Horizon Wealth’s commentary following recent market volatility

11 December 2018

HORIZON
WEALTH MANAGEMENT

1. EXECUTIVE SUMMARY

A 10-year run of broadly increasing asset prices and reasonable portfolio returns has experienced a material hiccup since early October.

- We are aware of the extent to which this plays out in the news media and, unfiltered, may cause a sense of unease amongst some investors.
- We take our responsibility to support the achievement of your long-term objectives seriously and see ourselves as your partners in this journey.
- We act as your adviser from a strategic perspective (incorporating the optimisation of superannuation, financial planning tax strategies and life risk (insurance) mitigation, where applicable). Concurrently, we are wealth managers, seeking to construct your portfolio in a manner which supports the achievement of your objectives: in line with *your requirement for, your capacity for, your understanding of, and your attitude toward investment risk.*

We seek below to provide a jargon-free, readable summary of and context to, current events and considerations for your portfolio.

We aspire to educate our clients, and support them in making informed decisions regarding their financial affairs.

1.1.Chart 1

Global Equity Indices 1 January – 5 December 2018

The Chart above and those that follow reference the following market indices all in Australian Dollars, unless otherwise indicated.

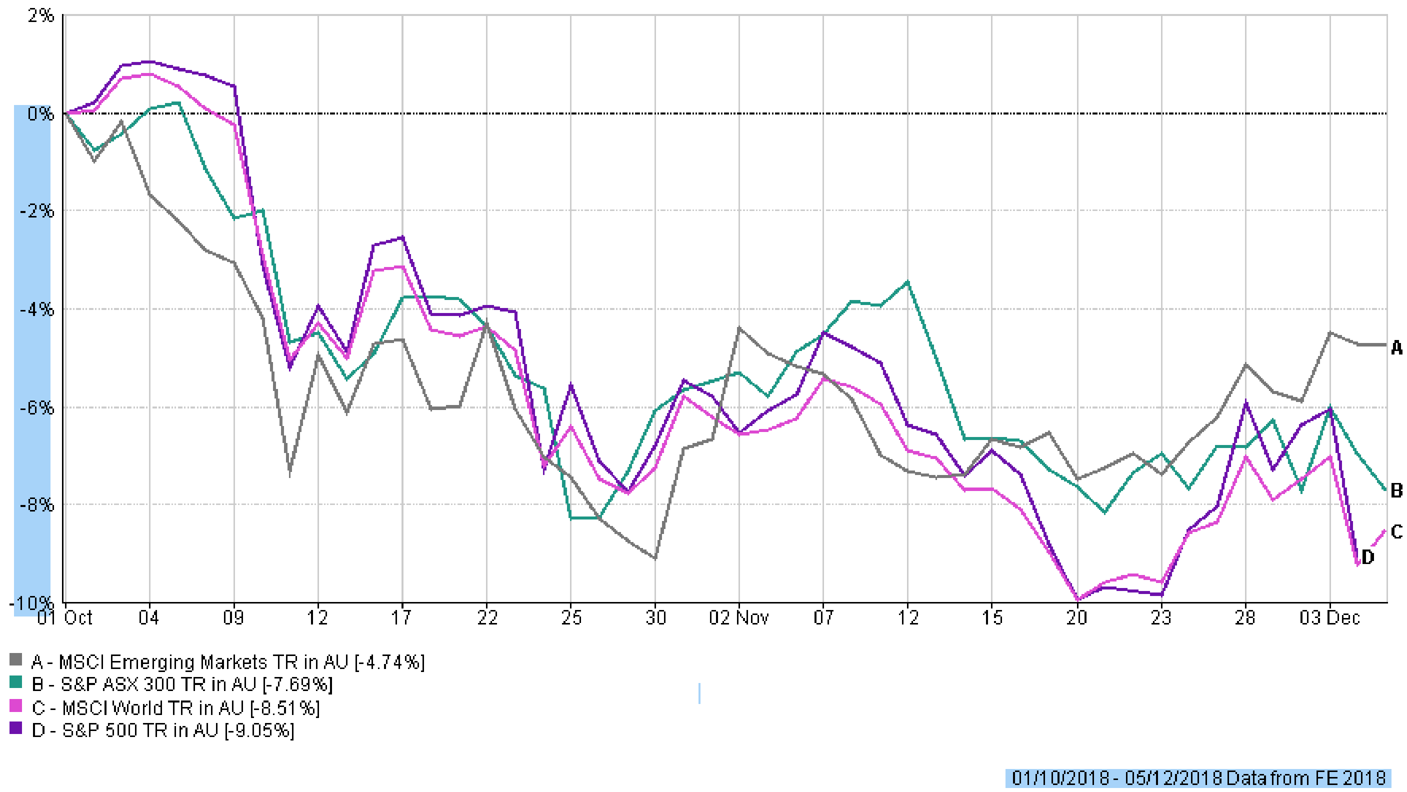
- *MSCI Emerging Markets* — ***Emerging Market Equities***
- *S&P 500* — ***Top 500 US Companies***
- *MSCI AC World* — ***Global Equities ex Australia***
- *S&P ASX 300* — ***Top 300 Companies listed on the ASX***

