WATERHOUSE
WEALTH MANAGEMENT PTY LIMITED

Quarterly

WINTER 2019

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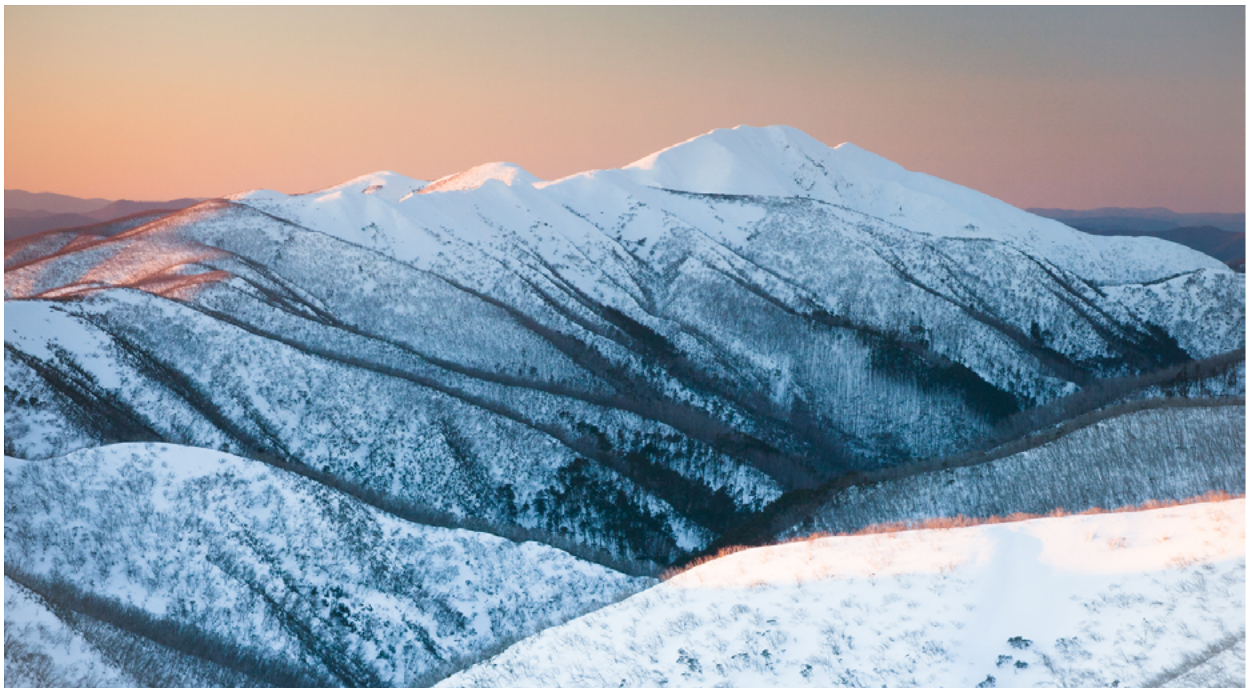


DNR investment review

Macroeconomic merry-go-round

June saw no easing in the focus on macroeconomic and geopolitical risks. Brexit and trade wars continue to dominate the financial headlines.

In the UK, contest for the leadership of the Conservative Party stumbled along with Boris Johnson emerging as a clear favourite for the parliamentary party with the outcome of the general membership vote to be announced on 22 July 2019. Markets do not like uncertainty and Brexit has turned out to be a torturously long and convoluted process. While a negotiated "soft Brexit" is the goldilocks scenario, the UK and EU have been actively preparing for the possibility of a "hard Brexit". While the short-term market reaction to a "hard Brexit" is impossible to predict, we think that any certainty will be a positive for markets in the medium term.

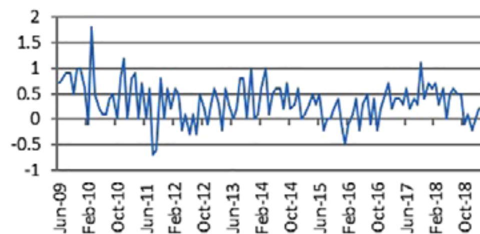
Political imperatives drive trade wars and given the nature of politics, we are very reluctant to try and guess how the current China/US trade war will play out. What we do know is that both sides would benefit from the successful negotiation of a deal, but that both sides are also very much focused on wanting to be perceived as the "winner". Just like the situation with Brexit, the market would love some certainty, but until that eventuates, we expect continued market volatility around trade war news flow… tweets or otherwise.

