We are in a period of historically-extreme investment risk.

This presentation explains why. Many historical extremes – debt, valuations, money printing.
http://puzzlefinancialadvice.com.au/Asian_Century-risks_and_opportunities_151110_14.pdf

How do you survive and thrive in these very unusual times?

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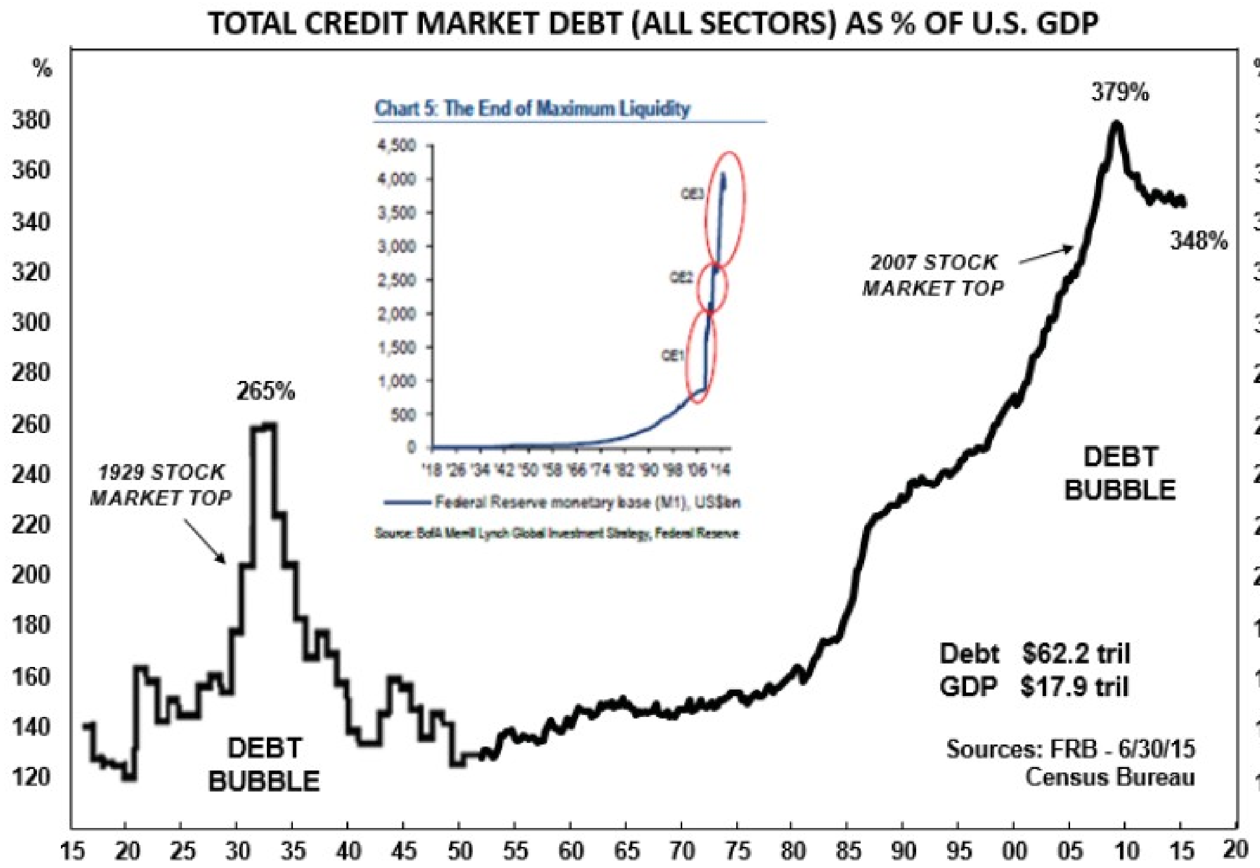
You need to understand these risks, to make money (and not lose a lot of money) in these times. Let us start with some of the historically-extreme risks.

