

Carnbrea

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A Bennelong Wealth Partners business

June 2016 Quarterly Investment Report

Prepared by Carnbrea Investment Advisory Committee

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 **bennelong**
wealth partners

27 July 2016

Index Returns as at 30 June 2016 (%) p.a.

	3 Months	6 Months	1 Year (% p.a.)	3 Years (% p.a.)	5 Years (% p.a.)
AUSTRALIAN EQUITIES	4.0	1.2	0.9	7.7	7.2
INTERNATIONAL EQUITIES	4.4	-1.7	0.4	14.8	14.9
DOMESTIC LISTED PROPERTY	9.2	16.2	24.6	18.5	18.0
GLOBAL LISTED PROPERTY	3.7	7.1	12.3	11.9	12.0
AUSTRALIAN FIXED INTEREST	2.9	5.0	7.0	6.2	6.7
GLOBAL FIXED INTEREST	2.9	6.7	9.3	7.6	7.7
CASH	0.6	1.1	2.2	2.5	3.1
SA VS USD	-3.2	2.2	-3.1	-6.6	-7.0

MARKET INDICES:
S&P/ASX 300 ACCUMULATION INDEX;
MSCI WORLD EX AUSTR. GROSS TR INDEX AS;
S&P/ASX 300 PROPERTY TRUSTS ACCUM INDEX;
FTSE EPRA/NAREIT DEVELOPED INDEX;
BLOOMBERG AUSBOND COMPOSITE 0+ YEARS INDEX;
BARCAP GLOBAL AGGREGATE INDEX HEDGED SAU;
AUSBOND BLOOMBERG BANK BILL INDEX

Economic View

The global economy and central bankers continue to face serious challenges in meeting growth and inflation objectives.

Global growth prospects continue to trend lower, with the IMF downgrading its global growth forecasts to 3.2% in 2016 (from 3.4%). IMF Managing Director, Christine Lagarde, warned that “the recovery remains too slow, too fragile, with the risk that persistent low growth can have damaging effects on the social and political fabric of many countries.”

Political uncertainty seems to be a common theme this year.

With the US election coming up in November and the continuing success of wildcard Donald Trump, the recent Brexit referendum, and the Australian election resulting in a narrow win to the LNP and no clear majority in the Senate, politics will play a bigger role in the direction of the economy than we are used to.

Australia

On the surface, the performance of the Australian economy appears to stand out on a global scale with real GDP expanding by 3.1% over the year. Interestingly, this does not seem to be resulting in earnings growth for large companies.

Despite Standard & Poors placing Australia’s AAA credit rating on negative watch citing the uncertain election result, we see the coveted AAA rating remaining intact, supported by strong growth, low unemployment and low government debt levels compared to other sovereigns.

Inflation remains weak, with the March quarter headline CPI recording an unexpected drop to 1.3%, and the

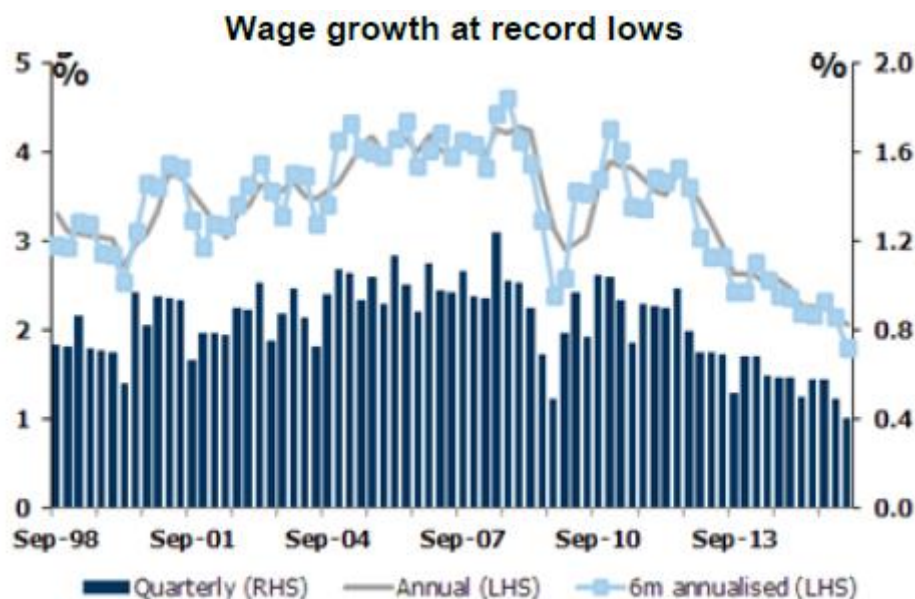
June quarter reinforcing the weakness with a sombre 1.0% read. (well below the 2–3% target). The RBA expects inflation to remain low for some time, given subdued labour costs. The RBA is expected to reduce interest rates again in the second half of 2016 (but is it one cut or two?).

The economy continues to face the challenges associated with the end to the mining boom. Mining investment as a proportion of GDP has fallen to around 3%, down from the peak of 6.5%, and this in turn is not providing the windfall to inflation experienced in the past.

The RBA, like most central banks, is now questioning the efficacy and impact of further policy easing. The “growth dividend” from successive easing appears to be diminishing while it risks pushing house prices even higher, raising the risk of financial instability.

Retail conditions have also deteriorated a little, possibly reflecting increased competition and price discounting.

One of the key ingredients to this weakness is the fact that incomes remain very weak (wages growth is below 2%). Part-time jobs have been the major source of growth, and this is undermining household income growth and is a reason for the recent softness in retail sales and consumer sentiment.



Source: Goldman Sachs Global Investment Research, ABS

Another concern we have is the high debt levels in Australia. Australia is currently using \$9 of debt to create \$1 of GDP growth, up from not much more than a ratio of 1:1 just seven years ago – this is higher than China where investor debt concern has been focussed. This highlights the need for greater productive investment in our economy.

Contrarily, despite concerns around inflation and income growth, the latest NAB business conditions index painted a relatively upbeat picture of the Australian economy. Employment growth also tends to lag the business conditions series, suggesting we should see some better jobs numbers in the second half of the year.

As always, China is still a key risk. While the economy can most likely cope with a gradual structural slowdown in Chinese growth, a disorderly downturn, would have severe repercussions for Australian growth. Nevertheless,

Australia has ample room to ease interest rates if necessary.

