12 August 2017

Woodhall's Weekly

Ron Bewley PhD, FASSA

North Korea dominates news

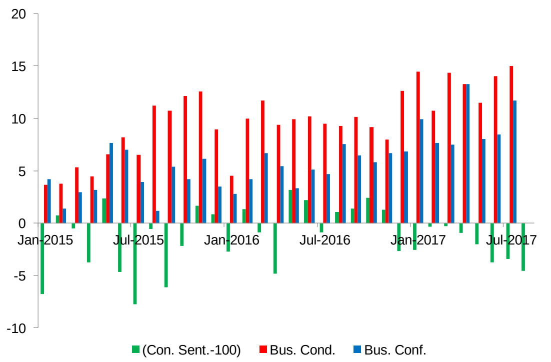
- **NAB Business sentiment indexes very strong**
- **Westpac Consumer confidence wallows**
- **US inflation misses**

Overview

Markets bounced around and the VIX climbed to 16 from 10 as North Korea flexed its muscles. It's far from clear where this stand-off is going. But it is doubtful if he markets will rally until there is some resolution.

The NAB and Westpac sentiment indexes came in during the week. As can be seen from the chart of the week, the Westpac consumer sentiment index is going nowhere – except possibly worse. On the other hand the NAB business indexes are doing well.

Chart of the Week: NAB and Westpac sentiment indexes



Source: Thomson Reuters Datastream

It is hard to fathom why business is so happy given the other data around. Governor Philip Lowe is strongly hinting the next move on rates is up.

But, having just spent a week in England, it is interesting to note that the same issues that face us in Australia are the key issues here. Energy prices are front and centre. And young people are bemoaning the cost of housing – just the same as in Sydney.

But one programme on the BBC was talking about Canterbury house prices being prohibitive. The interviewee's parents moved from London to Canterbury because of house prices a generation before. Now the interviewee has to move from Canterbury. And yet the RBA rate has no influence on Canterbury or London house prices!!!

US inflation came in at 0.1% against an expectation of 0.2%. This is not the stuff that can justify a rate hike!

This week also marked the 10th anniversary since PNB froze credit to some of its clients. Of course it was more than 12 months before world markets froze.

We're not hopeful for any rally next week but it does not seem to be a time to re-jig portfolios.

Woodhall Investment Research Pty Ltd. (ABN 17 141 486 160); www.woodhall.com.au

WoodHall Investment Research

Market expectations

Our start-of-year 2017 eoy forecasts for the ASX 200 are given in Table 1a (left column) together with the latest calculations (right column) and last week's (middle column) for comparison. Chart 1a includes a trace of the index to compare with the forecasts highs and lows. And we report the FY18 forecasts in Table 1b that were made June 30th 2018.

Table 1a: ASX 200 range forecasts 2017

Forecast	Forecast origin		
CY17	30-Dec-2016	4-Aug-2017	11-Aug-2017
Low	5,350	5,500	5,500
High	6,300	6,100	6,050
End	6,000	5,850	5,850
Fair value	5,600	5,800	5,800
Exuberance	1.5%	-1.4%	-1.9%
ASX 200	5,666	5,721	5,693

Table 1b: ASX 200 range forecasts FY2018

Forecast	Forecast origin		
FY '18	30-Jun-2017	4-Aug-2017	11-Aug-2017
Low	5,450	5,400	5,400
High	6,450	6,350	6,350
End	6,150	6,050	6,050
Fair value	5,850	5,800	5,800
Exuberance	-1.9%	-1.4%	-1.9%
ASX 200	5,722	5,721	5,693

Note: the latest forecasts in the right hand column do not provide updates of the original forecasts in the left column of numbers. Rather the latest forecasts facilitate an assessment of the degree to which the original forecasts are on track, or not. Moreover, exuberance is assumed to be eroded over a 12-month period and so the 'latest' forecasts are less reliable the closer is the current date to the end-of-year and the greater is any mispricing.

The eoy forecast for 2017 (left-hand column in Table 1a) was 6,000 with a forecast high of 6,300 and a forecast low under normal volatility of 5,350. The 'high-volatility' forecast low was 4,950. [See the IOZ:IVV:IHVV section for the decision rules surrounding these low and high forecasts.]

The updated eoy 2017 forecast (Table 1a, last column) is steady at 5,850. Fair value is steady at 5,800.

The eofy forecast for FY2018 in Table 1b is 6,150 with a high of 6,450 and a low, under normal volatility of 5,450. The low under high volatility is 5,000. Our updated FY18 forecast is steady at 6,050.

Our eoy 2017 – and our FY18 – forecasts for the S&P 500 are given in Tables 2a and 2b (FY 18 are not available until Saturday afternoon due to data drop delays). Because overnight data are not available to us until the afternoon, the latest data for Wall Street will usually be presented for the day before the ASX 200 in this *Weekly* that we try to publish at around 10am on a Saturday.

Chart 1a: Graphical representation of Table 1a

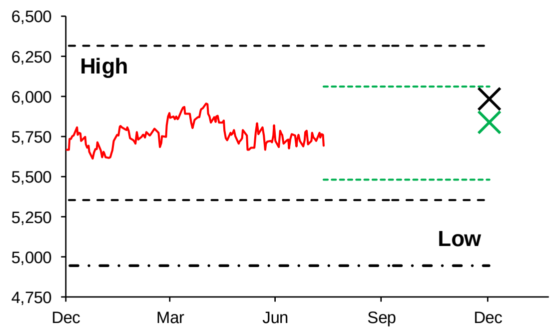
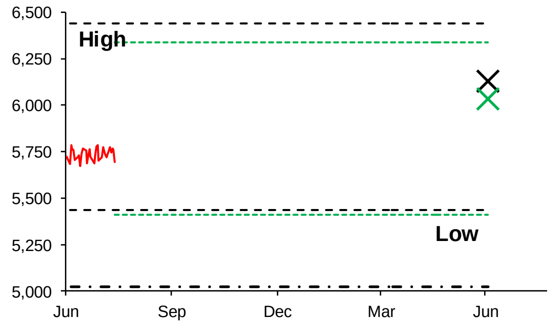


Chart 1b: Graphical representation of Table 1b



Note: the low and high are based on 'normal' volatility levels. The 'high-volatility' low allows for well above normal volatility and a breach of which starts to suggest the base-line forecasts may no longer be relevant. The dashed black lines are derived from average volatility assumptions; the dot-dash line corresponds to high volatility.