The uncertainty of this backdrop has seen some slowing in leading economic indicators. Business confidence surveys also show signs of weakness.

US business confidence (PMI)

Source: Bloomberg

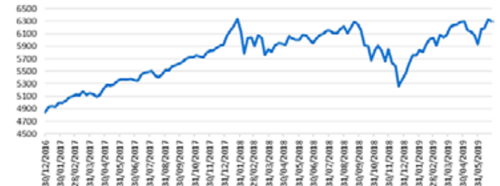
US leading indicators



Source: Bloomberg

Geopolitical uncertainty and softening economic data should point to weaker equity markets, but almost all developed equity markets are either at, or near, all-time highs.

MSCI World Index USD accumulation net



Source: IRESS

The market response is even more counterintuitive, given how bearish the average market participant is. In fact, the Bank of America Merrill Lynch June Global Fund Manager Survey shows that investors have not been this defensive since the GFC.

So why are the equity markets up?

The market sell-off in the December quarter of 2018 was in part driven by fears that an aggressive tightening in monetary conditions would quickly choke off any recovery. All asset prices had thrived on cheap money and even the thought of monetary conditions tightening was enough to spook markets.

Since the start of the 2019 calendar year there has been a seismic shift in expectations for monetary policy settings globally. Rising geopolitical risk and patchy economic data, along with no signs of any real inflation, have seen central banks shift significantly towards an easing bias.

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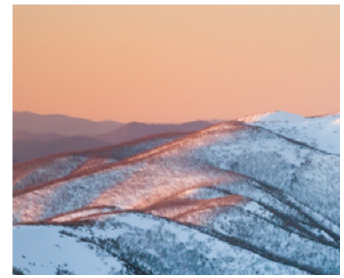

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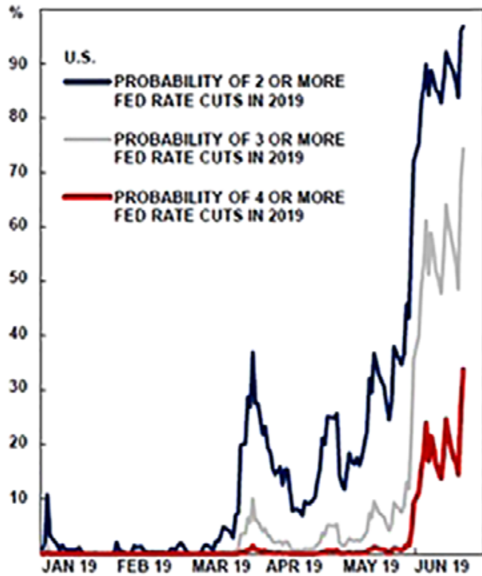
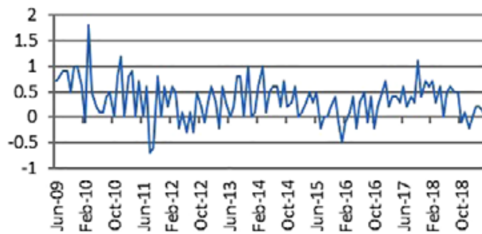
The US Federal Reserve: The question is not if, but how many



Source: BCA Research, Bloomberg

Australia has been at the forefront of the shift in more recent months, with the RBA cash rate expected to end the year well under 1.00%. The inflation outlook is anaemic at best and it's not hard to see why the longer-term expectation for rates in Australian has plummeted, with the 10-year bond rate at all-time lows.

Australian Government 10-year bond rate

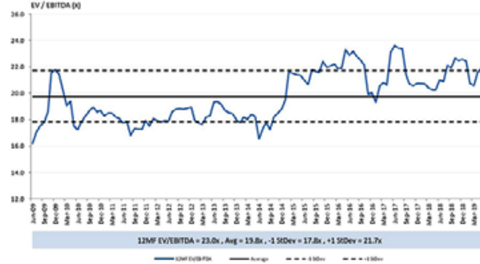


Source: IRESS

This material trend down in rates has driven frenzied buying in stocks with bond-like characteristics (infrastructure, A-REITs and utilities). On the surface this makes some sense given lower rates do make these asset classes more attractive, however the moves look very extreme in any historical context.