2. RECENT VOLATILITY

It is clear from **Chart 1** above, and **Chart 2** below, since early October, asset values have experienced a material correction - Down 5% to 10%.

2.1.Chart 2

Global Equity Indices 1 October – 5 December 2018



3. WHAT IS GOING ON?

3.1.The GFC, Low Interest Rates and Quantitative Easing

The Global Financial Crisis was a massive – twice in a century event. The other being the Great Depression in 1929 – 1939.

It was caused by a gradual, and then complete loss of trust and confidence in the financial system in the US and Europe over the period leading up to, including, and immediately following the collapse of Lehman's in September 2008. This lead to rapid knock-on effects on the real economy globally, contributing to significant declines in economic activity, increases in unemployment and a significant decline in asset prices *(the Dow Jones Industrial Average dropped by 54% from October 2007 to March 2009).*

Having learned the lessons of the Great Depression in the 1930's the Reserve Banks of the world flooded the markets with cheap money; by rapidly reducing interest rates, and commencing various stimulatory programs, including quantitative easing. By lowering the cost of money, the hope was to get businesses borrowing - and the banks' lending again – thereby promoting economic growth.

The strategy was initially slow to make an impact but has been gathering speed over the years, with ex-Federal Reserve Chair Ben Bernanke signalling the beginning of the end of US QE in June 2013 – which finally ended in October 2014.

Global Growth, and in particular US GDP growth, has recovered with commensurate improvements in corporate profits, declines in unemployment, and very little sign of inflation.

Wage growth has however, not recovered in the developed countries, leading to increasing dissatisfaction with the economic status quo by the middle classes – and consequent political upheaval apparent in Brexit, Trump, Europe, Australia and elsewhere.

Whilst wage earners have struggled to share in the upside of this growth cycle, asset owners have benefited tremendously – as low interest rates have had the effect of driving up asset prices.

3.2.Interest Rates and Asset Prices

Asset values (Investments) are a function of an assessment of the value today, of the expected returns from an asset over a period of time. This comprises income over the investment period plus the final return of capital at the end.

A good way of thinking of this – and the impact that interest rates might have on the valuation of these expected cash flows, is to consider the following example:

- Assume you hold an Australian Government security that pays you $10,000 per annum in interest forever – unless you sell it.
    - **What is the value of this security if risk-free interest rates are 10%? 5%? 2%?**
        - *Without going through the maths:*
            - If interest rates are 10% then an asset with a value of $100,000 delivers a return of $10,000 per annum;
            - If interest rates are 5% then the same asset must be worth $200,000 i.e. $200,000 * 5% = $10,000; and
            - If interest rates are 2% then the asset is worth $500,000 i.e. $500,000 * 2% = $10,000.

