PITCHER PARTNERS
INVESTMENT SERVICES PTY LTD
ABN 24 052 941 036 AFS LICENCE NO. 229887

The office will reopen on 9 January 2017

Investment News

ISSUE No. 77

An Independent Investment Advisory Practice Quarterly Newsletter // **By Sue Dahn**

2016 – What a Ride

We started calendar 2016 with a bear market correction with many markets experiencing falls of over 20% in the period to mid-February 2016.

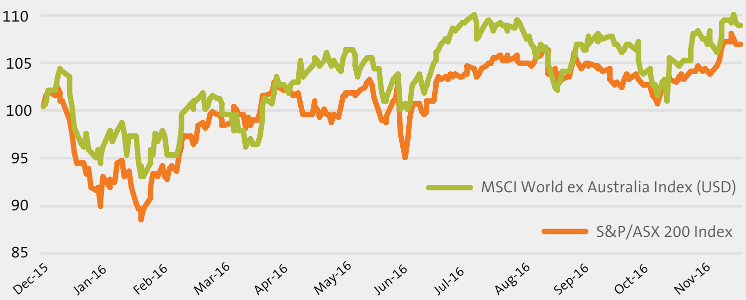
Investors were worrying about very low oil prices, negative interest rates, the strong showing of Donald Trump in the polls, refugee backlash in Europe and conflict in the Middle East, as well as the myriad of political events on the 2016 calendar.

We urged clients not to heed the calls to "sell everything" but to still expect continued volatility in the year ahead and to use that volatility to gradually deploy any overweight cash.

We said we would be looking to a commodity and bank rally before the end of the year and a full year reporting season that did not materially downgrade future expected earnings.

Markets intermittently worried again in April and May with concerns about stagnant economic growth and weak corporate earnings.

Index Performance 2016



Source: Iress.

Financial Markets at 22 December 2016

Indices	Current level	3 month return	12 month return
ASX 200	5613	5.1%	9.9%
ASX 200 (Acc)	**53441**	**5.9%**	**14.8%**
US S&P 500	**2265**	**4.7%**	**12.1%**
Japan Nikkei	19444	15.7%	2.8%
UK FTSE 100	7041	3.0%	16.7%
MSCI World	1761	2.3%	7.5%
German Dax	11469	9.9%	9.2%
French CAC	4834	9.6%	5.9%
HK Hang Seng	21810	-7.9%	0.1%
Shanghai Comp	3137	3.7%	-13.9%
ASX 200 Prop (Acc)	43249	-1.7%	11.4%
Global Prop	2334	-2.9%	6.3%
Aust. Bonds	**8782**	**-2.3%**	**2.5%**
Inter. Bonds	931	-2.3%	4.4%
Commodities (US$)			
Gold (oz)	1132	-15.2%	4.9%
Oil (Barrel)	**53**	**15.1%**	**47.0%**
Iron Ore (Tonne)	79	41.7%	95.7%
Aluminium	1721	8.6%	13.7%
Copper	5502	15.5%	16.1%
Lead	2195	13.4%	27.2%
CRB Index	191	3.2%	10.6%
Currency			
AUD/USD	**0.7238**	**-5.1%**	**0.7%**
AUD/EUR	0.6944	1.9%	5.4%
AUD/GBP	0.58586	0.2%	21.3%
AUD/JPY	85.072	11.2%	-2.3%
AUD/RMB	5.0366	-0.4%	8.1%

Then at the end of June the surprise Brexit vote startled markets into a further brief selloff before recovering.

In November the election of Donald Trump as the next US President triggered a return in volatility producing a sharp increase in bond yields (fall in bond prices) and a sharp rally in the equity markets.

Finally December has seen Italy's Prime Minister Matteo Renzi announce his resignation as the country cast a resounding 'No' vote against his planned constitutional reforms, which is seen as opening the door for populist parties in the next general election.

From 1 Jan to today:

Oil prices have risen	**41.6%**	The S&P 500 is up	**11.1%**
Iron ore is up	**84.1%**	The ASX200 is up	**6.0%**
Yields on 10 year US Treasuries are up by	**12.8%**	BHP has gained	**40.9%**

Market investment returns for our clients in the calendar year have been about 5%.

This is not high in absolute terms though it is broadly in line with the reduced expected return environment we have been discussing with clients this year.

