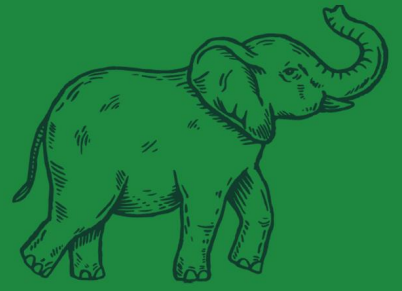


Investment Markets Report



3 March 2023



StanfordBrown

Private
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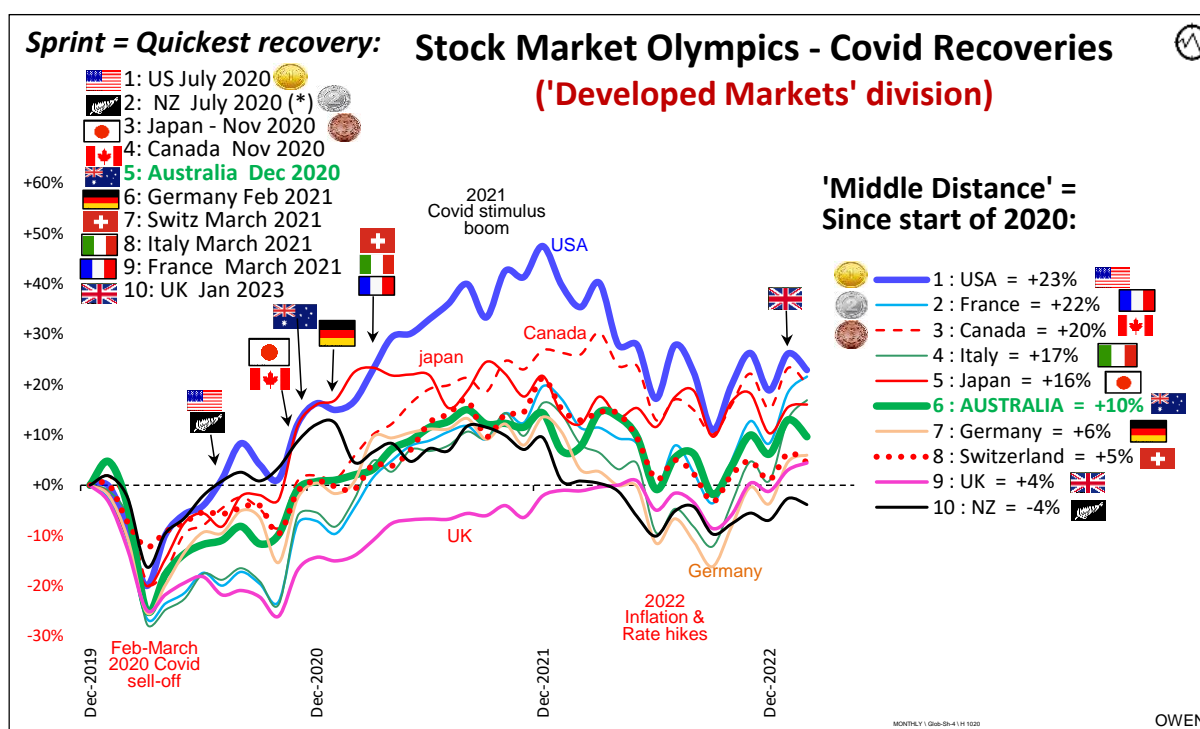
The Stock Market Olympics

Here is an update on the how different share markets around the world are faring. We have two 'divisions' – 'Developed markets' and 'Emerging markets' (the definitions are based on the level of average income per capita in each country). Here we look at the Covid era since the start of 2020. We look at two events here:

- The 'Sprint' – which is the quickest recovery from the February-March Covid sell-off.
- The 'Middle Distance' – share market index performance since the start of 2020.

(Although long term investing is a 'Marathon', there can be big differences between different markets in different stages of the journey along the way. We covered the 'Marathon' – returns since 1970 - in the January 2023 edition.)

First – the 'Developed Markets' division for the 'Sprint' and 'Middle Distance':

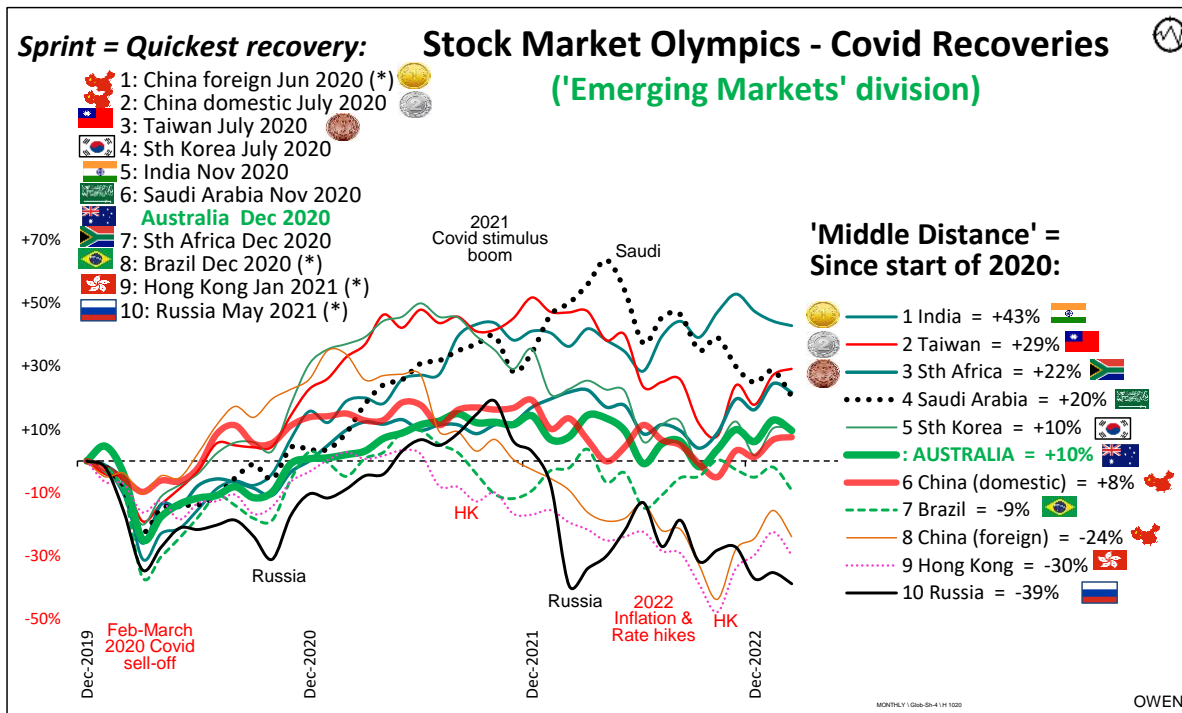


USA took gold in both the Sprint the Middle Distance events – it was quickest to recover from the Covid sell-off, and is highest today, since the start of 2020. The US tech/online giants fared relatively well during the lockdowns and benefited greatly from the Covid hand-outs. They were also the target of much of the speculative fever fuelled by the free money and cheap debt stimulus programs. However, those same US tech/online giants then dragged the US market down heavily in the 2022 rate hike sell-off, but the US still holds the lead in the Middle Distance race, just. We cover the US tech/online companies in more detail in the next story.