Note how, ***over a period of declining interest rates***, the investor receives a fixed amount of income each year, but the ***valuation of the investment is increasing***. This increase in value represents the capital gain, which - until sold – is the unrealised capital gain an investor receives from a rise in the value of the asset. The total return on the investment in any given year is therefore the income received plus the capital gain – whether realised or not.

Conversely, ***in a period of rising interest rates***, the income continues - but ***the valuation of the asset drops*** – with the extent of the decline linked to the extent of interest rate increases.

3.3.Leading up to October 2018

Over the last 2 years or so there has been increasing economic growth and activity with positive effects on corporate profits. Unemployment has been decreasing gradually, forcing employers to compete with each other, slowly increasing wage rates.

Wage rates drive up costs, which companies try to recover by increasing prices and so commences the inflation cycle.

The US Federal Reserve has been gradually increasing interest rates with a view to slowing economic activity in a measured way so as to prevent the inflation cycle from taking hold.

The net effect has been the interaction of two opposing forces affecting the outlook for asset prices.

These forces are – increasing corporate profits (increasing expected returns) - and increasing interest rates (devaluing the capital value of those increased returns).

In any market, there are buyers and sellers with opposing views on the valuation of assets – based on their own prevailing view. Everyone has mostly the same data – just different views regarding the future.

Considering that ***approximately 315 billion shares are traded in 69m daily trades on global stock exchanges every day*** (excluding another $1.1 Trillion in options + $1.4 Trillion in futures trades every month)[1]– share market values represent the majority view (buyers/sellers) at any point in time.

For the past 18 months or so those who have backed the 'c*orporate profit growth story'* (buyers) have overwhelmed those with the 'interest *rate increase story*' (Sellers) – and hence equity markets have performed strongly – until October 2018.

3.4.The only way is up?

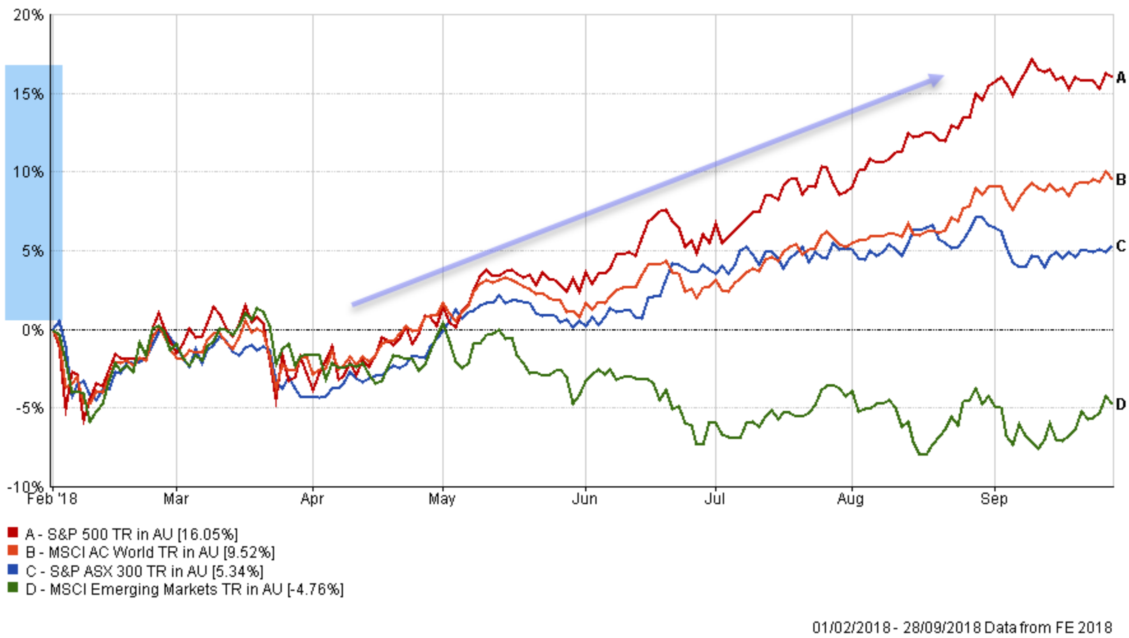
Record corporate profits were reported in the US in October (partially due to the reduction in corporate tax rates in the US). The expectations of these increased profits were reflected in the performance of equity markets (except emerging market equities)[2] in the lead up to October – shown in **Chart 3** on the next page:

