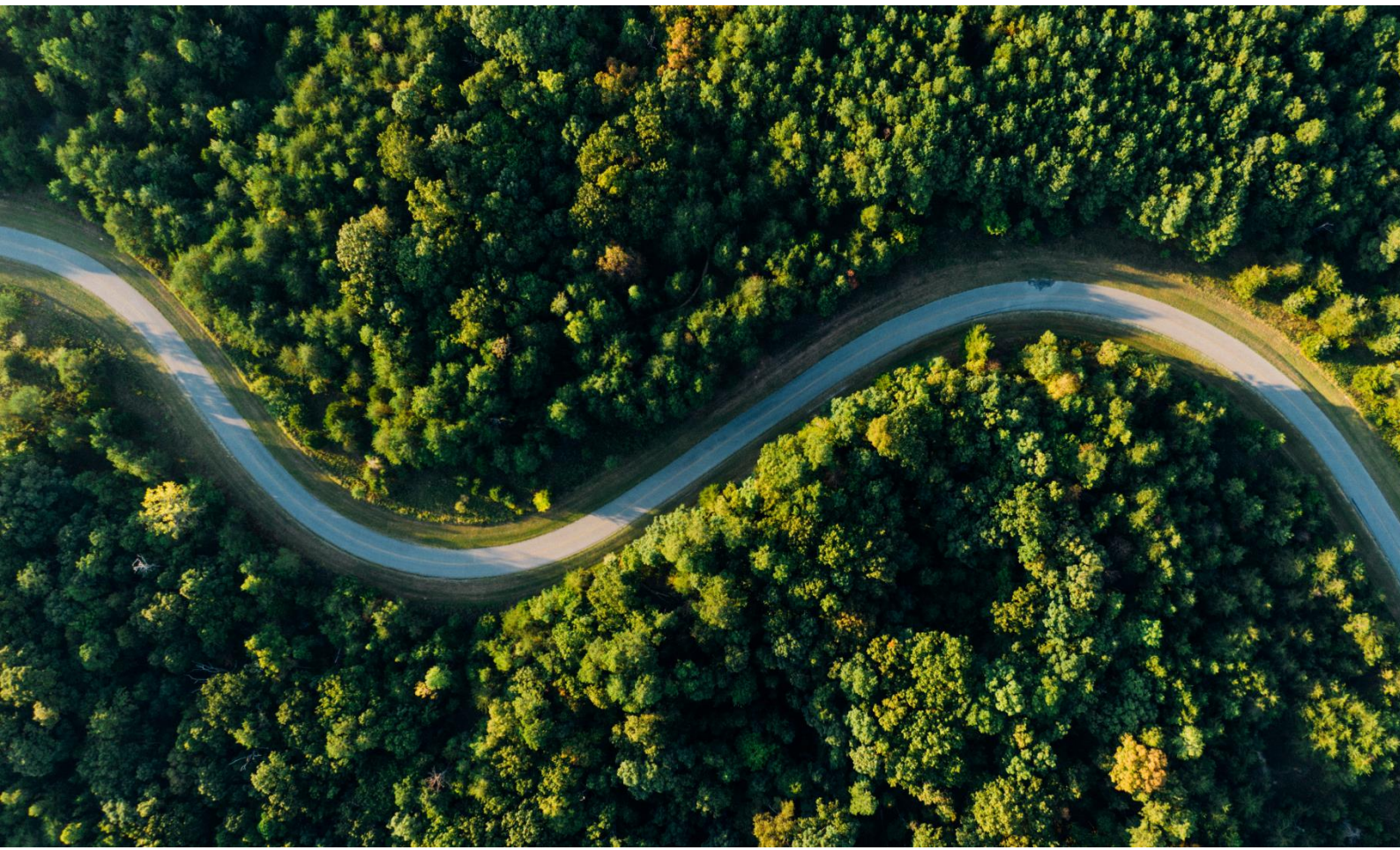


# Quarterly Investment Markets Report

8<sup>th</sup> of May 2023

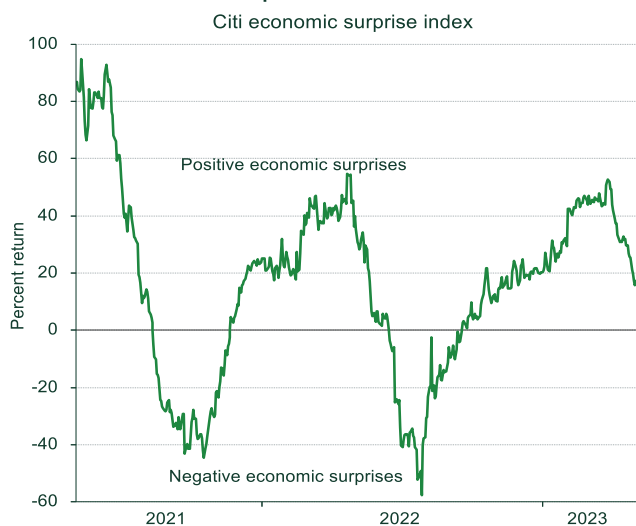
**StanfordBrown** Private  
Wealth



## Executive Summary

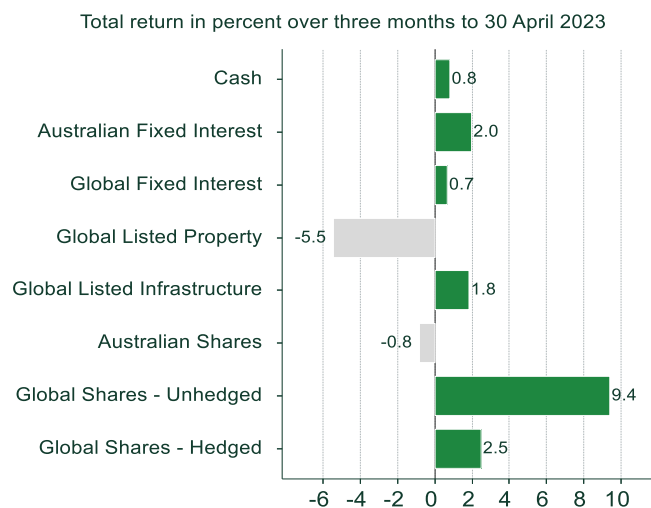
Coming into 2023, investors generally had a downbeat view of the global economy and equity markets. A Bloomberg survey late in 2022 showed economists were placing a 70% chance of a recession in the US this year and the consensus view of economists was for the Eurozone to slip into a recession as energy shortages impacted activity. Market strategists expected equity prices to decline in the first half of this year as corporate earnings contracted and then recovered in the second half of the year as interest rates were cut and investor focus shifted to the post-recession economic recovery. While recession risks certainly remain, economic data so far in 2023 has been mostly stronger than expected, helped by the mild winter in Europe, the economic rebound in China following the end of COVID lockdowns and resilient consumers in many countries who are yet to meaningfully trim spending in response to the combination of higher interest rates and higher consumer prices.

### Economic surprises in G10 economies



Source: Refinitiv Datastream 5/8/2023

### Asset class returns



Source: Refinitiv Datastream 5/8/2023

It hasn't just been the better-than-expected economic data that has helped financial markets this year. In a case of bad news is good news, the collapse of Silicon Valley Bank and the forced sale of Credit Suisse to UBS has helped asset prices. This is because an expected further tightening of lending standards in the US and Europe, as banks hoard cash to meet potential deposit outflows and become more cautious about lending into a slowing economy, is expected to be equivalent to several interest rate rises in terms of its impact on economic activity. Firms with less access to bank credit are expected to slow investment and hiring. This has meant investors now believe most central banks have either stopped or are soon likely to stop lifting interest rates even though inflation remains too high.

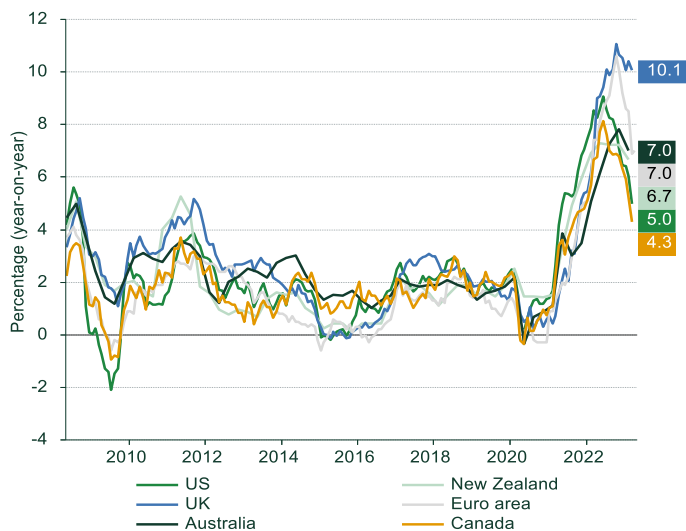
