LOGICAL THOUGHTS

logical financial management

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PART 1 - DEMOGRAPHICS

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What are Demographics?

Demographics are the study of a population based on factors such as age, race, sex, economic status, level of education, income level and employment, among others.

Two long established demographic trends are lengthening lifespans and declining fertility rates.

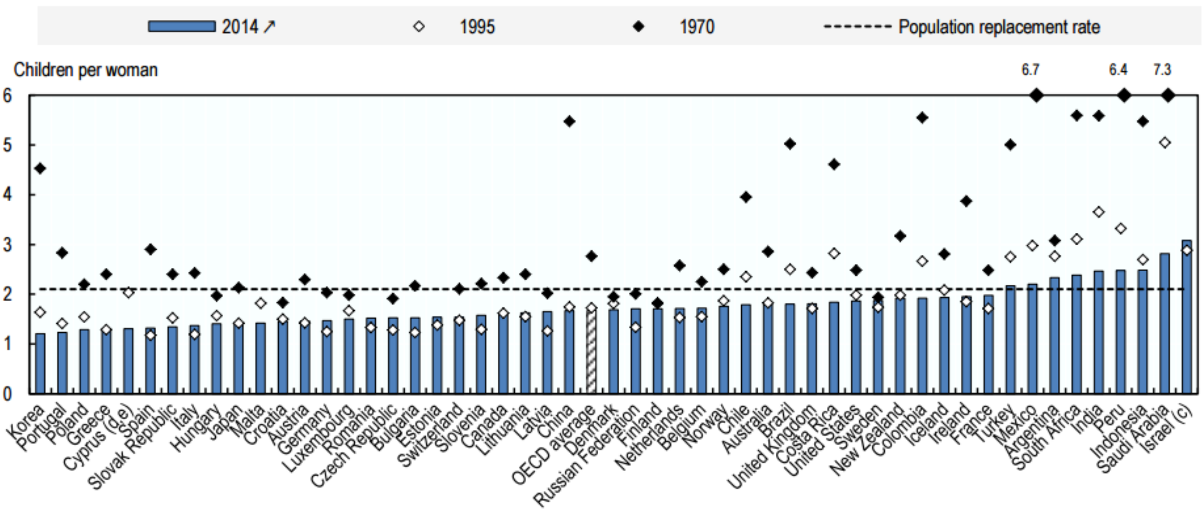
Declining Fertility Rates

As a country urbanises it becomes wealthier. It costs more to raise and educate kids and so couples naturally choose to have fewer kids or postpone having kids until later in life. Every developed country has seen such trends, as have the urban populations of emerging countries.

A fertility rate of about 2.1 will produce a stable population and the average fertility rate in OECD (The Organisation for Economic Co-operation and Development) countries is now just 1.6. Less than this and the population will decline unless the shortfall is made up by immigration.

Many reasons have been given for the dramatic change in fertility rates. The most convincing is that young women, now better educated than those of earlier generations, wish to have a career as well as a family.

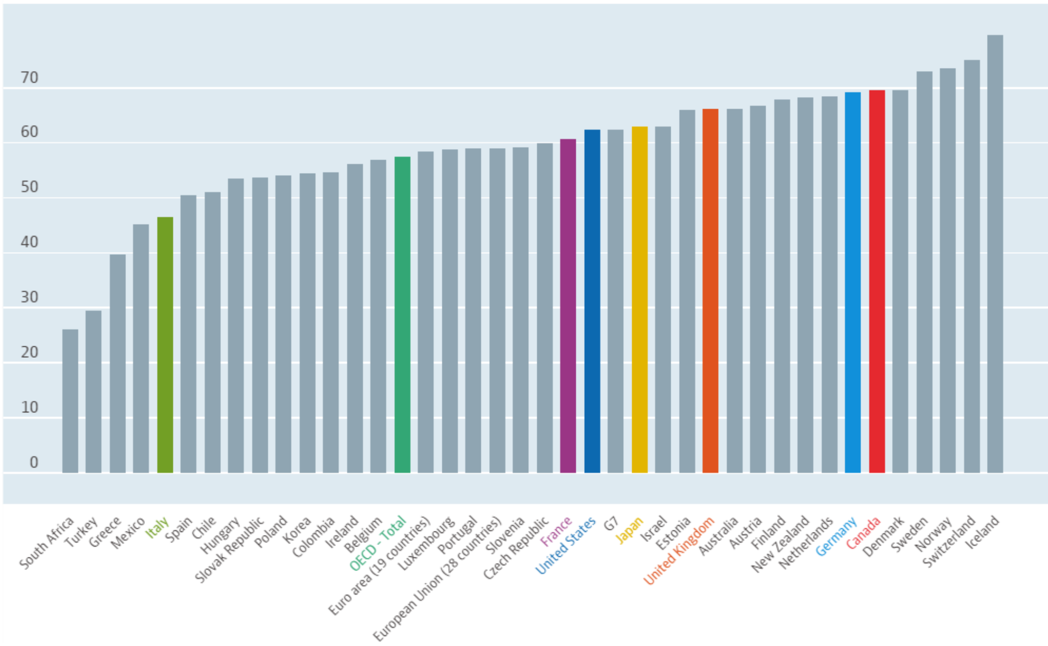
The chart below shows the long-term decline in total fertility rates over the periods 1970, 1995 & 2014. Generally, the countries which had the highest fertility rates in 1970 (as indicated by the black diamonds) have, unsurprisingly, recorded the largest subsequent declines. Finland, Denmark and Sweden are among those countries which recorded the smallest declines as these are countries which have traditionally had family-friendly employment policies including generous maternity/paternity leave and widely available childcare facilities.