1 World Federation of Exchanges November 2018.

2 Which declined because of increasing interest rates in the US making USD investments relatively attractive.

3.4.1.Chart 3

Global Equity Indices 1 January to 30 September 2018



On the 4th October 2018, near record low unemployment rates and signs of wage inflation lead the current Chair of the Federal Reserve, Jerome Powell to make the comment that "We (the US) are a long way from neutral on interest rates", ***indicating that interest rates may increase higher and perhaps faster <u>than what markets expected</u>. Interest rates spiked upwards.***

3.4.2.Chart 4

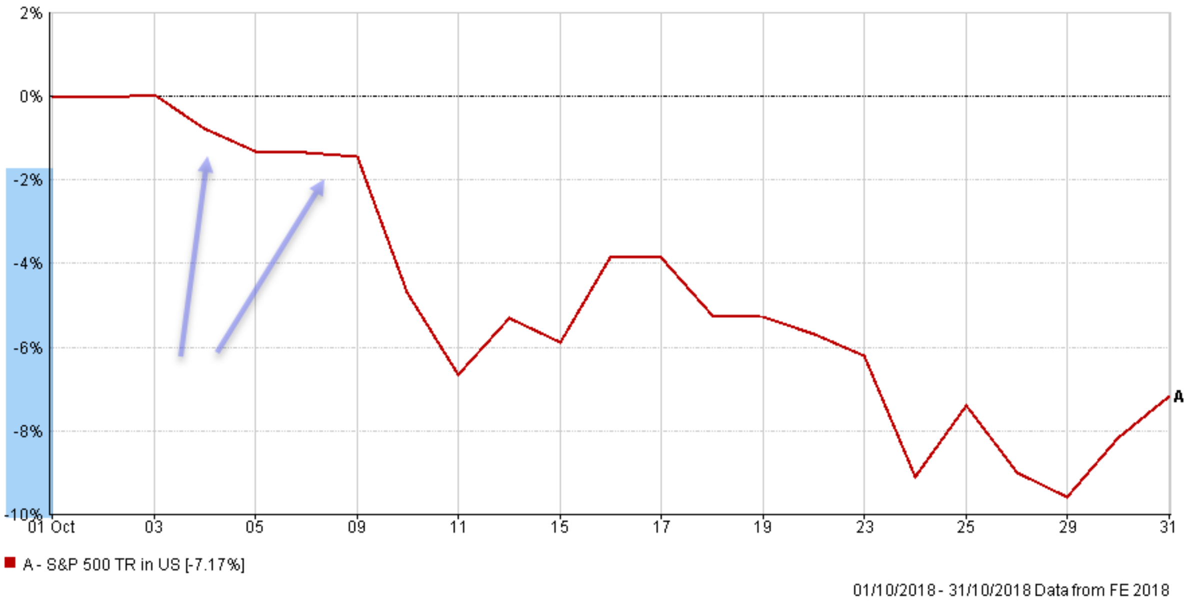
US 10 Year Treasury Yields %

3.5.Perhaps not.

With Jerome Powell's comment, the predominant perception of investors became one of higher interest rates, earlier than expected – and a **commensurate drop in the valuation of assets** – shown in **Chart 5**.