Many clients with overweight cash ready to deploy into the pockets of volatility have achieved returns considerably better than market returns.

For investors in Australian shares there are also franking credits to be considered which can add up to 1% to returns.

Again, these are not extraordinary returns but about double the return from term deposits with much greater liquidity.

The lesson being that market volatility is both a threat and an opportunity and, though the premium was modest, it certainly did pay to stay invested in 2016.

The Trump Jump

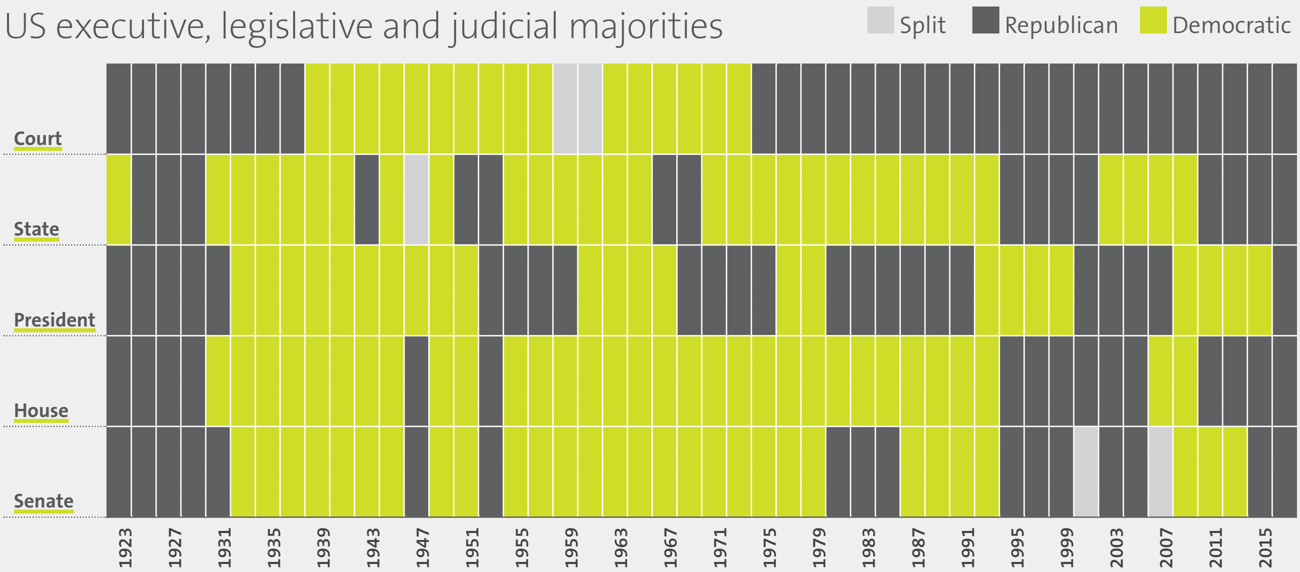
You may by now have read as much about Trump as you have an appetite to do, but the policy, budget, trade and political landscapes have changed dramatically following the US election result.

Many of the first order impacts are relatively easy to predict, but the second and third order impacts are far less predictable.

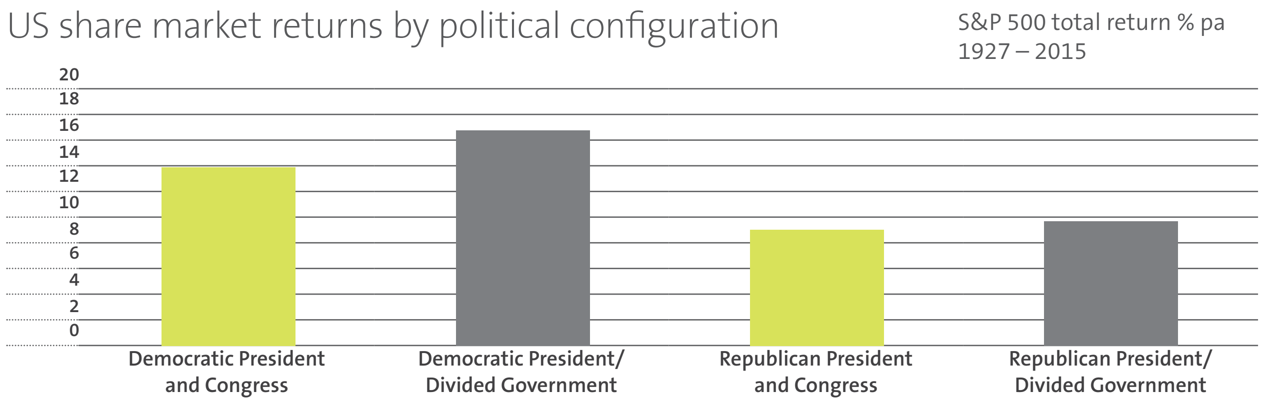
Much depends on the political context and it is only now that we are closer to a full line up of the Trump Cabinet and other senior officials. We will not know how the Congress works with the President and his advisers for some time after the January inauguration.

