PERENNIAL INVESTMENT PARTNERS

A rocky road to Shangri La: A financial year recap

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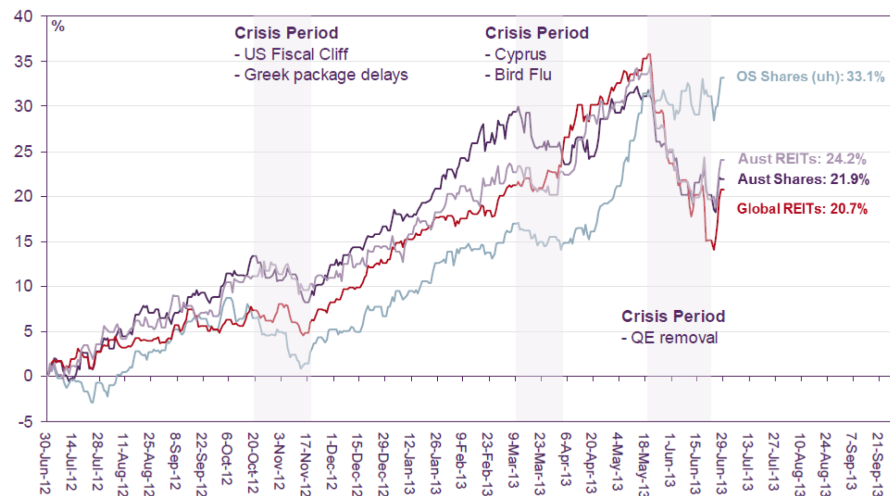
Frank is Perennial's Investment Strategist is responsible for the tactical asset allocation of the multi-boutique products.

- Overseas shares in Australian dollar terms which gained 33.1% over the financial year.
- Next best was Australian REITs at 24.2%, followed by Australian shares at 21.9%.
- The wooden spooner was global REITs at a very handy 20.7%.

After being pummelled for so long, investors in growth assets were well rewarded for hanging on to their longer term investment strategies. Throughout all of the drama of the past few years, central banks have remained steadfast in their desire to support financial markets and underwrite a recovery in economic growth. Their actions appear to be bearing fruit with conventional and unconventional policy measures helping to offset the headwinds from fiscal austerity measures and politically manufactured crises.

There certainly were no shortage of crises over the last financial year and investors could be forgiven for succumbing to crisis fatigue. There were three standout periods last financial year and all led to a temporary pull back in equity markets. Late in 2012, it was fears that a delay in getting a Greek financing package through could reignite fears of a Euro breakup. There were also concerns that if excessive US fiscal tightening measures came into effect at the start of 2013, the US economy would be pushed into recession. Political action meant that the neither of these fears were validated.

The Year That Was: Growth Assets



Source: Bloomberg. Daily cumulative returns to 30 June 2013.

The next risk off period occurred in March when markets became concerned that a default in Cyprus could destabilise the Euro Area. Around this time there were also emerging concerns about the pace of growth in China and reports of new cases of bird flu were also unhelpful. Once again, central bank action provided a circuit breaker. In early April, the Bank of Japan announced a significant expansion in its quantitative easing programme.

Ironically, the final risk off period was caused by too much good news on the US economy! Despite the near term drag on growth from a modest tightening in US fiscal conditions, the US Federal Reserve upgraded its forecasts for the US economy. They also announced a conditional exit strategy from their extremely accommodative policy settings. After an initial selloff, equity markets recovered some ground as it became clearer that any tightening in conditions was still some time away and dependent on further improvement in the US economy and labour market.