Our original forecast for eoy 2017 was 2,680 with a high of 2,750 and a low of 2,180. The 'high-volatility' low was 2,050.

The updated eoy forecast for the S&P 500 is 2,560. Fair value rose to 2,500.

Table 2a: S&P 500 range forecasts 2017

Forecast	Forecast origin		
CY17	30-Dec-2016	3-Aug-2017	10-Aug-2017
Low	2,180	2,390	2,370
High	2,750	2,660	2,640
End	2,680	2,580	2,560
Fair value	2,250	2,450	2,500
Exuberance	-1.2%	0.1%	-1.5%
S&P 500	2,239	2,472	2,438

Table 2b: S&P 500 range forecasts FY 2017

Forecast	Forecast origin		
FY '18	30-Jun-2017	3-Aug-2017	10-Aug-2017
Low	2,340	2,380	2,350
High	2,830	2,820	2,810
End	2,730	2,710	2,710
Fair value	2,450	2,450	2,500
Exuberance	-1.5%	0.1%	-1.5%
S&P 500	2,423	2,472	2,438

Note: the latest forecasts in the right hand column do not provide updates of the original forecasts in the left column of numbers.

Rather the latest forecasts facilitate an assessment of the degree to which the original forecasts are on track, or not. Moreover, exuberance is assumed to be eroded over a 12-month period and so the 'latest' forecasts are less reliable the closer is the current date to the end-of-year and the greater is any mispricing.

Chart 2a: Graphical representation of Table 2a

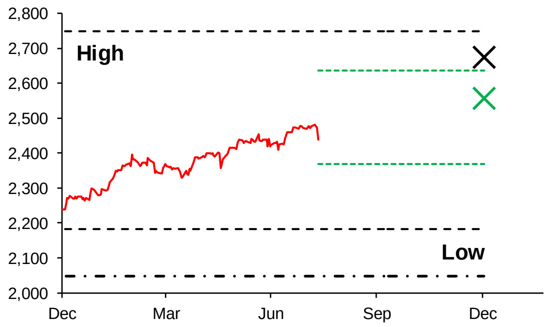
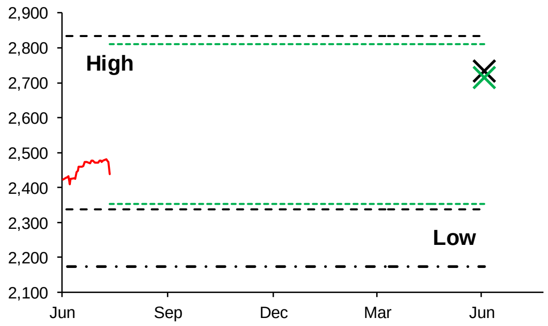


Chart 2b: Graphical representation of Table 2b



Note: the low and high are based on 'normal' volatility levels. The "high-volatility' low allows for well above normal volatility and a breach of which starts to suggest the base-line forecasts may no longer be relevant. The dashed black lines are derived from average volatility assumptions; the dot-dash line corresponds to high volatility.

The start of FY18 forecast for the S&P 500 is 2,730 with a high of 2,830 and/or a low (under normal volatility) of 2,340. The low under high volatility is 2,170. The updated eofy forecast is 2,710.

Market stats

Our market volatility index (Chart A-1 to be found in the Chart Appendix) is average at 12.9%. Our Fear Index (Chart A-2) is above the zone at 13.7%. The VIX stands at 15.5%, which is close to the historic low. Our Disorder index (Chart A-3) is below the zone at 0.6%. With market volatility average and fear a little high, more caution than normal should be exercised.

Our 12-month capital gains forecast (Chart A-4) is +4.7%. The market is under-priced -1.9% (Chart A-5). So that leaves the adjusted 12-month capital gains' forecast at +6.8%. The comparable 12-month adjusted capital gains forecast for the S&P 500 stands at about +13.0%.

Sector pricing (Chart A-6) is such that Materials (+2.7%) and Industrials (+0.2%) are the only over-priced sectors – so none are ready for a correction.

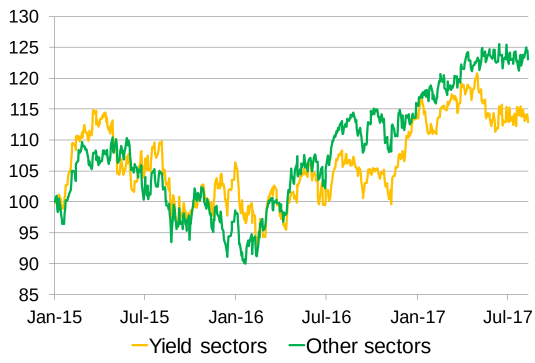
The yield play definitely waned during 2016 but there was a big comeback for a while. However, from Table 3, we note Yield is again getting back to underperforming across the boards.

Table 3: Yield play - total returns

	Sector		
Period	**Yield**	**Other**	**Difference**
1 year	6.2%	9.7%	-3.5%
6 months	-0.5%	4.2%	-4.7%
3 months	-2.6%	-0.6%	-2.0%
1 month	0.4%	0.6%	-0.3%

Chart 3 shows another interesting angle on the yield play. The yield sector lost relative to 'other' around the end of 2015 but the two lines got back together in February 2016 and broke free again at the end of June 2016. The bank tax effect is quite clear at the very end of the yellow line.