Notably this is the first time since the 1920s that the Republicans have enjoyed a clean sweep of the Congress, the White House, the States and the Supreme Court nominations.

US executive, legislative and judicial majorities

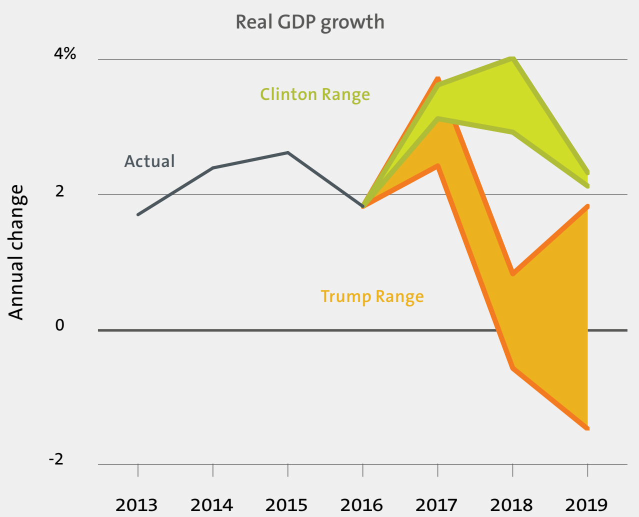


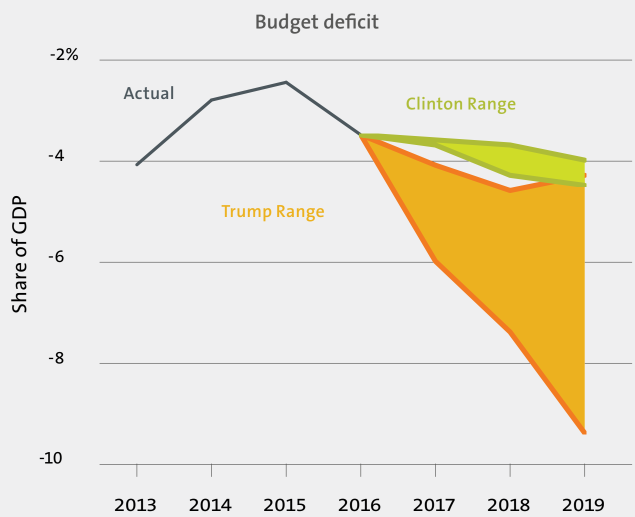
Despite the rally in the sharemarkets following the Trump victory seeing new records being reached by the Dow Jones index and the S&P 500, history tells us that the best sharemarket returns have been achieved under a combination of Democrat Presidents and a divided Congress.



Source: Bloomberg/AMP Capital.

What we do expect is a short term increase in economic growth funded by an increase in the budget deficit. Trump's spending policies on infrastructure, defence, health and education together with a program of massive tax cuts will provide a short term boost to growth and earnings. This will be positive for the share market in the short term. In the medium to longer term much depends on the momentum that a Trump administration can build in industry and the impacts of his trade and immigration policies on the $US, wage rates, etc. Hence the large range of growth and deficit outcomes modelled by BlackRock in the charts below.





Sources: BlackRock Investment Institute, IMF, Congressional Budget Office (CBO) and Moody's, June 2016.
Notes: Pre-2016 data are based on IMF data for GDP and CBO data for the budget deficit. The charts show the range of Moody's projections from 2016 onwards based on three scenarios for each candidate. Moody's considers three scenarios for each candidate: 1. election campaign policy proposals are implemented at face value; 2. campaign promises are largely implemented but on a smaller scale; 3. policies are scaled back due to political resistance.