3.5.1.Chart 5

US S&P 500 Index - October 2018 in USD



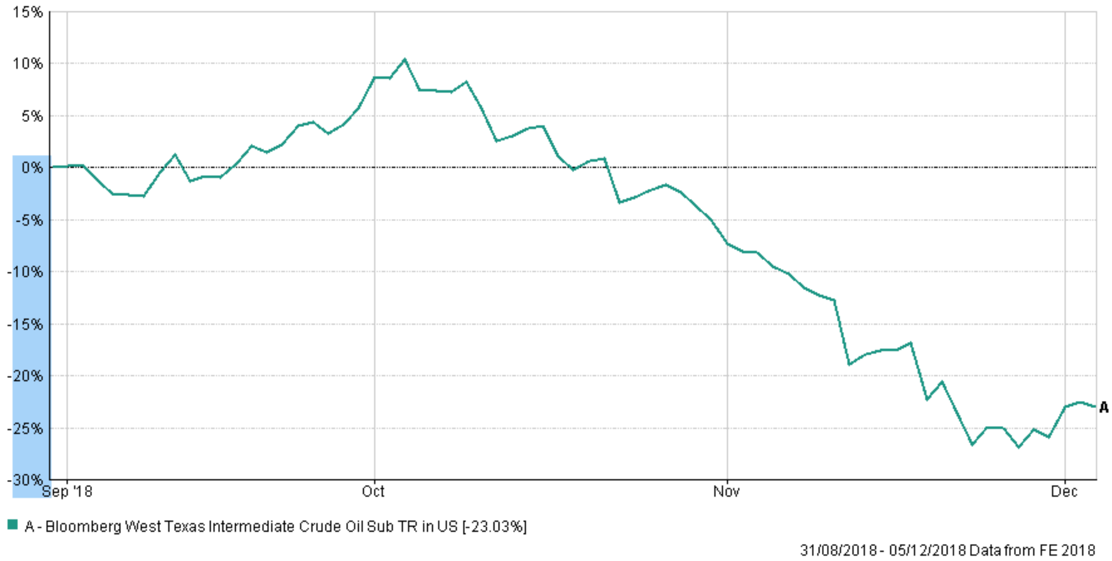
What is truly incredible – and shows how quickly thangs can change – is that the initial correction in October was a result of concerns around rapid economic growth in the US, leading to inflationary expectations and increased interest rates.

But then, suddenly in November certain key indicators suggested that in fact we had seen the best of global growth, and ***a US recession / global slowdown may be on the horizon***!

*See the rapid decline in the price of Oil (a good indicator of supply and demand imbalances in the global economy) in **Chart 6** on the page below.*

