

NEWSLETTER
July 2019

HUTTON
FINANCIAL

Introduction

Happy new financial year! In this special newsletter, we give a comprehensive analysis of the performance of the Australian sharemarket over the financial year that has just ended. As you will see, the year was a 'good average' one. In our next newsletter, we will provide a comprehensive analysis of the Australian property market over the same time period. Enjoy

Famous (Australian) People in Finance – H.C. (Nugget) Coombs

Herbert Cole 'Nugget' Coombs was the first Governor of the Reserve Bank of Australia (1960-1968). Coombs was born in Western Australia and studied both there and at the London School of Economics. In the mid-1930s he moved to Canberra where he commenced working in the Commonwealth Public Service. During WW2, he was in charge both of rationing in the Australian economy and of the process of rebuilding the Australian economy when the war eventually ended.

In the post-war period, he was a trusted adviser to both the Chifley Labor Government and the subsequent Menzies Coalition Government. Following his time at the RBA he headed both the Council for Aboriginal Affairs and the Australian Conservation Foundation. He died in 1997.



Shane Neaves

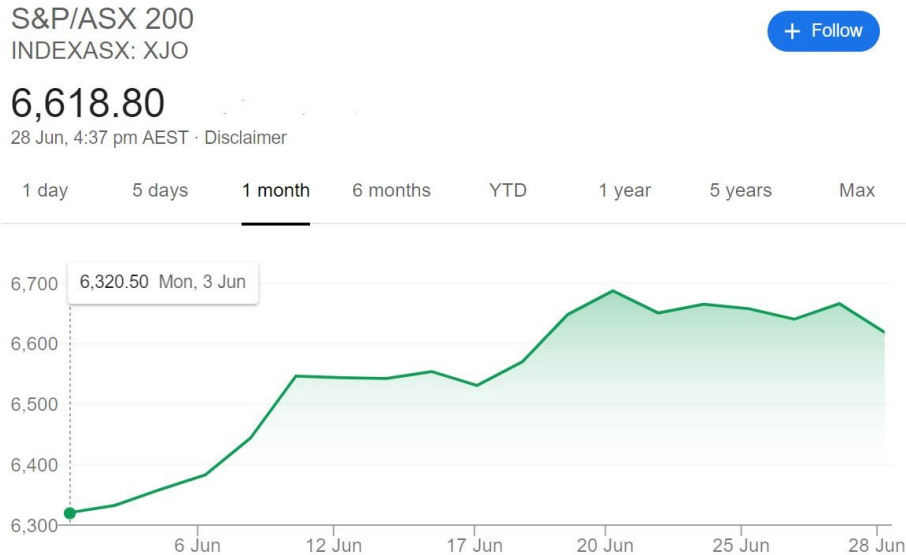
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The Share Market

If you already own shares in the Australian market, then June 2019 was probably a good month for you. The market rose by 4.7% as measured by the ASX 200, as shown in this graph sourced from Google:



The ASX 200 index for the Month of June, 2019. Source: Google/ASX.

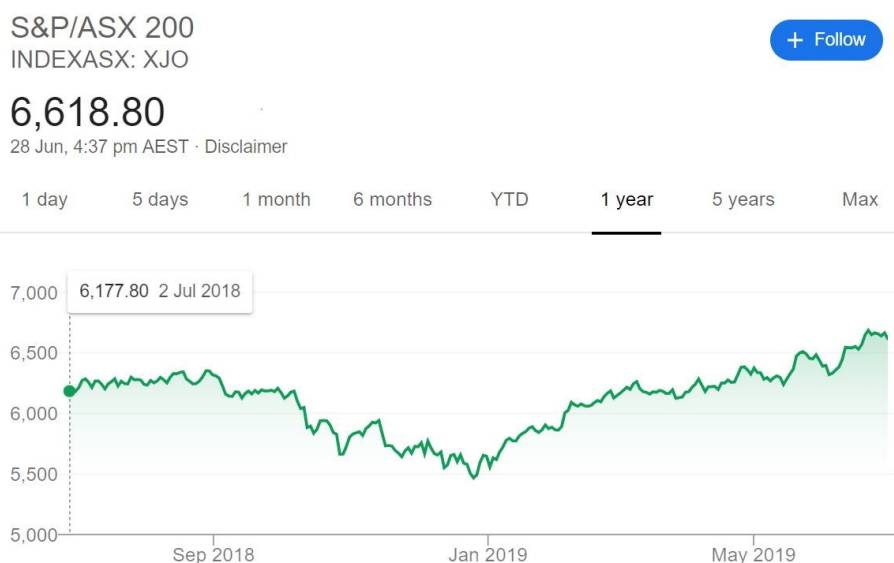
As you can see, the month was really one of steady upward pressure on prices. 4.7% might sound like an outstanding month for shareholders. However, once again, the Australian market was not quite as good as the experience in the US market, as measured by the S&P500 index (once again, thanks to Google):



The S&P500 Index (US) for the month of June 2019. Source: Google/Standard and Poors.