12 Days of a Trump Christmas

1. 51% of Americans are more confident of Trump's ability to lead the nation since the election.
2. The $US is once again the strongest currency in the world.
3. US third quarter GDP growth has been revised up to 3.2%.
4. Stock markets hit new record levels in December 2016. Investor optimism at highest level in 21 months.
5. US Manufacturing PMI has hit highest level in 13 months.
6. The number of US oil rigs in operation has hit a 10 month high.
7. Median US house prices have passed their pre-GFC level for the first time.
8. US unemployment is down to its lowest level in 9 years at 4.6%.
9. University of Michigan Consumer Expectations Index hits highest level in 18 months.
10. In November 46% of Americans believed the US will experience continuous good times in 2017 (up from 11% in October).
11. American's hope is highest for a decade – 36% believe their personal finances will improve in 2017.
12. Gun stores report drop in sales as more Americans adopt a more positive outlook of the future (and the risk of tighter gun control abates).

Bond Market Rally Reverses – Inflation and Interest Rates to Rise

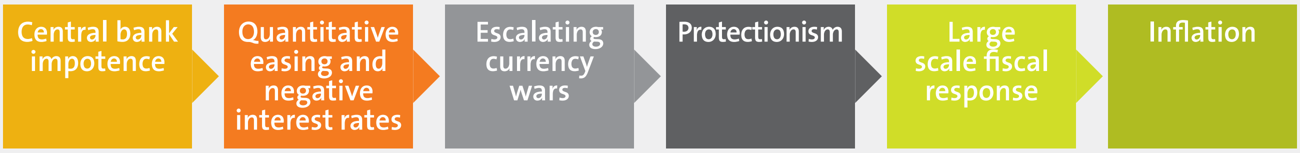
What we can predict is that the 35 year bond market rally will go into reverse and that inflation and interest rates will rise.

Market yields on 10 year treasury bonds have lifted from 1.8% to 2.5% and the US Federal Reserve lifted rates to 0.5% on 14 December as widely predicted signalling three more rate rises to come in 2017.

Source: Board of Governors of the Federal Reserve.

President-elect Trump is playing out Vimal Gor of BT's scenario of a politician brave enough to return to fiscal stimulus as the primary tool to support growth in the face of increasingly impotent monetary policy.

It remains to be seen how much of the Trump election campaign will actually be legislated.



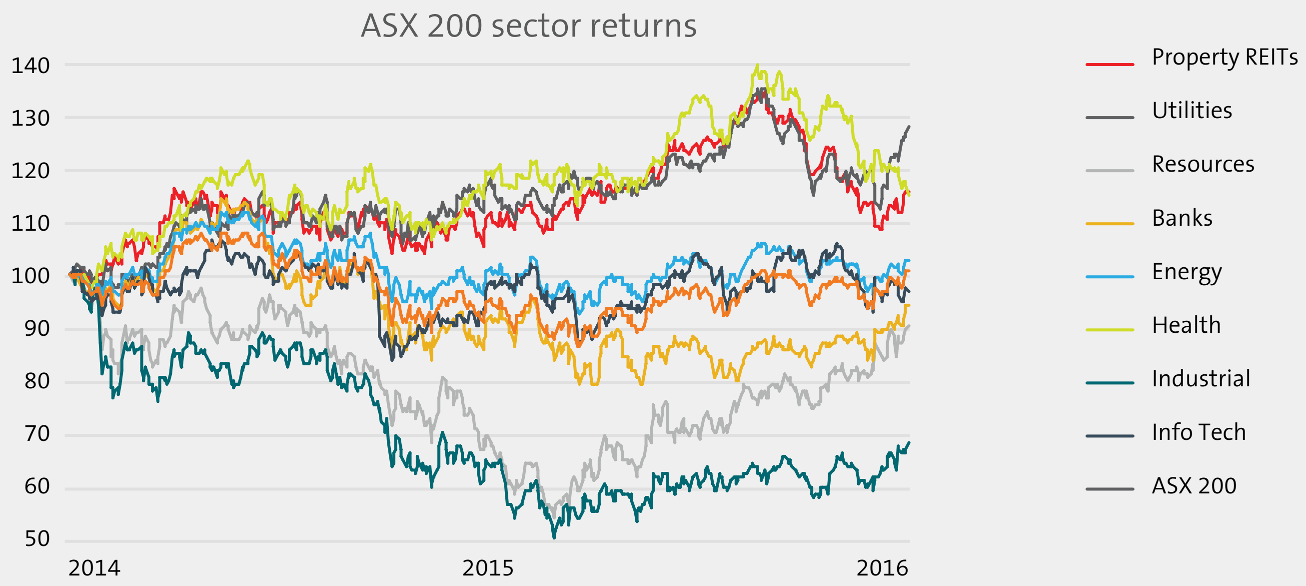
Source: BT Investments

Under Trump we can expect a boost to short term growth, higher inflation, rising bond yields and a stronger $US.

