nabprivatewealth

# Private Wealth View

# September 2014

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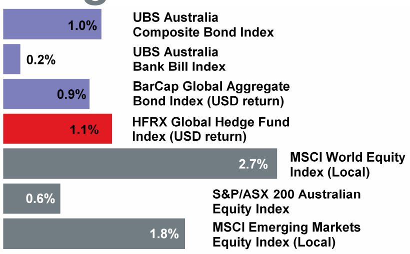
## August 2014




## What's changed in August?

With better US economic data and hints from the European Central Bank about further stimulus measures, equity and bond markets were stronger over the month:

- Developed market shares rose 2.7%, with the US market rising 3.8%, while Australian shares were 0.6% higher
- Emerging market equities gained 1.8%, with a strong 9.8% rise in Brazil
- 10-year government bond yields fell 22-28 basis points in the UK, Germany, Australia and the US
- Investment grade credit spreads were flat in August, rising just two basis points to a spread of 112 basis points
- The US Dollar was stronger against the British Pound, Yen and Euro, but the Australian Dollar rose slightly against the US Dollar to finish at US$0.9333
- Gold prices rose fell by US$4 an ounce to US$1,287 and WTI crude oil fell by US$0.40 a barrel in July, to US$97.86 a barrel

## Macro monitor

Global equities (as measured by the MSCI world index) shrugged off geo-political concerns to post a strong month. The index rose 2.7% in local currency terms in August and is up 20.9% for the past year.

The United States S&P 500 was weak in the early part of the month but then rose strongly to close the month on record highs. The index closed 3.8% up for the month at 2003, above the psychological 2000 barrier. US economic data was positive with a good durable goods report and a rise in consumer confidence to a post-recession high.

European equity markets were stronger in August (Germany 0.7%, France 3.2%, Spain 0.2% and the UK 2.1%) helped by central bank comments. France reported that its economy had stagnated for a second straight quarter, whilst the German economy contracted 0.2% in the second quarter. While the ECB sat on their hands in August, they have subsequently cut all interest rates by 10 basis points and announced a quantitative easing program targeting non-financial private sector assets.

China data was generally soft across the board, interrupting the more positive trend of recent months.

The Australian equities market (based on the S&P/ASX 200 Accumulation Index) rose 0.6% in August. The domestic data flow over August was mixed with further increases in house prices, solid headline credit, a slight improvement in retail sales and private capital expenditure offset by weaker building approvals, a fall in consumer confidence and a rising unemployment rate. The RBA left rates on hold and downplayed lower rates as the solution to the softness in domestic demand. Reporting season was generally positive, with very modest reductions in earnings per share forecasts more than offset by higher dividends buoying investor sentiment. The standout sectors were healthcare (+6.6%) and Telecommunication Services (+4.3%). The Australian Dollar rose nearly half a cent in August to 93.33 despite iron ore falling 8.4% over the month."

*By James Wright, Chief Investment Officer, JBWere.*

## Positioning

Despite continued concerns over valuations and the stability of earnings in the face of a policy shift by the Federal Reserve, we believe markets can grind higher on improved earnings. The market rally has largely been driven by higher price-earnings multiples rather than significant top line revenue growth. We have now entered the growth phase of the rally where price-earnings multiples are likely to trend down over time as earnings growth actually catches up. In international markets, we continue to be overweight technology and healthcare equities.

In Australia, the market continues to reward stocks delivering solid earnings and dividend growth or capital management. The chase for yield continues as investors look to replace lost income from falling term deposit rates. We continue to be overweight industrials, utilities and companies which benefit from a falling dollar. We expect the local currency to come under pressure as the US enters a tightening cycle and the commodity outlook remains flat.

## Summary of policy developments

**ECB starts "Private" QE** – Weak inflation prompts the European Central Bank to announce a program to buy asset-backed securities and covered bonds to stimulate demand. It has also cut interest rates by 0.1%.

**More mini-stimulus in China** – The Chinese government provides farm sector funding and ramps up investment in environmental protection and social housing.

