

# Prosperitas

ISSUE

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Prosperitas: Latin for prosperity & good fortune

## Bonds: Shaken But Not Stirred

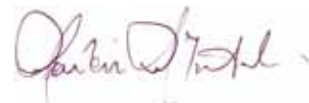
As the Royal Commission rolls on with a seemingly endless list of scandals and the White House release an official letter bragging about the size of it's 'nuclear capabilities', it can be difficult to separate the relevant and irrelevant noise as it pertains to investment markets. As usual, these issues tend to look far smaller in the rear-view mirror than they do through the windscreen as we attempt to digest new information in real time.

The political and economic uncertainty that arises as a result of this is not always borne out in investment markets, with volatility levels of global equity markets at historical lows in 2017. But as we all know, 'past volatility may not be indicative of future volatility'. Accordingly, the navigation of financial markets in a low interest rate world where equity and property investments are required to do the bulk of the heavy lifting to generate portfolio returns becomes increasingly challenging as we seek to manage an individuals' risk capacity.

While they are certainly not the most interesting people at a dinner party, Bond Managers play a very important role in stabilising portfolios when volatility does rise and we have discussed the effect that changing interest rates can have on bond prices. We have also looked at the science of behavioural finance and, in particular, how overconfidence might hamper investment decisions.

Following an extremely well received debut, 'That's a Fact Jack!' makes another appearance to wow you with some interesting facts while the Bookworm has returned from a hiatus to deliver a book review. And newsletter stalwart The Garden Gnome has got some winter tips to get you through the cooler months.

We hope that you enjoy this edition of *Prosperitas* and we look forward to seeing you next time you are in Camberwell.



Martin R McIntosh  
Managing Partner

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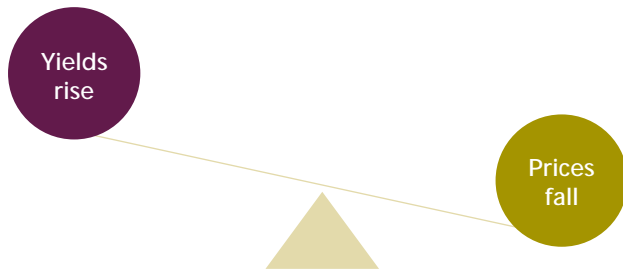
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# 5 Things You Need To Know About Rates

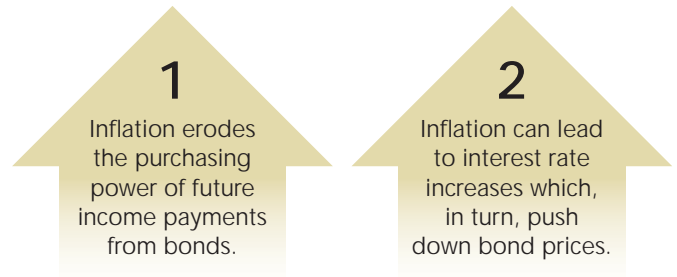
When interest rates move, it's not just mortgagees who are concerned with the outcome. As an important driver of bond prices, interest rates are also closely watched by bond investors. If you're investing in bonds, here are five key things you need to know about rates.

## Interest Rates and Bond Prices

One of the key drivers of bond pricing is interest rates. If rates rise, older bonds with lower rates will drop in price to compensate for the lower coupon payments (and vice versa).



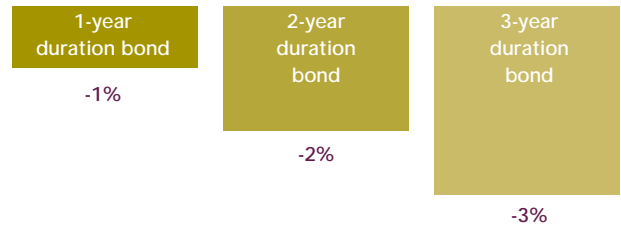
## The Inflation Double Threat



## Duration Risk

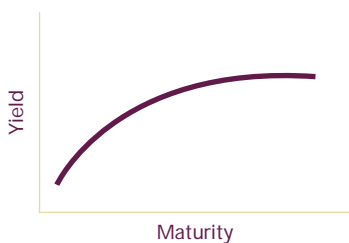
Duration risk reveals how sensitive a bond is to interest rate movements. The higher the duration, the more the bond value will fall if interest rates rise.

How a 1% rise in interest rates impacts bonds with different durations



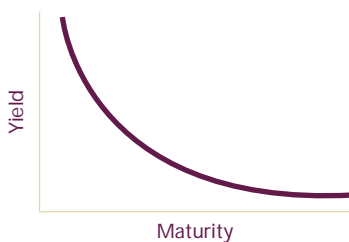
## The Yield Curve

The yield curve plots the interest rates for similar quality bonds against their maturities (years to expiry). There are three main types of yield curves.