Chart 3: Total returns indexes for 'yield' and 'other' aggregated sectors

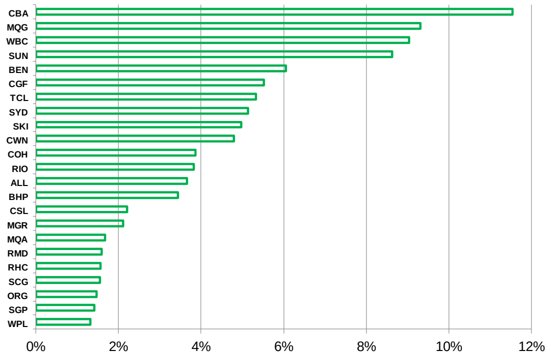


SMSF Share Portfolio

I last rebalanced my share portfolio in my SMSF on May 1st 2017. It is now 50% High Conviction and 50% High Yield by my definitions. I will keep my narrative on the rebalance in the section after the Chart Appendix until the next rebalance.

There are currently 23 stocks in my domestic direct equity portfolio. My current holdings are given in Chart 4.

Chart 4: Current holdings



The performance of my domestic equities in my SMSF portfolio – including various rebalances – against the ASX 200 since late June 2014 is shown in Table 4. That corresponds to an outperformance of +3.6% p.a. (annualised) since inception. After all of the turbulence of recent times the portfolio is still returning +8.8% p.a. over just more than three years.

Table 4: Total returns from SMSF (domestic equities)

Period	Portfolio	ASX 200	Alpha
Since inception	8.8%	6.2%	2.6%
3 years	8.0%	5.6%	2.4%
2 years	7.2%	7.6%	-0.4%
1 year	5.8%	7.9%	-2.2%
6 months	2.9%	2.8%	0.1%
3 months	-2.1%	-1.7%	-0.4%

Note: Since June 25th 2014. Returns include dividends. For periods above one year, the returns are annualised.

In Table 5, I show the performance (including dividends) of the individual stocks since the last rebalance.

Table 5: Individual stock total returns

	ALL	BEN	BHP	CBA	CGF	COH	CSL	CWN
Return	2.5%	-9.5%	7.9%	-8.0%	-3.2%	0.3%	-4.6%	-7.2%
Alpha	6.0%	-6.0%	11.4%	-4.5%	0.2%	3.8%	-1.1%	-3.7%

		MGR	MQA	MQG	ORG	RHC	RIO	RMD
Return		-4.8%	2.2%	-6.8%	-2.7%	2.7%	7.0%	0.9%
Alpha		-1.3%	5.7%	-3.3%	0.8%	6.2%	10.5%	4.4%

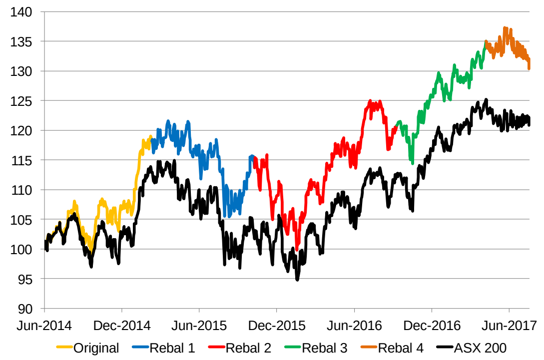
	SCG	SGP	SKI	SUN	SYD	TCL	WBC	WPL
Return	-6.4%	-11.5%	-2.4%	-4.2%	-2.1%	-5.0%	-8.9%	-9.0%
Alpha	-2.9%	-8.0%	1.1%	-0.7%	1.4%	-1.5%	-5.4%	-5.6%

Note: Since May 1st 2017. Returns include dividends.

We have two stocks beating the index by more than 10% since May 1 and none trailing by more than -10%.

The returns chart (Chart 5) shows the recent performance as well as the trend gains. The period from sometime in November 2015 to sometime in February 2016 was so far the worst for the SMSF. That's when the yield play took a big hit and the portfolio was 100% High Yield.

Chart 5: SMSF and ASX 200 total returns



Note: the different coloured sections show the impact of rebalancing.

Table 6 shows the gap between broker forecasts for one year hence (Target) and current price. A negative value for T/P - 1 expressed as a percentage change therefore indicates brokers on average think the stock is overpriced.

Table 6: Price and current broker forecasts

Sector	Stock	Price	Target	Rec	T/P - 1
Energy	ORIGIN ENERGY (EX BORAL)	6.88	7.65	2.50	11.2%
	WOODSIDE PETROLEUM	29.02	24.23	2.93	-16.5%
Materials	BHP BILLITON	25.55	21.70	2.47	-15.1%
	RIO TINTO	63.18	58.08	2.18	-8.1%
Industrials	MACQUARIE ATLAS ROADS	5.64	5.82	2.75	3.1%
	SYDNEY AIRPORT	6.73	7.21	2.83	7.1%
	TRANSURBAN GROUP	11.62	12.23	2.58	5.2%
Discretionary	ARISTOCRAT LEISURE	20.45	24.00	2.11	17.4%
	CROWN RESORTS	11.50	12.46	2.80	8.3%
Health	COCHLEAR	140.17	129.69	3.18	-7.5%
	CSL	126.26	109.17	2.27	-13.5%
	RAMSAY HEALTH CARE	72.28	77.55	2.30	7.3%
	RESMED CDI.	9.25	8.03	2.55	-13.2%
Financials	BENDIGO & ADELAIDE BANK	11.26	11.25	3.42	-0.1%
	CHALLENGER	12.86	13.15	2.50	2.3%
	COMMONWEALTH BK.OF AUS.	80.50	83.65	3.33	3.9%
	MACQUARIE GROUP	86.36	99.16	2.50	14.8%
	SUNCORP GROUP	13.42	14.41	2.71	7.3%
	WESTPAC BANKING	31.61	34.00	2.33	7.6%
Property	MIRVAC GROUP	2.17	2.34	2.33	7.8%
	SCENTRE GROUP	4.00	4.50	2.58	12.4%
	STOCKLAND	4.26	4.80	2.61	12.7%
	SPARK INFRASTRUCTURE GP.	2.47	2.55	2.60	3.2%

Note: T/P -1 is the broker target price divided by the current share price minus one giving an indication where the price might move to over the coming 12 months.

