Ten Best Investment Ideas 2014

Staying a step ahead during constant change

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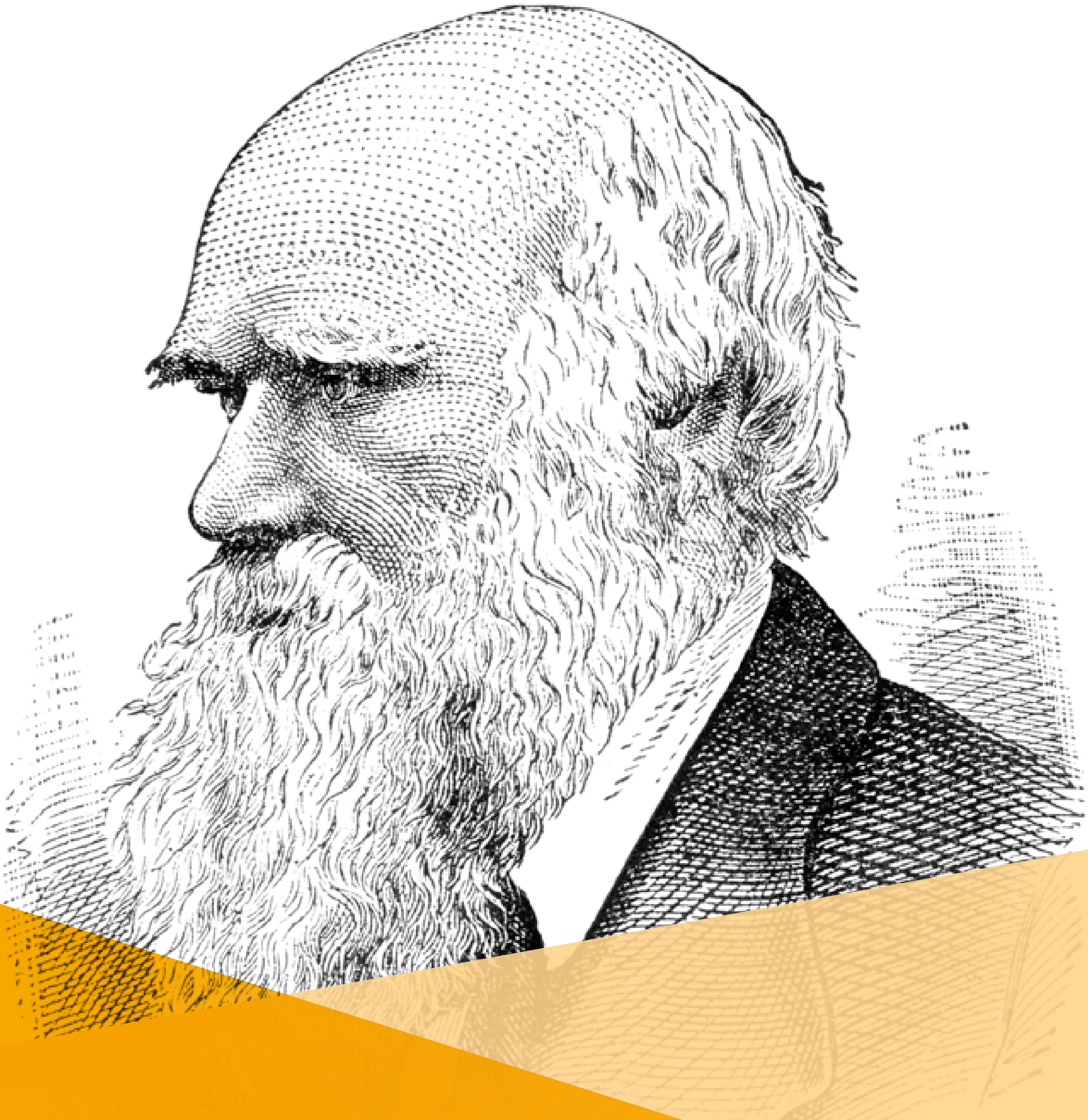

Charles Darwin once said that it is not the strongest of species that survives, nor the most intelligent, but **the one most adaptable to change.**

While Charles Darwin may have been referring to nature, his commentary has never been more true than in the current business environment.

Charles Darwin's expedition to the Galapagos Islands in 1831 developed his theory of evolution by natural selection.

On the Galapagos Islands, he observed that many of the unique creatures had similarities from island to island but had adapted to their environment.

Front cover: The unique Blue Footed Booby was observed by Charles Darwin during his voyage to the Galapagos Island.

Points of interest

For investors, each new year brings new opportunities and challenges. Some personal while others in the investment environment. One constant is change – social, political, technological, financial and economic.

Each year **to help you stay a step ahead through this constant change,** we try to make sense of what those changes bring and represent:

- from the shorter term ones, such as low global interest rates or the change to a Coalition Federal Government; to
- big trends already under way and longer term in nature, such as the rapid expansion of the Asian urban middle classes, technological change and the wave of Baby Boomer retirements.

We bring them together in 10 major ideas and practically interpret what they might mean from a strategic positioning of investment portfolios, through lifestyle impacts and specific investment ideas.

A large proportion of our Financial Advisors, Investment Analysts and Economists contributed to this report, making it our most important and thorough publication of the year. We hope you find it interesting and thought provoking.

For more content relating to this report or other topics, visit our website www.crowehorwath.com.au or contact us for more personalised thoughts and advice on 1300 856 065.

Ten Best Investment Ideas 2014

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With a life span of over 100 years, the Galapagos Island Giant Tortoise takes a long-term view. In investment terms, taking a short-term view of the market is gambling with your future. See page 4 for more.

The big picture for 2014 and beyond

Investment markets performed exceptionally well through 2013 with the USA and many European share markets pushing through record highs.

In most of the major developed economies, the threat of a fall back into recession has passed. Output, spending and employment are rising. Inflation and short term interest rates remain near record lows but longer term interest rates in many countries are edging higher on the back of improving global conditions.

Prices are also at record levels for many quality Australian companies. The overall market, however, remains below peaks seen in 2007. Refer to Figure 1.

Divergences between the world's different regions and countries seems likely to persist, but with some new twists and turns.

Europe and Japan look set for slow economic growth and in our view are the most at risk of falling back into recession in the near term. In the USA, growth in the next few years could be back to a robust 3-4% pa as solid private sector gains combine with the end of public sector contraction.

The emerging economies, like China, India, Brazil, Turkey and Mexico still seem likely to contribute 70-80% of global growth for the foreseeable future. Their rapidly growing urban middle classes are becoming richer and increasingly driving global consumption patterns. We explore this specific trend in one of our key ideas.

