CMC CONSULTING & MENTORING
cornerstone of advice

Quarterly

2018 WINTER EDITION

DNR investment review

A narrow range of sectors and companies are experiencing very strong returns. We highlight some of these in the table and chart below. The outsized returns from a range of information technology, healthcare and China-exposed companies are at odds with traditional companies like Telstra, the banks and hospital groups, which have been struggling.

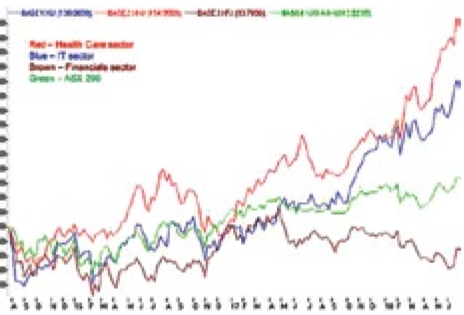
The growth being offered by emerging companies is significantly greater than that provided by traditional sectors. In a world awash with digital disruption, many traditional industries are struggling with legacy cost bases and systems that leave them in an uncompetitive position relative to new emerging players.

12 month share price performance

	% Gains/Loss
Afterpay Touch Group	218
The A2 Milk Company	176
WiseTech Global	123
Bellamy's Australia	123
CSL	38
REA Group	36
Treasury Wine Estates	35
Commonwealth Bank of Australia	-7
Brambles	-8
AMP	-27
Ramsay Health Care	-27
Telstra Corporation	-35

Source: DNR Capital

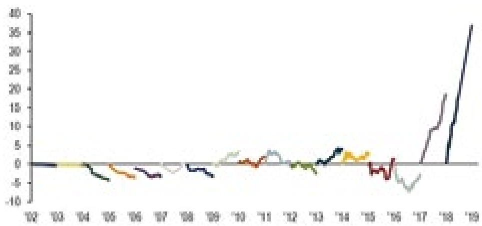
Leading and lagging sector returns



Source: IRESS

At the same time, low interest rates and quantitative easing mean the world has been awash with liquidity. This liquidity has been chasing those segments of the market with the best growth, with significant flows moving into the technology space. Furthermore, the increased predominance of smart beta/quantitative strategies has resulted in strong support for these sectors with good momentum and low historical volatility, which in turn creates a positive feedback loop of money into the same names.

Technology flows, $b (2018 annualised)



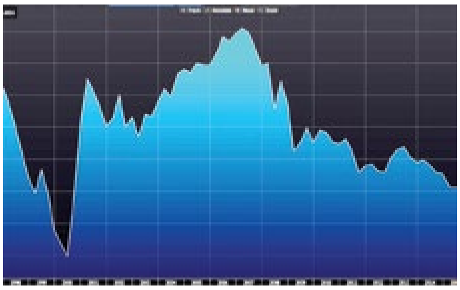
Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

The valuation gap between the companies operating in technology, healthcare and those exposed to the Chinese consumer has continued to open relative to other segments over the past year. We note that US value stocks have substantially underperformed the broader index. The following table highlights the multiples and growth rates for traditional sectors like resources and financials, compared with the IT and healthcare segments in the Australian market. IT and healthcare have more attractive growth profiles, but are trading at healthy multiples of 29x earnings.

… Continued on page 2

… Continued from page 1

S&P 500 Value Index versus the S&P 500 Index



Source: Bloomberg

Australian sector valuations spread widening

	PE 1 year fwd	P/Book	Growth
Resources	14	1.6	5%
Financials	11	1.5	2%
IT	29	5.3	15%
Healthcare	29	6.0	12%

Source: DNR Capital

This situation creates obvious questions. Are these multiples justifiable, and what will cause markets to alter the current positioning?

We are concerned that these trades are becoming crowded and believe some caution is warranted. We see a number of warning signs – aggressive valuation assumptions using low risk-free rates, use of new valuation techniques like price to sales to justify valuations, and heavy use of vague addressable market assumptions to increase the terminal value of these companies.

Given these warning signs, we consider potential factors that could cause the market to reassess valuations of these stocks:

- As growth-stock multiples extend, confidence increases and the market lifts earnings expectations to help justify valuations. This sets up some of these stocks for future disappointment. The downside for stocks on high multiples that disappoint can be savage.
- We have been discussing for some time the potential for inflation to rise in response to a changing political climate. Inflation is rising in the US and lifting risk-free rates. Given much of the value in growth stocks is reflected in the terminal value, a change in risk-free rates can have a significant impact on the valuation. A spike in inflation could negatively impact these stocks.

However, a key component to the outperformance has been a lack of viable alternative investments. As traditional stocks underperform, they have been forced to address their businesses. For example, Coca-Cola Amatil is reducing sugar content and reinvigorating its water offering. We expect the banks to move to an aggressive cost out phase and many of these traditional players are investing heavily in technology to improve their competitive position. While some players will remain at a significant competitive disadvantage, opportunities are emerging to buy companies that have rebased earnings and are at low valuations. The more companies that meet these criteria, the more alternatives will be presented to the market.