New Zealand recovered very quickly from the Covid sell-off (taking silver in the Sprint, just behind USA), but is now running dead last in the Middle Distance, due largely to Fisher & Paykel Healthcare, Auckland Airport, and a2Milk. Also near last place in the Middle Distance is the UK, with its on-going Brexit problems, higher inflation, and last year's political/budget deficit/debt crisis.

Australia was in the middle of the pack in the Sprint, taking five more months than the USA and NZ to recover from the Covid sell-off. Share prices of the big banks were hit hard by bad debt/recession fears, and the big miners were hit by the collapse in commodities prices in the global recession. Australia is also running in the middle of the pack in the Middle Distance, well behind the US, and also behind France and Canada, which have been boosted by their big oil/gas stocks profiting from the energy crisis.

In the 'Emerging Markets' division, the dispersion of returns between the winners and losers is even greater:



Chinese foreign shares (mainly Alibaba and Tencent) won the Sprint as they powered through the 2020 lockdowns. Taiwan and South Korea were boosted by chip-makers Taiwan Semiconductor and Samsung Electronics. Russia came dead last in the sprint due to the collapse in oil prices. Russia is also running last in the Middle Distance, even though it fared better than most expected through the sanctions after its invasion of Ukraine.

India is the clear winner in the Middle Distance race, (even ahead of USA), thanks to Infosys, its oil/gas and coal producers, and also due to India's relatively insulated local economy. China's domestic stocks have been dragged down by China's domestic slowdown and property crisis, and China's foreign stocks suffered from not just the global tech sell-off, but also by Xi Jinping's attacks on Chinese tech billionaires, and fears of a possible US ban on US citizens from owning Chinese stocks.

Australia also ranks in the middle of the pack relative to 'Emerging Markets'.

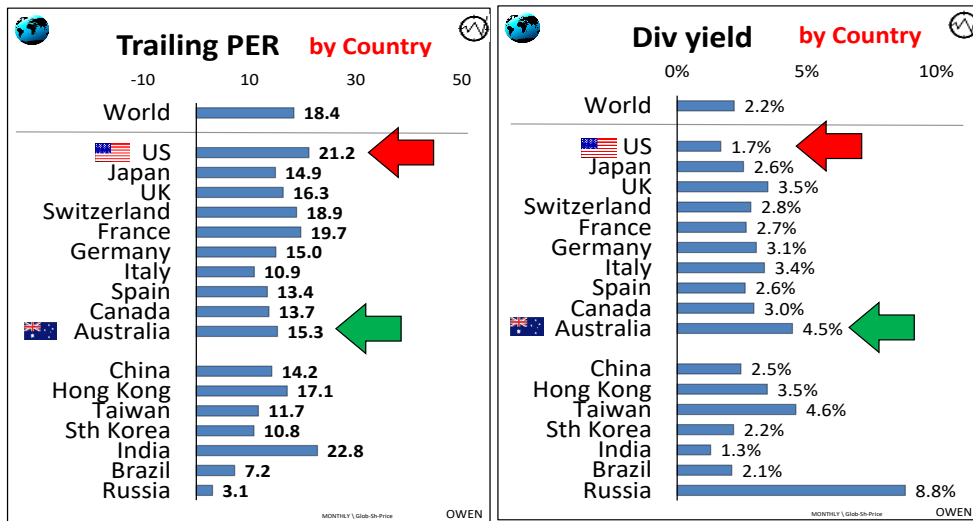
Looking at different country returns is not just an academic exercise. The past three years have been dominated by global events and conditions – but different investors in different countries experienced very different returns in their home markets. This was simply 'luck of the draw' – where they happened to live, because each country adopted different responses – different Covid lockdown policies, different border closure rules, different fiscal and monetary policies, different energy policies, different inflation experiences, and different rate hike responses.

As investors, we can't easily change where we happen to live and have our lives and businesses, but we can select different mixes of share markets in our diversified portfolios, and that is what we do here. A large portion of our share portfolios are in Australian shares (which have several benefits for local investors including currency stability and franking credits), but at least half of our share allocations are invested in international markets, and we change the mix from time to time as conditions, outlooks, risks and opportunities change over time.

In our diversified portfolios, we utilise a mix of active international share funds that specialise in different parts of the market and in different types of companies and industries across the various markets. The active fund managers who specialise mainly in developed markets include Antipodes, Bell, SGA and Capital Group. (Our quarterly reports contain details of all funds in portfolios). This mix of strategies is designed to achieve higher returns, with lower risk, than simply owning a passive index fund, or restricting investments to the Australian market. We removed emerging markets shares in 2020, but we added back an active emerging markets fund in 2022 (GQG), which has a long track record of success in navigating between different markets.

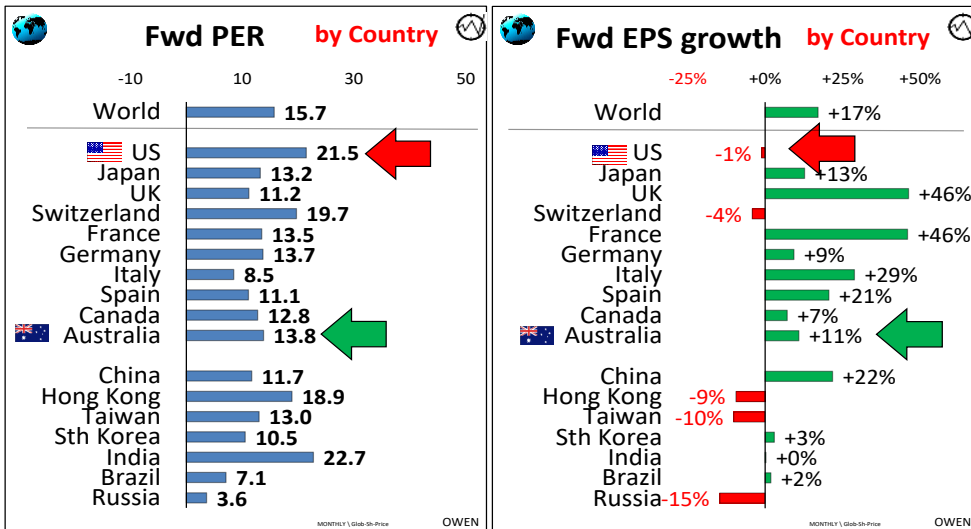
Pricing – still too expensive?

