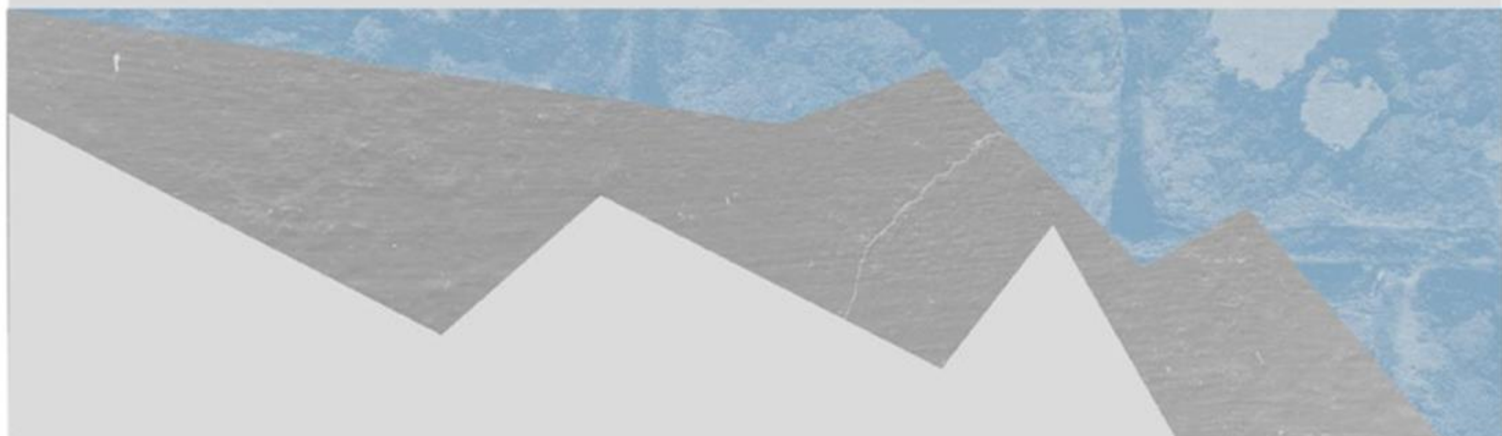
Cuffelinks
Showcase 2016



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Contents

1. **Superannuation** p. 5

2. **Retirement** p. 15

3. **SMSF management** p. 28

4. **LICs and ETFs** p. 39

5. **Portfolio construction** p. 47

6. **Equities investing** p. 59

7. **Property investing** p. 74

8. **Fixed interest investing** p. 86

9. **Other good stuff** p. 93

Foreword

Chris Cuffe, December 2016

Welcome to the Cuffelinks Showcase 2016, a free ebook exclusively for subscribers.

While many years pass without long-term historical significance, 2016 will always be remembered for Brexit and the election of Donald Trump. We do not know the consequences for investment markets, but as with the experiment of Quantitative Easing and record low interest rates, they add to the complexity and uncertainty of investment decisions.

It makes the need for independent and informed expert opinions even more important as investors plan their retirement savings knowing we are living longer than ever amid tight budget constraints.

Our team has reviewed the Cuffelinks archive of hundreds of articles published in 2016. This selection focusses on enduring insights that stand the test of time, rather than articles discussing markets or regulations which subsequent events may have superseded. Since Cuffelinks started in February 2013, over 300 market professionals have written articles for us.

My thanks for being part of the Cuffelinks community, now reaching 17,000 subscribers to the weekly newsletter and 30,000 regular visitors to the website. We recently exceeded two million pageviews of our website. We know from our Reader Surveys that we have a highly engaged readership from diverse backgrounds.

Thanks also to our prestigious group of corporate sponsors, whose commitment to financial education and knowledge allows Cuffelinks to remain free for its readers while our range of services continues to expand.

We will continue to inform your investing and planning decisions in 2017.

Chris Cuffe

The previous editions of the Cuffelinks Showcase for 2014 and 2015 are available on our website.

Cuffelinks has published over 1,200 articles on a vast range of subjects. To research our archive on investing, superannuation, demographics and hundreds of other topics, use the 'Search index' box on: www.cuffelinks.com.au

1. Superannuation

Morrison delivers a Costello supersize opportunity – Graham Hand

How SMSFs should plan for $1.6m pension cap – Doug McBirnie

Five questions after Super Scott's Santa surprise – Diana Chan and Jonathan Hoyle

My 'purpose of super' is probably not yours – Graham Hand

Morrison delivers a Costello supersize opportunity

by Graham Hand on 22 September 2016

Despite the intention to wind back the generosity of superannuation for large balances, Treasurer Scott Morrison has left open a wide window of opportunity to park money in this tax-advantaged system. Couples have a final chance to place up to $1.15 million into super in the next nine months, even if they are already each over the $1.6 million cap. Such a window might never open again.

The acclaim for the compromise on the super changes announced last week has been widespread. *The Australian* called it "Turnbull's super week", while *The Australian Financial Review's* headline went as far as saying, "Morrison wins over everyone", adding that the change was, "welcome across the industry as a fair and sensible compromise". Such praise means votes in politics, and veteran journalist Paul Kelly, *The Australian's* Editor-At-Large, wrote:

"Finally, on superannuation Morrison and Financial Services Minister Kelly O'Dwyer have achieved an astute, multifaceted compromise. They have won industry backing and party room endorsement, removed the main retrospectivity peg, replaced the $500,000 lifetime cap on after-tax contributions with a $100,000 annual cap, won the budget savings and set up a negotiation with the parliament that will see the super package become law."

Apparently everyone's a winner.

What about the lost personal income tax?

Wait a minute. Wasn't the reason for the proposed change to stop superannuation becoming a store for the wealthy? And to fulfil the objective of providing an income in retirement, not intergenerational wealth transfer? And to stop the drain on revenue from assets being placed in a tax-favoured structure?

The removal of the retrospective elements and limitations of the proposed $500,000 non-concessional contribution (NCC) cap is welcome. However, it's surprising that a couple under the age of 65 (who have not already triggered the bring-forward) can now put over a million dollars (two lots of $540,000) into super as an NCC by 30 June 2017. Adding a last stab of up to $70,000 in pre-tax concessionals gives $1.15 million, a supersized top up for anyone with access to enough money.

Sure, each person will have a limit of $1.6 million in pension mode where the income remains tax-free, but the balance will be taxed at 15% in an accumulation account. With franking, the average tax rate paid in superannuation outside pensions is about 9%, and higher-earning assets can remain in the pension fund. For those with multimillion-dollar super balances, their likely personal marginal income tax rate is 47% (excluding medical levy of 2%). They can reduce their marginal tax rate by 32%.

(People aged between 65 and 74 who meet the work test can make an annual $180,000 contribution but cannot use the bring-forward rule).

Assuming the $1,080,000 earns only 5%, or $54,000, the tax saving of 32% is $17,280 per couple per annum. Thousands of people will take this last chance – is this fully factored into the budget?

Does this sound familiar? Exactly 10 years ago …

The 2006/2007 Budget was wonderful for high income earners. I remember sitting at the ANZ Budget Dinner in the Westin Hotel ballroom with a thousand other financial market types as Peter Costello delivered the super goodies. The Reasonable Benefits Limits rules were abolished, payments received from a fund as either a lump sum or an income stream would be tax-free after the age of 60, and there was a $1 million top up each. The room was almost silent as executives imagined the dollar signs flipping through their minds. When Costello finished speaking, there was a hubbub as thoughts tumbled out. "Did you hear what I heard?" buzzed the tables as the waiters topped up the wine.

The coincidence in timing and content with the Morrison announcement is extraordinary, as it was almost exactly 10 years ago, on 5 September 2006, when Costello issued this statement:

"People will be able to make up to $1 million of post-tax contributions between 10 May 2006 and 30 June 2007 which will allow people who were planning a large contribution under the existing rules to do so. The $150,000 annual limit on post-tax

contributions will commence from 1 July 2007. People aged less than 65 will be able to bring forward two years of contributions, enabling $450,000 to be contributed in one year, with no further contributions in the next two years."

Wealthy Australians and their advisers set about accumulating as much in super as possible. It was the best tax management programme in town. Post-tax contribution $450,000 brought-forward. Tick. Annual pre-tax contribution $50,000. Tick. And the granddaddy of them all, the one-off $1 million. Big tick.

These were the good old days of mining booms, budget surpluses, reductions in marginal tax rates and even baby bonuses without a means test. And here was superannuation – not some dodgy and doubtful tax-minimisation scheme at the bottom-of-the-harbour – as a centrepiece of government policy, allowing millions to be parked tax-free.

It was a godsend for the wealth management industry. As the chart below shows, there was a massive spike in contributions during 2007. Of the $70 billion in total SMSF contributions, member contributions comprised $57 billion or 80% of total SMSF contributions in that year, and retail and industry funds experienced billions more.

Largely as a result of these limits, 2.6% of the 550,000 SMSFs now have balances over $5 million, according to the Australian Taxation Office (ATO). That's 14,300 funds representing about 28,000 members.

Massive inflows in the short term, then a drop off

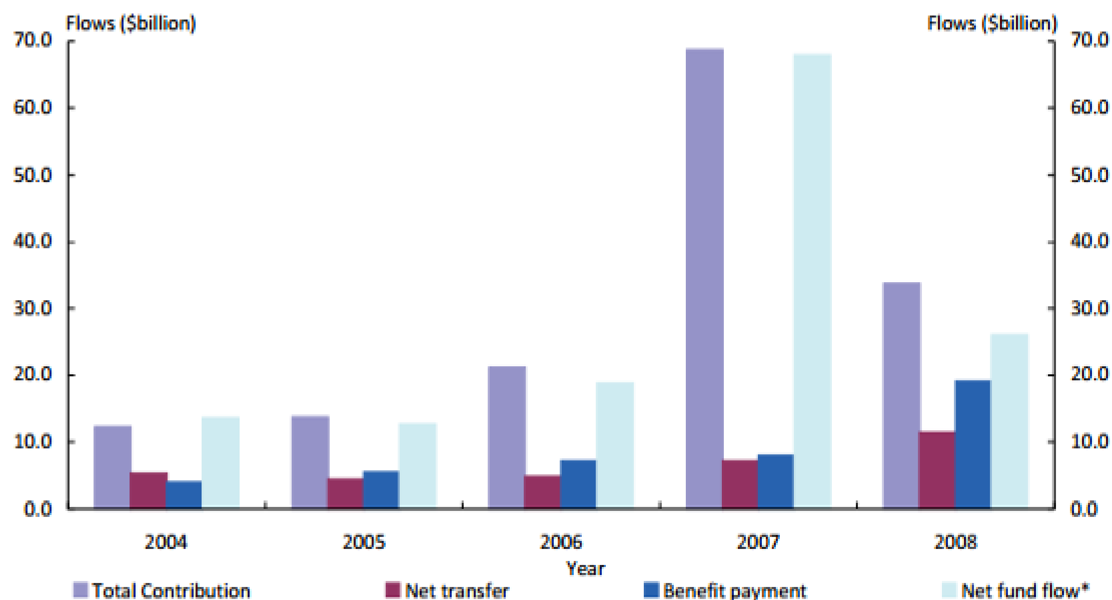
The removal of the $500,000 NCC and its backdating is not only good news for those who can afford large contributions, but also for the wealth management industry – fund managers, platforms, industry and retail funds, planners, accountants, SMSF administrators and thousands of others – in the short term. The public awareness of superannuation is higher now than it was in 2007, and this window of opportunity is special because the door to NCCs closes for many on 1 July 2017. In 2007, Costello allowed ongoing after-tax contributions of $150,000 a year, so there was not as much need to rush.

Under Morrison, from 1 July next year, anyone with $1.6 million or more in super cannot make further NCCs. Even those with smaller balances have a lower annual cap of $100,000, with a bring-forward. Particular attention will focus on property. The next nine months might be the last time the limits allow a lumpy asset like a property to be placed into super.

There may be some tempering of enthusiasm due to the ongoing tinkering with the superannuation system ensuring there is no certainty of the tax treatment.

In following financial years, the new limits will bite, as the wealthy make no more NCCs and the concessional limit drops to $25,000. With an ageing population drawing pensions approaching $70 billion a year and asset earning rates low, it's possible that super assets might peak for all time in the June 2017 quarter.

Breakdown of total SMSF fund flows, 2004 to 2008 (with $1 million allowed in 2007)



* Net fund flow = Total contribution + Net Rollovers — Benefit payments
Source: ATO

If this plays out, and given the stock market's usual myopic focus, wealth management businesses will be a good buy into 2017 as strong inflow and funds under management announcements are made to the market, followed by disappointments into 2018 and beyond.

Is the work test really such a stretch?

What about the reintroduction of the work test for people aged between 65 and 74, who cannot make NCCs unless they pass the test of being 'gainfully employed', contained in the SIS regulations 7.01 (3):

"A person is gainfully employed on a part-time basis during a financial year if the person was gainfully employed for at least 40 hours in a period of not more than 30 consecutive days in that financial year."

I have a friend who is over 65 and he took some part-time work (babysitting? gardening? acting?) for a few weeks. Is 40 hours within 30 days or 10 hours a week difficult to organise? A financial adviser told me, "I have a few clients that step in when local businesses need to replace a receptionist or clerical employee for holiday leave." Arrangements should be checked with the ATO but might be worth it for a last shot at a decent NCC.

What could Morrison have done?

There were two major issues where the politics forced Morrison and Turnbull to negotiate a compromise to the budget proposals: the retrospective treatment of NCCs to 2007, and the $500,000 limit. However, there was widespread (not universal) acceptance that the $1.6 million cap on tax-free income was a decent number.

Given all the 'budget repair' arguments, I'm surprised he did not simply remove the $500,000 limit and the 1 July 2017 start date for the new rules, and leave in place the requirement that anyone already over $1.6 million could not contribute more NCCs. It would have achieved most of the desired political outcome without the potential drag on future income tax caused by opening the NCC to everyone.

Not everyone should stick more into super

Of course, the vast majority do not have a cool million lying around. For many, super may not be the best place to lock up their money, especially above the $1.6 million cap where the tax rate becomes 15%. They can take advantage of the tax-free threshold of $18,200 on income earned outside super, and perhaps the Seniors and Pensioners Tax Offset, which allows tax-free earnings of up to $32,200 for singles or $57,800 for couples. If earnings rates are low with franking credits, it's worth calculating how much is better held outside super in individual circumstances.

These proposals are not yet legislated, although given the political wins for the Government last week, and the previous hammering it took with a public and backbench revolt, they may be reluctant to revisit the rules any time soon. Longer term, governments cannot resist fiddling.

Watch what happened in 2007

The timing of allowing $1 million into superannuation in 2006/2007 was unfortunate for some, as it was during a major bull run on the stock market, and thousands ploughed the money into shares. The GFC then hit and wiped out far more than the gains from the tax savings. The point to note is not to confuse the investment vehicle (superannuation) with the investment market (such as shares, cash, bonds, property, etc).

Every financial adviser (as soon as the changes are legislated) will be telling their better-off clients to ship as much into super as possible this financial year. Ever since Australians realised the mining boom and the good times were over, many have blamed Howard and Costello for frittering away the large surpluses, and the $1 million super allowance is often cited as an example of generous policy. Is Morrison creating a similar legacy?

(Editor's Note: We have received feedback on a different interpretation of the non-concessional contributions limits. We have checked with superannuation experts who confirm the content above. For example, Liam Shorte says, "Graham your article is correct. As long as they have not triggered the bring forward in the last two years then they can use the full $540,000 before 30 June 2017. The new $1.6m balance limit for contributions does not apply to contributions made before 1 July 2017.")

Graham Hand is Editor of Cuffelinks. This article is based on a current understanding of the proposals but these may change and individuals should seek financial advice based on individual circumstances.

How SMSFs should plan for $1.6m pension cap

by Doug McBirnie on 17 November 2016

Much has been written about the Government's superannuation changes, in particular the $1.6 million cap on the transfer into the tax-free retirement phase. The legislation shows how the Government wants the cap to work in practice and highlights what SMSF trustees should be aware of ahead of its introduction on 1 July 2017.

The transfer balance cap in brief

Under the legislation, if you don't already have a pension account, you can transfer a maximum of $1.6 million from your accumulation accounts into the pension phase once you choose to retire. This applies as a total across all your super accounts and not per fund. There will continue to be no limit on the amount you can hold in an accumulation account that is taxed concessionally at 15%, regardless of your age.

Everyone starts 1 July 2017 with a transfer balance cap of $1.6 million. As monies are transferred into the pension phase, those amounts will apply against this cap. Your transfer balance will be indexed proportionately each year in line with the overall transfer balance cap. For the purposes of the cap, defined benefit pension interests will be valued based on special rules outlined in the draft legislation. For most defined benefit pensions, this is expected to be the annual payment multiplied by a factor of 16.

If you already have a pension account at the start date, you will need to determine the total value of your pension interests and assess this against the transfer balance cap. If the balance is less than $1.6 million, you can use any remaining cap to transfer more capital into the pension phase in the future. If the value of your pension interests is greater than $1.6 million at the start date you are required to withdraw the excess either by rolling back to accumulation phase or withdrawing the excess from superannuation, or a combination of both.

After 1 July 2017, pension balances in excess of the cap can be subject to an excess transfer balance tax. This will initially be the 15% tax that should have been paid on earnings had the money been in the accumulation phase, but based on notional rather than actual earnings. The penalties become more punitive if you do not rectify them in good time.

Transitional arrangements

The legislation recognises that commuting exactly the right amount to bring your pension balance under the cap immediately on 1 July 2017 may be difficult. As such, there is a grace period where amounts of up to $100,000 over the cap will not incur the excess transfer balance tax provided the breach is rectified within six months. This doesn't give a lot of time for trustees to finalise their 2017 accounts to determine their 30 June 2017 pension balances.

Relatively generous transitional arrangements regarding capital gains tax means much of the panic over realising significant gains ahead of the new regime is likely to be unwarranted. In effect, the provisions allow SMSF trustees to reset their cost base on assets currently supporting pensions on 1 July 2017. This means that funds will not have to pay capital gains tax on capital gains made on these assets prior to the start date should they have to roll them back to accumulation phase to meet the new cap.

Planning ahead

Where SMSF trustees have pension phase assets greater than $1.6 million, they will effectively have two choices:

- Commute the excess from pension back to accumulation phase, keeping the assets in the fund but now subject to a 15% tax rate on earnings; or.
- Withdraw the excess from superannuation and invest it outside of super where earnings will be taxed at the individual's marginal tax rate (or alternative tax arrangement).

The tricky aspect of this decision is that once you withdraw the money from super there may be very limited capacity, if any at all, to get the money back in. This will often be an irreversible decision.

From a tax perspective it looks relatively easy to assess whether you will be better off having these excess assets in super paying 15% on earnings versus outside of super at your marginal tax rate.

However, offsets available to pensioners can often make your effective tax rate lower than your marginal rate. The gradual withdrawal of these offsets can also make your marginal tax rate significantly higher for certain income bands. To further complicate the decision, what is better today may not be better down the track depending on investment performance, spending decisions and legislative changes.

Trustees will need to weigh up their options and make a choice before the start date. If the decision is to keep assets in superannuation, which for those on the highest marginal tax bands may be reasonable, then it will be useful to re-assess this regularly and move assets outside super if non-superannuation assets decrease and there is capacity within the generous personal tax offsets to accommodate greater income without paying additional tax.

Placing assets in accumulation versus pension

Many SMSF trustees will be thinking about which assets to place in accumulation and which in pension to obtain the best tax outcome. However, it will make little or no difference. Where an SMSF has a member with super assets in excess of the cap (in any super fund), the SMSF will not be able to segregate assets for tax purposes. This means that all the fund's assets are assumed to be held in one unsegregated pool. An actuarial certificate will be needed to determine what proportion of all fund earnings is tax exempt and what proportion is subject to 15% tax.

The Government has introduced this new measure to stop funds from cycling assets between segregated pools for each phase to avoid capital gains tax. It's worth noting that trustees can still notionally allocate different assets to different members or accounts if they want to adopt different investment strategies.

Conclusion

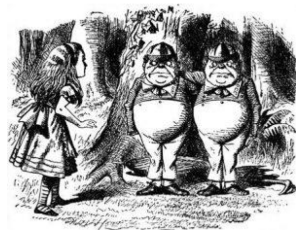
For those likely to have super balances at or over $1.6 million by 1 July 2017, there is plenty to think about, and it's important to understand the rules and plan well before next financial year.

Doug McBirnie is a Senior Actuary at Accurium. This is general information only and is not intended to be financial product advice. It is based on Accurium's understanding of the current superannuation and taxation laws. No warranty is given on the information provided and Accurium is not liable for any loss arising from the use of this information.

Five questions after Super Scott's Santa surprise

by Diana Chan and Jonathan Hoyle on 8 December 2016

"*Contrariwise*," continued Tweedledee, "*if it was so, it might be; and if it were so, it would be; but as it isn't, it ain't. That's logic.*"



Treasurer Scott Morrison has delivered the Christmas present to the financial planning industry that it had glimpsed six months ago but was too excited to actually believe – massive new complexity to the superannuation system. The body of Simpler Super has been incinerated, buried and interred. RIP Simple Super. In its place is a labyrinth of new rules that would make Alice wish she had never gone down the rabbit hole.

Long live complexity, bureaucracy and tinkering governments.

Quite what we have done to deserve this exhilarating Christmas present is a mystery, but we'll take it. The need for superannuation and wealth planning advice just became essential. Whatever next? Taxpayer subsidised advice (as the system is now utterly incomprehensible to all)? We are now prepared, like the White Queen, to believe six impossible things before breakfast.

The lucky folk who have had their superannuation retirement savings subject to hot debate recently have some big decisions to make over the next six months. We highlight five questions of critical importance.

1. Pension, accumulation or outside super due to the Transfer Balance Cap?

The recent passing of the legislation represents the biggest change to our superannuation system in a decade, with a limit imposed on how much you can save in superannuation and how much you place into a tax-free pension. At least you aren't hit with massive taxes if you withdraw the amount above the Transfer Balance Cap from super.

From 1 July 2017, if you have less than $1.6 million then you will still be able to save for your retirement and make additional personal after-tax contributions much like the current system. However, once you reach the $1.6 million balance (per member), whether it be from capital growth or additional contributions, you will no longer be able to make your non-concessional contributions from after-tax monies.

There are no grandfathering arrangements for those who already have more than $1.6 million in super. If you are a pension member, then the most you can have in the tax-exempt pension environment is $1.6 million. If your pension balance exceeds the Transfer Balance Cap, you will need to transfer the excess back into an accumulation account or remove it from the superannuation environment (for example, if your personal marginal tax rate is zero versus 15% in the super accumulation phase).

The alternative method applies a proportioning approach where the tax-exempt percentage of the fund is determined by an actuary based on the balance of pension interests to accumulation interests. If you have substantial income-generating assets outside of super, then it may be worth keeping your surplus super assets in the accumulation phase. This is your first major decision.

2. Can I still make a large contribution into super?

This depends on when you plan to contribute and how much you already have in super. The non-concessional limits are set to reduce from $180,000 a year to $100,000 a year from 1 July 2017, which means the three year bring-forward cap will be limited to $300,000. To add to the confusion, transitional bring-forward caps will apply if you have already triggered the bring-forward caps in the last two financial years but have yet to utilise the entire cap. Got that?

If you have the capital to consider a large non-concessional contribution, you may wish to act before the end of this 2016/2017 financial year, irrespective of your total superannuation balance. With the upcoming Transfer Balance Cap, individuals under 65 still have the capability to make a non-concessional contribution up to $540,000 within the next seven months (provided you haven't already triggered your bring-forward arrangements). Even if it pushes your balance over $1.6 million, lock it into super now and deal with the pension transfer issue later. **This will be one of the most significant decisions for higher net worth individuals to make over the next six months.** You may even decide to borrow the funds to make one last significant contribution to super. Don't ask us for a unique answer, as it depends on your circumstances and, frankly, like the Mad Hatter, '*we haven't the slightest idea*'.

3. Is segregation of assets still possible?

Yes and no. Curiouser and curiouser! Today, most SMSFs operate under a segregated approach where members could cherry-pick the assets used to support their pension account. This is a useful tax-planning tool where the pension assets have a tax-exempt status and therefore do not pay tax on the investment earnings or realised capital gains. The alternative method applies a proportioning approach taking into consideration the percentage of the fund that is tax-exempt based on the balance of pension interests to accumulation interests.

From 1 July 2017, SMSFs will no longer be able to use the segregation approach for tax planning purposes if a member's balance exceeds $1.6 million in the sum of any superannuation structure, be it the SMSF, retail or industry funds. This essentially prevents SMSF members cycling assets between accumulation and pension phase in order to maximise tax concessions available when a Capital Gains Tax (CGT) event arises.

On that note, there is the need for careful planning when transferring the excess amount from pension to accumulation before the end of the financial year as CGT relief may be available.

For the impacted members who have assets supporting pensions before 9 November 2016, you may wish to review the underlying assets and 'reset' the CGT cost base before 30 June 2017 to receive tax concessions on the capital gains that would otherwise apply if you had sold the pension asset. You don't have to sell the asset to reset the cost base and apply the CGT relief.

The CGT relief should not be applied to all assets as those currently on unrealised capital losses may be better off to continue carrying the original cost base whilst the assets on large gains, (particularly bulk assets such as property) may benefit from

revaluing the cost base before 30 June 2017. If you have an asset sitting on a large gain, it may be worth considering the CGT relief but it is an irrevocable election which means there may be some tax liability when you sell the asset in the future.

4. What happened to Transitioning to Retirement (TTR)?

Remember the days where you could access your super at 55 (or older), continue to work, pay less taxes but keep the same cashflow? Well, the government has caught up to all the smart people employing the TTR and salary sacrifice strategy, meaning there is no longer any tax arbitrage from transferring your super balance to a TTR pension as opposed to retaining the funds in accumulation phase. This is because the 15% tax on investment earnings will continue to apply up until the age of 65 (the magic age where everything becomes unrestricted). If you have a TTR pension, you will need to decide whether to roll into an account-based pension or to roll back into an accumulation account. You'll also need to determine whether you have met the SIS definition of 'retired' (it's not a definition you might expect).

5. Is it time to switch to an OPP?

If you don't currently have a financial planner and you are in the group of the so-called '1% of impacted pension members' (we believe Mr. Turnbull would refer to this as a 'post-truth'), then it may be time remove yourself from the DIY nature of managing your SMSF and switch to an OPP (Other People's Problem).