Given the stronger data, economists have either been dialling back recession expectations in the US and Europe or alternatively pushing back the expected recession start date into late 2023 or 2024. Talk of a hard landing, or economic contraction, has been replaced with talk of a soft landing, or slowdown, or even talk of no landing suggesting that the investors have become more optimistic that inflation will come down on its own without the need for further interest rate rises that could inflict more significant damage on labour markets. While headline inflation does appear to have peaked in late 2022, our expectation is that it will take a long time to return to the 2% target most central banks adopt and, in our view, the steep rate cuts that are priced into bond markets in late 2023 and 2024 appear optimistic.

The current inflation spike has three key components. Firstly, there was supply-driven inflation resulting from the pandemic. Elevated demand for goods such as cars, home appliances, furniture and clothing exceeded the capacity of factories and supply chains to keep up, leading to price rises, order backlogs and transport bottlenecks. Secondly, the war in Ukraine and resulting Russian sanctions created an oil and food price spike, given those two countries are major exporters of grain and Russia was a significant supplier of gas and oil into Europe. High energy prices also have had a second order impact on food prices through fertiliser and transport costs. While the first two inflation components have proven to be somewhat transitory in nature, the third part of the inflation story, services inflation, is potentially more sustainable and more closely tied to labour markets and wages.

Services inflation includes home rent, health insurance, education, travel, accommodation and eating out and while there may be an element of revenge spending and catch-up price increases to make up for the pandemic, there is also some evidence that some of the upward momentum in these prices may be sticky. At an aggregate level, consumers in many countries are still sitting on

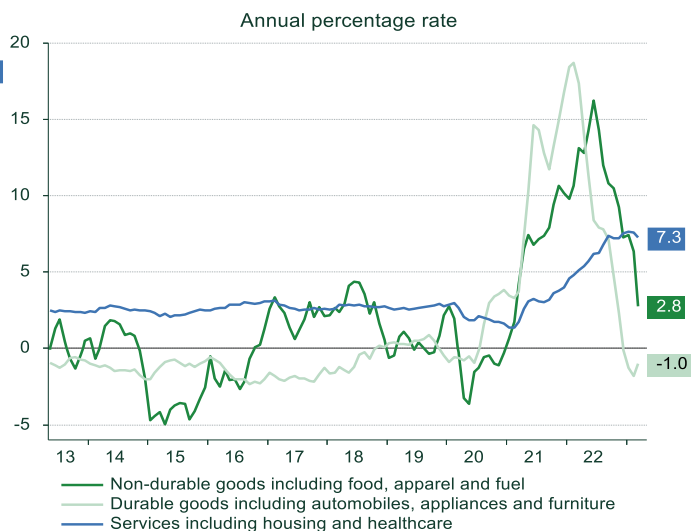
elevated pandemic savings which are now earning higher rates of interest. Many borrowers also locked in cheap fixed rate loans several years ago and in the United States more than 90% of home loans carry a fixed interest rate for 30 years. Finally, wage growth is still rising in most parts of the world and inflation is slowing which at the margin tends to boost consumer spending power even if wage rises are below the rate of inflation.