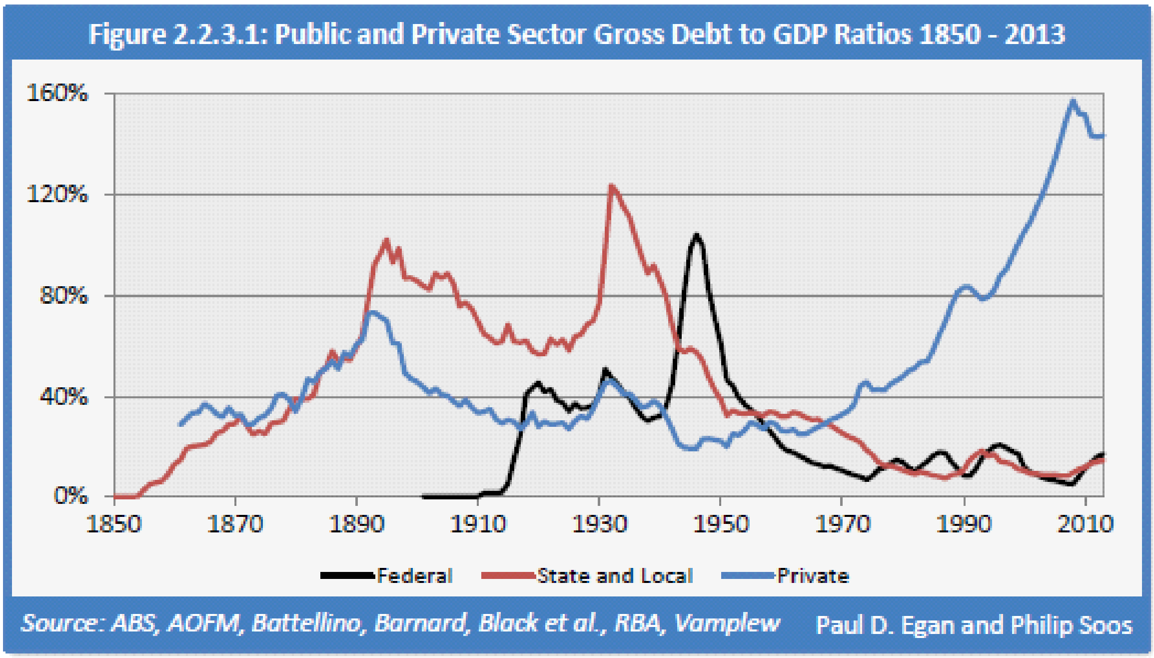
- **Extreme money printing in developed world.** Hyper-inflationary. Dangerous. Experimental.
  - USA, Japan, Europe (ECB), UK have all done it since the 2009. Quantitative Easing.
  - Usually leads to hyperinflation. Think Zimbabwe.
  - Germany (Weimar Republic) printed money like this in the 1920s. Hyperinflation.
    - https://en.wikipedia.org/wiki/Hyperinflation_in_the_Weimar_Republic
  - One way to get a sense of the level of money printing (and how historically unusual this is), is to look at huge rises in US bank reserves since 2008.
- **Extreme debt bubbles in the western developed world.** Deflationary.
  - Historically, this has usually led to economic depression.
  - The last time that the USA had a debt bubble anything like these levels, was around the time of the Great Depression ….. and this one is much larger.
  - This is why the US Fed/US government pulled out all stops during the 2008-2009 Global Financial – because they feared economic depression. This is why the US Federal Reserve started its massive money printing program – cutely named QE1, QE2 & QE 3.