An OPP is a complex structure that involves the stimulatory process of removing and spending all your excess super balance to take you just above the new age pension assets test threshold of $250,000 and so entitle yourself to the maximum age pension (this strategy sometimes goes by the less familiar term of PQE – the People's Quantitative Easing). This kills two regulatory birds with one stone, as the assets test taper rate will double on 1 January 2017 to $3 per fortnight per $1,000 of assets (that is, if you exceed the threshold by $100,000, your pension drops by $300 a fortnight or $7,800 a year). Unless you can find a risk-free way to beat a return of 7.8%, an OPP is worth considering.

Merry Christmas, Mr Morrison

Whilst it's fair to say that Scott Morrison has cut short the Christmas holidays for financial advisers and accountants, his poster hangs on all our bedroom walls.

It may be worth pointing out that the childcare industry is a warning not an instruction manual. If you make a service so expensive and complex by regulating it to within an inch of its life, and you then have to offer taxpayer subsidies just so that these same taxpayers can afford to use it, you are officially on the road to hell. Or, as Alice remarked, "*if you drink much from a bottle marked 'poison' it is certain to disagree with you sooner or later.*"

"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?"

We do, Alice. It would be so nice if something made sense for a change.

Diana Chan is Head of Compliance and Jonathan Hoyle is Chief Executive Officer at Stanford Brown*. This article is general information and does not consider the specific circumstances of any individual, and is based on a current understanding of the legislation.*

My 'purpose of super' is probably not yours

by Graham Hand on 17 December 2015

Have you ever been in a meeting where everyone in the room, except you, seems to agree on something? You wonder whether you should keep quiet or start asking a few probing questions. I sat through half a day of speeches before launching into my own special version of the truth, much to the dismay of other delegates.

It was in June 2015 at the inaugural conference of the newly-formed Committee for Sustainable Retirement Incomes (CSRI) where everyone else seemed in furious agreement that we not only need to define a 'purpose' or 'objective' for superannuation, but it was obvious what it was. As the Committee's Chairman, Michael Keating, wrote later:

"The FSI [Financial System Inquiry] recommended that the objective of superannuation should be to provide 'income in retirement to supplement or substitute the age pension', and there is an ***emerging consensus*** *that superannuation should be directed to providing a retirement income and not other benefits, including bequests." (my emphasis).*

Whatever the future, that was not the past

Is that right? It that the consensus? Not for me. I have been putting money into superannuation for 20 years without an expectation that I will need the majority of it 'to provide a retirement income'. It's a tax-effective place to save, entirely within the rules, and I have foregone current consumption to secure my future and avoid any likelihood of being a drag on the public purse.

For many people, superannuation is both funding a retirement and leaving a bequest. It's a piggy bank, a store of wealth, with a strong expectation there will be plenty left over beyond retirement income to give to their children or heirs. Why is it different to the favourable taxation rules around owner-occupied housing, or to a lesser extent, negative gearing, or family trusts? I could have bought a harbourside home and enjoyed tax-free capital gains, but instead I chose superannuation. If we are defining 'purposes', we should look at the entire package of different taxes and benefits, not only superannuation.

My view may even be part of the majority in the real world. At the recent 2015 CSIRO and Monash University Superannuation Research Cluster, a study reported that 90% of the amount an average retiree enters retirement with (including family home and non-super) remains unspent upon their death. On 23 May 2015, *The Australian Financial Review* quoted Treasury work which found that most people still have around half of their superannuation balances at the time of average life expectancy. This CEPAR research paper explains why retirees under-consume and over-accumulate.

So the 'purpose of superannuation' is far from settled based on actual experience, and while it may fund part of a retirement, it is at least as likely to become a bequest.

What did David Murray say?

David Murray and the FSI identified a major deficiency of superannuation being the lack of a clearly articulated objective to guide policy. Recommendation 9 states:

"Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objective over the long term."

That's a high bar for the 'objective' to jump over, and a major challenge for the government. It goes on to say, "Superannuation is a vehicle for individuals to fund consumption in retirement largely from working life income." Not much sympathy for bequesting there.

What does the Superannuation Complaints Tribunal say?

The government agency charged with adjudicating on superannuation disputes is the Superannuation Complaints Tribunal (SCT). In its Annual Report 2014-2015, it writes:

"There are some common misconceptions about superannuation death benefits that can result in unexpected outcomes for the beneficiaries of a death benefit, and may result in a complaint being made to the Tribunal. The most common

misconception, arguably, relates to the purpose of superannuation. Broadly speaking, ***the purpose of superannuation is to provide income in retirement to members and their dependants****; it does not form part of a person's estate. Accordingly, a superannuation death benefit should be paid to dependants and those who had a legal or moral right to look to the deceased member for financial support had they not died." (My emphasis. Thanks to Robin Bowerman of Vanguard for this point).*

There it is … "**and their dependants**". Sounds like a bequest to me. The SCT is an independent government body that deals with complaints relating to the decisions trustees make in relation to superannuation, and of the 2,700 complaints processed in 2014/2015, 29% were about death payments. A large amount of its work, therefore, is sorting out who should benefit from a bequest.

Superannuation specifically acknowledges bequests

Superannuation legislation has specific features designed for appropriate bequeathing. For example, Binding Death Nominations (BDNs) ensure superannuation is distributed according to the wishes of the deceased member, not at the whim of a new trustee of the fund or executor of the estate. Superannuation is not an asset of the estate and a trustee is not obliged to follow directions in a will, even if super is specifically mentioned in the will. The instructions in the BDN define the money flow.

The main reason a superannuation death benefit is paid directly to a dependant rather than the estate is to ensure other people (creditors, claimants for bankruptcy, etc) cannot access the payment benefits provided to a dependant.

In fact, the superannuation rules themselves facilitate bequests to non-dependants. There is no restriction on withdrawing money from superannuation for anyone who has reached preservation age and satisfied a condition of release (including retiring). However, on death, if it is given to anyone other than a spouse or a dependent child, there is a tax (on the taxable component) of 15% plus the Medicare levy (currently 2% for most people). The obvious approach is to gift it before death, if possible. Continuing from the Treasury work quoted in the AFR as above:

"People typically don't die all of a sudden. They might know it is coming so they draw down at least some of their super in advance and gift it to others to avoid the 16% tax that is payable if you leave your super to independent children or people other than your wife or dependent children," one source said."

Conclusion

A potential benefit of this debate about the 'purpose of super' is to force each person to consider their own objectives, but we will be sorely disappointed if we think this will create consensus. I know what my purpose is, I know what David Murray's purpose is, and I know what Michael Keating's purpose is. But most importantly … what's yours?

Graham Hand is Editor of Cuffelinks and has worked in the finance industry for almost 40 years.

2. Retirement

Strategies for retiring retirement: life, liberty and happiness after full-time work – Jonathan Hoyle

Safe withdrawal rates for Australian retirees – Anthony Serhan

Four ways to avoid super death benefit taxes – Mark Ellem

Pension winners and losers from 1 January – Rachel Lane

Meeting the retirement outcome challenge – with David Bell and Harry Mitchell

Spinning the wheel in retirement – Jeremy Cooper

Strategies for retiring retirement: life, liberty and happiness after full-time work

by Jonathan Hoyle on 31 March 2016

'Leisure is a beautiful garment for a day, but it will not do for constant wear.' Bishop Fulton Sheen

'Retirement is the filthiest word in the language.' Ernest Hemingway

The concept of retirement – a brief period of leisure following four decades of hard work before we shuffle off this mortal coil – is dead. First introduced by German Chancellor Bismarck in the late 19th century, and very much a product of the Industrial Age, retirement has run its course. It's time to call time on this outdated notion. Retirement has retired.

You're excited, right? You've dreamt of this moment for over a decade; no more pointless office meetings, no more stupid emails from your over-promoted boss, no more ridiculous team-building events, no more 6am alarm calls, no more strategic opportunities to leverage our agile, holistic, evidence-driven sustainable blah blah whatever. Soon, it will be just the two of you and endless days spent playing with grandkids who appreciate you for exactly who you are, sunny mornings on the golf course and leisurely walks on the beach, arm in arm with your loved one – your very own Utopian idyll.

But what if it isn't? What if those things you have looked forward to all these years are not enough to sustain you, to fulfil you, to energise you? Was the good bishop right? Can leisure survive 'constant wear'?

Work is more than just a source of income. It is a social life, a sense of utility and purpose, it provides dignity and pride, and self-esteem within a community. Prospective retirees list financial worries as their biggest concern. However, actual retirees rate alienation as their biggest disappointment. It includes loneliness, being cut off from former colleagues, missing their jobs and feeling behind the times (Mitch Anthony, *The New Retirementality*). How will you replace all this?

The questions we ask ourselves become much more profound with age. In our 20s, we obsess over what people think of us; in our 40s we stop caring; in our 60s we realise no one was actually thinking of us anyway. With time fast becoming that most precious of commodities, *'am I living the life I want to live?'* becomes the most profound of all. Retirees focus more on their legacy; not just *'what do I want to leave behind?'*, but *'how do I wish to be remembered?'*

Australian palliative care nurse, Bronnie Ware, chronicled the regrets of dying patients in her care in an eclectic and intriguing book, *Top Five Regrets of the Dying*. She found five recurring themes:

- I wish I'd had the courage to live a life true to myself, not the life others expected of me
- I wish I hadn't worked so hard
- I wish I had stayed in touch with my friends
- I wish that I had let myself be happier
- I wish I'd had the courage to express my feelings.

At Stanford Brown, working with our clients to help them enjoy a rich and rewarding retirement is our area of expertise. It's also our passion. The following 11 strategies are the cumulative knowledge of three decades of advising retiring Australians on the pursuit of life, liberty and happiness after full-time work. We hope you find something here of value.

Strategy 1 – Start planning long before you retire

Many people work furiously all their lives and then stop. This is not a plan. Far better is to start thinking and planning at least ten years prior to retirement. Ask yourself these questions. What do I love doing? What inspires me? What am I good at? What knowledge have I accumulated that I wish to use or to pass on? A good place to start is to reduce your hours or even work in a consulting capacity before leaving for good. This buys you time to experiment. Seek out internships, part-time jobs, volunteering or start studying.

Investments and Financial Planning

"I retire on Friday and I haven't saved a dime. Here's your chance to become a legend!"

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Strategy 2 – Create a list of the things to do in your retirement

Do your homework! Not just those bucket list places you'd like to visit, but experiences you'd like to have, skills to acquire, languages to learn, hobbies to pursue and relationships to rebuild. The following is a list of some of our favourite books and websites to peruse for ideas and inspiration:

- encore.org – a website packed full of ideas for second act (or encore) careers
- *The Big Shift* by Marc Freedman, CEO of encore.org
- *How Will You Measure Your Life* by Karen Dillon
- *The New Retirementality* by Mitch Anthony
- *What Color is Your Parachute* by Richard Bolle
- *Too Young to Retire* by Marika and Howard Stone

Strategy 3 – Take a personal inventory check

Before evaluating your Economic Capital, check your Human Capital. What are your skills, your passions, your experiences, your knowledge? Increasingly, our identity is wrapped up in our work. What will you miss the most? What are your key strengths? Start with Gallup's excellent Strengths Finder. It costs just $20 and will produce a detailed report on your strengths.

Then, take the National Seniors Retirement Quiz. This quiz assesses your retirement preparedness in terms of three resource types – health and finance; social; and emotional, cognitive and motivational.

Strategy 4 – Figure out exactly how much income you will need

'I'm living so far beyond my income that we may almost be said to be living apart.' EE Cummings

Sounds simple but it's fiendishly difficult. So it's time to apply the first of our Rules of Thumb. Planning is an art not a science, hence Rules of Thumb are often far more useful than the 30-year projections the financial planning industry insists on. First, determine exactly how much you spend today. Monitor your spending over a 12-month period and do not exclude 'one-offs' as they have a nasty habit of repeating themselves. A really good budgeting tool is Moneysoft.

Then apply the *'Retirement Smile'*. Most retirees assume they will spend less in the retirement years but this rarely happens. In fact, you are more likely to increase spending during the first decade, a time when you have energy and health. This is the time for travel, for exploration, for doing different things. Assume your spending will increase by at least 10%. Then the next decade will likely see a significant drop in spending (how many times can you visit the Pyramids?), followed by a surge in health-related expenses in the final decade. Assume the superannuation rules will gradually become less favourable and don't forget the spectre of inflation, which will erode your standard of living over time. Allow plenty room for error.

Strategy 5 – Estimate if you have enough

'I advise you to go on living solely to enrage those who are paying your annuities. It is the only pleasure I have left.' Voltaire

Another Rule of Thumb. Assume you will require investable capital of at least 20 times your annual spending if you wish to retire from age 65. This will vary according to your age, your risk tolerance, whether your capital resides in a tax-free environment like super and whether you wish to preserve the real value of your capital or gradually run it down (do the kids really need to inherit it all?).

Over the past 40 years, a relatively conservative, well-diversified portfolio of stocks and bonds has delivered strong investment returns. However, past performance is most definitely no guide to the future as interest rates are so much lower today and are likely to remain low. Stepping up your risk profile is not the optimal solution as it will lead to more volatile outcomes than you seek.

What to do if there is a shortfall? You can either work longer, work part-time, spend less or take more risk. There is no magic bullet. However, you can be more creative, for example, by using your existing assets harder by renting your house on Airbnb. You could downsize your home or you could take out a reverse mortgage and remain where you are. These products are safer than in

the past and better regulated. In our view, they are the most underused yet value-added products available to retirees.

Strategy 6 – Spend your money wisely

''Money can't buy happiness' is a lovely sentiment, popular and almost certainly wrong.' Harvard psychologist, Daniel Gilbert.

In a research paper intriguingly entitled *'If money doesn't make you happy then you probably aren't spending it right'*, Professor Gilbert recommends the following spending principles.

- Buy experiences instead of things. We like experiences more because we get to anticipate and remember them, whereas the delight of that shiny new BMW quickly fades.
- Spend money to help others instead of yourself. Our happiness is enriched from our social connections and nurturing these friendships is a fruitful way to spend our money.
- Buy many small pleasures instead of few big ones. The 'power of adaptation' is that we get used to the things we have around us all the time. Treating ourselves to many inexpensive indulgences is a neat way to provide regular bursts of happiness.
- Pay now, consume later. Delayed gratification gives the benefits of anticipation.

Strategy 7 – Know your behavioural biases

We are innately dreadful investors. We panic sell during market sell-offs, we buy during the good times, we anchor ourselves to prices paid for stocks rather than future outlooks, we develop an irrational aversion to losses and we overestimate our ability to beat the market. In their landmark study of risk taking behaviour, Daniel Kahneman and Amos Tversky, established that losses loom far greater than gains. More recent research by Professor Eric Johnson of Columbia University has shown that retirees display hyper-loss aversion. They were up to five times more loss averse than the average person.

Strategy 8 – Adopt the Odysseus strategy

Homer's *Odyssey* describes the adventures of Odysseus on his return from the Trojan War. One challenge was navigating his ships past the Sirens. These were dangerous yet beautiful creatures who lured nearby sailors with songs so haunting that they would throw themselves overboard just to get closer to them. Odysseus was aware of his behavioural biases and planned accordingly. He wanted to hear the Sirens but knew that their songs would be too much even for him. So he ordered his men to put bees wax in their ears and tie him to the ship's mast. As they passed the Sirens, he could hear their beautiful songs and tried desperately to untie himself. But the men ignored his pleas for help as he had forbade them to untie him. By knowing how you will react when markets get tough, you can avoid making costly mistakes.

The Sirens and Ulysses by William Etty (1837)

Strategy 9 – Seek professional help

Working with a good financial adviser will provide you with a retirement framework and the discipline to stick with the plan. Index manager Vanguard, in this research paper entitled *Quantifying Vanguard's Adviser' Alpha*, argues that good financial advice will add as much as 3% to investment returns through effective asset allocation, behavioural coaching and wealth management advice. This excellent article, *Seven questions to ask when picking a financial adviser* provides a comprehensive checklist.

Strategy 10 – Set clear goals

'You know you are getting old when you stoop to tie your shoelaces and wonder what else you could do while you're down there.' George Burns

At Stanford Brown, we send many of our clients to specialist retirement coaches who work with the individual and their spouse to map out every aspect of their Retirement Plan. Start with the Retirement Goal Heptathlon: Health, Family, Work, Legacy, Giving, Home and Self. Prioritise these goals and when you want them to happen. How will you measure a successful retirement?

Strategy 11 – Commence an encore career

According to encore.org, nearly nine million people aged 44 to 70 are engaged in second-act careers. Says Mark Freeman in *The Big Shift*, *'There is the financial question of how you will support yourself, and then there is the existential question of who are you going to be.'* Some retirement

trends in the US include retirees venturing back to college and 'retiring' to university towns; people choosing to retire in their own communities rather than escape to the Sunbelt; retirees are becoming entrepreneurs, reviving shelved passions; and phasing out work rather than stopping overnight.

It's a time to live the dream

Say bah humbug to that old curmudgeon, Mr. Hemingway, and tell him to stick to fishing trips in Cuba. For one brief moment, reflect on your enthusiastic yet naive 18-year-old self, leaving school and entering the big wide world for the first time. What regrets do you have now? What did you not get to be? What is still left to do? Life is not a dress rehearsal. You still have time. Good luck!

Jonathan Hoyle is Chief Executive Officer and Chief Investment Officer at Stanford Brown*. This article is general information and does not address the circumstances of any individual.*

Safe withdrawal rates for Australian retirees

by Anthony Serhan on 11 February 2016

I love it when someone takes a complex question and answers it with something simple. The danger with elegant simplicity, though, is that people forget the details that sit behind it, and what question it was actually answering. This was one of the catalysts for the recent Morningstar research paper 'Safe Withdrawal Rates for Australian Retirees' that I co-authored with David Blanchett and Peter Gee. The '4% rule' is often referenced in understanding what you can spend in retirement given a certain amount of savings, but where did it come from, and how relevant is it today?

1. What is this '4% rule' we hear so much about, and where did it come from?

The '4% rule' actually started in 1994 with an article published in the *Journal of Financial Planning* by William Bengen. He was a US-based financial planner who wanted to answer questions about how much his clients could spend in retirement. The way people interpret the 4% rule can vary, so let's set out some important parameters that underpin the number:

- 4% of the portfolio is used to calculate the first year's payment only, and each subsequent year that amount is adjusted for inflation.
- it assumed a minimum 30-year retirement period.
- historical return data from 1926-1994 was used, based on a portfolio comprised of 50% US equities and 50% US bonds.
- 4% was selected as 'safe', because at that level there was no past period where that rate would have exhausted all assets by the end of the 30-year period. So it was not a number based on an average return, but rather one that assumed returns at the very low end of the spectrum.

Before taking this framework forward, I'd like to tip my hat to Mr Bengen, who 22 years ago wrote a thoughtful and practical paper. The 51 simulations that he ran do not quite match up with the Monte Carlo simulators of today, but the paper still captured many important concepts.

An inflation-adjusted, constant income stream is pretty intuitive when you think about the way you want to plan retirement.

2. Does this 4% rule apply to Aussie retirees today?

The methodology can still apply in Australia today, but there are some important areas of improvement. First, we've included a fee assumption. Whether you're paying for someone to manage the portfolio, an advisor, an accountant, an administration platform, or some combination of these, there are costs. For our calculations, we've assumed an annual fee of 1% per annum. If you repeated the same study as above with the 1% fee, using Australian share and bond returns, but increase the return history to 1900–2014, that 4% would have come out closer to 2.5%. Why lower? Apart from the impact of fees on the returns, the Australian equity market has been more volatile than the US, and our inflation higher in the 1970s and 1980s, so you need a lower withdrawal rate to weather the worst-case scenario.

The full paper also shows that Australia has experienced some of the highest historical returns from markets when compared to 19 other countries. While the US has led the world in retirement research, we need to be careful about localising those results. Australia has outperformed historically, but it's arguable whether this will continue.

The next step was to replace past returns with our long-term expected returns, which take account of where equity markets and interest rates are today. In addition, if you diversify the portfolio further to include a mix of Australian and international assets, you get different answers again. If you want 99% certainty, the initial withdrawal rate is 2.8%, helped by the portfolio's reduced volatility. If you're prepared to lower that probability of success down to 80%, then that initial withdrawal rate can increase to 3.9%.

3. What is the probability of success or 'success rate'?

This idea of a 'success rate' is incredibly important. While it may be complex mathematically, the underlying principle isn't. It speaks directly to the sort of trade-offs we all have to make. Quite often, people talk about 'expected returns', and use these to build their plans. Even if someone has made a good forecast, an expected return will only have a 50% probability of coming through, and the final result may be higher or lower. You might be happy around this level, or you may want to be more certain that the path you're taking will meet your minimum goal. In our analysis, the goal is to make sure that whatever initial withdrawal rate you use, your account balance will run out exactly at the end of that period. Pick a success rate that you can be comfortable with, from the conservative 99% certainty, to the more optimistic 50% level, or somewhere in between.

4. What is the key message for Australians?

Equity returns over the next 20-30 years are likely to remain attractive relative to cash, but we're projecting them to be 2% lower than history. We need to adjust our expectations and plan accordingly.

Safe withdrawal rates for retirees now need to start at 2.5%, not 4%. Withdrawal rates could be even lower if life expectancy continues to increase. So we need to accept either spending less in retirement, OR saving more for retirement, OR running a greater risk of moving on to the aged pension sooner. It's important to understand the trade-offs, and where you're sitting.

The mandatory minimum withdrawal rates for account-based pensions in Australia are set higher than the safe minimums in our paper. The way these two rates operate is different after the first year, but the impact of the higher relative withdrawal rates still needs to be considered. Just because you've been paid an amount from an allocated pension doesn't mean you have to spend it. Some retirees will need to invest some of their pension payments outside tax-concessional superannuation to ensure they still have savings in the future.

Once again, the benefits of a diversified, balanced portfolio shine through in the study. Adding equities can help a portfolio, but only if you accept a lower probability of success. Most of the incremental benefit to withdrawal rates of adding equities is achieved when 50 – 70% is allocated to growth assets.

Lastly, while the paper provides some useful pointers, the reality is that we're all different, and reviewing your own personal circumstances will give you a much better answer to what you need in retirement than a rule of thumb.

Anthony Serhan, CFA, is Morningstar's Managing Director Research Strategy, Asia-Pacific. For a full copy of the report and data, click here*. This material has been prepared by Morningstar Australasia Pty Ltd for general use only, without reference to your objectives, financial situation or needs. You should seek your own advice and consider whether the advice is appropriate in light of your objectives, financial situation and needs.*

Four ways to avoid super death benefit taxes

by Mark Ellem on 29 September 2016

They say there are two certainties in life: death and taxes. Death, clear-cut, I'd agree. But with tax comes nuance, so let's take a closer look at superannuation death benefits and tax.

In the late 1970s, death duties were abolished in Australia, although a form of them remains in relation to lump sum benefits paid from a superannuation fund where a member has died and the ultimate recipient of that payment is not classified as a 'tax dependant'. In this situation, the 'taxable' portion of the benefit payment is subject to a tax rate of 15%, plus the 2% Medicare levy, a total tax take of 17% (where insurance proceeds are included in the payment it can be as high as 32%).

How can my adult child receive my super death benefit payment tax free?

A child of any age can receive a lump sum payment directly from a superannuation fund as a consequence of the death of a member. However, an adult child will only receive the taxable component of the payment tax free where, for income tax purposes, they are either:

- a 'financial dependant' of the deceased, or
- in an interdependent relationship with the member, prior to the member's death.

An adult child will receive any tax-free component of the death benefit tax free.

Dealing with interdependency first, two persons (whether or not related by family) have an interdependency relationship if:

1. they have a close personal relationship; and
2. they live together; and
3. one or each of them provides the other with financial support; and
4. one or each of them provides the other with domestic support and personal care.

On the face of it, where an adult child returns home to live, or actually never left the family home, they seem to satisfy the interdependency requirement. However, they may fall short, as the relationship needs to be more than simply one of convenience. It needs to be more meaningful, for example, when an adult child has moved home to care for an elderly or sick parent.

The other option is where the adult child is a 'financial dependent'. The ATO appears to have a narrow view of financial dependency, for income tax purposes. A number of Private Binding Rulings look at the following in relation to financial dependency:

- where a person is wholly or substantially maintained financially by another person
- if the financial support received were withdrawn, would the person be able to survive on a day-to-day basis?
- if the financial support merely supplements the person's income and represents 'quality of life' payments, then it will not be considered substantial support
- whether the person would be able to meet their daily needs and basic necessities without the additional financial support.

There is also a requirement to show a reliance on regular and continuing financial support to meet their day-to-day living requirements. Finally, evidence to support the facts and the claim for financial dependency is needed, including receipts for expenditure regarding living expenses.

Not all super death benefits paid to a non-tax dependant are subject to tax

Only the 'taxable' portion of a super death benefit is subject to tax, where a person receives it who is not a dependant for income tax purposes. Any 'tax-free' component is exactly that, tax free in the hands of the beneficiary. The 'tax-free' component is basically made up of after-tax contributions that the member has made to superannuation. Consequently, a common strategy to 'wash' taxable components to tax free, prior to a member dying, is the re-contribution strategy.

Is a re-contribution strategy still relevant?

It can be. The aim of this strategy is to convert the 'taxable' portion of a member's account balance to 'tax free'. The greater the extent of a tax-free component means less tax on benefits paid to a

member under age 60 and less tax on benefits paid to a 'non-tax dependant' on death of the member.

Tax will only be applicable on a superannuation death benefit payment where:

1. A payment is made as a consequence of the death of a member; and
2. The payment is made to a person who is not a dependant for income tax purposes; and
3. The payment has a taxable component.

Four major ways to avoid the tax

As 17% can be a big tax impost on substantial balances, the following are worth considering:

1. Don't die (I understand that medical science is working on this and making progress)
2. Make sure you have a beneficiary that qualifies as a dependant for income tax purposes at the time of death
3. Ensure 100% of your benefits form part of the tax-free component
4. Have nothing inside superannuation at the time of death.

The fourth option is especially useful, although the timing of withdrawals can be a challenge. As a person ages, particularly past 65, they can withdraw money from superannuation and hold the funds in their own name. The money will then form part of the non-super estate which is not subject to the 17% tax. However, this withdraws the funds from the tax-advantaged super system, so the personal tax implications need attention. By just considering the $18,200 tax-free threshold and assuming an assessable earning rate of 6%, that's around $300,000 that can be held in an individual name with no personal tax (assuming no other income).

Conduct regular reviews

Given the potential for significant tax to apply in relation to a payment from a superannuation fund as a result of the death of a member, an overall estate plan review should consider inter-generational wealth transfer and preserving that wealth by reducing tax.

