July 2019

PERPETUAL SELECT ANNUAL UPDATE 2018/19

SELECT SUPER, PENSION, INVESTMENTS – JULY 2019

WELCOME TO YOUR ANNUAL UPDATE

Thank you for trusting Perpetual to manage your money over the last year. It is not a role we take lightly - we know that trust needs to be earned every day.

The past financial year has been an up and down one in investment markets. Through it all our investment strategy of seeking first to protect, then grow your money for the long-term, has continued to work.

Your annual statement for 2018/19 is enclosed containing details of your account balances, returns and transactions.

A VOLATILE SHAREMARKET

We saw healthy gains in the early part of this financial year, as both local and global share markets continued their rise. Then, just as we were settling in for the summer, a very poor final quarter of 2018 saw shares tumble around the world. Thankfully, in the first half of 2019 we have seen a strong rally taking us above June 2018 levels for the end of the financial year.

The big question is: how long will the volatility continue? Perpetual does not believe successful investing comes from predicting these events, but from actively preparing for a range of events. That's why at Perpetual, we minimise volatility by diversifying across different asset classes and geographies and concentrating on strong fundamentals which deliver better returns over the long term. We believe our style will continue to deliver well into the future.

A SLOWING ECONOMY

The global economy has been slowing recently, partly thanks to the on-again, off-again trade war between the world's two biggest economies. The European Economic Area has also slowed, mostly due to weakening consumer and business confidence, and the ongoing Brexit dilemma continues to cause instability and uncertainty.

This global slowdown has weighed on the Australian economy, while local factors such as the decline in housing have also played their part. While overall economic growth for Australia is likely to be down on last year, it's not all bad news. Infrastructure spending is boosting GDP while having positive flow on effects for downstream businesses. Continuing high population growth, relative to other advanced economies, also has a positive ongoing impact.

AUSTRALIAN HOUSING MARKET

The big news for many in Australia over the past year was the slump in the residential housing market. House prices fell around 10% over the last financial year, with bigger drops in Sydney and Melbourne. While we've seen the pace of decline slow in recent months, partly due to the return of the Coalition government, it's too early to tell if this signals the end of the housing slump or whether it's a momentary lull.

THE PERSONAL, NOT THE POLITICAL

The election result in May surprised many. Whatever your political persuasion, it means no major changes to negative gearing, Capital Gains Tax and superannuation – which for many investors is good news. Interestingly, for many clients it is personal, not political change that prompts a visit to their financial planner – so don't hesitate to reach out if family or personal events have changed your goals or needs.

NEW CEO

In last year's letter I mentioned Perpetual's new CEO, Rob Adams. Rob is a proven financial services business leader and joins Perpetual with 30 years' experience locally and globally across funds management, financial advice and fiduciary services. Rob has had a busy time since he joined us in September last year as he focuses on a strong strategy for growth. While this is early in Rob's tenure the changes he is making are being well received internally.

My thanks again for trusting Perpetual, I wish you a successful and fulfilling year.

MARK SMITH
Group Executive,
Perpetual Private

FINANCIAL YEAR 2018/19 AT A GLANCE

AUSTRALIAN SHAREMARKET

The Australian stock market in FY2019 overall was another strong year for investors, with the S&P/ASX 300 Accumulation Index posting a strong 11.4% return for the year. However, the performance number alone doesn't describe the volatility we experienced over that year, with the December 2018 quarter suffering a significant loss of -8.4%. This return was reversed in a very strong March 2019 quarter, followed up with a strong run to the end of the year, highlighting the importance of staying invested through volatile markets.

As active value investors, it's been a difficult year to outperform the index. Active managers tend to outperform through superior stock-picking in less efficient parts of the market, such as mid-caps and small-caps. A divergence between the performance of large-cap stocks (the S&P/ASX 50 Accum returning 14.2% for the year) and small-cap stocks (the S&P/ASX Small Ordinaries Accum index returning just 1.9%) has seen this broader market dynamic overwhelm our managers' ability to add relative value by selecting stocks with superior fundamental characteristics.

As long-term investors, our managers try to look through these shorter-term market dynamics and continue to focus on the basic principle that buying quality companies at a price representing good value for investors will ultimately lead to outperformance over the longer-term. With the outlook for markets becoming more volatile and less predictable, we believe this style of investing will ultimately lead to better outcomes for members.

GLOBAL SHAREMARKET

In line with the Australian market, global markets had a strong year with the MSCI All Country World Index returning 11.3% on an unhedged basis in Australian Dollars, currency comprising a little under 1% of this return. It has been a volatile ride over the last 12 months, underscored by global tensions from the China-US trade war and geopolitical issues such as Brexit, leading to emerging concerns over global growth. This saw a sharp change in stance from the US Fed, which had been increasing rates into the end of 2018, to now being on hold in 2019, with an easing bias as we finish the financial year.