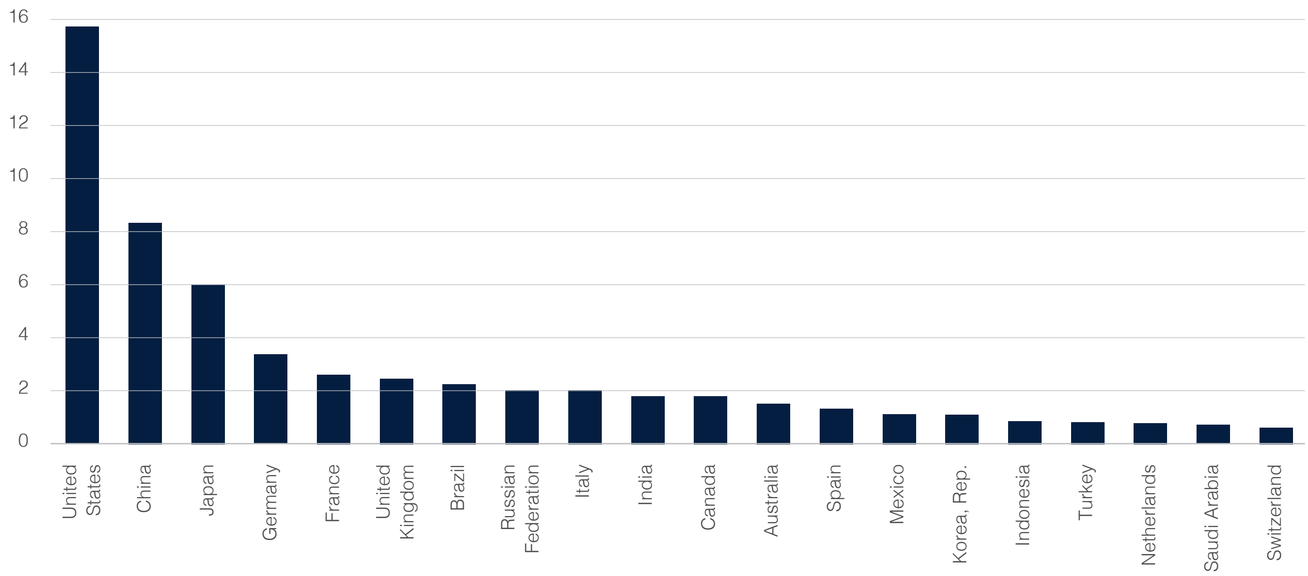
China's growth seems likely to continue at 7-8% per annum while India and Brazil slow down. China's relaxation of the one child policy, bigger roles for the private sector, property rights for farmers and relaxed urban residency rules are all aimed at ensuring a more consistent growth profile for their economy in future. This continues to provide

Figure 1. Select market returns 2007-2013, in local currency.

Performance (%, local currency)	2007	2008	2009	2010	2011	2012	2013
S&P/ASX 200 (Australia)	+16.1	-38.4	+37.0	+1.6	-10.5	+20.3	+20.2
FSE DAX (Germany)	+21.7	-28.6	-0.9	-4.8	-17.5	+29.4	+52.2
Nikkei 225 Average (Japan)	-14.9	-10.2	-10.1	-2.3	-12.9	+8.0	+49.6
FTSE 100 TR (UK)	-2.0	-34.8	+10.9	-4.2	-2.9	+13.6	+40.3
S&P 500 TR (US)	-5.3	-20.7	-2.0	+1.0	+2.1	+14.6	+53.6

Source: Morningstar Direct

Figure 2. Global Gross Domestic Product – Top 20 (2012). US $tr.



Source: World Bank

long term support and opportunities for our economy and businesses. Figure 2 shows China as the world's second largest economy by GDP.

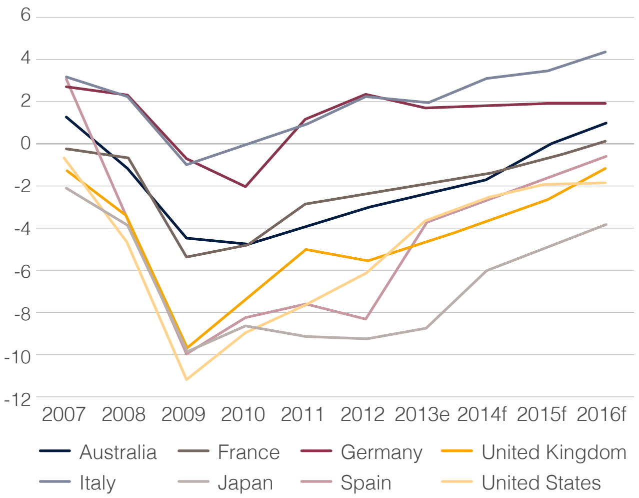
In the USA, the feared "fiscal cliff" of early 2013 and continued ructions on the debt ceiling have passed and economic growth has lifted. Despite the lack of a budget since 2011, their Federal Budget deficits have tumbled from 11% in 2009 to a forecast 3% in 2014.

Across most of Europe, budget deficits are also falling resulting in reduced concerns around European countries defaulting.

In contrast, the Japanese Government's spending is alarmingly high and will need to be addressed at some point in the period ahead.

Australia's Federal and many State budget's remain unbalanced and are at risk of expanding further which will lead to cutbacks that are now being planned.

Figure 3. Budget Deficits Declining in Major Economies. Primary Deficits, % of Gross Domestic Product



Source: IMF World Economic Outlook, Oct 2013

Political leadership is possibly more settled in many countries. New teams are in place in China, Italy and Australia but each seems likely to press for change with a greater private sector focus and pullback in the respective public sectors. This was a trend we noted this time last year. Elections will occur in Brazil, South Africa, India, Indonesia and New Zealand this year.

For Australian based investors, the election of a Liberal National Party Coalition likely means a more business friendly and less frenetic style of Government. Change is already underway and more is planned, including:

- The Carbon Tax is to be replaced by direct action;
- The company tax rate is to be cut to 28.5% but a parental paid leave levy added for bigger companies;
- The Budget deficit is to be cut.

Some of the likely policy changes could include more flexible employment regulation and an acceleration of bilateral trade agreements with countries such as China.

Overall, we see these reforms as a positive for the private sector and overall market confidence but at the same time, businesses must navigate these changes.

There also seems likely to be changes to child and aged care and age pension eligibility. While superannuation changes are promised to be off the agenda for a year or two, our theme of increasing individual responsibility for post work incomes looks increasingly relevant.

With this backdrop, other big issues also at play should be considered.

- Generally, the global population is getting richer and older, having less children, living longer on average and overall striving for more "Western" style lifestyles.
- All around us, technological innovation and commercialisation is accelerating. From the way we consume news and are touched by advertising. To how we communicate with each other and are fed. From how we get paid, to how we buy things and pay our bills. And from how we're diagnosed, to how we're treated. All are changing at a rapid pace.

At one level, these changes and the lingering turmoil of the Global Financial Crisis (GFC) looks likely to keep policy makers conservative and short term interest rates low - and disturbingly for investors, below inflation.

At another level, the accelerating pace of change, with the resulting ongoing creation and destruction of industry sectors and businesses, means more active portfolio oversight and management will be valuable.

Companies whose products and services on which we rely today can be made irrelevant tomorrow.

1. Focus on your own goals, not the Jones's

Asset allocation is the science of what proportion of an investment portfolio should be allocated to different asset classes. We aim to invest in appropriate asset allocations for every client to meet long-term goals by focusing on long-term performance and generating consistent and growing cash flows where possible.

We believe investors should keep a relatively simple process when implementing and monitoring investments while maintaining flexibility should circumstances change or access to cash be needed quickly. It is difficult to do this en masse and with a one size fits all approach without missing the opportunity to ensure investment portfolios are constructed with investors' specific goals in mind.

In setting a wealth management strategy, you need to consider your personal objectives and comfort level with specific investments, then attempt to achieve these goals in the most efficient way possible. Selecting a single fund, one manager or one asset class brings with it all kinds of biases and little awareness on how that investment will assist in meeting your long-term wealth objectives.

In terms of risk, most people think in terms of volatility of asset prices. Some may be excused for thinking the best way to avoid this risk is by not investing and leaving money in cash. While this does remove the risk of a drop in prices, it opens up a much more significant risk; failing to accumulate enough wealth for retirement. Long term investors can afford to ride out short term volatility if the portfolio is constructed in line with future spending objectives and buffers are in place that can take advantage of opportunities markets present from time to time.

"Take a long-term view" is often cited as the way to manage capital. We often see or hear daily, weekly and monthly returns quoted. Being able to objectively step back from the short-term and focus on what matters will make a substantial difference in the quantum of most peoples' wealth over the years ahead.

