Dan Farmer CIO - IOOF Investment and Market Update Transcript

I'm really pleased to talk with you all today after what's been a year of strong performance for our fund. In my session today, I'm going to touch on the key forces driving the economy over 2023 and how they affected investment markets. Investment positioning of the fund over the year and what that meant for your returns. Our outlook for 2024, and most importantly, how we continue to manage the fund in line with your best interests.

So looking back on the year that was, inflation was again the big story, which despite efforts from central banks, remained at elevated levels over the year. In an effort to lower inflation, the Reserve Bank of Australia or the RBA raised the cash rate five times over 2023, taking it to a 12-year high of 4.35%. Now these increases were designed to dampen consumer and business spending, with the aim of cooling the economy and reducing inflationary pressures.

Now, on top of this, the economy has remained resilient in the face of these higher interest rates and higher cost of living pressures. A number of factors that really helped hold the economy in good stead over the past year, included things like, firstly, Australian households had saved at above-average levels through the Covid lockdown period as we all stayed at home and spent less. Over 2023 households were out spending these excess savings, which really helped support the economy over the year. Now today we see these household savings buffers as having largely been spent.

In addition, many Australians with mortgages locked in their interest rates at very low levels through the Covid period. So many Australians are only just beginning to feel the impacts of these RBA rate rises, as these fixed-rate mortgages, roll off. Similarly, corporations around the globe were able to lock in lower interest rates, often for longer periods than individual mortgage holders were able to. So a lot of corporates, haven't felt the direct impact of higher interest rates yet. Many corporates will start experiencing higher rates from the end of 2024 as their existing debt arrangements, start to roll off.

Also, I think it's worth remembering that higher interest rates aren't bad news for everyone. Those people without mortgages and who are net savers earn more income as a result of the higher interest on their savings, giving them a little bit more to spend. And finally, economic growth was supported by wages moving higher, particularly in the US. This meant that the average worker had a bit extra to spend on eating out, buying a new outfit, or having a holiday. Again, all supporting economic activity.

Now, the upshot of all of this is that while inflation is on a downward trajectory from its highs, the robust economy may mean inflation is stickier on the way down from here. Geopolitical events added to economic uncertainty throughout the year. Unfortunately, the conflict in Ukraine continues. Now, while the initial spike in commodity in energy prices triggered by the conflict have subdued somewhat, the conflict remains an underlying risk while a path to resolution continues to be unclear. And more recently, the Gaza conflict has heightened uncertainty in the Middle East, a region critical to global oil supply. The global economy remains highly reliant on oil, even though we're slowly moving, towards renewables.

So whilst over 2023, these geopolitical events didn't have a significant impact on economic growth, the global economy is still vulnerable to these tensions. So we've looked at the global events influence in the economy over 2023. Now, I'd like to talk about what this has meant for investment markets. While movements in, share markets often grabbed media headlines over the last year, most investors, including us, were focused on some big swings in the bond markets. The bond markets bucked their usual stable but boring reputation. and things got quite interesting in the high inflation environment.

So how did bond markets fare in 2023? Well, bond markets had one of their most volatile years in decades. Over the first ten months of 2023 bond yields, which is just the interest rate you receive from owning a bond, rose sharply in most markets. Now, this big upswing in bond yields was driven by a combination of, the stubbornly high inflation we talked about rising official cash rates and a period of instability in the US banking system, which was triggered by the failure of three mid-size U.S. banks. Now, thankfully, this banking instability was short-lived, and we didn't see wider knock-on effects.

So as a result of these factors, the yield on the widely followed, US ten-year government bond rose from 3.8% at the start of the year to a high of nearly 5% in October 2023. Now while high yields mean income generated from more defensive parts of the portfolio is improved, it also means negative returns to bonds over the short term. Gyrations in the bond market have continued over the last three months, but with a direction of swings reversed. Bond yields have fallen sharply back to 3.8%. This recent fall in bond yields has been driven by both the downward trend in inflation we just talked about and just as importantly, trend in inflation we just talked about and just as importantly, trend in inflation we just talked about and just as importantly, the US central bank hinting in December that they may have raised cash rates enough to bring inflation back to more comfortable level.

Now the implication of their hinting being that there may be no more cash rate increases, and we actually may have a good chance that we see cash rate cuts later this year. So while 2023 was a real roller coaster ride for traditional stable fixed interest markets, the overall return to the major fixed interest benchmarks ended the year at a modest 5% return. Now if we shift our attention to equity markets over 2023, and again, we see resilience in returns in the face of higher interest rates. The outlook for equities actually appeared quite challenging at the start of last year, with many market analysts predicting an economic slowdown or even a recession, in the face of higher interest rates.

Now, as we've spoken about, the economy actually held up well and a recession didn't eventuate over the year. The sentiment in share markets strengthened late in the year as expectations grew, that central bank cash rate hikes were close to over, and the chances of an economic soft landing improved sharply. This improvement in the economic outlook, along with, stellar performance from a handful of AI related tech stocks, supported strong equity returns over the year. Over 2023, global share markets advanced around 21%. While back home, the ASX 200 gained, 12.4%.

