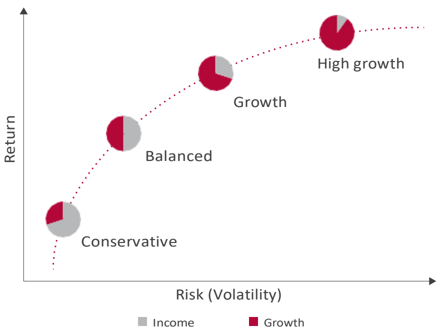
Independent Wealth Partners Asset allocation Report – September 2019



IWP's approach to asset allocation is to provide long-term returns that match investors' desired level of risk. The broad allocations to defensive (fixed income) and growth (equities) are the main factors influencing the risk/return profiles of our asset allocation strategies.

Our asset allocation approach is designed with a medium to long-term investor in mind (a time horizon of at least five years), reflecting the reality that the majority of Australian investors need to accept some market risk in order to reach their investment goals.

Why diversification matters

We believe that a successful investment strategy starts with an asset allocation suitable for its objective. In practice, diversification is a rigorously tested application of common sense: Markets will often behave differently from each other — sometimes marginally, sometimes greatly—at any given time.

Owning a portfolio with at least some exposure to many or all key market components ensures the investor of some participation in stronger areas while also mitigating the impact of weaker areas.

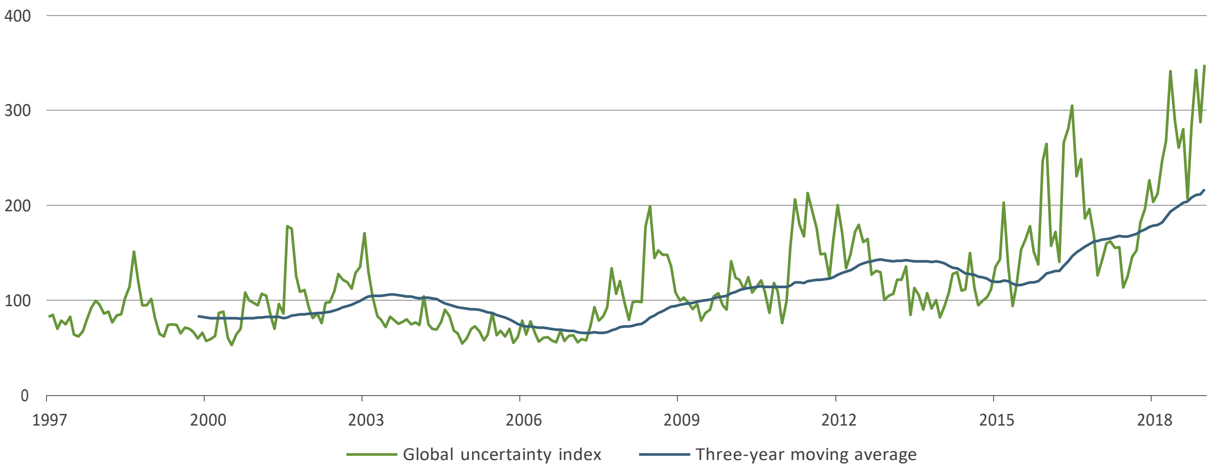
Many investors lack the time, interest, or skills, and can become overwhelmed by the choice of investment options, asset classes, and other implementation hurdles such as choosing between index and active management. Investors also face behavioural risks in adhering to their investment plan over time due to the temptation of performance chasing or overreacting to market events.

IWP's portfolios provide professionally managed portfolio solutions designed to help medium to long-term investors achieve their goals and overcome these challenges.

Quarter in Review

Uncertainty is the only certainty. Arguably, this phrase aptly describes how most investors felt in 2019. Rising recession risks, Britain's unclear path towards Brexit, and, especially, swirling US-Sino trade tensions have all left investors with a raft of questions to which there are no definitive answers. These concerns have been reflected in measures of economic policy uncertainty constructed from news stories around the world (**Figure 1**), with the index reaching its highest peak since 2012.