Developed Markets outperformed Emerging Markets (EM), the underperformance of Chinese equities (more than half the EM index) outweighing any outperformance from non-Asian segments of the index. Chinese trade volumes, manufacturing output and business investment have all slowed into the end of the financial year in response to the imposition of US tariffs. In contrast, the US economy has continued its record-breaking run of growth, posting the best GDP growth in developed economies over this period.

Despite the strong returns we've seen over the last year, our outlook remains subdued. Despite the 'trade truce' agreed to between the US and China in the last quarter, global trade tensions remain, also contributing to a significant slowdown across the Eurozone. Growing populism, as evidenced in recent European elections as well as the slow-motion car crash of Brexit and its implications for the UK economy creates significant uncertainty and a headwind for markets.

We continue to focus on managers that are active and take a fundamental approach to picking stocks, which we believe is the best way to navigate these increasingly tricky markets over the near to medium term.

INFLATION, INTEREST RATES AND CREDIT SPREADS

The previous outlook of stronger inflationary pressures leading to rising rates at the start of the financial year has seen a reversal over the last twelve months with central banks shifting to a more supportive and easing stance by year's end.

Domestically, the RBA had remained on hold for a record-breaking run of 30 consecutive meetings before cutting the official cash rate by 25bp in June 2019 and by another 25bp in July 2019, bringing the official cash rate to a record low 1%. The change can be partly attributed to the slowdown in global and domestic growth.

Locally, the Australian economy grew at an annual rate of 1.8% in March, below trend and below the G7 average of 2.0%. Inflation remains subdued at 1.3%, well below the RBA target range of 2-3%. On a brighter note, wages growth was 0.5% for the March quarter, delivering 2.3% growth for the 12 months ending March 2019.

The Federal Reserve 'broke from the crowd' over previous quarters, raising rates to a target Fed funds rate range of 2.25-2.5% by December 2018. The Fed maintained a hawkish stance into the last quarter, even stating that rates remained 'a long way from neutral' in November, however this was quickly changed to a more neutral stance after equity markets sharply sold-off in an expectation of higher rates in the new year and currently the market is expecting no moves this year and the possibility of one or 2 rate cuts in 2020.

The US is also suffering from low inflation, 1.8% for the March quarter with the Fed predicting this to fall to 1.5%. US GDP grew at an annual rate of 3.1% in the March quarter, much higher than the G7 average and the unemployment rate was 3.8%, down 0.1% from 3 months earlier.

We've seen a significant decline in rates over FY2019, leading to a rally in bond prices over the period, the Bloomberg Ausbond Composite Index returning 9.6% in FY2019. The Australia 10-year bond rate printed a record low yield of 1.32% at the end of June, indicating bond markets, at least, are expecting a worsening economic situation, in contrast with rallying equity markets.

FROM THE SELECT MANAGER

FY 2019 was another year of strong returns for equity investors, however what was markedly different was the volatility that members experienced over that period. The first half of the year, particularly the December quarter, saw the gains made during the last half of FY2018 largely wiped out, with the calendar year essentially delivering flat returns in equity markets. Contrast this with the next six months, which saw strongly resurgent markets, completely recouping losses from the previous half and then climbing strongly to the end of June, delivering another year of low double-digit returns in equity markets.

The importance of staying the course through markets could not have been more apparent. Had investors moved to cash at the end of that December quarter, and stayed on the side lines for just six months, they would have missed out on a near 20% return on the Australian stock market and 16.6% in unhedged International equities – some of the strongest equity markets we've seen in decades.

We are entering an interesting period in markets. Equity markets have been rallying against a backdrop of synchronous global growth, low unemployment and supportive interest rate settings. At the same time, fixed income markets have reached record lows in yields, reflecting pessimism on the economic outlook ahead. The RBA's two recent rate cuts are in response to below trend growth and a slowing domestic economy – indicators of the economy being late in the business cycle. Most business cycles end in recession, which Australians have not experienced since 1991. 28 years without recession is a record for a developed economy, however also presents challenges as many superannuants and investors today have not had the experience of managing portfolios through recessionary times.

As a member of Select, you are invested in an actively managed portfolio, accessing multiple investment teams' expertise across a broad range of diversifying asset classes. In a low-return environment, any potential of outperformance is increasingly valuable. Likewise, the ability to protect on the downside is even more important in terms of preserving members' capital in retirement, as drawdowns are harder to clawback.

Exploiting hard to access asset classes, such as alternatives, has been a feature of Select for many years. During the volatile markets that we experienced over this year, the stabilising role of these asset classes came to the fore, with a materially positive impact on the risk-adjusted returns of members' portfolios.

With the turmoil and turbulence being felt in the wealth management industry, you can rely on Perpetual to continue to earn the trust of members – everyday.