Global share markets have fallen heavily since the start of 2022 (mainly in the first three quarters of 2022). Are they good value yet, or still expensive? Here are two of the most common measures of pricing (or value) for share markets in the main countries:



Among the main countries, the US market has the highest level of pricing, having the highest price-to-earnings ratio (PER) – ie the price per dollar of aggregate company profits. The US also has the lowest 'dividend yields' – price of share relative per dollar of dividends. On both measures, Australia is around 'fair pricing'.

The above two measures are based on past profits and dividends, but as investors, we are more interested in the future, not the past (although the recent past is not a bad starting point). The next two measures look to the future:



The 'forward price/earnings ratio' (left above) is the current pricing relative to the next full year's forecast profits. The US is still very expensive on this measure. The 'Forward Earnings per share Growth' (right above) shows the current forecasts for profit growth for each market, based on analysis consensus surveys.

The notable feature here is the fact that the US market is still very expensive relative to the most recent profits (top left chart) and also relative to forecast next year's profits (bottom left chart), but the outlook for US profits is flat at best. The aggressive rate cuts over the past year have certainly taken the speculative fever out of pricing, and also out of the over-optimistic profit growth forecasts back in the boom, but they are still not pricing in a recession. In a broad recession, aggregate profits generally take a big hit – aggregate US company profits fell by -33% in the 2020 covid recession, by -92% in the 2008-9 GFC, -27% in the 2000-2 'tech-wreck'. If further aggressive US rate hikes trigger a broad recession, aggregate profits will probably fall by a similar amount again.

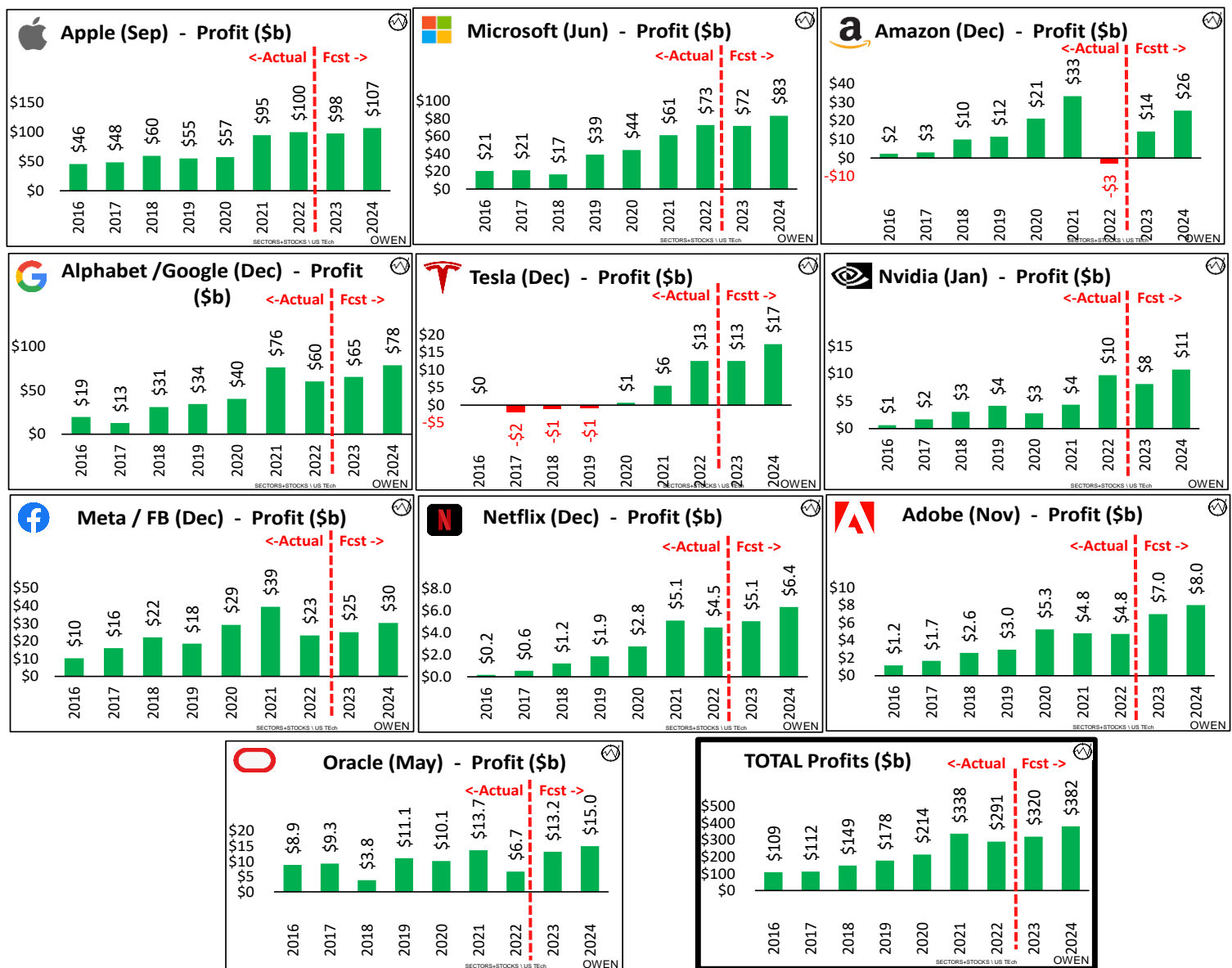
Our conclusion is that US market is still expensive relative to past and forecast profits, and current pricing levels assume the US will not have a recession with attendant profit cuts. This the picture at face value, but we need to look a little deeper because the US market is dominated by a handful of global giants. We look at these next.