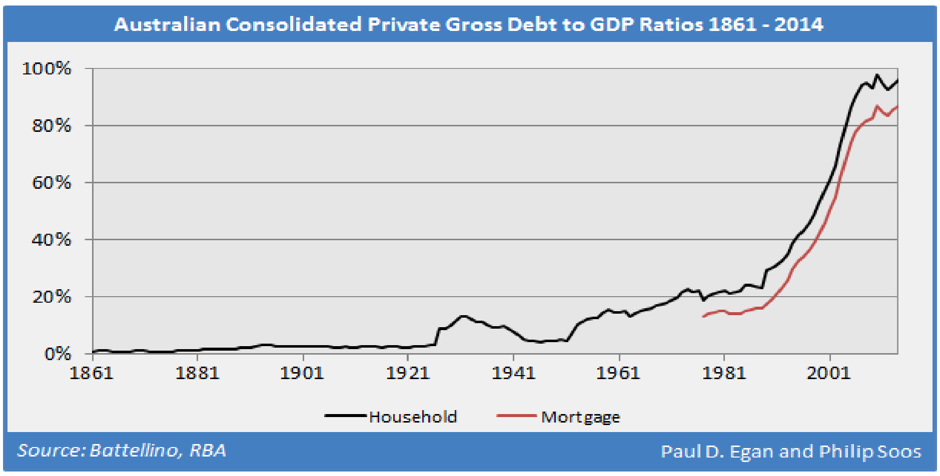
  - The above chart shows the period from 1915 – 2015.
  - Needless to say, much of the Western developed world currently has historically large debt bubbles.
    - Including Australia – see over-page.

- The Bank of International Settlements (central bankers regulatory) described the Global Financial Crisis as a “Balance Sheet Recession”, which has very different features from normal recessions that we normally had – such as the last Aussie recession in 1990. This document will help you understand that Financial Repression is likely to be part of our future – negative real interest rates for many years. This is a major risk factor for retirees, trying to living off their savings.
  - http://puzzlefinancialadvice.com.au/Balance_sheet_recessions_explained_140922_02_why_West_with_have_slow_growth.pdf