Members trust us to deliver on their objectives as consistently and reliably as possible. To do this, we construct a more resilient portfolio that brings the very best investment capability from across the globe to the benefit of our members. By delivering excellent investment outcomes, we seek to provide members of Select with a retirement that is well funded and, at least financially, worry free in your golden years.

Thank you for your continued investment in Select.

KYLE LIDBURY
Head of Investment Research,
Perpetual Private

ALTERNATIVE ASSETS

Select's Growth alternatives program underperformed its 'cash-plus' benchmark in FY2019, however continued to provide a source of portfolio stability, exhibiting much lower volatility than the wild ride that we saw in equity markets over the period. Our Private Equity managers experienced some negative mark-to-market returns, in line with a sell-off in equity markets, however they continue to realise historic investments at a significant return over initial investment. Against this backdrop, the rally in rate-sensitive assets led to strong returns in the program's infrastructure and property-related investments, while the absolute return strategies and hedge funds struggled in an environment that has been difficult for active investment managers globally.

Our Income alternatives program continues to provide a healthy return above the cash rate, which has been particularly beneficial in the historically low interest-rate environment prevalent since the GFC. Our managers continue to take advantage of markets where there is a shortage in capital, such as credit markets in Europe which continue to see a lack of availability of bank finance, where alternative lending managers can step in to fill the gap left by the banks. The specialist credit allocation in this portfolio is yielding 5.8% gross per annum, compared to the current Australian RBA cash rate of 1%.

PROPERTY

Property assets have responded to the change in stance of central banks, strongly rallying in response to the prospect of lower rates. Core property with strong rental income streams continues to rally off the back of investors' 'search for yield', bidding up valuations in the process. Australian listed Real Estate Investment Trusts (REITs) returned 19.4% to the year ending June 2019, well in excess of the returns that we expect from this asset class.

FY 2018/19 AT A GLANCE
CONTINUED

REITs remain in good shape, with real estate operating conditions remaining sound, although rental growth rates continue to moderate in some sectors and geographies. Any change in fundamentals is likely to be driven by a supply-side response. Supply has been slower to respond this cycle, however full valuations are now stimulating new construction which could erode medium term growth. While construction has begun, much of it has yet to be completed and is not yet having an impact on rents.

At the time of writing, following two quarters up upward price movement, REITs are broadly trading at or near their asset backing. Previously we have noted that REIT pricing reflects a discount to the private market values of their underlying property assets, despite this, we prefer listed markets over unlisted markets, despite the volatility that this might create in portfolios.

We expect that REIT pricing will remain supported by buy-backs and further M&A activity, particularly while credit remains readily available. Despite sound real estate fundamentals and reasonable growth prospects for the year ahead, we would not be surprised to see fears around rising interest rates and a maturing economic cycle weigh on the market's mood. Any surprise rise in interest rates is likely to weigh on the markets appetite for REITs.

SUPERANNUATION LEGISLATIVE UPDATE

To ensure you get the right advice for your situation, please consider speaking to a financial adviser.

PROPOSED CHANGES TO SUPERANNUATION

The Federal Budget announced on 2 April 2019 several measures that will provide more opportunity for older individuals to make personal superannuation contributions – both concessional contributions and non-concessional contributions.

Following is a summary of the key proposals.

It is important to note that at the time of writing, the following proposals had not yet been legislated and may not proceed or may be amended.

CHANGES TO ELIGIBILITY FOR THE WORK TEST

To better align the work test with the Age Pension age, the Government proposes to increase the work test lower age threshold from 65 to 66 from 1 July 2020.

Currently, individuals aged 65 to 74 are required to satisfy the work test in order to make personal contributions and have voluntary employer contributions made on their behalf (with the exception of mandated employer contributions such as Superannuation Guarantee Contributions and Downsizer Contributions).

The work test requires an individual to be gainfully employed for gain or reward for at least 40 hours within 30 consecutive days, during the year in which the contribution is made.

EXTENSION OF THE BRING-FORWARD PROVISIONS

The Government is proposing to extend eligibility to the bring-forward provisions to individuals aged 65 or 66 from 1 July 2020.

Currently, individuals aged 64 or less at any time during a financial year can, subject to their contribution caps and total super balance, make non-concessional contributions of $100,000 or $300,000 under the bring-forward provisions.

CHANGE TO ELIGIBILITY FOR SPOUSE CONTRIBUTIONS

The Government proposes to increase the qualifying age of the spouse from 69 to 74 from 1 July 2020.

Currently, an individual may be eligible for a tax offset of up to $540 on superannuation contributions made on behalf of their spouse.

To be eligible, the recipient spouse must be an Australian resident, under age 70, with total income less than $40,000, who has not exceeded their non-concessional contribution cap and has a total super balance less than $1.6m at 30 June in the preceding financial year. If age 65 to 69, they must also satisfy the work test (or the work test exemption).

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