Taking a short-term view of the investing world is really gambling with your future and a behaviour which should be avoided.

Unfortunately the long term is difficult to focus on as we're bombarded with attention-grabbing material.

Another difficult behaviour or bias to overcome is focusing on the recent past and projecting that as what could be expected in the future. This can be said of poor investments too. You just need to rewind the world to 2007 when there was very little consideration of risk, or downside, and how equities can and do fall in price. What followed was a period of deep despair in 2008, and a question of when the world was going to end in some people's minds! This period of despair is the one that remains clear in investors' minds today after many investments have largely recovered.

While we are certainly not saying we can time markets or avoid share price falls, we can say when certain parts of the world look expensive and when others are cheap. Generally when asset classes look expensive, future returns are lower, and vice versa. When prices eventually revert to more normal values it's anyone's guess, but we know that if valuations are on our side, it assists in long-term wealth management.

With these concepts and some of our key philosophical thinking in mind, we insert a word of caution for investors seeking a quick buck. Generally if it sounds too good to be true, whether it be higher than average returns, structures to save tax, guarantees to improve your financial world, then steer clear.

The people who generally make money from these schemes are not the investors but the promoters. It's important to always understand what it costs customers (upfront and ongoing), both financially (fees, taxes, transaction costs) and in time, to purchase the product or structure.

An example is gearing into property. This strategy may turn out fine for some, however you need to understand that if interest rates rise, if the property does not have a tenant or you need access to your money quickly you may end up in a worse position than was otherwise expected. Proceed with eyes wide-open.

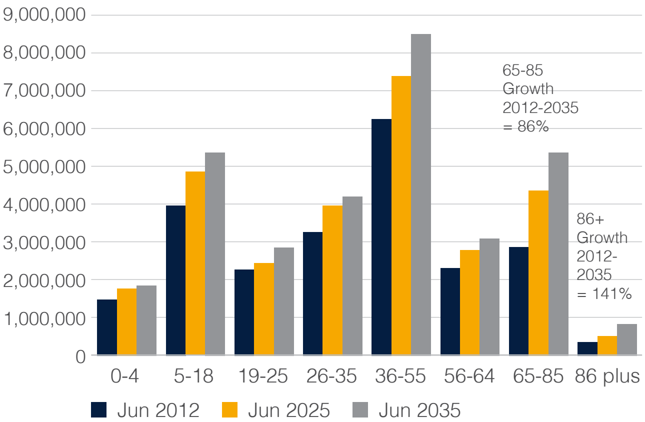
As much as the thinking behind asset allocation shouldn't change often or on a large scale, there are now more academic words being written on asset allocation, risk minimisation and how to improve retail investors' overall financial positions at different life stages. Specifically for those leading into and just after retirement. These works come after the GFC with an awareness that asset accumulators and wealth spenders require different strategies and investments. It is also an admission by the academic and funds management worlds that there is a definite distinction between managing a portfolio for an entire industry (large pension plans) versus one or two clients.

2. Change – the only real constant

In the post war era of 1946 to 1961 Australia underwent a population boom that is widely known as the "baby boomer" era. Now some 50 to 60 years later, Australia is about to undergo a structural shift as this generation enters a stage of life that allows them to enjoy the fruits of their labour. For some, this will be a switch from working to enjoying retirement. Others will toil for longer in the workplace, but likely seek flexible work environments to allow for additional recreation time.

Australia will now see a larger number of people entering the retirement age, currently 65, on an annual basis than any time in history. This comes with a number of challenges, none less than financial. This is demonstrated by the population pyramid (Figure 4 below) that displays the increasing number of people approaching retirement age in the years ahead. This transition is an important consideration from the perspective of both potential retirees and also investors.

Figure 4. Australia's Projected Population



Source: Australian Bureau of Statistics, Cat 3222.0, Series B

This shift is now likely to be hastened due the recent favourable investment market conditions. Some baby boomers that were planning on retiring in 2008 or 2009 delayed their transition as the Global Financial Crisis severely affected superannuation savings and overall consumer confidence.

As the global economy slowly recovers, equity markets have rallied to the point where most superannuation savings have returned, or recovered beyond pre-crisis levels. The performance of the S&P/ASX 200 Accumulation Index now exceeds the previous peaks of 2007 (see Figure 7 later). This index includes the affects of share prices and dividends that are assumed to be reinvested back into the market. This is a fair representation of superannuation savings for a person still in accumulation phase who has a more growth oriented investment strategy.

The situation now posed to potential retirees is that their retirement savings have rebounded, however they have worked for up to 6 years longer than desired. For some the question of "am I now in a position financially to retire?" may be asked.

We believe given the market recoveries, that those who were ready to consider retiring, can now make that significant life decision. This is clearly not a decision to be taken lightly and with the changing attitudes towards retirement this can be difficult decision for some. Considering an external voice for advice is certainly worthwhile if there are still question marks in relation to that decision.

We also see a marked change in the attitude to spending and areas of major expenditure between those now considering retirement relative to previous generations. As we live increasingly longer and healthier lives, the requirements for a high standard of living after work have increased. Previous generations had very conservative views on retirement where saving and frugal mindsets were front of mind and a legacy for their children was a given. The attitudes of forthcoming retirees are markedly different.

Retirement, for some, is viewed as a time for indulgence, a time for enjoying the fruits of one's labour and for new experiences. An interesting question to pose is: "how do you foresee your retirement relative to your parents?" We expect that the answer is generally more indulgent and fruitful.

The latest generation of retirees is characterised by financial and technological proficiency with higher levels of consumption of more luxurious pursuits. Baby boomers are spending more money on travel, housing, technology and healthcare that were previously thought to be excessive or indulgent for retirees. The best example is the rapid take-up of new technology by a generation previously thought to be too inexperienced for smart phones and tablets; this has been one of the fastest growth demographics in fact. Attitudes towards retirement lifestyles is a key consideration for superannuation accumulators and given current market conditions now is the time to be considering these options and whether you're ready to change your life.

While these are important considerations for people approaching retirement, investors should also be aware of potential investment opportunities aligned with these demographic shifts. The most obvious of these is the health-care sector. As an increasing number of retirees live longer and healthier lives, health and aged care services become a vital service.

(Cont.)

Hospital, medical diagnostics and testing, and vaccine and other medical solutions are some of the variety of opportunities.

Other market sectors poised to take advantage of this trend are travel and technology. Regular travel has now become a major component of retirement and there are numerous quality companies that can take advantage of this trend. For example, Sydney Airport is forecasting consistently increasing passenger numbers due to the increasing wealth of retirees and the expansion in Asian tourists. Combined with a strong currency and preferences for overseas travel, large airport infrastructure assets provide an attractive proposition.

This thematic is also blended with rapid take up of technology as numerous travel companies offer online systems where holidays can be planned, booked and purchased completely online. The adoption of mobile technology continues at pace and needs a strong support network to keep up with the rate of change. The providers of telecommunications technology are seeing rapid growth in older generations, but also a changing mix of demand (who wants a phone on the wall these days!). Telstra (TLS) is the obvious investment set to benefit in this sector however there are several smaller telecommunications providers set to benefit as the focus shifts from traditional fixed line voice services to wireless data centered solutions and cloud services and technologies. Security, capacity, scale and location should also be considered in relation to cloud computing.