### CPI inflation



Source: Refinitiv Datastream 5/8/2023

### US CPI inflation

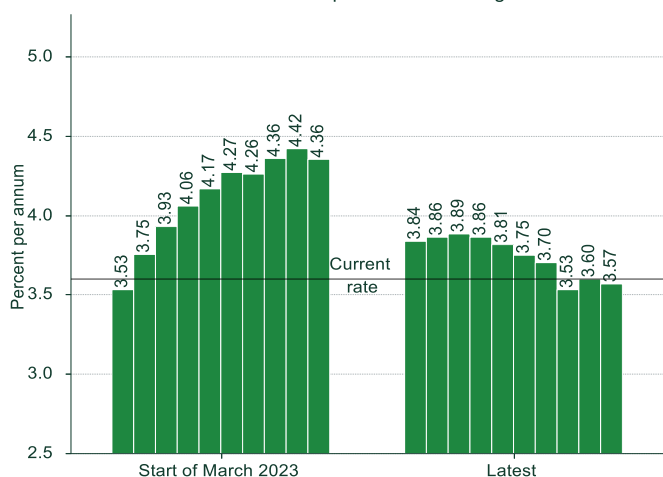


Source: Refinitiv Datastream 5/8/2023

All of this suggests to us that the interest rate rises to date may not prove sufficient to bring overall inflation back to 2% in a timeframe that would be acceptable to central banks which would mean either higher interest rates than currently priced and an unwinding of market pricing for large rate cuts in 2023 and 2024. This is particularly the case in Australia where interest rates are still mostly lower than other parts of the world, despite inflation being higher, and where residential property prices have risen for two months in a row, something that RBA Governor Lowe recently highlighted as one of the reasons for May's surprise rate rise. Unlike the US and Europe, our banking system does not have a plethora of smaller banks with weaker prudential standards, so rate rises rather than tighter bank lending may be needed. The RBA also remains concerned about the impact of strong immigration on inflation, particularly rent inflation, as well as the prospects of large catch-up public-sector wage rises later this year.

### Implied RBA cash rate

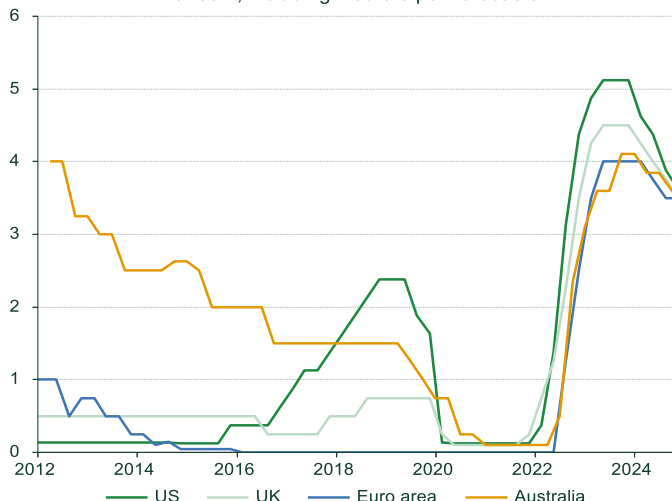
For each subsequent RBA meeting



Source: Refinitiv Datastream 5/8/2023

### Global central bank policy rates

Per cent, including Reuters poll forecasts



Source: Refinitiv Datastream 5/8/2023

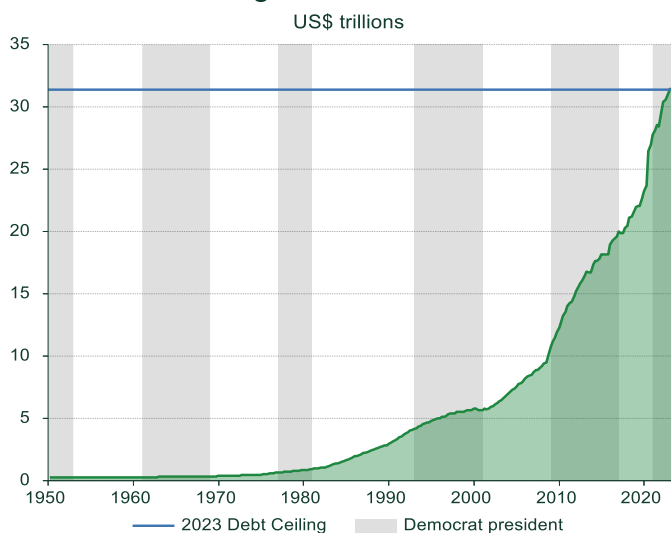
For this reason, our preference is to continue to maintain a slight underweight allocation to fixed interest and to reduce the current allocation to Australian Debt from overweight to underweight so that it is now in line with our underweight allocation to Global Debt. Within fixed interest we are also looking to gradually increase the interest rate duration (that is the sensitivity of bond prices to changes in bond yields) with the aim that once we are comfortable that global central banks have finished their interest rate hiking cycle our portfolios can move to a neutral allocation to interest rate duration to rebuild portfolio insurance against an economic or equity market downturn. Although bond and equity prices moved together over the last year when inflation and interest rates were rising, we would expect the relationship to fade as we get closer to the peak in short term interest rates.

In respect of our allocation to equities, we are also making some changes this quarter to bring our equity allocations into line with our neutral views for equities more broadly. We would not expect Australian Shares to outperform Global Shares over a short to medium term horizon and we are therefore increasing the allocation of Global Shares from underweight to neutral to bring it in line with the current neutral allocation to Australian Shares. With a high weighting to banks and miners, Australia's share market tends to have more of a value bias or cheaper companies that have lower earnings growth relative to the US equity market which has a higher weighting in information technology and healthcare companies that offer higher potential growth. As inflation, economic growth and ultimately interest rates begin to fall, this will tend to favour growth equities which have less cyclical earnings in a slowing macroeconomic environment where growth is more scarce.