- **Australia's debt bubble.**

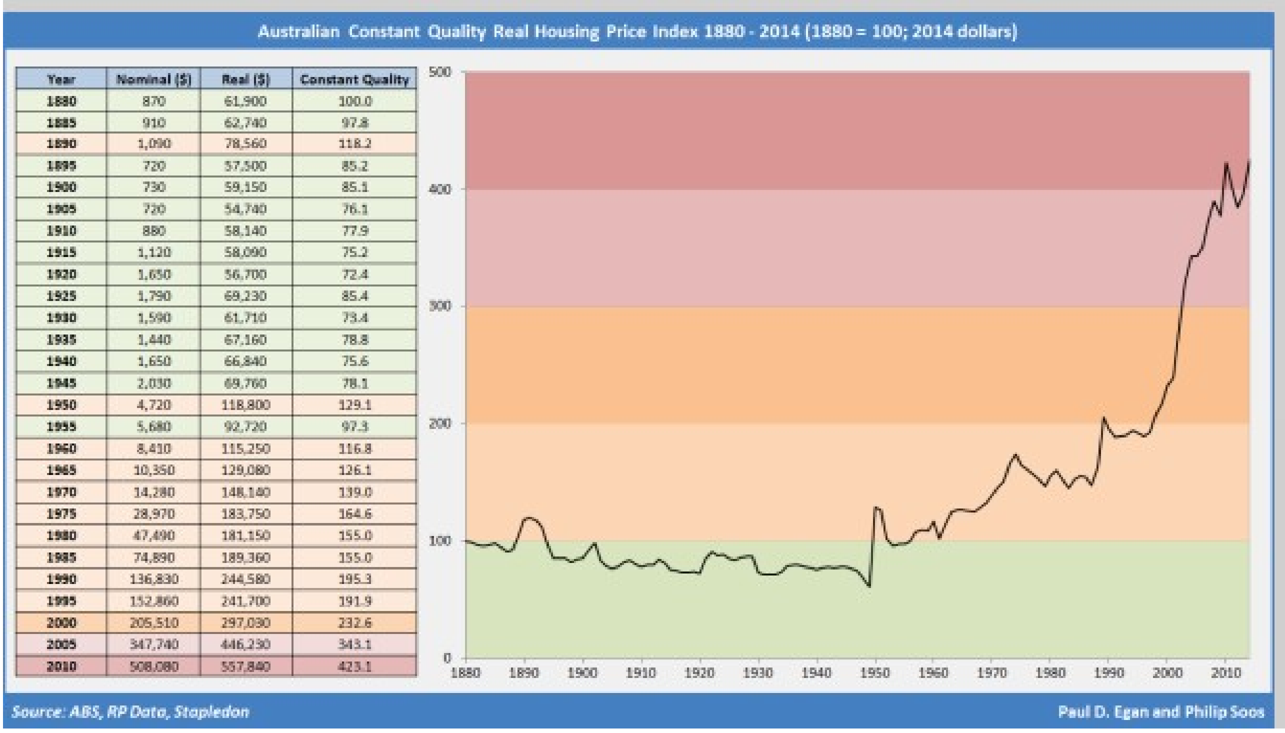


  - From the above chart please note:
    - In aggregate, the highest total debt /GDP has been around 1890 & 1930 – the last 2 economic depressions in Australia.
    - However, the really dangerous debt for an economy is private debt.
      - Most developed world governments can tax their way out of debt, or use financial repression (or default). Financial repression is being used now in much of the developed world – negative real cash rates.
      - But when private debt is very high, this ultimately causes the private sector to slow or contract (recession).
- The biggest part of Aussie private debt is currently personal debt, and the bulk of that debt is mortgage debt – and this mortgage debt bubble, has funded the biggest house price bubble in



Australia's history (see over page).

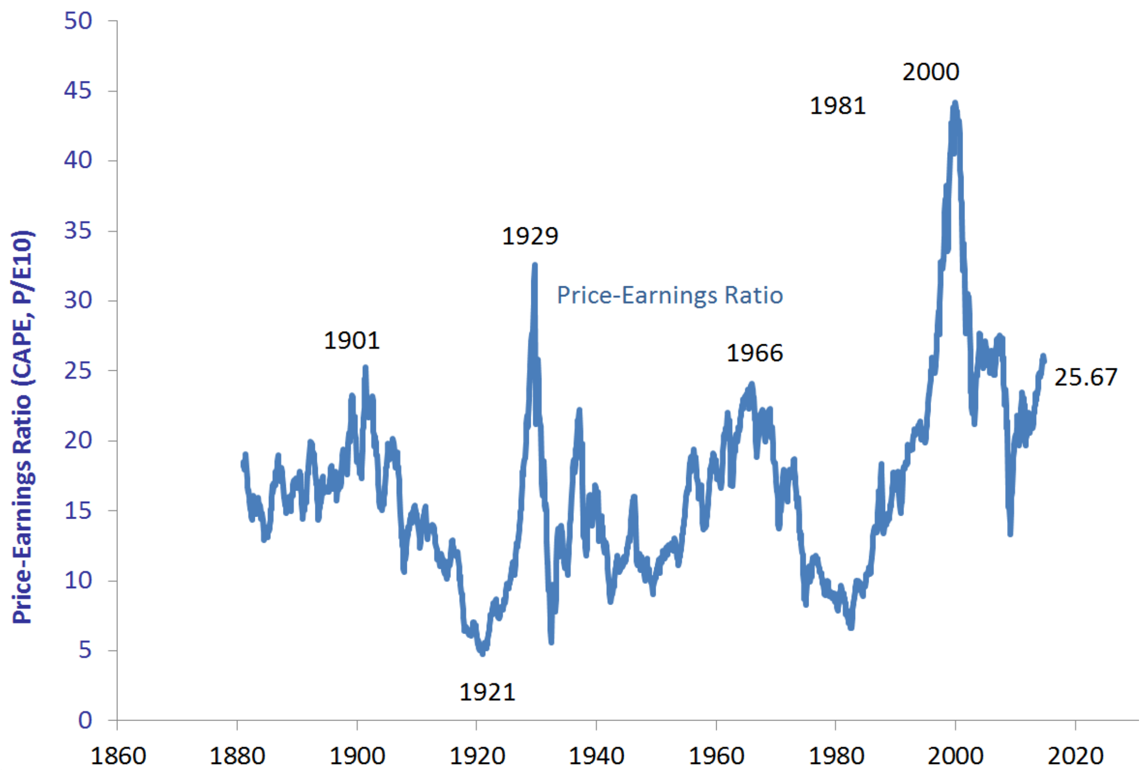
- This mortgage debt bubble has funded the **biggest house price bubble in Australia's history**. This suggests that in due course, it is likely that Australia will experience a very large house price crash – just like most of the Western developed world in and around the global financial crisis.



