

What's Inside...

Key issues over the last month

Equity Markets shine

- Equities markets have been strong across the globe in the initial stages of 2013. Following on from a strong end to 2012, share markets have rallied further, increasing gains and providing a welcome boost to investor confidence. But remember, nothing goes up in a straight line. Reversal of the trend can occur at any time and for those looking to enter, should consider if it is right time to add to their holdings.

Australian Interest Rates

- The Reserve Bank of Australia left rates on hold at its February meeting, but left the door wide open to reduce the official rate once again if the need arises. We anticipate that they will consider another reduction in either March or April given the modest deterioration in employment data that is gathering pace of late.

Japanese decide to act to reverse their deflationary spiral

- Newly appointed Japanese Prime Minister Shinzo Abe, announced to the world that Japan would take action to reflate its economy after decades of deflation, which has eroded the financial strength of the Japanese people. For years the Japanese Yen has been strong in spite of interest rates of almost zero and GDP growth rate of less than 2% for over ten years. The Japanese announcement has caused the Yen to devalue even more sharply than had already been occurring in the latter part of the 2012. It is now some 15% lower in value against the \$US since November 2012.

European banks still feeling the heat

- Even though the European Central Bank has created a great deal of stability within the EMS in the last year, recent announcements highlighting the fragility of the French Banking system became evident as Credit Agricole announced a €6.5Bil loss for 2012 resulting from write downs and losses on their holding in Greek Bank, Emporiki.

US Federal Reserve has less than unified view of strategy

- In late Feb 2013, it became evident that members of the Federal Reserve Governors are not at one in the strategy being applied to buy up Government bonds and provide market liquidity. This minor sense of policy difference will make equity markets concerned as it is the continuation of the quantitative easing policies that have driven equities to current levels.

Inflation...what inflation?

- Inflation data supports central bank belief that inflation is still not apparent in any of the major economies. Indeed in Australia, where annual inflation is running at 2.0%, wages growth has also been soft, well below expectations. While capacity utilisation is also soft, inflationary pressures are off the agenda...or so it seems.

Corporate Reporting starts with RIO & BHP signalling big changes

- The US\$8.9billion write downs on Rio Tinto's disastrous purchase of ALCAN spelt the end of (now) former CEO Tom Albanese in favour of Iron Ore head Sam Walsh. In late February, announcing an expected lower set of earnings for the half year, BHP also closed a chapter by having Marius Kloppers announce his retirement as CEO in favour of BHP Metals boss, Andrew Mackenzie. Interestingly, both of these new appointees are more experienced than their predecessors.

Inside – our feature article from AMP Capital

- We feature a highly relevant article from Shane Oliver, AMP Capital's head of strategy, addressing asset class issues.

Key Investment Data snapshot

Indicator	31 Dec 12	31 Jan 13	Change / performance
ASX 200	4649	4879	Up 230 pts / 4.9%
Copper \$US/tonne	\$7,966	\$8,150	Up \$184 / 2.3%
Iron Ore (Spot) \$US/t	\$152	\$149.40	Down \$2.6 / 1.7%
90 day bank bill %	3.04%	2.95%	Down 0.09%
\$A 10 year Bond %	3.27%	3.45%	Up 0.18%
\$A / \$US Exchange rate	1.0394	1.0451	Up 0.0057
\$A gold price / Oz	\$A1,571	\$A1,610	Up \$39 / 2.48%

Shares, property, bonds or cash?

EDITION 4 – 5 FEBRUARY 2013



Key points

- > Cash and bonds have been the place to be over the past five years as a whole, providing higher returns than residential property and shares.
- > But as we all know, past returns are not a good guide to future returns and this is particularly likely to be the case for cash and bonds, given the fall in interest rates and yields.
- > Going forward, shares and to a lesser degree property, are likely to be a better option for investors (depending of course on their individual risk tolerance) as global recovery supports growth assets and low yields hamper the returns from bonds and cash.

Introduction

For the past five years as a whole, bonds and cash have been the place to be, particularly if cash is taken to include bank term deposits. While yields on bank deposits have been single digit, at least they have been higher than the returns from both shares and residential property, which have experienced high volatility. Of course some shares and some property locations have done well but the broad experience has been poor as the global financial crisis and its aftermath have weighed on returns from growth assets.

This has led to a situation where investors have preferred cash as an investment destination over property, and particularly over shares. According to a recent survey, 35% of Australians nominated bank deposits as the wisest place for savings, compared to 24% who nominated real estate and just 6.3% who said shares. Reflecting this, investor fund flows into bank deposits and bonds have been very strong, but flows into property and shares have been poor.