Figure 1: Economic uncertainty on the rise

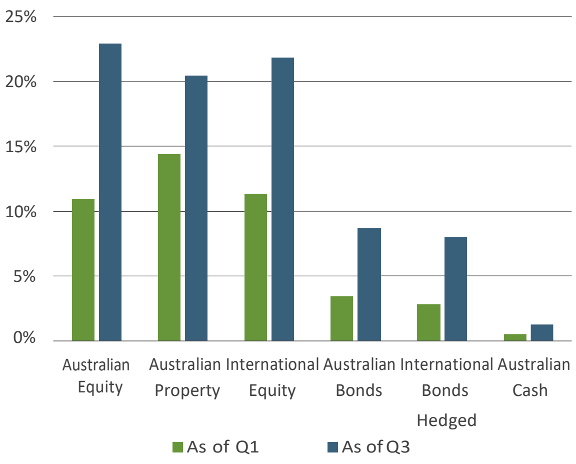


Notes: The World Uncertainty Index is computed by counting the frequency of "uncertainty" (and its variants) in quarterly Economist Intelligence Unit country reports for 143 countries from 1996 onward, adjusting for scale. A higher number means higher uncertainty and vice versa. Sources: Vanguard chart, based on data from policyuncertainty.com.

Under such circumstances, one would have expected to see equity markets in low or negative territory. **Figure 2** suggests otherwise. Despite elevated uncertainty, the investor who stayed the course would have managed to clinch more than 20% for equities and close to double-digit returns for bonds year-to-date, a combination not seen very often in today's low-return environment. One can attribute the simultaneous rally in equity and fixed income markets to investors revising downward their assessment of long-run policy rates in the world's major economies, and central banks agreeing with this recalibration by signalling a move to cut rates (**Figure 3**).

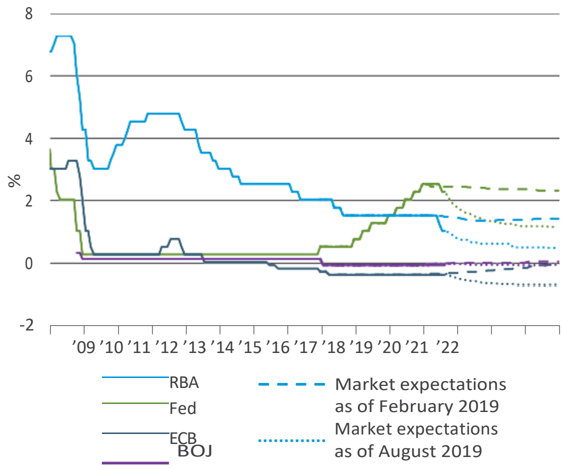
In the US, for instance, the Federal Reserve continued to lead the global easing cycle by reducing interest rates by another 25 basis points in September, marking the second cut this year intended to inoculate the US economy from persistent uncertainty and global headwinds. Shortly after, the European Central Bank joined the easing party by taking its deposit rate further into negative territory and restarting quantitative easing amidst growth concerns in its manufacturing sector. Even at home, the Reserve Bank of Australia eased monetary policy three times in the last five months and are expected to do so at least one more time within the next year given the lack of a strong alternative for spurring economic growth and inflation.

Figure 2. Strong performance amidst heightened volatility



Notes: Australian equity represented by S&P/ASX 300 Index, Australian property represented by the S&P/ASX 300 A-REIT Index, International equity by the MSCI AC World ex-Australia Index, Australian bonds by the Bloomberg AusBond composite 0+ Yr Index, International bonds by Bloomberg Barclays Global Aggregate Index Hedged in AUD, and Australian cash by the Bloomberg AusBond Bank Bill Index.
Source: Bloomberg, Factset.