Mark Ellem is Executive Manager, SMSF Technical Services, at SuperConcepts. A more comprehensive paper on this subject is attached here. This article is general information only.

Pension winners and losers from 1 January

by Rachel Lane on 3 November 2016

The biggest changes to the pension asset test in 10 years will occur in two months, on 1 January 2017.

Whenever the government makes such drastic changes it creates winners and losers, while some that stay the same will worry about the changes nonetheless. If you're a pensioner the important thing is to know which bucket you fall into and make a plan for how best to deal with it. If you're a financial adviser, communicating with your clients about the changes and the impact on them and putting strategies in place to minimise the consequences are imperative.

What is changing?

Currently the asset thresholds (ignoring the value of an owner-occupied home) are:

- Single Homeowner $209,000
- Single Non-Homeowner $360,500
- Couple Homeowner $296,500
- Couple Non-Homeowner $448,000

The fortnightly pension payment reduces by $1.50 for every $1,000 over the assets test threshold. To put it into context, if a pensioner exceeds the asset test by $100,000, their pension reduces by $150 per fortnight, or $3,900 p.a. If they can earn more than 3.9% p.a. on that asset then they may be better off investing the money rather than taking the pension.

Post 1 January 2017, the asset thresholds will increase to:

- Single Homeowner $250,000
- Single Non-Homeowner $450,000
- Couple Homeowner $375,000
- Couple Non-Homeowner $575,000

But here's the sting. When assets exceed the new threshold, the pension will be reduced by $3 per fortnight for every $1,000 excess of assets. So if assets exceed the new threshold by $100,000 the pension would reduce by $300 per fortnight, or $7,800 p.a. Those assets would need to earn more than 7.8% p.a. for the pensioner to be better off. This will not be easy to achieve and may result in some people reducing their assets and putting the money into their family home to achieve a better pension outcome (although this may reduce available liquid assets by $100,000).

Don't forget the income test

Of course, the pension is calculated under two tests: an asset test and an income test (with the one that produces the lowest pension entitlement being applied). In all the hype about the asset test changes it is important not to forget the income test. The government has not reported any changes to the threshold or taper rate for this.

The income test does not assume a portfolio of purely cash and fixed interest. The current deeming rate on the amount above $49,200 (single) or $81,600 (couple) is 3.25%, a rate of return that is hard to get in cash or term deposits. The income test reduces pension entitlement by 50 cents per dollar above the income threshold (about $4,264 for single and $7.592 for a couple), regardless of whether it is actual income or deemed.

Let's look at some examples, starting with a winner…

Betty is a single homeowner with $248,000 of assessable assets outside her home.

Her pension entitlement now is $819 per fortnight, and post 1 January 2017 her pension will be $877 per fortnight if the majority of Betty's assets don't produce income: for example cars, caravans, boats, vacant blocks of land and trusts don't produce taxable income.

But what if Betty's assets were primarily income producing? If she has $240,000 in investments and $8,000 in personal assets, then she is still a pension winner but her pension will increase by only $4 per fortnight not $58.

Now let's look at those who will stay the same, which is basically anyone who is currently receiving the full pension. Why? Because the changes will increase the asset test thresholds but anyone on a full pension is already under the required level.

Kevin is a single homeowner with $130,000 in investments and $20,000 in personal assets. He is entitled to $877 per fortnight under the asset test and the same under the income test. From 1 January 2017, his pension will remain the same.

As an example of how people will lose out under these changes, Fred and Shirley are homeowners with $600,000 in investments and $50,000 in personal assets.

They currently receive $792 per fortnight of pension entitlement (combined) and they earn $15,000 p.a. from their investments, meaning that their combined annual income is a little over $35,000.

Post 1 January, their pension will drop to around $497 per fortnight (combined), which means that their combined annual income (assuming they continue to earn $15,000 p.a. from their investments) will be around $28,000.

The major consequences

There are a couple of key messages the government is sending to retirees in these changes. The first is that the means-testing arrangements are likely to get tougher not easier and the second is that cash and fixed interest investments are not risk free.

If investment returns are not sufficient to meet the cash flow needs of retirees, they will be forced to dip into their capital. Sure, if the investments are in cash or term deposits, they are not at risk of the same volatility as they are in shares. However, the irony is that avoiding the potential drop in the value of the investments due to market volatility doesn't mean they are preserving the value of their capital. It's just that the retiree is eating it, not the market.

The bottom line is that retirees need to take more responsibility (and maybe a little more risk) in meeting their retirement income needs. While these changes are the biggest we have seen in nearly 10 years, don't expect they will be the last for another decade.

Rachel Lane is the Principal of [Aged Care Gurus] and oversees a national network of financial advisers specialising in aged care. This article is for general educational purposes and does not address anyone's specific needs.

Meeting the retirement outcome challenge

with David Bell and Harry Mitchell on 3 November 2016

For a while now, Jeremy Cooper (Chair of the Super System Review and now at Challenger) has been trying to remain both positive and patient with the super industry as it faces up to the retirement outcome challenge and securing retirement income streams for members. Jeremy has lamented about the 'CIO Problem' and suggests that super funds should think about appointing a 'CRIO' (Chief Retirement Income Officer). These views were formalised in a recent thought piece produced by Challenger and KPMG (linked here).

Harry Mitchell is the recently appointed CEO at superannuation fund, Mine Wealth + Wellbeing, while David Bell is the Chief Investment Officer (CIO).

GH: Harry, do you have a 'CIO Problem' at your fund?

HM: Is there something you know about David that I don't know, Graham?

GH: Well I've worked with David on and off for well over a decade. I can tell you a few stories …

HM: The 'CIO Problem' is based on the premise that CIOs have historically, due to their analytical skillset, been heavily involved in 'version 1' retirement solutions. I call these 'version 1' solutions because they have generally been investment-based solutions. This can only get you so far. Jeremy is referring to the need for what we call 'version 2' and 'version 3' solutions. 'Version 2' is product based but accounts for investment and mortality risks. 'Version 3' is holistic. It would have a greater degree of personalisation hence brings in all capabilities of a super fund – from digital and analytics to communications and advice, to governance and administration capabilities that act as enablers.

GH: So what is the role of your CIO then?

HM: In our case David has two responsibilities. First he leads our investment activities. Managing risk to achieve investment outcomes will always be a crucial function of any leading super fund. A small amount of extra annual return delivered over time can have a significant impact on the retirement outcomes of our members.

However, David is also responsible for our retirement outcomes modelling unit. We established this area nearly two years ago. You know that David went back to uni six years ago to gain the research skills to meet the retirement outcome challenge. I think he initially thought that he would be building all the complex models himself, however he has matured (a little!) and realises that his role is to oversee this function. He has hired some great academic talent in this area. We have an agreed IT modelling platform (MATLAB) and have fully built out our modelling and testing environment.

GH: This is all starting to sound complex.

DB: It is. The complexity of the retirement outcome challenge cannot be denied. At a minimum you need the following: a stochastic framework that accounts for variability in investment and mortality outcomes and integration with Age Pension, and a clear set of objectives. From there you can begin to innovate. If a super fund can't meet the complexity of the problem then they are likely to fail to meet the retirement outcome challenge.

GH: Surely the objectives are not that hard to land on?

DB: It is more complex than you think. The industry as a whole is only just now working out an objective (a recommendation of David Murray's Financial System Inquiry). Think about income in retirement: people want higher income; they would prefer an income stream which is smooth and not bumpy; they would be upset if they outlived their retirement savings; and a bequest is worthwhile. We also know that people are generally risk averse – the pain of a lower outcome is larger than joy of an equivalent higher outcome.

Some of these features pull against each other: income level versus bumpiness, longevity risk versus bequest and so on. We have spent the last year working through all these issues with a collection of industry experts and academics and have packaged this up into a mathematical function. We now have what we call a 'better scoreboard' for assessing retirement outcome solutions and services.

GH: This sounds good but where does it place you in the super fund pack?

DB: Actually we will be sharing all of this work with everyone – industry, academia, regulators and policymakers. There is a bigger issue at play – nationwide retirement outcomes – and we want to contribute. We will make sure you get a media pass Graham when we release all this work.

GH: Won't most people find this complex modelling a bit confronting? How do people know it is not just gobbledy-gook with some pretty pictures?

HM: I trust Dave and his team. They do a lot to test their models, including the use of external testers, and are active collaborators with the academic world which also acts as a control. Their commitment to education of our Board, our Investment Committee, our Executive team and our staff has really helped us along our journey.

GH: Well why don't you call David your 'CRIO'?

HM: We are uncomfortable with the concept of a dedicated CRIO. Delivering good retirement outcomes is at the heart of what we do as a firm. This makes me, in my role as CEO, effectively the CRIO that Jeremy refers to. It is my role to make sure that all my teams are collaborating, and that we engage with industry and regulators. It is my role to make sure we deliver the best possible retirement outcomes to our members. So my core responsibility is the delivery of retirement outcomes regardless of its complexities.

DB: I think you may see variations to this model. QSuper has a similar model to us. Some funds, particularly those with a defined benefit legacy such as UniSuper, have internal actuarial teams which could do the heavy lifting on the modelling side. Perhaps funds that don't quite know where to start could create the role of a CRIO.

GH: I haven't seen much evidence to suggest that other super funds are doing similar work. Do you think this will lead to further industry consolidation?

HM: Who knows what motives will drive the next wave of industry consolidation. We like the idea of merit-based mergers, and we hope that as the industry becomes aware of the work we are doing, they would like to collaborate and work with us in a variety of ways.

Harry Mitchell is Chief Executive Officer (the unofficial 'CRIO') at Mine Wealth + Wellbeing. David Bell is Chief Investment Officer at Mine Wealth + Wellbeing and is working towards a PhD at University of New South Wales. Both Mine Wealth + Wellbeing and Challenger/Accurium are sponsors of Cuffelinks.

Spinning the wheel in retirement

by Jeremy Cooper on 25 February 2016

A common perception in finance is that the risk in growth assets, like equities, declines over a longer investment horizon. Recent research by consulting economists, Drew, Walk & Co into the equity risk premium (ERP) shows that even over the long run, equity investing is like a chocolate wheel: there are plenty of winners, but also losers. Retirees should not assume that the volatility of equity returns will be smoothed out over time, not even over 20 years. Retirees need to factor this into their goals for retirement income.

What is the ERP?

The ERP is the additional return that investors require, on average, for taking the extra risk of investing in equities, over and above any risk-free return (the government bond return). If investors do not expect to receive this additional return, they won't invest in the risky asset.

The ERP has been labelled the most important variable in finance and is used in a number of applications. Just about every decision in finance has a link to the ERP.

Unlike a long-term bond, where an investor can hold to maturity and receive a known term premium, the equity premium is unknown in advance and is far from certain. The challenge for investors and superannuation fund members is the

range of actual equity return outcomes, compared to the originally expected ERP.

The (un)predictable equity risk premium

In their paper, Drew, Walk & Co explore whether investing in equities in previous 20-year periods was adequately rewarded for the risk taken. They calculated the historical equity return (out)performance over various periods in a range of jurisdictions. The report concludes, among other things, that the equity return (out)performance:

- is uncertain, and its timing and magnitude are unpredictable
- has shrunk in recent history to below its long-term average in Australia
- was only 1% per annum for the last 20 years.

The flaw of averages

Traditionally, the ERP is calculated by averaging the entire period of available historical data, and this average is then used to make an assessment of future returns. In using such an average, people miss the fact that an Australian retiree household is planning for roughly 30 years, which is obviously well short of the 115 years since 1900.

Long-run historical average returns can be flawed because:

- They are not an indicator of future outcomes.
- There are potential survivorship biases, where losses incurred in failed companies are not properly included.
- The early history reflects the benefit of Australia emerging as a financial economy. Since WWII, Australian equities have actually performed lower than prior decades and in line with other major global markets.
- Most people do not get the average outcome. Around 50% will do better and a similar proportion will do worse.

In addition, retirement is different, because most retirees:

- Need to spend their capital and so are impacted by sequencing risk.
- Segment their retirement capital over a range of time horizons within their retirement timeframe, to meet their investing and spending goals.
- Won't have an unbroken exposure to equities for decades.

Time doesn't diversify equity risk

Most people assume that 20 years is long enough to get the 'long-run average', however the research indicates that there are a wide range of potential outcomes, even when they can stay invested for 20 years.

Only with hindsight, at the end of the 20 years, will a retiree find out their premium (if any) for taking equity risk over that period.

Figure 1 shows the frequency of the 20-year historical equity return (out)performance. The graph shows that Australia performed better in the first half of the 20th century, when it would still have been an emerging economy rather than the fully developed market economy it is today. There have been 14 periods of 20 years in Australia

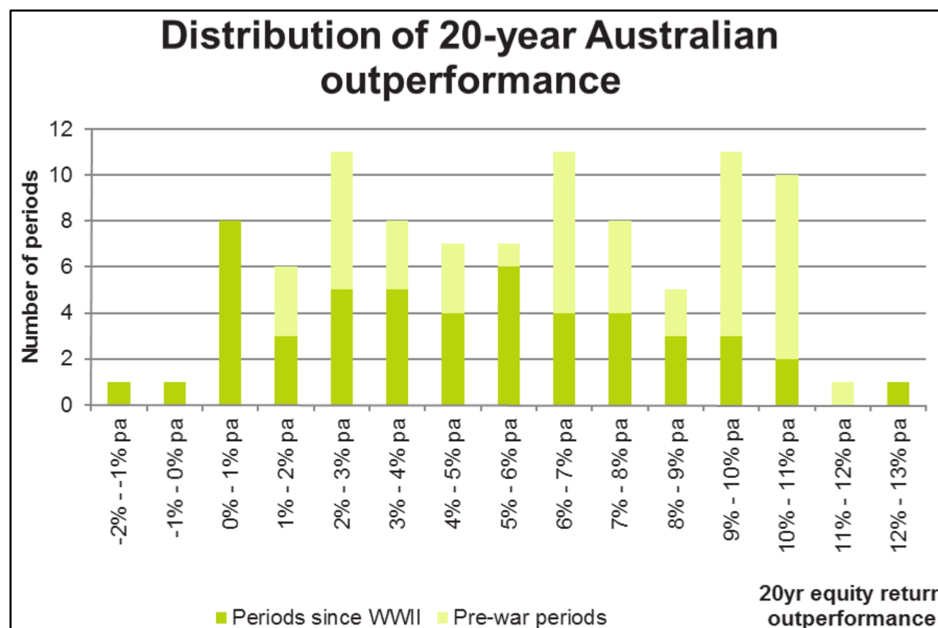


Figure 1: Distribution of 20-year Australian outperformance

where the equity return outperformance exceeded 10% per annum, but they were mostly before WWII (shown in light green).

The typical retiree needs some equity exposure

Even though equity investing is volatile over the long range, most retirees typically have the time horizon and risk tolerance to invest in at least some equities and they are likely to benefit from the premium. This is why the great majority of account-based pensions already have a generous exposure to equities.

A retirement risk management strategy

But what do retirees do about the equity risk? What happens when something goes wrong? Instead of adopting a conventional 'set and forget' approach, well-advised retirees work with a risk management strategy for their equity exposure in retirement. The idea of having a safety strategy is common in everyday life, and when it comes to investing in risky assets, retirees should be no different.

Using a long-term bucket for equities in retirement is one strategy that is sometimes used. However, as equity outperformance is uncertain over 20 years, a retiree will not have certainty about how much will be in the bucket after even as long as 20 years.

Portfolio allocation in retirement

Starting with Chhabra (one of the early papers that advocated goals-based investing rather than efficient frontier targeting), there has been a distinctly different approach for making asset allocation decisions in retirement. This approach is to consider the full range of the retiree's objectives and goals. Instead of trying to meet all targets with one investment decision, a goals-based approach will segment the main objectives. The approach is similar to the asset-liability matching practised by many insurance companies and defined benefit funds around the world.

Matching objectives enables a retiree (or their adviser) to consider the risk/reward trade-off that is represented by the ERP and select a suitable allocation of risk for each objective. For example:

- Generating income for life to meet essential spending needs will generally have a limited exposure to risky assets, as the objective is to maintain a minimum standard of living for life.
- Investing for spending on holidays and luxuries later in retirement can have a higher allocation to growth assets.

Under this approach, retirees with differing objectives, but the same wealth, age and risk tolerance will actually have different asset allocations.

Spinning the chocolate wheel in retirement

Retirees should think about investing as being like spinning the chocolate wheel shown. This has been assembled using the global historical numbers, the average of which roughly matches the forward projections for the ERP made by Drew, Walk & Co. in their paper.

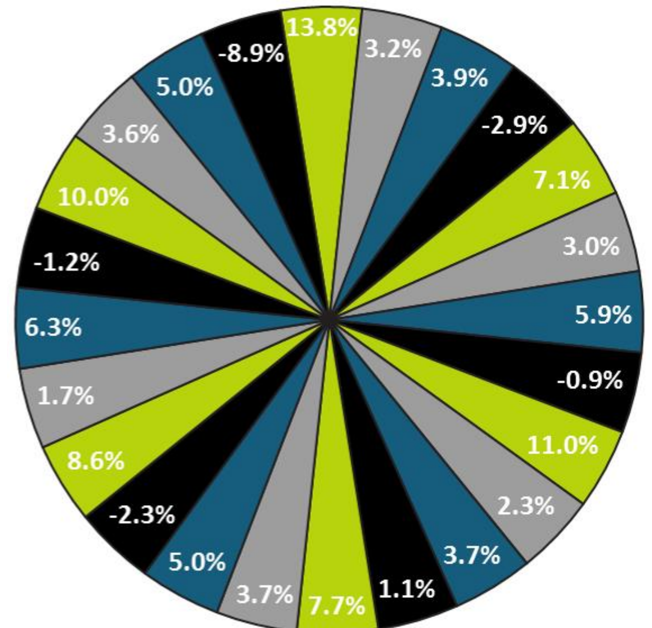


Figure 2: Chocolate wheel of global historical average annual equity return outperformance over-20 year periods

This 'chocolate wheel' reminds retirees that the average annual outperformance that might be expected over a 20-year investment period is not certain. It will not be a guaranteed rate. Most outcomes are attractive returns, but the risks are broader than what Australian history alone suggests.

Conclusion

For investors and retirees today, care needs to be taken drawing conclusions from long-term averages when planning for the future. In addition, a set and forget approach will not ensure that a retiree's exposure to equities risk will be appropriately mitigated.

Jeremy Cooper is Chairman of Retirement Incomes at Challenger, and chaired the Super System Review (the 'Cooper Review'). Drew, Walk and Co.'s full report, is available at www.challenger.com.au/equityriskinretirement

3. SMSF management

The story of your life viewed through your SMSF – Jo Heighway

Why SMSFs should have a corporate trustee – Liam Shorte

When SMSF members head for the exit – Julie Steed

SMSF asset allocation changes unexpected – Graham Hand

The amazing world of exotic assets in SMSFs – Will Munro

The story of your life viewed through your SMSF

by Jo Heighway on 25 February 2016

One of the most underestimated attractions of having your own SMSF is the power of a good story.

I love stories – whether it be reading a good book, sharing ideas with friends, or listening to a great story told by a successful entrepreneur, adventurer, close friend, or even a stranger. Stories are the best way to capture someone's attention, make them think, influence their mood, and maybe even make decisions that change their life.

One of the things I love about SMSFs is how passionate people are when telling their SMSF story. How they got one, why they did it, what they've invested in, what they love about it, what they hate about it, and what they wish they did differently.

Even when I think about the most memorable presentations I've seen from SMSF experts, what audiences love most is the stories about real people – the good, the bad, and the ugly of running your own fund.

Understanding that SMSFs deliver the power of a good story better than any other super fund structure can really change your perspective, whether you are:

- a trustee of your own SMSF, or thinking of establishing one
- in the business of competing with SMSFs in the superannuation industry
- an SMSF advisor looking to grow your SMSF business, or
- an auditor of SMSFs.

SMSFs made it cool to be interested in super

The popularity of SMSFs has grown so widespread some are calling this the 'golden age of the SMSF'. But how did that happen?

The answer is really simple – word of mouth!

Like many disruptive innovations, SMSFs delivered their members new stories worth sharing with friends at a BBQ. Just like many of the 'cool' start-ups today, their popularity didn't grow through large companies with massive advertising budgets urging viewers to 'compare the pair'. More often than not, the first time most people hear about SMSFs is from their friends. For Facebook users, it's the equivalent of 'like' and 'share'.

My life viewed through my SMSF

The journey of my SMSF has almost become like a biography of my life so far. Many of the major events in my life are mirrored in my SMSF in some way, and create stories in themselves.

I started my own SMSF when I was in my 20s. One of my first investments was to buy units in my employer's property trust when they were expanding, which I later realised was just their way of trying to tie me in without offering me s partnership (it didn't work!).

I learnt another valuable lesson when I got divorced. It turned out trying to save a few bucks by choosing individual trustees was a mistake, and I had to bite the bullet and buy a trustee company. It cost a fortune to change all my investments, but it was worth it so I never had to go through that again!

I'll never forget the first time I decided that I would contribute right up to my maximum contribution cap. I was young, self-employed and had a mortgage, yet I did it anyway SOLELY because I felt better knowing I held the fund's cheque book. Now it's one of my annual financial goals.

When I sold my share portfolio before the GFC, I gloated about the losses I'd avoided. And I was super proud to buy my first office premises and lease it back to my business, which I never could have done without my SMSF. I also invested in a software company I was passionate about.

Then there's the times I've helped my parents (members of my SMSF) use transition to retirement strategies to save tax and get cash when they need it, for a once-in-a-lifetime European holiday, or to fix their roof that blew away in a cyclone.

I tell how an industry fund stuffed my husband around for over six months when he joined our SMSF, giving every excuse not to pay his rollover. And I talk up how easy running my SMSF is now I

have a great broker. I don't have time to research and trade with four children and a busy career, so I found someone I trust.

My SMSF reflects the story of my life, and that's not unusual. Marriage, divorce, business success and failure, ageing, death, good fortune, luck and loss – who said super is boring?!

Thinking differently to compete with SMSFs

If I were looking for a way to compete against the SMSF industry, I wouldn't bother with the traditional arguments. Focusing on fee comparisons, administration burden, historical investment performance, or how much you need to start your own fund comes across as defensive and, to be honest, makes for a pretty ho-hum story.

What if, instead, the focus was on creating unique experiences for super fund members that made them excited to become a member, stay and tell their friends? I'm talking about the type of innovation in customer service that could actually turn super fund members into raving fans.

If the only experience members of a super fund have is receiving an envelope in the mail every six months with a super fund logo printed on the front, which they throw in the bin without opening, then it's fair to say they won't be sharing stories of your fund any time soon with their friends at a BBQ!

Using stories to grow an SMSF business

I'm not suggesting that an SMSF is for everyone, and there are most definitely many important factors that need to be considered. But if someone is looking to grow an SMSF business, it pays to think about giving clients the experience they crave.

Does your service, your technology, your support and ongoing engagement with your client provide them with the opportunity to 'like and share' their story with their friends?

Most importantly, are you focusing your expertise on ensuring their SMSF story is a good one, and that your clients can access the right support at the times in their life when they really need it?

Auditors need to be able to 'see the story' behind the numbers

The key to being a good auditor is to always understand the big picture. When I plan an SMSF audit I recognise that SMSFs are run by real people, with real lives, making real decisions. Rather than seeing my audit as a 'tick and flick' exercise, I read the financial reports like they're telling me a story.

What story do the numbers tell me, and what do I know about the fund that will point me towards the risks most likely to need my attention this year? It makes my work much more interesting but also means I don't waste anyone's time trying a one-size-fits-all approach. I zero in on the real risks and eliminate what doesn't apply.

I would love you to share your SMSF story with me, so feel free to comment and share.

Jo Heighway is a Partner, SMSF Assurance & Advisory, at Deloitte Touche Tohmatsu. Cuffelinks does not favour one superannuation type over another and welcomes other opinions on the merits of alternative fund structures.

Why SMSFs should have a corporate trustee

by Liam Shorte on 31 March 2016

Did you know that 78% of SMSFs are set up with individual trustees but that over 90% of professional advisers I have canvassed would always recommend a Sole Purpose Company trustee? In the haste to set up funds, most people miss this vital step with many having to pay high fees to change trustee later.

The issue is worsening as in the three years to 2015, there was a 4% decline in SMSFs registering with a corporate trustee. Of newly registered SMSFs in 2015, an incredible 95% had individual trustees (see: ATO Self-managed super fund statistical report – June 2015 appendix 1, table 6)

I believe it is essential to have a company as trustee and that the option to have individual trustees is short-sighted.

Table 6: SMSF trustee type

This table shows the trustee structure (either corporate or individual trustees) of the SMSF population as at 30 June 2015, plus new registrations for the years 30 June 2013 to 30 June 2015.

SMSF trustee type

Trustee type	% of all SMSFs (at 30/06/2015)	2013 registrations	2014 registrations	2015 registrations
Corporate	22.16	3,934 (9.67%)	2,811 (7.70%)	1,777 (5.44%)
Individual	77.84	36,768 (90.33%)	33,716 (92.30%)	30,894 (94.56%)
Total	**100%**	**40,702 (100%)**	**36,527 (100%)**	**32,671 (100%)**

Benefits of a corporate trustee

A corporate trustee facilitates:

- Time to grieve or adapt. The strongest reason from 10 years' experience with SMSFs is respect for your spouse or family's needs in times of grief. Do you really want to leave them an awkward and expensive set of tasks to carry out just to save $700?
- Continuous succession. A company has an indefinite life span; it does not die. A corporate trustee can ensure control of an SMSF is more certain following the death or mental or physical incapacity of a member.
- Administrative efficiency. When members are admitted to, or cease, membership of the SMSF, all that is required is that the person becomes, or ceases to be, a director of the corporate trustee. The corporate trustee does not change as a result. Therefore, title to all the assets of the SMSF remains in the name of the corporate trustee, especially useful when dealing with property in an SMSF.
- Sole member SMSF. An SMSF can have one individual as both the sole member and the sole director. Likewise, if a spouse is incapacitated, then the husband or wife can act as director under an enduring Power of Attorney to run the fund on their own without the need for interference by others.
- Meets lenders' requirements. Most lenders require a corporate trustee in the SMSF as it is easier to deal with.
- Higher Loan to Valuation Ratios accepted. With a corporate trustee, many lenders will go to 80% on residential loans and 70% on commercial real estate.
- Greater asset protection. As companies are subject to limited liability, a corporate trustee will provide improved protection for the directors where a party sues the trustee for damages. I use an electrician as an example here when I discuss this with clients. If he is on your property and is electrocuted because of the owner's (SMSF) negligence, then the SMSF may be sued but your own personal liability is limited to your shareholding and member balance rather than your entire wealth

Problems with individual trustees

Individual trustees cause issues with:

- Paperwork at the worst time. Welcome to a nightmare. When a spouse has barely had time to start grieving, they need to manage the SMSF and administer pensions, investments and deeds. Minutes to record death of trustee, deed update to add a new trustee or move to a corporate trustee, off-market transfer forms and identity forms and probate forms to put every investment in correct name(s). Worse still, deal with the Land & Property Management agency or Office of State Revenue and their endless forms!
- Complexities relating to death. If the SMSF has individual trustees, e.g. a husband and wife, then timely action must be taken on the death of a member to ensure the trustee and member rules are adhered to properly. For

example, SMSF rules do not allow a sole individual trustee/member SMSF.