The toll road operator Transurban Group (TCL) is the largest infrastructure company in the Australian market and it is trading at record high enterprise value/earnings before interest, taxes, depreciation and amortisation (EV/EBITDA) multiples.

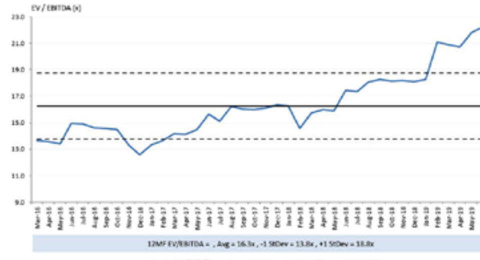
Transurban Group – 12 month forward EV/EBITDA (current 23.0x)



Source: FactSet, IBES Consensus Estimates, Morgan Stanley Research

The largest A-REIT in the Australian market is Goodman (GMG) and its valuation is similarly high.

Goodman – 12 month forward EV/EBITDA (current 22.2x)



Source: FactSet, IBES Consensus Estimates, Morgan Stanley Research

If the bond market is correctly pricing a deflationary economic outlook, these assets are more attractive. Our concern is that even if we assume rates go lower, we cannot reconcile the current valuations and see how these stocks can outperform from these inflated levels.

We have been wrong in our thinking that inflation would drive a push towards a more value-focused market and this positioning has dragged on relative performance. Low bond rates do have an impact on valuation, however the current bond rally has pushed through all previous highs and we are concerned that the ability of low rates to continue to drive valuations higher is limited. We do not believe that this is the right point in the cycle to be adopting the aggressive valuation methodologies needed to justify chasing these stocks.

Lower bond rates have impacted relative performance in a market that has risen almost 20% in six months. The sharp rally has been driven by a flood of money into bond proxies, which we fear are overvalued.

While the market has been very quick to capitalise lower bond rates into valuations for the bond proxies, other opportunities present in the market. We have been focusing our time on high-quality businesses that may not be overtly apparent but are generating solid growing yields. We continue to position the portfolios in these businesses, where we see fundamental valuation support and expect them to attract more investor interest, as the market broadens from its current singular focus on bond proxies. By taking on slightly more risk, we can find high-quality industrial businesses like Aurizon Holdings (AZJ), Wesfarmers (WES), Brambles (BXB) and Tabcorp Holdings (TAH). All these companies are paying yields above 4% that are growing into the medium term.

Aurizon Holdings (AZJ) is a good of example of how patient investing reaps rewards. Less than 18 months ago the market penalised the stock harshly for a poor regulatory outcome. Management has since resolved this issue, negotiating directly with the miners and reaching an outcome on better terms that also provides certainty and longevity for investors. This has improved investor sentiment towards the stock. We continue to see upside from higher coal volumes, new contracts (both above-rail and below-rail) and cost-out and capital management.

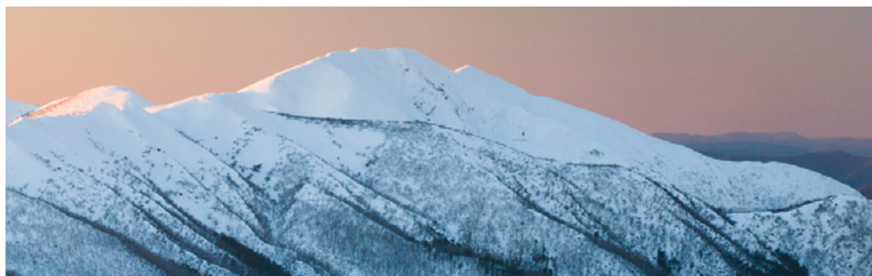
Based on consensus forecasts for 2020, we highlight that the DNR Capital Portfolios offer more growth, lower debt levels and a better return on equity (ROE) at a cheaper price, than the market.