Figure 3. Global monetary policy has turned accommodative

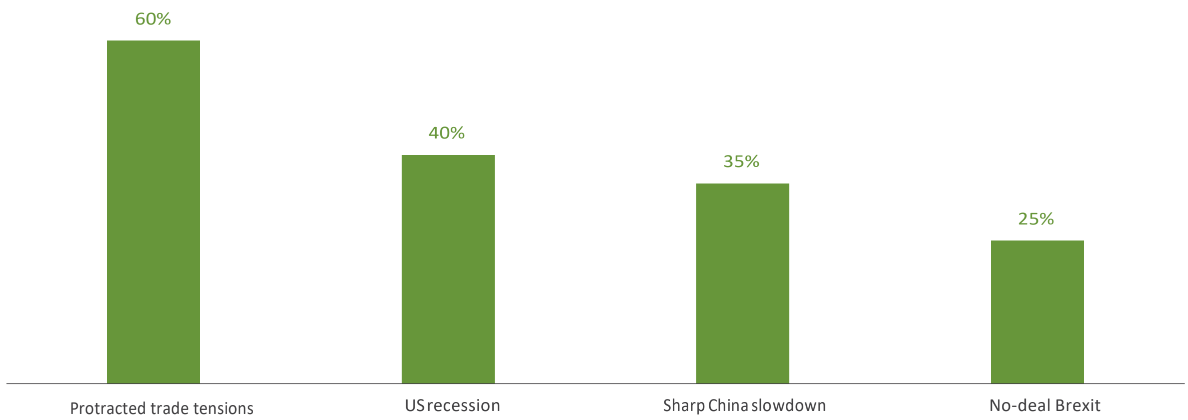


Notes: Market expectations are reflected by Overnight Index Swaps (OIS).
Source: Bloomberg, Factset.

Economic outlook

The shift to a more accommodative monetary policy stance globally should insulate Australia and the global economy from a recession in the near-term, resulting in a “muddle through” scenario for the rest of this year and further out in 2020. That said, investors should brace themselves for periodic “growth scares,” given numerous black swan events on the horizon (Figure 4). The most prominent of these are the trade and technology disputes between the US and China. Unlike conventional wisdom, we do not view these tensions as merely cyclical and resolvable by China buying more American goods to narrow the trade deficit. Rather, the primary battle is targeted more on long-term issues and is going to be much more strategic and prolonged, focused on fundamental issues to the structure of the Chinese economy. Hence, although a comprehensive trade agreement could be reached eventually, the bumpy path of negotiation between two of the world’s superpowers will continue. In other words, uncertainty is not likely to go away in the near-term.

Figure 4. Top global risks



Source: Vanguard.

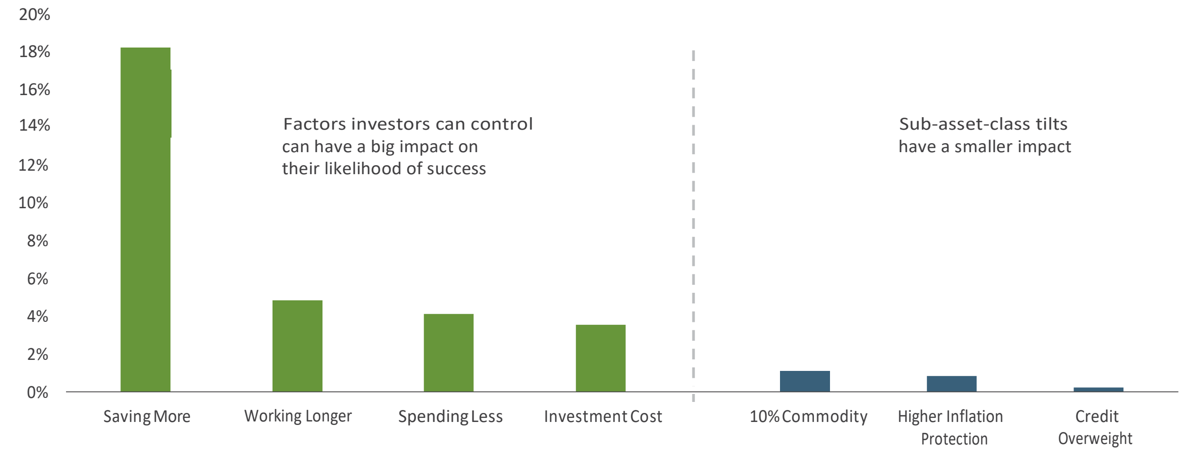
Rather than trying to avoid or discern how uncertainty will play out – a more sound way to future-proof your strategy will be to learn how to adapt to it.

