

What I lose sleep over!

(riskiest period for Australian investors since 1900)

& Where the opportunities are.

The extreme & unusual nature of the investment risks we currently face in the West including Australia. By comparison, Asia's time has come. This really is the Asian century.

By Bruce Baker BSc MBA
Certified financial planner

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The Transformation of Asia

- Globally, we are seeing a very rapid shift in economic power that will reshape the world.
 - On virtually every dimension. Are you ready?
- ANZ - "Caged Tiger: The transformation of the Asian Financial System"
 - <http://www.interest.co.nz/sites/default/files/ANZ%20caged%20tiger%20report.pdf>
- Asian now accounts for 25% Global GDP.
 - By 2030 they expect that to be 35%.
 - By 2050, they expect Asia's share to be 50%.
- US and Europe account for 50% of the world economy today, but this seems likely to drop to 25% by 2050.

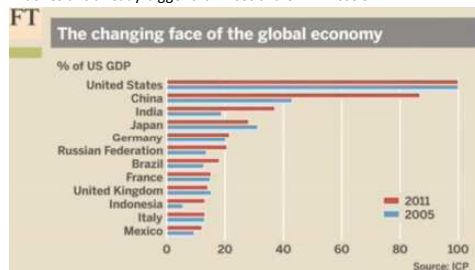
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"China poised to pass US as world's leading economic power this year" 30/4/14

- <http://www.ft.com/intl/cms/s/0/d79ff1f6-cb7-11e3-9b2b-00144feabd00.html?siteedition=intl#axzz30MPlayQfH>
- Note: Australia does not even rate on this list compiled by the World Bank.
- Comparison of sizes of economies on a Purchasing Power Parity (PPP) basis.
- Indonesia is already bigger than Australia on PPP basis.



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By 2050, Australia might drop out of G30

- <http://www.pwc.com.au/media-centre/2015/world-in-2050-feb15.htm>
- <http://www.pwc.com/consulting/publications/world-in-2050.htm>
- <http://www.pwc.com/pw/en/issues/the-economy/assets/world-in-2050-summary-report-february-2015.pdf>
- Just take a look at which countries are going to over-take Australia over the next decade or two.
- Australia's comparative importance in the world is expected to rapidly shrink.
- Our economic, international relations, military considerations need to take this into account.

Country	2014 GDP (trillion USD)	2050 GDP (trillion USD)
USA	16.5	16.5
China	7.5	21.5
India	4.5	11.5
Japan	4.5	4.5
Germany	3.5	3.5
Russia	2.5	2.5
Brazil	2.5	2.5
France	2.5	2.5
UK	2.5	2.5
Indonesia	2.0	2.0
Italy	2.0	2.0
Mexico	1.5	1.5
Australia	1.5	1.5

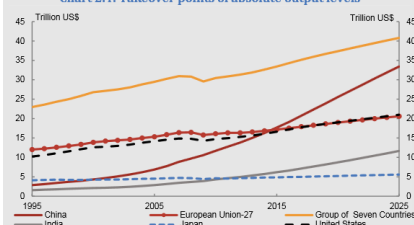
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Box 2.1: Asian economies will become bigger than advanced economies
The combined output of China and India will likely exceed that of the whole Group of Seven (G7) by early next decade (Chart 2.4). Asia is set to overtake the combined economic output of Europe and North America within the decade to 2020. India has become the world's third-largest economy and China could overtake the United States as the world's largest economy by 2014 in real purchasing power parity terms.

