

When diversifying your investments, remember to:

1. Reduce "security-specific risk."

Purchase a broad range of investments across various companies and industries rather than a limited selection of individual securities. This way, no single investment will dominate the performance of your retirement account.

2. Spread your money across different asset classes: stocks and fixed-income.

Each asset class has its own unique risk and return attributes. And because the risks of one asset may complement the risks of another, it may be possible to achieve higher investment earnings and reduce your portfolio's volatility.

By diversifying your investments, you can achieve smoother, more consistent investment returns over the longer term, balancing out the ups and downs, protecting your savings from short-term losses and allowing them the opportunity to grow over time.

Source: Russell Investments

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