One way to start would be to accept the limitations of our ability to predict the future. “Misguided convictions” or playing the market can often lead to suboptimal investment decisions, be it through the adoption of a higher- than-tolerable risk profile or turning over one’s portfolio more frequently than necessary. Both cases tend to lead to a subsequent reduction in returns, with previous research finding a strong negative correlation between the rate of trading activity and returns[1].

Once we are able to acknowledge our behavioural biases, we can adjust our approach accordingly. For one, we’ll be more inclined to hold diversified portfolios so that risk is not concentrated in any particular area. Framing portfolio discussions in terms of long-term goals and the total wealth picture can also resist the natural tendency to “over-evaluate” individual investment holdings and time the market. Instead, one would be encouraged to put their trust in factors that are within their control – such as saving more, working longer, spending less, and controlling investment costs. Figure 5 illustrates that these factors far outweigh the less reliable benefits of ad hoc return-seeking tilts.

1 Barber and Odean, “The courage of misguided convictions”. 1999, Association for Investment Management and Research.

Figure 5. Ways investors can raise their odds of investment success



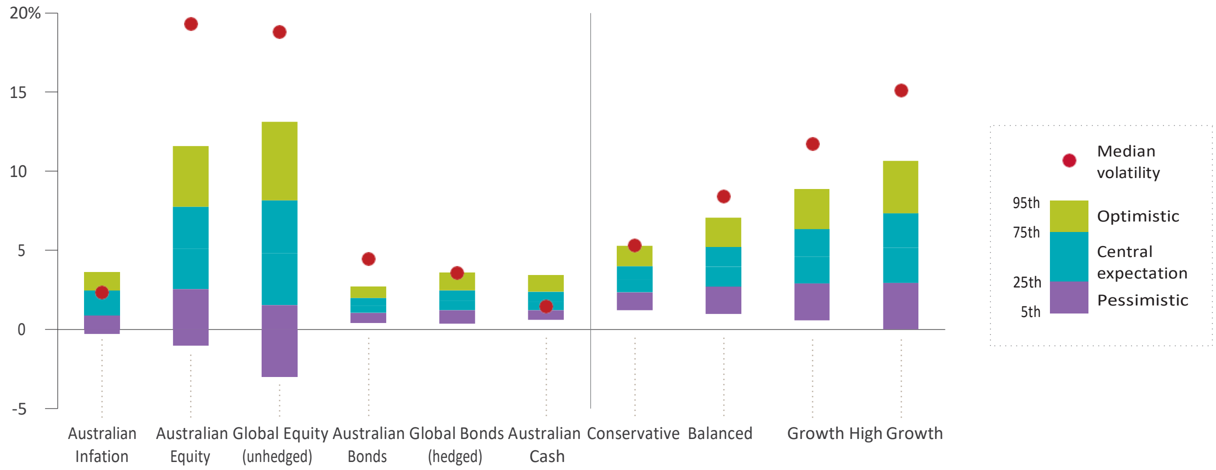
Notes: Probability of success is defined as the probability of having a positive balance in a target-date fund at age 95, based on specific savings and spending assumptions. Data show the impact of each factor changing from low (the 25th percentile of broad population data) to medium (the 50th percentile). VCMM simulations are as of March 2016. Investment cost is the relative impact on the probability of success of a target-date fund with a 50-basis-point higher fee or investment cost. For details, see Vanguard Life-Cycle Investing Model: A Framework for Building Target-Date Portfolios (Aliaga-Díaz et al., 2016).
Source: Vanguard US.