Chart 2.4: Takeover points of absolute output levels



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ANZ – ASEAN to become more important than China to us

- "China is hardly waning but ASEAN is the Next Horizon" ANZ
 - <https://bluenotes.anz.com/posts/2015/04/china-is-hardly-waning-but-asean-is-the-next-horizon>
- "There's a giant in Asia, shifting the tectonic plates of manufacturing, trade, services and the global economy. It's not China."
- "During the next 10 years we expect ASEAN to replace China as the world's manufacturing hub and we expect it to become the fifth largest economy in the world by the end of the decade."
- "ASEAN's great attractions are favourable demographics, a young population and growing consumer class. Its potential is greater than is commonly understood. Consider iron ore: the infrastructure investment required in the region is double the size of the infrastructure investment to which China committed in the financial crisis. The numbers behind ASEAN's transformation are truly astonishing."
- ASEAN could replace China as the world's leading manufacturing centre and emerge as a key market for Australian exporters with the potential for the Australia-ASEAN trade and investment corridor to double and exceed US\$210 billion by 2025, rising from US\$90 billion in 2013.
- "ASEAN: The Next Horizon" ANZ research paper
 - <http://china.commerce.gov.cn/templets/ftmitem/55F019550298186NzYwEtoatWkSU09LTF8v/HhWZTDt8t-1.html>
- AFR "ANZ Bank says Southeast Asia will replace China for manufacturing"
 - <http://www.afr.com/news/world/asia/anz-bank-says-southeast-asia-will-replace-china-for-manufacturing-20150424>
- "The report forecasts that two way trade between Australia and New Zealand and Asean and incoming Asean investment will be worth about US\$230 billion (\$300 billion) by 2025 compared with about US\$100 billion today. Australia's two-way trade with China was \$150 billion in 2014 and approved foreign investment from China in 2013 was \$15 billion."

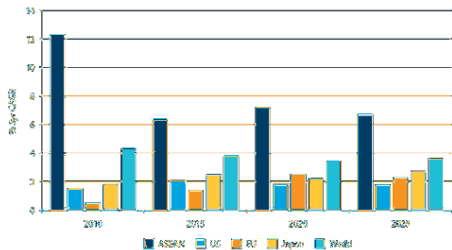
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More on ASEAN

- Much faster growth in ASEAN
 - <http://www.indepth.anz.com/supporting-data.html>



Indonesia

- “Why Australia’s relationship with Indonesia is so important.” ANZ
 - <https://bluenotes.anz.com/posts/2015/05/why-australias-relationship-with-indonesia-is-so-important/>
 - “Indonesia has a population 10 times the size of Australia’s and an economy half the size. It won’t stay that way. Much research, including ANZ’s own recent ASEAN study, leaves little doubt Indonesia is destined to become a much larger economic player and a more significant regional power.”
- Other useful links from ANZ
 - <http://www.indepth.anz.com/index.html>
 - “ANZ believes that Southeast Asia will eventually be as important to Australia and New Zealand as China is today.”
 - <https://bluenotes.anz.com/posts/2015/04/mike-smith-asias-importance-has-been-undersold/>
 - “I believe as we shift from a natural resources led relationship with Asia to a deeper, more multi-faceted engagement with the region, that Asia has never been more important to Australia’s future and to ANZ’s future.”

Objective of this presentation

- To give you some of reasons to invest in Asia
 - The world is changing very fast.
 - Developing world already 50% global GDP
 - That share to rise quickly
 - Aussie investors have little exposure to Asia
 - Asia is fairly cheap compared with West
- Western world has historic challenges & risks
 - implying weak returns likely in coming years
- Australia has some unique challenges
 - Tough time ahead for Australia
 - A\$ may fall a long way.
 - Offshore investors can make currency gains

Context of this presentation

- What is “normal” approach to investing.
- Show why timing matters.
 - And why timing particularly matters now.
 - Particularly in Western developed world

“Normal” approach to investing (simplistic version)

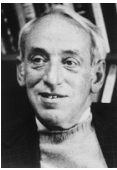
- Investment theory
 - Diversification – Harry Markowitz
 - James Tobin – Separation Theory
 - Risk vs return
 - Fama & French
 - Fama & French extension

