Integrated Wealth Solutions

The Good Life

Ideas, advice, beliefs and perspectives for the enjoyment and education of our clients and friends

June 2014

Period ending May 2014

Fixed Interest					
Years	1	2	3	10	YTD
One- year	2.9	3.2	4.0	5.3	1.2
Two-year	3.4	3.7	4.4	5.5	1.5
Five-year	4.2	4.9	6.4	7.1	3.1
Long Term	2.4	1.0	8.9	7.3	8.0
Australian Shares					
Large	17.1	22.6	11.2	9.9	4.8
Value	11.7	16.8	6.3	9.3	3.4
Small	11.4	7.0	-0.2	8.9	1.4
Global Shares					
Large	23.2	26.6	16.3	4.7	0.1
Value	24.9	30.9	16.0	5.5	0.2
Small	27.2	30.3	16.6	7.0	-1.5
Emerging Markets	7.7	13.0	1.7	9.0	0.3
Real Estate	11.9	17.7	14.2	4.1	9.8

Description of Indexes	
One-year FI	DFA Short-Term FI
Two-year FI	DFA Two Yr Div. FI
Five-year FI	DFA Five Yr Div. FI
Long-Term FI	Bloomberg Aus Treas. 10+
Australian Large	DFA Aus Large Co
Australian Value	DFA Aus Value
Australian Small	DFA Aus Small Co
Global Large	DFA Global Large Co
Global Value	DFA Global Value
Global Small	DFA Global Small Co
Emerging Markets	DFA Emerging Markets
Global Real Estate	DFA Global Real Estate
	Data presented may be based on a combination of simulated and actual returns.
	Past performance is not indicative of future performance.

What We Are Thinking

Dear Reader,

Welcome to the June edition where we continue looking at what is needed for successful long-term investing. Last month we looked at **Asset Allocation**, perhaps the most important factor in your investment success.

This month we look at the second of three portfolio strategies which IWS follows to give you the best chance of a successful lifetime investment experience. This strategy is **Diversification.** This is no more than the expression of rationality under uncertainty.

On the left hand side of this page you can see all the different asset classes: **Fixed Interest, Australian and Global Shares.** Within fixed interest we can further diversify between one, two and five year terms. Within the share class we can diversify between large, value and small companies.

"The aim should be to never own enough of any one thing to make a killing in it; and never own enough of any one thing to get killed by it."
-Nick Murray
.
Our article this month from Jim Parker is about "certainty" in the investment markets and the perils of trying to time the markets. We have followed his article with an example of a fictitious couple who panicked during the GFC and moved their portfolio to cash. In retrospect it was not a very good idea at all!

We finish with an article that is an antidote to some of the "doom and gloom" scenarios we hear from time to time in the financial press. This article paints a very different picture of the future, one of optimism that the world economies will expand over the next decade or so. Have a look at the evidence and see what you think.

The Certainty Principle Part 1

By Jim Parker Vice President DFA June 11 2014

A frequent complaint from would-be investors is that "uncertainty" is what keeps them out of the financial markets. "I'll stay in cash until the direction becomes clearer," they will say.

So when has there ever been total clarity?

Alternatively, people who are already in the market after a strong rally, as we have seen in recent years, nervously eye media commentary about possible pullbacks and say "maybe now is a good time to move to the sidelines".

While these kneejerk, emotion-driven swings in asset allocation based on market and media commentary are understandable, they are also unnecessary. Strategic rebalancing provides a solution, which we will explain more of in a moment.

But first, think back to March, 2009. With equity markets deep into an 18-month bear phase, the Associated Press provided its readers with five signs the stock market had bottomed out and followed that up with five signs that it hadn't.[1]

The case for a turn was convincing. Volumes were up, the slide in the US economy appeared to be slowing, banks were returning to profitability, commodity prices had bounced and many retail investors had capitulated and gone to cash.

But there also was a case for more pain. Toxic assets still weighed on banks' balance sheets, economic signals were patchy, short-covering was driving rallies, the Madoff scandal had knocked confidence and fear was still widespread.

Of course, with the benefit of hindsight, that month did mark the bottom of the bear market. In the intervening period of just over five years, major equity indices have rebounded to all-time or multi-year highs.

This table below shows the cumulative performance of major indices in the 18 months or so of the bear market from November, 2007 and then the cumulative performance in the subsequent five-year recovery period.