Bank deposits have been favoured since 2008



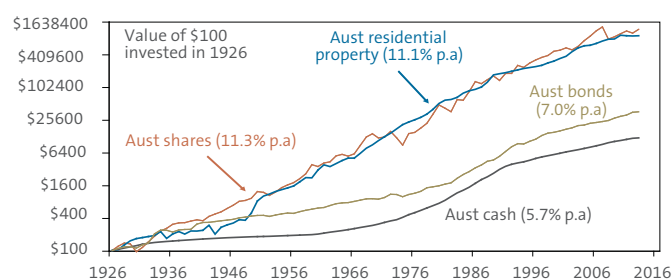
Source: Bloomberg, AMP Capital

This flight to 'safety' has been a world-wide phenomenon, albeit the focus in other comparable countries has mainly been on bonds given near zero interest rates in the US, Europe and Japan. The trouble is that all investment trends result in being pushed too far, eventually giving way to a reversal. We could be now at, or close to, that point with cash and bonds relative to growth assets like shares.

Historical experience

But first let's look at the historical experience. After allowing for costs, residential property has provided a similar return over the very long term to shares. Both have provided far superior returns over that of cash and bonds. This can be seen in the following chart, which shows the value of A\$100 invested in each of Australian shares, residential property, bonds and cash since 1926.

Long term asset class returns



Source: Bloomberg, AMP Capital

Since the 1920s, residential property has returned 11.1% p.a after allowing for capital growth, rents and the costs of owning and maintaining a property. Shares have returned 11.3% p.a after allowing for capital growth and dividends. While housing is less volatile than shares and for many seems safer, it offers a lower level of liquidity and diversification. Once the similar returns of housing and shares are allowed for, there is a case for both asset classes in investors' portfolios over the long term. By contrast, reflecting its liquid nature and low volatility, cash has returned just 5.7% p.a since the 1920s. Bonds are in between with a 7% p.a return, consistent with their higher level of volatility when compared to cash (i.e. a bond investment can lose money in a year if bond yields rise) but lower riskiness when compared to shares and property.

Focussing on the last decade, shares also surprisingly come out well. Thanks to great returns in the 2003 to 2007 period, shares have returned 9.1% p.a over the past 10 years. This compares to 5.3% p.a from residential property, which cooled down after a huge surge in property prices into early 2004, and 5.4% p.a from cash and 6.4% p.a from bonds.

However, for the past five years equity returns have been negative, reflecting the global financial crisis and its aftermath, with this also weighing on property while bonds and cash have done well.

Return comparison, Australian assets

Budget item	5 years	10 years	Since 1926
Shares	-1.6	9.1	11.3
Property	3.3	5.3	11.1
Bonds	8.3	6.4	7.0
Cash	4.9	5.4	5.7

Source: ABS, REIA, Thomson Reuters, AMP Capital

What's the outlook?

The return from an asset is a function of the income flow or yield the asset generates, and capital growth. Of course in the case of cash or term deposits, the yield is all that drives the return. On this front, the return outlook for cash is looking less promising.

Over the last year the official cash rate in Australia has fallen from 4.75% to 3% as the Reserve Bank of Australia (RBA) has sought to boost activity in areas like housing and retailing as momentum in the mining investment boom slows and inflation is benign. While this is not the only influence on bank term deposit rates it is the major one, at least directionally. As a result, while term deposit rates of 6, 7 and even 8% were available a few years ago they are now nearer 4% and falling. Given the softness in the domestic non-mining economy and the prospect for further RBA rate cuts, term deposit rates are likely to fall even further. This means that the prospective return on cash is rapidly dwindling.

Similarly for bonds, yields are now very low. Bond returns are driven by the underlying income yield they provide when the investment is made (the higher the better) and capital growth. If bond yields fall, bond prices move up at the same time resulting in a capital gain for investors. This is effectively what has happened over the past five years, which has seen Australian 10-year government bond yields fall from 6.3% p.a to currently 3.5% (after hitting a low of 2.8% last year) as interest rates fell and investors bought bonds as a safe haven. The decline in yields has effectively added around 2%p.a in the form of capital growth to the annual return from bonds, explaining why bonds returned 8.3% over the last five years even though their yield was much lower.

The problem is that yields need to keep falling if the return from bonds is to be maintained at anything like the levels seen in recent years. But with bond yields around record lows, the global economic outlook improving and safe haven investor demand likely fading, this is becoming less likely. In fact, the greater risk is that bond yields start to rise as investor flows switch out of bonds and back to growth assets and money markets start to factor in an eventual monetary tightening. This will see the bond returns of recent years go into reverse as rising yields result in capital losses for investors. So a best case scenario would be a return equal to the current yield from bonds of around 3 to 3.5%, but it could end up being much less if yields rise much more. This may already be starting to happen with bond yields rising recently.