Year	Nominal ($)	Real ($)	Constant Quality
1880	870	61,900	100.0
1885	910	62,740	97.8
1890	1,090	78,560	118.2
1895	720	57,500	85.2
1900	730	59,150	85.1
1905	720	54,740	76.1
1910	880	58,140	77.9
1915	1,120	58,090	75.2
1920	1,650	56,700	72.4
1925	1,790	69,230	85.4
1930	1,590	61,710	73.4
1935	1,440	67,160	78.8
1940	1,650	66,840	75.6
1945	2,030	69,760	78.1
1950	4,720	118,800	129.1
1955	5,680	92,720	97.3
1960	8,410	115,250	116.8
1965	10,350	129,080	126.1
1970	14,280	148,140	139.0
1975	28,970	183,750	164.6
1980	47,490	181,150	155.0
1985	74,890	189,360	155.0
1990	136,830	244,580	195.3
1995	152,860	241,700	191.9
2000	205,510	297,030	232.6
2005	347,740	446,230	343.1
2010	508,080	557,840	423.1

- **The developed world money printing has created asset price bubbles.** The US share index as represented by the S&P500 Index is a good example of a current share price bubble. Historically, when broad US share price valuations have been at these sorts of levels, they fell something of the order of 70% (plus or minus) in real terms somewhere over the following 10 years or so.

CAPE Price E10 Ratio



- Of course, the past does not provide you perfect vision into the future – nor does it tell you when, but it provides a useful warning about what might happen. ('History never repeats itself but it rhymes').
- Central bank money also seriously complicates investment planning at this time. At this time, a dominant factor driving share markets is central bank money printing – not the usual driver which is rising corporate profit levels etc.
  - In other words, you should expect that the many of the "usual guidelines" to investing cannot be relied upon to work.

This is why, economist John Hewson (Federal Opposition leader in the 1990s) says as follows:-

- **John Hewson – AFR 2/9/15**
  - 'The veteran forecaster admits he has ***"never seen it harder than it is today to say what's going to happen."*** Most of the world is afflicted "with short-term policies and they are not addressing the longer-term stuff".'
  - *'quantitative easing hasn't helped much, apart from creating bubbles*, and increasing inequality and debt levels. It sounds a bit like that cliché du jour – kicking the can further down the road. But *reversing that can-kicking process threatens to result in a stock market crash, bond market crash, and currency realignments*, Hewson says.'
- **Susan Gosling, head of MLC Investments** – one of the best thinkers in the big Aussie banks.
  - http://www.afr.com/personal-finance/think-laterally-in-a-challenging-investment-environment-20150618-gh7iqz 18/6/2015
  - http://puzzlefinancialadvice.com.au/Strategy_Gosling_A$_Asian_shares_150622.pdf
  - "**Defensive investments such as cash and bonds won't weather a severe storm, which is why Susan Gosling focuses on currencies, derivatives and gold**"
  - "One of your most conservative strategies contains zero Australian equities. What are your concerns?"
    - Australia sailed through the GFC, partly because of what happened in China, but if we look at Australia's position today, household debt is extremely high, among the highest in the world and that's gone into housing. It hasn't gone into any productive investment, but if we look at where funding for housing comes from, to an extent banks are dependent on raising capital overseas.
    - You could envisage Australia having its own crisis (BB: She is talking credit crisis) where maybe even the government has to come in and assist the banks. (BB: Brave comment for someone who, in effect, works for NAB.) So we started rethinking, again, for our less traditional funds. Does this exposure actually make sense?

