

Commentary

PORTFOLIO COMMENTARY

Low interest rates and falling bond yields have been a feature of investment markets over the past few years, but they each reached record levels in May, with the yield on 10-year Australian Government Bonds hitting a record low of 2.2% after the Reserve Bank cut its cash rate to its lowest ever level of 1.75%.

The sharemarket lapped it all up, with the All Ordinaries Index duly delivering a 3.1% return for the month. Our Equity Income Portfolio was slightly ahead of this figure, with a return of 3.7%. Since it started accepting real money for investment last July it has returned 18.1%, compared to 4.4% for the index; since inception in 2001 it has returned 13.7% a year, compared to 7.9% for the index.

The most obvious beneficiaries of the low yields are so-called 'income' stocks, whose dividend yields are flattered by comparison. But 'growth' stocks also benefit, with analysts plugging lower discount rates into their valuation models.

That's fair enough – valuation is a relative matter since you have to put your money somewhere – but it raises a couple of issues. The first is that the reason bond yields are low is that bond investors expect growth to be low in coming years. At the moment share investors seem to be soaking up the lower discount rate without acknowledging a lower growth rate, which is to try to have their cake and eat it too.

The lower growth rate will also affect income stocks, because more companies will find their earnings going backwards and ultimately have to cut their payouts. ANZ, BHP and Woolworths have all cut their dividends this year, and they will not be the last.

Ultimately, the theory tells us that if yield and growth assumptions are adjusted by the same amount, then it should have no net effect on valuation – but at the moment investors clearly see the glass as half-full.

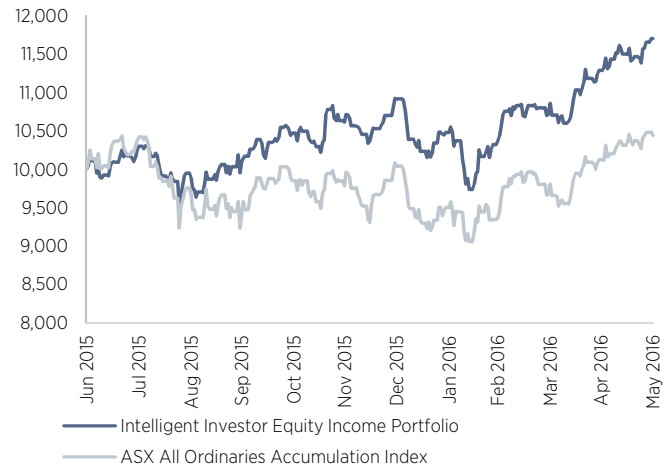
The other big question is whether interest rates will stay low or return to a more normal level – and what indeed is a more normal level? Since the 1980s, the 10-year bond yield has fallen steadily from around 14%. But looking back at developed economies over centuries (ie the US and the UK), the 1980s look like the outlier, with yields closer to 4% over the long term.

Even 4% would mean a near-doubling from current levels, which would likely cause a lot of pain for shares. The bond market is telling us, though, that this is a long way off and we're not ones to argue. We are, though, ones to be cautious – and we feel that the Equity Income Portfolio owns a good balance of attractively priced stocks with plenty of pricing power. Ultimately, we'd expect these to be the ones to perform best in most conditions.

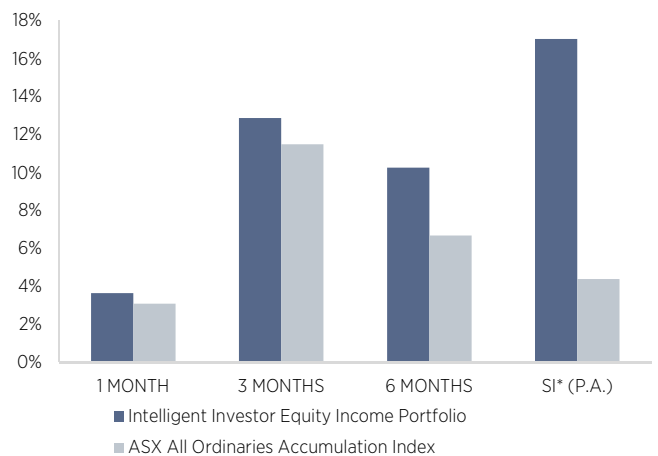
Macquarie Group was the portfolio's best performer in May, returning 22% thanks to increased calm in financial markets. GBST Holdings and Hotel Property Investments were also strong performers, rising 15% and 13% respectively, while OzForex recovered 10% as it finally started advertising its new brand OFX.

The biggest losers were miners BHP Billiton and South32, which lost 8% and 6% respectively, and IOOF Holdings, which fell 8% after warning that earnings would be flat in the current financial year.

The portfolio didn't conduct any trades in the month.

 Growth of \$10,000 **INCOME REINVESTED**


Performance Summary to 31 May 2016



Source: Praemium, RBA. Returns are before expenses and fees. Returns are shown as annualised if the period is over 1 year. * Since Inception (SI) date is 1 July 2015.

Top Ten Holdings as at 31 May 2016

CODE	NAME	WEIGHT
TME	Trade Me Group Limited	7.89%
CAR	Carsales.com Limited	6.72%
ASX	ASX Limited	6.69%
GBT	GBST Holdings Limited	6.40%
SYD	Sydney Airport	5.14%
VRT	Virtus Health Limited	4.95%
WOW	Woolworths Limited	4.93%
CPU	Computershare Limited	4.64%
SEK	Seek Limited	4.59%
IFL	IOOF Holdings Limited	4.32%

PERFORMANCE TO 31 MAY 2016

	1 MONTH	3 MONTHS	6 MONTHS	SI* (P.A.)
Intelligent Investor Equity Income Portfolio	3.65%	12.85%	10.24%	17.02%
ASX All Ordinaries Accumulation Index	3.09%	11.47%	6.67%	4.39%
Excess to Benchmark	0.56%	1.38%	3.57%	12.63%

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