### Normal Yield Curve

Seen during periods of economic expansion, it indicates that long-term bond yields may continue to rise.



### Inverted Yield Curve

Seen during periods of recession, it indicates that long-term bond yields are expected to fall.



### Flat Yield Curve

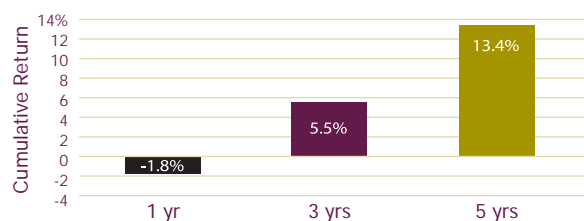
Seen when the economy is transitioning from expansion to slowdown (and vice versa).

## Rising Rates

Rising rates don't have to mean bad news for bond investors. As the chart shows, a fixed interest investment may decline in market value in the short term because the existing bond holdings fall in price.

However, higher interest rates will lead to a higher yield on the invested bonds in subsequent periods. Investors can also reinvest their coupons and maturing bonds into higher-yielding securities, which can return a bond portfolio back to growth more quickly.

### The upside of rising rates



Hypothetical example for illustrative purposes only.

Source: PIMCO, as of 31 December 2016. The chart shows the estimated performance of the Bloomberg Barclays U.S. Aggregate Index assuming a parallel rate rise of 1%, and no further changes in rates thereafter. Credit spreads are assumed to remain constant. In the analysis contained herein, PIMCO has outlined hypothetical event scenarios which, in theory, would impact the index returns as illustrated in the analysis. No representation is being made that these scenarios are likely to occur or that account all aspects of risk. Total returns are estimated by re-pricing key rate duration replicating portfolios of par-coupon bonds.

# Behavioural Finance: Overconfidence

In a world of uncertainty in which our brains are often subconsciously working against us, it's a good practice to regularly challenge our investment views.

“ Am I being overconfident in my beliefs about the future?

Am I being overly optimistic about the prospects of certain assets based on recent experience?

Is my portfolio diversified enough given a range of scenarios? ”

Of all the psychological biases investors are prone to, overconfidence is perhaps the most pervasive and damaging. Simply put, this is where confidence in our own judgements is greater than it actually is.

Surveys reveal that the vast majority of people rate themselves “above average” among their peers when it comes to positive traits, such as driving ability, employment prospects, or life expectancy. In one of the most famous survey an overwhelming majority of 93% of American drivers rated themselves as better than average <sup>1</sup>. Overconfidence is fuelled by a number of other related psychological biases:

1

**Optimism** is a perfectly sensible coping strategy for life but can be problematic when investing. We routinely underestimate the likelihood of falling ill for instance, yet, overestimate the probability of good events happening to us, which goes a long way to explaining lottery ticket sales.

2

**The illusion of knowledge** is the tendency for people to believe that the accuracy of their forecasts necessarily increases with more information. This however is not necessarily the case given information is not the same as insight.

3

**The illusion of control** is the tendency to overestimate our ability to influence events over which we have little control. Investors are bombarded daily with financial information, and every twist and turn in stock markets is discussed at length. This information encourages some investors to make frequent changes to their portfolios; however, studies suggest that these investors are overtrading and virtually guaranteeing themselves mediocre returns after transaction costs <sup>2</sup>. One explanation for overtrading is that investors feel motivated to master the environment -The illusion of control.

4

**Hindsight bias** can feed confidence levels further. By extrapolating recent experience into the future, (often based on limited data), investors often make confident predictions that are regularly shown to be flawed.

5

**Overconfidence** becomes particularly problematic in bull markets and in periods of sustained stability. During these periods, the “good times” are widely expected to continue forever.

Indeed, our collective bias towards overconfidence in good times seems to sow the seed of our subsequent downfall. Economist Hyman Minsky famously observed that “stability begets instability”. His ‘Financial Instability hypothesis’ suggests that people tend to take greater and greater risks in periods of sustained stability. Minsky observed that capitalists extrapolate stable financial conditions into the future, encouraging them to put in place ever-more risky debt structures, which ultimately undermine stability itself.



In challenging times, overconfidence can work the other way, combining with hindsight bias to result in over-pessimism. In the same way that we are guilty of becoming overconfident in the good times, during the bad times we can become much too confident things will stay gloomy. Again we are guilty of letting hindsight and information dominate our thinking.

There is much to be said for considering the contrarian view and taking account of a range of possible outcomes. Certainly, all investors should discipline themselves to challenge established or prevailing views and consider whether they are properly diversified across asset classes and regions.

