The Capital Market Opportunity Set and Implications for Long-Term Investors

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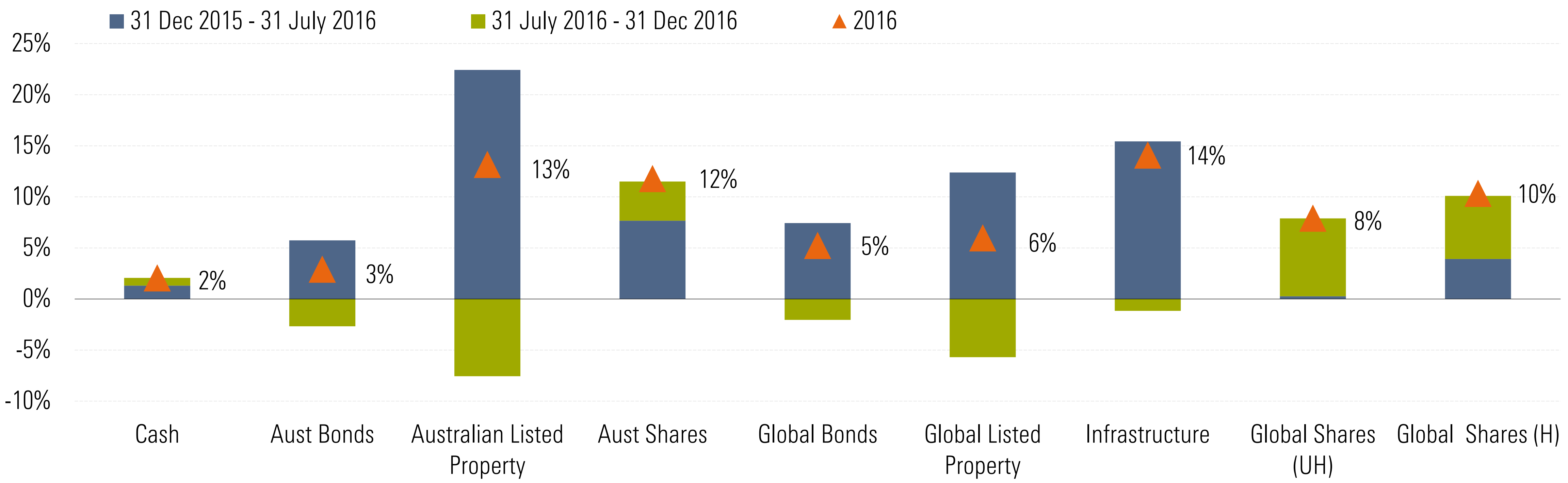
Between the start and the end of 2016 not a lot changed, but a lot happened.

The below markets provided returns of between 2% and 14% in 2016 but that masked the very large shifts experienced in some assets – like listed real estate and fixed income – throughout the year.

2016 Market Returns

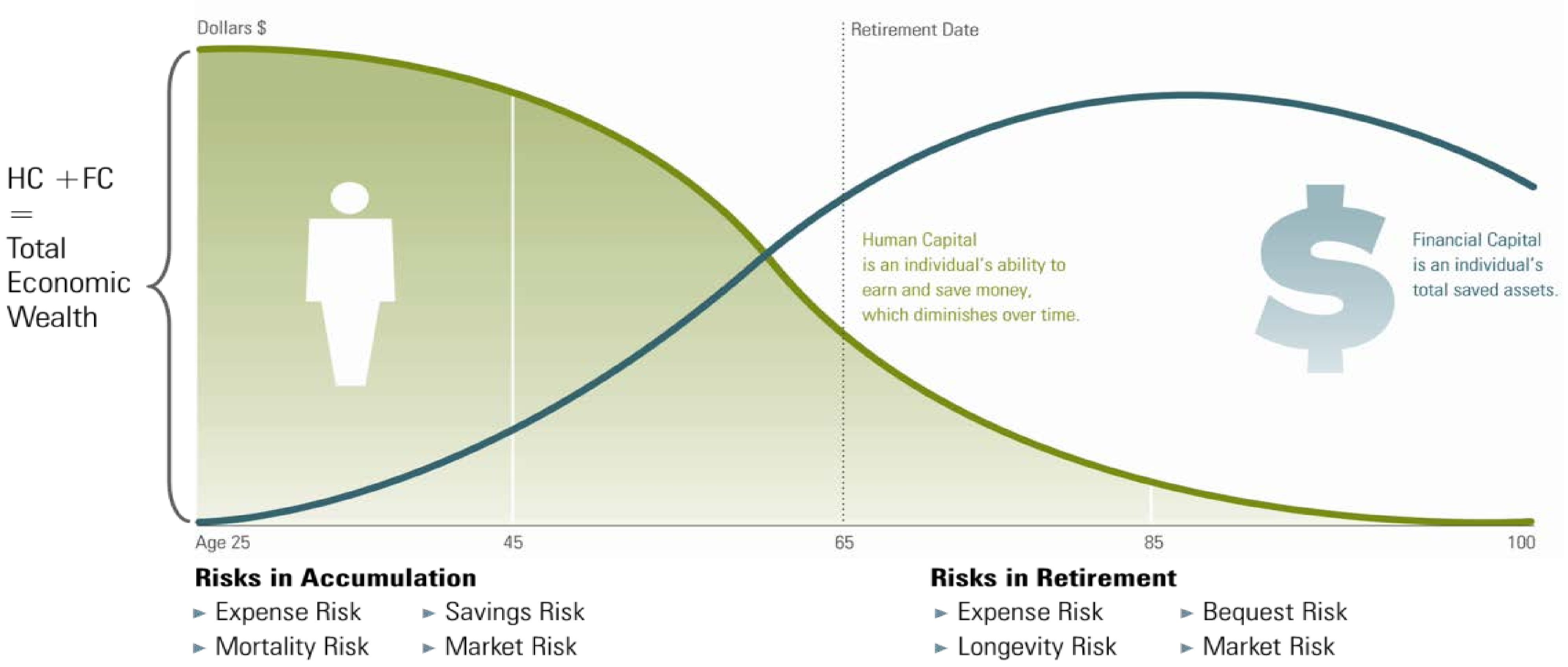


Source: Morningstar Direct. Data as at 31/12/2016 .