3. The innovators

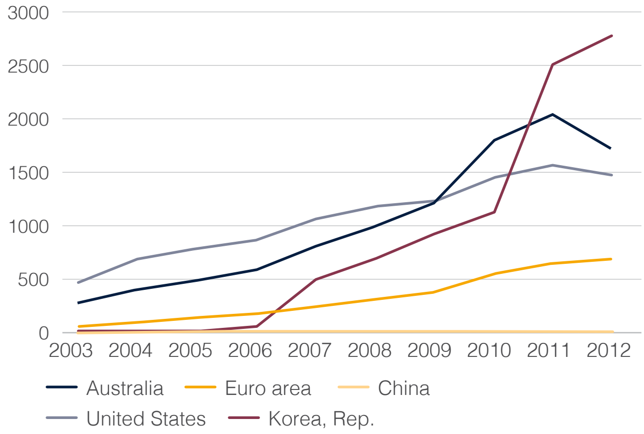
It was Charles Holland Duell, Commissioner for the US Patents Office from 1898 to 1901 who was credited incorrectly with this famous quote ‘Everything that can be invented has been invented’. What he actually said in 1902 was, in part ‘In my opinion, all previous advances in the various lines of invention will appear totally insignificant when compared with those which the present century will witness’. This statement could probably be repeated again in this century to reflect the changes we are witnessing today.

Businesses today readily accept the idea they must continue to evolve and shape their models to stay current, to hold market share and to attract new customers. Failure to do so renders them a dinosaur in today’s world and could mark the gradual demise of their business. There can be no greater example of this than Kodak, once the global market leader in photography and photographic equipment who which failed to see the shifting consumer trends, paying the ultimate price that ended in bankruptcy.

The internet has been another area of innovation allowing businesses to leverage the consumer experience across numerous platforms making print media near redundant. This heightened awareness and familiarity has resulted in people of all ages adopting new technology at an accelerating rate. More intuitive technology such as tablets has near eliminated fear of new technology and replaced it with excitement.

Technological change is happening at an accelerated pace. It took 26 years for 25% of the US population to adopt television, 13 for the mobile phone, but only five years for the iPad to reach the same penetration. Figure 5 shows the number of internet servers in selected countries. China has around 600 per million. Australia is closer to 1700.

Figure 5. Secure Internet Servers.
Per million.



Source: World Bank

Innovation and the ability to reinvent and evolve have become essential to survival. High profile successes such as Apple and Google had no more advantage than any of their rivals. But they invented new products that reached out across the globe with massive appeal. New intuitive technology such as the emergence of smart phones and tablets is leading to new software developments. This has substantially increased the number of contributors; these days anyone who has access to a computer can develop software.

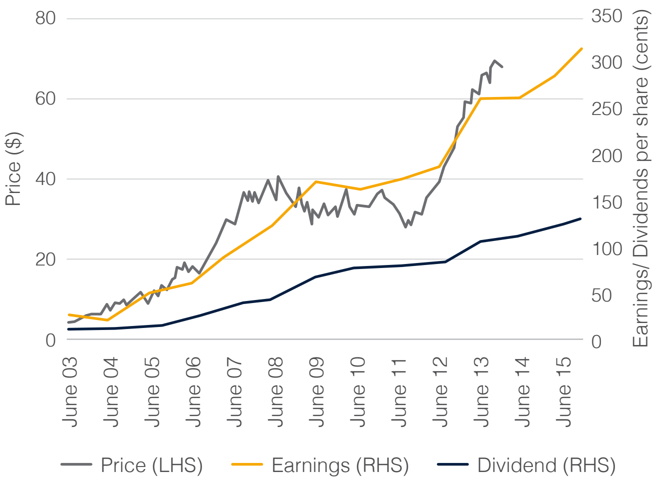
The latest directional change is the evolution of cloud computing. Opportunities that are yet to hit scale in this area include data centres, security providers, transition managers and software providers. This is an area to watch.

It is not just consumer electronics that is experiencing this progress. Healthcare, biotech, transportation, energy, agriculture and many other industries are finding new and better ways to produce at higher qualities and efficiencies. This age of innovation is not only good for consumers but is producing businesses that are more efficient and more profitable generating tangible shareholder value.

Investors may wonder how in this world of information at the speed of light, the next great product or service can be predicted? In reality this is almost impossible. However the good news is that a crystal ball is not a requirement to invest successfully and neither is taking a punt on a small or unproven company with high hopes.

Mature and experienced companies such as blood biotherapy company CSL (Figure 6) pour significant resources into research and development. With the growth of the global middle class, their market is snowballing and innovation is their only competitive advantage. While their share price has rocketed up in recent years reflecting the confidence investors have in their operations, their expanding target market (and given there is always some new strain of disease), their future seems bright.

Figure 6. CSL Limited



Source: Crowe Horwath Share Model

If the internet is the vehicle innovation is riding on, then social media is the fuel. Local businesses have used this medium to turn into global players with limited capital outlay. The power of information sharing allows companies to reach new markets and consumers, providing product education at a level previously impossible.

Financial services is a major technology beneficiary by allowing banks to provide online facilities and apps, reducing the number of customer service staff. However, technology developments by the major Australian banks have largely been predictable, opening up the opportunity for solutions that "wow" consumers, ultimately taking market share. This is also a big area of risk for the banks as non-financial companies start to offer payment facilities which could easily evolve to banking or other financial services companies.

Superannuation is likely the area this will emerge in given the massive move to Do It Yourself (DIY) Super funds post the Global Financial Crisis. All major banks are intent on this space and significant capital expenditure is being employed by them to develop capabilities.

With near 1 million members of a Self Managed Super Fund in Australia the profit potential from a viable service offer is immense.

While the colourful and new age style of Google's headquarters may help foster eager employees to generate new and insightful ideas, the real workhorses of innovation come from businesses that invest time and resources into reinventing themselves and their products or services, realising the benefits technology can provide their organisations. Companies that can create this culture successfully are worthy of investors attention.

Evolving over time and adapting to its unique environment, the coloration of the Galapagos Island Iguana varies among different Island populations.

4. Servicing the demographic

In last year's edition of the *Ten Best Investment Ideas*t, we talked about the demographics and dynamics of our population and the businesses that one might consider investing in when trying to take advantage of this long-term theme. In this years report, we continue to believe this theme has legs and will ultimately affect the entire population, from young to old.

At the time of writing, the Federal government announced a Productivity Commission inquiry into the childcare sector and early childhood learning. The anticipated outcomes of this report will include ways to provide a system that is more in line with today's family structure and not necessarily based on the standard 9 to 5 working week. It is also looking to address concerns around the need for higher women workforce participation and address learning and developmental needs of children, while remaining flexible and financially sustainable. The report is due in October 2014 and it will be interesting to see what opportunities lie ahead in that space.

In the media sector, online leaders are becoming more and more prevalent. News and information travels faster than ever before and is accessible to anyone, anytime. Most of it is free, but some media outlets are also charging subscribers for access. Online advertising is continuing to grow in a clear sign that consumers are looking to these mediums for solutions. There are a number of online businesses that have grown over the years to now become dominant and most importantly, profitable in their own right. Examples of these include employment and education provider Seek.com.au, CarSales.com.au and Realestate.com.au.

Telstra and Foxtel are examples of media companies capable of delivering a movie to your TV without you actually having to leave the house. With faster data speeds available upon the eventual delivery of the NBN, businesses will be able to offer new entertainment content.

Overseas providers like Netflix provide on-demand movies and TV content streamed over the internet for a monthly subscription and services such as this are likely once data speeds are acceptable to facilitate such services.

With our lives seemingly busier than ever before, online shopping has seen amazing growth across consumers of all ages. Most of the major retailers in Australia now have an online presence, but they swim in a global pool, often against far bigger 'fish'. We need to consider businesses in this space that have a recurring demand. Woolworths and Wesfarmers (owner of Coles and Bunnings), the dominant consumer staples retailers in Australia both provide services that allow shoppers to shop online at a time that suits the consumer and have goods delivered to home. All for a service fee of course. While this has been offered for a number of years, as our lives get busier and we find it less convenient to do the mundane, these services should continue to see greater use in future.