Ten US tech/online giants driving world pricing

The overall global share market consists of some 15,000 companies in more than 50 countries. It is over-priced in aggregate because of the over-pricing of the US market (which makes up nearly 60% of total world share market value). In turn, over-pricing of the US market as a whole, is being driven by a small number of US giants. The ten largest US tech/online giants make up 25% of the total value of the US share market, and 15% of the entire global share market of 15,000 companies, and that is even after their share prices fell by an average -38% in 2022.

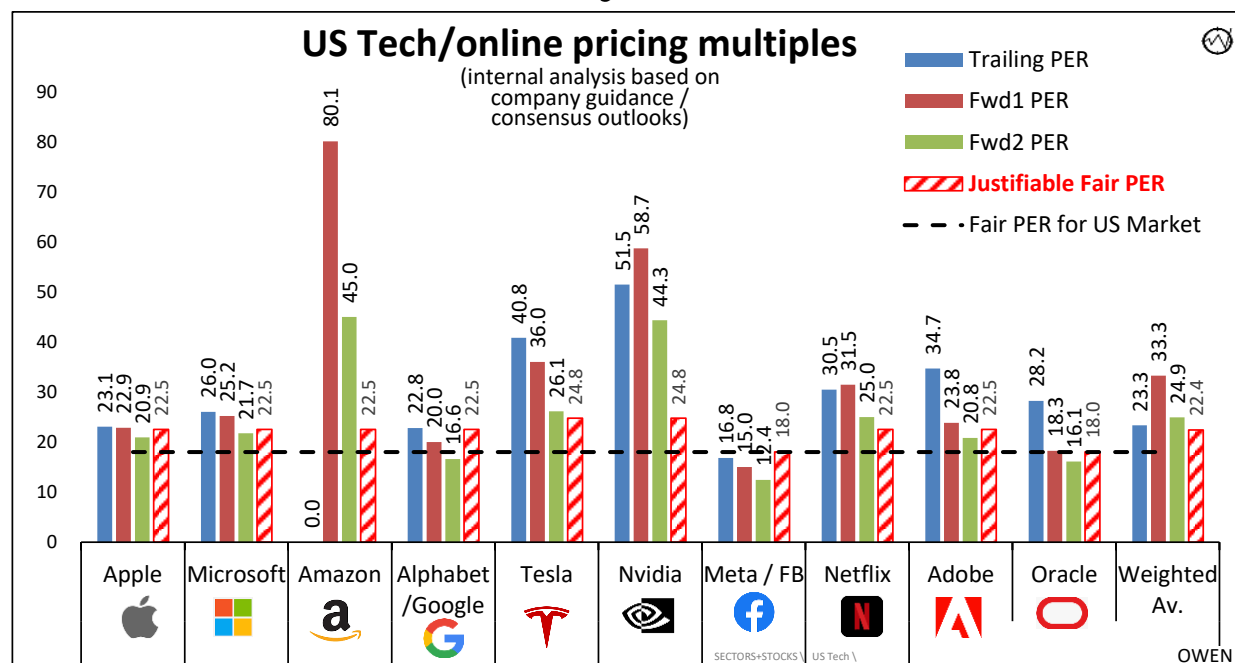
In summary, as a group, these ten US tech/online giants are still over-priced by around +20% based on our assessment of 'fair value'. This over-pricing means they are vulnerable to any negative shocks, like aggressive rate hikes, high unemployment, big cuts to consumer spending, etc. The current level of over-pricing, and their vulnerability to negative developments, comes down to two key questions – (1) how achievable (or outlandishly optimistic) are their forecast profits?; and (2) are the current share prices 'fair' value for these likely profits.

Here is a profit snapshot for each company – each chart shows net profits for the past seven years, plus forecast profits for the next two years (based on company guidance and analyst consensus outlooks). The totals are highlighted in the lower right chart:



There are two immediate observations. First, in each case (and in aggregate), profits have flattened and/or slowed over the past year. Second, the profit growth rates forecast for the next two years are more subdued than the growth rates over the past half dozen years (except Adobe, which are still outlandishly optimistic). Clearly the double-digit growth rates of the past decade are over, and this lowering of the profit trajectories no doubt contributed to the big share price falls across the board in 2022. But are they still expensive, or cheap yet?

The next chart shows four pricing ratios for each company. The first (blue bar) is the 'trailing price/earnings' ratio (ie the current share price relative to the most recent year's profits ('earnings' per share)). This is the most commonly quoted ratio in the media and online broker websites and company annual reports and filings. The second ratio (orange bar) is the share price relative to the next full year's forecast profit (the 'forward p/e' ratio). This is more important because we buy a company for its future, not past, profits. The problem is that the past is known, but the future is unknowable of course, and is going to be affected by a host of factors mostly outside the company's control. The third (light green bar) is the price relative to the subsequent year's forecast profits, which is even further into the future and thus even more vague and uncertain.



The fourth bar (red striped bar) is the most important. This is our fundamentally-justified 'fair price multiple' for each company. It is based on our assessment of each company's expected medium term revenues, profit margins and profits that are reasonably achievable given the company's market share, market growth, likely competition, regulatory conditions, etc. Forecasting the future is difficult of course, but when buying any asset, like a house or a business, we are making judgements about the future, by definition. Our 'fair value' price/earnings ratio for each company is different because the growth outlook for each company is different.

Finally, we also show our fundamentally justified price/earnings ratio for the US market as a whole (black dotted line). This is around 18 times earnings, based on our outlooks for returns on equity, pay-out ratios, interest rates, and risk premia for the US share market as a whole. It is notable that our 'fair' multiples (red striped bars) for most of these companies are higher than the overall US market ratio (black dotted line), because we are happy to pay more for some companies with good prospects of growing their profits at higher rates than the overall market.

The bottom line is that, as a group, these tech/online giants are still at least 20% over-priced relative to our estimate of their achievable earnings in the medium term. On this basis, Apple is more or less now back to fair value, Alphabet/Google and Meta/Facebook may be below 'fair value,' but the rest are well above our assessment of 'fair value'. Nvidia is the most over-priced, even after our adjustments.