1 Svenson, O. (1981). 'Are we less risky and more skillful than our fellow drivers?' Acta Psychologica, 47, 143-151.

2 Statman, Thorley and Vorkink (2004) 'Investor Overconfidence and Trading Volume' Review of Financial Studies, vol. 19, no. 4, pp. 1531-1565. Odean, T., (1999), "Do Investors Trade Too Much?", American Economic Review, vol. 89, pp. 1279-1298.

<https://www.fidelity.com.au/insights/investment-articles/behavioural-finance-overconfidence/>



# Garden Clippings



As the garden growth begins to slow down during the winter months you might be tempted to slow down yourself – don't! There are few non-negotiable duties / opportunities that will immediately position your garden for a springtime to remember.

A couple of tips to help you prepare and battle through our toughest months as a gardener;

- Water fruit trees deeply before covering the soil surface with mulch.
- Sow seeds of tomato, squash, melon and sweetcorn.
- Lift and divide crowded clumps of kangaroo paws. Cut back foliage by half to reduce moisture loss while they settle in.
- Raise the height of your mower blades, as longer leaves mean stronger grass that is better able to compete with weeds.
- Prune sasanqua camellias as they finish flowering.
- Move potted geraniums to a warm spot against a sunny wall.
- Regain control of your shed – wipe down your pruning and digging tools with an oily rag, throw out those pots that you thought you might need one day (and clearly won't), consolidate half used bags of potting mix and ensure that any hazardous chemicals are stored in air tight containers up high.

Embrace the cooler months!

GG

# That's a Fact, Jack!

- Every 450,000 years the Earth's poles flip, a process known as geomagnetic reversal.
- Indiana legislators once tried to pass a Bill that would legally redefine Pi as 3.2
- Elvis Presley's manager, Colonel Tom Parker, sold "I Hate Elvis" badges as a means of making money off of people who were not otherwise buying his merchandise.
- Boring, in Oregon, and Dull, in Scotland, have been sister cities since 2012. In 2017, they added Bland Shire, in NSW, to their "League of Extraordinary Communities."
- In 1974, the *Journal of Applied Behavior Analysis* published a paper titled "The Unsuccessful Self-Treatment of a Case of 'Writer's Block.'" It contained zero words.
- Queen Elizabeth II is a trained truck mechanic.
- A mother Sea Otter and her pup will hold hands while they sleep to stop from drifting away.
- The rumble strips on a portion of Route 66 in New Mexico plays 'America the Beautiful' when driven over at 45 mph.
- "The sixth sick sheik's sixth sheep's sick" is said to be the toughest tongue twister.
- If you plant an apple seed, it will likely grow a tree of a different type of apple.
- In golf, a score of 10 is called a Bo Derek.
- Frustration can be an effective means of weight loss; research has shown that banging your head against a wall uses 150 calories an hour.
- In "Silence of the Lambs", Hannibal Lector (Anthony Hopkins) never blinks.

## The Bookworm



### My Name is Lucy Barton – Elizabeth Strout

Rating: 7/10

A growing family has allowed The Bookworm precious little time for reading of late but the Christmas holidays did allow for some erosion of the growing pile of books on the bedside table.

Narrated by the title character, the novel is set in a hospital in Manhattan as Lucy recovers from a mysterious infection over many weeks. Her mother comes to visit after many years of estrangement following Lucy's marriage, to a German man ("with blond German looks") which was particularly difficult for her father to cope with as a World War 2 veteran.

Lucy and her mother talk of her hometown in Illinois where she was raised in poverty; however, the discussions remain light in nature as they gossip cheerfully of characters they grew up with. As the novel progresses, we realise the two are circling topics that they cannot - or will not - openly discuss. Lucy's father's 'episodes' are ignored, the physical violence from both parents is glossed

over and the days spent locked in her father's truck are mentioned briefly by Lucy in passing.

It's difficult to capture what a terrific book this is in a brief book review. The plot itself doesn't exactly scream 'page-turner' but in and among these stories we develop a picture of Lucy's past with snippets of heartbreak, devastation, joy, and abandonment. The chapters devoted to Lucy and her mother's discussions are particularly compelling as we instinctively wish that Lucy would ask the questions that we (and Lucy) want answered, while knowing her mother will likely avoid them altogether.

While not necessarily a challenging read, Strout has developed a substantial novel of words-left-unsaid (no easy feat when you think about it) in the style of Kazuo Ishiguro's 'Remains of the Day'. Longlisted for the Man Booker Prize, this is a novel that will stay with you long after the book is moved from the bedside table to the bookshelf.

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