Government policy and intervention from time to time will also play a part. As the population in Australia ages, the demand for aged care services is expected to grow at a faster rate.

It is likely that access to quality aged care facilities will become more difficult as demand outstrips supply and workers in the space become increasingly difficult to find. Providing affordable care in the home is likely to be the way of the future.

The key to investing in this area will be identifying who the major players are and how will they model their business to take advantage of upcoming opportunities. Ramsay Health Care and Sonic Healthcare are two well established healthcare companies that hold dominant positions within their respective fields.

The young Sally Lightfoot Crab are dark in colour, camouflaging well on the Galapagos Island coastline keeping them safe in their early years. Over time, the adult Sally crabs vary greatly in colour – reds, browns, pink or yellow.

5. The new political regime

A large portion of 2013 saw a steep decline in business confidence and business investment. The start of this can be traced back to the announcement of the Federal Election in February 2013, effectively turning the election campaign into a six month affair. Traditionally, a period between the election announcement and result is a time of uncertainty as businesses pause, awaiting the outcome and promises of the parties. Once an outcome is determined then companies typically recommence making longer term plans, taking into account the 'new' political landscape.

With the election behind us, the new Government are setting a major platform to assist businesses including unwinding the carbon tax. They consider this will reduce the cost of doing business in Australia, making our companies more competitive. This should be beneficial to many areas of the business community and assist with overall confidence. This may well not occur until the new Senate is installed in July 2014 as Labor and the Greens have both indicated they will oppose this action.

Notwithstanding this activity, the Reserve Bank has recently wound back its economic growth forecast for 2014 from 2.25%-3.25% to 2-3%. The reasons cited for the downgrade relates mainly to business investment. Mining companies are far more circumspect with their spending and project delivery. Surveys of the non-mining sector likewise indicate that whilst they are feeling more confident, there are few plans to increase investment in the coming 12 months. Expect unemployment to creep up through 2014, however don't expect it to reach anywhere near the disastrous levels of some European nations.

With businesses holding back on spending and thus holding cash on their balance sheets, we consider the year may provide increased activity in mergers and acquisitions.

This will be evident both in the large and medium end of town. We can expect to see continued bids from overseas for our companies particularly in the agricultural sector.

The best way to gain from this activity is via managed funds that invest in the smaller companies – those outside of the top 50 – as this is where a lot of the corporate activity is likely to be.

Consumer sentiment appears to have a slight uplift and spending into 2014 is forecast to lift. This should flow through to the retail and building sectors which have been in a definite slump over the past 18 months. Many households have held off upgrading their house over this period and there is now movement in this sector. Sentiment is strengthening with auction clearance rates increasing particularly in the Eastern states. The chance of a property bubble is unlikely with demand being at high levels and inventory at low levels. The low interest rate environment is likely to keep this sector buoyant however the record high levels of household debt are likely to constrain growth in the near term.

All in all, we consider business confidence will rise toward the latter part of 2014 however the headwinds highlighted by the Reserve Bank need to be considered when looking where to invest for the next 12 months. The Australian banks appear to be at full value (see Idea 10) whereas some of the companies outside of the top 50 may provide value. The best way to access these is via the better quality managed funds. Overseas opportunities should also be front of mind.

6. Urbanisation and the growth of the middle class

The discussion we had in our previous year's *Ten Best Investment Ideas* highlighted the changes in demographics and the rise of the middle classes in the large emerging nations; think China, Brazil and India. This trend continues at large, even intensifying, specifically in China as authorities there attempt to assist the economy transition from a construction-led spend to a consumer-led spend.

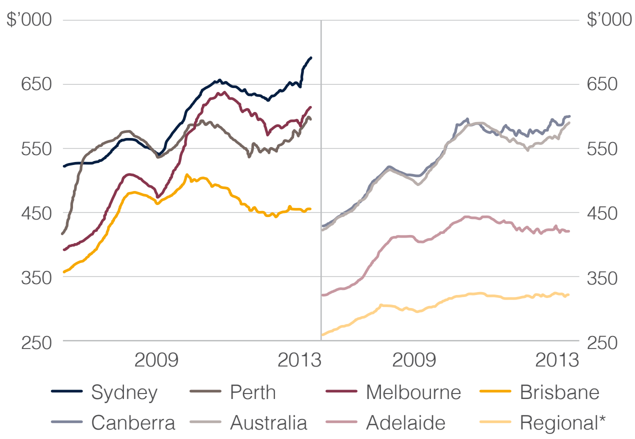
The global urban population has surpassed the global rural population in recent years. In addition to ever increasing wages in emerging markets, we are witnessing an era of increasing consumption of goods and services that have been regarded as the basic/normal requirements of the developed world. As incomes in these markets improve, so too does the spread of the population able to afford goods and services they hadn't previously been able to. It also begins to change consumer spending patterns. Goods in demand include the whole spectrum from the basics such as food staples (milk, cheese, grains) to those for the more affluent (such as wine, meats and fine foods). We see demand for resources remaining strong too, as well as domestic and overseas travel, higher education and personal investment advice and services.

Some of the implications for investors can be seen in the demand not only for Australian produce, which is seen as high quality, but also in the demand for companies that control parts of the supply chain. We have witnessed the battle for the Australian-listed Warrnambool Cheese and Butter which epitomises the global trend. This is all about the rising demand from the increasingly affluent Chinese consumers and large consumer products focused businesses being aware of this opportunity – it is really the globalisation of food product.

In terms of magnitude, China is now the world's second largest economy next to the US (refer to Figure 2), and is the fastest growing economy in the G20. With more than a trillion dollars sitting in various sovereign wealth funds, the Government in China realises the burgeoning requirements of feeding and housing a growing population of substantial scale. The capital is wisely being deployed into strategic opportunities around the globe to ensure the long-term prosperity of their people.

Since 2005, investments by the Chinese government and Chinese companies collectively have increased eightfold to almost $140 billion. Anecdotally, private Chinese individuals are also investing in offshore properties at a rising rate. For example, the Sydney property market has experienced the fastest national price growth in the last 12 months. A large amount of demand supporting Sydney prices has come from investors that are predominantly from mainland China, Hong Kong and Singapore seeking 'safer' markets to invest in.

Figure 7. Property Prices



* Excluding apartments; measured as areas outside of capital cities in mainland states

Source: RBA

China's aging population is also a factor to watch. The number of people aged 65 and above is predicted to reach almost a third of the nation's population by 2050. Chinese authorities have lifted the one child policy in an attempt to ease the burden this potential long-term demographic trend creates.

In the meantime, the Government has a huge challenge in managing the mass of aging population that may not have required family support.

From this trend, the question is what are the implications for investors?

Western multinationals are investing in the Chinese market directly in many sectors. This includes McDonalds who are aiming to increase stores in China by 50% to 2,000. Yum! Brands, who have 3,300 KFCs and 651 Pizza Hut stores in China, is looking to grow total store numbers to 20,000 in the years ahead.

Another interesting trend is the rise of the global luxury goods shopper with the Chinese now topping the list. In 2012, 70 million Chinese travelled abroad and 47% said they bought cosmetics when overseas. China's government imposes high taxes on premium skincare, makeup and fragrances. The World Luxury Association in Beijing reported that luxury goods sales in China slumped to the lowest level in five years in January, but soared by 18% overseas as many Chinese travellers took advantage of the three-day New Year holiday.

