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Investing in a low growth environment.

The Investment Report.

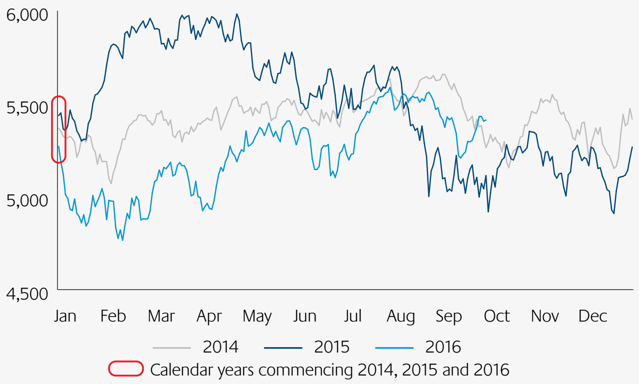
Australian Equities, Growth

Opportunities and resilience

Today's low return, low growth environment presents challenges to investors looking for income and capital growth. However, opportunities are out there – the key is knowing where to look. The Australian share market continues to be an attractive place to invest for domestic and international investors on many measures, and continues to compare favourably with other sharemarkets.

It has been a rollercoaster ride for investors in domestic and global equities in recent times. In the 10 months between April 2015 and February 2016, the S&P/ASX 200 Index traded in a range of 20%, from 5982 to 4765. However, calendar year returns for investors have masked this volatility. For example, the S&P/ASX 200 Index has finished the past three years back where it started, at around 5300 points. It is little wonder that equity investors may feel that they are not getting adequate returns for the risk they are taking on.

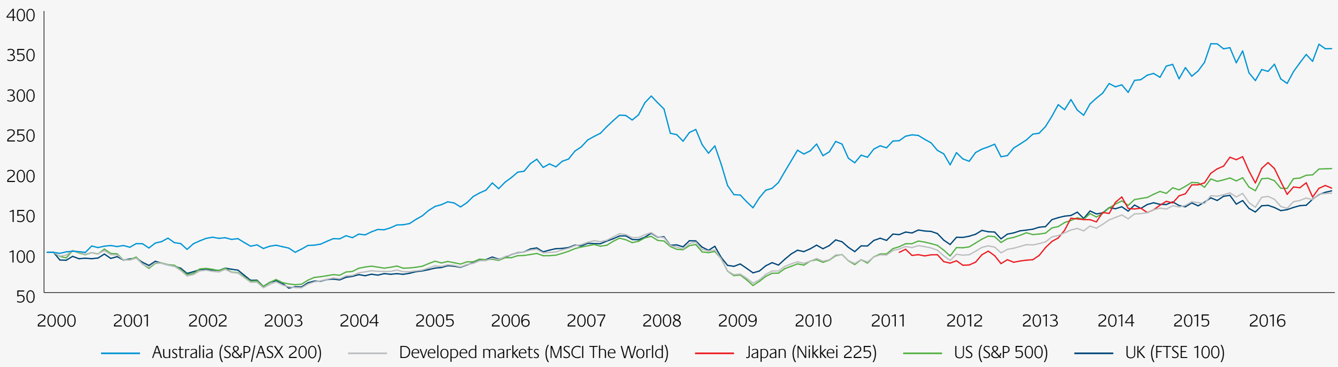
Chart 1: Calendar year performance of the S&P/ASX 200 Index



Factset, September 2016.

Add in dividends however and the picture begins to look a little different. The median yield of the Australian share market is 5%, which is around double that of its developed market peers. Over longer time periods and on a total return basis, the ASX 200 Accumulation Index has delivered a solid outcome – returning more than 11% pa for the five years to the end of September 2016.