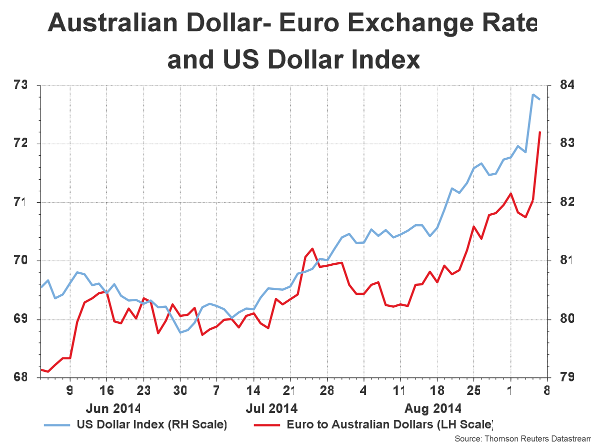
# Currency corner

The Australian Dollar traded in a tight band in August between US$0.9244 and US$0.9369, finishing the month up US$0.003 to US$0.9333. The stronger US dollar also saw the Australian Dollar strengthen against the Euro (2.4%), British Pound (2.1%) and Japanese Yen (1.6%).

Over the month, the currency was impacted by an unexpected increase in the Australian unemployment rate to 6.4% in July, from 6% in June. The currency was sold off but later recovered after the market discounted some of that increase due to changes in how the Australian Bureau of Statistics measures whether people are “actively looking for work”. The stronger NAB business survey saw the currency once again trade above US$0.93.

Market expectations are for the currency to decline in coming months. According to the Thomson Reuters currency survey of around 50 analysts, the median forecast is for the Australian – US Dollar exchange rate to trade at 93 US cents at the end of September, 90 US cents in February 2015 and 88 US cents by August 2015. Despite signals from the US Federal Reserve that a stronger US labour market will see short term US interest rates rise in 2015, the Australian Dollar continues to benefit from its low volatility and high yield characteristics.

*By Nick Ryder, NAB Private Wealth Investment Strategist*



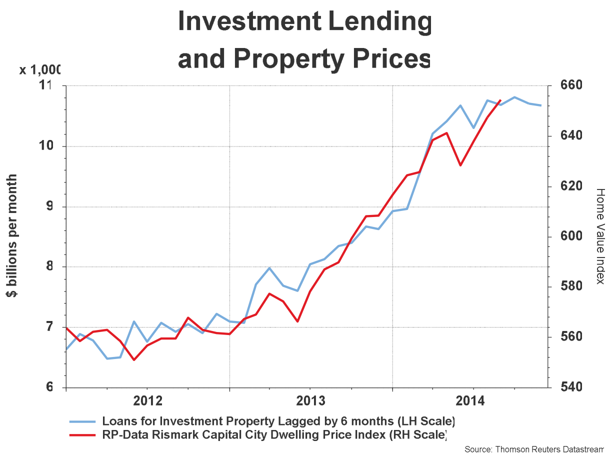

# Housing update

According to the RP Data-Rismark Hedonic Home Value Indices, Australian capital city dwelling prices recorded a strong rise of 1.1% in August and 4.2% over the past three months. This was the strongest winter rise since 2007. Again the data shows a two-tiered property market with Sydney prices up 5% and Melbourne prices up 6.4% over the past three months. Brisbane, Perth and Adelaide prices were up 1%- 1.5% in the period. Over the past year, capital city prices rose 10.9%, with the highest gains in Sydney (16.2%), Melbourne (11.7%) and Adelaide (5.9%).

Since the start of 2009, dwelling prices in Sydney have increased by 50% and in Melbourne by 46%, while the next best performer was Perth with a 15% rise.

Auction clearance rates have remained strong throughout winter and properties have generally been selling quickly due to lower supply. However, the expected supply increase during the spring selling season will be a key test of whether recent price growth can be maintained. Recent falls in gross rental yields, (for example, they fell from 4.1% per annum to 3.6% per annum in Sydney over the past year), may also dampen investor demand for residential property.