Typical lifecycle of human capital and financial capital

Early in life the biggest asset that most people have is their human capital as financial capital is typically very low. As people get older, human capital depletes and financial capital increases.

Investor Lifecycle

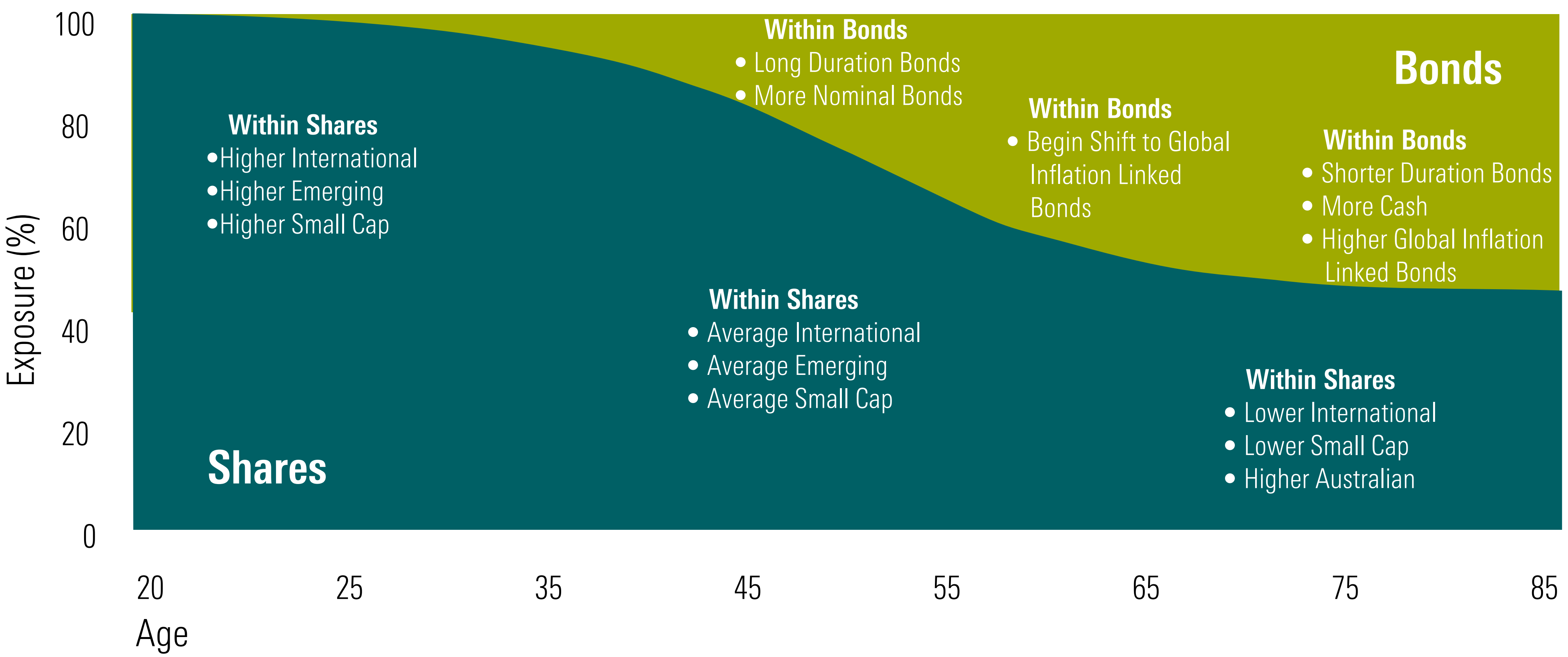


Source: Morningstar

Changing requirements and changing exposures

The purpose of the accumulation of wealth throughout one's working life is generally to fund a comfortable and sustainable retirement. As a client moves through the different life stages their asset mix should adjust accordingly, but valuation still matters.