Portfolio characteristics

DNR Capital Australian Equities Portfolios	PE 2020	EPS Growth 2020	Net debt/ EBITDA 2020
High Conviction Portfolio ex banks, resources	18.11	12.80%	1.36
Income Portfolio ex banks, resources	16.56	9.23%	1.29
Socially Responsible Portfolio ex banks, resources	19.11	11.27%	0.76
All Industrials ex banks	19.53	7.59%	1.85

Source: DNR Capital, FactSet

Article source: DNR Capital Pty Ltd
Author: Jamie Nicol



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Taxes matter. Just don't let them drive investment decisions

Now that the election is over, we know that refundable dividend franking credits will continue to be available to investors.

No matter where you stand on that issue, the debate was a healthy reminder that shifting government policy is a risk that can upend a financial plan. Nearly every election, the parties propose changes to the tax code, super, health care, or the age pension to attract certain voters. And that means that nearly every election, investment decisions based on the desire for a tax deduction or any other policy may become more or less appealing.

The potential for these changes is known as tax, policy or regulatory risk.

You can never predict what the government may choose to do, so minimising regulation risk requires not letting the bright lights of tax deductions or other lures dazzle you into making a financial decision you would not otherwise make.

Which is not to say how you structure your portfolio is not important, as long as you bear in mind the core principles of investment success; identify your financial goals, select a diversified, low-cost portfolio to achieve them and stay the course, no matter what financial markets do.

With those principles guiding you, if an investment has the added benefit of a tax incentive, then it makes sense. Tax incentives, however, can't save a bad investment. If an investment is sold primarily as a way to avoid or minimise taxes, keep your money in your wallet.

History provides all too many examples of tax-driven investments gone bad. A change to tax rules in 2007, revealed the weaknesses of certain agricultural investments (avocado and olive farms, to name two) propelled by tax breaks and hefty commissions for those who sold them.

Tax or policy-driven investments also can increase the risk of your portfolio in ways that may not be obvious. If you put money in certain shares based primarily on the desire for franked dividends, for example, you may inadvertently overexpose your portfolio to certain companies or industries.

The franking policy was designed to prevent dividends from being taxed twice — once at the company level and again when they are paid out to investors. It's important

to understand that managed funds, including exchange-traded funds, pass through franking credits to investors via end of year tax statements, something that, as the franking credit debate was raging in the run up to the election, was not well understood by investors in public seminars.

Tax and policy considerations are not irrelevant, it is important to take them into account, however it's more important not to put them in charge. Tax deductions provide healthy additional return only if an investment helps you achieve your goals in a diversified portfolio. If not, step away from the bright lights, and enjoy the warm, enduring glow of a financial plan chosen for the right reasons.

Article source: www.vanguardinvestments.com.au

Rebalance your portfolio, rebalance your emotions

BY **Robin Bowerman**

Is your portfolio suffering from what is sometimes called portfolio drift?

This occurs when a broadly-diversified portfolio drifts away from its strategic or target asset allocation with movements in investment markets and diverging returns from lower-risk and higher-risk assets.

Your diversified portfolio's strategic asset allocation to different asset classes should be set with the aim of reaching your goals without exceeding your tolerance to risk.

And then regular rebalancing of your portfolio back to that asset allocation will regain its intended risk-and-return characteristics. The primary benefit of rebalancing is to keep a portfolio's risk profile, not to maximise returns.

In today's low-interest, lower-return investment environment, investors may be more tempted to delay rebalancing their portfolios. This is a trap because a portfolio usually becomes progressively more volatile and riskier without rebalancing.

Repeated research over more than 30 years, including by Vanguard, has concluded that a diversified portfolio's strategic asset allocation is the main cause of variations in its long-term returns.