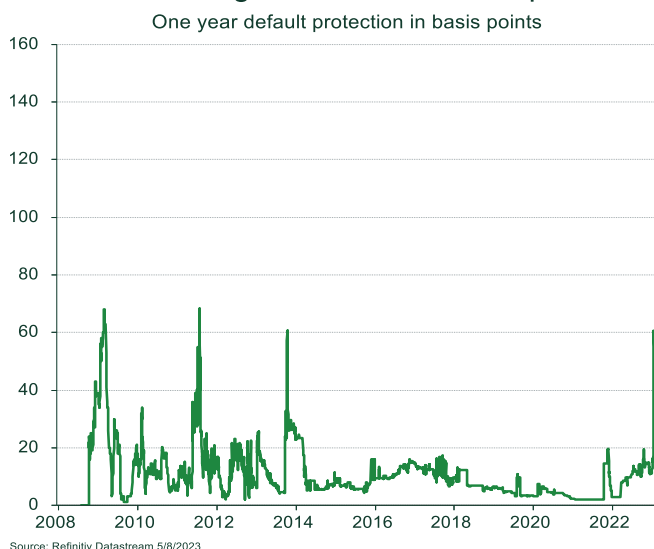
As highlighted above, although our view is that recession risks are still elevated, a global recession in 2023 is looking less likely and any recession would likely be mild given the lack of financial imbalances and current strength of labour markets. Given equity bear markets often occur during recessions, the prospects of a bear market (or 20% decline) in equities after 2022's declines are looking less likely in the near term. Equity valuations are broadly neutral relative to history and although international shares are marginally more expensive than Australian shares, this modest premium is influenced by the high exposure to US shares which offer superior long term earnings growth characteristics and arguably more stable earnings and pricing power than Australian shares.

The key risk to our outlook for the global economy and financial markets over the coming quarter, and one that we are monitoring closely, is the US debt ceiling negotiations. This has gained increased focus in recent days given the US Treasury is expected to run out of funds in June or July which could lead to a technical default on US government debt if the debt ceiling is not increased. Many investors remain somewhat blasé about this risk, given prior debt ceiling negotiations, such as the drawn out one in 2011 which resulted in a downgrade of the US government's credit rating, ultimately got resolved. However, bipartisan agreement in the US has arguably gotten harder to achieve since then and so there is probably a good chance for short term market volatility in coming months until the debt ceiling can be raised.

### US government debt



### US sovereign credit default swap cost



## Current Balanced portfolio positioning summary

Asset Class	Positioning	View
Cash	Underweight	Rising returns on cash are expected, particularly as banks need to pay higher interest on deposits as a result of global banking stress and deposit outflows.
Australian Debt	Underweight	Although the peak in short term interest rates is closer, risks remain that the RBA will need to lift rates more than market pricing suggests, given inflation remains well above the RBA's inflation target range of 2-3%. We are reducing our exposure to Australian Debt to bring it into line with Global Debt but increasing overall interest rate duration.
Global Debt	Underweight	Economies remain in relatively good shape and interest rate rises have had no major impact on growth, employment and spending yet. Once the stress in the banking system subsides, central banks such as the US Federal Reserve and European Central Bank may need to return to lifting interest rates later this year to tackle sticky inflation. Maintain an underweight exposure to Global Debt and interest rate duration for now.
Alternative Defensive	Overweight	Maintain an overweight exposure to alternative strategies where returns are not correlated with interest rate changes and broader risk sentiment.
Property & Real Assets	Underweight	Office properties face many headwinds from rising vacancies and higher interest rates. After sharp declines listed real estate valuations are more attractive than unlisted. Real assets such as infrastructure are becoming more attractive as bond yields get closer to their peak. Real assets tend to have earnings more closely linked to inflation which is also attractive.
Alternative Growth	Overweight	Maintain an overweight exposure to alternative strategies where returns are not correlated with interest rate changes and broader risk sentiment. Hedge funds provide additional diversification in a world where rapid interest rate moves have impacted valuations of traditional asset classes.
Australian Shares	Neutral	Earnings outlook is muted due to falling bank net interest margins as borrowers look to refinance. The lack of major Chinese property and infrastructure stimulus post lockdowns means demand for iron ore is also unlikely to lift. Equity valuations are about average relative to history.
Global Shares	Neutral	Valuations, economic and corporate fundamentals, and investor sentiment suggests a neutral allocation to equities with risks to the upside and downside being broadly equal. Move from an underweight to neutral allocation.
Currency hedging	Mainly unhedged	Interest rate differences between Australia and the US and expected moves in commodity prices due to a slowing global economy are not supportive of the Australian Dollar in the short term. Given the risk-sensitive nature of the Australian Dollar prefer to remain largely currency unhedged in Global Shares for additional diversification purposes.

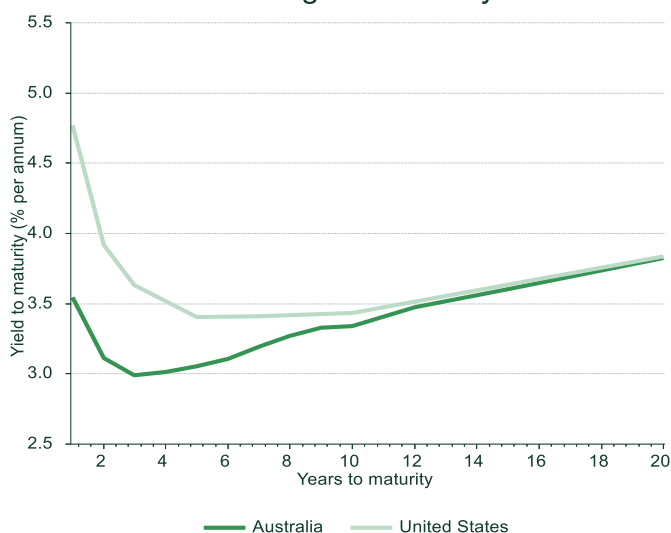
## Fixed Income

Fixed income remained relatively volatile over the past three months as better-than-expected economic data and sticky inflation led investors to initially expect higher short term interest rates, which was then rapidly unwound following the collapse of Silicon Valley Bank. Bond yields fell significantly across the entire yield curve in March after the banking concerns surfaced but as fears around a financial crisis receded, markets have removed some of the pricing for near-term rate cuts. Fixed income markets continue to price a move by major central banks to pivot from rate hikes to rate cuts over the next six months to reflect a combination of falling inflation and recession risks.

