NEWSLETTER

May 2019

Introduction

Welcome to our newsletter for May 2019. Having examined the Budget last month, this month we steer well clear of politics. Instead, we have a good look at the state of the share market and also have a good think about interest rates and their likely next move. Enjoy!

Famous People in Finance – Burton Malkiel

Burton Malkiel is an American Economist and author. His most well-known book is 'A Random Walk Down Wall Street,' first published in 1973. By 'random walk,' he means the day to day movements in share prices, which he essentially argues are almost impossible to predict because they do not move in any systemic way. As a result, he recommends 'passive' management techniques that involve diversified investments held over lengthy periods of time.

Malkiel spent almost three decades as a director of the Vanguard Group, the world's largest provider of managed funds and second-largest provider of exchange traded funds (which are essentially managed funds traded on a stock exchange). He then went on to become a Professor of Economics at Princeton University. According to his publisher, WW Norton, his book has sold more than 1.5 million copies.

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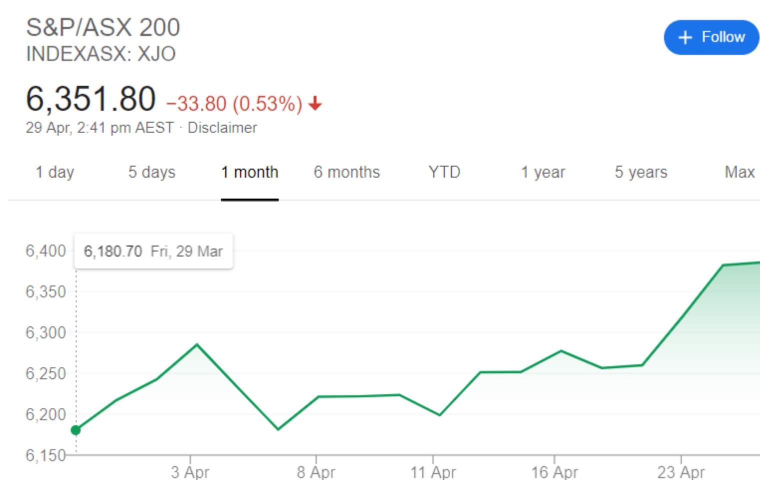
The Share Market

Our last newsletter focussed on the Federal Budget released in early April. This means it has been two months since we last had a look at the state of the Australian sharemarket. Those two months have been good to the market. Having ended the month of February on 6169 points, as of close of business on Monday, April 29, the market (as measured by the ASX 200 index) had risen to 6353 points. This is a rise of almost 3%.

The rise occurred almost entirely in April. On Friday, March 29, the market closed at 6180 points. Here is Google reported the one-month period to 29 April (the figure in red, accompanying the down arrow, is the performance for the single day of April 29):



As you can see, prices rose reasonably steadily across the month. There was no particularly outstanding event that drove the market higher - it was basically market-wide sentiment that shares are worth buying that caused prices to increase.

As it happens, Wednesday, April 24 was the first time that the ASX 200 had risen above 6350 points since December 2007, just before the global financial crisis saw a huge loss of market confidence such that the market bottomed out in March 2009 (just 16 months later) at less than 3150 points. If you can stomach it, here is how the period between 2007 and today looks on Google. We have highlighted the market bottoming in March 2009:

Between March 2009 and the end of April 2019 - almost exactly 10 years - the value of the ASX 200 doubled. This implies an annual rate of compounding capital growth of approximately 7.2% (later in this newsletter, we will show you a neat trick that lets you calculate a rate of growth like this very quickly). As we have said before, the index includes the market price of the shares. An increase in market price leads to what is known as a 'capital return.'

The capital return is only one of the two types of return available to share market investors. The other is the 'income return,' which comprises dividends that a shareholder receives while they continue to hold shares in a particular company.