United States

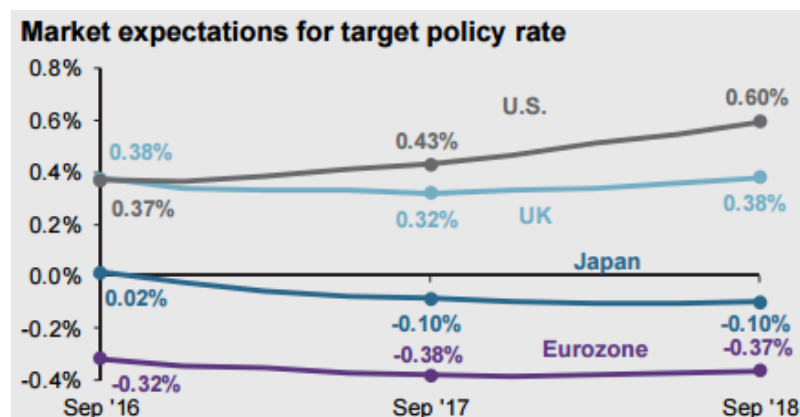
The US economy remains sensitive to a rising US Dollar and Fed hikes. Policy normalisation is now more important than ever. In her June statement, the Fed Chair Janet Yellen noted not only the ongoing concerns over business investment and a fragile global environment, she also highlighted for the first time that the impediments to higher growth and inflation could prove more stubborn than previously believed.

What we are seeing at the moment lends weight to the “secular stagnation” hypothesis put forward by former Treasury Secretary Larry Summers. This is a whole other discussion, but in summary it means longer term trends such as ageing population, higher paid baby-boomers retiring and weak productivity are primary contributors to the lower growth rates, lower inflation and extremely low interest rates we are seeing.

However, the US outlook has improved in the September quarter, with recent jobs reports, manufacturing and services sector surveys, and retail sales growth continuing to surprise on the upside. The manufacturing ISM registered its highest reading since February 2015.

After a very sluggish December-March period, the US economy appears to be gaining some momentum entering the second half of 2016, despite ongoing global risks and threats.

The June payrolls report was a much stronger than expected 287,000, improving from a very weak read of 11,000 in May (weakest in 5 years). The economy is near full employment. This remarkable improvement puts a Fed rate increase before year end back into play (compared to May when it was virtually written off).



Source: JP Morgan

The latest inflation data also pointed to a modest pick-up. Average hourly earnings growth is also now the highest level since 2009. The Fed will be keeping a close eye on this inflation data, with wages growth being a function of the strengthening labour market, and a key contributor to inflation. We believe there is upside risk to US inflation going forward.

We see the US economy as remaining resilient, and a stabilisation in energy prices and in the USD over the past 3-6 months removes some of the headwinds to growth. The housing sector has lost some momentum but data is consistent with an upward grind in starts. Perhaps the key detractor from the outlook (as in Australia) remains business investment.

Brexit – Where to now?

Much of the recent market news has been dominated by ‘Brexit’ and what it all means. Post the UK’s decision to leave the EU, equity markets and the Pound Sterling pulled back aggressively as markets had largely priced in that the ‘remain’ vote would win, conversely ‘safe havens’ like gold and defensive sectors such as utilities rallied. It also ushered in the prospect of further central bank policy easing. Thankfully, the Bank of England is not dictated to by European rules and can conduct independent monetary stimulus. Certainly there will be a growing desire for southern European countries to seek a form of monetary, fiscal and currency independence.

The Brexit result has been described as a vote against immigration, against the experts, a vote to save money from the European Commission and a vote for independence or sovereignty. The UK vote fuelled fears of a break-up of the EU as leaders of populist parties in France, Holland and Denmark called for national polls on leaving the Union. In addition to contagion risks, another main risk is the impact Brexit could have on the European growth situation, which is already very delicate.

However, it is still unclear of what it all means specifically for the UK and more broadly the EU.

In order to get the exit process going, the UK will need to enact Article 50 of the Lisbon Treaty, which is basically a letter notifying the EU that a member state is withdrawing from the EU. This follows a negotiation period (up to two years!) whereby an ‘exit’ is negotiated between the UK and the EU. In terms of the Brexit, the new PM Theresa May has promised not to trigger Article 50 until Scotland and Northern Ireland have been consulted.

The longer-term outlook for the UK economy would depend on the terms of the exit negotiations. The UK economy is likely to be dynamic enough to weather the changes, but the risk of a recession is real, including the potential for a cycle of economic stagnation, further weakening Europe’s economies.

Despite the shock of the Brexit result, we don’t believe the UK (or Eurozone) will fall apart, although growth will most likely suffer due to factors such as lower trade and falling foreign direct investment. The depreciation of the Pound will assist greatly by eventually attracting capital into the UK, given the exit will be protracted.

Europe

“The Eurozone will grow at a slower pace in the coming years due to political and economic uncertainty following the U.K. vote to leave the European Union,” the International Monetary Fund said.

Unemployment in the Euro area was reduced slightly to 10.1% in May. While there have been steady falls, unemployment remains unacceptably high with large dispersions persisting between low unemployment members, such as Germany (4.2%) and those with the highest unemployment rates, including Greece (24.1%) and Spain (19.8%).

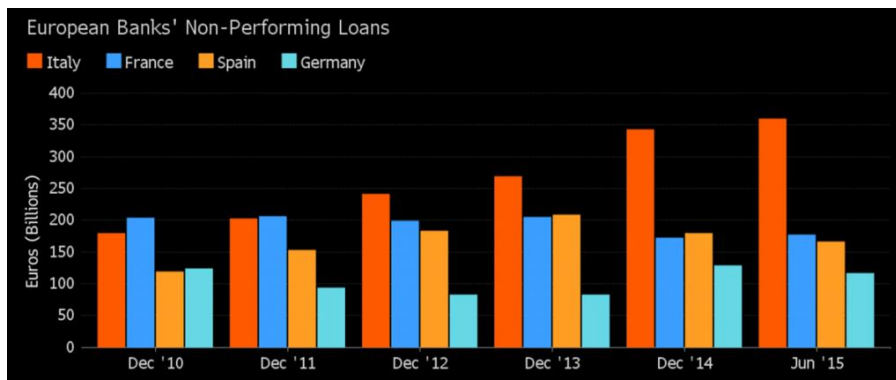
Headline Eurozone consumer prices fell 0.1% over the year to May, the fourth consecutive month of declining prices. Inflation expectations are declining, which can be a self-fulfilling prophecy by feeding back into actual inflation (why would you buy something today when it will be cheaper tomorrow?). This is causing the ECB great angst as the absolute worst case outcome of this is a deflationary spiral – we assign low probability to this though.