Conceptual Glide Path

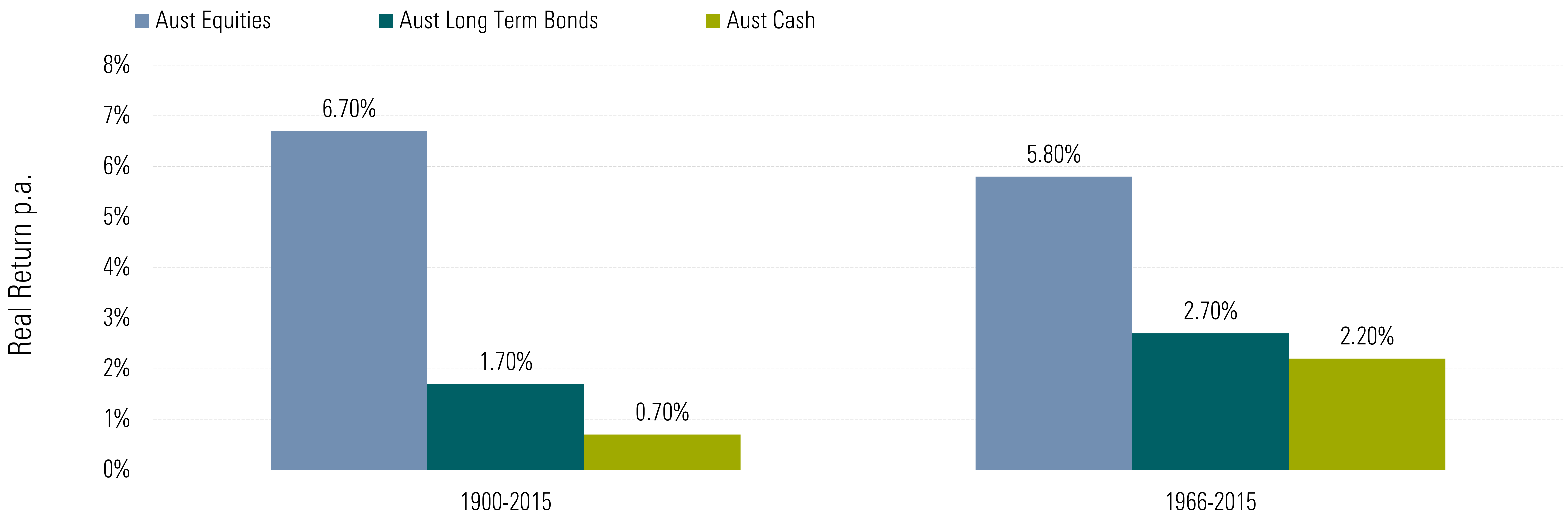


Source: Morningstar

The future ain't what it used to be…

Excluding any valuation impact our standard assumptions are that, in the very long term, Australian Equities should deliver 5.5% – 6.5% above inflation, Australian Government Bonds 2% - 3% above inflation, and Australian Cash 1% – 2% above inflation.

Australia – Long Term Real Returns (%)



Source: Credit Suisse, Dimson, Marsh, Staunton. Data as at 31/12/2015

Bond characteristics are not stable

Characteristics of two hypothetical Australian Commonwealth Government Bonds issued 31 October 2007 and 31 July 2016:

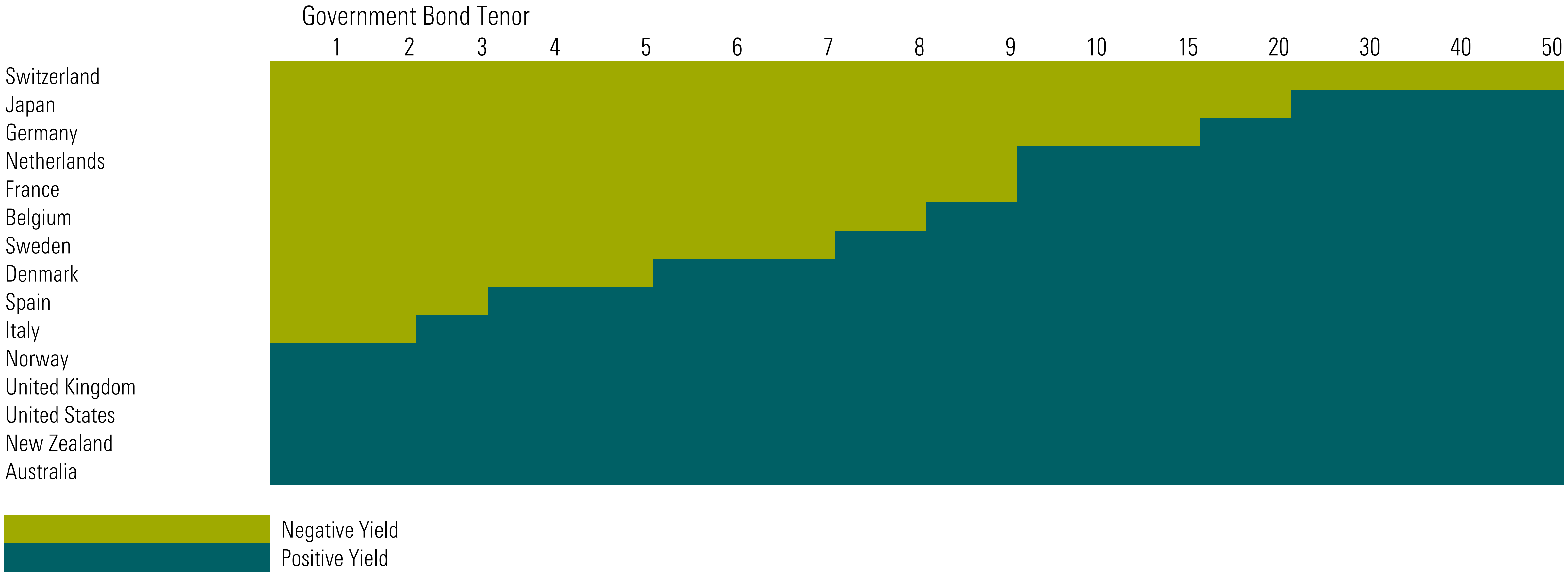
Australian Commonwealth Government Bonds	31 October 2007	31 July 2016
Australian 10-year Commonwealth Government Bond Yield	6.2%	1.9%
1-year inflation	1.8%	1.0%
Income potential	**High**	**Low**
Diversification potential	**High**	**Low**
Capital preservation potential	**High**	**Low**

Source: Morningstar

A return free risk?