3.5.2.Chart 6

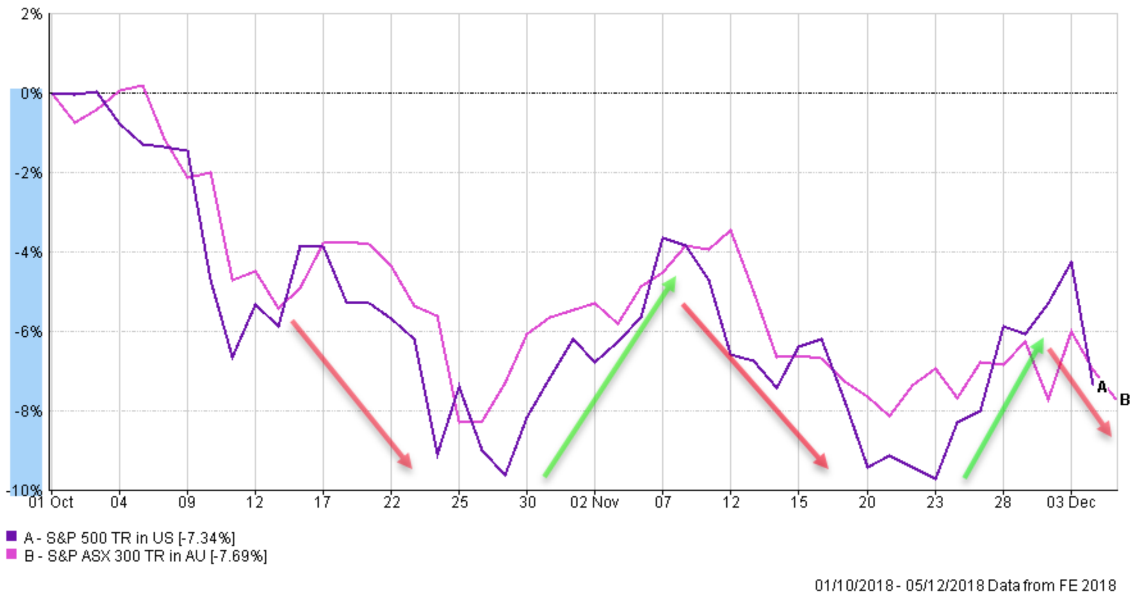
Oil prices – September to December 2018



The expectation of slowing economic activity suggests that *expected future returns from assets may decline*, and - while expectations of the **extent** of interest rate increases declined as well - the ***'lower growth story'*** partially overwhelmed the '***perhaps interest rate increases won't be as much as expected story'*** – with the duel between the opposing views reflected in the degree of volatility shown in **Chart 7** below.

3.5.3.Chart 7

US and Australian Equities – Local Currency – October to December 2018



Short–term investing (*or speculation if you prefer*) is a confidence game; and people are inherently wired with *confirmatory bias* – ***"the tendency to search for, interpret, favour and recall information in a way that confirms one's pre-existing beliefs or hypotheses".***

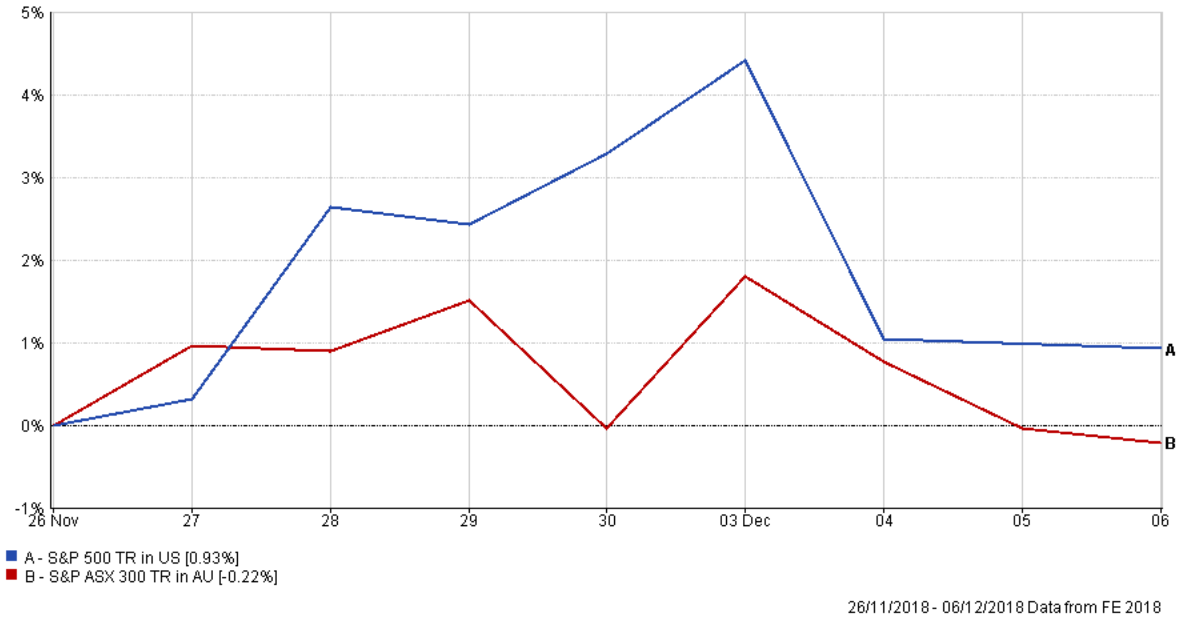
And so, with uncertainty regarding the economic growth story and the direction of interest rates, the impact of geopolitical factors has been magnified to the negative.

Market behaviour in the week leading up to and after the G20 meeting held on 1st and 2nd December 2018 – at which the US-China Tariff war loomed large - is a wonderful example of market skittishness – well displayed in **Chart 8**.