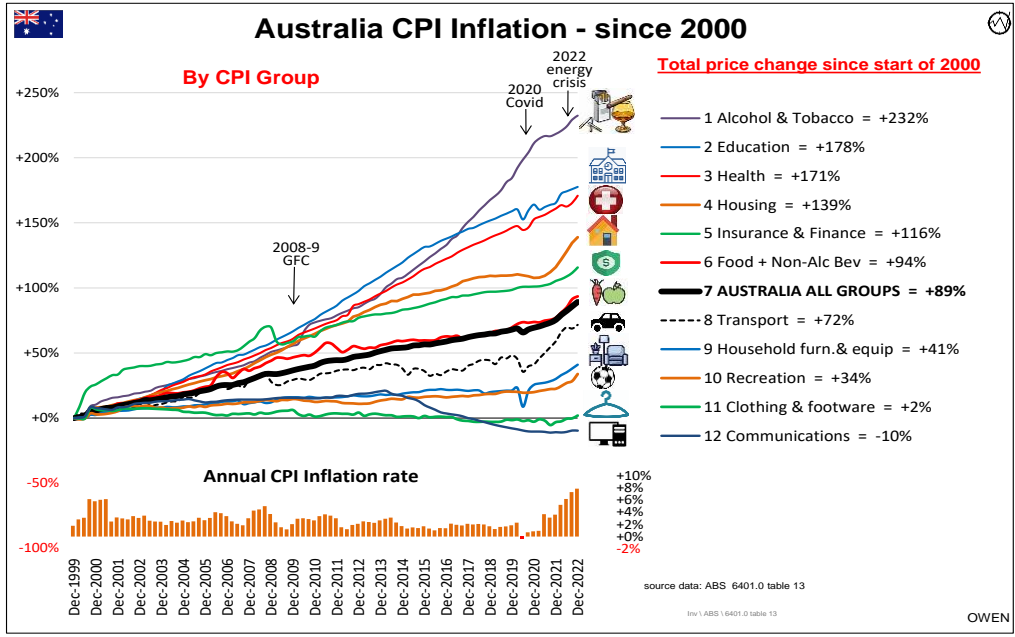
For those hardly readers who made it this far, we apologise for the level of detail in this story, but it illustrates how we dig behind the headline numbers to better understand what is driving markets.

The Australian market is much more reasonably priced, but, as always, the local market will fall heavily in the event of a US sell-off, so the US market is the key to the local and all global markets.

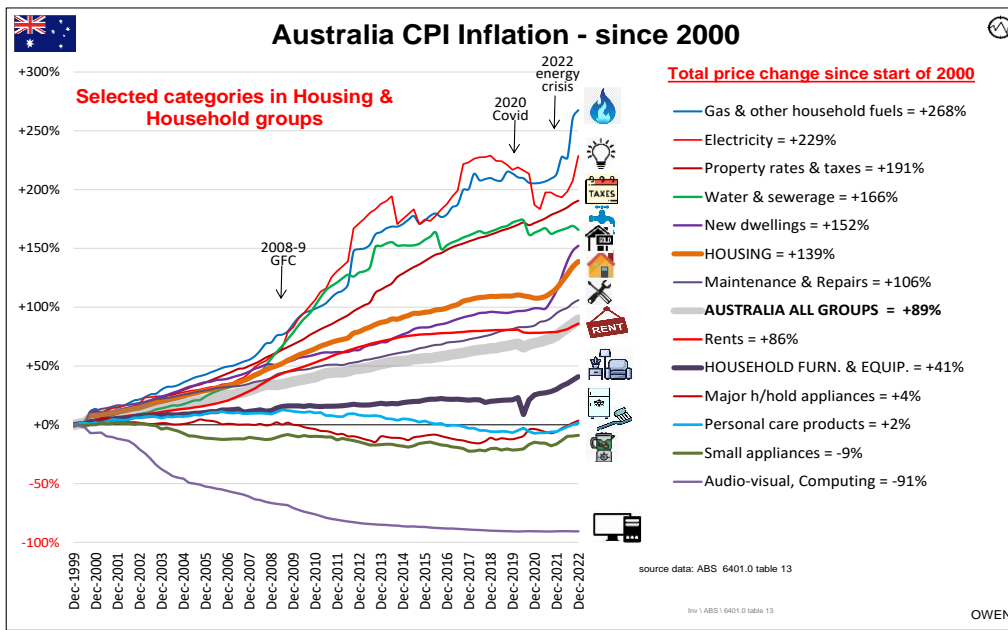
For asset allocation in our diversified portfolios - because the US (and global) markets have already come down substantially, and the speculative fever pricing evident in 2021 is no longer present, there is a good chance that most of the big falls are behind us, even in the event of a US recession. Our portfolios are positioned defensively, but are still set up to take advantage of the rebound when it occurs – most likely later in 2023.

'Inflation' is different for everyone

Here we take a closer look at inflation in Australia, and what is behind the 'headline 'CPI' numbers. The first chart shows inflation rates for each 'Group' of goods and services that make up the headline 'Consumer Price Index':



Next we show the main components in the 'Housing' and 'Household' Groups, plus some other household items:



Broadly, prices of items with a large Australian labour content (eg. healthcare, education, household repairs, power, water, gas) are rising at much higher rates than 'CPI', while items imported from low wage countries have actually become cheaper or stayed flat (clothing, footwear, computers, phones, appliances, cars).

It is important that long term investors understand their own 'personal inflation rate' may be quite different from the published CPI inflation. Why? The government age pension, income from annuities, and inflation-indexed bonds rise by CPI, but is this going to cover your own 'personal inflation rate'? Your retirement portfolio may be designed to generate returns of 'CPI+4%', which allows for withdrawals of 4% of the balance each year, with the withdrawal amounts and the capital sum after withdrawals both still rising at least for CPI inflation each year – ie preserving their 'real purchasing power' of the withdrawals and capital sum, without 'eating into capital'. (Note that the government's mandatory 'minimum withdrawals rates' for Super accounts in Pension phase start at 4% for people under 65, then rise to 5% for 65-74 year olds, 6% for 75-79 year olds, etc. This is because the Super rules are designed to run down Super ('eat into capital') and spend it, rather than pass it on to the next generation.

Talk to your adviser about your own 'personal inflation rate' and whether you have the right long term retirement portfolio given your personal inflation rate, and whether it is consistent with your views on the balance between spending it versus preserving it for the next generation.

Labor's radical new Super tax plan

At the end of February, the Federal Labor government announced its plans to introduce a new tax on 'Superannuation' account balances above a certain threshold. (<https://ministers.treasury.gov.au/ministers/jim-chalmers-2022/media-releases/superannuation-tax-breaks>). The threshold is to be set at \$3m initially, to make it politically acceptable enough to get it through parliament, as it affects 'only' 80,000 investors. However, once the new tax is in place, it would be relatively easy to lower the threshold to catch more people (Recall that Messrs Albanese and Chalmers expressly ruled out any changes to Super in the election campaign last May, after seeing Bill Shorten lose the 2019 election when he revealed his planned tax agenda before the election).