In July 2016 Swiss Government Bonds out to a maturity of 50 years were providing a negative yield….

Government Bonds with Negative Yields (As at 6 July 2016)



Source: ANZ. Data as at 06/07/2016

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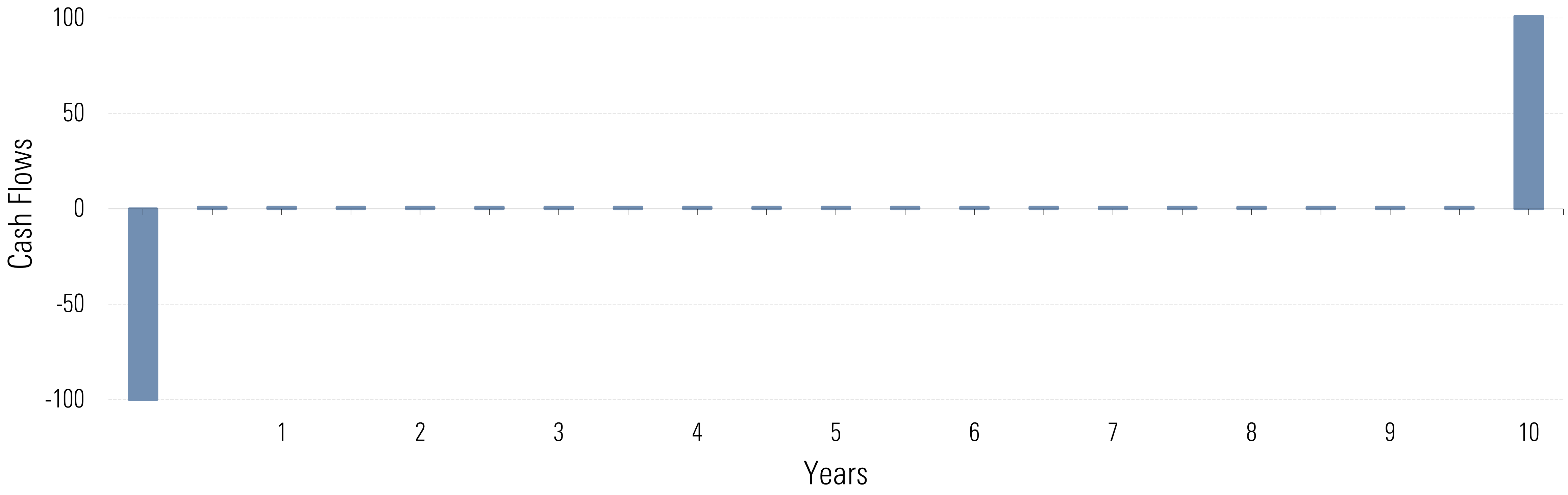
Basic bond mechanics

Cash flows from a hypothetical 10-year Australian Commonwealth Government Bond issued on 2 August 2016 at a yield of 1.82%.