Protectionism policies will likely lead to similar policies across the globe with the ultimate risk that the decline in globalisation and trade could lead to stagflation.

Global reflation will be the initial impact and moderate inflation is generally positive for most equities.

The exception are the class of equities that are valued on discount rates that are now rising such as utilities, REITs and listed infrastructure which have been under pressure since mid 2016.



The Crystal Ball – 2017

We wish we could provide you with the gift of certainty but the reality in the midst of such an extraordinary time in the history of globalisation and technology with its shifting impact on winners and losers, is that 2017 is likely to be as volatile as 2016.

The known unknowns include:

January	Trump Inauguration
March	Dutch General Election
Before April	Brexit Article 50
April and June	French Elections
October	German Elections

Our strategy positioning remains to keep plenty of cash available to deploy into downturns both general and sectoral with a reconsideration of short term weightings to the US.

Pitcher Partners Turns 25

Our firm recently celebrated 25 years of serving its clients and reflecting on where we have come since 1991 in the field of funds management is a reminder of the magnitude of change we are living through.

	Nov 1991	Nov 2016
Total surveyed fund managers	23	250
Securities listed on the ASX	~700	2069
Interest Rate	>15%	1.5%
Unemployment	10%	5.6%
Market P/E	8x	16.2x
Market yield	8%	4.3%
Largest stock on ASX*	BHP $21.2bn	CBA $135bn
Typical asset allocation	100% Aust shares	25% Aust shares
Graduate salary	$25,000	$54,000
Median Melbourne house price	$127,000	$740,000

*Commonwealth Bank's $135 billion market capitalisation is greater than the entire ASX market in 1991 of $108 billion (CBA was ~$7 billion in 1991 having listed in September that year).Source: Bloomberg; Iress; ABS.gov.au; Graduate Careers Australia; Macquarie University

> "One of the funny things about the stock market is that every time one person buys, another sells, and both think they are astute."
>
> **William Feather // American Author, 1889 -1981**

> "Our goals can only be reached through a plan, in which we must fervently believe, and on which we must vigorously act. There is no other route to success."
>
> **Pablo Picasso // Artist, 1881-1973**

Holiday Reflections

As you relax over summer you may wish to reflect on the passing of time and how that impacts your investment portfolios. Specifically:

1. How have you coped with the volatility of 2016? Has your investment risk appetite changed?
2. Does your asset allocation reflect your current risk appetite?
3. Have you accommodated the current levels of expected returns into your own expectations?
4. Have you considered succession planning for all of your investment vehicles?
5. Especially at this time, have you considered any gifting and philanthropic aspirations?

We encourage you to speak to your advisor on these and related matters at your forthcoming meetings.

We thank you for the opportunity to serve you this year and wish all of you a peaceful, happy and healthy holiday season.

Best Wishes Sue

> "Good judgement comes from experience and experience comes from bad judgement."
>
> **Fred Brooks // American Scientist, 1931 –**

> "We all want progress, but if you're on the wrong road, progress means doing an about-turn and walking back to the right road; in that case the man who turns back soonest makes the most progress."
>
> **C.S. Lewis // Author, 1898 - 1963**