- Extra and costly administration. To bring in a new member to an SMSF with individual trustees requires that person to become a trustee. As trust assets must be held in the names of the trustees, the title to all assets must be transferred to the new trustees.
- Sole member SMSF. A sole member SMSF must have two individual trustees. Does a spouse need to rely on the children, possibly from the first marriage? That's really not going to work as we know what a problem blended families are when it comes to estate planning.
- Tighter lending rules. Lower LVRs are common, due to legal concerns, lenders restrict the maximum borrowing of an SMSF with individual trustees to 70% for residential properties and 55-60% for commercial real estate.
- Less asset protection. If an individual trustee suffers any liability, the trustee's personal assets may be exposed. The trustee as well as the SMSF may be sued by someone doing work for the SMSF.

What do the ATO and ASIC think?

The Australian Securities & Investments Commission (ASIC) and the Australian Taxation Office (ATO) prefer corporate trustees. Last year, ASIC released a number of documents which outlined the advantages of an SMSF corporate trustee.

More recently, the ATO released an article and video on SMSFs titled Choose individual trustees or a corporate trustee that objectively outlines the pros and cons.

And even more advantages of a corporate trustee

With a bit of preparation and planning, combining your will and enduring powers of attorney, minuted resolutions and if needed clauses written into the deed, a person (usually the Executor or Legal Personal Representative) can be immediately appointed as a director so that the fund can continue to operate in the event of death regardless of whether a death certificate or probate have been granted.

Likewise, a person who loses mental capacity needs to be replaced if they were individual trustees. With a company, the constitution can immediately have a mechanism which allows the person holding the enduring power of attorney to be appointed as a replacement director, resigning the incapacitated director at the same time.

Under ASIC's new administrative penalties, if a fine is made in relation to an SMSF that has individual trustees, then each trustee will be fined in their personal capacity. The fine is personally payable and cannot be reimbursed by the fund. Only one fine is payable by a corporate trustee.

It is also easy for Superannuation Industry Supervision (SIS) regulation 4.09A(2)(a) to be contravened by an individual trustee. It says:

"A trustee of a regulated superannuation fund that is a self-managed superannuation fund must keep the money and other assets of the fund separate from any money and assets, respectively: … (a) that are held by the trustee personally …"

For example, if individual trustees receive rental property income or a dividend into a personal account in their own names instead of an account in their personal names but with the account designation of their SMSF, it is a contravention. With a corporate trustee, it's far less likely to mix fund assets with personal assets.

Summary

It's difficult to believe that 90% of SMSFs are currently being established with individual trustees. Even if some costs of registering a company are initially avoided, the trustees are almost certainly inviting complications later in the life of the SMSF.

Liam Shorte is a specialist SMSF advisor and Director of Verante Financial Planning*. This article contains general information only and does not address the circumstances of any individual. Professional personal financial advice should be sought before taking action.*

When SMSF members head for the exit

by Julie Steed on 13 October 2016

Establishment and growth of SMSFs receives plenty of coverage in the media, but relatively little attention is paid to the other end of the SMSF life cycle – when an SMSF is no longer appropriate for one or more of its members. ATO data shows about 1,000 SMSFs are wound up each month.

The increasing number of Australians living with dementia and Alzheimer's has encouraged some SMSF members to look at alternatives and there are circumstances where the members may need an exit strategy. The three main alternatives are:

- rollover to a retail or industry fund
- convert to a Small APRA Fund (SAF), as discussed previously in Cuffelinks here.
- pay benefits to members and close down the SMSF.

More on these choices later.

Why do some trustees wind up their SMSF?

It is important to consider the attitudes and abilities of the remaining SMSF members if one or more members die or are no longer able to be a trustee, perhaps due to declining physical or mental health. Will the surviving members want to continue the fund? Do they have the necessary skills, time and interest levels?

An exit strategy may also be needed due to the fund's investments. Does the fund have illiquid or indivisible assets that may affect its ability to make benefit payments?

The following 'Ds' are all trigger events that may lead to the need for an exit strategy:

Death and disability: The payment of a death or disability benefit is an important issue if indivisible or illiquid assets are involved, or if there are unique assets the family unit wishes to retain.

Dementia: If an SMSF trustee loses mental capacity they are legally unable to continue in the role of trustee and therefore unable to be a member of an SMSF. However, there are no legal issues with a person who lacks mental capacity being a member of a retail fund or a SAF.

Disinterest: Loss of interest can be a driving factor for many SMSF trustees who are skilled and committed at the outset but may become less interested and able as they age.

Divorce: When couples in an SMSF separate it is often highly desirable for each member to make their own future super arrangements. Running an SMSF with trustees who are not on good terms is difficult at best and often impossible. Additionally, if a family law split is being made from the SMSF, it is possible to take advantage of the capital gains tax (CGT) exemptions when moving one of the parties to a SAF or a new SMSF. However, this is generally not available if the family law split is paid to a retail fund.

Departed residents: If an SMSF member becomes a non-resident, it can be difficult for the SMSF to retain its eligibility for concessional tax treatment. There are generally no issues for departed members in retail funds. SAFs can also have non-resident members, however the members can generally not contribute.

Disqualified persons: A disqualified person is either an undischarged bankrupt or someone who has been convicted of an offence involving dishonesty. A disqualified person cannot legally be a trustee and is therefore unable to be an SMSF member. There are no issues with a disqualified person being a member of a retail fund or a SAF.

The three exit strategies have different tax outcomes, different abilities to retain private assets and different administrative requirements.

1. Rolling over to a retail or industry fund

Rolling over to a retail or industry fund is a CGT event. Any gains will be realised and tax payable. If capital losses exist, they cannot be carried forward. If members are in pension phase this may not be an issue, however it may be a significant cost if the fund is still in accumulation phase.

The range of investment options may also be a significant factor. It is important to compare the SMSF's existing investments with those available in a new fund. If the SMSF has assets that cannot be accepted, how do the members feel about disposing of the assets? This may be an issue if the SMSF has real property, collectables or shares in private companies. If the SMSF has a residential

apartment on the Gold Coast, the SMSF members may be perfectly comfortable in selling the property to facilitate a move to a retail fund. However, if it's a property that SMSF members are running the family business from, its sale may be highly undesirable.

For members who commenced a pension before 1 January 2015, any Centrelink deeming exemption will be lost if the pension is rolled over to a new fund. This may result in a reduction in age pension.

2. Converting to a small APRA fund

A SAF is an SMSF with a professional licensed trustee. The professional trustee manages the fund for the benefit of the members and is responsible for all of the fund's compliance, regulatory reporting, and administration.

This conversion can avoid CGT entirely. The existing trustees simply retire and appoint the professional trustee. The fund (the tax paying entity) continues uninterrupted and does not dispose of any assets; there is simply a change in trustee.

Moving to a SAF may also help members who wish to retain unique investments. Different SAF trustees will have their own rules in respect of allowable assets, however a SAF will be far more likely to accept a unique asset than a retail or industry fund. Provided that the total fund investments are relatively diversified, it is common for SAFs to allow holdings of real property, private company shares and collectables.

Importantly, converting an SMSF to a SAF does not have any implications for the grandfathering of Centrelink deeming on pensions.

3. Paying benefits and closing the SMSF

If the members have met a condition of release it is possible to simply pay the member benefits and wind-up the SMSF. Sufficient funds will be retained for wind-up costs and taxes and a final return will be lodged.

Naturally, the member needs to compare the tax-effective environment of superannuation with other forms of investments. This decision is often balanced with the expense of running an SMSF that has been paying a pension for many years and now has a relatively low account balance. There may also be Centrelink implications of cashing benefits from an SMSF.

An exit strategy may not be something that SMSF members think about often, but there are a number of instances in which one may be required. Taking steps to identify the potential trigger events and available strategies will assist members to better achieve their retirement goals, even when things don't go to plan.

Julie Steed is Senior Technical Services Manager at Australian Executor Trustees*. This article is general information and does not consider the circumstances of any individual.*

SMSF asset allocation changes unexpected

by Graham Hand on 11 August 2016

There has always been considerable mis-information surrounding the asset allocation of SMSFs. The main reason is the inadequate categorisation and long-time lags in the 'official' Australian Taxation Office (ATO) statistics. Cuffelinks has discussed this directly with the ATO, as reported in previous articles here and here.

The main shortcoming is that the category 'Overseas shares' only includes direct share investments, and excludes the billions invested through listed and unlisted trusts and other managed investments. When I confronted the ATO on overseas share asset allocation, their response was:

"It's fair to say a substantial amount is in international equities, much larger than the number quoted under the 'Overseas shares' category."

According to the official statistic, less than 1% of SMSF assets resides in 'Overseas shares'. Considering that SMSFs hold one-third of our $2 trillion in superannuation assets, this inaccuracy is a major shortcoming. In fact, people marketing global funds often take advantage of this low

Asset allocation of sample SMSFs as at 30 June 2016

Sector	30 June 2015 (%)	30 Sept 2015 (%)	31 Dec 2015 (%)	31 March 2016 (%)	30 June 2016 (%)
Cash and short term deposits	17.0	18.7	18	18.4	18
Fixed Interest	12.9	12	12.3	12.3	12.2
Australian Shares	37.1	36.4	35.4	35.8	34.5
International Shares	14.1	12	12.9	12.6	13.1
Property	18.3	20.4	20.8	20.4	21.7
Other (Hedge funds, agricultural funds, private geared & ungeared trusts and collectables)	0.6	0.5	0.6	0.5	0.5
Total	**100**	**100**	**100**	**100**	**100**

Source: SuperConcepts Pty Ltd

number, imploring trustees to correct their ridiculous asset allocation mistake and invest in their global fund. The truth is, trustees are already using hundreds of other available global channels.

A more accurate SMSF asset allocation number

SuperConcepts has released its 2016 Financial Year Analysis based on the actual investments of about 3,300 SMSFs administered by its subsidiary Multiport. Due to its relationship with AMP, this group has more financial adviser input than the average SMSF, giving a greater allocation to managed funds and global equities, but it is instructive of SMSF trends nonetheless.

The interesting and sometimes unexpected changes in the last year include:

- A fall in equity investments, with domestic down from 37.1% to 34.5%, and international down from 14.1% to 13.1%, refuting the claims about the TINA (There Is No Alternative to equities) mentality in the sector. SuperConcepts attributes this fall to trustees reducing their exposure during periods of higher volatility, and less appeal of the local large cap stocks. Among the most commonly held investments, two pooled structures, Magellan and Platinum, are favourites with this group for global exposure.

Over the course of 2015/2016, the amount held in the top 10 listed securities fell from 16.5% of all investments to 14%. The Top 10 shares by market cap still represent about 38% of Australian equities held by SMSFs, but the reduction recognises that investors are more concerned about the capital growth of the banks, BHP, Newcrest, and Telstra. Increasingly, SMSFs are looking for opportunities outside of the large caps.

- Cash holdings have increased from 17% to 18% (table below) despite low interest rates. Within this segment, term deposits rose more strongly than at-call cash, which took a hit in the last quarter in the face of falling cash rates. It's surprising to see the large allocation in this segment.

	30 June 2015 (%)	30 Sept 2015 (%)	31 Dec 2015 (%)	31 March 2016 (%)	30 June 2016 (%)
Cash	12.3	13.1	12.6	13.1	12.5
Term Deposits < 1 year	4.7	5.6	5.4	5.3	5.5
Total %	**17**	**18.7**	**18**	**18.4**	**18**

Source: SuperConcepts Pty Ltd

	30 June 2015 (%)	30 Sept 2015 (%	31 Dec 2015 (%)	31 March 2016 (%)	30 June 2016 (%)
Direct Property	14.6	16.5	16.5	16	15.7
Listed Property	1.7	1.7	1.9	2.2	2.1
Managed Funds	1.3	1.2	1.2	1.3	1.3
Other (Syndicates, Unlisted Trusts etc)	0.7	1	1.2	0.9	2.7
Total %	**18.3**	**20.4**	**20.8**	**20.4**	**21.7**

Source: SuperConcepts Pty Ltd

- Property has been the big winner, up from 18.3% to 21.7% (above table), including both listed and unlisted segments. Direct property (often business premises held by the SMSF and rented to one of the trustees, rather than residential property) rose steadily, but the major increase came in the 'other' category of syndicates and unlisted trusts. With listed A-REITS trading at a hefty premium to NTA, unlisted trusts have benefitted from the search for yield at better prices.
- Fixed interest allocations fell overall, but hybrids and direct holdings rose. Managed funds in this segment comprise only 4.4% of assets, losing out badly to cash.

(The full report also looks at market movements versus funds flow and makes the same conclusions regarding increases in cash and property and reductions in fixed interest and equities).

Trustees take cash flow decisions in the final quarter

Both inflows and outflows from SMSFs are always at their highest in the June quarter as trustees take action before the end of the financial year. However, with uncertainty surrounding the May 2016 budget, average inflows to SMSFs in the June 2016 quarter of $10,700 were the lowest since 2012. June withdrawals are also heavy, at $17,800, as trustees ensure they meet minimum pension requirements. Withdrawals are always heavier than contributions in any quarter, showing how much the continuing growth of SMSF balances relies on market performance.

Checking from another source

We checked these numbers against the Vanguard/Investment Trends March 2016 SMSF Investor Report, based on a survey of 3,531 SMSF trustees. Its major findings are consistent in direction and include:

- Direct shares (outside of managed funds and ETFs): 38% of total SMSF assets in 2016, down from 41% in 2015
- Cash and other cash products: 25%, up slightly from 24% in 2015
- ETFs: now at 3%, up from 2% in 2015
- Managed funds: 10%, up from 9%
- Direct property (residential & commercial): 11%, up from 10%
- Other investments: 13%, steady

Investment Trends believes the allocation to direct shares (outside of managed funds and ETFs) has declined over the past three years as a result of market performance and poor investor sentiment towards individual shares.

Marketing opportunities

These SMSF investment patterns suggest there are good opportunities for bond funds and other cash alternatives, ex-20 Australian equity funds and other global equity funds. Property is popular but managed funds miss out to direct property, unlisted and syndicates.

Graham Hand is Editor of Cuffelinks. See the full Investment Patterns Survey here. *SuperConcepts is a Cuffelinks sponsor.*

The amazing world of exotic assets in SMSFs

by Will Munro on 7 June 2016

Despite being involved in auditing SMSFs for many years, I still sometimes pick up an SMSF for audit and just think 'wow' ….

Whether it be the creativity of some investments, the risk-seeking nature of some trustees or just trying to get my head around what the trustee(s) were thinking when they put their hard-earned retirement savings into a particular investment, I can assure you that auditing SMSFs never gets boring.

I'm going to share with you some of my favourite investments from my time as an SMSF auditor. It certainly has opened my eyes to a world outside of listed shares.

As an SMSF auditor, aside from the yes/no compliance aspects, I am primarily concerned with a few key assertions with respect to investments – being existence, rights and obligations, and valuation. As you will see below, sometimes getting comfortable over all of these can be very difficult.

Animals – yes, believe it or not, some trustees have placed their retirement savings into animals, bulls to be precise. In September 2015, the Australian record for a bull sale was smashed, with an Angus bull being sold in NSW for $150,000!

Memorabilia – I've seen a cricket cap, *Back to the Future* memorabilia and many others. The irony of retirement savings being ploughed into *Back to the Future* memorabilia was certainly not lost on me! Genuine baggy green cricket caps, when they go to auction, can do very well indeed. One sold for over $400,000 because it was a Sir Donald Bradman cap.

Transport – I've seen taxi plates, plane hangars, a marina berth and a caravan, to name a few! Unfortunately for trustees who invested in taxi plates a few years back, with the rise of Uber, market values of taxi plates have dropped significantly in recent years, from a high of around $425,000 in 2011 for a Sydney plate to around $230,000 in December 2015. In fact, they dropped from $300,000 to $230,000 in one month at the end of 2015! Since November 2014, the value of taxi plates in Sydney has fallen by 38% and is now at its lowest level since January 2002. Marina berths are an interesting investment – they are generally long-term leases (without an option to renew), not actually direct ownership. So, while an SMSF may pay a significant amount of cash (hundreds of thousands of dollars in many cases), it does not actually own the site. The money is, quite simply, rent in advance. The way that trustees generally try to make profit from a marina berth is by renting it out short term at higher than the rent prepaid, plus of course the interest paid on borrowings for 25 years' rent up front.

Bible pages – one of the most interesting investments I have come across is pages from the original King James Bible! Rare antiquarian (antique) bibles that are investment-grade can often increase in value each year by 15 to 25% or more. The finite supply is continually bought-up by collectors and institutions.

Whisky – I've come across trustees investing in barrels of whisky, worth around $10,000 each! As the famous Irish playwright, George Bernard Shaw once famously said: "*whisky is liquid sunshine*!". Here's hoping the sun is shining on these investments!

ATMs – Most people think of their super as their own personal ATM for retirement – well, how about actually investing in an ATM! With many ATMs in Australia charging upwards of $2 per transaction, if only 50 people per day use the ATM that works out at $36,500 per year (less rent). Dependent on the location of the ATM, this could even be a conservative figure.

Moon rock – certainly one of the more unusual investments was a piece of moon rock, reportedly brought back from one of the moon landings.

There are many other exotic investments, including the infamous story of an SMSF that owned a pride of lions, which they leased back to a circus.

Compliance obligations of a trustee

Before you do decide to invest in some of the more exotic investments, always remember your compliance obligations as a trustee. The auditor of your SMSF will require evidence of the existence, rights and obligations, and valuation of your

investment, as well as storage and insurance for collectables.

As the Australian Taxation Office advises, collectables and personal use assets are things like artworks, jewellery, vehicles, boats and wine. Investments in such items must be made for genuine retirement purposes, not to provide any present-day benefit. So collectables and personal use assets cannot be:

- leased to, or part of a lease arrangement with, a related party
- used by a related party
- stored or displayed in a private residence of a related party.

In addition:

- the investment must comply with all other relevant investment restrictions, including the sole purpose test
- the decision on where the item is stored must be documented (for example, in the minutes of a meeting of trustees) and the written record kept
- the item must be insured in the fund's name within seven days of the fund acquiring it
- if the item is transferred to a related party, this must be at market price as determined by a qualified, independent valuer.

For collectables and personal use assets held before 1 July 2011, remember that trustees have until 30 June 2016 to comply with these rules.

Will Munro is Manager of the SMSFs Audit team at Deloitte. This article appeared on Deloitte's SMSF Inside blog. This article is general education and does not address the circumstances of any individual, nor is it taxation or investment advice.

4. LICs and ETFs

The major weaknesses of LICs and managed funds – Graham Hand

Three risk measures provide a fuller LIC picture – Nathan Umapathy

ETFs playing bigger role for investors – Ilan Israelstam

The major weaknesses of LICs and managed funds

by Graham Hand on 17 March 2016

"He who pays the piper calls the tune."

To state the bleeding obvious, sales people working for fund managers are biased towards their own product structures. It's the job of Chief Executives, Chief Investment Officers and Business Development Managers, and anyone working in distribution for a fund manager, to promote their company's particular structure. Another side of the job description requires them to point out the deficiencies of competitor structures.

So let's focus on the biggies. What is the main criticism that Listed Investment Company (LIC) folk use against managed funds, and what do managed funds folk say to criticise LICs?

Main weakness of managed funds, as nominated by LICs
Managed funds are open-ended, which means existing investors can redeem (cash out) at times of market stress, forcing fund managers to sell assets into poor markets.

Main weakness of LICs, as nominated by managed funds
LICs are closed-ended, which means the only way existing investors can cash out is by finding a willing buyer on the stock market, and this could be at a heavy discount to the asset backing.

Guess what. Both are correct. The irony is that these are also the strengths in the right markets. Let's consider each in more detail:

Managed funds are forced to sell in stressed markets

The harsh reality of the way many investors behave is that they invest more into the market when it is strong, expecting it to rise further, and redeem when markets fall, expecting further losses. The doom and gloom in the media prompts unfortunate investor reactions.

In extreme circumstances, managed fund redemptions may be suspended to prevent cash outflow, such as on mortgage funds around 2008 during the GFC. These products had a fundamental weakness. They offered next day liquidity, but their assets were both long-term and illiquid. There is no ready market for five-year mortgages at a time of distressed selling. Faced with a run on their funds, redemptions were suspended, and it was only recently, some seven years later, that the final mortgages were repaid allowing the last instalment to be returned to the investors.

Example of the problem: During the GFC, the only way the demand for cash from managed funds could be met was by selling assets. I remember one frustrated fixed interest manager telling me he could buy seven-year CBA subordinate debt (not hybrids) at over 9%, which he thought was excellent value (and indeed, it turned out to be), but he could not buy because he was desperate to sell anything to fund redemptions. Liquidity has a tendency to dry up when it is most needed.

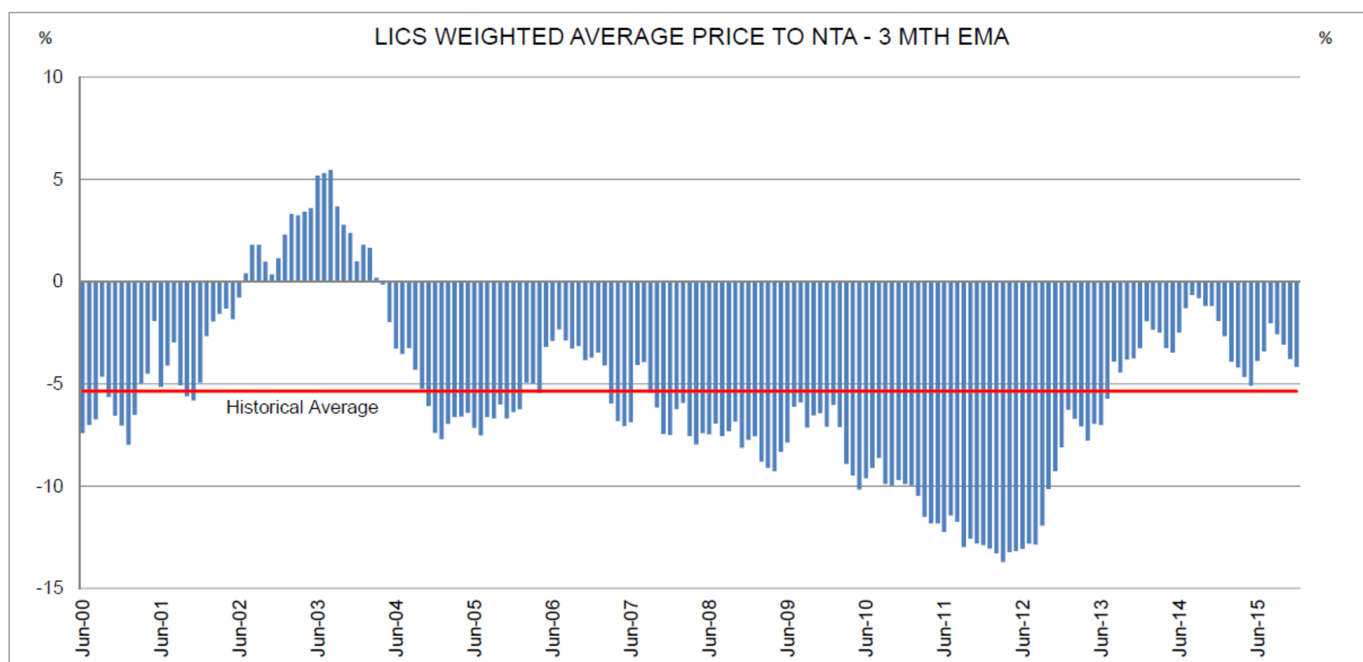
Similarly, when markets are peaking, new applications are usually at their highest. Since most managers accept as much money as they can, they are either forced to invest when the market is toppish, or hold the money in cash and risk underperformance if the market continues to run.

So the LIC criticism of managed funds can be accurate at market extremes. But the main strength of managed funds is due to the same structure. Managed funds are open-ended, and existing investors can redeem (cash out) at the net asset value (NAV) of the underlying assets every day. They do not trade at a discount.

LICs trade at a discount

LICs are not required to sell assets as investors cash out because the buyer on the ASX provides the liquidity, and the number of shares on issue remains the same. This advantage is balanced by the dependence on the strength of the market bid to support the price, and especially for larger sales volumes, the price can be pushed down relative to Net Tangible Assets (NTA).

For example, assume a buyer subscribes for an initial issue at $1, and the NTA at the start is $0.97 (due to the cost of listing). If the fund manager has a poor start to performance, or the overall market is weak, or the initial issue was not firmly placed with end-holders, then the issue can drift to a further discount to NTA, and sometimes take years to recover, if ever.



Source: Patersons Listed Investment Companies Report, December 2015. EMA = Exponential Moving Average, which gives more weight to recent data.

The table above shows the weighted average market price to NTA for all LICs in Australia, showing an average discount to NTA of about 5%, but it has been as high as 13%, with no positive average for the last 12 years.

These are averages, and there are some well-established LICs which have performed better, often trading at a premium to NTA. These include Australian Foundation (AFI), Argo (ARG) and some of the Wilson funds, such as WAM Capital (WAM). But since the sector as a whole is at a discount, many are at severe levels of 20% or more, and perhaps up to 30%. Examples of large discounts include Flagship (FSI), Contango Microcap (CTN) and Hunter Hall (HHV). The investor has only two choices in these LICs: hang on and hope the discount is removed, or sell and realise the loss.

The main reasons why some LICs trade at a premium are that the manager or fund is well-known, highly sought-after and communicates well with investors. The flip side is that if the manager loses the confidence of investors, it can take a long time to recover. Investors need to be convinced the manager can add value. There is no mean reversion.

Looking at the graph, it might sound attractive to buy at a discount of 13% and then sell at a discount of 5%, but it is extremely difficult to know which manager's reputation will improve, or even what caused the discount.