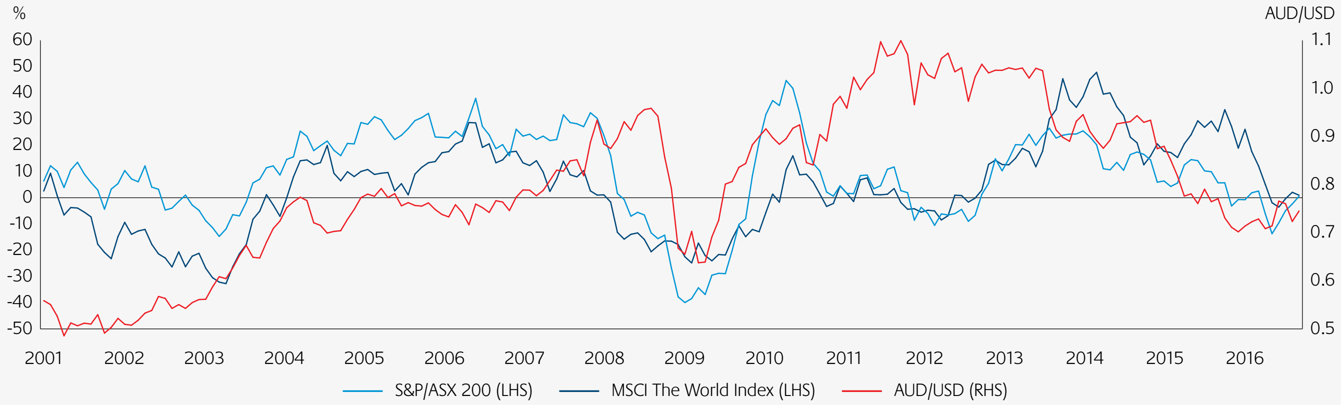
Chart 2: Equity market index total returns by country – June 2000 to June 2016



Source: Factset, September 2016.

The share market has recently underperformed international share markets when compared in Australian dollar terms, owing to the weaker domestic currency, as illustrated in Chart 3. However, the chart also shows that the market has bounced off its recent lows and now compares favourably against its global peers. This is a reflection of the resilient Australian economy and inherent vitality of select companies.

Chart 3: Rolling 12 month returns – Australian share market vs MSCI The World Index in AUD terms



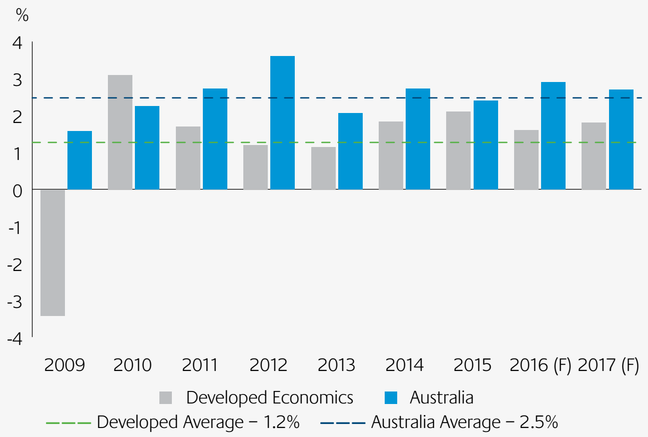
Source: Factset, September 2016.

A resilient economy

The domestic economy offers much more resilience and flexibility than many commentators would have us believe. For example, those that forecast a major downturn as the mining investment boom ended have been proven to be overly pessimistic, as Australia now marks 25 years without a recession.

Growth forecasts for this year, and next year, remain well above other developed economies. Australia has, therefore, been able to maintain an average level of annual growth more than double that of the developed world since the Global Financial Crisis, as illustrated in Chart 4.

Chart 4: GDP growth (%) 2009 – 2017

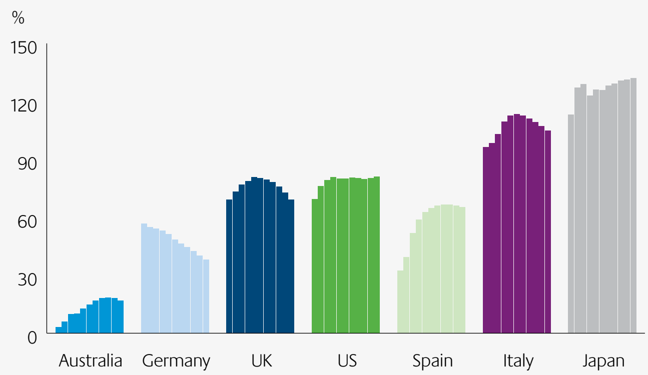


Source: IMF data as at October 2016.