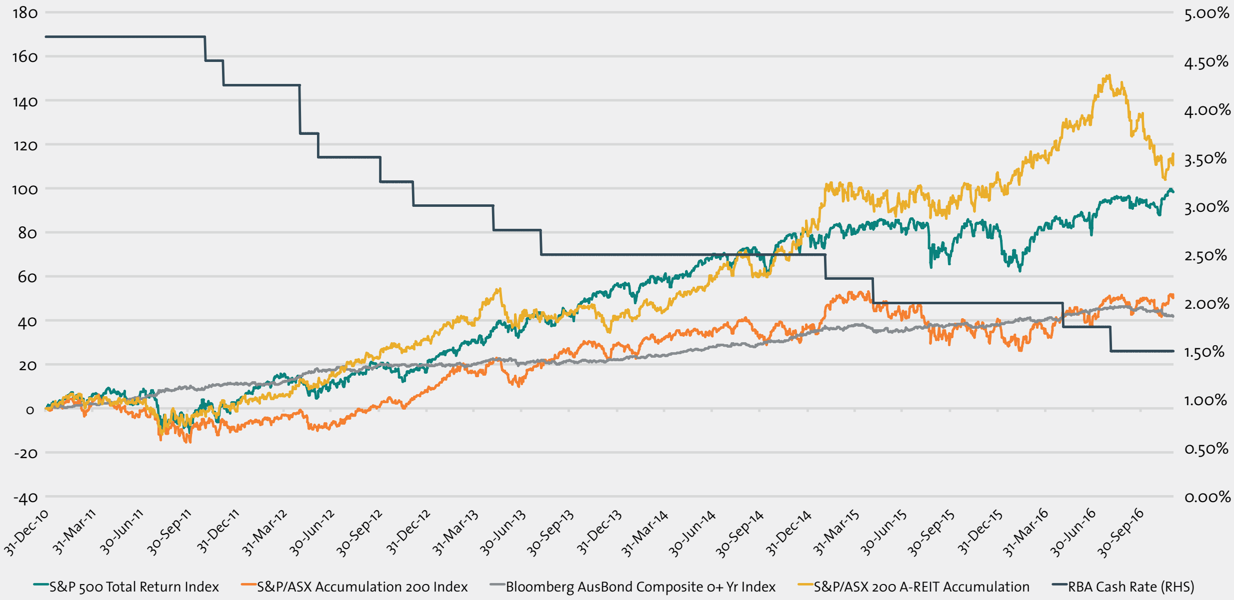
What are alternatives and why are they more relevant than ever?

By Marcus Damen // Director, Senior Advisor

Put simply, Alternatives are all of the investments that fall outside of the traditional asset classes of Equity, Property, Fixed Interest and Cash. The traditional asset classes represent the cutlery in that neat top drawer in your kitchen, whereas Alternatives represent all of the other utensils in that messy second drawer that come in very handy for particular circumstances. A portfolio that doesn't have an allocation to Alternatives is not as well equipped to prosper or protect from all of the situations that could arise in the financial markets.

Over the past five years, the traditional asset classes have performed quite well, largely driven by a fall in interest rates as investors chased higher returns than available from cash. The official Australian cash rate, for example, has fallen from 4.75% to 1.50% in that timeframe.

Figure 1



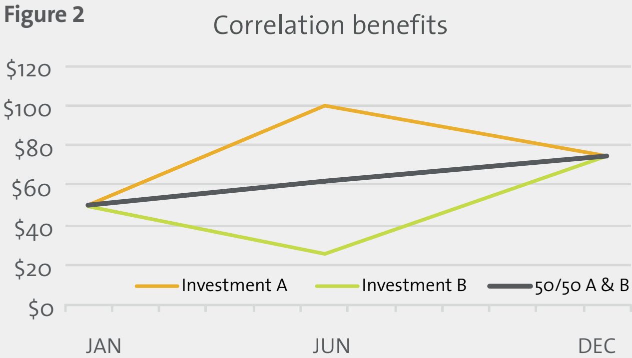
Given these recent conditions, there has been little need for Alternatives in an investment portfolio, however, with interest rates now at historically low levels (at zero or negative rates in some countries) and global central banks beginning to ease or reverse their accommodative policies, the expected returns from traditional asset classes have reduced and the risks have increased – particularly in long duration Fixed Interest where prices are directly and adversely impacted by rising interest rates.

Reducing shorter term correlation

For the reasons set out above, now is a good time to go looking in that second drawer for some investments that can perform in times where the traditional asset classes become more challenged. Ideally, we want to find investments that have a low correlation to traditional asset classes and are not reliant on low or falling interest rates.

Correlation is a measure of how related the returns are between different investments during a time period. For example, Figure 2 shows two investments that start a year at a price of $50 and end that year at a price of $75, but are completely uncorrelated during the year. Holding equal portions of both would deliver a much steadier experience throughout the year than holding one or the other.

Figure 2



While we want all of our investments to rise in value over the long term, we want them to behave differently over shorter time periods in order to achieve a smoother ride along the way.