Bond Cash Flows



Source: Morningstar Investment Management

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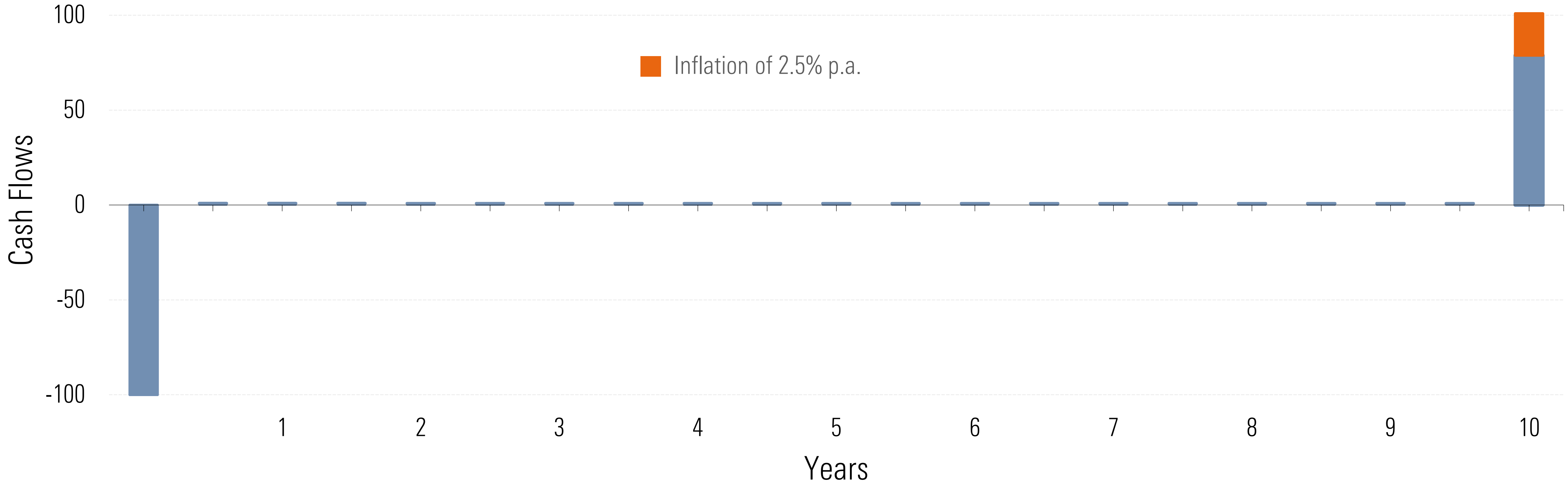
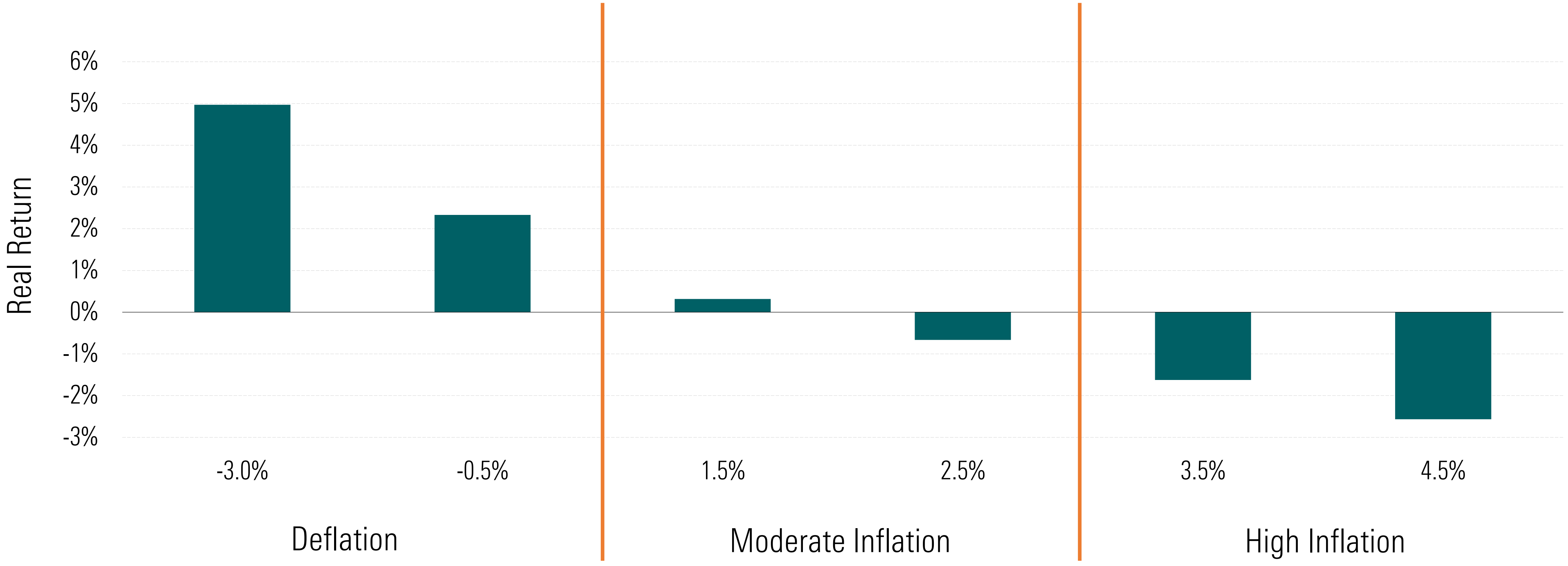


Source: Morningstar Investment Management

Why inflation matters….

Inflation is among the biggest unknowns when it comes to bonds. The below chart shows the real returns for different inflation outcomes. The example assumes a 10-Year Bond with coupon of 1.82% paid semi-annually.

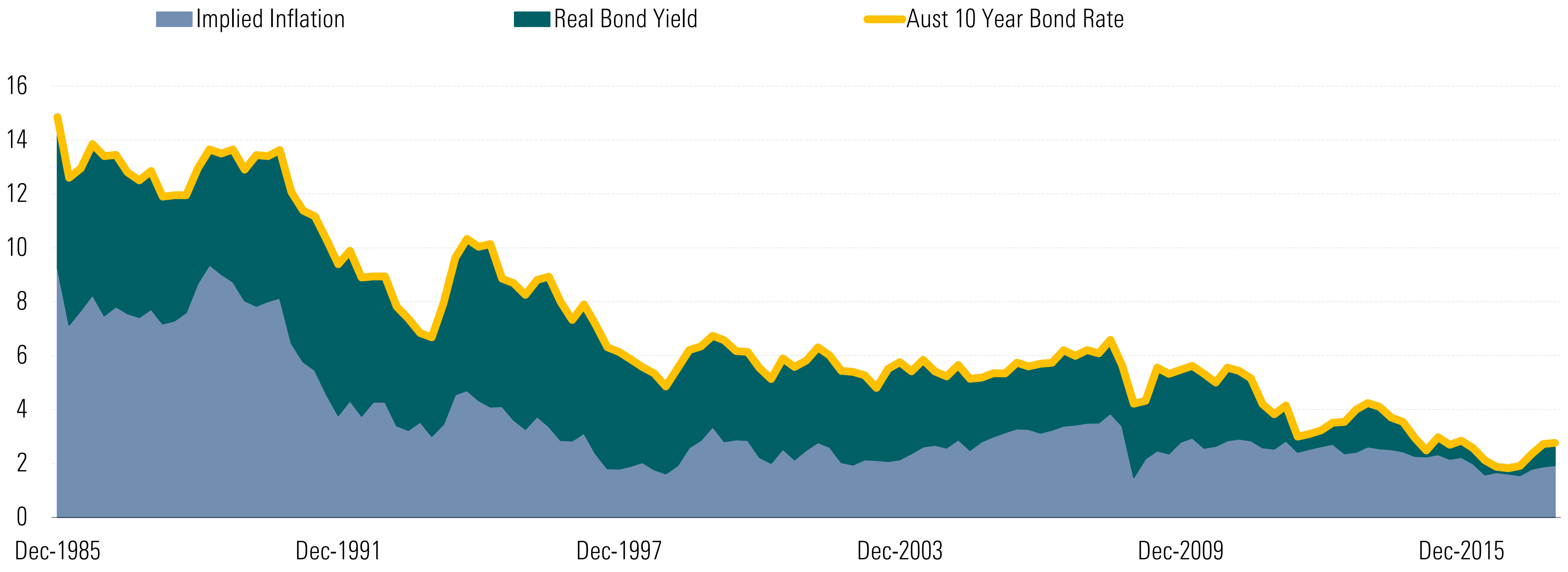
Real Return – Under Different Inflation Scenarios