Source: JP Morgan

Another development in Europe concerns Italian banks. Here the news was not new, with approximately 18% of Italian loan books stated to be in arrears. Italian banks are sitting on a large amount of problem loans – where borrowers are either behind in their interest payments, or have stopped paying interest altogether.

So the banking sector, and hence the credit generation system and lifeblood of the European economy, remains fragile.



Source: ECB; Bloomberg

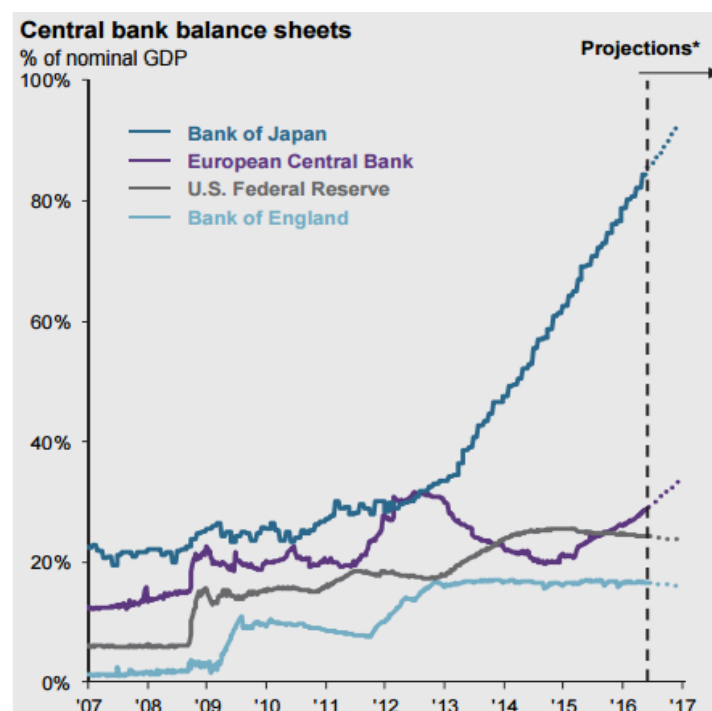
The turmoil in Italy developed as the bureaucrats in Brussels declared that Spain and Portugal would not meet their Eurozone fiscal commitments to rein in their Government deficits in 2016.

But on a brighter note, German manufacturers reported their best performance since February 2015, with the manufacturing PMI hitting a 28-month high of 54.4 in June.

Asia

In the recent Japanese election, Mr Shinzo Abe's ruling Liberal Democratic Party won a supermajority with its coalition partner. Following Abe's victory, the council confirmed plans to put together a new stimulus plan by the end of July – the much talked about "helicopter money".

The speculation over the adoption of a helicopter money program by the Bank of Japan (BOJ) is in response to the underwhelming response of growth and inflation to existing Quantitative Easing (QE) policies. In essence, this means that the BOJ would finance the budget deficit with a permanent increase in the central bank's monetary base. This is seen as a more effective way to stimulate spending than QE programs used in the past, but it could potentially have adverse effects as the Japanese economy already has a tremendous amount of money circulating.



These prospects of further stimulus have stemmed from the fact that Japan is still not on course to escape from deflation. Measures of the manufacturing and service sectors suggest weakness in both still. As has been the case for some time, the economy is still missing the 3rd arrow of Abenomics – structural economic change (i.e. regulatory reforms, business liberalisation efforts). We consider Japan a watching brief.

In August last year and January this year, talk of Chinese currency devaluation caused gyrations around the globe as markets feared the move would unleash powerful deflationary forces. Despite this, the government has continued to weaken the Renminbi to assist its international competitiveness. The economy has been improving as a result with positive data reads of late.

There is also evidence that the Chinese government is changing its investment priorities towards social and infrastructure work. In addition, among the state-owned enterprises the government is pressing for and achieving the closure of redundant capacity. The consumer is responding with greater willingness to use credit. In what has been a source of concern for many investors, the property market is also showing signs of stabilisation supported by strong demand as the population continues to urbanise.

China still remains vulnerable to further shocks and bouts of volatility. Curtailing capital outflows and a lack of meaningful progress in bringing debt to GDP under control also raise concerns. Although, the country's high savings rate does assist with this.

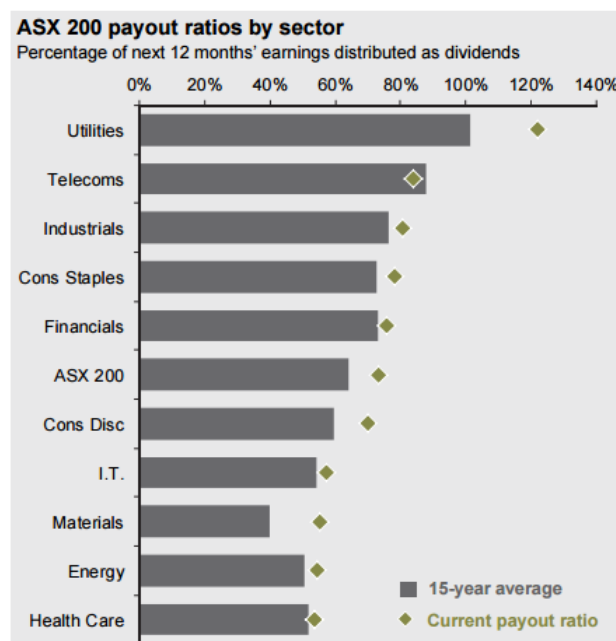
Australian Equities

The Australian equity market (S&P/ASX 300 Accum Index) fell in June, offsetting some of the gains seen in April and May, to post an increase of 4.0% for the quarter. A strengthening Australian Dollar, dovish US Fed comments and better commodity prices were the key drivers of the recovery over the June quarter.