The Bloomberg Barclays Global Aggregate Bond Index Hedged AUD returned +0.69% over the three months to the end of April as bond yields were little changed over the three months despite some large swings over the quarter and different moves in different countries. The two-year US Treasury bond yield rose from 4.21% at the end of January to 5.07% in early March and then back to 4.06% at the end of April. The 10-year US Treasury bond yield similarly rose from 3.53% in January to 4.07% in early March and ended April at 3.45%. Higher inflation in Europe relative to the US saw 10-year German Bund yields end higher over the quarter up from 2.28% to 2.32% and UK 10-year Gilt yields up from 3.33% to 3.72% over the three months.

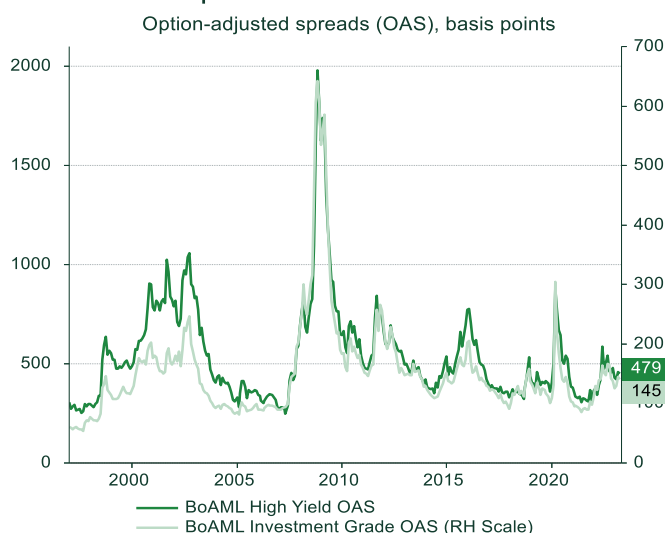
Australian fixed interest outperformed global fixed interest with the Bloomberg AusBond Composite Index returning 1.99% over the three months as the two-year Australian Commonwealth Government bond yield rose from 3.17% to a high of 3.72% and back to 3.08% at the end of April. The Australian 10-year bond yield rose from 3.56% to a high of 3.91% and back to 3.39% over the three months. Australian floating rate notes underperformed fixed rate bonds with the Bloomberg AusBond CreditFRN Index returning 1.16% over the three months.

### Australian and US government yield curves



Source: Refinitiv Datastream 5/8/2023

### US credit spreads relative to US treasuries



Source: Refinitiv Datastream 5/8/2023

The stress in the banking sector impacted global credit markets, particularly financial sector credits. High yield bonds, as measured by the Bloomberg Global High Yield Hedged AUD Index, lost 1.02% over the quarter driven by a widening of credit spreads (the difference between yields on the sub-investment grade bonds and government bonds of the same maturity). In the high yield sector these increased from 430 basis points to 522 and back to 450 basis points over the three months to the end of April. Investment grade corporate bond credit spreads also widened from 125 basis points to 164 and back to 140 basis points over the three months with spreads for issuers in the financial sector widening more than those of non-financial sector issuers.

As fears around the US and European banking sector fade, government bond yields may retest the highs seen in early March, particularly if inflation is slow to fall. We also take the view that the risks are tilted to central banks needing to resume rate rises after a pause to evaluate incoming economic data. For Australia, official interest rates are below those in many other countries, even though inflation is higher, and although Australian consumers are highly indebted, the RBA's own modelling suggests that the neutral rate (the interest rate that neither slows nor speeds up the economy) is at least 2.5% but could be as high as 4.0% which suggests that the current cash rate of 3.85% may not yet be sufficiently restrictive to bring inflation back to target within a reasonable time frame. We are therefore reducing the allocation of Australian Debt from overweight to underweight to better reflect these views and to bring the allocation of Australian Debt into line with that of Global Debt which remains an underweight allocation.

## Alternative Assets

Hedge fund strategies posted negative returns over the three months to the end of April as stress in the global banking sector caused instability in markets in March. According to the HFRX Global Hedge Fund Index, hedge funds returned -1.3% over the three months to the end of April. Trend-following strategies were impacted by the sharp reversal in market trends in March after the Silicon Valley Bank failure caused bond markets to rapidly switch from pricing rate rises to rate cuts. Macro funds and trend-following funds posted sharp losses in March although reasonable gains in February and April meant that the losses for the three months were halved. Event-driven strategies also posted weak returns as higher financial sector risks reduced chances that corporate events such as mergers would be financed and completed. Equity long/short strategies, relative value and equity market-neutral strategies were all broadly flat to slightly lower over the quarter.

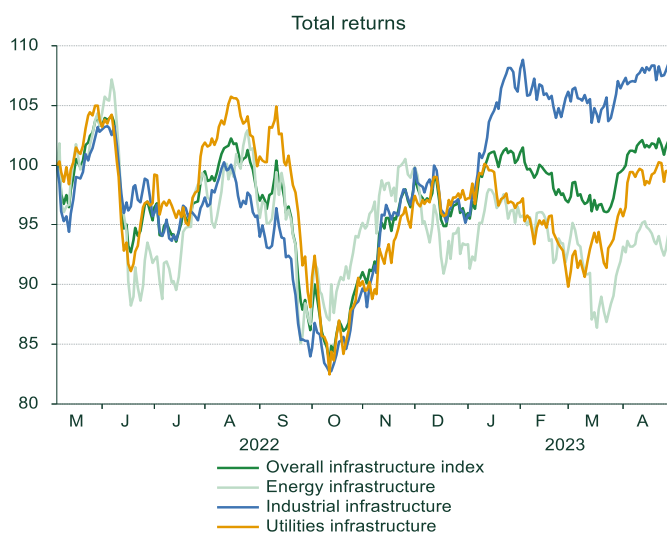
Conditions for hedge funds are reasonable with relatively low equity volatility reducing equity trading opportunities at an index level but within equity markets high stock, sector and style dispersion creates opportunities for active stock selection. Bond market volatility remains very high which helps macro hedge funds although with elevated uncertainty it is challenging for macro and trend-following hedge fund managers to identify clear trends and other trading opportunities with a high degree of conviction. This uncertainty is also reducing the opportunity set for event-driven managers given the lack of new debt and equity issuance and lower number of takeovers and mergers. Within the hedge fund universe manager selection remains more important than strategy selection with a wider than usual dispersion between the best and worst performing hedge funds.