The projected growth in this sector is highly appealing and it has led to the strategic acquisitions. Of note, one of Australia's famous brands, RM Williams, has been part-purchased by LVMH, the group that owns brands such as Louis Vuitton, Tag Heuer and Moet Champagne, in 2013.

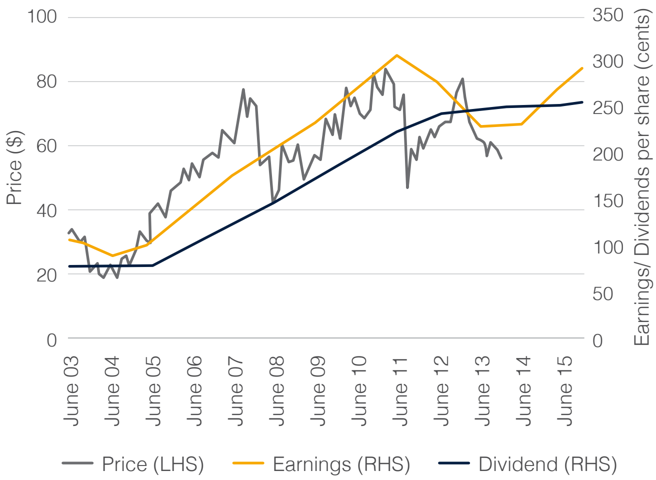
The pick up in overseas travel by Chinese nationals is also a positive for the likes of Sydney Airport, and Westfield Group, who were awarded the contract to oversee management of food, beverage and retail operations at Los Angeles Airport. We would expect companies like these to continue to benefit from these trends.

Australia has much to offer as a producer of quality food and wine. A more affluent Chinese consumer leads to diet changes too. This places Australia's land and its output in a very attractive position.

Should the Australian dollar weaken, this could also lead to greater attraction (i.e. makes it cheaper) for overseas investors seeking long-term investment opportunities.

Take advantage of the trends by being exposed to the Australian companies with global businesses such as the health providers which stand to benefit from the growing middle class population and aging population such as CSL and Cochlear. Property companies that stand to benefit from overseas interest in our real estate include Stockland and General Property Trust (GPT) and no doubt the international interest in our assets will continue.

Figure 8. Cochlear Limited



Source: Crowe Horwath Share Model

7. Where to invest offshore?

Australian investors maintain a natural bias to the local share market which is not too dissimilar to investors in the US and UK. The incentive for local investors to invest onshore are the higher yield expectation, greater tax incentives and a solid performance record relative to overseas markets, over the very long term.

Prior to the last three years, Australians were not highly rewarded for investing overseas. In addition, the impact of the GFC and the rising Aussie dollar offset much of the gains achieved, thereby muting performance in overseas markets. This had led to a further home bias.

To understand what is on offer overseas, we should first reflect on the opportunity set available at home. The Australian stock market is made up of over 2,000 listed companies with a combined market capitalisation of $1.49 trillion (as at 15 Nov 2013). The top 20 companies by size represent around $900 billion in size with a majority of that held in the big four banks, two large miners, two large supermarkets and a phone company. Therefore market performance is determined largely by a very small number of large corporations.

The performance of the local share market has been lifted over the past 10 years in large part by these index dominant businesses. As the mining boom peaked and the GFC passes us, investors more recently have sought high yielding stocks as we note later in this report.

The concerning point being, the mining boom has passed us and higher yielding defensive stocks have rallied significantly. While Australia confronts an environment where miners are under pressure, we seek growth from other sectors while at the same time investors need to consider broadening the very narrow domestic bias.

On a global scale based on market capitalisation, the Australian index represents only 2% of the total global market capitalisation.

So where to invest Offshore?

Investing offshore can provide exposure to brands with products that are either consumed, applied, utilised, watched or enjoyed by Australian's every day. Companies include: Apple (iPhone, iPad), Google (internet search engine), Microsoft (computer software), Johnson and Johnson (bathroom products) and Exxon Mobil (petrol/ energy). It would be difficult to find a household globally that doesn't have a product or two from these and other multinationals. And these are just US based companies. They not only have sales and profits driven from mature (some would say more stable) markets, they are also benefiting from the faster growing emerging markets.

(Cont.)

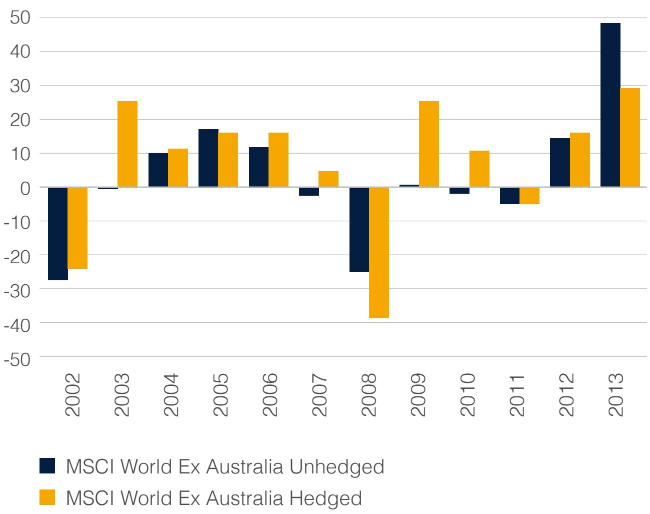
The global listed opportunity set consists of over 15,000 companies (those that are contained in the MSCI World index). The diversity in company names, their underlying revenue streams, sectors, countries and exposure to varying economic factors provides the Australian investor with greater opportunities in healthcare, technology and retailing.

The outlook for the major global economic centres including the US, China, Europe and Asia are mixed; some will be, in part, driven by the overall prospects of the US economy. Understanding different global growth prospects opens your eyes to many avenues we don't have direct access to on the ASX.

Asia continues to be a growth engine for the global economy. A misconception of Asia being that it is predominantly developing rather than developed should be challenged. The likes of China (7% GDP growth), South Korea (4%), Taiwan (4.7%) and Indonesia (6%) are all expected to grow greater than global GDP in FY14 and beyond. Global corporations such as Samsung, HSBC, China Mobile, and Petro China are all businesses which have originated out of Asia that are investment opportunities for global equity managers.

Investing offshore raises the issue of exchange rates and their impacts to the performance of an investment. The decision to be unhedged or hedged to the Australian dollar, or leave it up to the fund manager (active currency management) is a decision for you and your financial advisor.

Figure 9. International Equity Returns.
Calendar year %.



Source: Morningstar DIRECT

The surge in the Australian dollar through 2009 and 2010 to push through parity with the US dollar, has been driven in part by the commodities boom, our high interest rates relative to other "AAA-rated" nations (only 7 globally) and our perceived economic safety. This was a positive period for hedged investors.

For those in Australia, you could argue that many of the major Australian listed companies are global businesses with a large portion of customers and operations overseas. However given the Australian market is only 2% of world equity markets, the benefits of thinking more broadly, can provide diversity in growth and income for a portfolio over the longer-term.

The Galapagos Island Sea Lions seem clumsy on land but are extremely agile offshore.

8. Yield does not equal income

For those living from their personal investment wealth, record low interest rates are forcing investors to make decisions impacting lifestyles by taking risks they otherwise wouldn't, facing returns which are being eroded by higher prices of goods (inflation) or leading a lower standard of living. This is a global phenomenon.