The economy even appears to be successfully rebalancing post the mining boom, with consumer and business confidence remaining around long-term averages. GDP is growing, driven by public investment and government consumption. Portions of the economy, such as tourism and education, have also benefited from a weaker Australian dollar.

Although it has been rising it recent years, the Australian government has one of the lowest levels of debt as a percentage of GDP globally, which has helped fund public expenditure.

Chart 5: Government net debt as a percentage of GDP 2010 – 2020 (forecasts from 2016)



Source: Commonwealth Treasury – 2016/17 Budget.

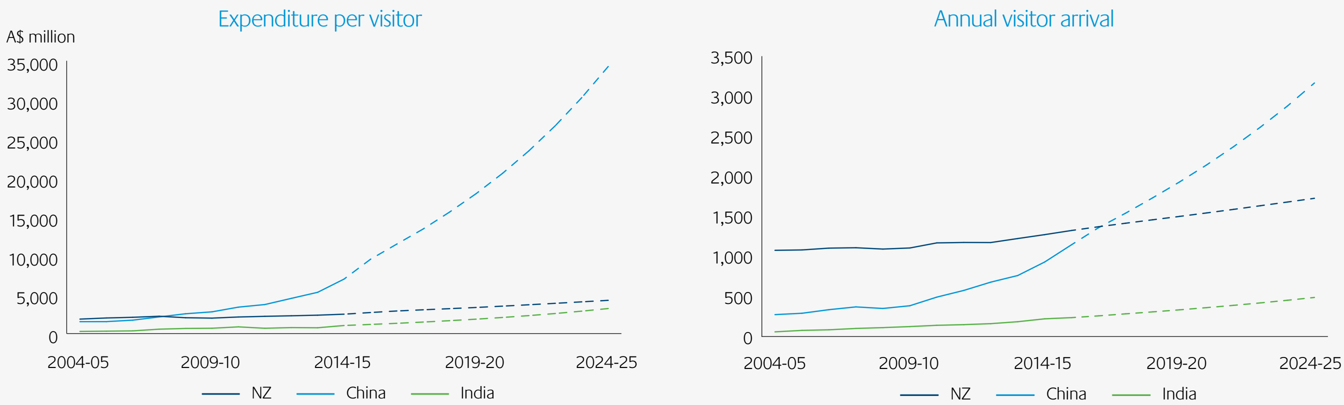
Australia v developed economies

The health, education, infrastructure and tourism sectors are a particular cause for optimism for a number of Australian companies. In the tourism sector for example, Australia now ranks behind only the US and the UK as a destination for overseas students. The number of visitors from China surpassed one million for the first time this year, second in number only to New Zealanders. Arrivals from China and India have doubled over the past five years, and are forecast to double again within the next five years.

Importantly, Chinese visitors, and a number of other visitors from Asia, are each spending a lot more than visitors from richer, more developed economies. As Chart 6 illustrates, they are either already spending more – or are soon to overtake – visitors from countries such as New Zealand, the UK and the US.

Combine the growth in visitors with the higher expenditure per visitor, and it quickly becomes apparent how important Asian tourists are to the local economy. By 2025, the contribution from Chinese visitors is expected to exceed $34 billion (bn). This will be more than double the combined total of the other three developed countries' visitors at $16bn.

Chart 6: Annual visitor arrivals and spending



Source: Tourism Research Australia.