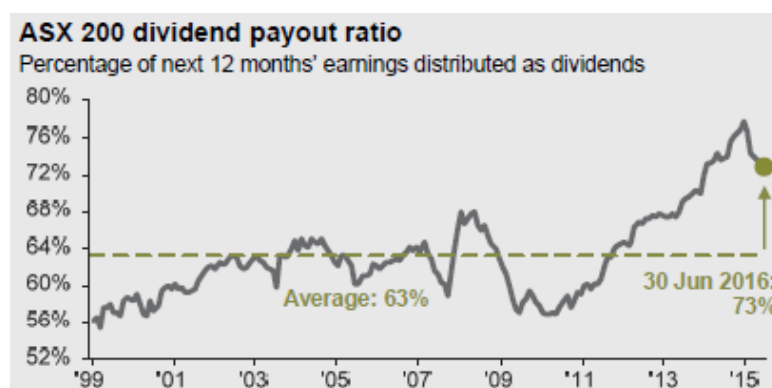
Rolling Three-Year Returns (p.a.) to 30 June 2016



Should the RBA cut the cash rate further, the share market will become even more attractive from a dividend yield perspective; however as the charts below show, company payout ratios are on average 10% higher than the long term average at around 70% of earnings. This indicates that in order to maintain dividends companies will have to pay out a higher level of earnings. Whilst not at alarming levels, should this trend continue companies eventually may have to consider reducing dividends, if earnings remain subdued.



Source: JP Morgan



Source: JP Morgan

Sector Performance

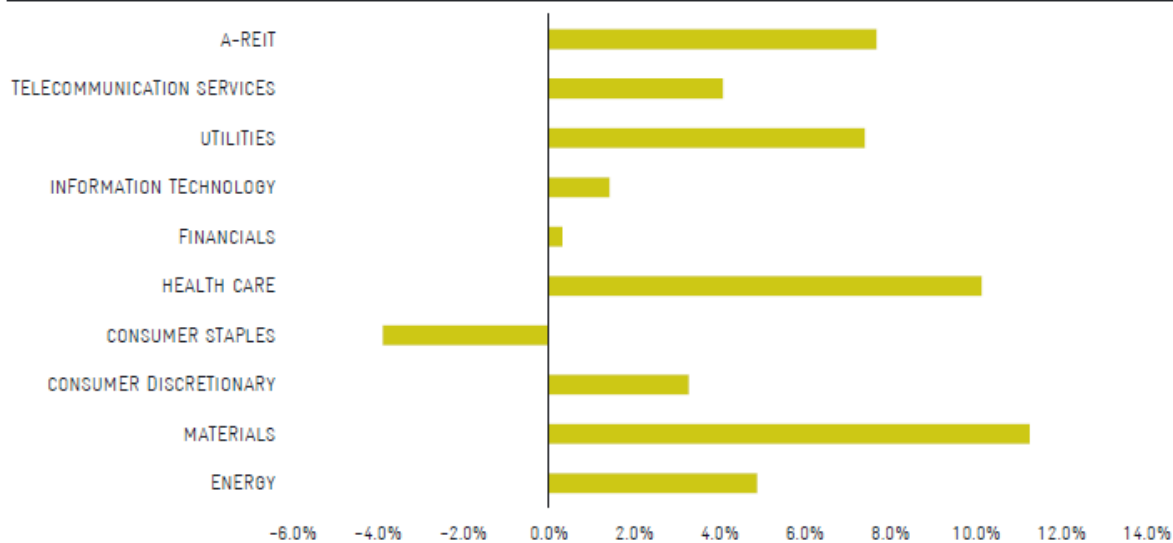
As can be seen from the chart on the following page, returns at the sector level were mostly up across the board. Materials ended the quarter as the top performing sector in the Australian market, aided by the rush for safe-haven commodities leading up to and after the Brexit vote. Most commodities recorded gains in the June quarter, with silver and gold among the standouts as a result of rising demand for precious metals. Notably, iron ore (+12.7%) has also continued to strengthen, rebounding from its multi-year lows in December 2015, driven in large part by China's decision to avoid expanding its steel production. However, the continued oversupplied state of the market is likely to remain as a headwind to significant future gains in iron ore prices.

Once again, 'defensive' sectors, including Healthcare and A-REITs, demonstrated further resilience, each delivering positive returns over the quarter. The Utilities sector also rallied on the back of investors' renewed appetite for yield in the prolonged low interest rate environment, and the increased investor demand for the safety and stability of 'defensive' stocks following Brexit. Elsewhere, the Energy sector also outperformed over the quarter, lifted by significant gains in natural gas and oil.

The worst performing sector over the quarter was the Consumer Staples sector, dragged lower by weaker-than-expected retail sales data and a lack of easing bias by the RBA.

Financials managed to end the quarter in positive territory.....*just* (+2.7%). The banks certainly look cheap with earnings deterioration well priced in to current share prices, but they lack an obvious catalyst. Lead indicators for credit growth have softened and concerns around capital and bad debts remain. Policy uncertainty is particularly bad for the sector. We expect the major bank stocks to continue to trundle along, supported by the chase for yield in the low interest rate environment.

Sector Performance Quarter to 30 June 2016



Source: Lonsec, IRESS

Outlook

Although Australian equities screen attractively from a yield perspective, valuations are not overly compelling, especially for the top 20 stocks. In particular, Bank earnings have most likely peaked for the foreseeable future, and as a proportion of the Australian market we would suggest they are over-represented. They are important for facilitating credit, but being 27% of the share market index is becoming hard to justify. The ability to extract earnings from leveraging credit is very difficult, and with Australia around the peak in terms of private and corporate lending, earnings potential is going to be difficult to come by. However, as mentioned the major banks' attractive dividends and safety mean they will continue to be a staple of any well-constructed portfolio.

Large cap Australian companies continue to face headwinds with earnings and expected earnings growth. Following the markets rally from March to May (and so far into July), the ASX is now trading at a historically high Price-to-Earnings multiple (i.e. investors are willing to pay higher prices for company earnings). But given it's a developed market with local flow support, Australia has always had a premium valuation.

Market volatility is also expected to continue in the short to medium term and with the full year reporting season just around the corner, the market will be eagerly awaiting company results for some form of direction for FY17.

Stock selection continues to remain critical, with yield plays likely to grind higher given the low interest rate environment – but there are obvious dangers here. Opportunities also lie in the mid and smaller cap space of the market.