You can see there have been substantial gains across the board since the market bottom. And while annualised performance over the six-and-half years from November 2007 is not impressive, the pain has been a lot less for those who did not bail out in March, 2009.

MARKET PERFORMANCE – FINANCIAL CRISIS AND POST-CRISIS

Returns (AUD %)

	NOV. 2007 – FEB. 2009 CUMULATIVE	MAR. 2009 – MAY. 2014 CUMULATIVE	NOV. 2007 – MAY. 2014 CUMULATIVE	NOV. 2007 – MAY. 2014 ANNUALISED
S&P BMI Value	-49.80%	134.31%	17.61%	2.53%
ASX Small Ordinaries	-59.33%	65.80%	-32.58%	-5.88%
ASX 100	-44.40%	109.79%	16.64%	2.40%
ASX 300	-45.99%	105.55%	11.01%	1.62%
MSCI World Value	-37.00%	76.75%	11.36%	1.67%
MSCI World Small Cap	-34.81%	118.45%	42.41%	5.59%
MSCI World IMI	-33.75%	80.78%	19.77%	2.81%

So those who got out of the market at the peak of the crisis and waited for "certainty" have realised substantial losses. But keep in mind, also, that these past five years of recovery in equity markets have also been marked by periods of major uncertainty.

In 2011, Europe was gripped by a sovereign debt crisis. Across the Atlantic, Washington was hit by periodic brinksmanship over the US debt ceiling. In Asia, China grappled with the transition from export-led to domestic-driven growth.

Around any of these events, there were a broad range of views about likely outcomes and how these possible scenarios might impact on financial markets. The big question for the rest of us is what to do with all this commentary.

The fact is even the professionals struggle to consistently add value using analysis of macro-economic events, as we see repeatedly in surveys of fund-versus-index returns. And history suggests that those looking for "certainty" around such events before investing could set themselves up for a long wait.

There is always something to fret about. Recently, the focus has been on low volatility, particularly when compared to the days of 2008-09. Sage articles muse over whether risk is being appropriately priced and whether volatility is being unnaturally suppressed by central banks' explicit forward guidance about policy.[2]

Just as in March 2009, one does not have to look far to find well-reasoned discussion in support of why the market has topped out, alongside equally compelling reasons of why the rally might continue for some time.

What is the average investor supposed to make of all this conjecture? One way is to debate the market implications of news and to try to anticipate what might happen next. But whom do you believe? We've seen there are always cogent-sounding arguments for multiple scenarios.

An alternative approach is much simpler. It begins by accepting the market price as a fair reflection of the collective opinions of millions of market participants. So rather than betting against the market, you work with the market.

That means building a diversified portfolio around the known dimensions of expected return according to your own needs and risk appetite, not according to the opinions of media and market pundits about what happens next month or next week.

It also means staying disciplined within that chosen asset allocation and regularly rebalancing your portfolio. Under this approach, you sell shares after a solid run-up in the market. But the trigger for this rebalancing is not media speculation, but the need to retain your desired asset allocation.

Say you have chosen an allocation of 60% of your portfolio in equities and 40% in fixed income. A year goes by and your equity allocation has rallied strongly so that the balance between the two has shifted to 70-30. In this case, it makes absolute sense to take some money out of shares and move it to bonds or cash.

It works the other way, too, so that if shares have fallen in relation to bonds, you can take some money out of fixed income cash and buy shares. Essentially this means buying low and selling high. But you are doing so based on your own needs rather than on what the armies of pundits say will happen in the market next.

Of course, this doesn't mean you can't take an interest in global events. But it does spare you from basing your long-term investment strategy on the illusion that somewhere, at some time, "certainty" will return.

1. ‘Five Signs the Stock Market Has Bottomed Out and Five Signs It Hasn’t’, Associated Press, March 15, 2009

2. ‘When Moderation is No Virtue’, The Economist, May 22, 2009

The Certainty Principle Part 2

The Effect of Panic on Your Portfolio

The article by Jim Parker in this week's newsletter is about "uncertainty". When things are looking bad many investors take all their money out of the stock market and put it in the "safe" haven of cash. They then hope that when certainty returns (when, we might ask?) they will move back into the stock market.