## Property and Real Assets

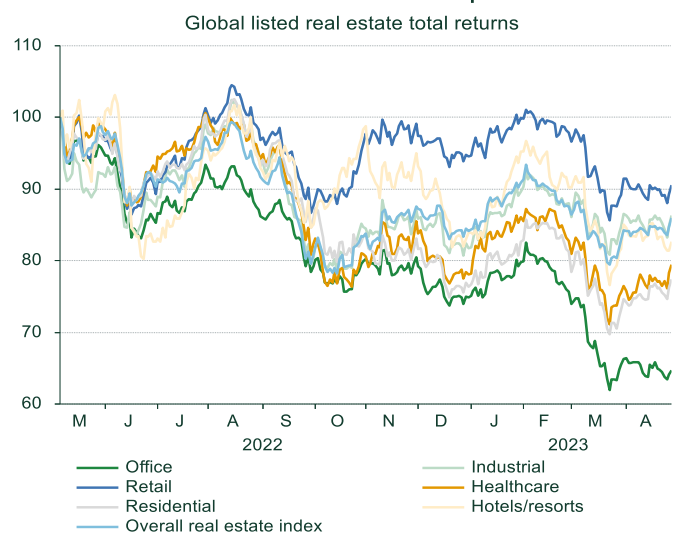
Global listed property had a difficult three months due to the issues with US regional banks and broader issues with the global office property sector. US regional banks are large lenders to the US commercial real estate sector and so investors expect that the tightening of lending standards may have a disproportionate impact on commercial real estate in the United States. In addition, several institutional property investors have reportedly recently handed ownership of individual properties and property portfolios to lenders after losing all their equity in the property or portfolio. A combination of continued work from home trends, white collar layoffs, rapid rises in interest rates and withdrawals from open-ended property funds has impacted real estate net operating income and property valuations, particularly in the listed property space where prices move more rapidly.

Global listed property, as tracked by the FTSE EPRA/NAREIT Developed Market Index Hedged AUD returned -5.46% over the three months to the end of April. The office sector was the worst-performing real estate sector while the industrial and residential sectors were the best performers although all sectors lost money over the three months. Australian listed property securities fared better than global peers with a return of -2.11% over the three months to April with positive returns from Stockland and Mirvac, which are more diversified given their residential development activities, offsetting declines in Goodman, GPT, Dexus and Scentre which are more focused commercial property owners.

S&P Global Listed Infrastructure



FTSE EPRA/NAREIT Developed Markets



Global listed infrastructure as measured by the S&P Global Infrastructure Hedged AUD returned 1.84% over the three months to the end of April with the utilities sector the best performing sector over the quarter while the energy infrastructure sector was the worst performer as lower oil and gas prices impacted volumes and revenues of energy storage and transmission companies. Infrastructure remains an attractive asset class given its inflation-linked revenues, regulated or monopoly-like income characteristics and the need for governments to encourage the private sector to invest more in infrastructure assets, particularly to support the transition to renewable energy, over the next several decades.

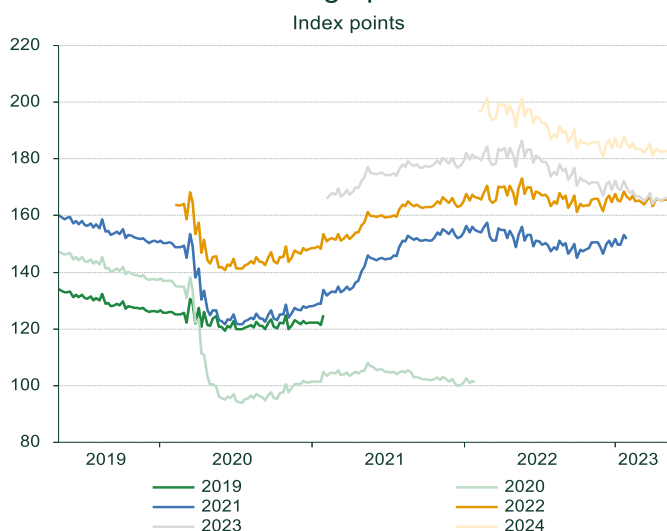
## Global Shares

Despite expectations for flat earnings in 2023, global shares have been helped by better-than-expected economic data, reduced fears of an imminent recession in the US and Europe and a drop in bond yields following the banking issues in March which has helped support equity valuations. In currency-hedged terms, global shares returned 2.47% over the three months to the end of April according to the MSCI World ex-Australia Hedged AUD Index including dividends. The currency-unhedged version of the same index returned 9.40% in Australian Dollars, boosted by a 4.4 US cent fall in the Australian Dollar over the three months.