The threshold is specifically not going to be indexed for inflation, so it will impact more savers every year through 'bracket creep' alone, especially with inflation likely to remain above target for many years, and inflation has historically been the largest component price gains on shares and real estate in Australia. However, there is an even more important impact of inflation with this tax, as we outline below.

It is clear from the announcement, and also from the worked examples they helpfully provided in the media release, that unrealised gains on investments will be taxed each year – ie gains from any rises in the value of shares or property or other assets every year, even if you don't sell them. This is an extraordinary departure from the existing tax system in Australia. As a result, people with super balances above the threshold would pay less tax if they held the same assets outside of super, paying tax at the top personal marginal tax rate of 47%, than leaving them in super paying the new 30% tax. How can this be?

The reason is that the current tax regime in Australia only taxes capital gains when they are realised, ie. only if and when an asset is sold for more than its cost base. This general tax principle of only taxing realised gains applies to all assets, whether they are held by an individual, a super fund, a trust, or a company. The big change here is that this new Super tax will tax all investment 'returns'. A 'return' is defined as any increase in the Super fund balance from the start to the end of each year (after adjusting for contributions and withdrawals). This is a new tax on unrealised gains every year, including 'paper' gains from rises in share prices, property values, or any other asset.

As most of the gains from shares, and real estate are from inflation, it means investors will pay tax every year on the 'paper' rises in the value of assets due simply to inflation. The government creates inflation by printing money and deficit spending, then it taxes assets you own that rise from the resultant price inflation! Inflation is already a tax on the purchasing power of money, but paying tax on that inflation every year will further erode purchasing power.

For assets with publicly available prices (shares, managed funds, LICs, listed bonds, etc), the unrealised gains will be easy to track and tax each year. The ATO has kindly offered to do this for you! For unlisted assets like direct real estate and collectables, it would be based on valuations, so it will depend on the frequency and also the basis of valuations. One natural next step for the government would to require regular valuations of all assets in self-managed funds (as required in public super funds), so it can collect taxes on annual value increases in unlisted assets, as they will for listed assets with the new tax. Where an unlisted asset (like a property) is the main asset in a super fund, the member may need to sell the asset if they can't come up with cash from other sources to pay the tax on the unrealised 'paper' gains in value every year.

Now we understand that the new tax will apply to unrealised and realised gains, we can return to the question of how holding assets outside super and paying tax at the top personal marginal tax rate of 47%, can incur less tax than holding the same assets in the Super regime at the new 30% on all 'returns' including unrealised gains.

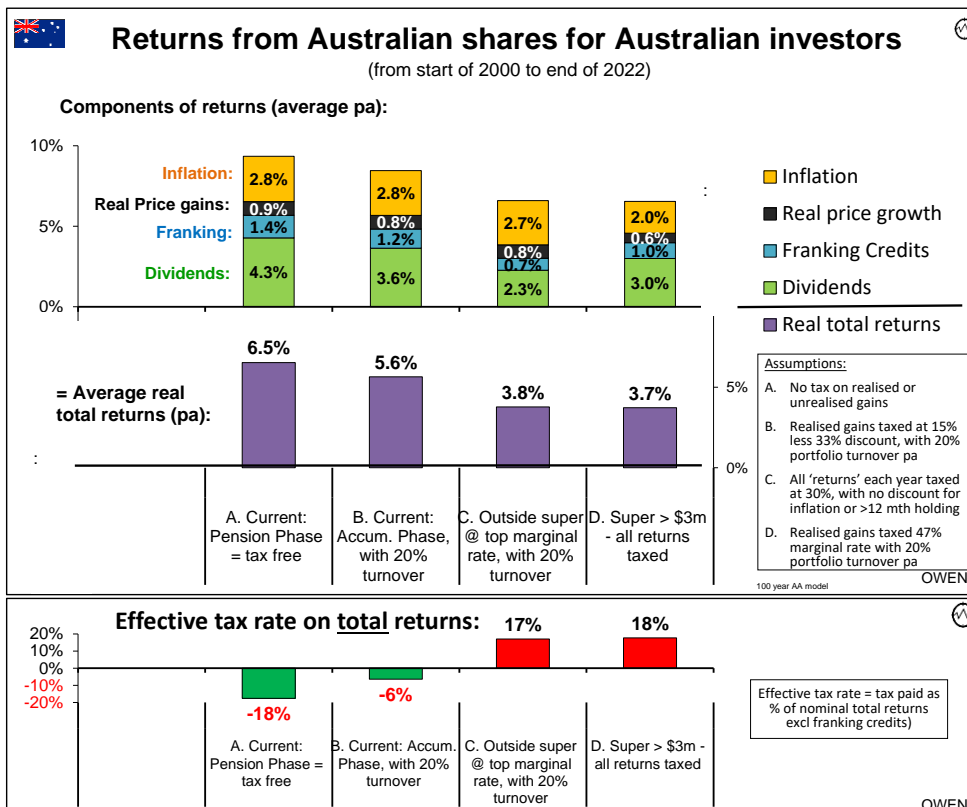
Let's take Australian shares, the most common type of asset in most Super funds. Since the start of 2000, the broad Australian share market generated total returns (prices gains plus dividends) averaging 7.9% pa excluding franking credits, and a 'grossed-up' total return of 9.3% pa including franking credits for Australian shareholders.

Where did these returns come from? Nearly half (4.3% pa) came from dividends, nearly one third (2.8% pa) was CPI inflation lifting share prices, one sixth (1.4% pa) was from franking credits, and less than one tenth of the total returns (0.9% pa) was from real growth in share prices above inflation. It is important to break down the returns into these components, because each component has different tax implications.