Professor Harry Markowitz. Diversification within risky assets



- Nobel Prize 1990
 - for contributions to Portfolio Theory.
- When building an optimal portfolio
 - “Risk means facing the possibility of losing rather than winning.” P43
 - “I was struck with the notion that you should be interested in risk as well as return.” P47
 - “It is necessary to avoid investing in securities with high covariances among themselves.” P50.
 - “The riskiness of a portfolio depends on the covariances of its holdings, not on the average riskiness of the separate investments.” P54
 - Investors should create an efficient frontier of efficient portfolios, then choose an acceptable level of risk. P58

James Tobin - Nobel Prize 1981



- **The Separation Theorem** "argues that the Markowitz process of selecting securities for the most efficient risky portfolio is completely separate from the decision of how to divide the total portfolio between risky and risk-free assets." P72.

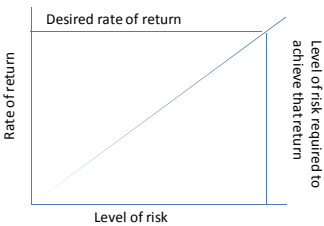
Cash & "Stable" Investments	Property
	International Shares
	Australian Shares

↑ Markowitz Guidance

← Stable vs Shares/property - guidance from Tobin

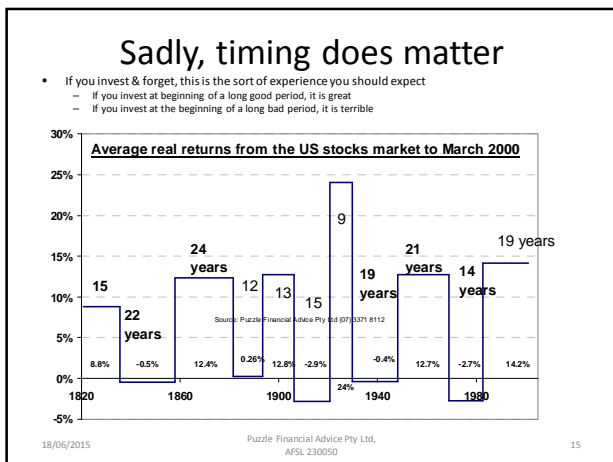
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Risk vs Return



- To get higher returns:-
 - diversify,
 - choose higher risk,
 - ride the volatility
 - & hang in for the long-term
- Fama & French (+ extension) enhance this, but principle still the same

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Where are we at in long investment cycles?

- It appears that:-
 - The US
 - commenced a long "good" period for shares in 1982
 - Ceased their long "good" period in 2000
 - Australia
 - commenced a long "good" period for shares in 1982
 - Probably ceased their long "good" period in 2007
 - The longest bull markets in Australia's history
 - Asia is in a very different cycle
 - See biggest emergence event discussion later

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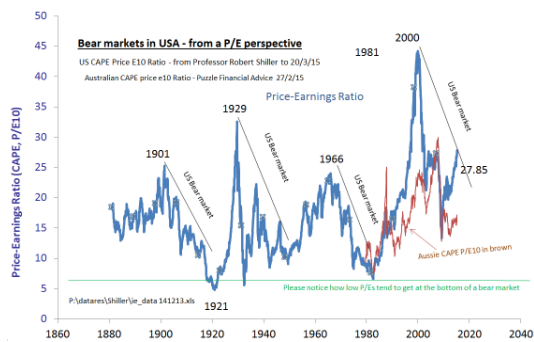
Western world has historic challenges

- Now. Discuss challenges posed from:-
 - **Debt bubbles**
 - risk of deflationary crash
 - **Massive money printing**
 - risk of hyperinflation
 - **Asset price bubbles**
 - correlated with low/negative returns
 - **House price bubble**
 - GFC-style event
 - **Largest emergence event in history**
 - China, India + Next-11
 - + technology revolution

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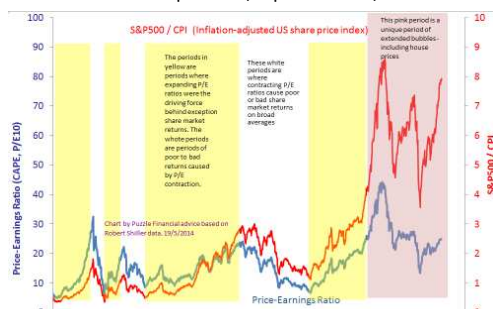
Bear markets – another perspective



- David Fuller defines a bear market as an extended period of declining P/E's

Why do these long cycles exist?