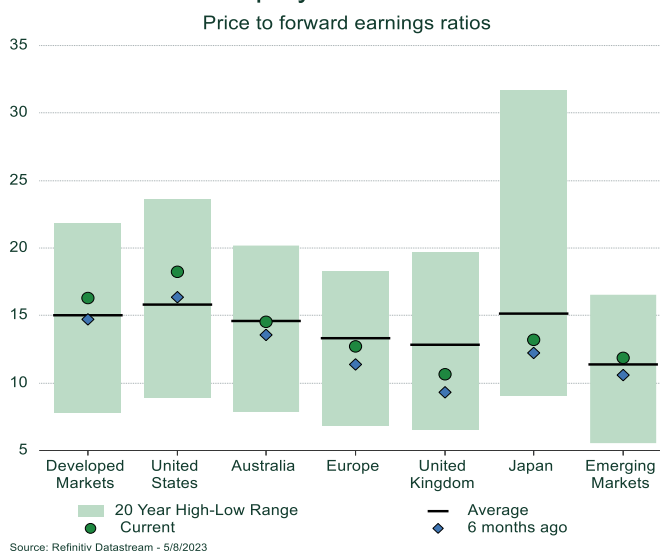
Global growth stocks (those companies with above average earnings growth) significantly outperformed value stocks (companies with shares that are cheaper than average) over the past three months given their earnings are mostly in future years and therefore they have greater sensitivity to longer term bond yields. Shares in these companies tend to also do better in an economic environment of slower economic growth when earnings growth is scarce, which was the experience in the pre-pandemic years. Many of these growth companies also have less cyclical profits and fatter earnings margins, less sensitive to rising interest rates, cost pressures and slower consumer spending.

Over the past three months, the best-performing global industry sector was the information technology sector and unsurprisingly financials were the worst-performing global industry sector given issues with US and European banks. Concerns around lower global growth also impacted commodity prices with both the energy and materials sectors showing negative returns over the three months.

MSCI World earnings per share forecasts



Equity valuations



In the United States, the S&P 500 Index returned 2.72% while the more technology-heavy NASDAQ Composite Index returned 5.8% reversing some of 2022's underperformance. With 65% of US companies having reported March quarter earnings, the results have been better than feared. 78% of companies reported better-than-expected earnings and a slightly lower percentage reported better-than-expected top line revenue. If the remaining companies to report track in line with expectations, it should mean that aggregate earnings for the quarter are roughly flat on the same period in 2022 instead of 7% lower which was the forecast at the start of reporting season. Interestingly it was consumer discretionary stocks that provided the largest

outperformance relative to expectations, which validates the theme that consumer spending has been resilient in the US and elsewhere.

In Europe, the STOXX 600 Index returned 4.33% led by solid performance of French and German stocks which have outperformed the US stock market over the past six months. European stocks have performed well on relief that Europe avoided a winter recession and the recovery in European exports due to China's post pandemic reopening and retail spending splurge. Of the companies that have reported quarterly earnings in Europe, around 70% have beaten analyst forecasts for both revenues and earnings. Companies in the utilities and financials sector provided the biggest outperformance relative to expectations as both sectors delivered results well ahead of forecasts despite the issues with Credit Suisse.

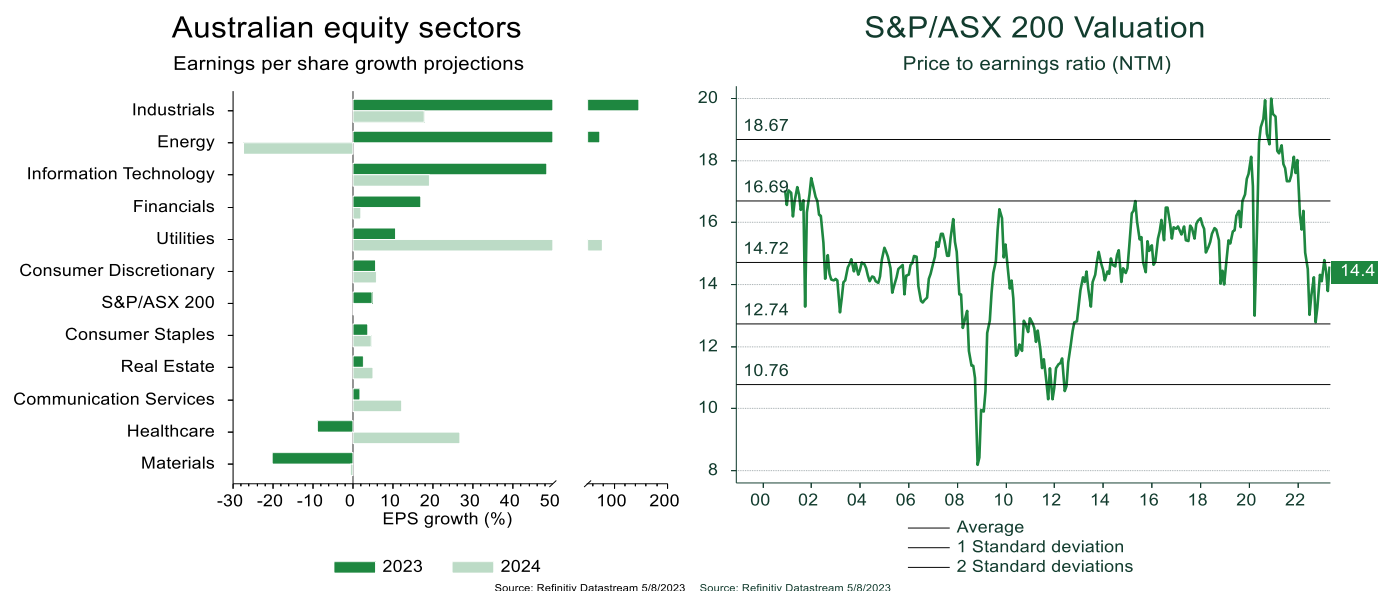
In Asia, Japanese equities measured by the Nikkei 225 Index returned 6.65% over the three months, while shares in Hong Kong lost 8.54% over the same period, based on the Hang Seng Index, as they retraced some of the strong gains seen following the end of lockdowns in China in late 2022. Singapore's stock market lost 1.44% over the three months as global trade in manufactured goods continued to weaken while mainland Chinese shares tracked by the Shanghai Composite Index generated a three-month return of 2.08%.