So against this backdrop, how did our funds perform? IOOF balanced Investor Trust, which is our default investment option many of you invested in, delivered a return net of investment management fees and gross of tax of 11.9% over the 12 months to 31st December 2023. This places it as the third best-performing fund in the Chant West Growth Fund survey for the year. This follows a top ten placing in the same survey for the 12 months to 30th June 2023. This return was also comfortably above the inflation rate for the year, meaning we've grown the real value of balances of our members invested in this fund.

We delivered this strong return by firmly sticking to our time-proven belief in deep diversification of our portfolios, investing across multiple asset classes and thousands of securities in both public and private markets. The strong return benefited from the fund being fully invested in international shares, which returned over 23% for the year, and also in Australian shares, which delivered over 12% for the year. Our alternative portfolios also contributed strongly to the result, which delivered double-digit returns.

Fixed income returns were more muted over the year, but our active portfolio was able to outperform the market with a return in excess of 6%. We took advantage of higher yields in fixed income assets over the year, and we continue to see attractive opportunities in these markets. An area that performed well for us in this environment was private credit, as the traditional banking sector has reduced its lending to some

areas, in part due to regulatory requirements, private credit markets have stepped in to partially fill the void.

We've continued to benefit from this opportunity, holding good allocations with well-diversified private credit managers. This has provided a valuable income stream while also contributing to portfolio diversification. We've also upped portfolio resilience with investments in alternative assets that have a low correlation of returns to other investments. That just means if, say, the equity markets would go down, these alternative assets should be less affected by such a market downturn and somewhat protect overall portfolio performance.

Our experienced investment team make these investment decisions, working closely with our high-quality external asset investment managers and asset consultants. So I've covered 2023 and given you an overview of our performance. The next thing I'd like to talk about is the investment outlook for 2024, and how we are positioning your funds to navigate the period ahead. Now, firstly, as I mentioned earlier, inflation looks like it's on the way down, although it could well be stickier with further declines coming more slowly.

In other words, it may take some time for inflation to fall back to the 2 to 3% range central banks like the RBA are more comfortable with. So while central banks have done a lot of good work, taming inflation through higher cash rates, we may not see actual cuts to the cash rate here in Australia until late in 2024. So interest rates may still stay high for a while yet. So what does that mean for economic growth? Well, it is a tricky environment for central banks to navigate, but we see a reasonable chance that economic growth can remain resilient in the face of higher rates, at least for the next 12 months.

Now we've taken this cautiously optimistic view of economic growth given the relatively good health of the economy today. And we also take comfort from central bank signalling their willingness to cut rates as inflation trends down. Now I've spoken a lot about inflation and cash rates as key factors influencing our outlook. Now, of course, the investment team take a wide range of factors into account when looking ahead.

Globally, the wars in the Ukraine and Middle East continue to persist. And investment professionals like my team and I must consider many eventualities, such as the possibility of the Middle East conflict widening. The impact on commodity prices from these conflicts has been muted to date, with oil prices now below levels when the conflict began. And as long as these conflicts remain constrained within each region, we

don't see these events as having a material impact on investment markets in the medium term.

It's another issue if these conflicts widen. And, for example, recent attacks on the Red Sea, commercial shipping by the Yemen-based Iran-supported Houthi movement, which has prompted US-led military action against the Houthis, does raise the possibility of an unsettling tit-for-tat cycle, again presenting risk to economic stability.

Now, looking at how we will manage your funds given this macro-outlook. First and foremost, we will always maintain well-diversified portfolios investing across multiple asset classes, multiple geographies, high quality investment managers and thousands of underlying securities. And we really believe this is key to continuing to deliver strong, healthy returns over the long run.

As always, the investment team will be on the lookout for attractive areas of opportunity and just as importantly, ways to manage risk, all while making sure we maintain balanced portfolios. As I mentioned earlier, we see a relatively benign economic environment ahead, and this is attractive for credit and private credit in particular. And we continue to position the fund accordingly.

The outlook for equities really varies by geography and industry, with some sectors looking relatively expensive, such as US technology is an example, while other areas appear more attractive overall. We are relatively neutral on equities, but we do remain cautious given high valuations in certain parts of the market and some lingering risk to economic growth which lifting yields bonds now better placed to play their, traditional role providing diversification and defensive benefits to portfolios.

When rates were very low levels during the Covid period, these benefits and bonds were less pronounced. We continue to see attractive opportunities to selectively invest in alternative strategies and these alternative strategies generate returns less dependent on macroeconomic conditions. And we see these as really important diversifiers in the portfolio given the current outlook.

And finally, over the year ahead, we aim to continue evolving and deepening the integration of responsible investment considerations into our investment decision making. And we really see this as further supporting strong performance outcomes over the long run. Now, regardless of what the period ahead brings, we can assure you that your investment team is well positioned to manage both the risks and opportunities through the years ahead. You have a large investment team of 47 experienced

investment professionals accessing a really wide range of knowledge and expertise, who are focused on the long run returns of your super.

So in closing, I'd really like to thank you all for trusting us to invest your money. Again, you can rest assured the investment team is working diligently, managing your portfolio in accordance with our time proven investment philosophy to help provide you with the retirement lifestyle you want. As Lindsay talked about, super as a long term investment, and in the years ahead, there will no doubt be periods of strong returns like we've just seen, along with more challenging periods. What's important is to stay the course and keep your eye on the long term. And over the long term, super funds have proven again and again to provide good outcomes to members.