While the average nominal total returns from the broad share market was 7.9% pa so far this century, the after-tax return is different in the hands of different types of entities. Here we look at four different ways of holding the same basket of shares:

- A. Currently, Super accounts in 'Pension' phase are effectively tax-free. However, because of the tax benefit of franking credits to Australian shareholders (which refunds the taxes that the dividend-paying companies already paid on their profits, so that those profits are not taxed twice), the 'after-tax' total return was 9.3% pa, which is higher than the 7.9% pre-tax return. This amounts to an effective tax rate of minus -18% on the original 7.9% nominal total return from the share market since 2000.
- B. Currently, Super accounts in 'Accumulation' phase pay 15% tax on dividends and franking credits, and realised gains are taxed at 15% (less 33% discount for sold assets that were held for more than 12 months). Assuming 10% portfolio turnover each year, taxes reduce the after-tax return to 8.5%. (NB. we need to assume some portfolio turnover, as even passive index funds have some turn-over to keep track with their chosen index. Portfolio turnover creates taxable capital gains, even in relatively passive long term funds.) This equates to an effective tax rate of minus -6% on the original 7.9% nominal total return (the negative tax rate is due to the impact of franking credits).
- C. An individual holding the same portfolio outside of super and paying tax at the top personal marginal tax rate of 47% - pays 47% tax on dividends and franking credits, and realised gains are also taxed at 47% (less a 50% discount for sold assets that were held for more than 12 months). Assuming the same 10% portfolio turnover each year, taxes reduce their after-tax return to 6.6%. This equates to an effective tax rate of 17%, which is a lower overall tax rate than the new 30% Super tax.
- D. Super accounts above the new threshold: all 'returns' each year are taxed at 30%, with no discount for inflation or discount for assets held more than 12 months. Despite the 30% 'headline' tax rate on all 'returns', the effective tax rate is actually 'only' 18%, due to the impact of franking credits. However, Labor may jump at the opportunity to scrap franking credits for accounts above the threshold, as it would bring the effective tax rate up to the intended 30% headline rate.

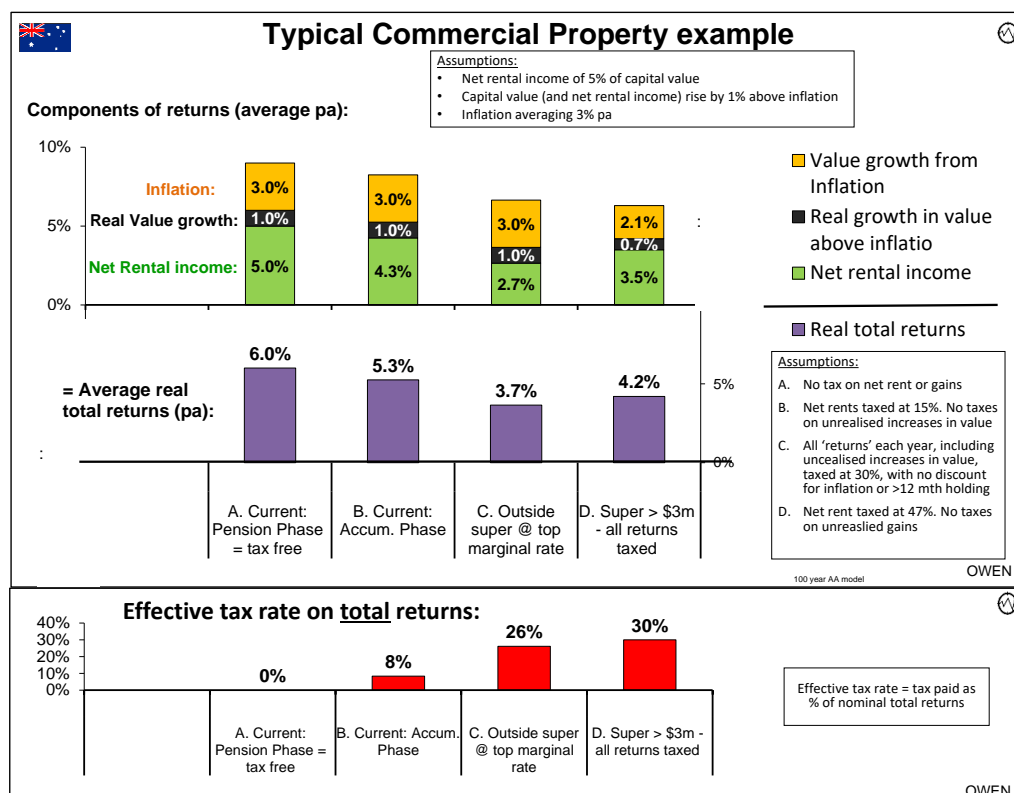
This chart shows the components of returns from the broad Australian share market from 2000 to 2022, and also shows the effective tax rates in the four tax scenarios:



The set of purple bars in the middle show the average after-tax 'real' (ie after inflation) total returns for each entity. This is the most important number for building long term portfolios that aim to generate cashflows that keep rising for inflation, and also keep the capital base (after withdrawals) rising so that future incomes also grow for inflation. These are the critical 'CPI+' numbers that drive long term investment planning. Retirement funds need to generate at least CPI+4% after taxes and fees, and most of this comes from shares. This is not possible in scenario C or D.

It is similar with other types of long term assets. Foreign shares are often more favourable outside of super because less of the total return pie comes from dividends, and more comes from capital gains.

It is also the same picture for another common asset in Super funds - commercial property. It is a very common strategy for professionals and business owners to own their business premises inside Super. Here is a typical example of a commercial property with a net rental income yield of 5% of the capital value. The value can be expected to rise by an average of 1% above inflation, and we assume long term inflation at 3% pa.



As with shares, an individual holding the same assets outside of super and paying the top personal marginal tax rate of 47%, still ends up with higher after-tax returns, and a lower effective tax rate on total returns, than holding it inside Super with the new 30% Super tax for balances above \$3m. The reason of course is that the higher 47% personal tax rate applies only to the net rental income, not to unrealised capital growth.

It is true that, if or when the asset is eventually sold, capital gains tax would be paid at that time, but there would still be several benefits of doing this outside of super:

- the tax on the increase in capital value would be deferred until the eventual sale, instead of being taxed each year of unrealised capital growth;
- the capital gains tax would be reduced by the 50% discount on sold assets held for more than one year;
- the sale could be done at a time when the owner's marginal tax bracket is lower (eg in retirement), reducing the tax further; and
- Holding inside super may result in having to sell other assets to pay the yearly tax on unrealised gains, but if holding outside of super, you only pay tax when you have the cash from the eventual sale.

For housing investments, the picture would generally be even more favourable to holding outside super (even at the top marginal tax rate) because the net rental income for residential properties is usually lower than for most commercial properties, and the real capital growth is usually higher (although each case is different, of course).

