Private Capital Advisers

Market Report July 2021

Market returns

Yet another strong quarter for equities and property securities which, in turn, has contributed to the strong performance numbers over both the past 12 months and two years that we see in Figure 1 below.

Bonds (fixed interest) bounced back this quarter after a poor first quarter of the year – however they are still showing negative returns for the full year.

Figure 1: Performance for period ending 30 June 2021

	3mo	1 year	2 years
Australian equities[1]	8.3%	29.4%	10.2%
International equities[2]	9.2%	28.0%	15.9%
Listed property[3]	10.5%	33.2%	2.4%
Bonds[4]	1.5%	-0.8%	1.6%
Term deposits[5]	0.4%	1.8%	2.1%
Cash[5]	0.0%	0.2%	0.5%

1.ASX 200 inc Franking; 2. MSCI World Ex Aus Index; 3. ASX A-REIT Index;
4. Aust Comp Bond Index; 5. RBA data

There are a number of points we would like to make about these results;

- **Diversification remains vital**. The two-year returns show that, among the growth assets where we would expect similar returns in the long-term, we can get large divergences in the shorter term. In particular, Listed Property, with its focus on offices and shopping malls, was deemed by the market to be a long-term casualty of the pandemic and has returned just 2%pa over the past two years while International Equities returned 15.9%pa.
- **Markets over-react**. The property sector which was deemed to be the biggest casualty of COVID, has been the strongest performer of all the sectors over the past year. We are often asked why we continue to hold property when the outlook is so bleak? The answer has been that the outlook is not as bleak as the market suggested and this type of rebound is a typical reaction to a market over-reaction.
- **Even secure investments are capable of producing negative returns over shortish time periods**. Government bonds have had a negative return over the past year; however, over longer time frames returns are more reliable. This, of course, is why we always focus on the long-term.
- **These type of equity returns are absolutely unsustainable.** We are delighted when we do earn these sorts of returns but also need to recognise that even the seemingly more modest two-year returns are much higher than we are likely to earn in the longer-term.

The Long-Term Outlook

The returns we expect going ahead are outlined in Figure 2 below, which shows our forecasts for the next ten years. These forecasts are built up from assessing what we earn from dividends, how fast we expect company profits and property rents to grow and how much we expect future investors will pay for those profits and rents. Unfortunately, these forecasts tell us very little about returns over the next

one to three years, which as we have seen over the past two years, can fluctuate enormously. However, they do give us a very good guide to the longer term – and it is quite a sobering picture.

Figure 2 : Ten-Year Forecast Returns

Base case	Australian Equities	Global Equities	Listed Property[1]	Unlisted Property[2]	Hi Yield Debt	TDs or Govt bonds
Income	4.8%	1.8%	4.4%	5.3%	5.5%	1.5%
Currency impact		0.6%				
Earnings growth	2.3%	4.5%	1.0%	-0.7%	-1.5% [3]	
Valuation change	-2.4%	-3.7%	0.3%	0.8%		
Forecast	**4.6%**	**3.2%**	**5.8%**	**5.3%**	**4.0%**	**1.5%**
PE now	22.2	28.5				
PE 2031	17.4	19.6	4.3%	5.8%		

1. Commercial Property traded on the sharemarket; 2. Commercial property in unlisted funds; 3. Allowance for credit losses

Rather than the 10%pa or more we have earned in equities over the past two years, we now expect the next decade's returns on growth assets will be around 4 to 5%pa. Lower than we would like but still 2.5% to 3.5% better than we expect to get from fixed interest or cash.

This difference is often described as the equity risk premium – the amount of extra return we should receive from equities for taking on equity risk. This premium falls when share prices rise and rises when prices fall. Our assessment of the current risk premium across different markets is shown by the colours in the Tipping Point Tables below.