Source: Morningstar Investment Management, RBA

Investors were accepting the prospect of almost zero real returns

Australian Commonwealth Government Bonds: 10-Year Yields

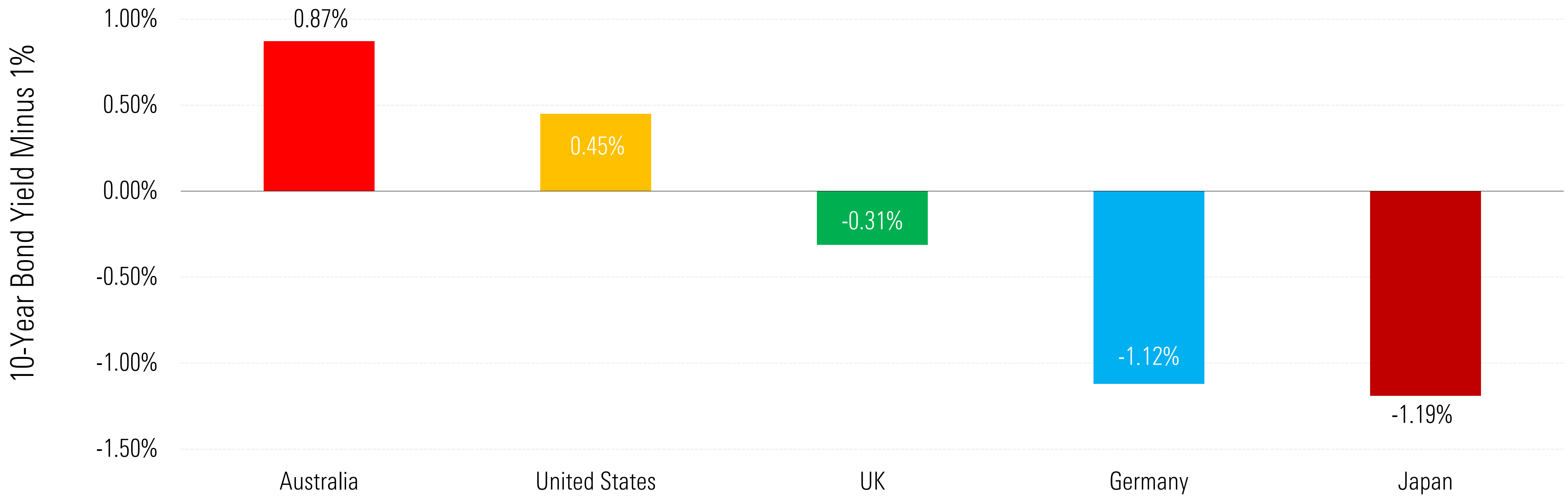


Source: Bloomberg. Data as at 31/12/2016 .

If you are lending money to someone for a long time, you would typically ask for a higher rate.

How low would cash rates need to be to achieve a 1% premium over cash?

Average Cash Rate over the Next Ten Years for 10-Year Bonds to Offer 1% Yield Premium (As at 31 July 2016)



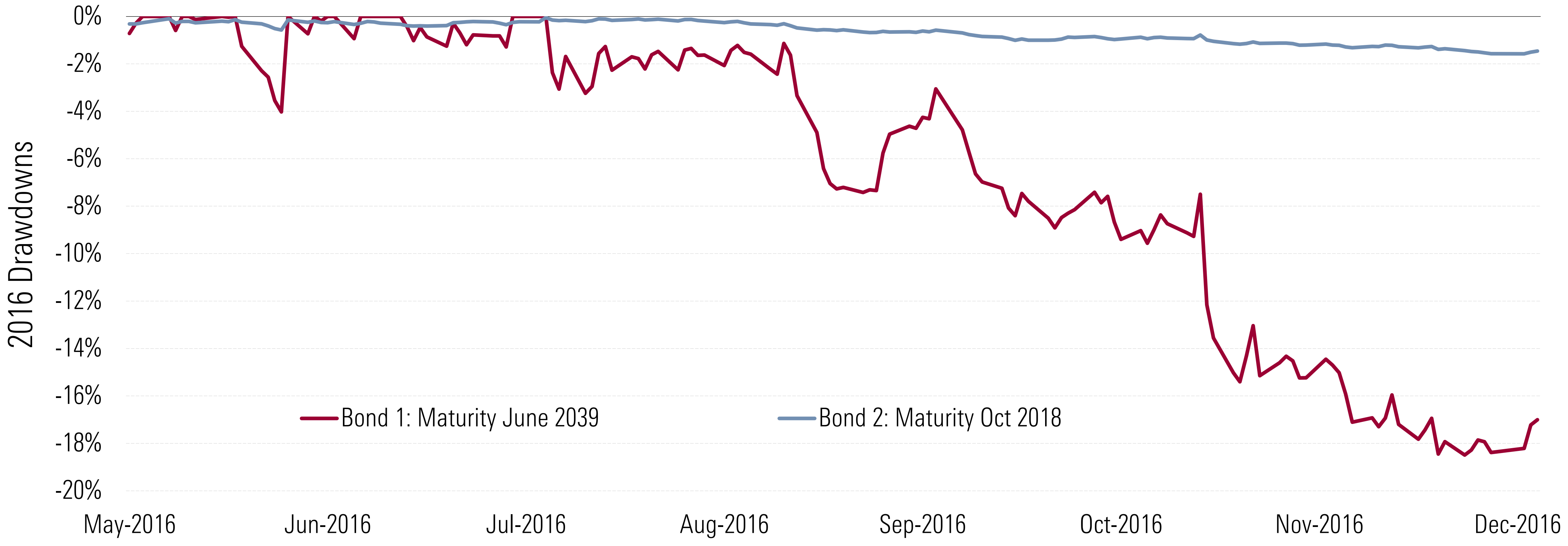
Policy Rate as at 31/07/16	1.75%	0.25% to 0.50%	0.50%	0.00%	-0.10% to 0.10%

