



January 2018

During the year, anecdotal evidence allowed us to suggest that business was picking up and that housing and construction was busy, mining and resource prices were improving. Resource companies were again spending on maintenance, new equipment & opening up new areas to mine. New expenditure was flowing through the economy and ultimately reflect on results and improve share prices, which has occurred. Headline statistics for the 6 months to December are as follows:

ASX All Ordinaries for 6 months to December +7%
Property Trusts +7%
Balanced Superannuation Fund (Median) +4.4%
Growth Superannuation Fund (Median) +5.4%

We would expect mining and oil companies to be doing it nicely with: Oil at US \$67 per barrel, Gold at US \$1342 per ounce, Metallurgical coking coal at US\$255 per tonne, Steaming Coal at US \$102 per tonne, Iron Ore at US \$78 per tonne, Copper at US \$7,070 per tonne. Whilst the resource prices are probably not sustainable they are likely to last for the next 6 months. These Companies are now re-hiring engineering consultants. Resources pricing is one of the reasons for the strength of the Australian Dollar.

We believe that inflation will remain low and see no strong reason for interest rates to rise. Internationally, we believe that the US Economy is humming along, that Europe continues to improve and even Japan is looking good.

It is hard to know exactly how much future good news is built into current asset prices. So, whilst conditions look more favourable for risk assets, the need for selectivity and due diligence increases and we see further divergence from the mainstream in our portfolios in the year ahead. Our equity market positioning focuses on the niche rather than the core.

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Fair winds

guide investment returns

2017 Year in Review:

Investors had plenty to smile about in 2017, despite a world of worries on the geopolitical stage from the Middle East to North Korea and the South China Sea. The global economy continued its steady improvement and financial markets produced some excellent returns.

The year began with the inauguration of President Donald Trump, whose populist policies on issues such as trade and energy have impacted the global economic agenda. As the year closed the Trump administration's corporate tax cuts were approved by Congress, which should boost US economic activity.

The US Federal Reserve lifted its benchmark interest rate three times in 2017, with more expected this year as the economy strengthens.

Positive economic growth

The global economy grew steadily throughout 2017 with the US and other G7 leading industrial nations growing at around 2.2 per cent. China's growth has slowed, but at 6.8 per cent it's still a global powerhouse and a major customer for Australia's natural resources, education and other goods and services.ⁱ

Australia's economy grew by 2.8 per cent in the year to September, marking 26 years without a recession. The biggest contributor was private sector investment as business profits posted their strongest gains in 15 years.

Unemployment fell to 5.4 per cent, but sluggish wage growth remains an issue for the Reserve Bank.ⁱⁱ A jump in consumer confidence to 103.3 on the Westpac Melbourne Institute scale – anything above 100 is viewed as optimism – was good news for retailers leading into Christmas.ⁱⁱⁱ

Mixed signals on financial markets

The Australian dollar finished the year at US\$78c, up 8.6 per cent, due mostly to strong commodity prices. The cash rate held steady at 1.5 per cent all year while interest rates on government 10-year bonds fell from 2.77 per cent to 2.64 per cent.^{iv} The consensus is that the next interest rate move will be up although perhaps not until later this year.

Commodities were a mixed bag. Global oil prices rose 12.5 per cent to US\$60 a barrel as OPEC members agreed to extend production restrictions. Iron ore fell 3.3 per cent on lower demand from China, while coal rose 5.7 per cent.^v

The shooting star award of 2017 goes to Bitcoin. The value of one Bitcoin soared from around \$1300 in January to a high of over \$22,000 before dropping to around \$17,000 at year's end.

Shares surprise on the upside

Global shares powered ahead, fuelled by economic growth, strong corporate profits and low interest rates.

US shares rose to record highs, up 19 per cent partly in response to the weak US dollar. The low dollar and Brexit uncertainty were a drag on the UK market, but it still managed a 7 per cent lift. Eurozone leaders Germany and France posted gains of 12 per cent and 9 per cent respectively. Asian and emerging market shares were also among the top performers, with the Japanese market up 19 per cent.^{vi}

Property cools

Australian home prices rose 4.2 per cent last year compared with 5.8 per cent in 2016, dragged down by the cooling Sydney market which was up just 3.1 per cent. Hobart (up 12.3 per cent) and Melbourne (up 8.9 per cent) were the strongest capital city markets, followed by Canberra (4.9 per cent), Adelaide (3.0 per cent) and Brisbane (2.4 per cent). Darwin fell 6.5 per cent and Perth was down 2.3 per cent.^{vii}

Most observers predict subdued growth rather than a market bust in the year ahead.