Given that valuations, fundamentals, and investor sentiment remain broadly neutral in respect of global shares, and we don't foresee a near term recession in the US or Europe, we recommend a neutral weight to global shares and are therefore removing the current underweight allocation to bring the exposure to global shares into line with that of Australian shares.

## Australian Shares

Australian equities, as measured by the S&P/ASX 200 Index, lost 0.80% over the three months to the end of April more or less in line with the weakness in global value stocks. The local market was held back by declines in the financials and materials sectors while communication services and information technology sector shares produced solid returns over the quarter similar to performance of global peers. Iron ore, oil and metals prices declined over the quarter as concerns about slowing global growth and the lack of major Chinese stimulus, to support the property and infrastructure sectors, impacted commodity prices. Despite Australian banks being well-capitalised, with little evidence of large-scale deposit withdrawals, Australian bank stocks were impacted by the global sell-off in bank shares and concerns around falling net interest margins as borrowers increasingly look to refinance to get a cheaper mortgage rate.

First half earnings reports in Australia were fairly lacklustre with only 38% of companies in the S&P/ASX 200 Index beating analyst expectations at the revenue line and 32% beating expectations at the profit line (while 49% of companies missed profit expectations) below the long run average in terms of the ratio of earnings beats to misses. Over the past three months, earnings forecasts for 2023 have remained fairly stable but analysts have trimmed 2024 earnings and now expect earnings to be marginally lower next year compared with this year.



Looking forward, the outlook for the financials and materials sector, which collectively account for more than 50% of the value of the S&P/ASX 200 Index, is for relatively flat earnings. Net interest margins in the banking sector may have peaked with headwinds from rising funding costs, competition for new loans and higher staff costs starting to offset the benefit that banks get in a rising interest rate environment when the difference between mortgage and deposit rates tends to widen. For the major miners in the materials sector, namely BHP and Rio Tinto, new home construction in China remains subdued and the Chinese government remains concerned about trying to improve housing affordability and reducing property market leverage and speculation, which is weighing on property development and construction activity and therefore demand for key construction commodities.

At a ratio of 14.4, Australian shares are trading slightly below their 20-year average price-to-earnings multiple of 14.7 based on expected earnings over the next 12 months. The expected dividend yield over the next year is 4.3% which is also around long-term average levels suggesting that the market is close to fair value. However, the earnings outlook and sensitivity of the Australian market's earnings to an economic slowdown suggests that a neutral weighting is appropriate at present.

## Strategic Asset Allocation (SAA) and Dynamic Asset Allocation (DAA) weights

Portfolio	Conservative		Moderate		Balanced		Growth		High Growth	
Asset Class	SAA	DAA	SAA	DAA	SAA	DAA	SAA	DAA	SAA	DAA
Defensive Assets	70	69	50	48	35	32	20	17	5	5
Cash	10	3	7	3	5	3	2	3	2	3
Australian Debt	30	26	22	18	15	11	9	4	2	2
Global Debt	30	27	21	16	15	12	9	4	1	0
Alternative Defensive	0	13	0	11	0	6	0	6	0	0
Growth Assets	30	31	50	52	65	68	80	83	95	95
Property & Real Assets	5	4	7	6	8	7	9	8	10	6
Alternative Growth	0	2	0	3	0	4	0	4	0	4
Australian Shares	15	15	25	25	32	32	39	39	45	45
Global Shares	10	10	18	18	25	25	32	32	40	40
Total	100	100	100	100	100	100	100	100	100	100

## Major financial markets

To 30 April 2023	Latest	1 Month	3 Month	Year-to-date	1 Year	3 Year	5 Year
Equities	Total returns including dividends in percentage, not annualised						
Australia - S&P/ASX 200	7309	1.9	-0.8	5.4	2.8	48.1	34.7
Japan - Nikkei 225	28856	2.9	6.7	11.7	10.0	57.1	43.3
US - S&P 500	4169	1.6	2.7	9.2	2.7	50.2	71.9
US - NASDAQ Composite	12227	0.1	5.8	17.1	0.0	40.8	81.0
UK - FTSE 100	7871	3.4	2.6	7.1	8.2	48.5	26.9
Europe - STOXX 600	467	2.6	4.3	11.4	7.0	49.7	41.2
Developed Markets - MSCI World	2206	1.7	2.7	9.4	3.7	48.4	56.8
Emerging Markets - MSCI EM	58880	2.2	3.8	3.8	-6.2	18.8	9.9
Government bond yields	Change in annual yield in percentage points						
Australia - 2 year	3.08	0.00	-0.09	-0.34	0.58	2.85	1.01
Australia - 10 year	3.39	0.08	-0.18	-0.66	0.21	2.48	0.61
US - 2 year	4.03	-0.01	-0.18	-0.37	1.33	3.84	1.54
US - 10 year	3.43	-0.05	-0.10	-0.40	0.54	2.80	0.49
UK - 10 year	3.72	0.23	0.38	0.05	1.81	3.49	2.30
Germany - 10 year	2.32	0.01	0.04	-0.24	1.38	2.91	1.76
Currencies and Commodities	Change in price						
Australian Dollar (US\$)	0.6609	-0.009	-0.044	-0.017	-0.050	0.006	-0.094
US Dollar Index	101.66	-0.85	-0.44	-1.86	-1.30	2.64	9.82
Gold (US\$/ounce)	1982.55	2.85	58.65	170.20	71.25	279.80	669.35
Iron Ore (US\$/tonne)	104.53	-21.28	-23.10	-12.03	-38.54	20.81	39.58
Crude oil (WTI, US\$/barrel)	76.75	1.08	-2.12	-3.48	-27.94	57.91	8.18

## **Nick Ryder**

Chief Investment Officer

Nick Ryder is an investment professional with deep and broad experience built over 30+ years in the investment management and financial services industries. Before joining Stanford Brown, Nick was a senior investment strategist at Commonwealth Bank, JBWere and NAB providing investment strategies to wealthy individuals, families and not-for-profit clients.

He is passionate about helping clients grow and preserve their wealth, ensuring they also have a strong understanding of how their money is being invested.



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