So, opportunities will be presented outside of some of the crowded trades in the market, but we caution and reiterate:

- In an era of rapid technology change value traps are prevalent, so we need to avoid companies at risk of further disruption.
- Some growth stocks continue to justify their valuations given their earnings growth, and so we 'do not seek to throw the baby out with the bath water' by exiting companies where we have a good line of sight in terms of the earnings outlook. The important factor is to retain valuation discipline.

Buy now, pay later... manage carefully

Before heading off on an overseas holiday, Sam decided to buy an expensive new camera to document his travels. The camera store offered a 'buy now, pay later' option, and attracted by the 'no interest' promise of the credit provider, Sam signed up.

All was well to begin with. Sam had a great time on his trip – in fact, maybe a bit too much of a good time. On returning home, he'd maxed out his regular credit card and, with insufficient savings, he was unable to maintain the required repayments on his separate camera debt. And while (true to the issuer's promise) he didn't have to pay interest on the overdue payments, he was charged late fees on the repayments he skipped. Along with the standard payment processing and account payment fees, Sam's camera ended up costing a lot more than he anticipated.

Plenty of temptation

The number of 'buy now, pay later' services is increasing. Afterpay, Certegy and ZipPay are three examples. Provided that payments are made on time, this type of service can be a great way to spread the cost of purchases over several months. Just make sure that the fixed fees aren't too big a fraction of the total loan. For example, if you buy something for $1,000, and over the life of the loan, establishment and payment processing fees total $100, you're paying 10% more than if you had paid in full at purchase.

Seeing a good opportunity, several banks now offer repayment plans on credit card purchases. These also operate more like a loan than regular credit cards, with a fixed repayment term and regular installment amounts. Unlike the other 'buy now, pay later' operators, they may charge interest – although initially this is usually at a much lower rate than the standard purchase rate. However, if any payments are missed and an outstanding balance remains at the end of the fixed term, interest may be charged at the purchase rate. This is often well over 20% per annum.

Sam's options

Sam now faces a double whammy of a debt trap. While he's meeting the minimum repayments on his credit card, the outstanding balance is accruing interest at 22% pa. Plus his 'buy now, pay later' debt is accumulating ongoing late fees. What can he do?

The textbook method for managing this situation is to take out a personal loan at the lowest rate possible and use this to pay off the debts. While the camera loan may not have an interest rate as such, left too long the fixed fees can add up to a significant percentage of the outstanding loan amount. By consolidating the debts Sam is left with one regular payment, and with a much lower interest rate he can pay off the outstanding balance far more quickly.

But Sam had another idea. He rolled over his credit card balance to a new card with a zero per cent interest rate on balance transfers for 12 months. This meant all his repayments went towards reducing the balance and he was also able to afford normal repayments on his camera loan.

Sam knew that if he didn't clear the card debt during the interest-free period he would again be saddled with high interest rates, but now being more 'debt aware' he was able to get on top of things and was on track to be debt-free within the year.

Source: https://priority1.net.au/buy-now-pay-later-manage-carefully

Handling volatility as an inexperienced or experienced investor

It is sometimes assumed that experienced investors typically have an advantage when it comes to handling a sudden bout of sharp share market volatility.

Certainly, experienced share investors have had to deal with repeated corrections and bull markets that may have taken them by surprise. While these experiences should be an advantage, many investors quickly forget or neglect the lessons from past downturns.

And because experienced investors usually have more at stake, they may be more vulnerable to overreacting to a market downturn than their younger counterparts.

Given the latest gyrations in global and Australian share prices, it's timely to revisit a few long-standing suggestions of smart ways to handle higher market volatility.

Buy a pair of noise-cancelling headphones (figuratively speaking)

Block out the "noise." Don't overreact to daily media commentary and news reports on daily market movements; and try to ignore short-term fluctuations in share prices. A recent New York Times article – So it's your first market hiccup. What should you do? – veteran personal financial journalist Ron Lieber suggests investors ask themselves: Is the stream of news useful? "Those talking heads know nothing about you and why you invested in the first place," Lieber comments. "So, don't base your actions of their pontificating and pronouncements."

And a recent Vanguard research report, How to navigate market corrections, aptly illustrated with a pair of noise-cancelling headphones, warns about the dangers of repeatedly checking the gyrating value of your shares. "Making a decision based on a recent market event usually results in a mistake," it cautions.

Don't treat a sharp market downturn as a rare event

Investors can expect to face many downturns in their investing lifetime. "Knee-jerk reactions in this market environment can lead to costly mistakes," the Vanguard report stresses. "Dramatic [paper] losses can sting but it's important to keep a long-term perspective." The sale of shares after a price fall locks in a loss, preventing an investor benefiting from a subsequent market upturn.

Global share prices have had 11 corrections (declines of 10% or more) and eight bear markets (declines of 20% or more, lasting at least two months) between January 1980 and February this year.

In those last 38 years, global investors have had to deal with Black Tuesday in 1987 (Black Monday in the US due to time difference) when global share markets crashed, the tech boom/bust and the GFC. Yet investors who had stuck to appropriate long-term asset allocations and reinvested their dividends where possible would be well ahead today.