Some things to be considering in these times :

- Understanding the problem, is the first part of the solution.
- **The role of cash**
- **Role of low volatility hedge funds** – cash + 3% over 2 year rolling periods.
- **Secular share market trends.**
    - A secular bear market is a period of declining cyclically adjusted P/E ratios … not just a straight line down, but rather a period with cyclical bear and bull phases embedded within it.
    - http://puzzlefinancialadvice.com.au/Secular_and_Cyclical_Markets_13_141217_abbrev.pdf
    - Note: Secular trends can be in different phases in different markets.
        - Japan was in a secular bull market to 1990.
            - From 1990 to 2012, Japanese shares were in a secular bear market
                - Falling from 39000 at the beginning of the secular bear market to a low of around 7000 in 2009.
                - This shows just how nasty a secular bear market can be. If you look at the Japanese secular bear market example, one thing that should be obvious – is that a long-term BUY-AND-HOLD strategy do
                - Not all secular bear markets are that bad ….. but that experience is a useful reminder.
        - Australian shares commenced a secular bull market commenced in 1982.
            - A strong case can be made that the Aussie share market commenced that the Aussie secular bull market came to an end in 2007 (after a historically long 25 year)….. and this has some potentially ugly implications. But each secular bear market has its own personality.

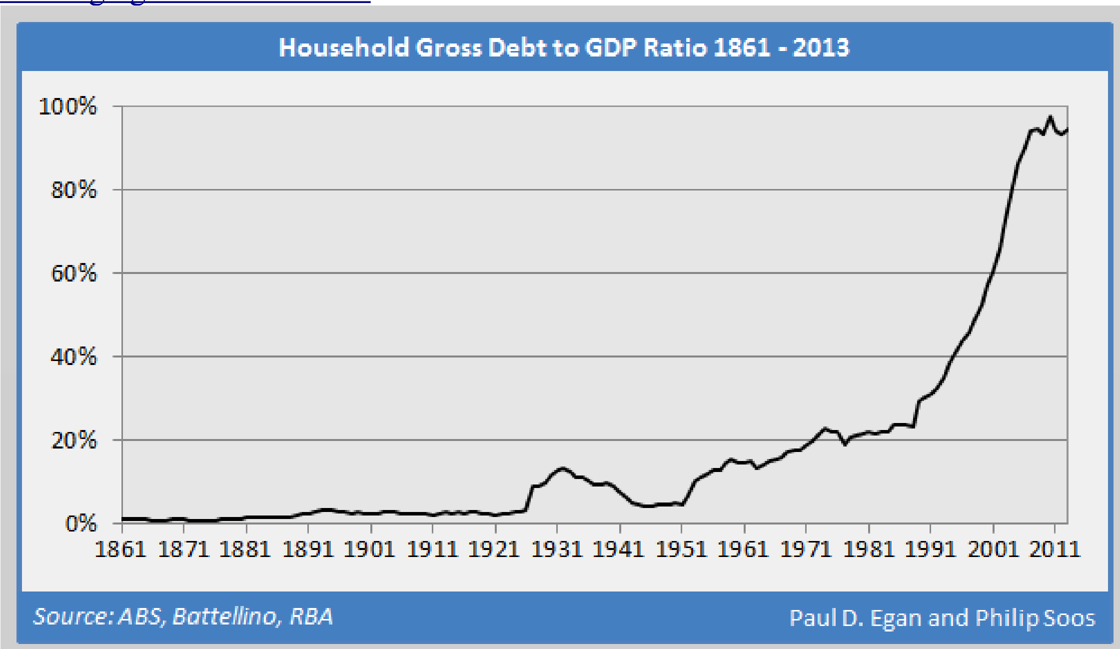
Some other recent quotable quotes.