There are only three stocks with a recommendation at 3.0 or worse: BEN, CBA, and COH. None of these were recommended by our algorithm. These stocks are "Captain's picks" that have served me well over the years. I also held onto them to reduce churn in the last rebalance.

The IOZ:IVV:IHVV Update

Decision rules: *given the data in Tables 1 and 2, I use the following decision rules – until new rules are formed, expected to be January 1 2018. These rules are based on calendar year forecasts:*

Buy IOZ at 5,350 from Table 1a (up to maximum levels determined by risk assessments) and start to sell at 6,300 for new investments. If the ASX 200 falls to 4,950 (high-volatility low) it might be prudent to exit the strategy until clarity emerges and then buy back in at (well) above 4,950 but below 5,350.

Buy IVV:IHVV at 2,180 (up to maximum levels determined by risk assessments from Table 2a) and sell at 2,750 for new investments. If the S&P 500 falls to 2,050 (high-volatility low) it might be prudent to exit the strategy until clarity emerges and then buy back in at (well) above 2,050 but below 2,180.

For older investments, some regard is taken of the trigger points set when the investments were made.

The difference between the price index for the ASX 200 in Chart 7 and the IOZ accumulation index in Chart 11 is more than stunning.

Charts 7 to 10 are based on the price indexes as this is the metric where the signals are being made.

The strategy has been returning +10.8% p.a. since inception (Table 7) (including dividends). The IVV-IHVV leg is up +12.7% p.a.. The IOZ part of the strategy is up +8.9% p.a.. The table below shows that I am 65% hedged in the Wall Street component. The domestic share of the portfolio is 48%.

Table 7: Total returns on IOZ:IVV strategy

11-Aug-2017	Inc divs.	Current allocation	
ETF	IRR pa	Total	USA
IOZ	8.9%	48%	
IVV+IHVV	12.7%	52%	100%
IVV	9.9%		36%
IHVV	16.8%		64%
Total	10.8%	100%	
Indexes		Alpha pa	
ASX 200	6.4%	2.6%	
S&P 500	9.3%	0.6%	
S&P 500 ($A)	10.1%	6.7%	

NB: IRR is the internal rate of return (p.a.) that compensates for the different buy and sell points and include dividends on the day they were paid and not the ex-div date. See notes in the Strategy Section for further explanation and charts. The index returns are based on a start date of 1/7/2014 for the ASX 200 and S&P 500 when the strategy was launched. The S&P 500 ($A) return starts from 22/12/2014 when IHVV first became available.

I have also included the benchmarks for each ETF in Table 7 so I can calculate any outperformance from the buying low – selling high strategy. Annualised outperformance is eroded in the long-run to zero unless fresh buys are made or a sell signal arrives.

The Charts 6 to 10 in the strategy section now include a yellow square to show where the hedging trades were made. The red diamonds denote the buys. I have also included a currency chart to show where the hedging trades were made in that metric.

The AUD has fluctuated in a range of about 72c – 80c since I started hedging at 76.0c in late February 2016. Because the $A fell from 78c to 72c before retracing to 80c, a fleet-of-foot trader might have performed better than my sit and wait philosophy. I don't have the energy or the predictive ability!

There is nothing in recent behaviour to suggest to me that the underlying forecasts for the ASX 200 or the S&P 500 have been proven to be invalid. I plan to flag any perceived weaknesses if and as they eventuate. I can't define a composite benchmark as the allocations are expected to evolve over time. But all three components are well ahead!

The IOZ:IVV:IHVV Strategy

(Except for the charts, this section does not usually change week to week)

I plan to use the Table in the 'IOZ:IVV:IHVV Update' section to keep readers informed about the performance of my geared portfolio [an approximate equal mix of two ETFs: IOZ for the ASX 200 and IVV:IHVV for a partially hedged exposure to the S&P 500]. I will await the sell signals in times to come.

The basis of the strategy is to buy when the indexes (using ETFs) get very close to or cross the beginning of the year predicted low – and to sell when the indexes reach the predicted highs – as indicated in the 'Market Expectations' section. I do not use the weekly updated lows and highs for this purpose. These update statistics help me consider whether or not the strategy is going awry.

Since the IVV ETF is unhedged it benefits from $A depreciations and vice versa. I switch to IHVV – the hedged version of the S&P 500 ETF – when I think the currency is more likely to appreciate – or at least insure against it. When I am unsure, I blend IVV and IHVV.

Note that the irr is a single annualised return to summarise all of the buys of the three ETFs and the current value including dividends when paid and not when the ETF went ex-div..

The following charts show where I bought. Since the 'buy' signals are based on the S&P 500 (as I do not have credible exchange rate predictions – hence an implicit no-change assumption) I show both the S&P 500 expressed in $US (unhedged) and $A (hedged).

Chart 6: IOZ buy points - ASX 200

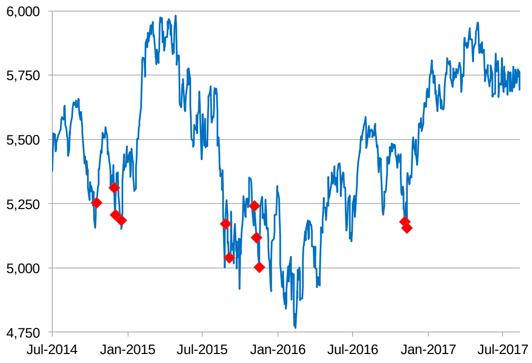


Chart 7: Buys - S&P 500 ($US; i.e. unhedged)