Compression/expansion of P/E's

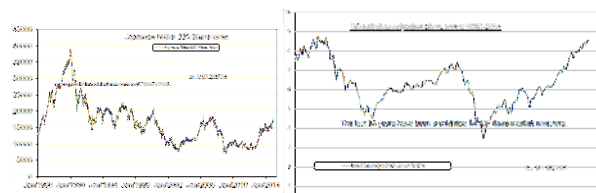


Implications

- Investors currently face extreme market timing risks.

Market Timing Matters

- Some people preach that "it is time in the market, rather than timing", that is the key to getting good investments returns.
- Ask Japanese investors who invested in December 1989 if this is true?
- Ask US investors who invested in January 2000 if this is true?
- The problem with the "Time in the market" dogma, is that if you invest just before the beginning of a secular bear market, you are likely to have a very traumatic experience for a very long time.
- Therefore have no real choice to grapple with the difficult market-timing problem.



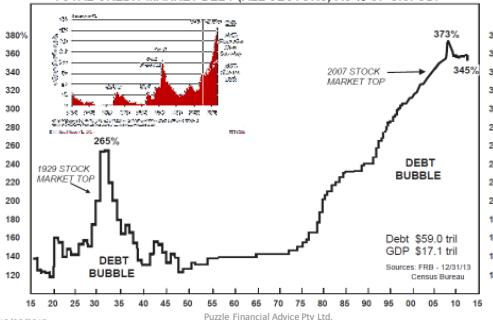
What are some timing risk factors?

- THE REST OF THIS PRESENTATION
 - Discusses some sources of timing risk
 - Debt bubbles
 - Central bank money printing
 - Asset price valuations
 - Shares
 - House prices
 - Emergence event

History – on debt bubbles - USA

- Debt bubbles can lead to economic depression eg 1930s in USA
- Austrian School of Economics explains why

TOTAL CREDIT MARKET DEBT (ALL SECTORS) AS % OF U.S. GDP



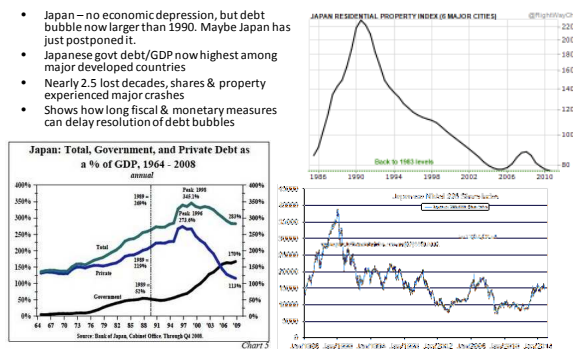
History – on debt bubbles - Australia

- Experience is debt bubbles lead to economic depression.
- In Australia, economic depression in the 1930s & 1890s



History on debt bubbles - Japan

- Japan – no economic depression, but debt bubble now larger than 1990. Maybe Japan has just postponed it.
- Japanese gov't debt/GDP now highest among major developed countries
- Nearly 2.5 lost decades, shares & property experienced major crashes
- Shows how long fiscal & monetary measures can delay resolution of debt bubbles



Debt bubble summary

- Borrowing too much is very risky for individuals
 - Same for nations
- Debt bubbles
 - A deflationary force
 - tend to lead to bad outcomes
 - Often economic depression (USA, Australia)
 - Japan kept spending
 - avoided economic depression (at least so far ...)
 - But had major asset price crash (asset price deflation)
 - & 2 lost decades
 - Shows how long fiscal & monetary measures can postpone resolution
 - Bank of International Settlements
 - GFC was a "Balance sheet recession" (too much debt)
 - A couple of decades of low growth
 - No recovery from 2008, like from a "normal" recession

Debt & Austrian School of Economics

- *"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."*
 - Ludwig von Mises (Austrian School of Economics).