Example of the problem: Templeton Global Growth Fund (TGG) is a long-established LIC from a global brand with a market value of about $280 billion. Until a year ago, TGG had been trading at around NTA, with a 12-month high of $1.50, but is now at $1.13 against an NTA of about $1.30. The share price has fallen roughly twice the market fall. They recently held an investor update where a member of the public criticised the board for twice issuing new shares at a discount to NTA, diluting the value of shares for existing shareholders. The investor argued that the placement had contributed to the discount to NTA. A board member of TGG admitted they had underestimated the consequences of both the issue at a discount and the placement. He said their communication must improve, especially by better explaining their style and in what conditions it might not work (they are deep value, which has underperformed growth recently). It will take a lot of time and effort by TGG to remove the discount to NTA.

As with managed funds, the main weakness is also the main strength. LICs are closed funds, which means the manager is never forced to sell assets on market at times of stress.

Are LICs or managed funds better?

There is a lot more to the overall merit of these two structures than the two main points highlighted here. Consider the quality of the manager and investment team, the time frame of the investment, the asset class and the need for liquidity.

For investors who find high quality managers who put a lot of time and effort into nurturing their clients and who deliver consistent performance,

LICs are a good structure. For investors who demand liquidity at market value and trust a large institution with a strong investment management business, managed funds can work well.

But next time you hear the predictable criticism of an alternative structure, ask about their own potential weaknesses.

Graham Hand is Editor of Cuffelinks. This article is general information only. Disclosure: Graham holds investments in both managed funds and LICs, including TGG, he is on the Board of a LIC (Absolute Equity Performance, ASX:AEG) and sits on the Compliance Committee of a managed fund business (Lazard Asset Management).

Three risk measures provide a fuller LIC picture

by Nathan Umapathy on 11 August 2016

Historical returns can be a good guide when evaluating the merits of a Listed Investment Company (LIC). However, investment performance represents only one side of the risk-reward equation. Investors also need to factor in the risk metrics when assessing a LIC, such as the following three:

- Beta
- Standard deviation
- Sharpe Ratio

Beta

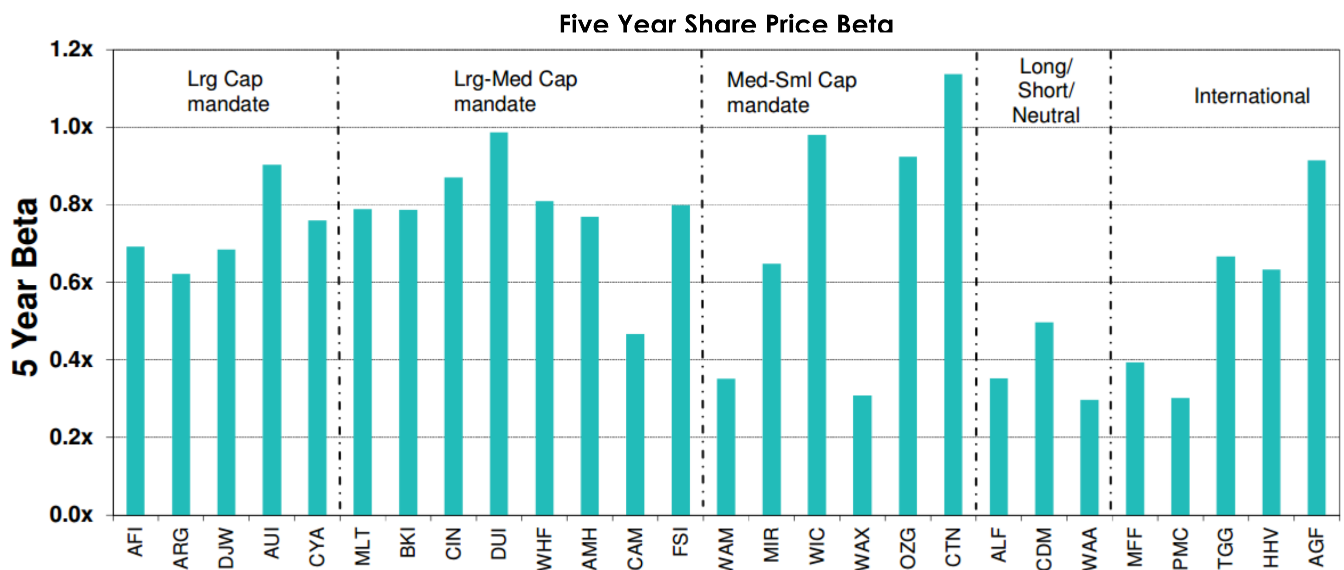
Beta measures the magnitude of a LIC's movement relative to its benchmark. A beta measurement of 1 conveys that the LIC is moving in line with its benchmark. A beta of less than 1 indicates it is less volatile than its benchmark, and a beta of more than 1 suggests that the LIC is more volatile than the benchmark.

For example, if a LIC has a beta of 1.1 in relation to the S&P/ASX All Ordinaries, then the LIC historically has been 10% more volatile than the index. Therefore, if the S&P/ASX All Ordinaries has gained 10%, with everything else being equal, the LIC would be expected to have gained 11% (10% x 1.1). The reverse is true if the index has fallen.

In the graph below, we calculate some LIC's five-year share price beta. Overall, the graph suggests that the share price movement of the LIC is lower than the market. This also suggests that the inherent active nature of a LIC would be a good addition to an investment portfolio to smooth out long-term volatility.

Other observations from the graph:

- LICs within the Large Capitalisation and the Large to Medium Capitalisation mandate have a beta largely between 0.6x-0.9x compared with the market. This suggests that,



with the right LIC, an investor could achieve the same performance as the market with less risk..

- All the Wilson Asset Management LICs (ASX: WAM, WAX and WAA) have a beta of less than 0.5x due to their historically high portfolio weighting in cash..
- Australian Leaders Fund (ASX: ALF) and Cadence Capital (ASX:CDM) have low betas due to their ability to short investments in comparison to their benchmark.

Standard deviation

Standard deviation is a statistical measurement of historical volatility and is the most common definition of risk. It measures a LIC's dispersion of investment return from its historical average. A larger standard deviation indicates higher volatility.

We use the pre-tax net tangible assets (NTA) as our data point to assess the standard deviation. The pre-tax NTA represents a better measure of a LIC's investment performance.

The graph below reflects the pre-tax NTA performance of LICs over the past five years. This is reflected by its position along the horizontal, with LICs further to the right achieving higher returns. The graph also highlights the standard deviation of the LIC's pre-tax NTA performance. This is reflected by each LIC's positon along the vertical axis, with more volatile LICs positioned higher on the graph.

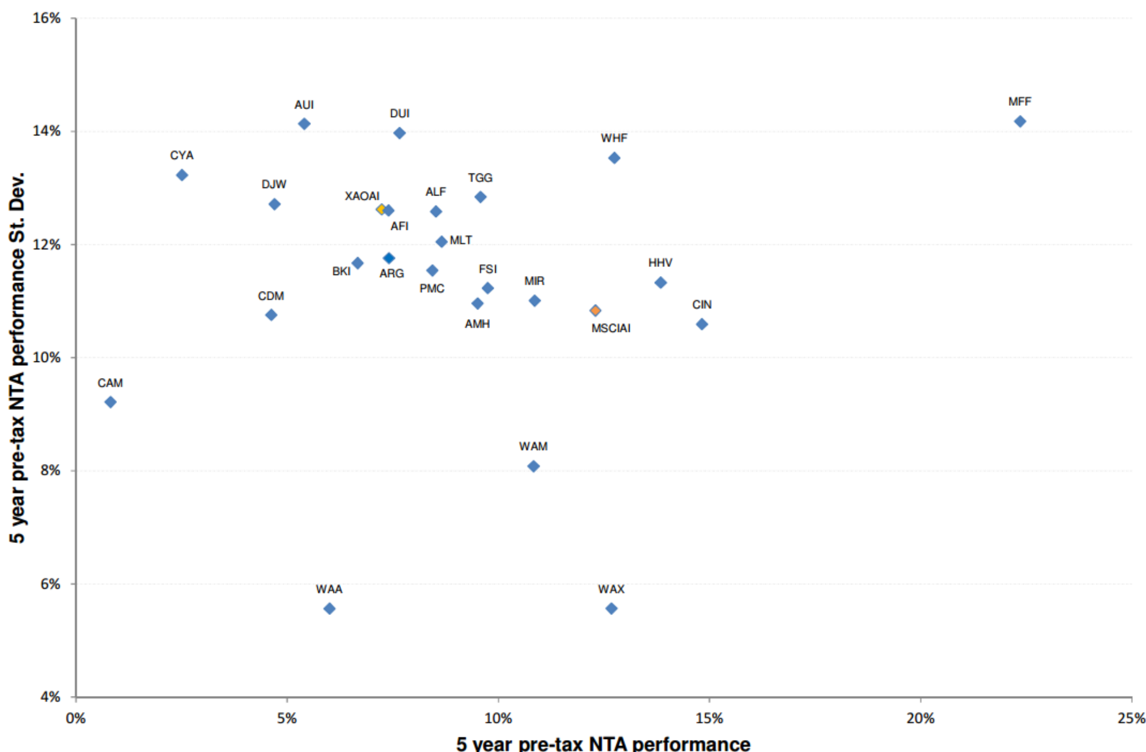
Other observations from the graph:

- Century Australia Investments (ASX:CYA) and Australian United Investment (ASX:AUI) have domestic investment mandates but slightly higher risk profiles than the S&P/ASX All Ordinaries Accumulation Index..
- Diversified United Investments (ASX: DUI) also has a higher risk profile due to its holding international exchange traded funds (ETFs) in its underlying portfolio..
- The majority of LICs have a lower standard deviation than the S&P/ASX All Ordinaries Accumulation Index, of 12.6%, and nearly half of these LICs outperformed this index.
- .Wilson Asset Management LICs (ASX: WAM, WAX & WAA) attributes its low standard deviation to holding a significant amount of cash..
- Magellan Flagship Fund (ASX: MFF) has been the best performing International LIC on a risk-adjusted perspective.

Sharpe Ratio

The Sharpe Ratio reflects the ratio of all excess returns over the risk-free rate divided by the standard deviation. The higher the Sharpe Ratio, the better the LIC's performance in proportion to the risk it's taken. A LIC with a negative Sharpe Ratio would suggest that a risk-free asset (example, government bond) would be a better investment.

Pre-Tax NTA Performance Standard Deviation vs Pre-Tax NTA Performance



SOURCE: COMPANY DATA, IRESS & BELL POTTER

The graph below shows the Sharpe Ratio of some LIC's investment performance over the past five years.

Key notes from the graph above are:

- Large market cap LICs and large-to-medium cap LICs have an average Sharpe Ratio of 0.36x, which is also the ratio for the S&P/ASX All Ordinaries Accumulation Index..
- International-focussed LICs have outperformed risk-free assets over the past five years.

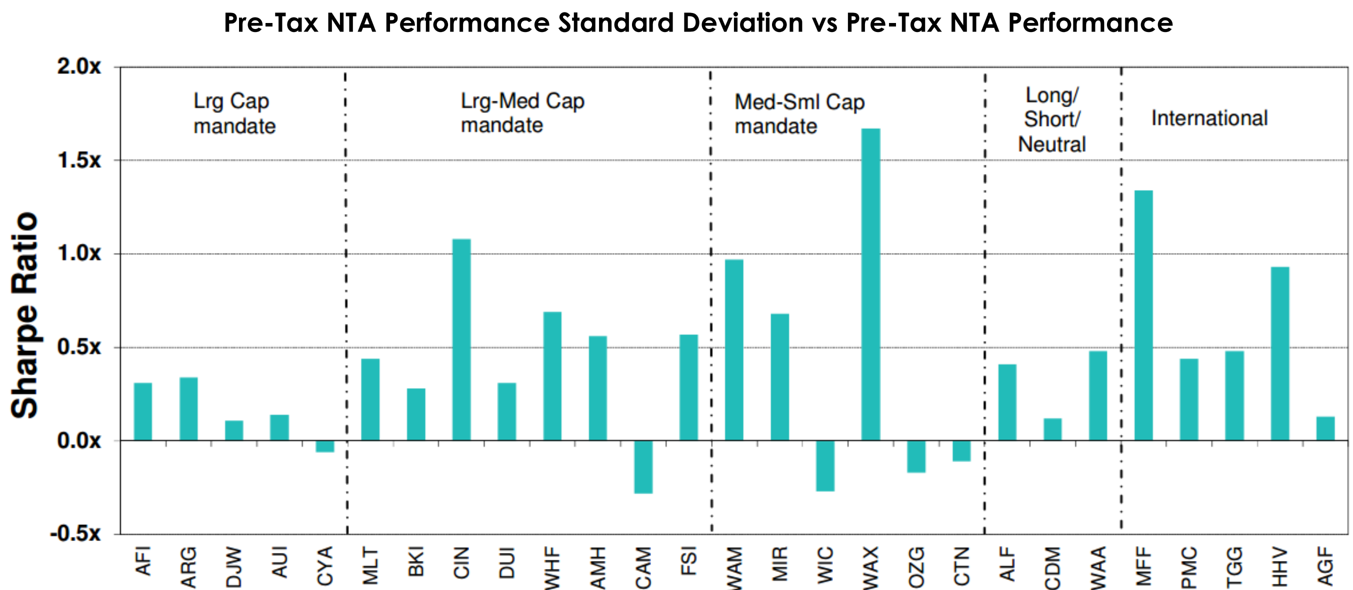
Conclusion

The return is only one side of the investment equation. Investors also must be aware of the risk they are assuming to achieve those returns before they can make an informed judgement when comparing LICs.

These three metrics do not tell the complete story. However, they should be used together with historical return, and qualitative factors such as investment philosophy, management experience and the cost of running the LIC. Together, these factors will make investors far more informed when determining which LICs to add to their portfolios.

Nathan Umapathy is Research Analyst at Bell Potter Securities. This document has been prepared without consideration of any specific client's investment objectives, financial situation or needs and there is no responsibility to inform you of any matter that subsequently may affect any of the information contained in this document.

For the latest Bell Potter Quarterly Report, click here, and for the Weekly NTA update, click here.



ETFs playing bigger role for investors

by Ilan Israelstam on 21 April 2016

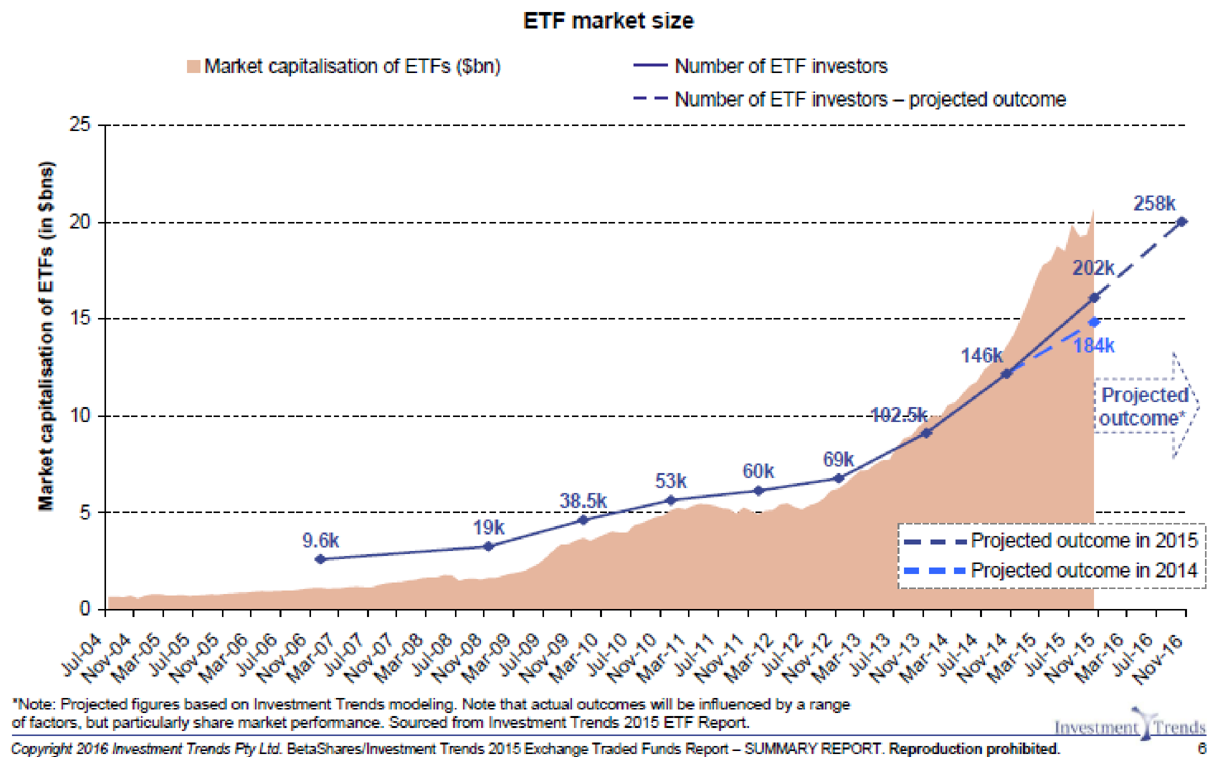
The annual BetaShares/Investment Trends Exchange Traded Fund Report was released recently. BetaShares has been associated with this Report for the past five years and it provides a snapshot of the key statistics and drivers in the Australian ETF industry, from the perspective of individual investors, SMSFs and financial planners.

The insights are based on the responses of 9,418 investors and 676 advisers.

Key findings of the Report

The specific details reveal:

- the number of ETF investors increased 37% to an estimated 202,000 in 2015



- a record number of investors intend to make their first ETF investment in the next 12 months, estimated at 110,000
- 41% of current ETF investors (~83,000) invest through an SMSF
- financial planner usage of ETFs continues to increase. with 64% intending to start or continue using ETFs in the next 12 months
- strong latent demand for exchange traded managed funds is an unmet opportunity for industry growth.

For a copy of the 2015 Exchange Traded Funds Summary Report, click here.

The chart above shows the market capitalisation growth of the ETF market (currently at about $22 billion), the estimated user numbers and future projections.

Strong demand from retail and SMSF investors

Repeat investment into ETFs is high with 71% of investors indicating they would consider re-investing in ETFs in the next 12 months.

The number of SMSFs holding ETFs has grown in line with the increase in the number of ETF users, with an estimated 41% of ETF investors using an SMSF. This also indicates that 59% of investors are buying these products outside of SMSFs, showing the adoption of ETFs by mainstream investors.

Diversification remains the primary reason individual and SMSF investors use ETFs. However, for the first time since the Report has been published, access to overseas markets has become the next most important reason individual investors use ETFs, overtaking low cost.

The Report revealed that the majority of ETF investors did not reduce usage of any other form of investment in order to invest, with 56% of investors in ETFs investing via money that was not currently invested in shares or managed funds.

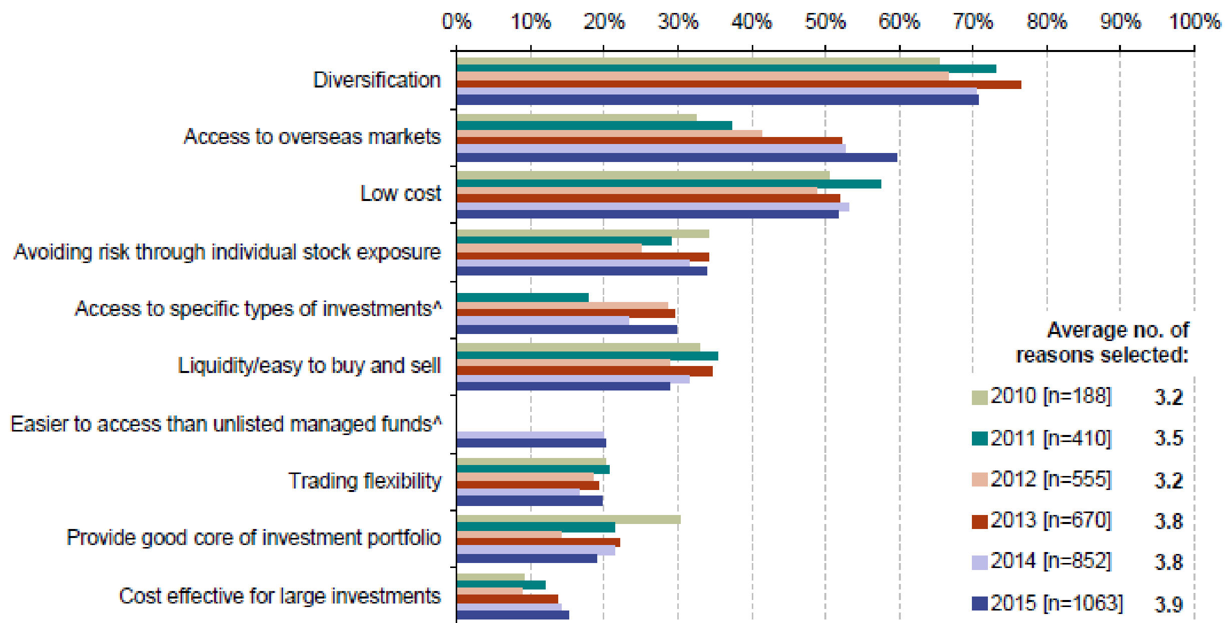
Financial planners want more from ETFs

Financial planners' appetite for ETFs continued to increase, with the Report showing 44% of advisers currently use ETFs, with an additional 20% consider-ing ETFs in their practice over the next 12 months.

In addition, the extent of ETF usage is set to increase. While ETF flows comprise only 6% of total financial planner flows, current users have allocated 13% of new client flows to ETFs and expect this to increase to 18% by 2018. 90% of financial planners cited low cost as the top reason for recommending investment in ETFs.

Additionally, advisers who recommend ETFs allocate 46% of new ETF investments to international equities, up from 40% in the previous year, overtaking domestic equities for the first time.

While diversification is the primary driver behind ETF adoption for individual investors, about 90% of financial planners indicating low cost is the key reason for using ETFs in their practice. The Report



also indicates that ETFs are used by financial planners who typically have higher levels of funds under advice and higher inflows versus those that do not use ETFs.

Strong outlook for exchange traded managed funds

One of the more exciting developments for the exchange traded product industry has been the launch of exchange traded managed funds. The Report revealed a strong latent demand for such actively-managed funds in the next 12 months. For example, 61% of financial planners indicated an interest in using these types of products, which includes 34% of planners who are not currently using ETFs at the moment.

The Report revealed a record number of 258,000 investors intend to make an ETF investment in the next 12 months (including new and existing investors).

ETFs are well on their way to becoming mainstream, based on their diversification, cost, transparency and access. There are also more sophisticated requirements from investors and their advisers. In our own business, for example, we are seeing increasing appetite for outcome-oriented products such as managed risk exposures that are starting to be used as complements to 'plain vanilla' index-based ETFs.

Ilan Israelstam is Head of Strategy & Marketing at BetaShares. For a comprehensive summary of the 2015 Exchange Traded Funds Report, click here. This article is general information and does not address the needs of any individual.

5. Portfolio construction

Market serves up some savage volatility – Roger Montgomery

Don't sweat the big stuff – Mark East

10 hints on realising capital losses for EOFY – Marcus Padley

Major investment themes and the fund manager's dilemma – Hamish Douglass

Don't be misled by investment classifications – Chris Cuffe

If this is the new normal in a low return world … give me more! – Ashley Owen

Market serves up some savage volatility

by Roger Montgomery on 3 November 2016

I recently surveyed our portfolio and was stunned by the magnitude of the daily price moves. It was only 1.50pm yet APN Outdoor was up 4.32% on no announcement, TradeMe was down 2.77%, Healthscope was down 2.64% and Challenger down 1.92%.

Now, it is true that we don't give two hoots about short-term movements. In the short run, price movements are largely random and will always be far more volatile than valuations. Prices can move on the back of sentiment and other factors that have little or nothing to do with the underlying business. A company's valuation will change much more slowly, roughly in line with the growth in equity, from the retention of profits and redeployment of those profits at rates of return exceeding its cost of capital.

Unprecedented movements

Nevertheless, it seems that an unprecedented number of stocks have been hit with issues which have wiped significant amounts off their value, almost overnight. I cannot recall many other periods when a conga line was so populated with companies whose share prices have taken a 10-20% hit in a single day.

Recently, the announcements of the arrest of Crown Resorts executives in China caused its share price to fall almost 20% from $12.95 on 14 October 2016 to $10.40 12 days later.

Healthscope, the operator of 45 private hospitals, announced on 24 October that first quarter admissions for some procedures had slowed and that if the experience of the first quarter were repeated for the next three quarters, earnings would be flat for FY17. This caught the market, that was expecting 10% earnings growth, by surprise and the shares initially opened down 27%. As I write this, the shares are trading 24% lower than the closing price before the announcement.

Ardent Leisure's shares have fallen by 25% following the Dreamworld tragedy, Blackmore's shares are down 33% and Bega Cheese's share price is 22% weaker. Unlike Woolworths, whose long-term competitive issues have resulted in a gradual weakening of its share price, the above examples have been rapid.

The questions on investors' minds are:

1) Given examples where shares were 'priced to perfection', and the propensity for businesses to inevitably stumble or naturally endure weaker periods as part of the normal cycle, do these moves indicate a much deeper issue about market valuations overall?, and

2) Are investors, who have been virtually frog marched into equities by rapidly diminishing returns from term deposits, overestimating returns and underestimating the risks of share market trading?, and

3) Should the volatility be seen as 'risk' or as 'opportunity'?

Volatility clusters

Volatility is still taught at school in the form of risk and portfolio construction, and dominates Wall Street thinking. However, our practical understanding of volatility has moved on somewhat from the days of Bachelier applying probability theory to French bonds, and the subsequent and elegant-but-flawed work of Eugene Fama's Efficient Market Theory. Bachelier's assumption that price changes are statistically independent and normally distributed is not borne out in the real world. The tails of the normal distribution curve fail to even remotely predict the frequency with which large price moves occur. Enter Benoit Mandlebrot, who observed that volatility tends to cluster around points in time, and after longer periods of lower volatility.

While roulette wheels spin by chance, over time the share prices of Blackmores, Woolworths or BHP don't move by chance. But because prices can be described as if they move by chance, that has been how they've been described. As the aphorism goes, to a man with a hammer all problems look like a nail. And so odds and risks are being miscalculated.

The investor is best served by the work of Benjamin Graham, who without the benefit of a computer, observed that in the short run the market is a voting machine, but in the long run it is a weighing machine.