Looking ahead

There is every reason for cautious optimism in the year ahead, although there are risks too. Continuing investigations into Donald Trump could destabilise his leadership and global markets, while closer to home the Reserve Bank is keeping a watchful eye on wages, inflation, the Aussie dollar and property prices.

Even so, local economic growth is on track, interest rates are likely to remain low for some time yet and first home buyers have their best chance in years to get a foothold in the market. Australian shares look fair value although global equities are likely to continue to provide higher returns.

i Trading economics, <https://tradingeconomics.com/country-list/gdp-annual-growth-rate?continent=america>

ii Reserve Bank of Australia, <http://www.rba.gov.au/snapshots/economy-indicators-snapshot/>

iii Westpac Melbourne Institute Consumer Confidence, 13 December 2017, <https://www.westpac.com.au/content/dam/public/wbc/documents/pdf/aw/economics-research/er20171213BullConsumerSentiment.pdf>

iv RBA, rba.gov.au

v Trading economics, <https://tradingeconomics.com/commodities>

vi Trading economics, <https://tradingeconomics.com/stocks>

vii CoreLogic, 2 January 2018, <https://www.corelogic.com.au/news/national-dwelling-values-fall-03-december-setting-scene-softer-housing-conditions-2018#.WIKzW1WWZhE>



Lessons from the GFC

10 YEARS ON

It's been a decade since the market crash known as the Global Financial Crisis rocked the investment world. At the time investors could only watch in disbelief as 50 per cent was wiped off the value of their shares. Arguably, the actions those investors took are still reverberating today. Which begs the question: what are the key lessons of the GFC and did we pay attention?

Predictably, there were warning signs before the eventual market crash. Just as predictably, no-one could predict the exact timing or the magnitude of the crash.

What happened?

Ground zero of the GFC was in middle America. A lengthy period of low interest rates and poor home lending practices left homeowners vulnerable when rates began to rise and house prices fell below the amount they owed the banks. When whole neighbourhoods walked away from their homes and their debts, the liability shifted to the banks.

Compounding the housing bust was the proliferation of new financial products that packaged up sub-prime loans along with higher quality debt and sold them on to global investors. These derivative products with names like collateralised debt obligations (CDOs) were sold as cutting edge but few investors understood the risks.

When in 2007 investors tried to dump their CDOs the investment banks that issued them were unable to finance redemptions. The crisis led to a credit crunch and the eventual collapse of major investment firms like Bear Stearns and Lehmann Bros.

The shock impacted markets around the globe. The Australian sharemarket followed Wall Street, falling around 50 per cent from its peak in November 2007 until it hit rock bottom in March 2009.

What lessons did we learn?

Ten years is a long time on global markets. The US sharemarket is experiencing its second-longest bull run in history – eight years and still going strong. Australian shares have also had eight good years, although prices are still below the 2007 peak.

All of which makes this a good time to ask if investors still remember the lessons of the GFC. Judging by a recent investor survey by Deloitte Access Economics for the ASX, it could be time for a refresher.ⁱ

Overall, 21 per cent of investors said they had little tolerance for risk but still expect annual returns of 10 per cent plus. Worryingly, less than half have diversified portfolios. But the real surprise was that older investors who lived through the GFC were less risk averse than younger investors who have no direct experience of a market crash.

Be aware of market cycles

Perhaps older investors have learned what goes down comes back up, albeit with some twists and turns along the way. Time in the market also makes investors aware that one year's best performing asset class can be next year's worst. The best way to avoid timing the market is to have a diversified portfolio and ride out the short-term volatility.

These lessons were borne out recently when Vanguard looked at the outcome for three investors with a diversified investment portfolio of 50 per cent shares and 50 per cent bonds when the GFC hit.ⁱⁱ When the market bottomed in March 2009, one sold the lot and switched to cash. One sold all their shares and put the money into bonds. And one stayed put in a balanced portfolio.