*By Nick Ryder*



# Global performance markets monitor – 29 August 2014

| | Last Price / Level | 1 Month | 3 Month | Year to date | 1 Year | 2013 | 2012 |
|---|---|---|---|---|---|---|---|
| **Global Equity Markets Performance** | | | | | | | |
| Australia - ASX200 | 5625.9 | 0.6 | 3.5 | 8.2 | 15.4 | 20.2 | 20.3 |
| Japan - Nikkei 225* | 15424.6 | -1.3 | 5.4 | -5.3 | 14.6 | 56.7 | 22.9 |
| Japan - TOPIX | 1278.0 | -0.9 | 6.6 | -0.7 | 16.7 | 54.4 | 20.9 |
| Hong Kong - Hang Seng | 24742.1 | 0.2 | 9.1 | 9.8 | 18.8 | 6.6 | 27.5 |
| Shanghai Composite (A&B)* | 2217.2 | 0.7 | 8.7 | 4.8 | 5.7 | -6.7 | 3.2 |
| Singapore - STI* | 3327.1 | -1.4 | 0.9 | 5.0 | 9.5 | 0.0 | 19.7 |
| New Zealand - NZX50** | 5223.3 | 1.1 | 0.9 | 10.3 | 15.5 | 16.5 | 24.2 |
| US Dow Jones | 17098.5 | 3.6 | 2.9 | 4.8 | 17.9 | 29.7 | 10.2 |
| US S&P 500 | 2003.4 | 4.0 | 4.7 | 9.9 | 24.9 | 32.4 | 16.0 |
| NASDAQ* | 4580.3 | 4.8 | 8.0 | 9.7 | 26.5 | 38.3 | 15.9 |
| Canada - TSX | 15625.7 | 2.1 | 7.7 | 16.9 | 26.6 | 13.0 | 7.2 |
| Mexico - MSCI* | 43634.2 | 3.7 | 11.3 | 7.0 | 17.1 | -1.2 | 18.2 |
| India - Sensex* | 7880.4 | 3.0 | 9.7 | 26.6 | 49.0 | 6.5 | 30.6 |
| Brazil - Bovespa** | 61288.2 | 9.8 | 19.6 | 19.0 | 22.8 | -15.5 | 7.4 |
| UK - FTSE100 | 6819.7 | 2.1 | 0.7 | 3.9 | 8.9 | 18.7 | 10.0 |
| France - CAC40 | 4381.0 | 3.2 | -2.5 | 4.7 | 13.6 | 22.2 | 20.4 |
| Germany - DAX** | 9470.2 | 0.7 | -4.8 | -0.9 | 15.6 | 25.5 | 29.1 |
| Spain - IBEX | 10728.8 | 0.2 | 0.5 | 11.6 | 33.2 | 27.8 | 2.8 |
| Italy - MIB | 20450.5 | -0.6 | -5.0 | 10.0 | 24.4 | 20.5 | 12.2 |
| **World/Regional Indices Performance** | | | | | | | |
| MSCI World (Loc)* | 4652.3 | 2.7 | 3.4 | 7.8 | 20.9 | 29.6 | 16.4 |
| MSCI World Value | 2582.2 | 1.4 | 1.4 | 5.2 | 17.4 | 23.3 | 12.1 |
| MSCI World Growth | 1911.9 | 2.6 | 2.5 | 5.4 | 18.8 | 24.9 | 14.2 |
| MSCI AC Europe* | 1077.3 | 1.8 | -0.9 | 5.2 | 14.4 | 21.2 | 16.5 |
| MSCI Asia ex Japan USD* | 601.1 | 0.4 | 5.7 | 9.0 | 19.6 | 0.7 | 19.4 |
| MSCI Emerging Markets Local | 50794.5 | 1.8 | 6.4 | 7.7 | 16.0 | 0.9 | 13.9 |
| World EPRA/NAREIT Property USD* | 4200.7 | 1.5 | 3.3 | 14.3 | 20.0 | 4.4 | 28.7 |
| **World/Regional Indices Performance** | | | | | | | |
| MSCI World Cons Discretionary | 181.6 | 0.4 | 1.5 | 0.2 | 14.6 | 38.3 | 21.4 |
| MSCI World Cons Staples | 197.3 | 1.0 | -0.4 | 3.7 | 12.6 | 19.2 | 10.2 |
| MSCI World Energy | 300.5 | -0.7 | 1.4 | 9.9 | 17.0 | 16.0 | -1.5 |
| MSCI World Financials | 104.6 | -0.1 | 1.5 | 3.0 | 15.4 | 24.5 | 25.6 |
| MSCI World Health Care | 193.0 | 1.7 | 4.9 | 12.3 | 25.6 | 34.8 | 14.6 |
| MSCI World Industrials | 202.6 | 0.3 | -1.0 | 0.7 | 16.3 | 30.2 | 13.3 |
| MSCI World Materials | 249.9 | -2.0 | 0.7 | 4.5 | 13.6 | 1.6 | 9.1 |