Source: ASX, The Montgomery Fund

In the short run, prices will frequently move independently of the underlying business, but in the long run they cannot help but follow the accretion or diminution of the value of the underlying business.

The above chart shows the movement, over the last 60 days, in the share prices of the companies that make up the Small Ords Index. There are some remarkable changes.

Markets at high earnings multiples

In general, the frequency and magnitude of negative share price moves suggests a general overvaluation of markets. We know for example that the CAPE Shiller P/E ratio for the US S&P500 is at the 97th percentile at the moment – in other words, the earnings multiple has only been exceeded on 3% of occasions. Similarly, the P/E ratio for the Australian Materials index is at an all-time record as it is for the S&P/ASX200 index ex banks. This is to be expected when interest rates are at multi-century lows, however forecasts of a 'new normal' extended period of low interest rates is simply another version of 'this time is different', the four most dangerous words in investing.

Investors who own companies trading on high multiples need to be on their guard, especially those in large caps offering little or no growth thanks to high payout ratios (Telstra and the banks), challenged business models (Woolworths, Wesfarmers) or cyclical industries (it will take much less time for BHP and RIO to ramp up production if the price of iron ore rises again thanks to the mine development work having already been completed during the last boom).

Investors also need to be wary of the elevated prices of infrastructure stocks such as Transurban, Sydney Airports and Auckland International Airports. They are only justified by the application of the weighted average cost of capital calculation in valuing those businesses. Due in part to low interest rates and high levels of debt, the result is a high estimated valuation. But should interest rates rise, the justification for these valuations disappears, and the two listed airports are situated on a vacant block at the end of a global cul-de-sac, which hardly justifies them being the world's two most expensive listed airports on an EV/EBITDA basis.

When market valuations are extreme, investors need to be wary of any stumble or miss in market expectations. Inevitably, it will be through this mechanism that extreme valuations are de-rated. In time, we will look back with surprise at the low rates of returns managers were committing their investors to for extended periods.

Ultimately, however, lower prices are a good thing. All investors should see themselves as net buyers over time. It is only through this lens that they will make wise decisions with respect to quality and value.

Net buyers want lower prices in the future. With that in mind, investors should always see heightened volatility as an opportunity, as long as the long-term economics and prospects for the business are bright. In the case of an operator of

45 hospitals with the ability to manufacture more hospital beds at one-third of the cost of the government, and in a market where the number of people over the ages of 65 and 85 are growing as a multiple of the population, we believe this is the case.

*Roger Montgomery is the Founder and Chief Investment Officer of The Montgomery Fund, and author of the bestseller '*Value.able*'. This article is general information and does not consider the circumstances of any investor.*

Don't sweat the big stuff

by Mark East on 14 April 2016

It is amazing how much brainpower is dedicated to thinking about the big-picture macro issues and staying up-to-date on the minutia of the daily financial news flow. News on US non-farm payrolls, China's latest PMI reading, and Yellen's latest utterance consume considerable media and investor attention. In our opinion, all of this can be a time-consuming distraction for investors and confuses their ultimate goal: building and protecting wealth.

The economy is unpredictable

Investment success is ultimately determined by what happens in the future, and trying to pick the big-picture macro issues is extremely difficult.

The economy is practically infinite in size, is interlinked, and is self-adapting. In science speak, the economy is a 'complex adaptive system'. In simple terms, it is all over the place. Just one of the many reasons given for the recent run up in the iron ore price was a flower show in October in Tangshan, an important industrial Chinese city whose steel mills have been told to shut down in an effort to reduce pollution in time for the show. Notice of the shutdown brought about a build-up in steel inventories beforehand, bringing forward demand for iron ore which is used in its production. Thus, to ensure some healthy gerberas in China, we saw the iron ore price run up hard, Fortescue's stock price double, Western Australian and Federal Government budgets get a boost, and a range of other economic consequences including a strengthening Australian dollar. It is doubtful, however, that economists will incorporate flower shows into their calendar of important upcoming events.

At least in hindsight, the effects on an economy of a flower show can make sense. Less rational factors can also come to bear on how an economy evolves. To take an example that has troubled the Reserve Bank of Australia (RBA), Australian business investment has been lacklustre in recent years despite supportive low interest rates. The culprit in the RBA's view has been a lack of 'animal spirits'. Factors like boardroom confidence, consumer confidence, and banks' risk appetites are obviously not easily given to financial modelling or forecasts, yet they can have a significant impact. The economy is the sum of a great number of transactions entered into by real people in which human nature inevitably plays a part.

To summarise, the range of factors affecting the wider economy is virtually infinite, and not all are given to rational analysis.

Very few investors have done well by placing their bets largely behind economic forecasts; indeed, many like Warren Buffett have succeeded by ignoring them. Paul Samuelson, a US economist, famously said in the 1960s that the stock market has predicted nine out of the last five recessions. In recent Australian history, the record has been worse. Taking some other examples:

- offshore hedge funds have predicted nine of the last zero Australian housing busts and lost bundles shorting the Australian banks in the process
- almost no one predicted the oil price falling from US$100 to US$30 a barrel and the significant loss of value from holding oil stocks like Origin and Santos
- only a few characters depicted in The Big Short movie saw the mayhem start to unfold in the US housing and mortgage markets that gave rise to the GFC.

Yet despite the difficulties, the media and investors spend considerable time second-guessing the Fed

and the RBA's next rate decision, whether GDP growth will be 2.5% or 2.7%, and the year-end level of the All Ordinaries. Even when we don't believe in the data itself, as is the case for Chinese GDP and other data, we still insist on having a guess on what it will be. But for what?

Predicting the economy and investing as separate endeavours

Even if investors could accurately predict the big macro variables, it does not follow that they will enjoy strong investment returns. Studies reveal that there is little correlation between GDP growth and the share market's return, and to the extent that there is a relationship, it is slightly negative. This may seem a somewhat surprising conclusion. No market commentator will say, "The economy is continuing to deteriorate and so I remain bullish on the stock market." Interestingly, this line of thinking has proven itself to work for most of the time since the GFC. Bad economic news has been taken as reason for further monetary easing, which in turn provided support for share prices. Bad news for the economy was therefore good news for stocks. Some investors whose macro predictions from some years ago now look like nonsense have produced some of the best investments returns, and vice versa.

One of the intricacies of investing is that successfully predicting the future does not ensure success. Asset prices are discounting mechanisms, meaning that markets discount, or incorporate, expectations of future earnings, interest rates, oil prices, and other relevant variables. Taking the example of stocks, there is little prospect for investment outperformance by holding a stock whose earnings perform in line with expectations, and which was probably therefore priced right after all. Investment outperformance generally requires that a company actually exceeds expectations, however bullish they might be. Thus, investment outperformance often requires the investor to have both a differentiated view and that it ultimately proves correct. In this respect, investors should consider where they might find an investment 'edge'.

Finding your edge by recognising levels of complexity

In our view, it is far easier to find such an edge once it is broken down into bite-size pieces. We admit to having no skill, for example, in accurately forecasting currencies. Here, the game is played across a large and complex world, quite literally, and it involves an almost infinite number of inter-related variables (flower shows included). The less variables that come into play, and the more predictable the outcomes, the more likely investors can find an edge.

Moving down the difficulty scale, the oil price is a somewhat more manageable game to play. Unlike most commodities, demand for oil is quite stable, growing slowly on a global basis. Likewise, those that put in the effort can get a reasonable handle on oil production. While understanding the supply-demand dynamics might not afford precise oil forecasts for the near term, it can give rise to some reasonable assumptions over the medium and longer term that could be used in assessing oil company valuations.

Further still down the difficulty scale is demographics, where predictions of an ageing population can form a useful view on the growing need for healthcare services. Or in a specific industry such as the supermarket or fast food industries, it is possible to understand which operators might eventually win and lose.

At Bennelong Australian Equity Partners, we tend to keep it simple by focusing on the more predictable companies, typically those high quality businesses selling recurring and often relatively-defensive products. These are the types of companies that will see through difficult economies and prosper over time. Two examples our funds have owned for many years are Ramsay Health Care, the largest private hospital operator in Australia and which benefits from an ageing population, and Domino's Pizza, the pizza shop business that has clearly beaten its competition through innovation and an improved customer offering.

Of course, it is not necessary to find a personal investing edge to achieve a decent return if you can find someone else with an edge. A fund manager with a successful long term track record is the obvious place to start. Genuine diversification is vital, not the type from concentrating a portfolio in the big banks, Telstra or Woolworths, and a resource stock or two. Genuine diversification means a portfolio spread across a range of macro exposures. Such a portfolio can better deal with the unpredictable and should provide the investor with the comfort that comes with being prepared for any macro eventuality.

Conclusion

We are inundated with negative headlines, dire economic outlooks and even predictions of imminent doom. Unfortunately, the reasoning behind this negativity often seems to make sense,

and indeed, sounds prudent. The alternative argument, rarely put forward and seemingly blasé, is that capitalism will find a way for the economy and markets to advance through whatever arises, as it always eventually has.

In our opinion, trying to second guess the broad macro variables such as currencies and GDP growth offers limited 'value add' over time. Investors are better advised to focus their efforts on the actual task of building wealth and setting up a portfolio to deal with continuing economic uncertainty and that makes use of any investment edge.

Mark East is Chief Investment Officer of [Bennelong Australian Equity Partners] *(BAEP). This article is general information and does not consider the circumstances of any individual.*

10 hints on realising capital losses for EOFY

by Marcus Padley on 2 June 2016

The end of the financial year is a good time to assess your capital gains and work out if you have a net capital gain from stocks sold. If so, you should also be looking through the portfolio for stocks with losses that you could sell to offset paying tax on the gains.

You know the stocks, those duds you didn't sell when it was obvious you should sell. Those stocks that you shut your eyes to and hoped against hope they would rebound miraculously … but they kept falling. Those stocks. Those small illiquid stuff ups that you regretted buying but let linger in your 'portfolio'. All those short-term trades that became long-term 'investments'.

Now is the time to think about selling them, especially the illiquid ones because by the time everyone else wakes up to their capital gains tax loss in the last two weeks of June, these stocks will have been dumped, making your emotional turmoil even harder to squeeze a trade out of. So better you assess and sell now before the bloodbath starts, which it does every year, in every small trading stock that has gone down.

Selection is personal

I have had an email asking which stocks are likely to be most affected by tax loss selling. From your point of view, it is simply which stocks are in your portfolio, have not performed well this year and are small and illiquid and likely to get sold off by tax loss sellers. There are no 'good' stocks to take a loss on generally … just your own stocks. The stocks to sell are staring you in the face.

I could print you a list of the worst performers this year but it wouldn't help. It's personal. What do you hold that you could sell and what do you hold that other people will sell?

The only 'game' to play here is as a trader buying stocks that are small illiquid bad performers if they have been pummelled running into the last week of June. Stocks that are trading favourites always have a lot of stale holders. They are killed in June and often resurrect in July.

Hints for taking a loss

It is one of the hardest things to convince a broker, let alone a novice trader, to take a loss. So to help with the process, we have developed arguments to persuade you (they don't seem to work on ourselves). If you are having trouble taking a loss, not enjoying your trading, are getting emotional and the stock is still in your possession … read my 10 reasons for why you should think about letting go of the dogs. You will put the sell order on before you get to the end:

1. If a stock is going down it is far more likely to continue going down than it is to turn on a sixpence to suit you.

2. The further a stock falls the more intense the selling becomes as higher losses cause more selling decisions, so sell early – an early loss is the smallest loss.

3. If you sell 10 falling stocks, it will be the right thing to do in nine cases, but you will only remember the other one.

4. If you sell now, you are no longer exposed, and all you have to do is come to terms with the loss.

5. If you sell now you can always buy it back – you might even buy it back lower than you sold it. Be aware of the ATO's 'wash-sales' rules explained later.

6. If you sell now, you enter the eye of the storm and all becomes calm. You have a moment to think and you can watch from a distance. You can always choose to enter the storm again and you will be thinking more clearly and be armed with a plan.

7. If you are making a loss on a stock, think to yourself … "if I had cash would I buy this stock now at this price?" If the answer is 'No', then why are you holding it? Sell it. Most people begin to 'hate' the stocks they lose money in … so this argument always works.

8. Your state of mind has a value. What would your spouse pay (or you pay) to have you carefree at the weekend instead of ripping the heads off the kids. Look after yourself. There are not that many weekends in the year or your life. Don't ruin too many of them by keeping risky loss making positions until Monday because you didn't have the guts to sell them on Friday. There is no logic in being emotional about losses. If it's gone it's gone.

9. Averaging down is a mug's game. If you have money to invest you should be putting it in the best investment in the whole world. Do you really think that will be the very same stock you have already bought at a higher price and that is falling at the moment? Very unlikely. You already have an exposure … why do you need more of something that has already proved itself to be a dog.

10. If in doubt, sell it. It crystallises a capital loss for this tax year. Why wait until the end of the year to take your losses? Taking losses today could set you up for making and taking gains this year. You can always buy it back once you've made the sale.

ATO wash-sales provisions

If you do decide to take a loss before 30 June but plan to re-adopt one or more of your dogs in the new financial year, be mindful of the ATO's position on wash-sales. If you repurchase the shares you sold very shortly after at a similar price, the ATO will look at that transaction unfavourably and you may be subject to anti-avoidance rules.

Hopefully you hold good long-term stocks and won't have to take a loss, but when you do, read this again and see if you can get to the bottom of the list before you have put on the order to sell.

Marcus Padley is a stockbroker with MTIS Pty Ltd and founder of the Marcus Today share market newsletter. Marcus has been advising institutional clients and a private client base for over 34 years. This article is for general education purposes only and does not address the personal circumstances of any individual, nor does it cover all possible events. Professional advice should be sought before taking any action, including taxation and financial advice.

Major investment themes and the fund manager's dilemma

by Hamish Douglass on 8 September 2016

We've been through an extraordinary period where global asset prices have been dramatically influenced by the activities of the major central banks. We don't need to look too far to gain a perspective on whether the world is 'normal' at the moment.

Two-year government bond rates in virtually every European country except Portugal and the UK are currently negative. This includes Spain, where unemployment is above 20%. Mexico recently issued a 100-year bond, while Unilever issued a four-year bond at a zero yield. Is this the 'new normal'?

Central banks distorting asset prices

These sorts of dynamics in bond markets are having rather unusual consequences. Investors now pay Japan or Switzerland to hold their money for the next decade to achieve some semblance of a yield. This is clearly a distorted situation

caused by the G7 central banks. It's also distorted by countries such as China, Saudi Arabia and (until recently) Switzerland, which are actively accumulating foreign exchange and buying bonds. The central banks of these countries have bought 70% of all debt issued by the US, Europe, the UK and Japan over the past 10 years or so.

A situation where central banks buy vast amounts of bonds is unprecedented. As more bonds are bought, prices rise and interest rates fall. This leads some investors to the conclusion that government bonds are not attractive in this environment, so they invest in the next closest asset: investment grade corporate bonds. In trying to visualise the impact of central banks pouring more money into the system, think about a champagne glass pyramid, where champagne is poured from the top and eventually overflows and floods the glasses below. In a financial markets context, flooding the market with liquidity means everything gets repriced – even emerging markets, junk bonds and commodities. The central bank actions that began in 2009 and ran through to June 2015 are having quite a pronounced impact: bond prices and equity markets have soared while junk bond spreads have halved.

The questions that need to be answered are these: when will central banks start selling the assets they have bought? When will the US Federal Reserve start shrinking its balance sheet? When will the European Central Bank stop its printing presses?

I argue that we have seen the first 'canary in the coalmine' over the past year as China, Saudi Arabia and Switzerland have started to sell some assets. And there has been a repricing of assets such as high-yield or junk bonds, and a fall in some emerging-market currencies. When central banks eventually tilt away from extraordinary monetary policy measures, other assets might find new lower levels.

The fund manager's dilemma

We are at a definitive fork in the road. As a fund manager entrusted with fiduciary responsibility for the life savings of many individuals, it's a real dilemma positioning yourself in a world where interest rates could either rise or fall from today's extraordinary low levels. In our view, the most likely scenario is a stabilising environment. Markets have bounced back from their early 2016 lows and we have seen more benign economic signals from China, so we don't expect a major fall in the renminbi.

But there could easily be further economic turmoil, which is why the Fed is holding fire at the moment. The Fed doesn't have enough evidence regarding China's economic prospects. That said, we absolutely recognise the risk of the complete opposite occurring: a world-wide recession. I put this probability at only about 15%, although a year ago I rated it at only a 5% chance of occurring.

Where we still find value

We have retained a cautious stance on equity markets for the past two years, which is reflected in our portfolio positioning in high-quality names, along with a material exposure to cash. We want to pay our investors a satisfactory total return on the capital they've entrusted us with over the long term, and we are not concerned about what markets do in the short term.

We invest in many companies that feature globally recognisable brands: Apple, eBay, Oracle, Microsoft, MasterCard, PayPal, Alphabet (Google), Lowes, Home Depot and Woolworths (in Australia). The positions in these names reflect some major trends that we see playing out over the medium to long term. For example, there are powerful technology platforms that are having a profound impact on the way people interact and do business.

There is a trend towards moving computer power away from offices to huge data storage facilities around the world known as the 'cloud'. Alphabet and Microsoft have large businesses here.

There are two huge digital advertising platforms in the world: search-based advertising controlled by Google and social media-based advertising controlled by Facebook.

The monetisation of consumer services via smartphones is led by Apple and Google. In 10 or 15 years, cash will become largely redundant in the world as digital payment systems are entrenched in our everyday lives. We own MasterCard, Visa and PayPal, which are clear beneficiaries of this trend.

Apple's success in recent years has been tied to the iPhone, with about 70% of its profits generated from handset sales. But history tells us to be wary of this sector. There are plenty of examples where seemingly cutting-edge devices are rapidly developed, only to become commoditised. Nokia was once the darling of the mobile phone market; today it doesn't exist. Microsoft bought the company for US$8 billion and has written down almost the entire amount. Remember the Blackberry? And the Motorola Razr was the fastest-growing consumer electronic device in history before the iPhone; it no longer exists.

But today, Apple really shouldn't be seen as simply a hardware device manufacturer. Its intrinsic value lies within the operating platform and it's the software inside the phone that reflects its future earning power. Today there are just two operating systems in the world, Google's Android and Apple's iOS. This duopoly is here to stay and it is highly unlikely we will see another operating system developed in at least the next 10 to 20 years.

Buying an iPhone actually represents a subscription to the ecosystem, which adds about $30 a month to your phone bill. Look forward a few years and Apple won't be worried about 'winning the war' because nearly all handsets sold will be replacements. There is still plenty of new growth potential as only about 40% of people globally have a smartphone. We believe Apple is fundamentally cheap because the market's short-term focus is on how many phones were sold in the past year.

Our job as a fund manager is to focus not on the past six months, but on the next three to five years. It's a different mindset when considering the long-term prospects for people's retirement savings.

Hamish Douglass is Chief Executive Officer, Chief Investment Officer and Lead Portfolio Manager at Magellan Asset Management*. Magellan is a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any individual.*

Don't be misled by investment classifications

by Chris Cuffe on 21 April 2016

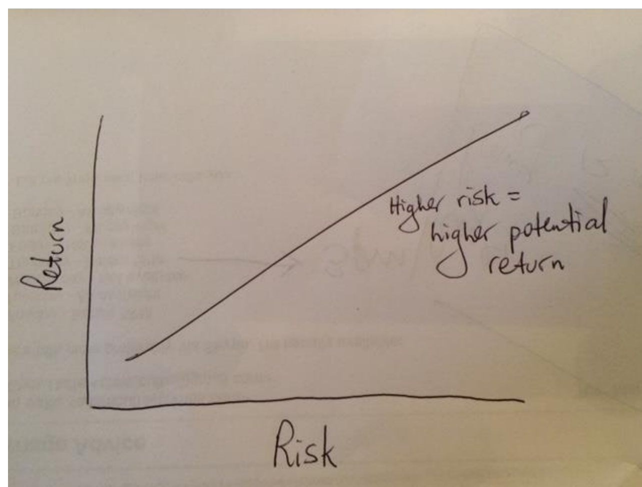
Investment professionals need to communicate as clearly as possible, and some classifications which market experts think are obvious can be confusing. This is a short piece with a few simple ideas on some investment descriptions. Anyone expecting a great piece of gravitas from me here will be disappointed.

In my view, many institutional investors follow herd-type thinking, without robust logic, because everyone before them followed the same line of thought. My many years of experience in investment markets have caused me to dismiss some of this traditional thinking. Much of what is preached is not robust enough in my view and I am not alone in my skepticism, though certainly in a minority. The investment community is prone to putting concepts into neat little boxes, which does not work because investing is more of an art than a science, despite the continued attempts to make it a more predictable subject.

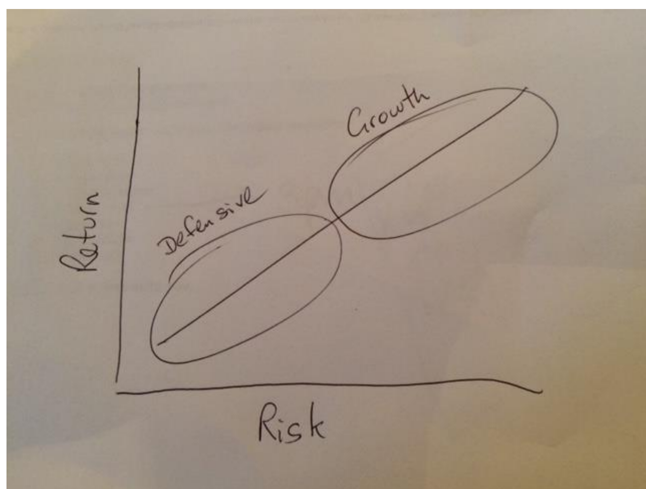
Thinking about risk and return

A good example of what I am talking about is the distinction between defensive assets and growth assets and their relationship to risk and return.

Like many, I think a good and simple way to think about investing is to visualise a line graph with risk on one axis and return on the other and with an arrow pointing from lower left to upper right. It represents the range of possible investment outcomes. This basically depicts the view that the greater the expected return from an investment then the greater the risk. This is a sensible way to think of investing within a framework of *no free lunches*.



Many investment professionals then segment this risk/return line into two sections. The bottom part comprises 'defensive' assets and the top part comprises 'growth' assets.



And most think of defensive assets as comprising cash and fixed interest, with growth assets comprising shares and property.

It's neat, simple and convenient but in my view, these classifications are likely to mislead.

Avoid the word 'defensive'

The largest option category run by institutional superannuation funds is their *Balanced Accumulation option*. Such investment products are usually classified as having approximately 30% in defensive assets and 70% in growth assets. And if the manager is feeling bearish about equity markets, they will proclaim that they are increasing their allocation to defensive assets.

The language is wrong. If we must use a two basket classification, then I prefer the terms 'income' and 'growth' which is a reference to where the majority of the return of a security or asset class is predicted to come from. Generally speaking, assets whose returns are largely from income (on the assumption the income is relatively secure and predicable) are considered less risky than assets whose returns are largely from growth (and hence dependent on many variables, mostly on future prospects).

I dislike the term 'defensive' because it is subjective and makes no reference to current valuations, timeframes or investment objectives. Defensive against what? And if I look in the dictionary the word 'defensive' has positive and comforting connotations like defending, guarding, safeguarding, protecting and shielding. So if the term is used, we need to be sure we know what we are talking about.

Some simple examples to illustrate the point:

- You will lose a lot of money from holding a 10-year government bond (regarded as a risk-free asset and hence one of the more defensive of all assets) if interest rates move up materially and you are required to sell it before maturity, or if your performance and measurement are judged on a quarterly basis.
- Cash is considered a very defensive asset. But if my investment objective was, say, to achieve a return in excess of CPI over the medium to long term, then cash may be a high risk asset. Many investors who went into cash after the GFC saw their incomes fall significantly, with real returns now below zero. Similarly, holding a portfolio of high quality equities over the long term gives a high probability of beating inflation, and dividends from shares and rents from property usually fall only 20-30% in a recession. But 'cash' is usually the lowest risk (and most appropriate) asset if your investment time frame is very short (say less than one year).
- If the spread (margin above a government bond) on the debt of blue chip company is much tighter than the long-term average, then it may be a high-risk investment. Spreads can easily widen in different economic climates with resultant capital losses.

My point here is that hard-wired classifications can be misleading. It's better to think of defensive as a relative concept, not the absolute that the word implies to most people.

Cash does offer certainty of capital value and immediate liquidity, and those are fine 'defensive' qualities, while bonds offer certainty of capital value and interest income if held to maturity (and assuming no defaults).

What do we really mean by 'risk'?

What does the term 'risk' mean when we are trying to look at the risk/return characteristics of a security on the assumption we have a long-term time frame?

Most investment professionals (and non-professionals) equate risk to the degree of volatility in asset prices, usually measured as some variance around a mean return. However, I don't believe this tells us much at all. In my article titled 'We need to talk about risk' I state that, like Howard Marks (a renowned US investment manager and investment author), I think the possibility of a permanent capital loss from owning an asset is at the heart of what investment risk is truly about. Then follows the possibility of an unacceptably low return from holding a particular asset. Marks believes much of risk is subjective, hidden and unquantifiable and is largely a matter of opinion. He makes the point that investment risk is largely

invisible before the fact – except perhaps to people with unusual insight – and even after an investment has been exited.

No less an investor than Charlie Munger, Warren Buffett's investing partner, said:

"In thinking about risk, we want to identify the thing that investors worry about and thus demand compensation for bearing. I don't think most investors fear volatility. In fact, I've never heard anyone say, 'The prospective return isn't high enough to warrant bearing all that volatility.' What they fear is the possibility of permanent loss."

I agree with him. Market professionals like the traditional measure of risk, volatility, because they can measure it and sound intelligent. But if I am confident about the long-term prospects of a company, and I plan to hold its shares over the long term, then I don't care about the short-term volatility. In fact, I try to ignore the share price except when I'm forced to do my accounts.

Like the word 'defensive', let's also be careful how we think about and use the term 'risk'.

Chris Cuffe is co-founder of Cuffelinks; Portfolio Manager of the charitable trust Third Link Growth Fund; Chairman of UniSuper; and Chairman of Australian Philanthropic Services. The views expressed are his own and they are not personal financial advice.

If this is the new normal in a low return world … give me more!

by Ashley Owen on 1 December 2016

One of the sillier pieces of nonsense bandied about in recent years by so-called experts has been the '*new new normal*' in the '*low return world*'. This wonderful idea was coined by Bill Gross and Mohamed El-Erian, then joint Chief Executives of PIMCO (the largest bond fund manager in the world) in 2011 to spruik their bond fund.