A recent Vanguard research paper, Getting back on track: A guide to smart rebalancing, suggests three straightforward practices for portfolio rebalancing:

- **Rebalance to manage your risks and emotions:** A disciplined, easy-to-follow rebalancing strategy helps remove emotions from your investment decisions. And as discussed, rebalancing reduces the likelihood of your portfolio becoming riskier with movements in investment markets.
- **Set rebalancing trigger:** Most investors following a rebalancing strategy use either a "time trigger" or a "threshold trigger". With a time trigger, you rebalance your portfolio at set intervals of, say, once a year or more frequently. And with a threshold trigger, you rebalance when your portfolio drifts from its asset allocation targets by a predetermined percentage.
- **Minimise rebalancing costs:** Keep potential tax and transaction costs of rebalancing to a minimum. Some investors use cash where possible – perhaps from dividends and savings accounts – to replenish asset classes that have become underweight over time. Those with investments inside and outside superannuation should keep in mind when rebalancing that their super savings are either concessionally-taxed or exempt from tax.

The rebalancing of a portfolio can seem counter-intuitive. This is because rebalancing requires the selling of currently outperforming assets to buy currently underperforming assets.

Article source: www.vanguardinvestments.com.au

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Protecting your super package

BY **SuperGuide**

The Protecting Your Super Package of reforms commenced on 1 July 2019. These reforms are designed to protect your super accounts from being eroded by insurance policy fees and premiums that you may not require, as well as help to consolidate your low balance super accounts.

This article outlines each of the key reforms and how they may impact you.

Insurance within inactive super accounts

Under the Protecting Your Super legislation, your super fund will be required to cancel the insurance cover that goes with your super account if it is deemed to be inactive (in other words, if you haven't contributed a payment to your super account for more than 13 months).

However, your super fund is required to inform you if you're at risk of having your insurance cover cancelled and to give you the option to retain it even if you're not making regular super contributions. Super funds have been progressively contacting inactive members ever since the legislation was announced.

Should you cancel insurance coverage you have in super?

Cancelling your life insurance is an important decision and it's one that shouldn't be taken lightly. If you have dependants or a significant amount of debt, it's important to have an appropriate amount of life insurance coverage.
Your super accounts may currently be automatically providing you with the following cover:

- life insurance
- temporary and permanent disablement insurance, and
- income protection insurance.

It's important to understand that your premiums for this type of cover will generally be cheaper through your super fund than they will be if you obtain the cover yourself. Super fund insurance coverage may also have reduced (or no) medical examination requirements prior to obtaining it.

However, if you have multiple super accounts, it's possible that you'll be paying for life insurance coverage through each of them. You may be paying for more cover than you actually need, unnecessarily reducing your super balance.

It's important to do an audit of your total life insurance cover through all of your super accounts to see if it's adequate for your specific financial circumstances before you decide whether or not to cancel any insurance cover through your super.

Your insurance needs will change during different stages of your life.

If you've changed jobs several times over the years and aren't sure how many super accounts you have, you can check via the myGov website. You should then contact each of your super funds to check how much life insurance coverage you have across all your super accounts.

Closure of inactive super accounts

If you have an inactive super account with a balance of less than $6,000, the new legislation requires it to be closed automatically by your fund and the balance transferred to the Australian Taxation Office (ATO) by 31 October 2019. The ATO will then use data-matching technology to combine the low balance amount with one of your active super accounts.

Cap on fees for low balance accounts

If you have a small, active super account with a balance of $6,000 or less at the end of a financial year, your fees will be capped at 3% per annum under the Protecting Your Super reforms.

Switching funds without exit fees

Exit fees are also banned under the new legislation, allowing you to switch your super fund without having to pay any penalty or fee.

Removal of 'opt out' insurance for active super fund members under the age of 25

Prior to the introduction of the Protecting Your Super Fund reforms, super funds could provide insurance coverage to members under the age of 25 under an 'opt out' basis. This means that insurance coverage could automatically be provided by a fund unless a member under the age of 25 formally 'opted out' of receiving it.

However, from July 1, 2019, super fund members under the age of 25 must formally 'opt in' to obtain life insurance coverage. Younger super fund members typically have lower fund balances and lower life insurance coverage needs, so this reform prevents their lower balances from being further eroded unnecessarily.

The bottom line

The introduction of the Protecting your Super Package of reforms provides you with an opportunity to review all your super accounts and any associated life insurance coverage you have. It's important to do that review to ensure you have the right amount of insurance cover for your needs. If you have too much, you may be reducing your super balance unnecessarily. If you have too little, you may be exposing yourself and any dependents to financial risk.

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