In contrast, OECD countries such as Japan, Italy, Portugal and Greece have seen their fertility rates decline. Women who have children in these particular countries receive little support from government, corporations or their partner.

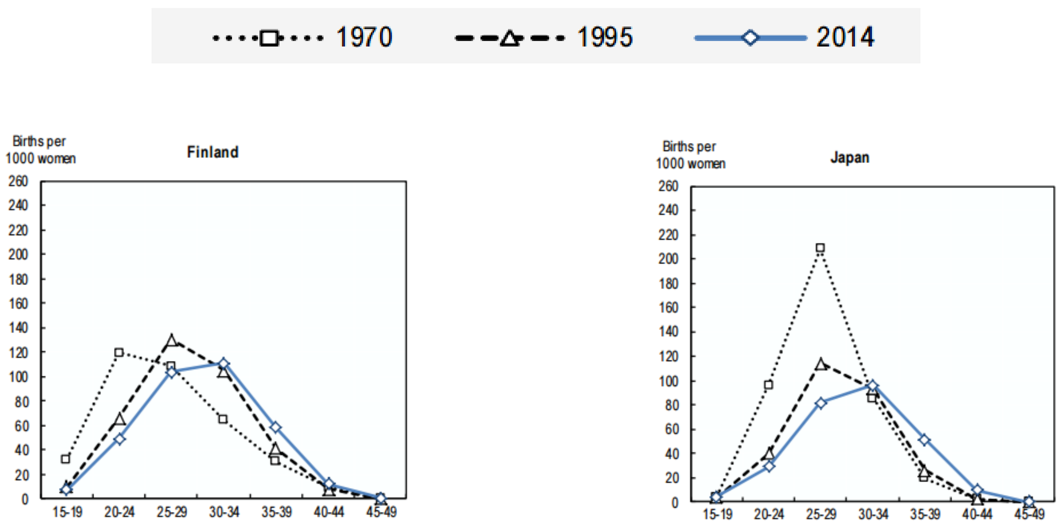
This level of support is highlighted further in the chart below which shows that Finland, Denmark and Sweden have some of the highest employment rates of women across all OECD countries yet, as mentioned above, has seen little decline in fertility rates.

Women, % of working age population, Q4 2013



Source: OECD Data

The decline in fertility rates can be broken down even further. The charts below show the births per 1,000 women, by five-year age groups and over the period 1970, 1995 and 2014. Focussing on the 25-29 age group, we can see that the births per 1,000 women for Finland has remained relatively unchanged at approximately 100 – 130 over the three periods. Whereas, Japan has recorded a reduction in their births per 1,000 women from circa 220 in 1970 to circa 80 births in 2014.