| MSCI World Telecommunications Serv | 71.4 | -3.0 | -1.8 | -0.7 | 15.8 | 26.8 | 2.0 |
| MSCI World Utilities | 120.9 | 0.1 | 0.1 | 10.3 | 15.0 | 9.3 | -2.2 |
| MSCI World Information Technology | 136.5 | 0.8 | 6.5 | 11.5 | 28.7 | 28.5 | 10.0 |
| **Global Rates Levels Change** | | | | | | | |
| AUS - 10Y Govt | 3.30 | -0.23 | -0.38 | -0.94 | -0.62 | 0.96 | -0.51 |
| AUS - 3Y Govt | 2.64 | -0.10 | -0.22 | -0.34 | -0.08 | 0.29 | -0.46 |
| AUS - 5Y Swap Rate | 3.22 | -0.09 | -0.16 | -0.58 | -0.44 | 0.43 | -0.95 |
| AUS - 3Y Swap Rate | 2.87 | -0.06 | -0.10 | -0.38 | -0.24 | 0.27 | -0.95 |
| AUS – 1Y Swap Rate | 2.64 | 0.00 | -0.04 | 0.01 | 0.10 | -0.17 | -1.07 |
| AUS - 3 Month Bill Rate | 2.96 | 0.09 | 0.12 | 0.16 | 0.23 | -0.33 | -1.77 |
| US - 30Y Govt | 3.08 | -0.24 | -0.24 | -0.88 | -0.63 | 1.01 | 0.06 |
| US - 10Y Govt | 2.34 | -0.22 | -0.13 | -0.68 | -0.42 | 1.27 | -0.12 |
| US - 5Y Govt | 1.63 | -0.13 | 0.09 | -0.12 | 0.02 | 1.02 | -0.11 |
| US - 2Y Govt | 0.49 | -0.04 | 0.12 | 0.11 | 0.09 | 0.13 | 0.00 |
| US - TIPS 10Y | 0.22 | -0.07 | -0.02 | -0.56 | -0.43 | 1.51 | -0.63 |
| US - 10Y Breakeven | 2.12 | 2.27 | 2.23 | 2.25 | 2.11 | 2.49 | 1.98 |
| Bund - 30Y Govt | 1.73 | -0.32 | -0.52 | -1.02 | -0.92 | 0.59 | -0.20 |
| Bund - 10Y Govt | 0.89 | -0.28 | -0.47 | -1.05 | -0.97 | 0.64 | -0.52 |
| Bund - 5Y Govt | 0.18 | -0.13 | -0.26 | -0.75 | -0.65 | 0.63 | -0.45 |
| Bund - 2Y Govt | -0.03 | -0.06 | -0.10 | -0.23 | -0.26 | 0.24 | -0.17 |
| Gilt - 30Y Govt | 2.96 | -0.33 | -0.44 | -0.72 | -0.61 | 0.58 | 0.04 |
| Gilt - 10Y Govt | 2.37 | -0.23 | -0.20 | -0.67 | -0.41 | 1.20 | -0.14 |
| Gilt - 5Y Govt | 1.71 | -0.28 | -0.16 | -0.16 | 0.14 | 1.00 | -0.20 |
| Gilt - 2Y Govt | 0.84 | 0.00 | 0.17 | 0.28 | 0.42 | 0.24 | 0.00 |
| JGB - 30Y Govt | 1.63 | -0.05 | -0.06 | -0.11 | -0.13 | -0.25 | 0.07 |
| JGB - 10Y Govt | 0.50 | -0.04 | -0.08 | -0.24 | -0.22 | -0.07 | -0.19 |
| JGB - 2Y Govt | 0.16 | 0.01 | -0.02 | -0.08 | -0.11 | 0.06 | -0.16 |
| **Global Currency & Commodity Levels Change** | | | | | | | |
| AUD/USD | 0.9333 | 0.00 | 0.00 | 0.04 | 0.04 | -0.15 | 0.02 |
| EUR/USD | 1.3132 | -0.03 | -0.05 | -0.06 | -0.01 | 0.06 | 0.02 |
| GBP/USD | 1.6597 | -0.03 | -0.02 | 0.00 | 0.11 | 0.03 | 0.07 |
| JPY/USD | 104.05 | 1.26 | 2.27 | -1.25 | 5.71 | 18.56 | 9.80 |
| NZD/AUD | 1.1165 | 0.02 | 0.02 | 0.03 | -0.03 | -0.17 | -0.06 |
| Gold (USD Spot) | 1287.07 | 4.98 | 36.38 | 82.13 | -120.57 | -469.40 | 110.54 |
| WTI Crude (USD Spot) | 97.86 | -0.38 | -5.55 | -0.31 | -10.66 | 6.34 | -7.00 |
| GSI Commodity Index | 4755.75 | -1.64 | -4.88 | -1.53 | -6.10 | -1.22 | 0.08 |
| Volatility Index (VIX) USD | 11.98 | -4.97 | 0.58 | -1.74 | -4.83 | -4.30 | -5.38 |