As most of the gains from long term investment assets come from long term value gains (most of which is just inflation), rather than cashflows (rent, dividends, etc), this new Super tax would amount to a heavy tax on long term investment. It is a wealth tax on the big savers. But savings is the source of capital for investment, which creates jobs and innovation, which is the source of increased productivity and living standards for the whole nation.

This is only draft legislation at this stage, but it does spell out the plan quite clearly, with worked examples to show how it will operate. It is our belief that, once the broader implications are fully understood, it could not possibly get through parliament. If it does get in, it will add complexity and costs to running super funds. This, and other mooted plans for super, like commandeering super funds to invest in government agendas like renewables and social housing (however well-intentioned), would appear to depart further from the goal of simplifying super. As always, readers should speak to their adviser about their individual circumstances.

What Lies Ahead

For interest rates – there will almost certainly be more rate hikes in Australia and the US, which are the two critical markets for us. How many hikes depends on the lagged impacts of the recent rate hikes on spending and jobs, and how quickly the easing of supply constraints bring down the inflation numbers. We are starting to see the effects of rate hikes on the residential housing market, especially in the construction industry. Construction bankruptcies are likely to accelerate, with significant knock-on implications for trades, customers and suppliers. Of all countries, Australia is probably the most vulnerable to rate hikes, due to its uniquely high proportion of floating rate debt (and high levels of household debt generally), and our large construction sector.

For inflation - the worst of the inflation spikes are probably behind us, as supply constraints are eased, alternative sources of supply (energy, raw materials, components, food) kick in, and as rate hikes slow spending. We are not returning to persistent double-digit inflation like the 1970s, although inflation will probably remain stubbornly high.

For 'recessions' – we are not particularly interested in arcane definitions, and economists' proclamations of 'recessions' after they occur. We are more interested in the future outlooks for company profits, cashflows and dividends, as these are what drive share markets.

For share markets - In Australia, current market pricing already assumes big cuts to profits and dividends. This is no big deal, it just reflects the temporary nature of last year's bonanza iron ore and fossil fuel profits and dividends. In the critical US market, profit outlooks are at least no longer infected by the over-optimism of 2021, but a 'soft landing' is still assumed. The US market is still over-priced and there is no buffer for big cuts to profits if there is a deep US recession. The overall market has fallen back since the start of 2022, but we have not had a full 2000-2-style 'tech-wreck' yet. Further aggressive Fed rate hikes may bring this on. If so, the local market will fall by less.

For house prices - Australian house prices are unlikely to suffer big falls across the board. Australia has had two big housing collapses: the first had -35% price falls in the 1892-6 depression (when unemployment reached 20% and half the banks in Australia closed their doors). The second also had falls of -35% in the 1930-1933 depression (when unemployment reached 30%). In the US, house prices fell nationally by a similar -35% in the 2007-12 sub-prime/GFC crisis. The last housing/banking mini-crisis in Australia was in the early 1990s, when unemployment reached 10% and median house prices fell by a similar amount. We highlight unemployment because this is just as critical as interest rates and debt levels. In 2023, there will certainly be an increase in forced sales and foreclosures with higher interest rates, but unemployment is unlikely to reach depression-like levels. Nor are we likely to have an existential banking crisis like Australia had in the 1890s, US had in the 1930s, and in the GFC. This time, the banks are much stronger, and forced sales will probably be confined to over-gear, late-to-the-party buyers, and highly geared builders. We are not expecting a nation-wide meltdown with -30% price falls.

For the Australian Dollar – it will broadly follow the share market as it nearly always does. (Eg. in 2022, both were down -7%. In 2021, both were up: shares up 13%, the AUD/USD up 10%. In 2020, both were dead flat, and so on). If shares suffer a big 'tech-wreck'-style fall in 2023, so will the AUD. When (not if) the strong share rebound arrives (rebounds are always quicker and stronger than expected), the AUD will rise with the global lift in confidence.

For Russia's war on Ukraine – Ukraine's resistance has been stronger than Putin expected, but Russia's resilience to sanctions has also been stronger than most people expected. The West is being drawn in to more direct support of Ukraine, and China is being drawn in to more direct support of Russia. We are wary that an increasingly isolated and desperate Putin being backed into a corner by NATO sanctions may be similar to the increasingly isolated and desperate Hirohito being backed into a corner by US blockades in 1941. However, we have faith that diplomacy and common sense will prevent a sudden escalation into global nuclear war.

For China - trade relations with Australia continue to improve under the Albanese government. China needs Australian exports (for its domestic construction-based economy, and also for building its Belt & Road trade / military bloc, probably more than Australia needs China. Since the 2018 flare-up in Chinese trade tensions under Trump/Morrison, Australian exporters have done a better job at diversifying their export buyers away from China, than Chinese importers have been able to diversify their imports away from Australia. This should continue.

As always, we remain vigilant and willing to make further adjustments to portfolios to protect capital and capitalise on opportunities where warranted. Wishing you all the best.

Ashley Owen, CFA

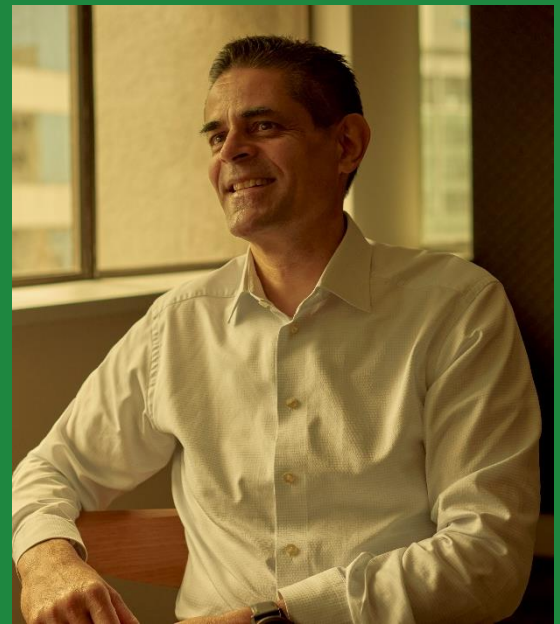
Ashley Owen

Chief Investment Officer

CFA, LLM, BA, Grad. Dip Applied Finance

Ashley is one of Australia's leading portfolio managers of diversified investment funds for long term investors. His mission is to manage portfolios that provide investors with confidence that their investments will generate the wealth they need to live the life they wish to lead for the rest of their lives – for themselves, their families and as a legacy for future generations.

His primary focus is protecting investors from losses and risks, rather than chasing high returns from the latest hot funds or fads.



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