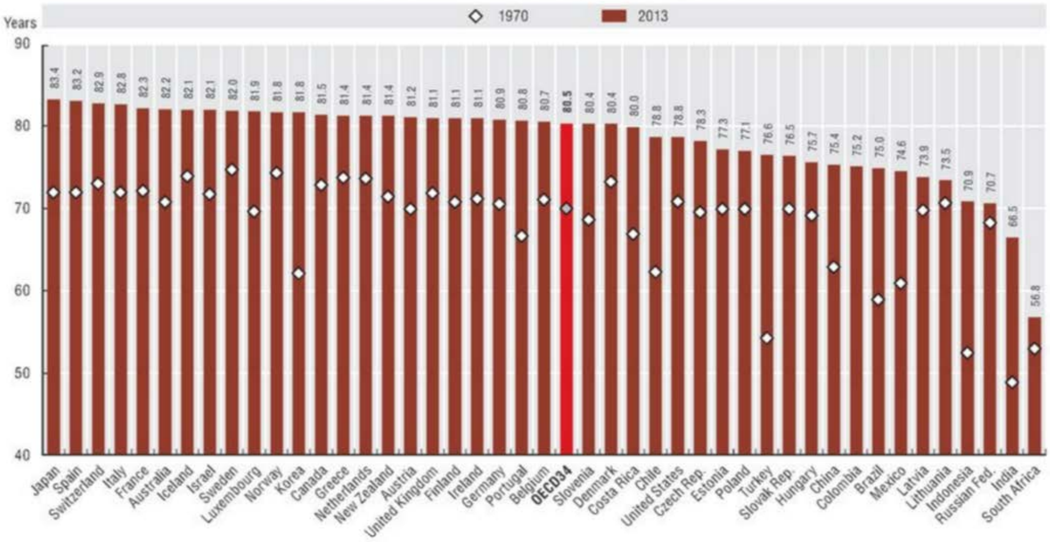


Lengthening Lifespans

There have been remarkable gains in life expectancy over the past 50 years in OECD countries. On average, **life expectancy at birth reaches 80 years** across OECD countries, a gain of more than 10 years since 1960. **Women live about five years longer than men, averaging 82 years versus 77 years for men**. The OECD countries with the highest life expectancy are Japan, Spain and Switzerland with an average life expectancy of 83 years. At the other end of the scale, life expectancy among OECD countries is the lowest in the Slovak Republic, Turkey, Mexico and Hungary, at around 75 years.

Recent OECD analysis suggests that health care spending growth has contributed to the improvement in life expectancy, but other determinants such as rising living standards, environmental improvements, lifestyle changes and education are also important drivers.

3.1. Life expectancy at birth, 1970 and 2013 (or nearest years)



Source: OECD Health Statistics 2015

Implications for clients

The combined impact of decreasing fertility along with an increasing longevity means that the number of working people for every retiree will dramatically reduce in Australia. Today the number of people aged 15 to 64 for every person aged 65 or more is around 4.5. By 2054-55 this is projected to nearly halve to 2.7 people *(Source: 2015 Intergenerational Report, Commonwealth of Australia).*

These demographic shifts will have a profound effect on individual companies, firms and governments, specifically the labour force, savings and spending habits.

For our clients, this will have the following implications:

- We believe that there will be an ever-increasing reliance on your superannuation and personal savings and less on the age pension.

- Your investments must not be left to lie dormant in savings accounts or low returning investments that will not add any value after inflation and taxes to ensure it lasts as long as possible.

- You need to plan for a spike in living costs in the very latter years of retirement. Aged Care costs are likely to increase as demand rises and government subsidies for these services are likely to be restricted to those with lower means.

- Ensure your portfolio is intelligently diversified and you have an allocation to global markets. “Best of breed” international share managers that can take advantage of these demographic changes in the following ways:

    - The African continent and countries such as India and Indonesia, are expected to benefit from these demographic changes due to their population growth and their young demographic structures. In other words, to invest in regions with above-average growth potential with the most favourable demographic trends and/or in companies whose registered offices are still located in ageing countries but whose customers are mostly located in emerging economies.
    - Biotechnology and pharmaceutical shares, which stand to profit from an ageing population, but also energy shares and commodities, which are becoming increasingly scarce in the face of rising demand.
    - As the emerging economies are typically characterised by urbanisation and strong economic growth, infrastructure and transportation may also present attractive investment opportunities.

- The expectation will be for people to remain in the workforce longer. This is evident by the Age Pension qualifying age increasing to 67 years by 1 July 2023 and the proposed legislation to increase this further to 70 years by 1 July 2035.

PART 2 - WHICH INVESTMENT STYLE PERFORMS BEST?