# Asset allocation

Our asset allocation recommendations contain suggested exposures to property. However, clients have many options as to how they allocate to property: if they are large enough they can buy commercial properties or invest in an managed fund that buys unlisted commercial properties or they can buy property securities traded on the stock exchange. Clients may also own residential investment property directly, or through a self-managed superannuation fund. But what do we mean when we talk about property and should all forms of property be treated the same? For example, should property securities be viewed as property or shares and will a leveraged residential investment property provide the risk, return and diversification benefits that are needed in a diversified portfolio?

Many advisers argue property securities (e.g. Westfield Group) should be viewed as just another listed industry sector, like retailers or media companies, which also form part of the stock exchange. And many Australian share funds will also invest in property stocks anyway, so you are getting exposure to property securities through your allocation to Australian or international shares. In the case of residential property investments, many of us are already heavily exposed to residential property and rental yields are either very low or negative (if geared) so residential property isn't necessarily providing income or diversification, particularly if house prices tend to be tied to interest rate cycles. Overall, residential investment can be a more risky property class than other commercial property.

Therefore, when considering the reasons for including property in a portfolio, our views tend to align with institutional investors. For us, the best form of property investment is core unlisted commercial property, with low to moderate gearing, rather than property securities or residential property. This was best highlighted during the financial crisis, when securities in listed highly leveraged property companies such as Centro and GPT plummeted along with equity markets, while core unlisted commercial properties retained their values, maintained their rental income streams and provided strong diversification to the rest of the portfolio.

*By Nick Ryder*

# Asset allocation summary

| Asset Class | View | Comments |
|---|---|---|
| Cash | + | • Hold a slight overweight position in cash until better opportunities emerge<br>• We suggest term deposits out to two years are preferred over at-call cash |
| Fixed Income | + | • We suggest an overweight position in fixed income<br>• Developed world government bonds are expensive and offer poor absolute value, so prefer products with limited interest rate risk<br>• We suggest an equal split between Australian and (hedged) international bonds<br>• Tactical income, absolute return fixed income strategies, floating-rate corporate securities and short duration fixed income are all preferred over benchmark-aware bond strategies |
| Australian Equities | – | • Remain underweight<br>• Valuations are somewhat stretched and growth is lower the in other markets, meaning attractive opportunities in the Australian share market are harder to find<br>• Hold positions in quality smaller companies but do not add |
| International Equities | N | • Given higher valuations in developed market shares, hold a neutral weighting<br>• An unhedged allocation gives some protection if global growth disappoints as the currency is likely to decline<br>• Emerging markets are relatively cheap so maintain exposure either directly, or indirectly through the emerging markets earnings of global companies |
| Alternatives | N | • Maintain a neutral allocation until opportunities emerge<br>• We believe that alternative sources of risk and skilled active management represent important diversifiers for the future<br>• Alternatives as part of an overall strategy of building allocations to assets with low/moderate correlation to equities. |
| Property | N | • Hold a neutral allocation to commercial property. Demand for core property is robust and rental growth fundamentals should improve<br>• At current pricing, Australian and international property appears fair value |