International Equities

Global markets finished FY16 mixed with the broad MSCI World TR Index (AUD) finishing up around 1%. Breaking down this performance shows there was great dispersion between regions, with the US market gaining 7.3% while European and Asian markets were down.

It is noticeable that there are clear divergences opening up globally between the US, Europe and Asia.

Global equities made a confident start to the second quarter of 2016 after a tumultuous first quarter as cyclical stocks played catch-up with defensives, then Brexit contributed to a spike in market volatility in June and investors flocked to 'safe haven' assets.

Outside of Brexit, investors continue to be concerned about the growth situation in China as well as the political uncertainty in the United States. Central banks are also playing a pivotal role in market sentiment.

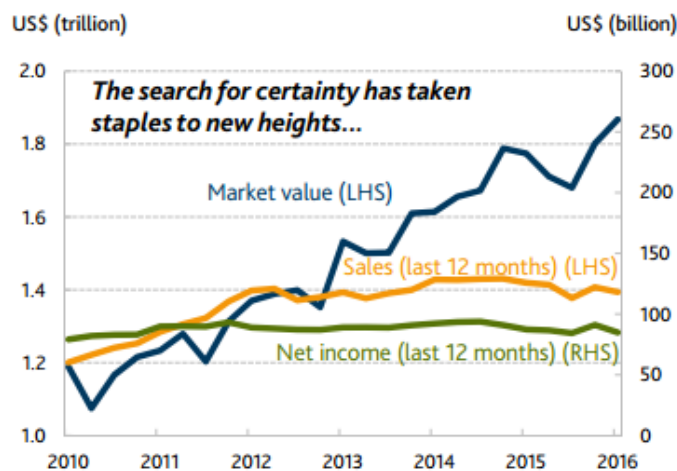
Share prices of many high quality companies experienced sharp corrections throughout the quarter, reflecting the often indiscriminate selling seen at times in markets when there's a perception of elevated risks. However, separating the volatility from the fundamentals of a company can open up opportunities as the fundamentals determine the ability of a company to generate shareholder returns over time. This is what we pay high calibre, successful fund managers to focus on.

A 3% fall in the AUD/USD helped buffer the falls for Australian investors in many international markets and boosted US equity market returns. Moving forward, the AUD/USD is expected to remain under downward pressure given the RBA retains an easing bias while the US Fed is expected to retain a hiking bias (albeit modest).

US equities advanced 2.4% in the second quarter of 2016 in local currency terms, with energy stocks leading the way. The oil price rally (27% during the second quarter) assisted in this. As higher interest rates would likely improve the profitability of the banking sector, if the Fed were to increase interest rates soon financial stocks could benefit. However, if lower interest rates persist, this will likely favour Telecommunications, Utilities and Property sectors.

In this environment of uncertainty investors are paying a premium for any company that can offer transparent and reliable outlooks. This search for certainty in equity markets is exemplified by consumer staple companies, particularly in the US, whose prices outperformed the broader market despite their sales and earnings remaining subdued (hence the term "expensive defensives").

S&P500 Consumer Staples



Source: Platinum Investment Management

The US market is trading at all time highs, and we would say that it appears expensive on many fundamental measures. This is why we believe the “easy gains” that many investors have enjoyed by investing in the broad US index have passed. Going forward the market should grind higher, but returns are more likely to be subdued and have some wider dispersion.

For investors seeking returns above cash rates and inflation, they are faced with **T.I.N.A. – “There Is No Alternative”** but to invest in sharemarkets to reap some kind of reasonable return going forward.

Immediately following the Brexit vote, most markets fell significantly; however, this was short lived, with most indices having already recovered. The UK equity market staged a remarkable recovery that seemingly matched the fall in its currency. The market was also supported by guidance from the Bank of England that stated they could provide additional monetary policy stimulus to counter any impacts. This fall and bounce back is a typical example of why you do not sell out of fear, panic and uncertainty.

UK banks took centre stage after Brexit and sold off heavily as investors feared a British departure would possibly cause contagion. In the longer term however, Brexit may actually be beneficial for the oligopolistic UK banking sector that have significantly stronger balance sheets since the GFC.

Negative interest rates are further complicating the picture (the total amount of sovereign bonds trading in negative territory now exceeds US\$11 trillion). Many sovereign bonds in Europe (e.g. Germany, Switzerland) are yielding negative interest rates, and this distorts the capital allocation decision for investors as it forces them to invest in equities with elevated risk to obtain *some* form of return. European banks remain an ongoing concern and negative interest rates only serve to exacerbate this situation as they adversely affect the banks’ bottom lines.

The uncertainty surrounding the timing and implications of the British exit from the EU, in conjunction with the delicate political situation across Europe, uncanny money and bond markets and still a lack of evidence of meaningful economic improvement, will likely mean uncertainty will weigh on European markets for some time.

Japan extended losses in the June quarter to a staggering -19.5% in 2016 and central to this decline has been the significant strengthening of the Japanese Yen. This was driven by two events; the first being off the back of a surprise announcement in April that the Bank of Japan (BOJ) would not extend both its negative interest rate policy and asset purchase programme; the second being the risk-off stance the market took where the Yen is seen as a safe haven currency. So should the BOJ go ahead with “helicopter money” this will no doubt help the Japanese market by weakening the Yen and making their exports more competitive.

The quarter was a relatively uneventful one for the Chinese market; A-shares were down 2%. Close to every investor is by now aware of the challenges that face China in its transition, but we are confident the administration is focussed and well resourced to deal with these challenges. So, although we may see more bouts of volatility, there is an investment case for China using a high quality filter to take advantage of themes such as the enormous number of emerging consumers and the strength seen in consumer facing businesses.

We see Asia as the next potential opportunity from a geographical perspective. But, as always, this comes with elevated risk due the nature of the Asian economies, their political regimes and currency volatility. Hence, stock-picking and sensible, quality investing is key to unlocking these opportunities.

Cash, Fixed Interest and Hybrids

As we continue to head to global economic entropy morphing from “low and slow” to “lower and slower” we see the domestic interest rate structure being driven by global interest rate relativities (shadow currency wars) with domestic inflation providing amplitude. With the majority of Central Banks mentally locked into a semi-permanent crisis e.g. installing negative yield structures, we expect global and local interest rates to remain artificially low and suppressed. Clients searching for income will be forced further up the risk spectrum to generate yields and certainty of reasonable income.