The Alternatives asset class provides many investment opportunities that have a low or negative correlation with the traditional asset classes. While the asset class is too broad for there to be a true average or index, the Dow Jones Credit Suisse Hedge Fund Index is a useful proxy as it encapsulates a wide range of investments that carry out a wide range of different alternative strategies. The correlations between this index and the traditional asset classes are set out over page:

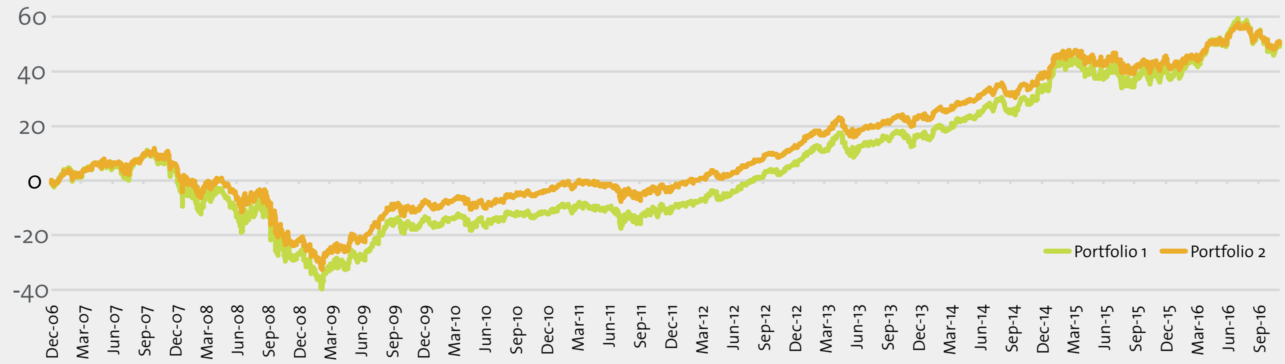
	Aust. Equity	Int'l Equity (50% Hedged)	Alternatives (Hedged)	Aust. Listed Property	Aust. Direct Property	Int'l Listed Property (Hedged)	Aust. Fixed Interest	Int'l Fixed Interest (Hedged)	Cash
Australian Equity	1.00								
International Equity (50% Hedged)	0.69	1.00							
Alternatives (Hedged)	0.57	0.57	1.00						
Australian Listed Property	0.62	0.45	0.32	1.00					
Australian Direct Property	0.03	0.03	0.08	0.02	1.00				
International Listed Property (Hedged)	0.64	0.54	0.43	0.66	0.00	1.00			
Australian Fixed Interest	-0.12	-0.15	-0.10	0.18	-0.07	0.00	1.00		
International Fixed Interest (Hedged)	-0.01	-0.15	0.05	0.22	-0.15	0.17	0.60	1.00	
Cash	-0.08	-0.13	-0.02	-0.14	0.12	-0.12	0.22	0.07	1.00

* Correlation based on historical index data from 30-Nov-1996 to 31-Oct-2016

Note: A correlation of 1 means that the asset classes move perfectly in tandem together and a correlation of -1 means that the asset classes experience fluctuations in complete opposite directions.

The chart below illustrates the historical benefits of having an allocation to Alternatives. Portfolio 1 comprised 1/3rd Australian Equity, 1/3rd Australian Listed Property and 1/3rd Australian Fixed Interest, whereas Portfolio 2 was split in quarters between these three asset classes and adds Alternatives.

The main benefit of holding the Alternatives was during the Global Financial Crisis of 2008. Note that Portfolio 2 fell only approximately 30% as opposed to approximately 40% for Portfolio 1:



(Based upon index returns for the relevant asset classes and assuming no rebalancing throughout the period.)

What kinds of investments/strategies exist within Alternatives?

There are many investments and strategies available, each with their own volatility and correlation characteristics that make them suitable for particular market conditions and/or particular investor risk profiles. The most common types of Alternative investments/strategies include:

- Unlisted investments
- Currencies and commodities
- Short selling
- Options
- Futures
- Gearing/leverage

Managed funds that carry out some or all of these strategies are often referred to as 'Hedge Funds' or 'Absolute Return Funds'.

Which Alternatives are attractive at present?