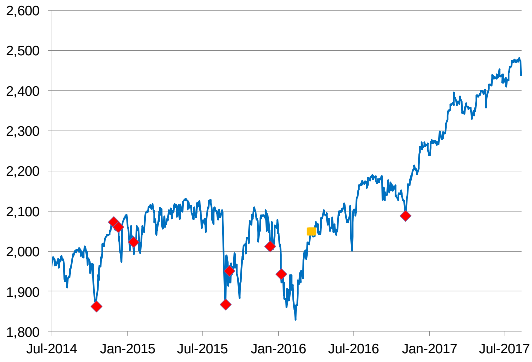


Chart 8: Buys S&P 500 ($A; i.e. hedged)

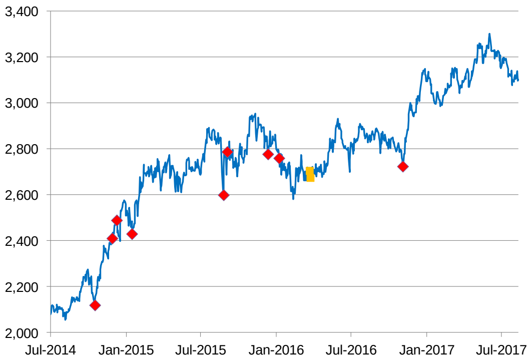


Chart 9: AUD hedging points

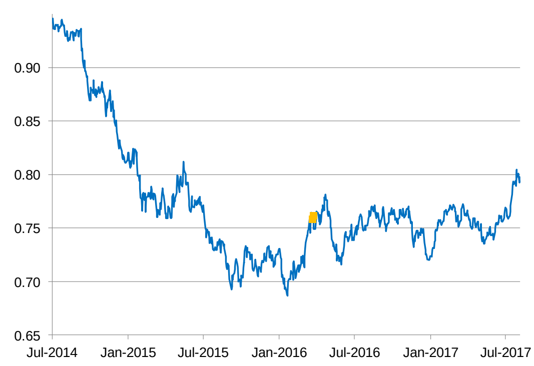
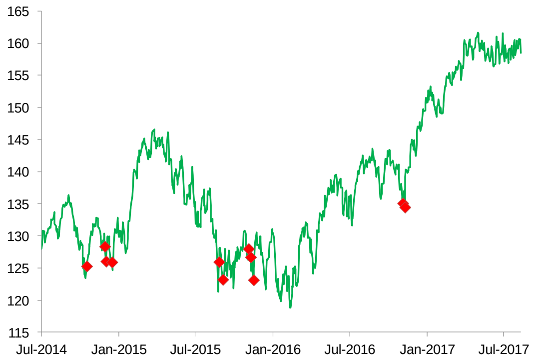


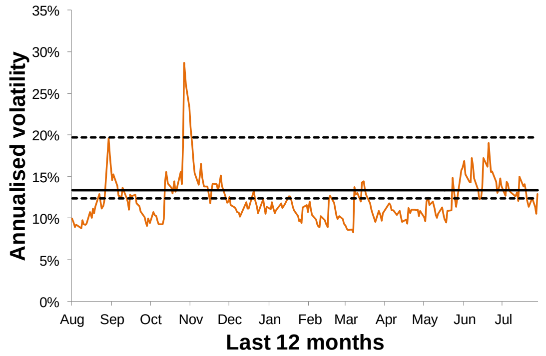
Chart 10: IOZ buys – IOZ accumulation index



The charts in this strategy section include a yellow square to show where the hedging trades were made. The red diamonds are the buys. There is also a chart to show where the hedging trades were made in the AUD metric. The dots in Charts 9 and 10 refer to either IVVV or IHVV or both. Hedging or not refers only to the underlying index.

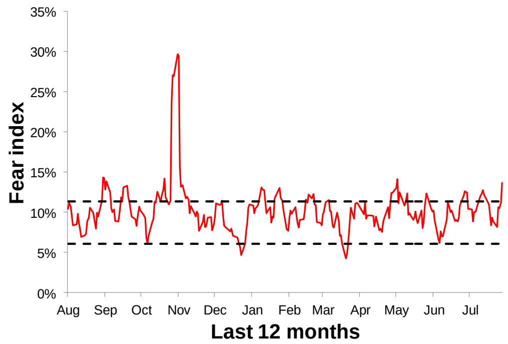
Chart Appendix

Chart A-1: Market volatility



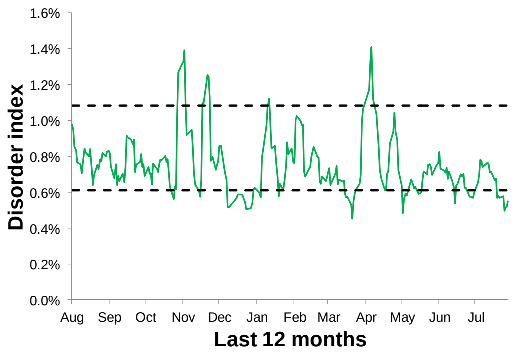
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index volatility.

Chart A-2: Fear index



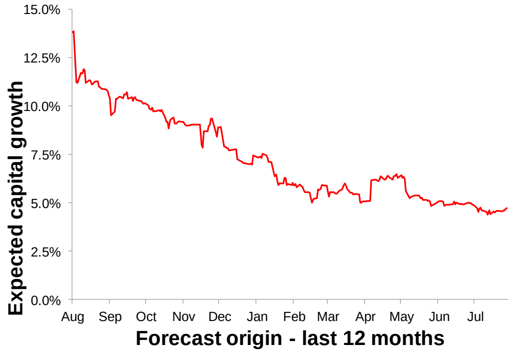
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended periods, or extreme values, of the index above the higher dotted line might indicate a propensity for the market to overreact in an irrational manner.

