The year in review

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'As 2014 draws to a close, it's time to review what's happened in investment markets this year and look ahead to 2015.'

Another good year for share market investors

World share markets produced solid returns in 2014 (see Table 1). While geopolitical issues, concerns over the durability of the global recovery and the prospect of quantitative easing (QE) in the US coming to an end all contributed to bouts of market volatility, they didn't prevent global share markets posting reasonable gains.

By the end of November, global shares had produced a return of more than 13% for Australian investors in hedged terms (that is, when the foreign currency exposure is hedged to the Australian dollar) and nearly 12% in unhedged terms. However, there was a great deal of variation in market performance between regions and countries.

The Australian dollar lost a little more ground over the year against a resurgent US dollar, which was boosted by the impending end of QE in the US, ongoing QE in Japan, and the potential for QE in Europe.

Table 1: Asset class returns (%) in Australian dollars – periods to end November 2014

Asset class	Return (%)*				
	2014 to date	1yr pa	2yr pa	3yr pa	5yr pa
Cash	2.4	2.7	2.8	3.2	3.8
Australian bonds	8.0	8.6	5.0	6.1	6.9
Global investment grade bonds (hedged)	9.5	9.2	6.0	7.8	8.1
Australian property securities	21.6	19.9	15.7	19.0	11.9
Global property securities (hedged)	21.5	22.4	18.0	21.4	18.0
Australian shares	3.5	4.3	13.4	13.8	7.1
Global shares (hedged)	13.1	15.3	22.0	20.6	14.8
Global shares (unhedged)	11.9	16.3	28.4	22.7	12.2

*Annualised returns except for year to date.
Sources: Datastream, MLC.

Benchmark data include Bloomberg AusBond Bank Bill Index (cash), Bloomberg AusBond Composite 0+ Yr Index (Aust bonds), Barclays Global Aggregate hedged to $A (global bonds), S&P/ASX200 A-REIT Accumulation Index (Australian property securities), MLC global property strategy benchmark hedged to $A (global property securities), S&P/ASX200 Accumulation Index (Aust shares) and MLC global equity strategy benchmark (MSCI All Country Indices hedged and unhedged in $A).

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Emerging markets continued to underperform

For the second year running, emerging share markets underperformed those in the developed world, despite several key emerging markets being among the world's best performers. Share market returns were lifted by the election of reform-minded leaders in India (where the market produced a spectacular 38% return for the eleven months to the end of November) and Indonesia (a return of 24%). However, returns from share markets in Eastern Europe, China and Korea were more lacklustre.

Following losses in 2013, Chinese shares delivered a return of over 9% for the eleven months to the end of November, particularly after a surprise cut in official interest rates boosted share prices in November.

Quantitative easing remained a key influence on markets

In the developed world, the US share market enjoyed a solid 13% return for the year to date, while Japan extended 2013's stellar performance with a 10% return. So far, US shares have taken the end of QE in their stride, particularly as US economic news has remained positive enough to support the perception that QE is no longer needed. The Bank of Japan's QE program, which was given a dramatic boost in October, has provided strong support for the Japanese share market in the face of economic news which has tended to be disappointing: against expectations, the Japanese economy again fell into recession in the September quarter.

European shares were undermined by signs that Europe's economic recovery came close to a halt in 2014. This development prompted further interest rate cuts by the European Central Bank (ECB) and raised hopes that the ECB would embark on a QE program of its own.

Australia's share market was weighed down by the iron ore price

Back at home, our market managed a positive return, but had a generally disappointing year, despite signs of improving economic growth outside the mining industry. Strong gains in listed shares in the real estate trust, healthcare and telecommunications sectors were offset by losses in mining shares, due to a 48% fall in the iron ore price for the year to date – down to its lowest level in five years.

Lower bond yields worldwide…

After very low returns in 2013, bond investors enjoyed much better returns this year, with yields falling in most major markets (bond yields and prices move in opposite directions). However, there was generally a widening in credit spreads – the difference in yield between government and non-government bonds – so non-government bonds tended to underperform government.

Returns from European bonds were particularly strong, supported by a deteriorating eurozone economy, the ECB's looser monetary policy and a very low inflation rate. There was a plunge in government borrowing costs, as measured by the yields on the bonds they issued, particularly in peripheral European markets like Spain and Italy.

Here in Australia, bond yields also declined, as both economic growth and inflation remained subdued and the Reserve Bank of Australia left the official cash rate unchanged.

...helped boost listed real estate

The extraordinarily low level of interest rates and bond yields across the globe encouraged investors to keep seeking alternative sources of income. As a result, real estate investment trusts (REITs) both in Australia and globally continued to be highly sought after this year. Despite the very strong performance of Australian REITs in recent years, the sector has yet to recoup the losses it incurred during the global financial crisis.

Overall, the investment environment remains uncertain

Australian investors have enjoyed very good returns from multi-asset investment strategies over recent years, underpinned by the strong performance of world share markets. However, some important issues are unresolved and the investment environment is still unpredictable.

We remain concerned that in key markets such as the US, share prices have run too far ahead of corporate profits. We're also concerned that too much of the performance of US and global share markets has depended on the extraordinary monetary measures (such as QE) implemented by the US Federal Reserve and other central banks.

At present, inflation rates are generally benign in much of the world, and too low or even negative in Europe and Japan. However, the extraordinarily loose monetary policy in some key economies is designed to stimulate growth and – either explicitly or implicitly – to produce higher inflation. If increases in inflation could be achieved, they could help to reduce the burden of public debt across the world by bringing down its value in 'real', or after-inflation, terms. However, financial markets are not expecting any rise in inflation: bond yields, which are influenced by market expectations for inflation, are at or close to all-time lows and short-term interest rates are already negative in real terms in a number of countries.

Another reason for caution is that after a period of strong returns from rising markets, it's not easy to find well-priced investments. Our share managers continue to report that while there are plenty of companies they are comfortable to continue holding, finding new companies to invest in is more difficult.

The geopolitical environment also remains a source of concern, despite the apparent ability of investment markets to overlook disturbing developments in the Middle East, the Ukraine and elsewhere. For example, oil prices have fallen sharply this year, despite the so-called Islamic State controlling large swathes of Iraq, which has the world's fifth largest oil reserves. That's because the world is currently awash with oil, partly due to previous high oil prices encouraging new sources of supply.

While financial markets find it almost impossible to price geopolitical risk, this risk is always present, and it's currently at a higher level than for many years.

How does MLC deal with these uncertainties?

At MLC, we focus strongly on risk management. We believe managing risk for our investors is at least as important as generating returns for them – and in this unpredictable investment environment, it's more critical than ever.

As a result, we design and manage our multi-asset portfolios to be resilient in a wide range of possible market conditions. Using our market-leading investment approach, we constantly test how our multi-asset portfolios are likely to perform in many potential market scenarios, both good and bad. We can then adjust our portfolios to manage possible risks and take advantage of potential return opportunities.

This careful analysis means our portfolios are widely diversified, risk-aware and positioned for many market environments.

Important information

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