Source: Bloomberg. Data as at 31/07/2016.

The longer the maturity, the more changes in yields affect prices

The graph shows the drawdowns in 2016 of two bonds with different maturity dates. Bond 1 matures in June 2039 while Bond 2 matures in October 2018. It highlights that rising yields affected the long maturity bonds much more.

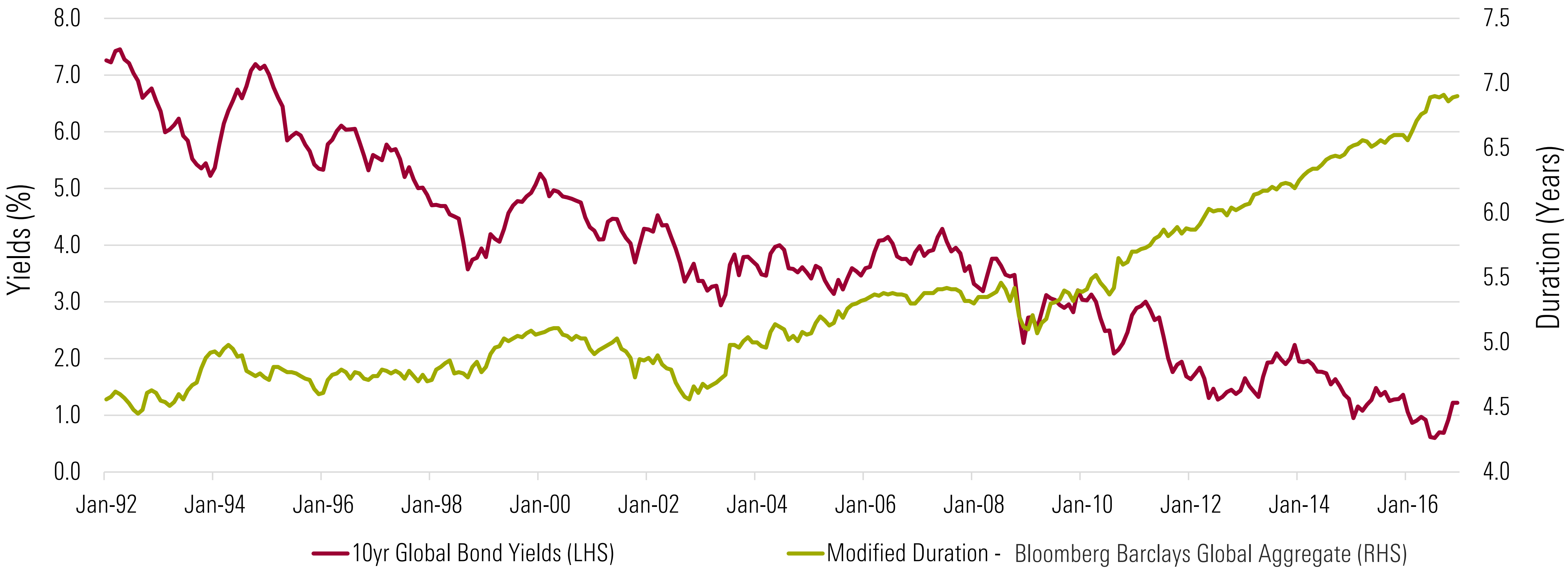
Australian Commonwealth Government Bonds: 2 Examples



Source: Bloomberg. Data as at 31/12/2016.