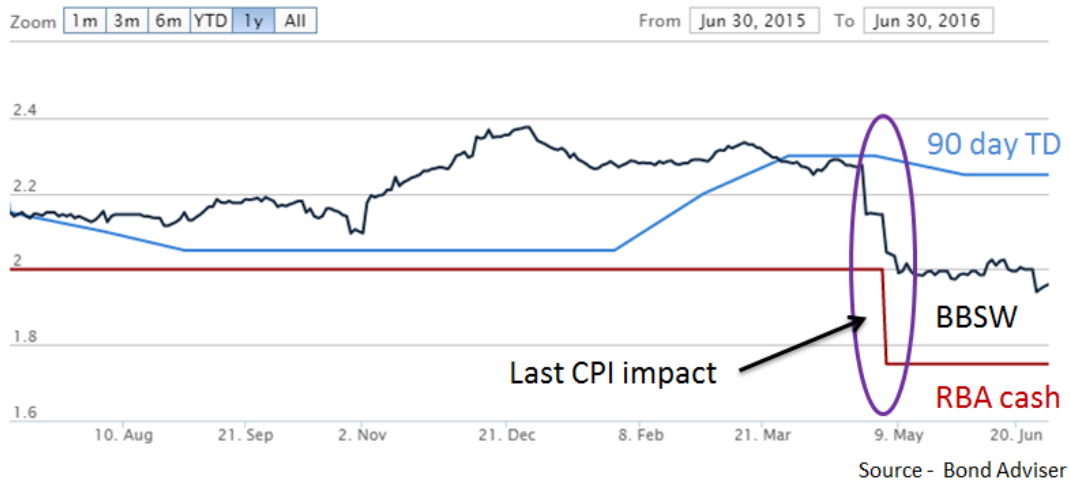
We remain Overweight Cash for optionality, Underweight Fixed Interest (local and global, as Bonds are expensive), extremely short on duration and Overweight domestic hybrids but only out to 3 or 4 years.

Cash and Term Deposits

Despite falling wholesale interest rates, retail Term Deposit (TD) rates are higher now than six months ago. This is driven by the increased pressure being applied by the regulator – APRA – on Banks ensuring that liquidity ratios are less dependent on Wholesale Funding markets.

We expect that this gap over Wholesale funding rates will continue for the medium term providing some minor consolation for retail investors (albeit still at very low rates).

Sticky TDs – telling a tale

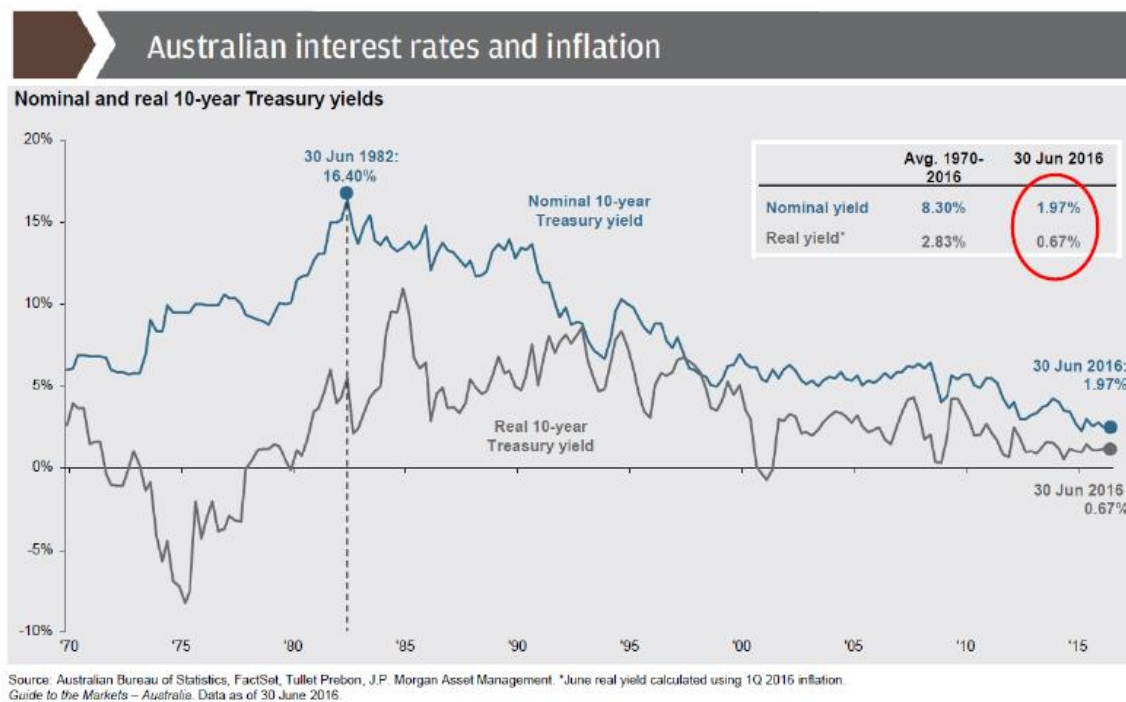


The 90-day bank bill swap rate (BBSW) – which is the rate at which Australia’s major financial institutions lend money to each other – has sustained a 25basis point premium to the RBA cash rate. Again, we expect this liquidity premium over the 90-day rate to remain. The big question is around the RBA’s next move. One thing the market agrees on is it will not be up! The trigger for the last cut in May was the very soft march quarter CPI. So another soft inflation number for the June quarter may see a reaction from the RBA to ease monetary conditions and create some downward pressure on the AUD (see above comment on currency wars being fought through interest rates). The RBA like the US has an inflationary target, but the US looks to be closer to theirs than we are to ours.

Fixed Interest

The Fixed Interest asset class has proved to be the surprise outperformer over the year. Old Fixed Interest dealers remain in a state of shock with the 10-year Commonwealth bond rate now below 2.0%. Despite the risk of losing “AAA” status, reliance on capital flows to support a commodity based currency, a semi-dysfunctional political environment and a half glass full investor psychology - we remain one of the better sovereign credit stories.

Unless an investor fears financial Armageddon and wants to park money away for the long term, the Fixed Interest market is providing little reward for a lot of risk. The graph over the page from JP Morgan Asset Management displays the squeeze on nominal rates and real returns. With a post inflation return of 0.67%, unless the investor sees a sustained bout of disinflation the reward for the risk is not there – *except for parking cash into a liquid market out to 18 months.*



Hybrids

The hybrid market has performed one of the better rallies in asset classes over the past quarter. Following on from the Commonwealth Bank issue in the last quarter, we also had NAB and Westpac launch successful issues.