They toured the world in mid-2011 skiting about their decision to sell US Treasuries early that year. It was lousy timing as Treasuries promptly rallied strongly in the European bank crisis and US credit downgrade crisis in mid-late 2011. PIMCO realised their mistake and bought back into Treasuries in 2012 right before bond yields rose during 2012 and 2013. Both were bad calls and Gross and El-Erian were fired (I met El-Erian in May 2011 and questioned him about the ill-timed decision).

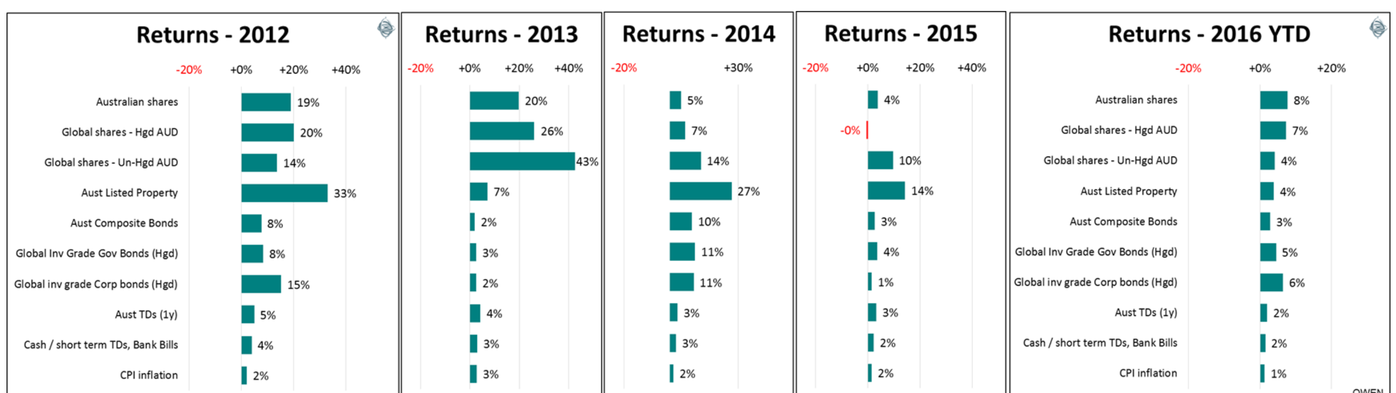
But somehow the catchphrases 'new new normal' in a 'low return world' were picked up and repeated ad nauseam in headlines and articles by lazy reporters.

The best run of positive returns ever

So what has happened in the five years of supposedly low returns since the start of the 'new new normal, low return world'? Actually, five years of good returns from every asset class!

What is remarkable is that there are no red bars (indicating negative returns) in the below charts. None of the major asset classes suffered negative returns in any of the past five years. This has never happened before for Australian investors, ever.

Never in the history of Australian markets have investors received positive real (after inflation)



returns from Australian and global shares and bonds, local cash and commercial property in five consecutive years. (For commercial property returns I used listed property trust returns since 1974).

The best run in the past was for four years from 1925 to 1928. Apart from that, the best investors have done has been two consecutive years of positive real returns from all of the main asset classes: 1944-45, 1997-98, and 2004-05.

Some readers might retort with something like, "Ah yes, but that was just because of quantitative easing and negative interest rates."

Well, not really. In the US, which is still the world's largest market and the one that drives markets in the rest of the world, the Fed scaled back QE during 2014, started reducing the Fed balance sheet in 2015 and 2016 as bonds matured, and then started raising interest rates in December 2015. So the early monetary expansion turned into monetary tightening. In Europe and Japan, the central bankers are backing away from QE and negative rates. On the fiscal front, expansion turned into tightening; the four years of trillion-dollar deficits in the US from 2009-12 has been followed by fiscal tightening from 2013-16. But still the stock markets, bond markets and property markets powered on.

On top of all that, we've had a steady stream of 'sell everything' panics along the way that have provided sensible long-term investors with great buying opportunities, such as:

- the Greek defaults
- a couple of bond yield spikes
- a 'flash crash' or two
- the Cyprus banking collapse
- the US 'fiscal cliff' crisis
- the shut-down of the US Federal government because it couldn't pay its bills
- the violent unwinding of the Arab Spring uprisings across the Middle East
- the rise of ISIS
- the fracturing of political structures into radical right and left wing parties across the world
- the collapse of commodities prices causing a string of bankruptcies in oil, gas and steel industries
- the slowing of China
- stagnant or weak economic growth in Europe, Japan and just about everywhere else in the world
- a currency war between all of the main central banks in the world
- a series of escalating military tensions in the disputed waters off China
- another Chinese stock market bubble and bust
- the rise of nuclear threats in Iran and North Korea
- deep recessions in Russia and Brazil
- a plethora of pathetic Prime Ministers in Canberra, plus
- a good measure of Brexits and Trumps to boot!

And every asset class did well through it all.

If this is the '*new new normal in a low return world*', then I want more of it!

It is another reminder for investors to ignore the chatter of fund spruikers, so-called 'experts' and the financial media in particular and focus on the facts. Bring on 2017.

Ashley Owen is Chief Investment Officer at independent advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.

6. Equities investing

In share investing, perception is reality – Peter Thornhill

Six factors guide when to sell your winners – Chris Stott

'Short selling' and the Australian banks – John Pearce

High yields may ignore fundamental weakness – Anton Tagliaferro

Technology and investing: this time may be different – Hamish Douglass

Innovation offers opportunities for investors – Dawn Kanelleas

In share investing, perception is reality

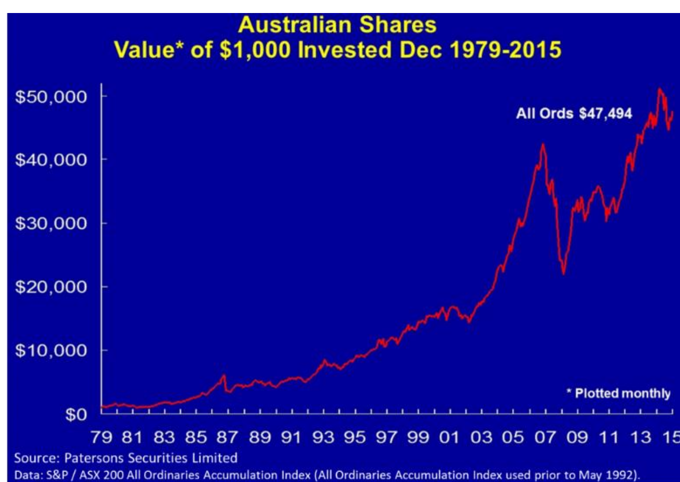
by Peter Thornhill on 10 March 2016

Some years ago, as my wife and I contemplated the transition to full retirement, we decided to take charge of our future and opted to manage our own super. One of the primary reasons for this was to ensure that the assets reflected our conservative nature; that is 100% shares. This may sound contradictory to many but after more than 45 years in the financial services industry, I had learnt some important lessons.

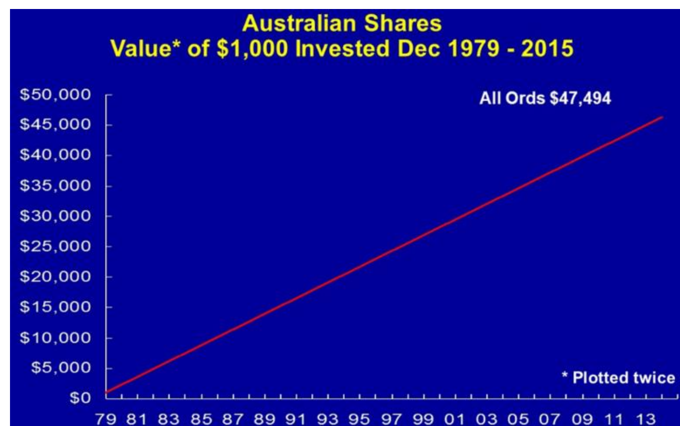
What does risk really mean?

The word 'risk' is bandied about but many do not understand the investment risks associated with retirement. Still today, the definition of investment risk remains the volatility of share prices. So, leaving our future hostage to an industry still wedded to this outdated dogma did not appeal to us. We refuse to accept volatility as a problem. Our primary risk is not losing money but outliving it.

In many presentations I have tried to curb this unhealthy focus on prices by offering an alternative view. The chart below is the All Ordinaries Accumulation Index plotted monthly over 35 years. One can see the constant volatility which gives mindless speculators, day traders, hedge funds, computer traders etc. and the media, a fertile environment for spreading their germs.



As 'perception is reality', consider my perception of this same picture.



You will note that in both cases we arrived at exactly the same point. I have simply chosen to ignore all the dead ends, shortcuts and deviations along the way! I know what I paid for the shares and I know what they are worth at the end of each day as every one of them is publicly 'auctioned'. The revelation for me, some years ago, was that all the noise in between purchase and today was just useless chatter. Unless of course you are a 'chartist'. It is difficult to draw trend lines on my chart and identify the 'double tops' and 'head and shoulders'!

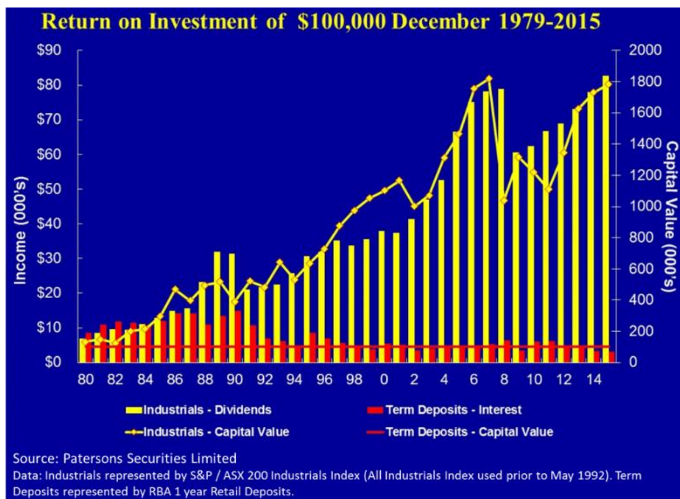
In retirement, it's income that matters most

When discussing whether we could afford my ceasing full-time work, the consideration was not how much money we had but how much income we needed. We looked at the three assets available (cash, property and shares), considered their income prospects both present and future, and opted for shares.

The income they generated would meet our immediate needs without having to rely on selling, thus maintaining the integrity of our asset base. Also, over the long term I knew that the dividends from a diversified portfolio of shares had and would grow in a relatively stable way and being linked to the productive efforts of the nation, they would be superior to the income from other sources.

The chart below is worth a thousand words. This shows the Industrial Share Index and cash broken into their two separate elements, income and capital. The income streams (the vertical bars) have been available to every one of us for the last

35 years and beyond. It is regrettable that those people who required the most income often chose the asset (cash) that produced the least income because shares were classified as risky due to their price fluctuations.



The dividends, during the 80's and 90's whilst I was still working, were being reinvested. When I quit the industry and wound down my business in 2007/2008 it was simply a matter of redirecting the dividend stream from reinvestment to pension mode.

A real time test of the strategy

With nearly a decade behind us now and the GFC to add some spice, we can now look at our strategy being tested in real time. As painful as it was to watch our portfolio almost halve in value, the income only dropped by 20%. However, as we held enough in cash to cover two years' worth of pension withdrawals, we simply followed our parents example who, when times were tough, tightened their belts.

Today, too many retire with too little, too early and leave themselves exposed to the disaster that is cashing assets to produce income when prices have retreated. As we drew down on our cash buffer the dividends replenished the account which avoided us having to cash any of the holdings. In fact, with cash available, we were able to take advantage of the turmoil generated by the GFC to modestly enhance our future income.

During the GFC, our biggest bank, CBA, fell from $64.00 to below $30.00. Credit markets had frozen so the only way companies could raise capital to bolster balance sheets was through a rights issue, usually new shares pro rata to existing shareholders, or a share purchase plan. CBA did this at $26.00 per share. Similarly, one of Australia's larger conglomerates, Wesfarmers, fell from around $40.00 and issued shares at $13.50. This was repeated with all of the major banks and many of the country's leading companies.

The table below shows the current situation with those share parcels that were purchased.

Those and other new share issues that we were able to take up have paid off handsomely with their cash flow and continue to do so. These figures do not include the recently announced dividends.

Bearing in mind that we were able to purchase shares at the lowest point in the market, our personal portfolio benefitted substantially when compared to the cash versus shares comparison chart above. It is now seven years later and our income is above where it was and the portfolio value has more than fully recovered. The importance of never having to rely on cashing your asset base to provide income cannot be overstated.

Focus on the dividend flows

I can think of no better 'longevity' insurance than that indicated by the yellow bars above. How do we get people to stop following daily share prices and, more importantly, paying heed to mindless media commentary? By focussing only on the income and not the prices of our shares, we have avoided much of the angst associated with the GFC. Also, as longevity appears to be a potential genetic advantage that we enjoy I need to be sure that the asset base remains intact and the

CBA – Return from GFC	Wesfarmers – Return from GFC
Purchase price in 2008: $26.00 Total dividends paid = $21.29	Purchase price in 2008: $13.50 Total dividends paid = $10.19
80% of the purchase price has been returned PLUS Shares are worth over three times amount paid	75% of the purchase price has been returned PLUS Shares are worth over three times amount paid
Last annual dividend is $4.16 which puts them on a current yield of 16%	Last annual dividend is $2.04 which puts them on a current yield of 15.1%

income stream will continue to grow for decades to come.

I have watched as my parents, in-laws and many of their peers were reduced to living totally on the old age pension because they had initially relied on bank deposits in what they thought was the 'safe' option. The nail in the coffin (no pun intended) as far as I was concerned was watching as the two respective family homes were sold as neither widow (the husbands having pre-deceased their spouses) could afford to maintain them.

As the probability is that my wife will outlive me, we will continue to invest solely in shares, the conservative option, as I am determined that she will continue to live with dignity.

Peter Thornhill is a financial commentator, public speaker and Principal of Motivated Money. This article is general in nature only and does not constitute or convey specific or professional advice. Formal financial advice should be sought before acting in any of the areas discussed.

Six factors guide when to sell your winners

by Chris Stott on 15 September 2016

After selling a 'winner' to realise a profit, many investors feel frustrated when that company's share price continues to soar. The prospect of foregone gains can be exasperating, leaving investors wishing they'd waited until the price had peaked before selling.

However, this is incredibly difficult to achieve in reality. I can count on one hand the number of times I've sold a stock when its share price had hit its high.

So, when you own a stock that has performed strongly and it looks like it will continue to perform well, when should you sell? As an active, as opposed to a buy and hold, investor, determining when to sell shares is a critical part of our investment process at Wilson Asset Management.

Our approach means we have a tendency to sell before a share price peaks. One example is Ainsworth Game Technology (ASX:AGI). We started buying AGI shares at around 30 cents and selling them at $2.04 before they reached a remarkable $4.79.

Outlined below are some important factors that form part of our investment methodology and inform our decisions to sell our investments, including our winners:

1. Invest with an exit strategy

At the time we invest in a company, we ensure we have a strategy to exit our position. As part of this strategy, we have a clear valuation target for the securities and identify a catalyst we believe will re-rate that company's share price.

In theory, once it has hit our target valuation, we sell. In practice however, this scenario only plays out approximately 5-10% of the time. More commonly, we identify an additional investment catalyst we think will generate further upside and adjust our target valuation accordingly. Such catalysts may include an earnings surprise, or changes in management, regulatory environment, or industry structure.

2. Realise when the company is 'discovered'

Many companies we invest in are initially not well known or understood by the market. This can create a significant opportunity: once the broader market discovers that company's 'story' and recognises its value, its share price may climb. This is frequently a signal to sell as further share price growth may then be constrained. Two factors that indicate a company has been discovered are 1) when large institutional investors join its share register and/or 2) stock analysts initiate coverage of the company.

3. Watch for a significant change in outlook

When circumstances or events have an adverse effect on a company's outlook, this is a compelling reason to sell a winner. This is particularly important in the case of small to mid-cap stocks as they are more prone to be affected by one-off events and their share prices can be more volatile. An intimate understanding of a

company, its operations and commercial drivers is crucial to identifying such circumstances or events that may impact the business's future prospects.

Until earlier this year, there was considerable enthusiasm in the market for companies leveraged to Chinese consumers and their demand for Australian products, such as vitamins and infant formula. At the time we owned Blackmores (ASX:BKL) and The a2 Milk Company (ASX:A2M), which provided excellent exposure to this trend and both companies had experienced strong share price growth. Based on our research, it appeared there was considerable regulatory risk building for these companies because of changes to online imports foreshadowed by the Chinese Government.

While the market's support for Blackmores and a2 Milk remained robust, we decided the emerging regulatory risk represented a major catalyst to sell so we sold out of both companies. Both remain well managed businesses with strong brand names.

We often form a negative view of a company when the majority of the market is still enthusiastic about its outlook. In our experience, it pays to take a contrarian approach and, as Warren Buffet has cautioned, be fearful when others are greedy.

4. Manage the portfolio re-balancing

When a stock has experienced a meteoric rise, it can quickly become a large proportion of a portfolio. Therefore, selling (or at least selling down) a winner can be a prudent risk-management measure. In the case of small and mid-cap companies, which can be relatively less liquid, we often sell down a position when short-term liquidity is created, for example, after a results announcement.

5. Let winners run

In our experience, there can be wisdom in the often-cited adage, 'let your winners run'. In some instances, a stock has reached our target valuation and there is no further identifiable catalyst to re-rate its share price. However, if we believe there is a degree of momentum in the market, we will maintain our position for a period.

When accommodation operator Mantra Group (ASX:MTR) made its market debut in mid-2014 at $1.80 a share, we invested and set a target valuation of $2.30. When Mantra hit our target price within a few months, we felt the market's enthusiasm would drive its share price higher given there was plenty of evidence that the tourism sector was improving due to the lower Australian dollar. We revised our initial target, maintained our position and eventually sold our Mantra shares at an average of $4.25 earlier this year.

When we started buying a2 Milk at 52 cents, our target price was 75 cents. We felt confident the company would announce an earnings upgrade due to demand outstripping supply. This belief was based on my personal experience of trying to track down a tin of the company's infant formula only to find there was a considerable shortage of supply. a2 Milk subsequently announced an earnings upgrade which surprised the market and saw their share price surge, surpassing our target. We continued to ride the momentum, ultimately selling at $1.68.

Proximity to the market and an understanding of the psychology of its participants can help in assessing whether there is momentum that could drive a company's share price. When a stock reaches a 12-month high, this can be a tangible measure of such momentum. Conversely, a 12-month low can indicate the company has lost the market's support.

6. Don't fall in love with a stock

Depending on the investor's objectives, it is important to consider a range of factors when selling a winner. Establishing an exit strategy, developing an in-depth understanding of the company, and insight into the market's view of the stock is imperative.

Above all else, avoid forming an emotional attachment to an investment. Having spent considerable time and energy researching and understanding a company, its industry and its management, it can be difficult not to fall in love with a stock, particularly a winner. Yet an emotional attachment can inhibit your ability to properly evaluate the company and its prospects.

Chris Stott is Chief Investment Officer of Wilson Asset Management *(WAM). This article is general information and does not consider the needs of any individual, and WAM may or may not hold some of the investments mentioned.*

'Short selling' and the Australian banks

by John Pearce on 21 April 2016

Short selling (or 'shorting') literally involves selling something you don't own. Here's a hypothetical example of the basic steps involved:

1. An American hedge fund manager thinks the price of ANZ shares is going down.
2. The hedge fund doesn't actually *own* any ANZ shares so it borrows the shares from an Australian fund, and then sells the borrowed stock on the market.
3. At some point the hedge fund will need to buy back the shares and return them to the lender.

The profitability dynamics of those steps are reasonably straightforward. Let's assume the hedge fund borrowed ANZ shares at $30. Ignoring the small amount of borrowing and transaction costs involved in establishing the short position (usually less than 1.0% p.a.), the hedge fund will profit if the price of ANZ falls below $30. However, if the price rises above $30, its short position will incur a loss when the shares are bought back.

Hedge fund activities raise the ire of some market participants who see them as unscrupulous predators exploiting the very market instability they helped create. There's no doubt that short selling can exacerbate a market panic – sometimes leading to a ban on the practice (the most recent example being in China).

We believe that the ability to short sell is fine in a normally-functioning market, as it actually adds to the liquidity and efficiency of a market.

Short selling is not without risks, as share prices can go up as well as down. Shorting Australian banks has indeed been a losing trade for a long time (referred to as a 'widow maker' in market lingo), but this hasn't stopped hedge funds from continuing with the practice.

Why Aussie banks are perceived to be the next 'Big Short'

The Australian Securities Exchange (ASX) discloses the amount of a company's shares that is shorted. For our major banks, the number is currently around $7 billion, close to a record high. Although it's certainly a big number, it represents only 2% of the total value of the banks. This compares to Myer, for example, which has around 11% of its market value shorted!

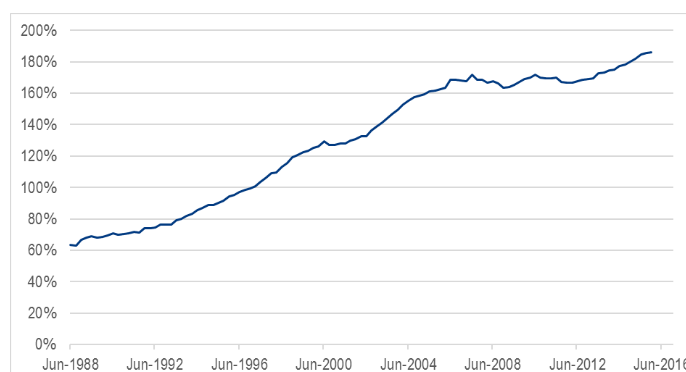
Given the dearth of hedge fund managers in Australia who can short-sell, it's reasonable to assume that most of this activity originates offshore. The term 'Big Short' is the title of a book (and now made into a movie) written by Michael Lewis which (simply and colourfully) documented the GFC through the eyes of four very successful hedge fund managers.

The following two graphs capture the essence of the short selling argument. Graph 1 shows asset prices growing at a rate far in excess of income growth. This has been made possible by increased borrowings as shown in graph 2.

Graph 1: House price to income ratio

Source: Goldman Sachs Global Investment Research

Graph 2: Household debt to income



Source: Reserve Bank of Australia

History tells us that extreme valuations fuelled by high debt is an accident waiting to happen. In the most pessimistic commentators' eyes, the

Australian situation resembles the bubble we witnessed in America and Ireland leading up to the GFC – and we know how that ended. Given that around 50-70% of Australian bank loans are secured by housing, the implications of a housing crash are self-evident.

Other features of the Australian environment also bear an unfortunate resemblance to the American experience. In particular, there's mounting evidence of an apartment oversupply projected to continue for the next couple of years as developers complete the current construction pipeline. Sharp falls in prices (up to 30%) are now being recorded on some apartments bought off-the-plan at the height of the boom and some developers and investors will lose money.

The major banks claim they have limited exposure to high-risk property developers, although there's little doubt that they have played their part in fuelling the boom. In 2014, around 40% of all housing loans written were interest-only investment loans (as distinct from loans to people who are buying a primary residence). According to our analysis, we believe at the peak, some banks were writing over 50% of new business in interest-only investment loans.

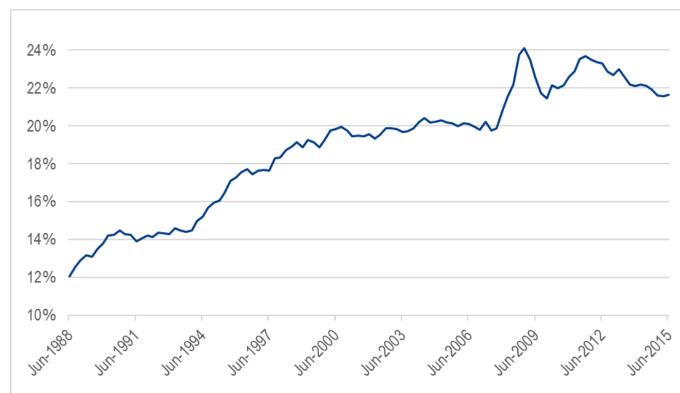
Fortunately, the banking regulator, APRA, clamped down on such practices in mid-2015, limiting investment loan growth to 10%. While it's comforting to see bank lending on a more prudent path, it is somewhat of an indictment of bank management that it has required the 'big stick' of the regulator to make it happen.

Not all bubbles burst; some just deflate

Forecasts of a crash in Australian house prices are not new, and of course the property market didn't come through the GFC unscathed. Property prices will always remain vulnerable to large systemic shocks, principally recessions. However, a general collapse in housing prices leading to a sharp rise in bad loans and write-offs for the banks is far from inevitable, given some mitigating factors.

Compared with the commonly referenced data in the first two graphs, graphs 3 and 4 paint a very different picture of the state of household finances. Unlike graph 2 which compares the amount of debt to annual income, graph 3 compares debt to total assets.

Graph 3: Household debt as a percentage of assets



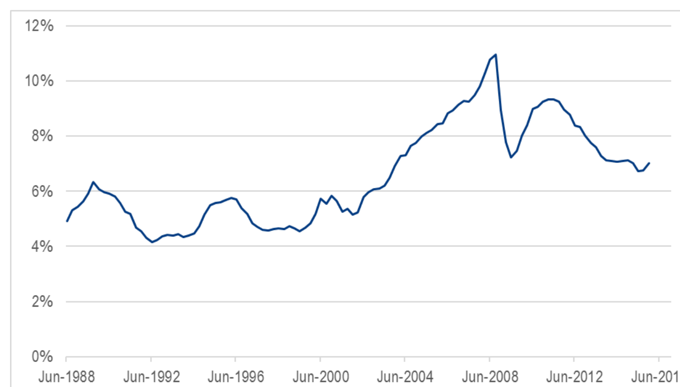
Source: Reserve Bank of Australia

Based on this data, Australian households – on average – currently look far from a debt crisis, with the value of assets about four and-a-half times greater than the value of debt.

Clearly, there are individuals above and below the average. However, we gain some comfort from the stricter lending criteria in recent years, which should help limit borrowers from over-extending.

To complete the picture, we also need to look at debt serviceability. That is, how onerous is it for Australian households to meet their interest payments? Graph 4 shows that on average, at current interest rates, only 7% of income is required to meet interest bills. On this measure, household affordability is nearly as cheap as it's ever been.

