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SE Market Wrap

HD **Shares look best in a tame field**

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Investment Double-digit returns are unlikely this year, but shares still look best, writes Bianca Hartge-Hazelman.

Shares will outperform cash and fixed interest in the year ahead, but don't expect a repeat of the 2014 financial year story, some fund managers say; the double digit returns we're enjoying now are unlikely to be repeated in 2015.

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Indeed, Australian shares are expected to underperform their international rivals over the next 12 months, as domestic headwinds stemming from federal budget measures, potentially higher interest rates in 2015, and a high Australian dollar act as major drags on corporate profitability and investor sentiment.

Australian Super chief investment officer Mark Delaney: "We think the factors that have driven markets over the last year will remain in place over the next six to 12 months. Low interest rates, steady economic recovery, will both **lead** to moderately strong **equity** performance. And the very low rates will also make it very hard to make strong returns in fixed interest or cash. So the same-order returns we've seen for the last 12 months, we expect to see in the next 12 months."

BT Financial Group head of Advance Asset Management Patrick Farrell: "I think the low interest rate environment is going to be a key support pillar for risk assets in general and I think that's going to be reflected potentially over the course of the next six months. But I also think that people know that interest rates need to normalise, they need to get back to levels which are more akin to the sort of conditions that we're used to.

"It's going to be a tightening on the economy and it's not necessarily going to foster a lot of **equity** market benefit. So we're going to be in a position where I think over the course of the next six months, equities [are] going to go through pockets of very strong performance followed by very weak performance and that volatility is going to continue on for the next six months.

"People and investors need to get used to much lower levels of return going forward and I think we're going to be on the brink of that from now on in. I think that the returns that we've been seeing on **equity** markets are not necessarily going to be there in the future, certainly not at the levels that we've seen."

Mercer Multi-Manager Funds chief strategist David Stuart: "We are not expecting a repeat of last year's performance for equities, but given that the other asset classes are looking quite expensive we think that equities should deliver on a one-year view something close to or even exceeding their long-run return, which is probably of the order of 7 to 10 per cent.

"We still have a preference for international equities and we think the Australian dollar probably has further to come down over time – though timing the fall of a currency is always extremely difficult. The Australian economy is subject to some headwinds; I think that will restrain profits growth and potentially deteriorate the Australian market relative to global markets. It's looking just a touch expensive.

"We expect bond yields to steadily rise. They have rallied quite a bit in the first half of this year. We think, from here, that they're looking a little bit rich so bond yields will rise and that means capital values of **bonds** will fall. That will be offset by the yield, but a fairly muted return possibly below cash for **bonds** – so not our favoured asset class.

"In Australia there's quite a lot of pent-up demand for unlisted property so you'll probably see a good return from that in the short term, but we shouldn't ignore the fact that the fundamentals of the property market are quite challenging at the moment. So although prices may get pushed up by a weight of both domestic and foreign investors, we suspect in the medium term that the returns from property won't be as good as equities."

How have asset classes performed in FY2013-14?

Delaney: "The best-performing asset class has been shares. They have benefited from the pick-up in the global economy and easier monetary policy. In particular international shares [have] done really well. The share markets have done very well and the Australian dollar has come down a touch from very high levels the previous year.

"Property and infrastructure have done pretty well as well. We think they will do around double-digit returns for the 12 months to the end of June and the lower-returning asset classes have been **bonds** and cash, reflecting the fact that those rates were already very low, there [are] limited opportunities to earn more than what their underlying yield is."

Farrell: "Over the past financial year, equities has been the star outperformer – Australian equities and international equities. It's been about 22 per cent, and if the market stays where it is it's been about a 22 per cent return for the last 12 months; that's been a really good outcome. Worst-performing asset classes: probably cash with 2.7 per cent over the last 12 months; it's been hard to get anything lower than that.

"**Gold** has been probably one of the worst performers; it's down about 11 per cent over the last 12 months. Other precious metals have gone down in value; silver's down about 18 per cent over the last 12 months, base metals in general just haven't had that sort of flow on. **Energy** as a commodity is probably up around 8 to 10 per cent, and in the agricultural sector, cattle has been a very good performer and that's because there is a demand for protein, particularly around the emerging world; but other things like corn that really had a strong year last year [have] really given a lot of it back this year."

Stuart: "Clearly international equities have done better than any others with a return of about 21 per cent for the financial year to date. Australian equities weren't far behind with a return of about 19 per cent but still a very strong performance for equities. I think the Australian market has been held back by clearly difficult economic conditions. Falling commodity prices has a big impact clearly on the resource stocks within Australia. We've also had political uncertainty leading up to the May budget and even uncertainty following the budget. So we see the Australian economy as muddling through at the moment, notwithstanding quite a strong first-quarter growth number. That's probably the best number we'll see this year. We've still got a strong headwind of a decline in **mining** investment which needs to be offset by other parts of the economy though; overall, a mixed outlook I think for Australia."

Delaney: "The big thing which has driven **equity** market returns over the last year has been the easy monetary policy adopted by the central banks in both Europe and the US and luckily also in Japan. The very easy **equity** has propped up sharemarkets and made it very expensive to hold fixed interest investments or cash investments.

"The second factor which has been important has been the gradual economic recovery we are seeing both in the US, Europe and also seeing some signs of it in Australia as well. That gradual recovery has fed through to earnings growth."

Farrell: "We also can't forget the fact that **China**, Brazil, Russia have got a lot of wealthy individuals now; they are looking for places to actually invest their money. They don't necessarily want to invest it all in their home countries for obvious reasons, so getting money out, particularly into the US market, has been one of the key factors that's been driving equities higher.

"But one of the most important factors has been the fact that companies themselves have been buying back their own shares, so in the $US550 **billion** [$587 **billion**] worth of money has basically flowed from companies back into their own sharemarket. Now, that money has to find a home because it has been given to the investors to buy back their shares, those investors then need to actually reinvest it in other companies, so that's been one of the major supports of equities in the last 12 months."

Stuart: "Well it's predominately a re-rating of equities. It hasn't been matched by profit or earnings growth over the last year I think investors have become more comfortable that we're slowly emerging from the aftermath of the global financial crisis and they're looking forward to a period of low interest rates, low inflation and sustained economic growth, and that's a pretty sweet spot for equities. We tend to call it a 'Goldilocks' economy."

Delaney: "When we build portfolios, we like to build them for the long run. A 20-year horizon. And think about the investor's needs in building the portfolio, and diversification. Given that caveat, we still think it leads to one where you tilt your portfolio to more equities in the next 12 months reflecting the different return expectations in those two asset classes.

Farrell: "I'**m** not necessarily going to look to my fixed income assets to generate significant returns and in fact the potential for some negative returns coming in from a fixed income are a real possibility depending on how fast interest rates rise. OK, there will be pockets of value in equities markets and I think that will be a particular focus for a lot of investors. But there are also pockets of risk in equities. So to look at a broad base equities market portfolio, getting a very low return is probably our expectation but there will be pockets of opportunity and I think also, one of the things is looking at maybe more absolute-return-based strategies and this can come from either alternative assets or basically structures that have been put in place to take advantage of some of the volatility we could see.

Stuart: "We've been advising our clients to move their money overseas for the past few years and we do advise some of the major super funds in Australia. I think we're only part way through that, I think that it's been positive investment. I think Australian investors do recognise they are probably overexposed to the Australian **equity** market, which is a very concentrated market. The banks and the resources make up a very substantial part of the market. So you're not getting the diversification that you'll get by investing internationally. So we think it's still got further to go and we think it's a good thing for the Australian economy to have overseas investments as well as domestic investments."

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