- **Ken Henry, past head of the Federal Treasury.**
  - http://www.afrsmartinvestor.com.au/p/market-intelligence/an_economic_cycle_without_precedent_DLcP9vMlY13I6bMGUKocDN
  - “'Australia’s most battle-hardened economist has compared the flight to yield to some of the worst examples of herd-like behaviour”
  - 'have contributed to the most overcrowded trade there is – the rush to yield.'
- **Maurice Newman (ex Chair ASX) AFR 29/9/15**
  - Newman has similar concerns to mine re Australia:
    - “Newman has made it clear in various newspaper columns that he thinks Australia is in economic trouble but does not realise how bad it is. He thinks Australians are not cognisant of the decline in the standard of living, the lack of real wages growth and the threat of a downgrade in the country's AAA credit rating from excess debt.
    - He is also concerned about developments in the housing market and the excessive amount of residential housing exposure in the balance sheets of the major banks.”
- **Secretary to Federal Treasury (John Fraser)** - Sydney housing 'unequivocally' in a bubble, says Treasury boss. http://www.sbs.com.au/news/article/2015/06/01/sydney-unequivocally-housing-bubble-treasury-chief
- **ASIC chairman Greg Medcraft.**
  - "ASIC's Greg Medcraft 'quite worried' about Sydney, Melbourne house prices:
    - "History shows that people don't know when they are in a bubble until it's over," Mr Medcraft told The Australian Financial Review.
    - Mr Medcraft's comments come as the **Reserve Bank** and the **Australian Prudential Regulation Authority** grow increasingly concerned about the *build-up of risks to the financial system* arising from a combination of low interest rates, rising house prices and elevated household debt levels.
- **David Murray, chairman of Financial Systems Inquiry.**
  - AFR 3/6/15 “Soaring house prices threaten the economy, David Murray says”
- **Famous Sydney property developer Harry Triguboff** 17/4/15 says “"The broader country has more risk of oversupply because the councils say that their income comes from approving apartments, so everyone is approving apartments," he said. http://www.afr.com/real-estate/whole-country-at-risk-of-housing-oversupply-triguboff-20150417-1mnlby
- **Financial Systems Inquiry. US GFC-style event would render big 4 banks insolvent.**
  - http://puzzlefinancialadvice.com.au/151021_AFR_Joye_Malcolm_Turnbull_paves_way_for_more_bank_rate_increases.pdf
  - The FSI (Financial System Inquiry) found that "the major banks have a leverage ratio of around 4.5 per cent … [and] an overall asset-value shock of the range experienced overseas during the GFC would be sufficient to render Australia's major banks insolvent'
- **Treasury, Reserve Bank tell Australians to be ready for slower growth 25/11/15**
  - http://www.afr.com/news/economy/monetary-policy/treasury-reserve-bank-tell-australians-to-be-ready-for-slower-growth-20151124-gl6sqt#ixzz3sTPYXqou
  - Speaking at the same event, Mr Stevens (RBA governor) warned older shareholders that their appetite for constantly rising dividends were unsustainable unless they accepted the need for companies to take on more risk to generate higher profits.
  - He predicted that global interest rates would remain "very low" for most of the decade ahead, and that yields for most investors would remain depressed for the foreseeable future.
  - "In a low interest rate world, the problems of providing retirement incomes will become

ever more prominent," Mr Stevens said.

- *"The very low level of yields on fixed income assets means that it is very expensive today to purchase a secure stream of future income, which is what someone who is retiring is usually seeking*. And there are more of such people, living longer.

- **Bob Joss Westpac CEO 1993-1999**
  - "Any time credit has grown rapidly we have usually ended up with a crisis."
  - Recently, Australia's major banks have raised almost $20 billion in capital, following recommendations from the federal government's financial system inquiry, which highlighted risks of high household debt and house prices. Mr Joss, who owns a property at Palm Beach north of Sydney, said it was a "big issue" for Australia in trying to figure out whether or not there is a house price bubble. "The short answer is I don't know. There's some reason to be very nervous," he said.
  - http://www.afr.com/business/exwestpac-ceo-bob-joss-warns-of-peer-to-peer-lending-risks-20151107-gktgrn#ixzz3sI1iI6TA AFR 20/11/2015



- **Financial Security. The mainstream does not recognise some key things investors need to know regarding financial security.**
  - First, my long-term (eg 150-year) research indicates that medium-to-long term real-returns for index investors is far-more unreliable that most investors and advisers believe. http://www.puzzlefinancialadvice.com.au/010501%20how%20to%20achieve%20financial%20security.pdf
  - This unreliability of investment returns has led to the Puzzle 4%-rule for financial security which basically says, that the only certain path to financial security is to live within your means. Puzzle's recommended consumption strategy to clients (who are living solely off their investment portfolio) is that each year, clients value their investment portfolio, and set a budget of only up to 4% of the value of assets that year.
    - In good times, they can have a higher budget.
    - In tough times (which often happens), they have to tighten their budget.
    - http://www.puzzlefinancialadvice.com.au/financialsecurityhow.htm