Ultimately, our economic outlook suggests a somewhat more challenging and volatile environment ahead. Yet, the principles of investing suggest that investors with an appropriate level of discipline, diversification, and patience are still likely to be rewarded over the long term. Adhering to investment principles such as long-term focus, disciplined asset allocation, and periodic portfolio rebalancing will be more crucial than ever before in these times.

Long-term market outlook

The chart below shows the Vanguard Capital Markets Model® (VCMM) return forecasts over the next 10 years for a range of asset classes and Vanguard's Diversified Funds which we use as a proxy for our portfolios.

Figure 6. Projected 10-year nominal return outlook



Source: Vanguard, 30 June 2019 VCMM Simulation.

It shows two concepts: the range of annualised 10 year nominal returns and the median volatility experienced. The bars show the range of return outcomes over a 10 year period. The central return expectations for the asset class or portfolio are shown in the middle of the bars. Observations in the optimistic or pessimistic regions should not come as a surprise though; goals and portfolios should always be positioned with these possibilities in mind.

The red disks show the median volatility forecasts. This represents the volatility of the asset classes that can be expected over the 10 year period. The chart shows that equities are expected to produce a higher return over a 10 year period than bonds, however the trade-off is that an investor can expect a more volatile experience and greater uncertainty over the end point, which could be a much wider range of outcomes.

An important point to remember is that asset returns are not perfectly correlated, which means that if an Australian equity return over 10 years is in the optimistic range, this does not necessarily mean that Australian bond returns will also be in the optimistic range. Combining assets can therefore present strong diversification benefits.

The next charts show the trade-off between targeting a CPI+ return target and the risk of a loss along the way. Taking more risk means that an investor increases the probability that they will achieve their target over 10 years. Highlighting the importance of managing expectations, it also means there is the increased probability of experiencing a negative return or a large annual loss in at least one year over the 10 year period.

Figure 7. Probability of achieving real return target

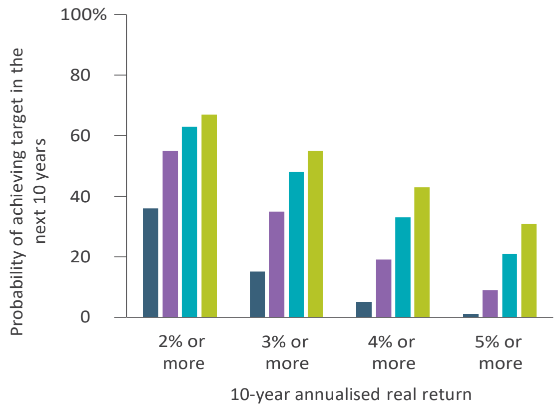
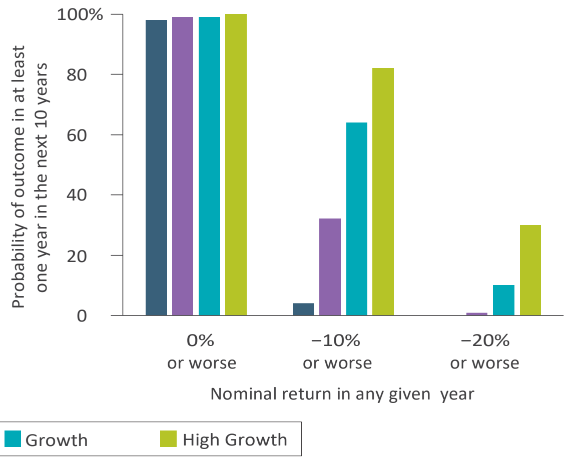


Figure 8. Downside risks



Note: The projections or other information generated by the Vanguard Capital Markets Model (VCMM(regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modelled asset class in AUD. Results from the model may vary with each use and over time.
Source: Vanguard, 30 June 2019 VCMM Simulation