Whilst we see a continuation of the factors supporting the market, namely:

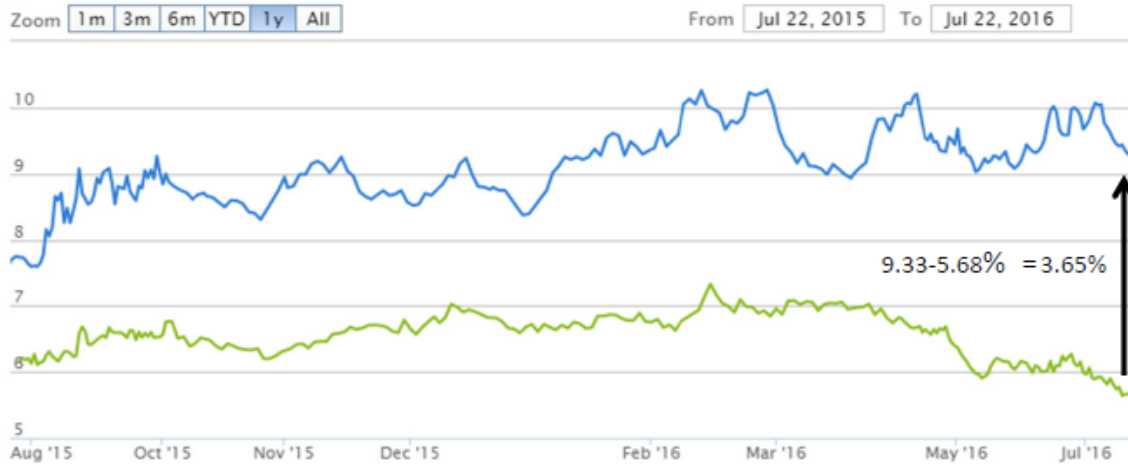
- **Outright hybrid yields remaining attractive**
- **Compression in yields in equity markets** (excluding banks)
- **Bank dividend policies spotlighted as being vulnerable to future reductions**
- **Fear of No Income (FONI)**

the market may have rallied a little too hard too quickly, and therefore a pullback in prices is possible.

We remain attracted to hybrids out to 2020 for investors looking to extend some risk into the hybrid space blending in returns on maturing TDs. However, we would wait until ANZ comes forward with their expected issue at the end of the year.

Another pause point is the widening between the grossed up return provided by ordinary bank shares 9.33% compared to bank hybrids averaging 5.68%. Given hybrids have some equity risk; the reward is now tilted toward the underlying equity (even with share price volatility).

Mind the Gap
Major Bank Div Yield vs. Bank Hybrid (Gross) – 1 year



Source - Bond Adviser

Gold – An Update on the Sector

After four years of sharp falls from 2011 to 2015, a sudden revival has been taking place in the gold market. In the first six months of 2016, the price of the yellow metal soared by 25% - its best quarterly performance since the financial crisis erupted in the final three months of 2008. The gold price, currently around US\$1,330 per ounce, is still below its record peak of almost \$1,900 achieved in July 2011, at the height of the European sovereign debt crisis. Negative interest rates in Europe and Japan are the key reason why central bankers and institutional investors have turned their attention to the commodity, and are now returning or expanding their allocations to gold. Driving investors' focus back to gold, is the fear that the move from central banks to implement negative interest rates will fail in its aim of stimulating growth and fending off the threat of deflation. Time will tell whether this latest phase of monetary policy will work, but one thing is clear: it has been helping fuel gold's rally over the past couple of months.

Insight: Alternative Investments

Many investors today would have heard of the term “Alternative Investments”, but what does this catch-all term actually mean and what assets does it encompass?

Alternative Investments range from soft commodities (e.g. Grains, Beef, Coffee etc.) and hard commodities (e.g. Gold, Oil, Rubber), through to investment strategies such as hedge funds, including absolute return funds and market neutral funds. There has been increased attention on this space of late as investors look for other avenues to generate returns in a volatile and subdued growth environment.

Following we have provided a snapshot on two of the major categories in Alternative Investments.

Absolute Return Funds

In short, these investments aim to deliver returns in both rising and falling markets. A common objective among absolute return fund managers is to preserve investor capital. To do this, they invest in a wide range of asset classes and employ various investment strategies.

As a result, a fund’s performance is often not tied to the performance of traditional asset classes such as shares, property or fixed interest.

Absolute return funds typically use more complex investment strategies than managers in traditional managed funds and listed investment companies (LICs).

These strategies often include using derivatives. Absolute return fund managers may also invest in exotic securities or take ‘short’ positions (whereby the investor can make money when a company’s share price falls). Absolute return funds may also take a ‘fund of funds’ approach, where the manager invests in a number of other funds.

Underlying investments in absolute return funds vary greatly and may include bonds, currencies, derivatives, futures, metals, money markets, mortgages, options, real estate securities, swaps, stocks, warrants or other specialised financial instruments.

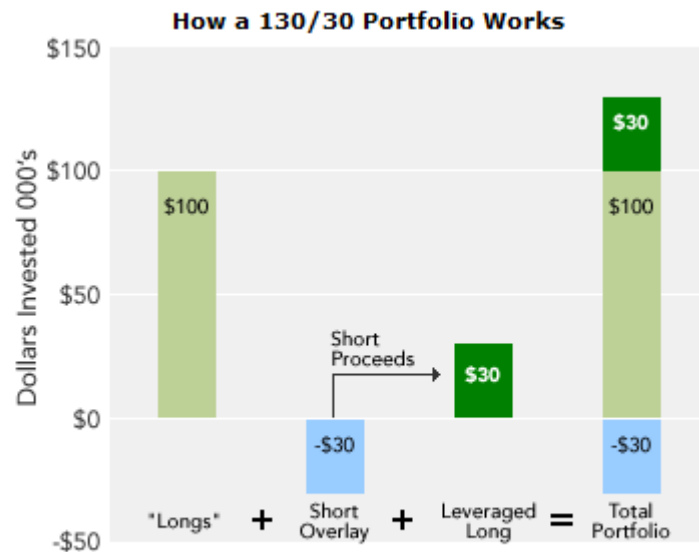
The type of returns received by investors varies depending on the fund’s strategy, and may take the form of dividend or distribution income, capital appreciation or a combination of both.