Personal debt bubbles create the risk of Minsky Moments

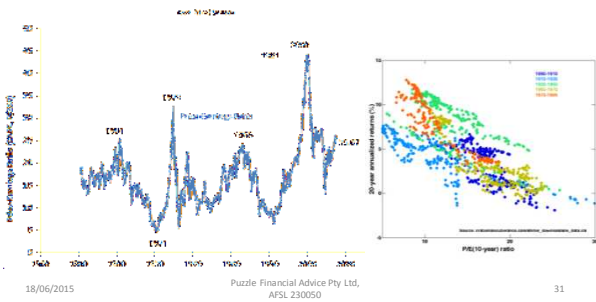
- A **Minsky moment** is a sudden major collapse of asset values which is part of the **credit cycle** or **business cycle**. Such moments occur because long periods of prosperity and increasing value of investments lead to increasing speculation using borrowed money. The spiraling debt incurred in financing speculative investments leads to cash flow problems for investors. The cash generated by their assets no longer is sufficient to pay off the debt they took on to acquire them. Losses on such speculative assets prompt lenders to call in their loans. This is likely to lead to a collapse of asset values. Meanwhile, the over-indebted investors are forced to sell even their less-speculative positions to make good on their loans. However, at this point no counterparty can be found to bid at the high asking prices previously quoted. This starts a major sell-off, leading to a sudden and precipitous collapse in market-clearing asset prices, a sharp drop in market liquidity, and a severe demand for cash.
- http://en.wikipedia.org/wiki/Minsky_moment
- Australia has its largest personal debt bubble in history
- Making Australia particularly vulnerable to a Minsky moment

Western response to Global Financial Crisis

- GFC brought on by debt
- US Fed recognised risk of economic depression
- US Fed **prints massive amounts of money**
 - Europe & Japan follow US in money printing
 - Usually leads to hyperinflation historically
 - Eg German Weimar Republic in 1920s
 - Zimbabwe more recently
 - Strong inflationary force battling strong deflationary force
- US gov't response to GFC
 - Deficit spending
- In Western developed world
 - More debt now than pre-GFC
 - Problem not resolved

Massive money printing leads to

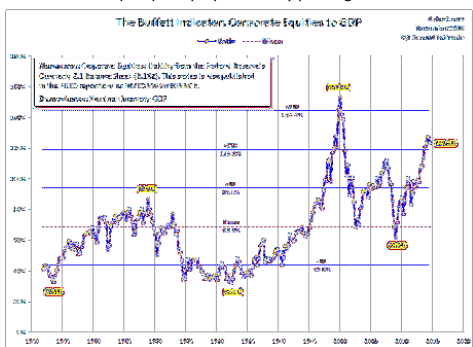
- Asset price inflation
- Asset price bubbles eg US shares
 - Buying assets at high prices tends to lead to low returns over medium-to-long-term



Massive money printing leads to

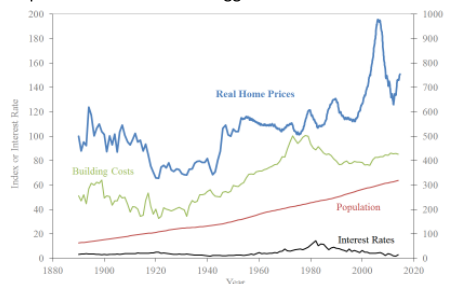
- Alan Greenspan (Ex Chairman US Fed) Oct/14
 - He (Greenspan) went on to say he thought that the lingering effects of quantitative easing could lead to inflation more or less at any moment, and that inflation is now basically out of the Fed's control.
 - “Gold – measurably higher. Interest rates – measurably higher.”
 - Political realities, he explained, in the form of entitlement spending and off-balance sheet obligations of the US government, trump the need for sound money every time