Remember time is probably on your side

In most cases, your intention is to create long-term wealth. So, remain focused on the long haul without being distracted by day-to-day market movements or any short-term setback. Young investors truly have time on their side and recent retirees, for instance, can expect many investing years ahead.

Don't try to time the market

Keep in mind that volatility works both ways – up and down, as reinforced by market movements over recent months. Unfortunately, these gyrations present a temptation to try to time the market. Even investment professionals rarely succeed in consistently picking the best times to sell or buy.

Investors can readily recognise the futility and difficulty of trying to time the market by looking at how the best and worst trading days have occurred closely together. Between December 31, 1979, and January 31, 2018, 12 of the 20 best trading days on the S&P 500 index of US shares occurred in years with negative annual returns. Further, nine of the 20 worst trading days occurred in years with positive annual returns.

Rather than trying to time the market, consider the benefits of a dollar-cost-averaging strategy. Dollar-cost averaging simply involves investing the same amount of money into, say, shares or broadly-diversified managed funds at regular intervals over a long period – whether market prices are up or down.

The principal benefit of dollar-cost averaging is not the price paid; it is the following of a disciplined, non-emotional approach to investing that is not distracted by market sentiment.

Think about creating a volatility 'bucket' if retired or nearing retirement

This strategy involves setting aside one to two years of living expenses if possible in a cash "bucket", depending on an investor's circumstances. The aim is to try to avoid having to shares during a market downturn to provide retirement income.

Never overlook that share market returns are much more than capital gains

While your share prices will keep fluctuating, your dividends will keep flowing from a well-diversified share portfolio. Historically, dividends have made up a large proportion of the total returns from Australian shares.

Source: www.vanguardinvestments.com.au/retail/ret/articles/insights/research-commentary/investment-principles/handling-volatility.jsp?lang=en

Downsize your home, upsize your super

Over 65? Thinking of selling your home? From 1 July 2018 you may be able to contribute up to $300,000 ($600,000 for a couple) from the proceeds of the sale of your home to your superannuation fund.

This incentive, known as the 'downsizer contribution', is part of a federal government program to improve housing affordability. It offers a further opportunity for some home sellers to benefit from the tax advantages associated with superannuation. On the downside it may adversely affect eligibility for age pension.

RULES APPLY

Of course, it wouldn't be a super contribution without lots of rules, and the main ones are:

- You must be 65 or older when you make the contribution. This could affect decisions on the timing of a sale. For example, Anne (67) and Rod (63) are thinking of downsizing. As only Anne can make a downsizer contribution they may want to delay selling their home until Rod turns 65 so he can also make one.
- You or your spouse must have owned the home for at least 10 years prior to sale; it must be your main residence; and cannot be a caravan, houseboat or mobile home.
- You can only use this concession once. You can't use it with subsequent home sales.
- The contribution is limited to the lesser of $300,000 each or the total proceeds from the sale of the home. In the case of couples, contributions don't need to be evenly split. Take Tom and Stephanie. They sold their house for $500,000. Rather than contribute $250,000 each, Stephanie contributes her $300,000 maximum. Tom's downsizer contribution must then be no more than $200,000.
- The contribution must be made within 90 days of receiving the proceeds, though an extension may be granted in limited cases.

Curiously, given the name of this initiative, you don't need to physically downsize your home. If you have the funds available you could buy a bigger or more expensive abode. In fact, you don't even need to buy a new home at all.

THE EFFECT ON SUPER

On the superannuation side, you can make a downsizer contribution if your total super balance exceeds $1.6 million. However, the contribution will count towards your transfer balance cap (i.e. the cap on the amount you can use to establish a tax-free superannuation pension). Even so, it may still be advantageous to hold these funds in the concessional (15%) tax environment applicable to the super accumulation phase.

AND WHAT ABOUT THE AGE PENSION?

Anyone thinking of downsizing needs to consider the impact on eligibility for age pension. A main residence is exempt from the assets test, but if its sale frees up money – for example, through buying a cheaper home or renting – those funds will be assessed under both the income and assets test even if they are used to make a downsizer contribution. This may result in a reduction or loss of age pension.

The extent to which you can benefit from making a downsizer contribution depends very much on your individual situation. And it isn't just a financial issue; lifestyle considerations are also important. Before making a decision it's important to consider all the angles, so contact to discuss about whether a downsizer contribution is right for you.

Source: http://clearpathfa.com.au/latest-articles/downsize-your-home-upsize-your-super

With compliments from
CMC Consulting & Mentoring / RetireWell With a Plan

PO Box 400,
Newstead TAS 7250

25 York Street,
Launceston TAS 7250

P 03 6334 3143
E enquiry@cmctas.com.au
W www.cmctas.com.au
www.retirewelltas.com.au

CMC
CONSULTING & MENTORING
cornerstone of advice

Tassie Small Business Finance Pty Ltd ABN 83 081 235 832 trading as CMC Consulting & Mentoring and RetireWell [With a Plan]
is a Corporate Authorised Representative of The Advice Exchange Pty Ltd. ABN 55 107 629 194.
Australian Financial Services Licence No 278937. Registered Office: Level 2, 177 Toorak Road, South Yarra, 3141