## About our recommendations

The asset allocation recommendations reflect NAB Private Wealth's views on the relative attractiveness of the asset class over a 1–3 year holding period. A neutral allocation (orange) means hold a neutral strategic allocation to the asset class, single minus underweight (orange) or single plus overweight (light green) recommendations are meant to rebalance the asset class progressively towards the bottom or top of your strategic asset allocation range using cashflows inflows or outflows to the portfolio. A double plus overweight (dark green) or double minus underweight (red) recommendation is intended to be rebalanced to the top end or bottom end of your strategic asset allocation range immediately by selling some assets and buying others.

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# Asset allocation

## Australian Equities

The S&P/ASX 200 Accumulation Index gained 0.6% in August, with gains in industrials shares of 1.4% offset by a 2.3% fall in the resources sector as the iron ore price dragged the miners lower. Full year earnings results were broadly in line with expectations, which had been downgraded ahead of the reporting season. 31% of companies beat earnings forecasts, however, revenue results were a little weaker than expected and the outlook is unclear.

We favour the industrial and utilities sectors and companies with offshore earnings. With stocks trading at 15.8 times forecast earnings, stock picking remains the key to generating acceptable returns.

**We suggest:**
**Remain underweight.**
**Valuations are at the upper end of fair value, meaning attractive opportunities are harder to find.**

## International Equities

In August, global equities returned 2.7% in local currency terms with the US S&P 500 Index rising 3.8% to making new fresh highs, helped by stronger economic data. European stocks were boosted by speculation of a fresh round of monetary stimulus from the ECB. Emerging market shares rose 1.8% in US Dollar terms with Brazil up 10%.

Price-earnings multiples for developed market shares have risen to 16.1 from 15.6 due mainly to the price rises. In emerging markets they have also increased from 11.8 to 12.1 times. While investor sentiment and company fundamentals are still supportive for global equities, valuations are somewhat less compelling.

**We suggest:**
**Given higher valuations for developed market shares, maintain a neutral exposure to international shares.**
**Favour US over Europe.**
**Maintain exposure to emerging markets shares.**

## Fixed Income

Australian bonds returned 1.0% in August, as bond yields fell significantly. Three-year government bond yields fell 10 basis points to 2.64% per annum, while 10-year Australian government bond yields fell from a yield of 3.53% to 3.30% per annum during the month.

Internationally, falling bond yields pushed up the BarCap Global Aggregate Bond index by 0.9%. During August German 10-year government bond yields posted a new record low of 0.86% per annum.

Investment grade credit spreads were slightly higher over the month.

**We suggest:**
**Overweight overall exposure with an equal split between Australian and international bonds.**
**Stay underweight long duration government and corporate bonds.**
**Prefer tactical income and absolute return fixed income strategies.**

## Cash

Australian bank bills returned 0.21% in August as short-term bank bill yields fell slightly. The three-month bank bill yield fell one basis point to 2.63% per annum over the month. At the September RBA meeting, the RBA kept official cash rates unchanged at 2.50% per annum and appears to be reasonably comfortable keeping interest rates stable for an extended period.

A recent speech by RBA Governor Stevens indicated that the RBA is unwilling to overstimulate the housing market through further rate cuts even though unemployment is rising. With the release of the stronger than expected June quarter GDP figures, markets have stopped pricing in a rate cut over the next 12 months and are now showing no interest rate changes.

**We suggest:**
**Retain an overweight position.**
**Bank term deposits preferred relative to government bonds and at-call cash.**

## Alternatives

Globally, hedge funds posted gains of 1.1% in August with most of the strategies generating positive returns. The best performing strategy was long/short equity hedge funds with a growth bias which returned 2.4% for the month. Funds that invest in convertible securities and distressed securities lost money during August.