Chart A-3: Disorder index



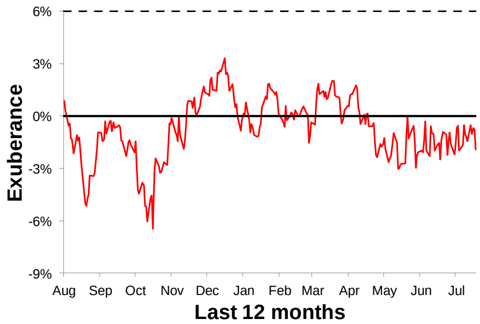
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little information to have different impacts on different sectors. Extended periods, or extreme values, of the index above the higher dotted line might indicate investors and traders are lurching from sector to sector in search of a new trend.

Chart A-4: 12-month capital gains forecasts



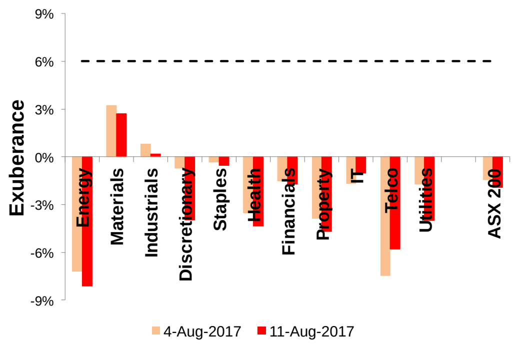
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart A-5: Market exuberance



Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10% - or for the market to move sideways for an extended period.

Chart A-6: Sector exuberance



Notes: The estimates in this chart are based on the same notions as for Chart A-5. More detailed information on mispricing is contained in our companion weekly publication in the same section of our website

Glossary

Abenomics – Japan's Prime Minister Shinzo Abe came to power early in 2013 and has brought a new economic style to managing that economy.

ASX forecasts - We have further supplemented our forecasting process for the ASX 200 by including not just a forecast of the peak (at some unspecified time during the year) but also the low. Thus, we now have an end point (e-o-y forecast) and a range for the whole year. Naturally, on a rising market the low is more likely to occur earlier in the year and the high nearer the end. Since we publish our forecasts to the nearest 50 points to reduce the sense of false accuracy a change of just a couple of points can kick the forecast over by 50 points at around the 25 and 75 marks.

Australian debt ceiling – Labor brought in a debt ceiling in mid 2008 of $75bn to self-impose some fiscal discipline during the onset of the GFC. Within seven months that ceiling was almost trebled to $200bn and it has since been raised to $300bn during Labor's term in office. Since before 2008 we had no debt ceiling that is equivalent to an infinite ceiling!!!

Bad debt, good debt – Whether one is referring a household or national debt, the classification implies the following. Good debt is expected to produce income or other returns in the future – such as from infrastructure spending or buying a principal place of residence. Bad debt is used to finance 'recurrent' expenditure such as pensions or family holidays.

Black Friday – This term is used for the Friday after Thanksgiving in the US to denote the start of the shopping season for the holidays. Black refers to the accounts going back into the black from increased sales – it is certainly not a negative term!

Brexit – on 23rd July 2016 Britain voted to leave the European Union. The process is expected to take at least two years and negotiations must take place to engineer a smooth transition.

CAIXIN (formerly HSBC) flash PMI – CAIXIN publishes an alternative to the official PMI for China. It is based on a survey of predominantly small to medium sized firms – unlike the official version. The number on the 1st of the month gets much less attention than the official but the preliminary, or 'flash', reading gets attention as a read a week or two before the official numbers.

China's shadow banking – In essence, the China government dictates what all banks must lend at and pay for deposits. As a result, if a potential borrower is deemed too risky at the prevailing rate, the banks refuse to lend (rather than increase borrowing rates as may happen here). The 'failed' borrower may then seek funding from the shadow banking system that is not so regulated.

FOMC – The Federal Open Market Committee determines monetary policy in the United States. It can be thought of as being similar to our Reserve Bank board.

GOP – stands for Grand Old Party which is an alternative name for the US Republican Party.

High-Yield Sectors: by this, we mean Financials, Property, Telcos and Utilities.

International Monetary Fund (IMF) – Managing Director, Christine Lagarde (French), since 28th June 2011. The IMF is charged with fostering global monetary cooperation.

ISM - Institute of Supply Management produces a 'PMI-like' number for the US economy. Like the PMI, 50 is the cut off between improving and worsening expectations.

Long-run mispricing – Our measure is based on analysing trends over more than a century of data. The average period of over- or under-pricing is about 18 months. That is, we do not expect the market to rapidly approach its fair value.

MYEFO (Mid-year economic and fiscal outcome) is a mid-year update on the Australian Budget situation – usually in December.

PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The official statistics are published in the first few days of each month – with China on the 1st. A reading less than 50 means the sector is decreasing in its growth rate – so If China growth slows from 8% to 7%, its PMI should be below 50. If the US speeds up from 2% to 2.5%, its PMI should be above 50. Note also the existence of the CAIXIN measure and its 'flash' or preliminary estimate.

Savings ratio – In Australia, the ratio of net savings to household disposable income defines the savings ratio.

Short-run mispricing – Our exuberance measure is our mispricing statistic reported in Chart 5. It is based on 12-month-ahead forecasts of the ASX 200. Please see the notes under Chart 5.

Tapering – It was the name given to the exit strategy from QE3. It is not a tightening monetary policy – just an increasingly less accommodative stimulus.

US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong. Of course less new jobs are needed when the economy is running at full employment.

Key people

Australia – Prime Minister, Malcolm Turnbull, (Liberal) since 14th September 2015; Treasurer, Scott Morrison, since 21st September 2015; Governor of the Reserve Bank of Australia (**RBA**), Dr Philip Lowe, since 18th September 2016.

China – President Prime Minister, Xi Jinping, since 14th November 2013; Premier, Li Keqiang since 15th March 2013; President of the People's Bank of China (**POBC**) since December 2002.

Europe – President of the European Central Bank (**ECB**), Mario Draghi (Italian), since 1st November 2011; Chancellor of Germany, Dr Angela Merkel, since 22nd November 2005; President of France, Emmanuel Macron, from May 2017; Prime Minister of Greece, Alexis Tsipras, since 21st September 2015.