We have written before about the paradoxical performance of the Australian and US markets in the 10 years since the global financial crisis. While the US market was hit much harder during the GFC, its rate of recovery since then has substantially outpaced that of Australia.

June was, of course, the last month of the 2018/2019 financial year. The performance of share prices in June added to a general increase in prices throughout that financial year. Once again, Google provides a comprehensive indicator of the performance of the ASX 200:



The ASX200 for the 2018/2019 Financial Year. Source: Google/ASX.

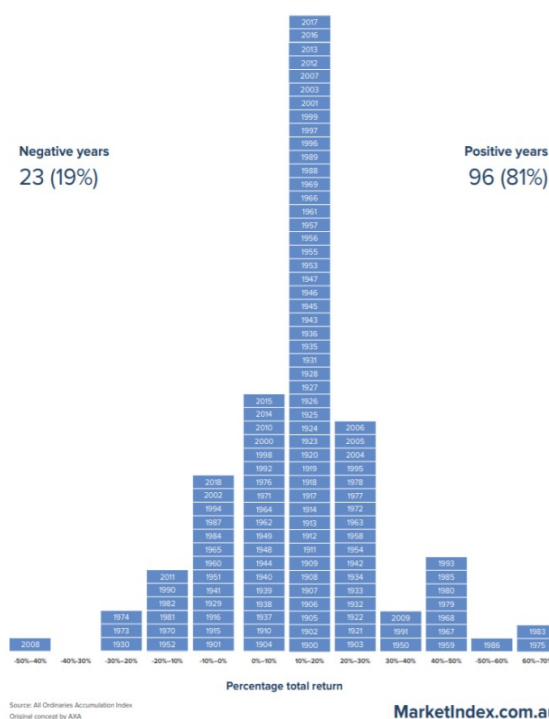
Across the entire 12 months, the market rose by 7.1%. As the graph shows, however, the market spent the first half of calendar year 2019 recovering from falls in prices during the December quarter of 2018.

The rise of 7.1% is what happened to share *prices*. As we have written before, changes in share prices represent only one of two forms of investment return for shareholders. The other is *income return* - dividends received while a shareholder holds shares. According to market analyst www.marketindex.com.au, the average dividend yield in the Australian market for the last 12 months was very close to its long-term average of 4.1%.

Taken together, a rise in prices of 7.1% and a dividend yield of 4.1% imply a total annual return of 11.2% for the average Australian shareholder. This is a strong rate of return. At this rate we would expect an investment into the market to double in value after 6.5 years (have another look at our May newsletter to see how we have calculated this time period).

Interestingly, a rate of return in the double figures has actually been the most common experience in the Australian stock market since the year 1900. Consider this very useful infographic, provided by Market Index, showing the relative prevalence of different rates of return over a period of 119 years (source: www.marketindex.com.au):¹

Since 1900, the Australian sharemarket has returned an average of 13.1% per annum.



Distribution of total average Australian sharemarket returns, 1900-2019. Source: www.marketindex.com.au

¹ If the small numbers are too difficult to see, you can view the original of this graph here: <https://www.marketindex.com.au/sites/default/files/statistics/historical-returns-infographic-2018.pdf>. Please note that the infographic has a minor typo under the return for 1986; the negative number should be a positive one.

As you can see from the graphic, the average share market return in the Australian market over the last 119 years has been 13.1% per annum. Returns have been positive for slightly more than four out of every five years. In 83 of the 119 years, returns have been somewhere between 0% and 30%.

Looked at in this context, the 2018/2019 year was an ordinary, good year.

As financial advisors, at this point we are programmed to point out that “past returns should never be used to indicate future returns.” However, the philosopher George Santayana famously observed that “those who ignore history are doomed to repeat it.” While no one can guarantee positive sharemarket returns into the future, history tells us that as a long-term proposition, an average investment in the sharemarket is one of the most likely investments to succeed.