Hedge funds are, in general, still conservatively positioned given that many asset prices appear expensive and volatility remains low. As with selecting individual shares, bottom-up individual manager selection is more likely to provide better returns than top-down strategy selection.

**We suggest:**
**Maintain a neutral position.**
**Manager selection remains more important than strategy selection.**
**Liquid alternative investments including hedge funds remain favoured over equities for incremental risk exposures.**

## Property

Returns from unlisted Australian core property funds were 8.9% in the year to the end of July 2014. Average distribution yields are 5.8% but range from 5.2% for retail property, 6.1% for offices and 7.7% for industrial property. Listed property continues to perform well, with 2014 year-to-date returns of 20.4% in Australia and 14.3% globally, ahead of broad equity indices.

Sentiment and capital flows are still favourable for commercial property with the lower interest rate environment helping support investor demand for local property. Property fundamentals are supported by economic growth that is currently around long term trend levels and low interest rates. In some international markets property valuations are expensive, but in others they appear at around fair value.

**We suggest:**
**Remain neutral with no preference for Australian over global property.**

*By Nick Ryder*

# Strategy

## Objective-based investment strategies

Why do people invest money? In simple terms, people invest so that they have more money in the future than they have today. However, when we actually sit down with our clients and work with them to understand what they are seeking to achieve with their investments, we discover that they have a range of different objectives. In general, investor objectives fall into three categories: preserve capital, generate income and grow capital and people can have multiple objectives at the same time.

Some investors also have very specific objectives. For example, a client may want to purchase a property in six months' time with part of their capital and with another part they may want to generate a certain level of income to support their lifestyle and with the money left over they may want to make long term investments on behalf of their grandchildren. In this example, the investor may need to make different investments to satisfy the different objectives.

Let's look at these three types of investment objectives and examine what types of investments can best be used to meet the objective in the current market environment.

**Capital Preservation**

Investors with a capital preservation strategy primarily want their capital to remain intact over a period of time with a high degree of certainty. They are less concerned with income and growing their capital. The time frame over which the capital needs to be preserved will determine the precise blend of investments, however, for shorter time periods cash investments and bank term deposits are usually the most suitable investment choices. This is because in Australia, bank deposits of up to $250,000 are guaranteed by the Australian Commonwealth Government and Australia's banks are relatively healthy compared to banks in other parts of the world.
For longer time horizons, fixed income securities such as bonds that are highly rated by a credit ratings agency are the most suitable. For example, ten-year Australian Commonwealth Government bonds are rated AAA by Standard & Poor's and, although the yield on these bonds is only about 3.5% per annum, there is an extremely high probability that investors will get their capital back on the maturity date.

We also find that some of our clients want to preserve the "real" value of their capital. This means that they want their capital to be protected against a loss in purchasing power from inflation. For these investors we can source inflation-linked bonds and inflation-linked bank deposits which grow in line with inflation. These bonds and deposits can have both their interest rate and capital value adjusted to the Consumer Price Index, which is a quarterly measure of inflation in Australia.

**Income Investing**

Investors seeking income are primarily interested in generating a high level income and are prepared to accept some degree of short-term fluctuation in the capital value of their investments, as they usually have a longer term time horizon, with no requirements to sell the income-generating investments. Income-seeking investors may also be interested in trying to maximise their after-tax income and also ensuring that the income grows with inflation over time as their living expenses grow.

Income-based investing, however, cannot have a sole focus on just the level of income generated and capital preservation should also be taken into account in selecting the mix of investments. We often see less sophisticated investors gravitate towards investments promoting very high rates of interest without fully understanding the risks that they are taking on and the higher possibility for a capital loss at a later date. That's why it is also important to have a diversified range of different income-producing investments.

Some of the best income-generating investments at the moment are corporate and high-yield bonds and corporate loans. These are bonds and loans to companies which may be rated either investment grade or lower (i.e. speculative grade) by the major credit ratings agencies. With lower-rated securities it is very important to have a large number of securities so that if one company runs into financial troubles, the potential losses to the investor are minimised.

Within this corporate bond and loan category we encourage investors to consider investing internationally on a currency-hedged basis (so that currency changes don't impact the value of the investment). This is because international investment provides a much larger number of bonds and loans outstanding, compared with the number available in Australia.