Gavin Shepherd
Portfolio Construction & Investment Research Manager

Australian Share market

The Australian share market performed strongly over the past year (as at 31 January 2017), with the Australian Share market (S&P/ASX200) finishing up a healthy 17.34% on a total return basis, and the midcap stocks finishing up higher at 22.27%.

This strong performance however masked a year that was divided into two halves. The first six months of the year saw the S&P/ASX200 up only 3.23% (including dividends), while the second half of the year saw more fruitful gains for investors with the S&P/ASX200 returning 14.13% for the six months to January 2017.

Fund Manager Investment Styles

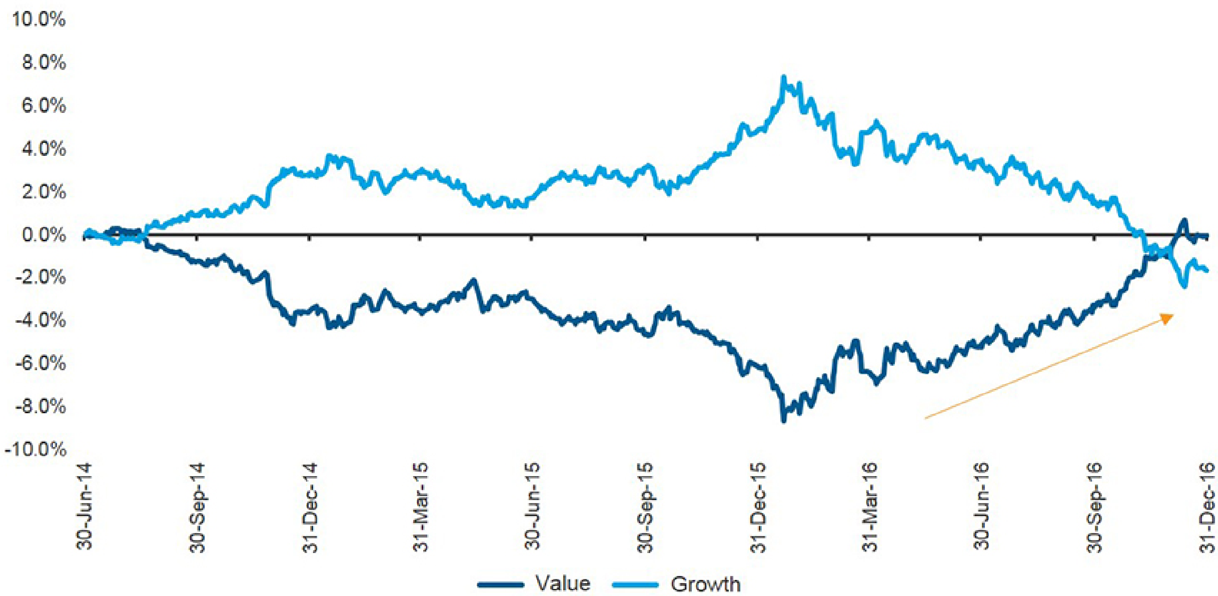
The last 12 months not only demonstrated the importance of having a diversified portfolio of assets, but also the importance of having diversification in investment fund manager styles.

Fund Managers approach investing differently by focusing on different aspects of a company. A growth manager, for instance, looks for companies/stocks that are likely to grow earnings at a faster rate than its peers. A value fund manager tends to look for companies/stocks that seem to have been neglected by investors and appear cheap in valuation. These fund managers look for stocks that have low price to earnings ratio.

The argument over which investment style is likely to outperform over time is heavily dependent on market conditions, economic growth cycles and the performance period in review. Growth strategies have historically outperformed value strategies during periods of stronger earnings and falling interest rates. Conversely value managers are likely to outperform growth managers during periods of uncertainty or rising interest rates.

As shown by chart 1 below, the divergent half-year performance of the Australian share market was also marked by significant fund manager investment style rotation. Growth-oriented companies, such as information technology, outperformed strongly until February 2016 (as did growth fund managers). Thereafter, markets corrected and favoured more traditional value companies (energy and resource companies), thereby causing “value” managers to outperform for the remainder of the year.