Perhaps there is a ‘trick,’ however. Average results can obscure individual experiences. There is an old saying that a person with their head in the oven and their feet in the freezer feels fine - on average. Within an average return some people do very well and some people do very badly. As advisers, we tend to take a cautious approach. We prefer to minimise the chances of our clients being someone who performs badly. While this might also reduce the chances of our clients doing extraordinarily well, it makes it much more likely that they will have an experience close to the average. And given that this is usually a good experience, we are happy with this compromise.

We want our clients to be average and proud!



Diversification between companies reduces the extent to which one poorly-performing company affects your wealth.

So, how do investors target an average rate of return? There are three main ways. You may have heard of at least one or two of them - but they are all well worth revisiting. The first is **diversification in shareholdings**. Put simply, the more companies in whom you own shares the more likely you are to achieve an average investment result. This is particularly the case if you diversify across industry types as well. For example, owning shares in the four big banks will probably not get you a terribly different investment result than if you held shares in only one or two of the four big banks. However, owning shares in the four big banks as well as shares in companies in the mining and manufacturing sectors will give you a broader level of diversification.

These days, diversifying your shareholding is incredibly easy. Most people do it via some form of managed investment - either an old fashion managed fund or a newer form of managed investment known as an *exchange traded fund*. Both of these kinds of investment operate on the same principles: a number of smaller investors (that is, you and me), pool our resources in one larger investment vehicle - the managed fund. We each own a small portion of this managed fund. The managed fund uses our pooled resources to purchase shares in a diversified range of companies. The fund owns the shares, and we own the fund.



Diversification over time: Lots of smaller investments at multiple periods of time.

Managed funds are operated by investment managers. Investment managers vary as to the approach they take when selecting their shares. Some take a very simple approach where they simply mirror an index such as the ASX 200. This means that their managed fund will perform in close concert to the ASX 200. As the infographic from Market Index shows, investors who follow indices like the ASX 200 have done well in four in every five years since Australia was federated. Other fund managers will use at least some of their pooled resources to try to specialise in purchasing shares in companies that they think will do even better than average. These fund managers will perform out of concert with the underlying index. They might beat it. Or they might do less

well. The extent to which their performance varies depends in part on the proportion of their total investment assets they invest away from the index. However, virtually all fund managers use some form of diversification, which means that their investment performance will approach (but not necessarily match) the average for the entire market.

The second way to target the average is to make sure that you do not invest all of your money at one point in time. Sometimes, this is called **diversification over time**. To understand diversification over time, have another look at the performance of the ASX 200 for the 12 month period that ended on June 30, 2019:

S&P/ASX 200
INDEXASX: XJO

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28 Jun, 4:37 pm AEST · Disclaimer

1 day 5 days 1 month 6 months YTD 1 year 5 years Max



As we write above, if you had bought an average portfolio of shares on the first day of the financial year, your total return for the year was approximately 11.2%. However, if you look at the above graph you can see that in late December 2018, the ASX 200 dropped to a value of around 5500 points. If you had bought an average portfolio of shares at these prices, then by the end of the financial year the value of your shareholdings had risen by 20.3%. Add to that a dividend yield of approximately 2% (half of the *annual* average dividend yield of 4.1%), and the total return becomes 22.3%.

The six-monthly return of 22.3% is almost twice the annual return of 11.2%. Sounds great! There is an obvious problem, however. To have achieved this better return you would have needed to have known on July 2, 2018 that the market was going to fall over the coming six months but would then recover in the subsequent six months. If you ever meet someone who tries to predict future markets with this much specificity, walk away. That person is guessing! The reality is, nobody knew in July 2018 which direction the market was about to take. And now that it is July 2019, the same thing holds. No one knows which direction the market is about to move. It may be about to rise, in which case you would be better off making an investment today. Or it might be about to fall, in which case you would be better off making your investment next month when prices are cheaper.



Saving for retirement through superannuation involves regular investing over time for most employed Australians. This helps those people achieve average investment returns over time.

The best way to manage this short-term volatility is to reduce the importance of any one point in time. You do this by investing smaller amounts more frequently as opposed to larger amounts less frequently. Working Australians automatically achieve this effect through their superannuation investments. Provided your boss is doing what he or she should be doing, every month or quarter they will be sending an amount of money to your superannuation fund. Your super fund will probably then be investing it into some sort of managed fund - and you will automatically be diversifying your investments across time.