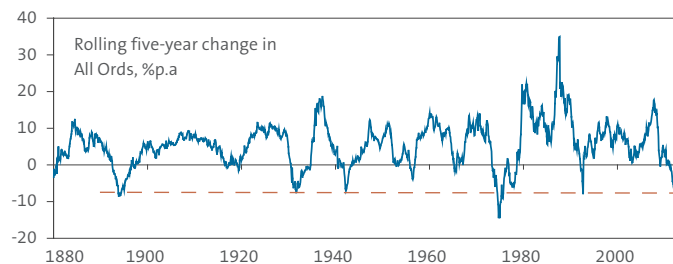
By contrast, residential property and shares already offer higher yields and will benefit as economic growth improves. House and apartment yields are running around 3.7% and 4.8% respectively, which are well up from their lows last decade. With mortgage rates well off their highs and likely to fall further, the residential property market appears to have bottomed out after falling since mid 2010 with a mild cyclical recovery likely over the next 12 months. However, on average, short term gains are likely to be limited to around 5-7% as buyers remain cautious about taking on excessive debt, particularly as job insecurity remains high. More broadly, capital growth in residential real estate is likely to be constrained over the next five to 10 years by still very high property prices relative to incomes and rents and house prices still above their longer term trends. This suggests that a cyclical rebound in real estate prices over the next year should be seen as part of a broad range-bound market for property prices in real terms as the market continues to work off the excesses that built up over the property boom that started in the mid-1990s and continued into last decade. Of course, good quality properties in sought after locations will do well, but the medium term back drop for property returns is likely to remain constrained, albeit better than that from cash and bonds.

There are two risks for property. The main downside risk is that China has a hard landing with the hit to export earnings resulting in sharply higher unemployment, forced sales and hence lower house prices. The risk of a hard landing in China seems to be receding though. The other risk is on the upside. There is always a concern that the old housing bubble is reignited by the latest collapse in mortgage rates. Again, this seems unlikely though given Australians have developed a more cautious approach to debt since the global financial crisis.

Shares are probably the most attractive asset. After a five year period of poor returns, despite the rebound over the last year, Australian shares are offering a relatively attractive starting point with dividend yields of around 5.7% (including franking credits). This is not to say that shares are in for a smooth run. Risks remain in the US and Europe regarding public sector debt problems, but they seem to be fading. However, with reasonable starting point yields (or income flows), only modest capital growth of 3 to 4%p.a is required to provide a decent return. If global growth continues this should be achievable. The main downside risk here would be if global and Australian growth slides into recession taking profits with it. This seems unlikely given how easy monetary conditions are. Counter to this there is always the possibility that the easy monetary environment really takes hold globally, resulting in a huge surge in economic growth and investor flows back into growth assets. This would be very positive for shares.

The next chart also provides some support for shares. We all know that Australian shares fell over the past five years as a whole. But as can be seen below, rolling five-year changes in Australian share prices tend to be “mean reverting”. Historically, whenever five-year rolling capital losses have ever been as negative as they were over the last five years (ie in 1894, 1930, 1942, 1974 and 1992), the subsequent five- year capital growth has been strongly positive (in fact with an average gain of 13.4%p.a). This points to solid gains in share prices over the next five years.

Mean reversion in Australian shares



Source: ASX, Bloomberg, AMP Capital

Concluding comments

Drawing this together suggests medium term (five-year) returns of around 4.5% p.a or less for cash and term deposits, 3% p.a or less from bonds, 5% p.a from residential property and around 10% p.a from shares.

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 Performance review	For month ended: 31/1/13	
	1 month return	12 month return
Investment Performance		
International		
Platinum International Fund	4.69%	16.21%
DWS Global Thematic Fund (Hedged)	5.46%	16.36%
CFS Global Resources (long only)	-0.09%	-12.54%
Magellan Global Fund	4.80%	28.31%
Schroders Global Emerging Markets Fund	0.37%	13.42%
Australian		
Fidelity Australian Equities	4.79%	21.96%
Kinetic Emerging Companies Fund	3.33%	9.78%
Antares High Growth Shares Fund	4.26%	21.75%
Perpetual Concentrated Equity Fund	5.02%	24.32%
Property		
Perennial Global Property W/S Trust	3.32%	25.60%
Vanguard Property Securities Index Fund	4.62%	31.53%
Fixed interest/cash		
Macquarie Income Opportunities Fund	0.84%	8.43%
Perennial Tactical Income Trust	0.27%	8.12%
Schroder Fixed Income Fund	-0.05%	8.03%
BT Wrap Cash A/c		
Multi-managers		
Russell II	1.20%	9.44%
Russell IV	2.97%	13.26%
Russell VI	3.79%	14.42%
AMP Index Conservative	1.42%	9.98%
AMP Index Moderately Conservative	2.38%	12.86%
AMP Index Balanced	3.34%	15.48%
AMP Index Growth	4.09%	17.46%
AMP Index Aggressive	4.89%	19.21%
AMP Active Conservative	1.51%	10.49%
AMP Active Moderately Conservative	2.55%	13.82%
AMP Active Balanced	3.67%	16.69%
AMP Active Growth	4.39%	18.58%
AMP Active Aggressive	5.20%	20.23%
Indices	1 month	1 year
ASX All Ords	2.08%	18.68%
S&P/ASX 300	4.98%	19.57%
MSCI World Index ex Australia (Un-hedged)	3.87%	14.22%
ASX 300 A-REIT Acc	4.41%	29.37%
Australian Mercer Unlisted Property	3.50%	12.75%
UBS Warburg Bank Bill	0.27%	3.84%

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