Fast forward to 2016 and the investor who fled to cash was sitting on a cumulative return of 27 per cent. The investor who put everything in bonds had a return of 71 per cent. But the investor who sat tight with a mix of shares and bonds enjoyed the best return of 93 per cent.

While each boom and bust cycle is slightly different, investors who understand the trade-off between risk and return, hold a diversified portfolio and stay the course, are best placed to ride out market cycles for long-term success.

If you would like to discuss your investment strategy, give us a call.

ⁱ ASX Australian Investor Study 2017 by Deloitte Access Economics, <http://www.asx.com.au/education/2017-asx-investor-study.htm>

ⁱⁱ 'Lessons from the GFC 10 years on' by Robin Bowerman, 4 October 2017, <https://www.vanguardinvestments.com.au/retail/ret/articles/insights/research-commentary/investment-principles/gfc-10-years-on.jsp>



Introducing the new smart (er?) home

Driving towards a mega mansion and watching the house light up as the gates open. Clapping hands to dim the lights and turn up the music. Blinds opening automatically to reveal a stunning vista from the exclusive perspective of a minimalist holiday home / evil lair. If these scenes sound familiar, it's because they've been TV and film tropes for years, used to illustrate a certain kind of conspicuous consumerism. But home automation has come a long way from its inception in the 70's and is no longer the domain of the super rich.

Contemporary smart home systems allow users to automate a huge variety of manual functions. Think of something you'd normally have to be home for – or something you hate getting off the couch to do – and a smart home system can probably do it. All those jokes about having a robot to grab a beer for you in the middle of a match? Not that far off reality any more.

You might have heard the phrase 'internet of things' (IoT). This describes the way the internet now connects a variety of devices, not just computers. According to some theorists, contemporary smart home tech has come to the market in three waves:

- (1) wireless devices with a proxy server,
- (2) AI that controls devices, and
- (3) actual robots as we'd recognise them from those shows and movies.ⁱ

There is a wide range of functionality available. More sophisticated platforms on the market allow you to pre-set a variety of conditions for any activity; blinds, lights and heater for a cosy movie night, or music and flashing lights to get the kids up in the morning. If you've ever seen an ad for the Google Home or Amazon Echo/Alexa, you've seen an example of second gen devices.

On the up side...

Speaking of those two devices in particular, the good news is that the technology is getting cheaper and cheaper. Where once a home automation system – even first generation – would have cost tens of thousands of dollars to install, home control AI now starts at under a couple of hundred bucks. What's more, the fact that the systems are modular means they can be built up over time. There's no massive initial investment, and you don't necessarily have to buy all the components from the same manufacturer. In other words, it's an increasingly scalable lifestyle investment.

The other benefit is that if used well, home automation systems can reduce your energy costs. Smart thermostats can detect when you've left the building and adjust heating/cooling on the fly and lighting controls use sensors to turn lights on only when rooms are occupied. Smart power strips shut power hungry electronics (like DVD players, video game consoles and coffee machines) down when they are not in use.

Too smart for their own good?

Smart homes are more affordable, scalable and effective than ever before. So what do you need to consider? Well, one of the concerns that's been raised with the advent of AI systems is privacy. Some units are 'always on', constantly listening for your next command. That means they hear *everything*. Wi-Fi-connected units may also have the potential to be hacked.

The good news is that there's a lot you can do to prevent someone messing with your new smart home. Ensure you compare security specs just as closely as you inspect the cooler features when you're shopping around. Look for component suppliers who continuously work with security testing companies (a.k.a. ethical hackers) to seek out and eliminate security flaws.

One thing is for sure, home automation is a trend that is not going away any time soon. Incorporating some level of automation into your home can potentially add significantly to your lifestyle, and may even reduce your bills and improve the value of your property. While it's important to ensure your household's privacy and security is maintained, there's something to be said for kicking back with your robot butler waiting on you, under auto-dimmed lights with the game on. Another cold beer anyone?

ⁱ Li et al, 'Sustainable Smart Home and Home Automation' International Journal of Smart Home, Vol. 10, No. 8 (2016) pp. 177-198. Available at http://www.sersc.org/journals/IJSH/vol10_no8_2016/18.pdf