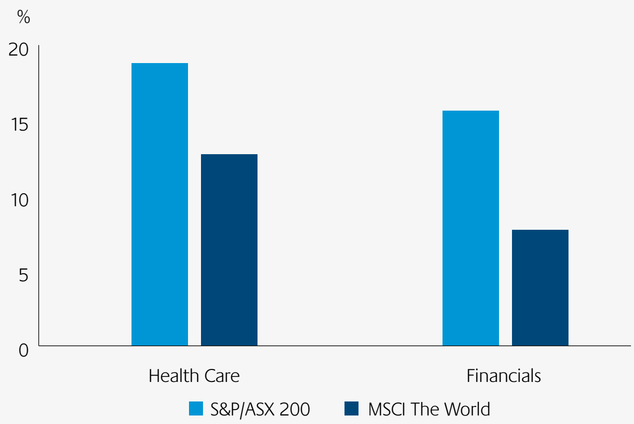
Strong growth prospects for Australian companies

Australian companies continue to score well on many economic and financial measures relative to their global peers. Companies in the Financials and Health Care sectors generally have a much healthier return on equity, as illustrated in Chart 7.

Despite Australia's relatively-small size, outward-looking strategies have seen many companies expand globally with great success.

In the Healthcare sector for instance, CSL, Cochlear and ResMed have all become global leaders in their product lines, and we have seen companies such as Sonic Healthcare, Mayne Pharma and Sirtex Medical, establish significant offshore operations.

Chart 7 : Health Care and Financials return on equity – S&P/ASX 200 vs MSCI The World Index

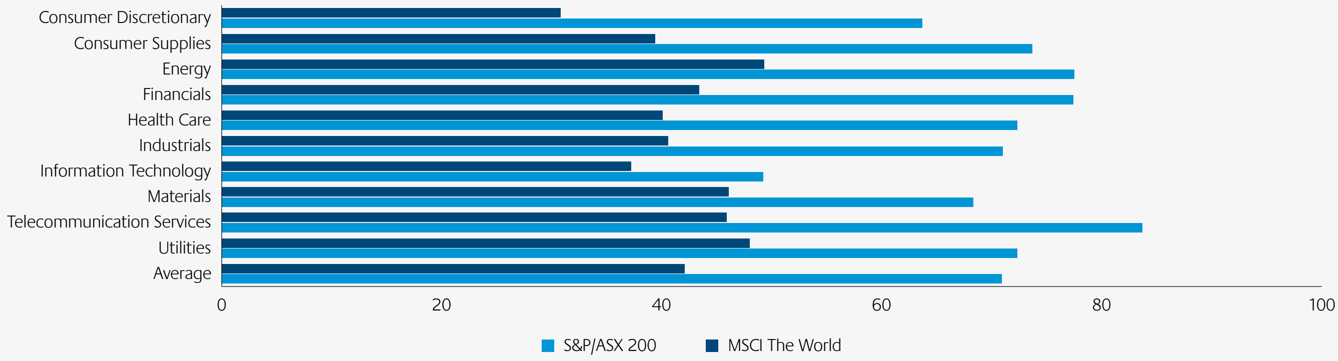


Source: Factset, September 2016.

Outside of the Healthcare sector, there is an abundance of quality companies that have great management teams and bright prospects in the areas of agriculture, tourism, education and infrastructure. Companies as diverse as Amcor (packaging), Brambles (pallet pooling), James Hardie (fibre cement products), Goodman Group (industrial property), Macquarie Bank (financial services), have all developed substantial and high returning businesses outside of Australia.

Australia also scores very well on a range of environmental, social and governance (ESG) measures. ESG risks are material investment issues that have the potential to impact long-term investment performance. A positive approach to ESG issues, supported by shareholder activism and a strong regulatory framework, is essential for achieving sustainable financial markets and a sustainable economy.

Chart 8: ESG score by sector – S&P/ASX 200 vs MSCI The World Index



Source: Factset, September 2016.

Of course there are risks in the Australian market as well. Concerns remain around the overheated property market, while wage growth and inflation remain lower than desired. Cost-cutting and productivity improvements continue to be the main source of earnings growth for companies, but clearly these cannot continue forever.

In the context of a world with political uncertainty in the US, somewhat opaque Chinese growth, re-adjustment in a post-Brexit UK and social upheaval in Europe, investors in the resilient Australian share market have reasons to be confident with the investment opportunities on offer.

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