Japan – Prime Minister, Shinzo Abe, since 26th December 2012; Emperor, Akihito, enthroned 12th November 1990; Governor of the Bank of Japan (**BoJ**), Haruhiko Kuroda, since 20th March 2013.

New Zealand – Prime Minister and Treasurer, Bill English, since 12th December 2016; Minster of Finance, Steven Joyce, since 20th December 2016; Governor of the Reserve Bank of New Zealand (**RBNZ**), Graeme Wheeler, since 26th September 2012.

United Kingdom – Prime Minister, Theresa May, since 11th July 2016; Chancellor of the Exchequer, Philip Hammond, since 13th July 2016; Governor of the Bank of England (**BoE**), Mark Carney (Canadian), since 1st July 2013.

United States of America – President, Donald Trump, from January 20th 2017 (4 year term); Chair of the Federal Reserve Bank (**Fed**), Dr Janet Yellen, since 3rd April 2014 (4 year term).

May 1st 2017 Rebalance

I was discharged from hospital after 17 nights as an inpatient just after the eom close for April 2017! Over that weekend I updated all our models, thought and planned a rebalancing strategy. I found the new generated portfolio compelling.

So on May 1 (despite it being the day for communists around the world have their May Day Parades) I sold 10 stocks and bought 15 on a bit above one-third of my portfolio. I decided to move into a 50:50 Conviction:Yield portfolio from a 100% Conviction (which was 100% Yield until the October 2016 rebalance).

Under many circumstances it could have been a simple roll-over from the old to the new but I wanted to keep down churn while holdings on to three favourites: BEN, CBA and COH.

The following table shows what a 'disciplined' investor' might have done.

Table of recommended buys and sells

21	100.00%		-48.79%	24	100.00%		51.21%	7.29%	41.50%	12.36%	-5.09%
Code	Holding	Sector	Sell All	Code	Desired	Sector	Holding	Change	Buy All	Buy more	Sell some
AGL	4.31%	Utilities	-4.31%	WPL	1.45%	Energy			1.45%		
AMC	4.27%	Materials	-4.27%	ORG	1.53%	Energy			1.53%		
BEN	6.60%	Financials	-6.60%	BHP	3.19%	Materials	3.90%	-0.71%			-0.71%
BHP	3.90%	Materials		RIO	3.64%	Materials	4.81%	-1.17%			-1.17%
CBA	9.61%	Financials	-9.61%	TCL	5.58%	Industrials	3.89%	1.69%		1.69%	
CGF	8.39%	Financials		SYD	5.25%	Industrials	3.68%	1.58%		1.58%	
COH	3.85%	Health	-3.85%	MQA	1.58%	Industrials			1.58%		
CSL	2.32%	Health		ALL	3.51%	Discretionary			3.51%		
GMG	3.08%	Property	-3.08%	CWN	5.20%	Discretionary			5.20%		
IPL	6.12%	Materials	-6.12%	CSL	1.84%	Health	2.32%	-0.48%			-0.48%
JBH	3.63%	Discretionary	-3.63%	RMD	1.59%	Health	1.57%	0.02%			
MQG	7.38%	Financials		RHC	1.75%	Health	1.55%	0.20%		0.20%	
RHC	1.55%	Health		WBC	10.00%	Financials	6.71%	3.29%		3.29%	
RIO	4.81%	Materials		MQG	10.00%	Financials	7.38%	2.62%		2.62%	
RMD	1.57%	Health		SUN	10.00%	Financials	7.02%	2.98%		2.98%	
STO	5.39%	Energy	-5.39%	CGF	5.66%	Financials	8.39%	-2.73%			-2.73%
SUN	7.02%	Financials		BOQ	10.00%	Financials			10.00%		
SYD	3.68%	Industrials		AMP	5.08%	Financials			5.08%		
TCL	3.89%	Industrials		MGR	2.20%	Property			2.20%		
TPM	1.93%	Telco	-1.93%	SGP	1.61%	Property			1.61%		
WBC	6.71%	Financials		SCG	1.66%	Property			1.66%		
				VOC	2.56%	Telco			2.56%		
				DUE	2.39%	Utilities			2.39%		
				SKI	2.72%	Utilities			2.72%		

But I was caught out before by VOC; I don't like AMP and I prefer BEN over BOQ. So I kept all of my BEN, CBA and COH. I steered clear of VOC and AMP and I reduced my additional SUN to make the rebalance work.

Regulars might recall I kept hold of JBH last October instead of ALL. That turned out to have been a big mistake – so I didn't repeat it. At least I took profits on JBH mid-rebalance. I also didn't make a small CSL/RHC switch this time around.

A couple of days later – I did all of my trades on the Monday – VOC fell through the floor yet again. All was looking good until the Budget tax on banks came through but, all in all, I feel confident about the newly constituted portfolio.

The October 2016 rebalance

After thinking about it for six months, I finally started the process of rebalancing on Monday, October 3rd – one month short of a year since the previous rebalance.

With the Monday being a holiday in NSW, I was particularly surprised by the strength of the market. I decided to do most of the 'sells' that afternoon and leave the buys to another day. In the table below, I show the new Conviction portfolio I had produced over the long weekend in my regular monthly update. The right panel shows my September 30th portfolio and weights.