Figure 3: The Tipping Point Tables

Australian Equities		
All Ords 7,587.1	10 yr F'cast return	Status
9750	1.2%	Overpriced
9500	1.5%	Fully priced
9250	1.9%	Fully priced
9000	2.2%	Fully priced
8750	2.6%	Fully priced
8500	3.0%	Fully priced
8250	3.4%	Fully priced
8000	3.9%	Fully priced
7750	4.3%	Fair value
7500	4.8%	Fair value
7250	5.3%	Fair value
7000	5.8%	Fair value
6750	6.4%	Fair value
6500	7.0%	Cheap
6250	7.6%	Cheap
6000	8.2%	Cheap
5750	8.9%	Cheap

US equities		
S&P500 4,352.34	10 yr F'cast return	Status
4400	0.0%	Overpriced
4300	0.3%	Overpriced
4200	0.5%	Overpriced
4100	0.8%	Overpriced
4000	1.1%	Overpriced
3900	1.4%	Overpriced
3800	1.7%	Fully priced
3700	2.0%	Fully priced
3600	2.3%	Fully priced
3400	2.9%	Fully priced
3200	3.7%	Fully priced
3000	4.4%	Fair value
2800	5.3%	Fair value
2600	6.2%	Fair value
2400	7.2%	Cheap
2200	8.4%	Cheap
2000	9.7%	Cheap

World Ex US		
FTSE World Ex US 322.3	10 yr F'cast return	Status
550	0.1%	Overpriced
525	0.6%	Overpriced
500	1.1%	Overpriced
475	1.7%	Fully priced
450	2.3%	Fully priced
425	2.9%	Fully priced
400	3.6%	Fully priced
375	4.3%	Fair value
350	5.1%	Fair value
340	5.5%	Fair value
330	5.8%	Fair value
320	6.2%	Fair value
310	6.6%	Cheap
300	7.0%	Cheap
290	7.4%	Cheap
280	7.8%	Cheap
270	8.3%	Cheap

A REITs		
ASX REIT 1551.4	10 yr F'cast return	Status
2300	0.5%	Overpriced
2200	1.1%	Overpriced
2100	1.7%	Fully priced
2000	2.3%	Fully priced
1900	3.0%	Fully priced
1800	3.7%	Fully priced
1700	4.5%	Fair value
1600	5.4%	Fair value
1500	6.3%	Fair value
1450	6.8%	Cheap
1400	7.3%	Cheap
1350	7.9%	Cheap
1300	8.5%	Cheap
1250	9.1%	Cheap
1200	9.7%	Cheap
1150	10.4%	Cheap
1100	11.2%	Cheap

In the Red Zone, expected returns are less than those from fixed interest and it is time to start heading for the exits – only the US sharemarket is in that territory today. In the Yellow Zone, we have a smaller than usual risk premium – and so it is time to be cautious. Today most markets are in the Fair Value Blue Zone. This is where we expect 2.5% or higher returns than fixed interest. While expected future returns are modest, they are better than term deposits (TD's) and other very secure fixed interest securities.

High Yield Debt

High Yield debt is essentially an investment in loans to companies where the repayment of the debt is not assured (as compared with TDs and government bonds where the return of capital is government guaranteed.)
Why would we even bother with this type of investment? Because the interest rates on these loans are higher, often much higher, than can be earned on TDs and government bonds.

As can be seen in Figure 2, these types of loans pay interest of around 5.5% on average (compared to government bonds at 1.5%). In our forecasts we have allowed for loan defaults to reduce these returns by around 1.5%pa, to end up with expected returns of 4%pa – much higher than very secure fixed interest and at a similar level to our current expectations for returns from growth assets. These sort of loans, while more risky than TDs, carry about one third of the risk of equities and so are beginning to look quite attractive in the low return environment we foresee ahead.

Accordingly, we are currently spending a considerable amount of time researching the available alternatives in this sector where both the types of funds and the quality of managers can vary considerably. We believe that this is definitely an area where high quality, well resourced managers can make a substantial difference to investor outcomes – particularly when it comes to minimising the inevitable credit losses that will occur in this sector. If and when equity markets enter the Yellow Zone, you should expect that we will be recommending an increase in investments in the High Yield sector.

This market update has been prepared inconjunction with farrelly's Investment Strategy without taking into consideration any of your objectives, financial situation or needs. Therefore, you should carefully consider the appropriateness of the information contained in this market update based on your personal circumstances, needs and objectives before acting on it. We strongly recommend you seek personal advice from Private Capital Advisers Pty Ltd and its representatives prior to acting on the information contained in this market update. Personal advice is advice that is given after having considered your relevant objectives, financial situation and needs. If you choose to act on this information without first seeking personal advice, you risk making a decision that may result in a financial loss.