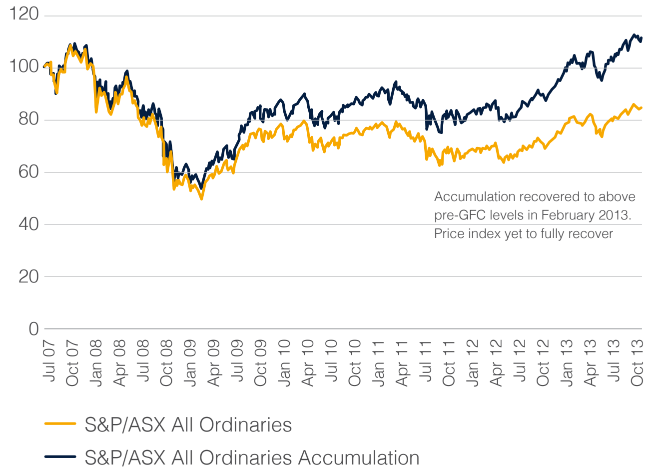
At the time of preparing this report, the Reserve Bank of Australia set the official cash rate at 2.5% while 6-12 month term deposits are paying approximately 3.6%. These rates are less than compelling and put pressure on investors to seek other avenues of return.

Taking this into consideration, the chase for income has only intensified in the last couple of years, with high-dividend stocks having emerged as the chief focus for many investors.

Australian companies are generally reporting modest results amid difficult operating conditions. Many are focused on driving out costs as sales growth remains weak. In the post GFC world, most sectors in the Australian stock market that have outperformed have been those which have larger dividend payments. In particular, banks and telecommunication companies have been major beneficiaries of the demand for higher-yielding stocks.

This is highlighted by the performance of the All Ordinaries Index which summarises the movement in share values of Australia's largest companies and the All Ordinaries Accumulation Index, which also incorporates dividends paid by the companies. As illustrated in the following chart, the All Ordinaries Accumulation Index (including dividends) has recovered to pre GFC levels whereas the All Ordinaries (prices only) has not.

Figure 10. All Ords vs All Ords Accumulation Index (Common Base from 2 July 2007)



Source: IRESS

Receiving a portion of your total return in the form of a dividend presents investors with two choices:

1. It can be taken as cash and spent; or

2. It can be reinvested for potential growth and further return generation.

It is important to recognise that yield is not a measure of income receipt. Yield merely compares the income generated from an asset through time. The dividend yield is a function of an investment's price. A high dividend yield could just indicate that the stock is cheap, and in some cases cheap for a reason.

A "yield trap" refers to companies that promise high dividends without the cash flow to support the payments over time. Sometimes the dividend yield gets so high it is the market's way of saying it does not believe the prospects for the company are sustainable. Using historic dividends can also distort yields; if a company is reducing rather than increasing dividends, yields can appear higher than what should be expected in future.

As an example, Telstra Corporation Limited (TLS) is referenced as a high yielding stock. The company has seen flat earnings per share growth, leading to a stagnant dividend payment since 2005. This is illustrated in Figure 11 (over page).

Strong cash profits to support dividend payments are what matters over the long-term. Dividends are proof that companies are making profits, with growth in profits protecting the sustainability of the dividend which should ideally grow over time too.

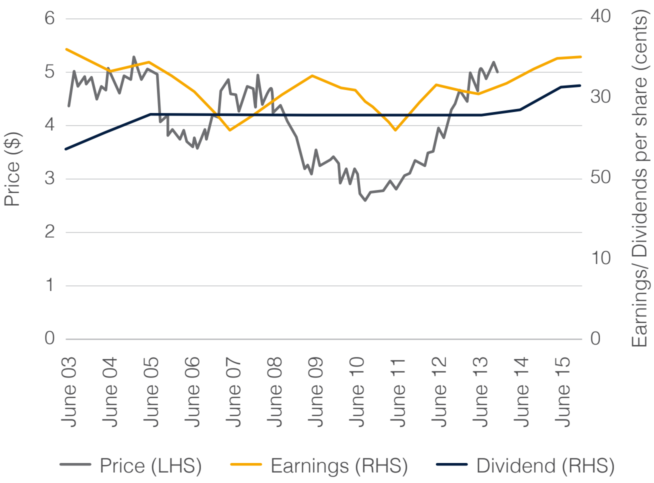
Companies that exhibit growing profits over time, generally exhibit increased in share price and are sometimes less volatile. Recurring earnings also allows a company to forward plan two or three years with reasonable transparency. The broad industrial sector has provided more favourable earnings per share certainty versus resources especially from businesses that operate staples franchises (supermarkets), healthcare and the large banks.

As a result of consistent earnings per share growth, Sonic Healthcare Limited (SHL) has been able to increase its dividend by 210% from 20 cents per share in 2002, to 62 cents per share current day. This is illustrated in Figure 9 (over page) – for those simply focusing on yield, these opportunities may be missed.

Sonic is an example of a good dividend growth company yielding in the order of 3.5% which might be low right now because the company's earnings are expected to grow in future.

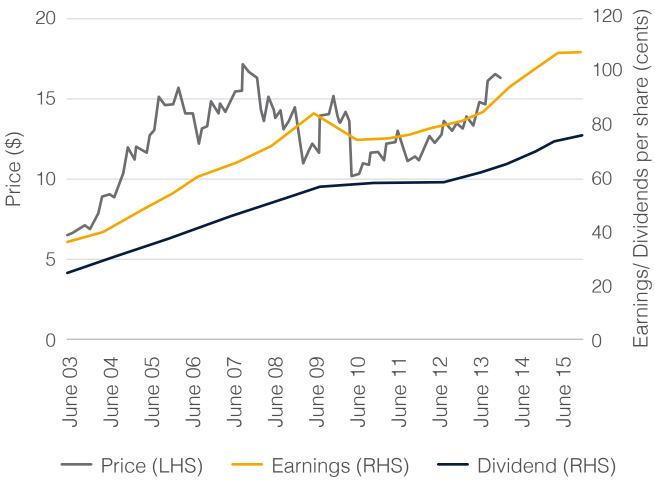
Given dividends represent a reasonable portion of total returns and wealth creation, it is important to identify quality companies where there is a strong correlation between earnings per share growth and dividend growth.

Figure 11. Telstra Corporation



Source: Crowe Horwath Share Model

Figure 12. Sonic Healthcare Limited



Source: Crowe Horwath Share Model

9. Infrastructure and property – the new annuities

In an environment of historically low interest rates, the search for sustainable income becomes ever more important. Investors are forced to move funds from the relative safety of term deposits and cash, guaranteed by the federal government in certain circumstances into risky investments in the search for income that is sustainable and is higher than inflation.

Other areas outside of cash and equities are also worth looking into. In some instances, investors look to annuity products. An annuity is a product whose main benefit is to provide investors with a guaranteed income payment over a pre-determined period of time. As an investor in these products, you can elect to receive all or none of your capital back over the period of the contract at an interest rate which is set from the purchase date.

Whilst annuities are not covered under the Federal Governments deposit guarantee, companies that sell annuities are heavily regulated by APRA.

You should still understand what security backs the annuities to ensure full confidence that in 15-20 years there is a provider that will be there to continue the income payments.

So, whilst annuities might provide more certainty of return on the surface and have their place in a portfolio under the right circumstances, there are a number of risks attached to them, that investors need to be aware of.

We continue to be wary of placing client capital in long term investments at very low rates of return. The advertisements which play up to the fear of not having enough cash flow do not mention that the cash flow from these investments is currently extremely low. Investors that locked away investments as a result of a fear of equity markets did so at a low point in market prices (through 2008). These investors have missed a strong recovery in market prices while locking away low rates of interest. Further, the guarantees are only guaranteed by the issuer.

If an annuity is not your cup of tea, then where should you look for a reasonable distribution on a regular basis that also provides some inflation protection? Our view is infrastructure and property.