Let's look at some real figures to see what would have happened if our baby boomer couple had panicked during the global financial crisis and moved their whole portfolio to cash.

We assume our couple had $500,000 in superannuation. This was split in a 70/30 Growth/Defensive (commonly called Balanced) Portfolio in November 2007, when the first signs of the GFC hit. Between then and February 2009 the growth part **lost 46%**, while their defensive part **earned 15%.**

Let's have a look at the **overall effect** of going to cash:

Original value of portfolio Nov 2007	Value in May 2014 after moving to cash during the GFC	Value in May 2014 after staying put during the GFC
$500,000	**$508,000**	**$625,000**

From these figures we can see that our couple would have been 23% ($117,000) better off by ignoring all the bad news and staying the course.

This is where a **Good Financial Adviser is worth their fee**. This fee is a lot less than the extra $117,000 that the couple would have had in their superannuation account if they had followed their adviser's sage advice to stay put.

Please contact Ian Davis if you wish to go over the finer details of this calculation, please read Disclosure & Disclaimer below

I hope you enjoyed this issue and would like to receive your feedback on articles you would be interested in or ways we can improve our newsletter. We have a lot more information on our website at www.integratedwealthsolutions.com.au where you can register to receive this free monthly newsletter.

Dr Baden Rumble
Editor

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That Bit Extra…

Faith In The Future.

Many people think that more wealth will be created in the next 10-15 years than in any equivalent period in human history. It's going to be a period of enormous wealth creation because of a number of factors including these three:

1. Relentless Technological Innovation

This revolution has only just begun. We are only just getting to the point where product and service design can now be premised upon the widespread access to powerful mobile computing power, allied to high-speed interconnectedness of the web. It's at this point that the focus shifts from the development of better and faster access to the *application* of this technological power to our everyday lives. In the not too distant future, our cars will drive (and park) themselves; computers will learn, and adapt to their environment as humans do; we may travel into space for a holiday; our medical professionals will have instant access to real time biomedical data and analysis of our vital signs. Pipe dreams some of these may be, but they indicate the scale of humanity's creative potential in our present era.

To take a more concrete example. We are now starting to see the possibilities of this level of computing power applied to areas such as manufacturing, material science and so on – for example the development of "additive manufacturing", otherwise known as 3-D printing. For us, if the technology continues develop on its current trajectory, we do not think it an overstatement to suggest that we could be at the start of a second, computer-driven, Industrial Revolution that will radically alter not only the quality, speed of production and prevalence of highly customised goods but also how production itself is organised. This has massive implications for the structure of our labour markets, the cost of production and so on.

2. Reduction In Energy Costs

There is an energy revolution underway in the US. In the US this is based on use of new technology to exploit previously inaccessible gas and oil resources (often referred to as "shale gas" and "tight oil"). Not only are energy costs in the US falling dramatically, the US is now a net producer and will potentially be the largest single producer of oil in the next few years. This will make US manufacturing much more competitive but will also reduce its dependence on the Middle East – with significant geopolitical implications. A PwC estimate suggests US manufacturers will save an annual $11 billion (around a third) on natural gas expenditures by 2025, while the new industries that have sprung up to extract this energy will employ one to two million people. All of these factors are incredibly bullish for the US economy and there will be knock on effects for other countries (some quite positive). While Europe and other parts of the world are still playing catch up on the energy front, technically the largest shale reserves in the world are in China so the energy revolution should spread elsewhere. Since the price of energy underpins the cost of almost everything, the impact could be felt almost everywhere.

3. The Rise Of The Asian, Latin American and African Consumer

The most populous nations on earth are now starting to experience levels of economic development at which they can command the sort of goods and services that middle class Westerners take for granted. The scale of demand is incredible. Already numbering almost 2 billion people predominantly young and upwardly mobile, people their current annual spending is around $7 trillion (around 10% of global GDP or 4 times Australia's GDP) but by 2020 this will have trebled and will account for almost one quarter of global GDP. Added to this is the urbanisation dynamic: the size of the capital investment required to house and move them to and from work, and to support their leisure activities is simply staggering. And this trend will be unceasing. Some estimate that the labour force in India will, by the middle of the century, surpass the combined labour forces of both China and the USA (the next two most populous nations on the planet).

This is likely to be the strongest global growth driver throughout the 21st century.

From Ascendant Strategy and Investments Ltd