Over the last 10 years, the average rate of dividend return on the Australian stock market has been a touch more than 4%. When added to the rate of capital return, the annual rate of growth over the last 10 years becomes a very healthy 11.2%.

Taken together, if you had invested $1000 in a portfolio that matched the composition of the ASX 200 in March 2009, and then reinvested all dividends received on that portfolio, as of the end of April 2019 your investment would be worth $2890.[1] Overall, your return is almost 190%.

Of course, back in March 2009 you would have needed to have been brave enough to invest $1000 into a sharemarket that had lost half of its value over the preceding 16 months - and not many people had the courage to do that! Courage and fear are the two most common emotions that investors need to manage if they going to do well in sharemarket investing. One of the easiest ways to manage these two emotions is to minimise the impact that specific points in time will have on your portfolio. Basically, this means purchasing a series of smaller parcels of investment units (for example, shares) over a period of time rather than purchasing one large parcel of investment units at a single point in time. The same logic is applied when selling - sell smaller parcels of investment units at multiple periods of time rather than a large parcel at a single point in time.

This type of buying is exactly what happens for most people while their super fund is in 'accumulation mode' (ie, while they are still working and regular contributions are being made into their super fund). Depending on the investment strategy of the particular super fund, the regular contributions lead to automatic 'spreading' of the purchase of investment units. Amongst other things, this removes the the need for super fund members to be especially brave!

We have talked about this in previous newsletters - but we would be more than happy to return to this most favourite of topics if you would like us to. So, please do not hesitate to get in touch if you'd like to discuss ways in which you too can smooth out the inherent volatility of markets such as the Australian sharemarket.

Where to Next for Interest Rates?

Australian interest rates are currently at very low levels historically. Despite this, many commentators are predicting that interest rates will fall between now and the end of 2019 - with some people even predicting that the Board of the Reserve Bank of Australia will decide to lower interest rates in its May meeting next Tuesday.

One of the reasons for this is that Australia's rate of inflation has fallen below the Reserve Bank's target level. Traditionally, the Reserve Bank aims for annual inflation of between 2 and 3%. In the 12 months to March 2019, the annual inflation rate was just 1.3%. For the three months to March 2019, inflation was actually 0%.

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1 Please note this analysis assumes there are no fees involved when you reinvest your dividends.

RESERVE BANK
OF AUSTRALIA

Inflation is the extent to which prices are rising. Therefore, you could be forgiven for thinking that inflation of 0% is a good thing. Unfortunately, things are not that simple. Historically, people who have borrowed money to buy valuable assets have benefited when the value of those assets rose due to inflation. Typically, rises in inflation are matched by rises in income - after all, if prices rise and incomes don't, people will have to stop buying things. (When they do that, prices fall - which is actually what has happened over the last few years. Incomes have not risen. Combined with high prices for nonnegotiable purchases such as housing, 'discretionary' spending is the part of household spending that has to fall.)

If inflation increases the price of an asset that money has been borrowed to purchase, then the proportional value of the debt is reduced. For example, if I borrow $100 and purchase an asset worth $200 (obviously using $100 of my own), and then prices rise by 5%, the asset is now worth $210. But my debt remains at $100. My debt was originally worth 50% of the asset. Now the debt represents less than 50%. My equity rose from $100 to $110 while my debt remained at $100.

So, rising general prices reduce the relative value of debt. This has helped generations of borrowers pay off large debts such as home loans.

Australia has just experienced an extended period of house price increases. This has driven house prices to a very high level in terms of how many years people need to work to earn sufficient income to finance a purchase. Over the last 12 to 18 months, house prices have been falling. This has the opposite effect on the relative indebtedness of people who borrowed to buy their homes: the value of the asset is falling, but the value of the debt remains the same. Debt rises as a proportion of total asset value.

The Reserve Bank does not want this to happen. That is why it targets a minimum inflation rate of at least 2% per year. Now that inflation has fallen below that target, most commentators are expecting the Reserve Bank to act by reducing interest rates. This should encourage new borrowing and therefore new spending, creating demand which is intended to give a positive nudge to general prices. Put simply, lower interest rates mean that people borrow more, buy more and push prices upwards.