Another view on US share market bubble pumped up by US money printing



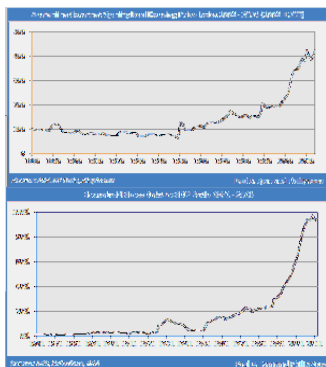
And house prices

- Robert Shiller study on US house prices
 - House prices go sideways in real terms over the longer-term
- House price bubble crash was trigger for GFC



And house prices ... Australia

- Mortgage bubble
- House price bubble
- These are the same bubble
- Heed Shiller data warning
- Heed warning from Austrian School of Economics

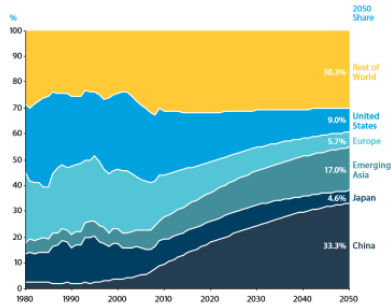


Biggest emergence event in history

- Emergence
 - China, India, Next-11
- Bigger than US emergence 1840-1910
 - That emergence kept Europe in deflation & recession for much of that 70-years
 - Threatened employment in Europe
- What will this emergence do to the West?
 - Over next 3 decades

Biggest emergence event in history

GLOBAL ECONOMY BY REGION: 1980 TO 2050



Source: CDC and ANZ Projections.

- Asia's time has come. Asia & related themes look rosier places to invest

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Rate of technological change

- Robotics
 - Finally delivering
 - Rapidly replacing jobs in East & West
 - Western jobs being replaced by cheap labour in developing world
 - AND technology
- Low-cost sensor-technology
- Low-cost networking
- Low-cost computing power
- High-speed web
- Maturing artificial intelligence
- And much more

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Summary

- Historically extreme period
 - on many measures
- Investment risks are very high
- Opportunities exist
 - Some markets & sectors very expensive.
 - Some markets & sectors cheaper & better return prospects.
 - Long cycles at different stages
 - In different countries and
 - In different sectors
- Volatility likely to be high
- Discussion

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Jon Pain's view on Asia 4/11/14

- ***“exciting times ahead for investors in Asia”***
- *“I know the majority of you just cannot accept the notion that Asia could somehow be some kind of safe haven as the western prism through which you view the world has ‘hard-wired’ you to reject such a preposterous proposition.”*
- On the October 2014 volatility
 - *“Interesting to note, however, that my three favoured markets, China, India and Indonesia were far less volatile than their counterparts in America or Europe”.*

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Some resources

- Recognising & understanding “the problem”
 - Is first stage to finding solution
- Kindleberger:
 - Book: “Manias, Panics, and crashes. A history of Financial Crises”
 - Bubbles are a type of mass hysteria
- Reinhart & Rogoff: Book: “This time is Different”
 - Eight Centuries of Financial Folly”.
 - “Financial Repression” a common government remedy to extreme govt debt
- “Australia in the Asian Century” – white paper.
- “ANZ insight: Caged Tiger: The Transformation of the Asian Financial System”
- Jim O’Neill <http://www.bloombergview.com/articles/2014-05-20/a-ten-step-program-for-understanding-emerging-markets>
- Hugh White June/13. Indonesia to be 10th largest economy in world by 2030. <http://www.themonthly.com.au/issue/2013/june/1370181600/hugh-white/what-indonesia-s-rise-means-australia>

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