Table: The rebalancing proposition

Conviction portfolio		Old portfolio	
Code	share	Code	share
AGL	3.50%	AGL	1.59%
ALL	7.24%	AMC	2.05%
AMC	4.66%	AMP	4.10%
BHP	4.25%	AZJ	3.82%
BOQ	6.49%	BEN	4.42%
BXB	3.13%	BHP	1.68%
CGF	7.28%	COH	3.47%
CSL	3.04%	CSL	1.67%
GMG	3.16%	DUE	2.00%
IPL	5.14%	GMG	1.36%
MQG	7.50%	IFL	4.50%
ORG	2.89%	JBH	5.78%
RHC	3.34%	MGR	2.60%
RIO	4.70%	MQG	8.78%
RMD	3.60%	PRY	3.24%
SUN	6.86%	RHC	1.53%
SYD	3.42%	RIO	1.77%
TCL	3.37%	RMD	1.30%
VOC	6.93%	SGP	2.37%
WBC	6.77%	SPO	1.83%
WPL	2.74%	STO	3.64%
		SUN	5.51%
		SYD	4.83%
		TCL	4.64%
		TLS	4.17%
		TPM	2.53%
		TTS	2.42%
		VCX	2.26%
		WBC	10.12%

I had a number of particular considerations to take into account. My old portfolio was a 50:50 blend of my Conviction and Hybrid Yield November 2015 portfolios. Since I decided to go 100% conviction this time around, there was going to be a lot of selling. I also wanted to hold about 20% cash – most unusual for me.

Part of the reason for holding cash was to have a buffer going into the US Presidential elections next month – and part was because I want to invest in my High Octane portfolio. Since I have never invested in an octane portfolio before, I wanted a breather first. Octane – to me – requires quite a few stocks and an emphasis on market timing. More of that next week!

If I did not have a legacy portfolio, I possibly would have just bought the one in the left panel of the table. I chose to modify it because I have come to learn quite a bit about my existing stocks – so I made some substitutions – and it reduced transaction costs and effort.

I had already placed a request to sell all of my TLS in the buy-back offer. That transaction will not be completed until Tuesday 11th October. Since I do not yet know how many stocks they will buy, nor for how much, I decided to assume all will be sold and the proceeds will be added to the 20% cash – and I'll sort it all out later. I also am in the hunt for some extra JBH following their capital raising that hasn't yet arrived.

I chose not to substitute ALL for JBH in my Discretionary holding as the conviction portfolio dictates. I got attached to JBH. Also ALL (gambling) always worries me because of the chance of changes to regulation – and I vividly remember when the stock plunged over 10 years ago when it lost just one big contract in South American.

While I am in stocks for the long-haul, it will take some time to assess whether it was a wise move not to switch. In the first week (from Sep 30th to Oct 7th) ALL was up +4.2% against -0.1% for JBH. Not enough to sting (too much) – but I can always change my mind later! I think it is fine to rebalance just one stock in such circumstances. ALL does have a very strong recommendation at 2.0 – but that doesn't allow for my perception of its risk.

I also chose not to substitute BOQ for BEN. Both are regional banks but I am also holding the Queensland-based SUN. A little 'regional' diversification! In the first week, BOQ was down -2.8% after a moderate report while BEN was up +2.2%. I'm happy with that and it cancels the ALL:JBH play. Moreover, BEN is about to offer a share purchase plan that might be attractive.

I refuse to sell my COH! I have done so well backing that one for years when it was very unloved by brokers. I bought several times under $60 and sold most above $80. With current prices over $140, this last parcel is 'for the manager'. This meant I did not add to CSL, RHC and RMD as my model portfolio recommended. In the first week, COH was up +0.5% while the other three Health stocks are mixed: CSL (-0.6%), RHC (+1.1%) and RMD (+0.8%). Not much in it overall.

I also held on to STO. It is a bit of a risky stock but I like its chances against ORG and WPL. So no substitution there either. In the first week, STO was up +8.0% while the others were up a little less: ORG (+3.7%) and WPL (+4.3%). Got lucky there!

My final substitution was in the Telco space. My TLS will be sold soon – if only partially – and VOC was the putative substitute. TPM and VOC both took hammerings in recent times. I think the TPM fall was over-done on what didn't seem like a bad report. Therefore, I kept TPM and bought enough VOC to fill the Telco void once TLS has gone. That's about 50:50 TPM:VOC. When in doubt diversify more! VOC fell -10.0% while TPM fell -5.8%.

So, on Monday's rising tide I sold all of my holdings in AMP, DUE, IFL, PRY, SPO, TTS, VCX and the overweight part of MQG, SYD, TCL and WBC.

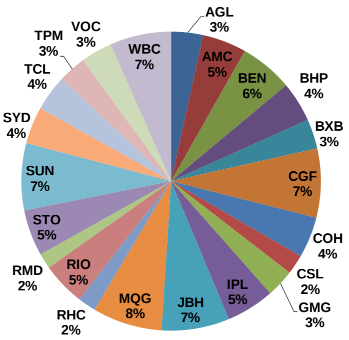
On Tuesday, the market fell so I bought all of my BXB, CGF, IPL and VOC. I topped up AGL, AMC, BHP, GMG, and RIO. I sold AZJ, MGR and SGP. That's 23 trades in two sessions!

I chose not to make some other trades as brokerage does not make small transactions economical – and the paperwork for tax records gets unnecessarily burdensome. I also took capital gains' calculations into account in a similar fashion.

Since I don't transact at closing prices, I wanted to evaluate my performance in making these transactions. As it happens, I sold 58% more than I bought – to generate my cash holding. The sells by the end of the week fell -0.8% while the 'buys' have fallen -0.3%. Not much in it – just a little bit ahead!

The new composition of my portfolio without the cash and TLS at the close on October 7th 2016 is in the following pie chart.

Chart: New portfolio after rebalance



The changes in sector weights are shown in the table below. The biggest change is the increase in exposure to Materials which was offset by falls in Industrials, Financials and Property. Although the percentage point increase in Utilities is small, it does represent a doubling of the exposure.

Table: Sector weights at October 7th 2016

Sector	New	Old	Change
Energy	5.0%	3.6%	1.3%
Materials	22.2%	9.3%	12.9%
Industrials	7.9%	11.3%	-3.4%
Discretionary	7.3%	8.2%	-0.9%
Health	10.1%	11.2%	-1.1%
Financials	34.6%	37.4%	-2.8%
Property	3.0%	10.6%	-7.6%
Telco	6.4%	6.4%	0.0%
Utilities	3.4%	1.6%	1.8%