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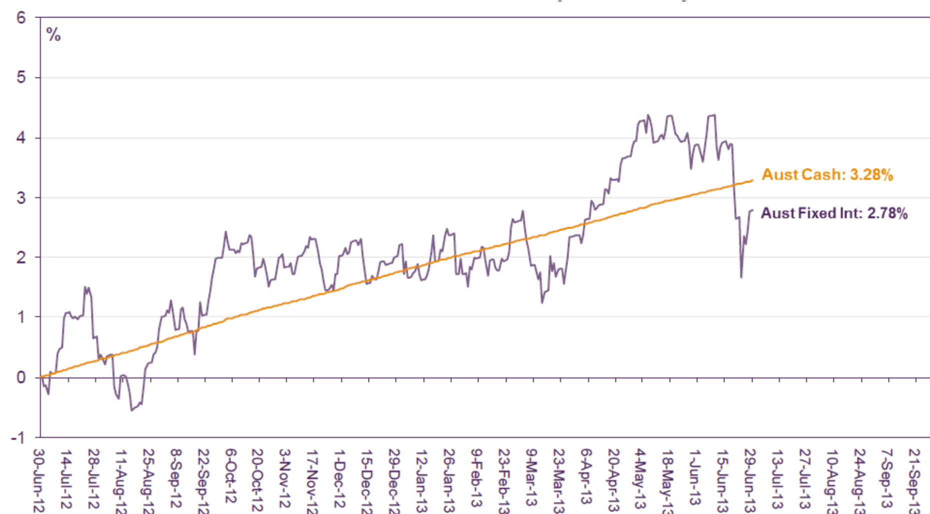
So despite several rocky patches, growth assets* rewarded investors for their patience. The icing on the cake for investors with unhedged exposure to overseas shares was a sharp fall in the Australian currency towards the end of the financial year.

In order from highest to lowest, top honours went to overseas shares in Australian dollar terms which gained 33.1% over the financial year. Next best was Australian REITs at 24.2%, followed by Australian shares at 21.9%. The wooden spooner was global REITs at a very handy 20.7%.

Investors in defensive assets, such as cash and fixed interest experienced positive returns for the financial year, though these were subdued by the standard of recent years. Lower returns reflected two factors:

For the cash sector, the primary driver of returns is the official cash rate. This began the financial year at 3.5% and fell progressively to a historical low 2.75% by the end of June. For the financial year as a whole, the cash sector returned 3.28%. Unless the Reserve Bank of Australia lifts the cash rate significantly over the next year, which we think is unlikely, returns from the cash sector will be even lower over the year ahead given the low starting point for the cash rate. Further monetary easing over the second half of 2013 is a distinct possibility.

The Year That Was: Defensive Assets



Source: Bloomberg. Daily cumulative returns to 30 June 2013.

For the Australian fixed interest sector (6), the lower level of return of 2.78% reflected both the low level of yields and financial markets beginning to discount the end of easier US monetary conditions during June. Quantitative easing, in particular, had been a factor pushing bond yields lower around the world. When bond yields fall, fixed interest investors experience capital gains. Recall the handsome 12.4% return from the Australian fixed interest in the previous financial year. Of course the reverse also applies, so when yields began to rise in June, the resultant capital loss began to eat into total sector returns.

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The year ahead presents its usual challenges but is shaping up to be one where global growth begins to lift as accommodative policy settings begin to work and the headwinds from austerity measures gradually abate. The Australian economy is expected to grow at a below par rate as the mining boom peaks and has to be replaced with other sources of growth. This transition period is unlikely to be seamless and further monetary easing maybe required to facilitate this process. With commodity prices having peaked, recent falls in the exchange rate are unlikely to be reversed and this should help with the rebalancing task the economy faces. Against such a backdrop, we think growth type investments are poised to outperform defensive type investments.

*Sector Benchmarks
(1) = International equities - MSCI World (ex Australia) Accumulation Index – unhedged
(2) = Australian REITS - S&P/ASX 200 Property Accumulation Index
(3) = Australian equities - S&P/ASX 300 Accumulation Index
(4) = Global REITS - FTSE EPRA/NAREIT Global Real Estate Total Return Index (Hedged to $A)
(5) = Cash - UBS Bank Bill Index
(6) = Australian fixed interest - UBS Composite Bond Index (All Maturities)

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