Absolute Return Funds can be suitable to use in a market experiencing increased volatility and can introduce a level of return that is uncorrelated to other assets in your portfolio i.e. an excellent diversifier. Perhaps their greatest potential advantage is their ability to produce an “acceptable” return with much lower volatility than if you invested directly in the underlying asset class itself.

As always, manager selection is crucial.

Below is a worked example of how an absolute return strategy may work by leveraging investments:

1. The chart on the right illustrates hypothetically how the portfolio is designed to work. With a \$100,000 investment, the first green bar would represent this initial "long" investment, similar to a long-only fund.
2. Next, in this example, the manager might sell short \$30,000 of stock that he/she has a negative view on, represented by the blue bar.
3. When selling a stock short the seller receives proceeds from the sale, just as with any other sale. The proceeds of the short sales are then invested in additional long investments.
4. The result is \$160,000 of exposure to the portfolio manager's best buy and sell ideas, while maintaining the same net exposure to the market as a long-only strategy.



Soft Commodities

Agriculture presents investors with real assets that are connected to the globe's growing population's most basic need – to eat. This is supported by a declining supply of readily available arable land per person, and the fact the potential returns are little correlated to traditional assets such as equities and bonds.

Agricultural investment is normally lumped into one of three broad categories.

1. Annual/Row crops such as wheat/corn;
2. Permanent crops such as olives/grapes; and
3. Livestock such as sheep and cattle.

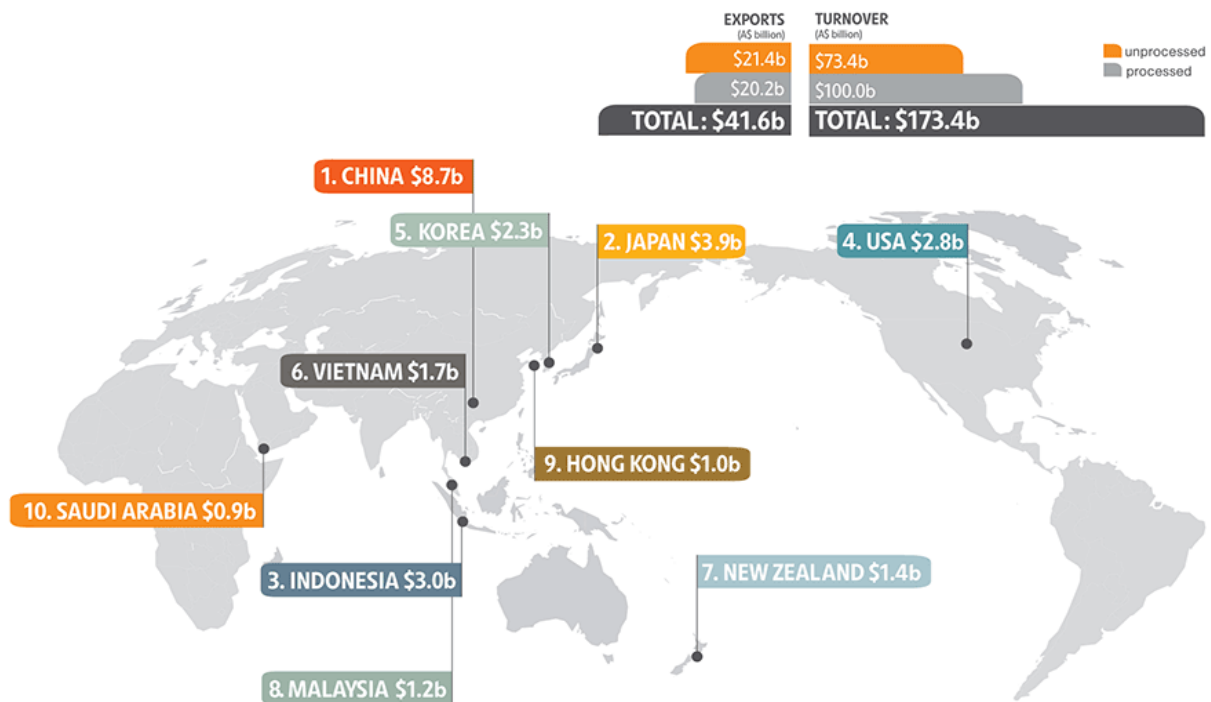
Each of these categories and even different agricultural commodities within the same category can have quite different economic characteristics. Further, there are a multitude of other factors such as land quality, farmer skills, weather, and commodity price movements that will impact the economic returns achievable from each.

Australia represents one of the best destinations for food security and is supported by several factors:

- sovereign stability
- potential for further productivity gains
- accessibility to scale; and
- the opportunity to partner with multi-generational farmers that produce some of the best quality food in the world.

Further, half the world's population is located in a prime position for supply from the Australian food bowl. Asian markets are rapidly growing in close proximity to sustainable livestock production in Australia's north.

Top 10 Export Destinations for Australian Food



Sources: Exports by country based on DFAT, Country and Commodity pivot table – FY2005 to FY2014; turnover based on ABS Catalogue 8155.0 Australian Industry 2013–14, June 2015 (released 29 June 2015); exports of processed and unprocessed food and fibre based on DFAT, Composition of Trade 2013–14; Austrade

The real issue for the sector is in the implementation, i.e. finding appropriate investment vehicles that can take advantage of what appears to be an attractive thematic. The sector is littered with stories of poor performance of numerous high fee, tax driven schemes. Moreover, the operating profitability from many agriculture businesses is poor and quite volatile. As a non-institutional investor there are also very limited ways to gain exposure to these assets directly, particularly in liquid form.

Overall, the sector does have opportunities and benefits in terms of diversification and attractive long-term fundamentals, but patience is necessary as many themes take many, many years to play out. An in depth understanding of the specific asset and structure you are investing in is also crucial to understand the risks and drivers, an elevated understanding to that typically used when investing in a listed company's shares. These potential benefits and risks then need to be weighed up against other possible investments that may fulfil your objectives.

Sources: Lonsec, JP Morgan Asset Management, Bond Adviser, IRESS, Magellan Financial Group, Platinum Investment Management, PM Capital Limited, Clime Asset Management, JCP Investment Partners

Disclaimer

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