Lengthening duration combined with reducing yields meant higher risk

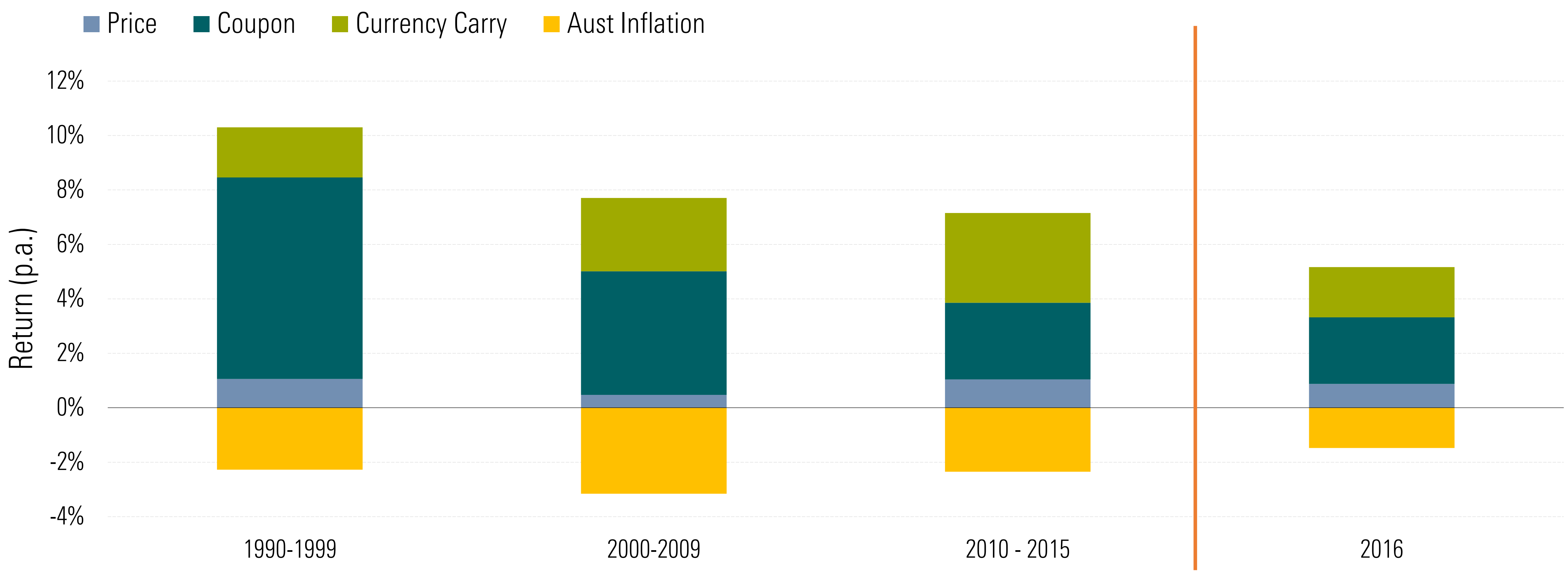
Global Bonds



Source: Bloomberg. Data as at 31/12/2016.

Returns from global bonds have been supported by currency hedging

Bloomberg Barclays Global Aggregate (Hedged)

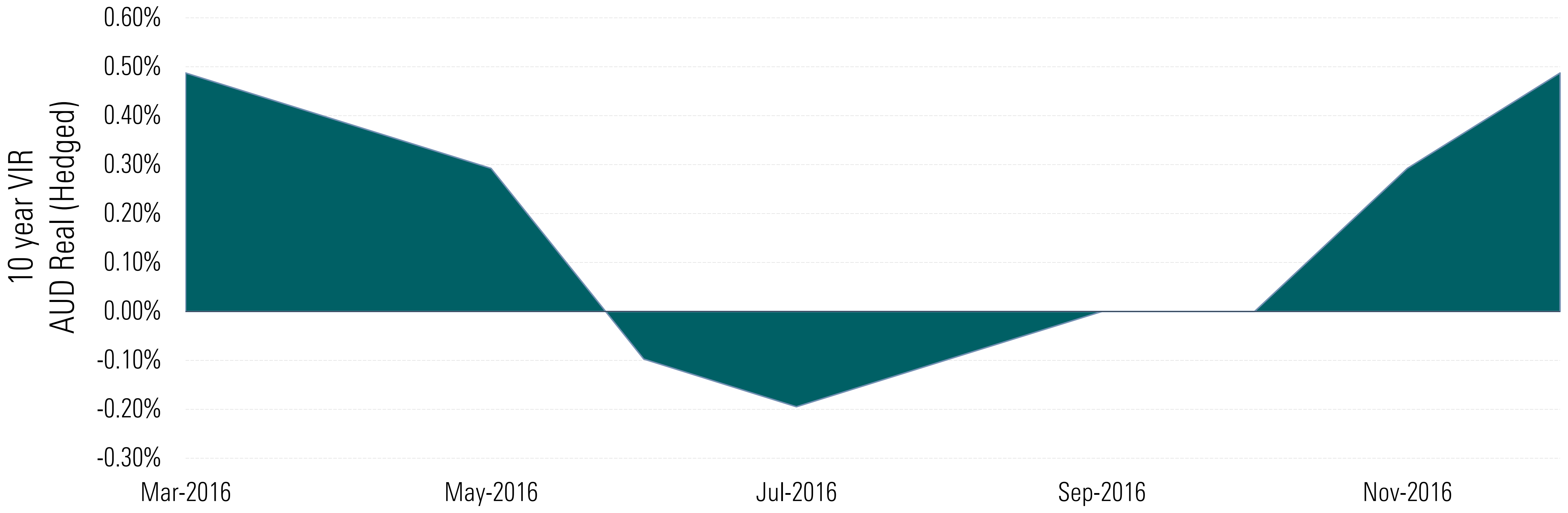


Source Omega Global Investors. Data as at 31/12/2016.

Expected returns throughout the year for global bonds

Expected returns for Global Bonds fell markedly throughout the year as yields reduced. Expected returns then improved again towards the end of the year as yields rose. The chart shows the expected real return including hedging.

Bloomberg Barclays Global Aggregate – 10 Year Valuation Implied Return (AUD Hedged, Real)



Source: Morningstar Investment Management. For illustrative purposes only.

Conclusion

- Point today wasn't that bonds are bad but they were bad last year. All assets go through cycles and periods in which expected returns are high and periods in which they are low.
- Just because a client is nearing retirement and needs to de-risk and reduce equity exposure or target income does not mean that they invest more in bonds no matter the price. Valuations do and always will matter.
- In the current challenging environment a set and forget approach is unlikely to suffice, making active valuation driven investing more important than ever. Markets can move quickly and portfolio exposures should reflect these changing prospects.

Important Information