Other income-generating investments include high-yielding shares and commercial property. Shares which have been popular for their high dividends include banks, telecommunications companies, food retailers, property securities as well as utilities and infrastructure companies. Many of these companies have stable earnings, which means that their dividends tend to be relatively stable and grow with inflation over time, for example as food prices, phone and utilities bills increase.

However, the global financial crisis reminded us that companies with stable earnings and high levels of debt, such as banks and some listed property and infrastructure companies can suffer in a financial crisis and often dividends need to be cut to help such companies survive.

# Strategy

## Objective-based investment strategies (continued)

Another income-generating investment we can include in client portfolios is unlisted commercial property. This gives investors exposure to rental income from office, retail or industrial properties and rents tend to increase over time with inflation and can often have tax deferral benefits. Unlike listed property, the value of the unlisted investment tends to only fluctuate with changes in the valuation of the building rather than stock market moves, although investors are generally locked into the investment until the properties can be sold, which for investors with a longer term time horizon may be acceptable for a portion of the portfolio.

**Capital growth investing**

For investors with long term investment horizons, (for example ten years or more), interested in growing the value of their capital, we will generally recommend higher growth investments such as some types of shares, certain types of property and alternative investments. Generally such investments do not provide much in the way of income, as any income generated is usually reinvested or used to reduce debt, which in turn increases the future capital value of the investment.

Within this category, certain types of listed shares can provide strong potential capital growth over longer time frames. For example, shares in smaller companies, technology and biotechnology shares, emerging markets shares, shares of companies in cyclical industries such as resources, media and airlines can, at different times in the business cycle. be attractive as high growth investments.

Certain forms of property investment are also attractive as a source of potential long term capital growth. For example, many investors borrow to invest into residential property which will mean that they have “negative income” from the investment but will enjoy magnified capital gains on their equity in the property if it rises in value over time. Other property investment strategies such as property development, land ownership and property repositioning or renovation are other growth strategies which don’t necessarily generate income but which can provide attractive capital gains over long term time horizons.

Alternative investments that offer attractive growth potential which we can recommend for long term investors include venture capital, private equity, hedge funds, commodities and collectible investments. Venture capital and private equity are shares in unlisted companies that offer high levels of earnings growth because the businesses are either high growth technology businesses or more mature businesses purchased with significant amounts of debt funding.

Hedge funds, similarly, usually do not pay out income, but generally reinvest capital, so that investors enjoy the benefits of compound returns over many years. Finally, commodities and collectibles, such as gold bullion or works of art, can provide long term capital growth potential at certain times. Although they don’t generate income, over longer time frames such assets can rise in value and keep pace with inflation.

**Conclusion**

So as we can see in the example of the $10 million portfolio above, different types of investments can be used to try to meet different investment objectives that an investor may have. In this example, the investor has created three “sub-portfolios” with different levels of risk and expected return and time horizons. Each sub-portfolio is designed to meet specific objectives and performance against these objectives is monitored over time. This portfolio construction process, is, however, fairly different in its thinking and construction to the traditional balanced or conservative portfolio, which may be designed more around the investor’s maximum risk tolerance, rather than attempting to meet specific objectives and track performance against those objectives over time.

*By Nick Ryder*

**Portfolio**
**$10 million**

| Objective / Sub-portfolio | Capital Preservation | Income Generation | Capital Growth |
|---|---|---|---|
| Investment | $3 million | $5 million | $2 million |
| Time horizon | 24 months | 5 years | 10-15 years |
| Investments | • Cash and term deposits<br>• AAA-rated short term government bonds | • Portfolio of corporate bonds and hybrid securities<br>• Portfolio of ASX-listed high yield shares<br>• Unlisted commercial property funds<br>• International high yield bond and loan fund (hedged into Australian Dollars) | • Portfolio of international shares in the technology and healthcare sectors<br>• Private equity funds<br>• Hedge funds<br>• Property development fund |
| Expected annual return | 3% or $90,000 | 6% or $300,000 | 12% or $240,000 |
| Expected risk | Very low | Medium | Very High |

| | |
|---|---|
| Blended return | 6.3% or $630,000 |
| Blended risk | Medium |

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