Hopes in the lead-up, initial relief on the 3rd December and then the re-emergence of doubts and fears.

3.5.4.Chart 8

Fear / Relief / Fear - Before and after the G20 meeting



In the meantime, companies throughout the world have continued to go about their business, making investments, generating profits, distributing a proportion of their earnings to shareholders (called dividends) and preserving a portion for future investment. These investments are only made if companies can generate a return that exceeds their cost of capital – which is another story.

Forecasts (for what they are worth) suggest a decline in US earnings growth – from approximately 23% in 2018 to 10% in 2019[3] – with a broad variation among market participants from higher growth expectations to lower growth expectations.

4. THE BIGGER PICTURE

There is currently much uncertainty; and each day that brings another decline is unsettling.

Psychologically, ***"the (discomfort) one experiences in losing a sum of money appears to be greater than the pleasure associated with gaining the same amount"***[4]. Even if the loss is notional not real; i.e. unrealised as opposed to realised.

A loss or gain is only realised when an investment is sold and converted to cash. **The key is never to be a forced seller.**

It is important therefore to maintain a sense of perspective, and review market performance over time.

The performance of the Dow Jones Industrial Average from **1915 to November 2018 follows in Chart 9 on the following page.**

The key take-outs from **Chart 9** are that despite ***many periods of crises*** – wars, famines, epidemics, terrorist attacks, assassinations, genocides, political crises etc. **- *as long as global economic participants are free to create new wealth through innovation and competition, stock markets will rise in the longer term*** – shaking off bear markets and corrections.

That said, it is important to note that:

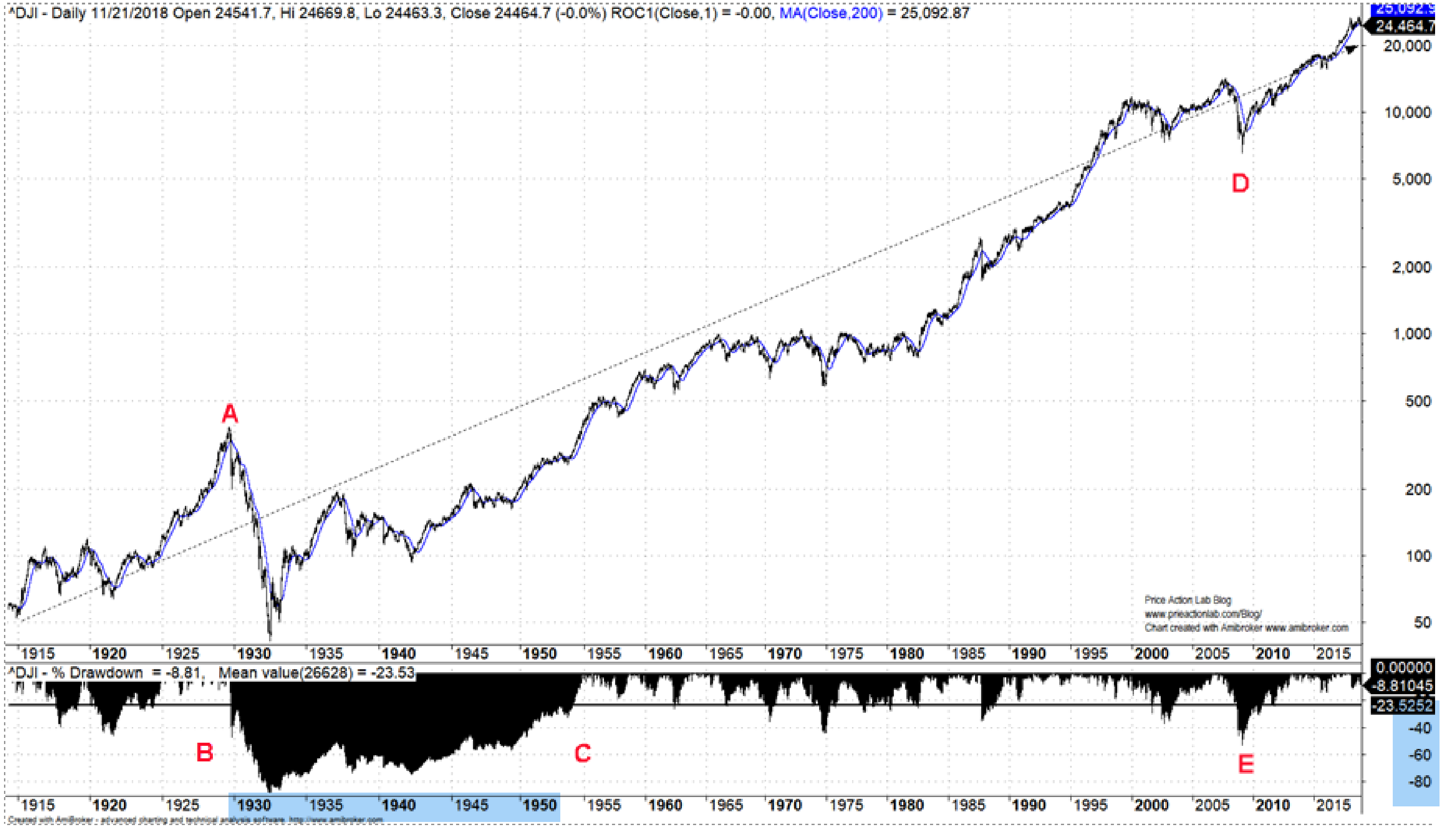
- Crashes can destroy wealth (80% from 1929 through 1933);
  - Poor policy response can extend the recovery period to years and even decades (1930 through 1952 / 53);
- The 20th Century was largely built off the growth and economic development of the US and Europe;
- The late 20th Century saw the emergence of China and now India – whose individual populations are far larger than either the US or Europe.