Assuming that the end of the interest rate cutting cycle has arrived or is close and assuming continued uncertainty in global politics (and particularly trade relations) then the following strategies are of particular interest:

- Unlisted investments such as private equity and/or direct infrastructure, while still exposed to interest rate risk, may fare better than their listed counterparts.
- Exposure to currencies or commodities (either directly, via exchange traded funds or derivatives such as options or futures) should also provide significant opportunity to profit given that volatility should be exacerbated by economic uncertainty and political uncertainty.
- Short selling strategies are particularly attractive, especially if the traditional asset classes experience a downward trend and/or significant volatility, as these are the ideal conditions for such strategies;
- Options strategies are as attractive as ever for risk management purposes for investors who wish to narrow the range of possible outcomes that they could experience;
- Gearing/leverage strategies may also be attractive due to low borrowing costs, however borrowing to invest in assets that have experienced significant price inflation from falling interest rates is a risky strategy. Pitcher Partners Investment Services typically do not recommend gearing strategies.

For further detail in relation to these strategies and to discuss whether they may be relevant for you please contact your advisor.

A global 'make local/use less' future?

By Victoria Lindores // Senior Advisor

Ten years ago a trip to your local shops on a Friday night would have included your favourite takeaway and a rental from the video store. Such is the pace of technological change, a child born today may never even use a DVD player.

The last two decades of technological advances have focussed on making everything faster (think computers and logistics) or more efficient (think houses and cars). Takeaway food and a movie are now only a few clicks away.

So where to from here? With our limited natural resources and a growing focus on the interaction between climate and health, the next great technological advances may well have to focus on 'using less'.

Make Local: Widespread distribution of 3D printing has the potential to remove the need for large transport hubs and warehouse networks, disrupting the transport and logistics industry that currently represents 8.6% of Australian GDP.

Use Less: Air pollution is estimated to cost China 6.5% of its annual GDP, with causes ranging from smog related illness to manufacturing shutdowns. The Government is investing heavily in renewable energy technologies, realising the potential for political unrest that stems from a reduced standard of living for those in big cities.

Improved efficiency: Americans spend 17.1% of GDP on healthcare (World Bank 2014), so any innovation to 'use less' – from improved drug delivery to online health portals – would have a big impact on the health care industry.

To participate in the next technological revolution, we need to invest in companies willing to invest with a long term view to growth. This includes new companies with new ideas and old companies willing to reinvest profits in new ideas, not just those that are focussed on maximising dividends in the short term.

Thanks to Brendan Fahy (15 years service), Simon Briggs (14 years) and Andrew Aylward (6 years) for their long and loyal service to the firm and its clients and best wishes for the future as they leave us this Christmas.

Sue Dahn
Partner – Investment Advisory
+61 3 8610 5124
sue.dahn@pitcher.com.au

Adam Stanley
Partner – Investment Advisory
+61 3 8610 5517
adam.stanley@pitcher.com.au

Kellie Davidson
Partner – Investment Advisory
+61 3 8610 5334
kellie.davidson@pitcher.com.au

1991 CELEBRATING **25 YEARS** 2016

Est. 1991

Pitcher Partners is a full service accounting and business advisory firm with a strong reputation for providing quality advice to privately-owned, corporate and public organisations.

In Australia, Pitcher Partners has firms in Adelaide, Brisbane, Melbourne, Perth, Sydney and Newcastle. We collaboratively leverage from each other's networks and draw on the skills and expertise of 1200+ staff, in order to service our clients.

Pitcher Partners Melbourne is the leader in the middle-tier market and is the fifth largest accounting services firm in Melbourne after the Big 4 multinational firms.

Pitcher Partners is also an independent member of Baker Tilly International (BTI), the eighth largest network in the world by fee income. Our strong relationship with other BTI member firms, particularly in Asia Pacific, has allowed us to open many doors across borders for our clients.

MELBOURNE
+61 3 8610 5000
partners@pitcher.com.au

SYDNEY
+61 2 9221 2099
sydneypartners@pitcher.com.au

PERTH
+61 8 9322 2022
partners@pitcher-wa.com.au

ADELAIDE
+61 8 8179 2800
partners@pitcher-sa.com.au

BRISBANE
+61 7 3222 8444
partners@pitcherpartners.com.au

NEWCASTLE
+61 2 4911 2000
newcastle@pitcher.com.au

PITCHER.COM.AU

an independent member of BAKER TILLY INTERNATIONAL