One conundrum for the Reserve Bank is that an election is looming. Historically, boards of the Reserve Bank have preferred not to change interest rates during an election campaign, for fear that doing so will give a boost to one or other of the major parties. But this year may be different - especially as so many commentators are forecasting a reduction in the official interest rate. To *not change* interest rates may actually be seen as boosting one or the other party's prospects.

Much will depend on the extent to which the Reserve Bank Board trusts that Australians know that interest rates are not set by the Government of the day. All eyes will be on the Reserve Bank's board when it meets next Tuesday morning.

What to Do If Interest Rates Fall

The best response to falling interest rates depends on whether you are a borrower or a lender. Remember, everyone with an interest-bearing investment such as a term deposit or cash management account is actually a lender.

If you are a borrower, reduced interest rates give you a greater capacity to repay your debt. If you maintain the same level of repayments, then the amount of each repayment that is used to pay interest each period will be less. That means that the amount of each repayment that is used to repay principle each period will be more - you will be automatically reducing the amount that you owe. Keeping up the same level of repayments will reduce your debt without you really even noticing.

This is a terrific response to the opportunity that lower interest rates create. So, if you are a borrower, our basic advice is to keep repaying your debt as if interest rates had not changed. This is the financial version of "making hay while the sun shines."

If you are a lender, things are not so simple. Basically, you should come to see us and we will examine whether your portfolio needs to be 'tweaked' away from interest-bearing assets towards some other type of asset.

The Rule of 72

Here is a neat little mathematical trick that you may not have heard of. We used it ourselves in the above analysis.

When a compounding rate of interest is divided into the number 72, the answer that you get approximates the number of periods it will take for the effect of compounding to double the initial amount. That sounds like quite a mouthful so let's use a specific example.

If I invest $100 at an interest rate of 7.2% per year compounding, after 10 years I will have $200 (72 divided by 7.2 equals 10). If the interest rate is 8% per year compounding, it will only take nine years for my investment to double to $200 (72 divided by 8 equals 9). If the interest rate is 9% per year compounding, it will only take approximately eight years for my investment to double (72 divided by 9 equals 8). And if the interest rate is 10% per annum, my investment will double in approximately 7.2 years (72 divided by 10 equals 7.2).

In the analysis above, we used the rule to work backwards: the ASX 200 had roughly doubled over a period of 10 years. 72 divided by 10 gives an approximate interest rate of 7.2% per annum compounding.

The "rule of 72" can be used as a quick way to understand the longer-term impact of something we do today. Let's say you have a home loan and you are paying interest of 5%. You receive a cash bonus of $1000. If you use that bonus to make an extra payment on your home loan, over the next 14 years or so you will save an extra $1000 in interest that you don't have to pay because of the extra payment (72 divided by 5 is approximately 14). If interest rates rise to 6%, it would only take 12 years for you to save that extra $1000 in interest.

You can also use the rule of 72 to judge the value of an investment. Let's say some charlatan offers you a dodgy investment with a "guaranteed rate of return of 3.5%." That might sound great until you divide 3.5 into 72 - and realise that it will take approximately 20 years for your investment to double in value.

Or, you can use the rule of 72 to estimate the impact on purchasing power of Australia's annual inflation rate. The Reserve Bank of Australia targets and inflation rate between 2 and 3% per year. Inflation calculations are compounding. If inflation is running at 3%, it will take approximately 24 years for prices to double (72÷3). As we say in the above article, though, inflation is currently just 1.3%. 72 divided by 1.3 is 55 – so at the current rate of inflation, prices would not be expected to double until 2074.

Not great news if you would like some help smashing that mortgage! (There are other things you can do, though – so don't forget to talk to us about ways to pay off debt more quickly).

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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