EQUITY Super

Liquidity, Volatility, Risk, and Return

Simon Whiteley, Equity Trustees Superannuation Limited

With sharemarkets continuing to exhibit extreme volatility over the past year, investors are looking for alternative asset classes to boost returns and provide greater security. One asset class with which most investors are familiar is residential property. Residential property has been at the heart of much debate over the past 12 months. While some investors continue to believe that residential property never falls in value, the numbers paint a different picture. A closer look at property prices year-on-year in the table below shows a softening in most capital cities (with the exception of Sydney and Canberra).

City	Median Price	% change in index value year on year*
Sydney	$515,000	1.2%
Melbourne	$485,000	-0.40%
Brisbane	$430,000	-6.80%
Adelaide	$381,000	-2.10%
Perth	$468,250	-7.10%
Darwin	$442,250	-0.70%
Canberra	$490,000	0.7%
National	$468,000	-1.50%
Hobart*	$315,000	-2.90%

*(*Hobart results are based on final March 2011 data)*
Source www.rpdata.net.au

Investment strategies

Investing in traditional assets of shares, property, bonds, and cash have provided investors with adequate returns over the long-term. Of course, there are risks involved in any type of investment which will result in investment values rising and falling. But maintaining a portfolio in traditional assets has a proven track record of results. The table below provides the long-term returns for each asset class.

For some investors who have tied up their retirement funds invested primarily in residential property this is a particularly nervous time. Further downward pressure on property prices could magnify the liquidity issues that residential property experiences. Vendors, reluctant to sell at lower prices than the market has offered in the short-term, combined with buyers holding off to see if prices become more affordable, can potentially culminate in a liquidity trap that magnifies the scale of a correction (as with any asset class). Fortunately, rental returns are reasonable for those who purchased wisely and have had the good fortune of well-behaved tenants and minimal property maintenance. For other property owners, the reality that tenants do not look after rental property as if it is their own can be a heart-wrenching and expensive experience.

In my October 2010 article, Torrens Title, I referred to my home town Sydney as this is the market about which I know the most (without professing to be an expert!). I spoke about the cycle of the Sydney property market, and given recent data on the Sydney market, it would appear that the cycle is on track. Although prices are continuing to rise overall in Sydney, it does appear that we are seeing signs of softening in the market with the number of houses on the market continuing to rise and the number of transactions decreasing. If the theory of supply and demand tells us anything, we could be due for a small correction by the end of this year.

Regardless of investment preferences, it is important at all stages of an investment strategy implementation to maintain diversification within a portfolio. This is because, most of the time, different asset classes are not perfectly correlated. In other words, cash, fixed interest, property, and shares generally perform at their best and worst at different stages of the business cycle. I use the words 'most of the time' because when markets experience a major event such as the GFC, the various asset classes will tend to converge during the sudden crash and then again during the initial stages of the recovery that follows soon after, before normalising.

To highlight the importance of a well-diversified portfolio, let's look at the Australian sharemarket. What really stands out here are the 10-year figures. While direct property appears to have peaked 12 months ago, we are seeing Australian shares gradually returning to their long-term return target of around 10% p.a. This is a fantastic achievement given that we have recently been through a major financial crisis. The table below breaks down the Australian sharemarket into sectors to provide a clearer picture of what is driving the growth in our economy. I am sure it is no surprise that resources and materials have really driven returns, not only over the last 12 months, but also over the last decade. Banks have retained their long-term returns but have struggled to provide the capital growth of other sectors in the past year. Ratings agency downgrades have put some pressure recently on bank valuations with potentially more downgrades to follow. Ratings agency, S&P announced in May that it would have a new ratings methodology implemented by the fourth quarter this year. As the big four banks continue to rely heavily on overseas funding, as opposed to local funding through deposits, analysts suggest they could face headwinds depending on how the overseas debt story plays out.

Index	1yr %	10yr %
Australian Equities		
ASX All Ords Acc	5.44	8.41
S&P/ASX 200 Acc	4.58	8.2
ASX Acc Small Cap Ords	10.5	9.11
ASX 300 Banks Accum	-0.04	10.02
ASX 300 Materials Accum	16.65	N/A
ASX 300 Resources Accum	15.98	17.38
ASX 300 Industrials Accum	0.33	5.82

Source www.vaneyk.com.au

The real laggard is the industrial sector. This sector generally takes primary resources and processes or manufactures them into finished goods. Hampered by the falling cost of imported goods and the rising dollar, this sector has been experiencing significant stress.

Although the sharemarket recovery is showing attractive long-term valuations, it is not without short-term risks. Sovereign debt globally is at an all-time high and the scenario in the EU is yet to play out. Germany appears to be growing weary of propping up countries such as Greece, Italy, Portugal, and Spain, that arguably should never have been permitted to join the EU. All eyes are on the now politically-incorrect 'PIIGS' and the US.

Locally, the Australian sharemarket appears to be at an inflection point, awaiting the ratification of various Government policies. Combined with the overvalued Australian dollar, which is making our country an expensive place to conduct business, this appears to be constraining growth.

The introduction of a carbon tax has the potential to cause some degree of economic slowdown and with the Government's execution of Pink Batts, School Halls, Immigration Policy, it is not unreasonable to suspect that their execution of the Carbon Emissions Scheme will fall short of excellent. Let's not also forget that there will be money to be made on the secondary carbon-trading market and it would be unusual if the pollies don't already have a vested interest in the development of the carbon-trading markets success.

In the meantime however, it continues to place uncertainty over the future of our economy while the Government recycles the idea and fails to make a decision on its implementation.

These factors, along with the mining tax and next year's Flood Levy, have contributed to some degree of uncertainty for overseas investors considering whether or not to invest here. It is partly to blame for our subdued sharemarket recovery compared to that of the US in the Post-GFC era.

According to our asset consultant, vanEyk Research, a further detractor from our sharemarket performance is the potential for a hard landing in China if high inflation persists. This could be induced by further interest rate tightening in China to combat inflation. The impact of such a hard landing would likely reduce the demand for our resources and depress share values of resource companies. This uncertainty may have possibly caused global investors to take some risk off the table (i.e. divest from Australian shares) especially when the Australian dollar is above parity with the US dollar.

van Eyk suggests that although the global economic recovery remains intact, the more supportive period of growth momentum, profit growth, liquidity and interest rates are behind us. Global growth and commodity prices will continue to support the Australian economy but with the prospect of one or two more rate rises, the outlook for the domestic-focused sectors is likely to remain weak.

Financial advice

For any further information or to discuss your financial situation, please don't hesitate to contact me on **0413 244 733** or email **simon.whiteley@eqtsuper.com**. I look forward to hearing from you.

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