Our current Prime Minister Tony Abbott has made much of the fact that he wishes to be known as the 'Infrastructure Prime Minister' leaving behind a legacy of long life, productive assets that will continue to provide the economic growth Australia is seeking. The key to successfully investing in this space as part of a diversified portfolio is understanding the cash flow being generated and the longevity of that cash flow.

In last year's report, we talked about the attractiveness of the cash flows generated from good quality infrastructure and property assets and how those types of assets provided a natural hedge against inflation and your purchasing power. Essentially, these types of assets provide long life, regular income streams that if managed correctly, should also provide a level of capital growth over time.

Takeover activity has been strong in the sector. We saw the Future Fund, the entity responsible for looking after Australian public servants pension liabilities make a successful takeover bid for Australian Infrastructure Fund. Again, a number of assets with the potential to generate growing income streams for many years that can be used to fund the pension liabilities as they fall due.

We have also seen APA Group make an offer for Envestra. This comes after APA Group took over Hastings Diversified which owned the pipeline connecting many of APA's pipelines.

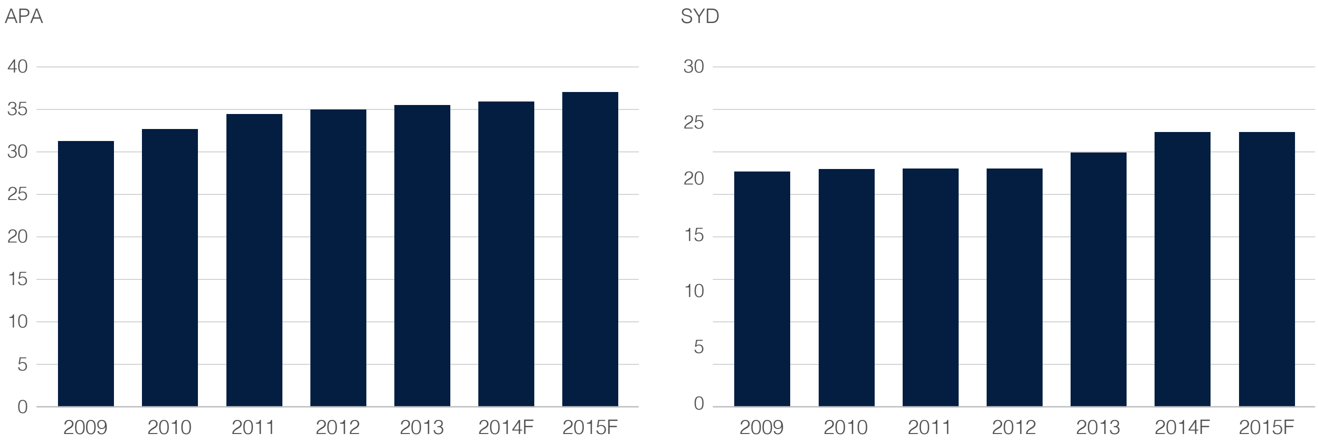
The consistent distribution flow and steady growth are attributes that are demonstrated in Figure 13 for APA Group and Sydney Airports.

In the property space, activity has thus far been more subdued save for investors' recognition of the reward that income distributions provide. Recent action has surrounded two bids for Commonwealth Property Office Fund from Dexus and also GPT. This is recognition of the quality of the underlying investments and the long term, inflation protected rentals paid by the tenants. This is clearly a space worth watching.

There are some pitfalls in these asset classes that investors need to be aware of. The most obvious ones relate to revenue receipts falling short of projections. Well established business models with mature assets are least risky here. Further the structure of the investment must be considered.

We continue to see sound cash flows being generated for our clients in an ever decreasing field of assets. We also look toward new infrastructure assets joining the listed universe and becoming long term cash flow investments that can be a substitute for other income generative investments while providing some inflation protection characteristics.

Figure 13. Infrastructure Distribution Growth – APA Group & Sydney Airports



Source: Iress, Morningstar

10. What to do with the banks?

The notion that you are better off owning the banks rather than lending money to them through term deposits has proven correct over the last 12 months.

Not only have we seen the cash rate fall to record low levels, there has also been a rise in bank share prices along with a healthy yield along the way. This chase for yield has pushed the prices for the 'big four' banks to much higher values and has led overseas commentators to report that our banks are not only fully priced but that Commonwealth Bank is the most expensive bank in the world "on every metric".

Shareholders who accepted Commonwealth Bank's share purchase plan in 2009 at $26 would be extremely happy with the current share price growing to near $80 a share.

Figure 14 shows a summary of bank valuations from 2011 to demonstrate the change in yield, PE and price to book measures. Each show that banks are less attractive now than in the preceding 2 to 3 years. Notably, yields dropping from around 7% to under 5% and price to book ratios near or over 2 are not attractive for new investors.

Figure 14. Bank Valuations 2011-2014

	PE Ratio				Yield				Price to Book		
	2011	2012	2013	2014F	2011	2012	2013	2014F	2011	2012	2013
ANZ	9.1	11.1	13.4	12.7	7.0%	6.0%	5.1%	5.5%	1.41	1.64	1.96
CommBank	11.3	13.8	16.5	15.1	6.8%	5.6%	4.7%	5.0%	2.32	2.18	2.59
NAB	9.4	10.1	13.7	12.7	7.3%	7.4%	5.5%	5.9%	1.48	1.28	1.39
Westpac	9.8	11.7	14.4	13.3	7.6%	6.5%	5.3%	5.7%	1.88	1.51	1.76

Source: Iress, Morningstar

But where do we go from here?

Most portfolios are likely to be showing an overweight position to the banks in general. Should profit be taken or should shareholders accept the risk of an overweight position? Capital gains tax is of course an issue to be considered. Generally, given the heady valuations (refer to Figure 14 above), we would suggest investors should be prudent and consider trimming an overweight position. If something should happen to the bank prices it will have a much greater impact on the overall portfolio. Of course, there is then the dilemma of where to reinvest. Where only a single bank is held, the others may be worth looking into, but it will be undertaken on the same high valuation you should be wary of. Given the still appealing yields, greater intra-sector diversification can be beneficial whilst still maintaining the attractive bank dividend.

Although it may appear that our banks are invincible, we must keep in mind that business cycles come and go and some companies have finite lifetimes. No corporation is immune to mistakes and this is why we recommend taking profits when they are available. The major risk for the future of the banks is a recession, which could lead to a rise in unemployment that leads to higher loan defaults and hence bad debts. Although banks always have provisions for bad debts, an increase will not only affect profitability but undoubtedly dividends and therefore share prices. When holding onto the banks or contemplating future purchases, you must consider why you own them.

If it is for income, then the banks offer excellent dividends in a range of around 5%-6% fully franked, which equates to around 7% including the franking credit. If you own them for growth, then they do appear to be fully priced.

So beware of buying them in expectation of similar growth in share price that we have witnessed over the last year – expectations should be for a more subdued outlook.

Staying a step ahead during constant change

So what does all this mean? How can you stay a step a head during constant change? Keep a level head, understand the quality characteristics of any investment opportunities and be valuation aware when investing.

A large array of inputs should be considered and in the informational age we operate in, distilling the important information from the noise is paramount. Finally, tying all this together, you need ongoing advice to navigate and make sense of the ever changing world in which we all live.

As outlined in this report we see numerous opportunities in the future for investors and businesses. Many that will play out over an extended period of time. We encourage readers to seek guidance to ensure their portfolio of investment assets continues to not only be appropriate for specific circumstances and goals, but also to navigate the many changing and evolving investment opportunities and risks.

At Crowe Horwath we will continue to maintain this as our primary focus for our clients and look forward to helping readers achieve their financial and lifestyle objectives in 2014 and beyond.

For more information call 1300 856 065 or speak to your advisor.

www.crowehorwath.com.au

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