Diversification across time can also work when it comes time to sell a shareholding. Once again, looking at the graph above, if you had decided to sell all of your shares in December 2018, by June 2019 you would have been kicking yourself as prices had risen by 20%. Ideally, when it comes time to liquidate an investment, you will be able to spread your sales out over multiple points in time. You will sell some at high prices and some at lower prices and be much more likely to sell your shares at the average price.

Just as diversification across companies means that you're not going to 'hit the ball out of the park' in terms of picking a truly outstanding company, diversification across time means that you're not going to profit hugely by timing the market. Both of these forms of diversification will bring your performance back towards the average.

As we say above, most investors invest access the sharemarket via some sort of managed fund. This is particularly the case for those investors who are prepared and happy to accept an average investment result. All managed funds impose a cost on the investors who use them. This cost is incurred regardless of the performance of the fund - although it can vary with that performance if the fees charged by the fund manager are calculated as a percentage of either the value of the fund or the return achieved by the fund. Accordingly, paying fees will reduce the investor's return below the return actually experienced in the market. So, an investor who has targeted the average investment return via a diversified managed fund will still experience an investment return that is below the average return in the market.

How far below depends on the level of fees. And so **minimising fees** becomes the third way for an investor to target an average investment return. Put simply, the lower the fee, the more likely investor is to achieve an average investment return.



Paying less in fees means more eggs in your investment basket.

Management fees charge between various managed funds vary greatly. As financial advisors, helping clients minimise fees is one of the best ways for us to add value to your investment returns. Understanding how management fees are calculated and knowing what options are available can be complicated - managed funds must make this information available to investors, but some do it in a way that is more transparent and clear than others.

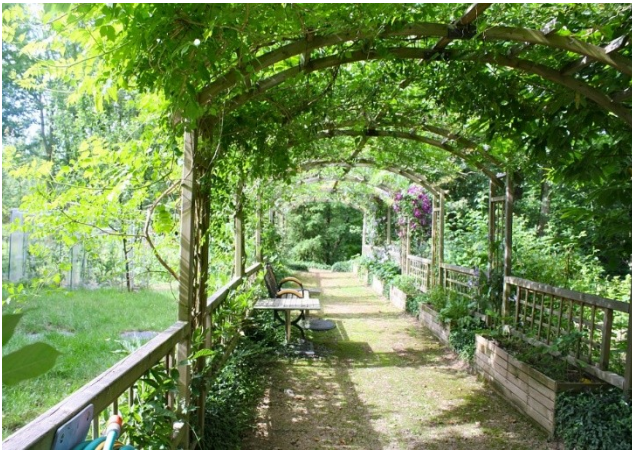
Over time, a small difference in fees can make a substantial difference to the effective investment return enjoyed by you as an investor. This is because the amount paid out as a fee is a permanent reduction in the amount that you can invest. This means that your wealth is not only reduced by the amount of the fee you pay today - your wealth is also reduced by all the future investment returns that the money used to pay that fee could have achieved. For those who are interested, this is what Warren Buffett means when he says that his number one rule of investing is 'don't lose money.' High fees mean not only that you lose money today - but you lose everything that that money could have achieved for you in the future.

Summary

If you had money invested in a diversified portfolio of shares throughout the 2018-2019 year, then right now you should be feeling pretty good about yourself. With inflation below 2%, a total return of 11.2% means that the average share investment has around 10% more 'purchasing power' in July 2019 than it had in July 2018. So, well done.

If you did not have money invested in a diversified portfolio of shares throughout the 2018-2019 year, then right now you might be feeling like it's too late. If that's the case, have another look at Market Index's infographic. History tells us that markets rise approximate four out of every five years. History also tells us that a return of 11.2% is a bit *below* average. So, while it is true that you would have been better off investing this time last year, that's a bit like saying that the best time to plant a shady tree was last year. If you follow that logic, you will never plant anything.

Just because you missed out on previous growth doesn't mean that you shouldn't try to benefit from future growth. Come and talk to us to see how you can access average market returns from now into the future.



The best time to plant a shady tree was always last year. But this year will soon be next year, so don't keep putting things off!

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial and/or taxation advice prior to acting on anything you see on this website.

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