Finally, there really is no guarantee that the past can be relied upon as a reliable indicator of the future. That is why there is risk, and why we expect a higher return for perceived higher risk.

3 Reuters, October 11 2018

4 Khaneman &Tversky, 1979 p29

4.1.1.Chart 9: US Dow Jones Industrial Average 1915 to November 2018



A: Immediately before the Crash of '29 **B**: Start of the Great Depression **C:** 20 Years for the US market to reach its 1929 Peak

D:The Collapse of Lehmans and the GFC **E**: The success of Monetary Intervention – limiting economic dislocation

5. YOUR RESPONSE

You may ask whether one should be moving to a more defensive position within your portfolio by decreasing your exposure to growth assets for the time being?

Given that the future is unknown – and that markets can shift from positive to negative to positive very quickly (July to September, and October through December are a case in point), this approach may be positive or may be negative – but it is impossible to know in advance.

There are three decisions one has to make in order to be a successful market-timer

- When to invest,
- When to exit (sell), and
- When to re-invest.

Empirical evidence shows that the great majority of institutional and professional investors cannot get this right consistently, with *time in the market* overriding *timing the market* as the more successful approach to investing.

What really matters though is **your personal assessment** of the following:

- Your current and likely financial position, income and employment position in 10 or 15 years' time;
- Your family situation at that time (in terms of financial support for dependants and other factors);
- Your objectives for your retirement; and
- Your attitude to and psychological approach to periods of market volatility.

6. OUR APPROACH

We manage portfolios to objectives, and not short-term market movements. We do make asset allocation adjustments between Cash, Fixed Interest, Listed Property, Infrastructure, Australian, Global and Emerging Market equities from time to time – based on long term secular factors - rather than short term cyclical factors.

In addition, we continuously review our recommended fund managers to ensure that they are delivering according to their mandate.

We structure portfolios with allocations to growth and defensive assets, with adequate defensive assets being used to limit the probability of being a forced seller – leaving time for growth assets to recover from periods of weakness, before being called upon to support cash flow requirements or legacy objectives.