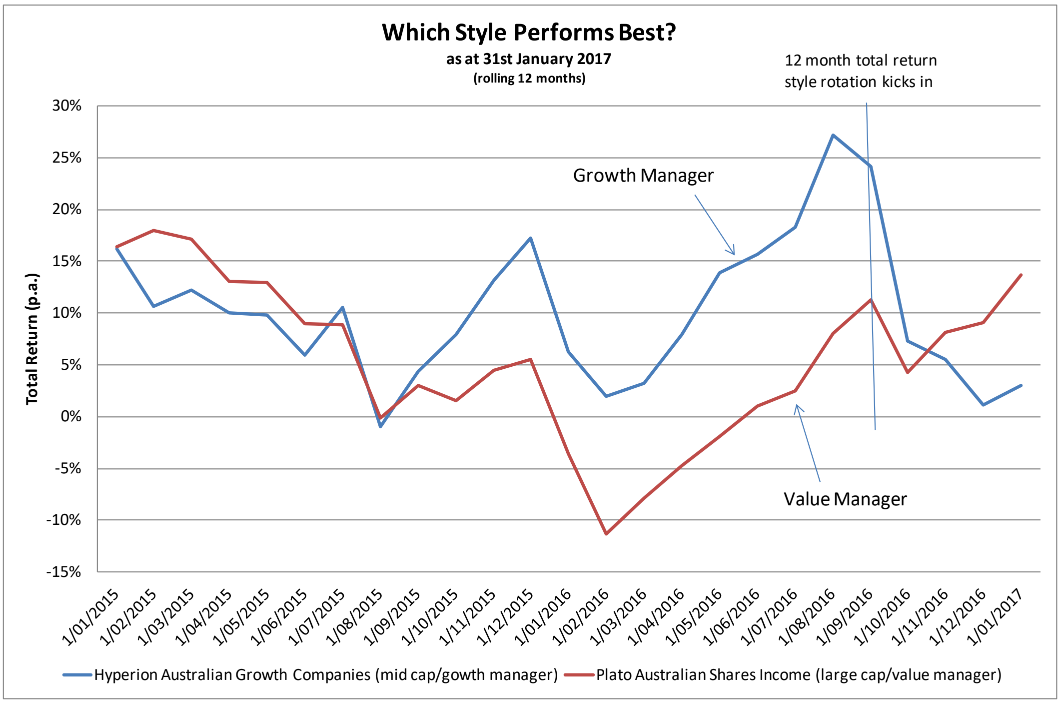
Chart 1: Cumulative Performance of Australian Value and Growth Companies



Source: Macquarie Securities

The following graph shows the recent style rotation for two fund managers, Hyperion Australian Growth Companies Fund (growth manager) and Plato Australian Shares Income Fund (value manager). As can be seen from the chart Hyperion (growth manager) over the last 12 months has underperformed Plato (value manager) as the market has rotated out of growth stocks into value stocks.

Chart 2: Plato Australian Shares Income Fund (large cap/value manager) and Hyperion Australian Growth Companies Fund (mid cap/growth manager) rolling 12 months



As with investment style there has been a rotation within the various Australian sectors. As the table highlights below the Materials (-23.70%) and Energy (-27.62%) sectors in the 1 year to January 2016 were the worst performing sectors. However, over the last 12 months (end of January 2017) materials and energy have been the best performing sectors, returning +65.4% and +24.03%, respectively. In 2016 many value managers believed on their valuations that resource stocks had become ridiculously cheap versus counterparts.

Table 1: Total return for the top 4 best performing sectors (1 year to the 31st January 2017) vs. how these sectors performed in the same period last year.

S&P/ASX 300	Total Return (1 year) As at 31 January 2017	Sector Rating 2017	Total Return (1 year) As at 31 January 2016	Sector Rating 2016
Materials	+65.42%	1	-23.70%	10
Energy	+24.03%	2	-27.62%	11
Utilities	+20.60%	3	+16.69%	1
Financials ex-Property	+15.56%	4	-8.36%	9

Client Implications

By combining a number of complementary investment styles in the one investment portfolio, the overall return of the portfolio will be less volatile. Ideally, when one of the fund managers' investment style is going through a period of underperformance due to the stage in the investment cycle, another manager with a complementary style may be outperforming.

That is, not all managers in your portfolio will outperform at all stages of an investment cycle. It is important not to try and pick last year's winner and consider your total portfolio as opposed to the individual investment.

At Logical, we attempt to ensure your portfolio is optimally diversified and that not one single security or investment drives your performance. Diversification includes a spread across asset classes, sectors and fund manager styles. Intelligent diversification is one of the best methods of managing risk of a portfolio and protecting against volatility in financial markets.

Looking for Financial Advice?

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