Graph 4: Debt servicing (housing interest payments to income)



Source: Reserve Bank of Australia

Nevertheless, assets can go down in price whereas outstanding debt only falls with actual repayments so Graph 2 is not totally irrelevant. It is arguably useful in estimating the potential extent of a debt crisis rather than drawing firm conclusions on the probability of it occurring.

In summary, the pessimists will point to statistics which on face value look alarming, but are also

potentially misleading. The reality is that 'on average' Australian households have assets well in excess of debt and even if asset prices fall, the ease with which the debt can currently be serviced provides a cushion if income is maintained.

And this is the crucial point – it's all about employment. If Australia can maintain unemployment around current levels, there's no reason why the bubble has to burst. It can simply deflate, with a gradual decline in house prices and gradually rising incomes.

Fuelling the fire are bad corporate loans

With our major bank shares currently trading around 30% below the highs of March 2015, the short sellers appear to have the upper hand, despite the absence of a housing crash. How so?

The latest swoon in the share prices followed ANZ's announcement that impairments (i.e. expected losses) on their corporate loan book would be "at least $100 million higher" than previously guided. Recent failures such as Dick Smith, Slater & Gordon, Arrium and Peabody Resources are well known to the market so an increase in impairments (particularly from a historically low level) should not come as a surprise. However, in the week following the announcement $8 billion was wiped off ANZ's market value!

The market's reaction reflects concerns that ANZ's announcement is the tip of the iceberg, and talk of dividends being slashed to shore up capital is gaining traction. While a cut in dividends is possible, it is premature to predict they will be 'slashed'. And by no means are all of the banks equal.

During the GFC the major banks cut their dividends on average by 20%. However, to put this in context, at that time CBA's ratio of bad debt costs to total loans was around 4.5 times higher than the level reported in its latest financial results.

At this point, with bank shares well off their highs, it seems that the bank short sellers are right, but for the wrong reasons.

John Pearce is Chief Investment Officer at Unisuper. This information is of a general nature only and has been prepared without taking into account any individual objectives, financial situation or needs. Before making any decision in relation to your personal circumstances, you should consider whether to consult a licensed financial adviser.

High yields may ignore fundamental weakness

by Anton Tagliaferro on 6 October 2016

There's a misperception that equity income investing is as easy as ranking the market's highest-yielding stocks and building a portfolio from that basis. While on the surface stocks that yield in excess of 7% might look attractive, it may be a complete illusion if one looks closely at the market's fundamentals. It is what we refer to as an 'income trap' or an 'income illusion'.

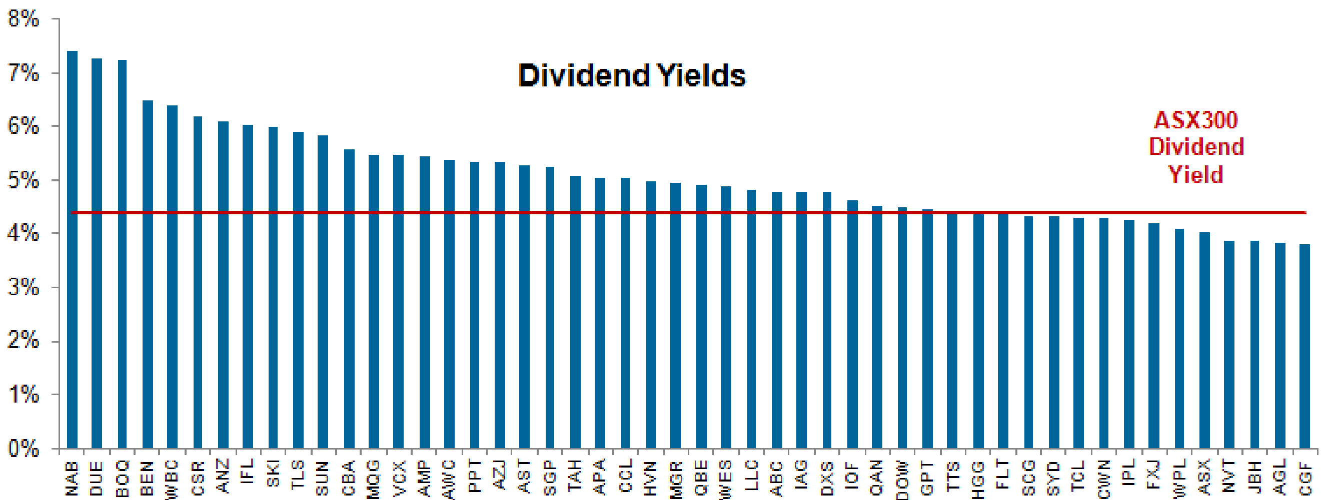
There are countless examples of ASX100 companies that trade on attractive dividend yields. Often investors support these stocks based on yield alone, compounded further by passive 'equity income' ETFs.

In investing parlance, a 'value trap' refers to a stock that looks cheap on the surface, but the trap springs into action when the fundamentals continue to deteriorate and investors lose patience and sell out.

Watch for the 'income trap'

We call it an 'income trap' when a stock may look attractive from the headline dividend yield alone, yet is unsupported by robust company fundamentals. As a bottom-up value manager, fundamentals are crucial to us, be it the quality and transparency of the earnings, cash flow generation, gearing levels or balance sheet strength. When the fundamentals are weak or challenged for a prolonged period, more often than not a dividend cut is inevitable, springing the 'income trap'.

Companies yielding over the ASX300 headline



Source: Factset, 12 August 2016

Additionally, while passive ETFs can play a role in equity investing, investors should be cautious when investing from a headline yield perspective. A look at 50 of the most widely-held names on the ASX ranked for yield in the table above shows the vast majority of companies yield over the ASX300 headline yield, which currently stands at approximately 4.5%. While attractive on the surface, this does not justify constructing an income-generating portfolio around these seemingly high-yielding companies.

Questions to ask when investing for yield alone

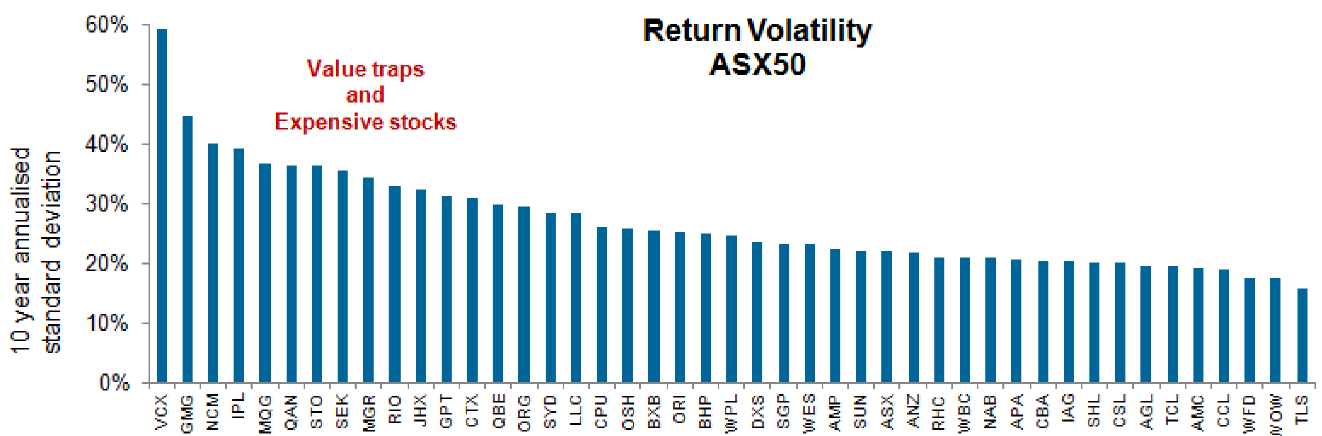
Before investing in an equity for income alone, ask:

- Why is the yield at an elevated level?
- Has the stock fallen and is this a potential value trap?
- Is the company's payout ratio too high?
- Is the company putting its balance sheet at risk by maintaining the dividend?
- Do cash flows reconcile with underlying earnings?

The two most important attributes of a retiree's stock portfolio are high levels of income and lower absolute risk than the overall market. By investing in a portfolio of quality companies, drawdowns are reduced with a higher probability of capital preservation.

The left-hand side of the chart below represents those companies with meaningfully higher historical volatility on an annualised 10-year basis, symptomatic of the curse of either being value traps or simply too expensive. Beholden to exogenous shocks or wider economic shifts, these companies have shown over the longer term to be much more volatile, given the cyclicality of their business or financial models. While the investment case for a number of these stocks can be made for those in the accumulation phase chasing capital growth, in our view they are simply not suitable for retirees.

Companies ranked by their absolute historical volatility



Source: Factset, 12 August 2016

Dividend per share	FY-1	FY0	FY1	12-month share price performance to June 2016
BHP	$1.7	$0.4	$0.43	-27%
RIO	$2.63	$2.96	$1.45	-10%
ORI	$0.96	$0.96	$0.58	-38%
ANZ	$1.78	$1.81	$1.6	-20%
WOW	$1.39	$0.77	$0.81	-18%

Source: Factset, IRESS, June 2016

Retirees have special needs

So what should we invest in on behalf of retirees? A portfolio of companies with recurring earnings that provide a healthy, consistent dividend trading at reasonable valuations can significantly reduce aggregate volatility.

The table above shows a number of blue chip companies that are well represented in retiree portfolios. When a company cuts its dividend it is a clear signal to the market that its earnings are challenged. The implications for retirees holding these stocks is bad – generated income is falling while the share price is also under duress.

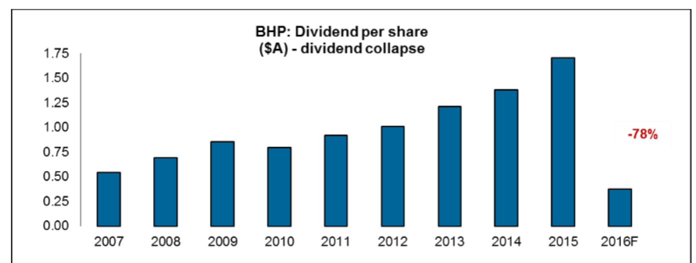
These companies have cut their dividends due in part to a low-growth environment but also because of problems with their business models. Mining-related companies are suffering from low commodity prices and supermarkets and banks are suffering from margin pressure and increased competition. Investors need to pay greater attention to the company's fundamentals and its earnings sustainability before jumping on board because it appears attractive on a dividend yield basis.

In minimising volatility within your stock portfolio, avoiding both income traps and overvalued stocks is paramount. Being aware of what cues to look for in individual companies and understanding trends of underlying fundamentals can assist greatly in picking stocks for your retiree portfolio.

Case study: BHP Billiton (BHP)

In 2015, BHP traded with a perceived healthy dividend yield of 7-8%, seemingly attractive from a retiree's perspective. However, as commodity prices collapsed through 2015, the company's fundamentals continued to deteriorate, their earnings fell and gearing levels increased. The unsustainable payout ratio reached almost 400% as the company tried to maintain its promise of increasing dividends over time. It was unsustainable.

In February 2016, the company took the prudent step of cutting their 'progressive dividend' to protect the company's balance sheet, reduce its gearing and thus preserve its credit rating. The decision was encouraging from a capital management view as it will help BHP stabilise its balance sheet. Yet, from a retiree's perspective, a cut of this nature can have a significant impact on the dividend income received as an investor.



Source: Factset

Conversely, Spark Infrastructure is an owner of regulated electricity transmission and distribution assets, primarily located in South Australia, Victoria and New South Wales. Like BHP, Spark also had a strong CAPEX programme over the past five years. However, unlike BHP, Spark took the prudent measure of de-gearing its balance sheet, whilst maintaining a low pay-out ratio, in order to assist in funding the company's growth projects. Ultimately, Spark has a stable earnings profile given it operates as a regulated monopoly. When the CAPEX programme slowed down, Spark decided it was in a position to reward investors by raising the dividend.

Fundamental analysis is paramount when building retiree portfolios. We have always believed that companies that can grow their earnings through their own initiatives, that offer a degree of immunity to the economic cycle, and are backed by robust fundamentals are best suited for retirees.

Anton Tagliaferro is Investment Director at [Investors Mutual Limited](). *This article is for general educational purposes and does not consider the specific circumstances of any individual.*

Technology and investing: this time may be different

by Hamish Douglass on 4 August 2016

I am often reminded of the sage advice from Sir John Templeton: "The four most dangerous words in investing are 'this time it's different'." As investors, I think we need to question whether we are entering a new technological and machine age over the next 10-25 years that could disrupt most businesses and possibly society as we know it. In this regard, the new technological and machine age may be more important than The Industrial Revolution. Quite possibly, this time it is different and whilst heeding Sir John's advice, as prudent investors we believe it would be neglectful to ignore the technological developments that are almost certain to provide substantial threats and opportunities to businesses.

In a recent TED interview, Charlie Rose asked Larry Page (Co-Founder of Google) what is his most important lesson from business. He said that he has studied why many large businesses fail and he concluded: "They missed the future." As investors, can we afford to miss the future? In our view, there is mounting evidence that we are approaching a tipping point of exponential technological advancement, particularly through accelerating improvements in artificial intelligence, 3D printing, genomics, computing power and robotics.

We have numerous recent powerful lessons on the rapid disruption of businesses from technological innovation:

- In 1998, Kodak had 145,000 employees and sold 85% of all photographic film. In 1999, Kodak's stock price peaked and in January 2012 it filed for bankruptcy. What is surprising about the Kodak story is that it invented the digital camera in the 1970s and yet the company was effectively destroyed by its own invention.
- In 1998, Nokia overtook Motorola to become the world's largest mobile phone manufacturer. By 2007, Nokia controlled in excess of 40% of the mobile phone market and was highly profitable. In July 2005, Google bought Android and in January 2007, Apple launched the iPhone. In September 2013, Nokia sold its loss-making mobile phone business to Microsoft.
- Google was founded in September 1998. In 1999, newspapers' share of global advertising revenue was approximately 35%. In 2015, Google generated advertising revenues of over US$67 billion, or 14% of global advertising. Meanwhile, newspapers' share of global advertising revenue had fallen to approximately 12%.

Another lesson is that large scale/global disruption from technological advancements appears to be occurring at a faster and faster pace. Uber was founded in March 2009 and is now the world's largest 'taxi company', with operations in 429 cities in 71 countries. Facebook was founded in February 2004 and has in excess of 1.6 billion monthly active users. The company is expected to generate advertising revenues in excess of US$20 billion this year. Airbnb was founded in August 2008 and is now the world's largest accommodation company, with over two million listings in 34,000 cities in over 190 countries.

Exponential versus linear growth

It is difficult to comprehend that we could rapidly face a radically different world from the advancement of technology, when our own experience suggests that fundamental change is occurring incrementally and at a gradual pace. A reason why we may be underestimating the impact of technological change is that most changes in our life (like ageing, learning, career progression, etc.) occur in a well-established linear trajectory whereas technological progression is exponential.

In exponential growth, a measurement is multiplied by a constant factor for a given unit of time (e.g. computation power doubles every year), whereas for linear growth the measurement is added to incrementally and by a constant factor (i.e. we grow older by one year per year). Early on, it is difficult to feel the difference between linear and exponential growth (i.e. from 1,2,3,4 … to progressions of 1,2,4,8…); however,

after 30 iterations the linear sequence is at 30 whereas the exponential sequence is over 500 million. In an exponential world nothing is perceived to be changing in the early stages and then suddenly change starts occurring at an explosive rate.

There are numerous examples of technology progressing at an exponential rate. Three well-cited examples are:

- **Computational power** – In 1965, Gordon Moore, Co-Founder of Intel, predicted that the number of transistors in an integrated circuit would double every two years (the so-called Moore's Law). Over the last six decades, computation power has increased over one trillion times per integrated circuit. An iPhone 5 released in 2013 has twice the processing power of the 1985 Cray-2 supercomputer, which at the time was the world's most powerful computer. At the current rate of progression, a mobile phone is likely to have the processing power of the current largest supercomputer – China's Tianhe 2 – in around 15 years.
- **Genome sequencing** – When the project to sequence the human genome was started in 1990, given the speed at which the genome could be scanned at that time, it was thought it would take thousands of years to sequence the entire human genome (six billion bases). The full genome was sequenced 10 years later. In 2000, the cost to sequence an entire human genome was around US$100 million and by 2015, the cost had fallen exponentially to US$1,000.
- **Data** – It has been estimated that the amount of digital data in the world is doubling every two years. To put it another way, estimates suggest that more data has been created in the past two years than in the previous history of the human race.

In order to predict what will happen in the future through technological change, you need to extrapolate and think exponentially. Ray Kurzweil, a natural language processing pioneer and entrepreneur, a renowned futurist and currently Director of Engineering at Google, wrote in a March 2001 paper titled, *'The Law of Accelerating Returns':*

"An analysis of the history of technology shows that technological change is exponential, contrary to the common-sense intuitive linear view. So we won't experience 100 years of progress in the 21st century, it will be more like 20,000 years of progress (at today's rate)."

"It is important to ponder the nature of exponential growth. Toward this end, I am fond of telling the tale of the inventor of chess and his patron, the Emperor of China. In response to the Emperor's offer of a reward for his new beloved game, the inventor asked for a single grain of rice on the first square, two on the second square, four on the third and so on. The Emperor quickly granted this seemingly benign and humble request. One version of the story has the Emperor going bankrupt as the 63 doublings ultimately totalled 18 million trillion grains of rice."

"As exponential growth continues to accelerate into the first half of the 21st century, it will appear to explode into infinity, at least from the limited and linear perspective of contemporary humans. The progress will ultimately become so fast that it will rupture our ability to follow it. It will literally get out of control."

Bill Gates has commented that "we always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next 10." This tendency to overestimate change in the short term and underestimate the long term creates an interesting (and possibly dangerous) paradigm for an investor – acting too early by selling or short selling businesses that are most likely to be disrupted may well be detrimental to short-term returns, whereas waiting too long could be very costly, as in the end disruption may occur very rapidly. Judging where we are on the exponential path of technological development is becoming critical for any longer term investor. In thinking about the investment impact of exponential growth, it is instructive that five of the world's 10 largest companies by market capitalisation are currently technology companies (Apple, Alphabet, Microsoft, Facebook and Amazon) and three of these companies did not exist less than 25 years ago.

Are we nearing a tipping point?

We believe there is evidence that technology may be nearing a tipping point – technology is now advancing at such a rate that a breakthrough in Artificial General Intelligence (AGI) may be rapidly approaching (AGI is a computer system that is as smart as a human across any intellectual task).

Firstly, we believe that the world's major technology companies are collectively assembling the equivalent of the 'Manhattan Project' that led to the development of the atomic bomb in World

War II. Companies such as Alphabet (Google), Facebook, Microsoft, IBM, Alibaba, Baidu, Amazon and Apple are investing unprecedented amounts of money in artificial intelligence research and development, expansion of computational power, collation of the world's data and knowledge and assembling the world's leading intellectual capital by hiring leading graduates, researchers and scientists in fields of artificial intelligence and computer engineering from the world's leading universities.

Secondly, over the last few years there have been dramatic advances in machine learning, voice and image recognition, machine understanding of language (machines can now read and understand documents) and the early development of quantum computers. Each of these areas appear important in the development of AGI and it seems reasonable to expect accelerating advances in the years ahead.

Finally, March 2016 may well be remembered as a seminal moment in the advancement of artificial intelligence, when AlphaGo (a computer program developed by Google DeepMind) beat the Go world champion, Lee Sedol, in four out of five games. Experts had predicted that a computer program would not master Go, an ancient Chinese board game still played today, for another decade given the complexity of the game. There are apparently more possible moves in a game of Go than there are atoms in the universe. The breakthrough with AlphaGo is that it is a self-learning algorithm that learns from raw data. AlphaGo taught itself to play by playing itself 30 million times. Google DeepMind's website states:

"The algorithms we build are capable of learning for themselves directly from raw experience or data, and are general in that they can perform well across a wide variety of tasks straight out of the box."

An algorithm that learns for itself is a fundamental building block of developing AGI. The winners in the AGI arms race are likely to have access to the best intellectual capital, massive computing power and vast data across all areas (personal, written documents, image/video).

In our view, disruptive and profound changes to businesses, industries and economies from exponential advances in technology appear to be ever closer to our doorstep. As investors, we need to carefully weigh up nearer-term investment opportunities against the likelihood of exponential progress and be prepared and positioned for fundamental and disruptive change over the longer term. The risk is that we will fail as investors if we fail to see the future. This time it may well be different.

This is an extract from Magellan Asset Management's Annual Investor Report for June 2016.

Hamish Douglass is CEO, CIO and Lead Portfolio Manager at Magellan Asset Management. This material is for general information purposes only and must not be construed as investment advice. It does not take into account your investment objectives, financial situation or particular needs.

Innovation offers opportunities for investors

by Dawn Kanelleas on 20 July 2016

Australia's National Innovation and Science Agenda appears to have sharpened the focus on companies perceived as 'innovative' in nature. From an investment perspective, innovation represents opportunity. It also present risks, however, primarily for incumbents whose margins or market shares are threatened by new entrants or more innovative competitors.

By understanding the breadth of opportunities for new entrants in an industry, as well as the threats to incumbents, professional long-short investors are able to profit from opportunities on both sides of the ledger. In this article, we consider what innovation means in the Small Companies sector and how innovation and disruption can drive investment decisions in this often under-researched space.

What does disruption mean for small company investors?

The information technology age in which we live means many people associate innovation with something digital or online. Consider how innovative products like Uber and iTunes have revolutionised the taxi and music businesses. In fact innovation, and therefore disruption, is occurring in all kinds of businesses in Australia, across a wide range of sectors.

From an investment perspective, you need to consider much more than the innovation itself. Many other factors will determine whether an innovative company is a good investment such as the size of the market for the product or service. Then there are questions like:

- are there barriers to entry or lack thereof?
- how many years a product has been in development?
- is it meaningfully different from competitors?
- is it patented?
- how much money has been invested in research and marketing?
- how broad is the distribution footprint?

All of these considerations determine whether a company has competitive advantages and, importantly, the sustainability of those advantages over time.

There are also investment considerations for incumbent operators. Some of these established, listed companies may have been operating successfully in an industry for many years, with earnings streams that were previously deemed defensive and sustainable. For long-short investors, the potential negative effects of disruption can be as appealing as the potential benefits of innovation.

Innovation in established industries

In any industry, there is almost always some level of product development or innovation occurring. The car industry is one of the most established and competitive in the world and there is an astonishing level of innovation underway, including the development of electric motors and the release of prototype driverless vehicles.

For Australian small cap investors, there are exciting earnings opportunities from companies with innovative products and services in rather less futuristic areas.

In the 1970s, owners of 4×4 vehicles relied on homemade or ill-fitting equipment for use in rural or outback regions. At that time, ARB Corporation was established and the company started designing and producing a range of 4×4-related accessories. Following more than 40 years of product development and innovation, the company is a global market leader in the manufacture and supply of bull bars and other accessories. The 4×4 market is growing at a double-digit pace due to the ever-increasing popularity of SUVs and utility vehicles.

ARB currently exports to more than 100 countries, has a vast distribution footprint and owns its own outlets to service the aftermarket for additional, non-standard accessories. The global reach of this business model is not easily replicated. The company is on a strong financial footing, too. ARB is in a net cash position and earnings margins in the 20% range are the envy of companies in many other industry sectors.

Whilst many of ARB's products are perceived to be innovative, the key appeal for us as investors is the sustainability of the competitive advantages developed over more than four decades.

Innovators completing Initial Public Offerings (IPOs)

Many of the most innovative companies are relatively immature, unlisted companies. Some of these go on to complete IPOs, crystallising gains for founders and seed investors and raising capital to fund future growth. An example in the Australian small cap sector is Reliance Worldwide Corporation, a recent IPO of a company operating in plumbing, an established and 'old fashioned' industry.

Among the company's main products is a 'push-to-connect' pipe fitting. The product offers plumbers and DIY users an efficient, less labour-intensive solution to repairs following pipe leaks. While Reliance Worldwide has about 80% share in the push-to-connect market in the US, Canada and Australia, the real attraction is that push-to-connect currently only accounts for about 10% of the plumbing supply market in the US. The growth opportunity is significant and the company is experiencing sales growth of more than 10% per annum.

Reliance Worldwide has been distributing plumbing products into the US for more than 16 years and has market-leading positions in primary locations. Trademark protection of the product provides another important competitive advantage. Market share is protected from

imitation products and, importantly, means Reliance Worldwide can maintain decent pricing power with stockists.

Will we continue to see innovative companies in Australia?

Given the National Innovation and Science Agenda of the Federal Government, we expect to see a steady stream of start-up companies threatening incumbent operators in many industries. Some of these companies will have aspirations to list and will go on to complete IPOs.

As pioneers such as REA Group (in real estate digital advertising) and TPG Telecom (in both internet and telephony services) have proved, disruptive companies with innovative products and services – combined with the right focus from a capable management team – can generate handsome returns for investors.

On the other hand, there have been countless examples of companies whose products and services have not lasted the test of time, resulting in a permanent loss of capital for investors. The challenge is to identify the key differences between the two and position your investment portfolio accordingly.

Dawn Kanelleas is Senior Portfolio Manager at Colonial First State Global Asset Management. *This article is general information and does not consider the investment needs of any individual.*

7. Property investing

What to look for in unlisted real estate funds – Adrian Harrington

Can US house price falls happen here? – Roger Montgomery

Pleasure and pain: a personal journey buying off-the-plan – Graham Hand

Time and tide should dampen negative gearing proposal – Noel Whittaker

What to look for in unlisted real estate funds

by Adrian Harrington on 28 April 2016

In the current low interest rate environment, the hunt for yield is a powerful force. Non-residential real estate via listed real estate investment trusts (A-REITs) and unlisted real estate funds (syndicates) have both benefitted from strong investment inflows. To date, investors have not been disappointed. According to the Property Council/IPD Unlisted Core Retail Property Fund Index* published by MSCI, unlisted syndicates generated a total return of 37.8% in the year to 31 March 2016, with an income return of 8.8%. For the same period, A-REITs generated a total return of 11.4%, with an income yield of 5.8%.

In this Part 1, we show the characteristics of unlisted real estate funds and how the Net Tangible Assets number is calculated, while in Part 2, we demonstrate how returns are affected by gearing, and the various exit strategies.

However, choosing to invest in any investment whether it be an A-REIT, a bank stock, or an unlisted real estate syndicate based on just the first year yield may lead to problems down the track when the market turns. Investing is about total returns – income and capital – over the life of the investment and a syndicate typically has a term of between five and seven years.

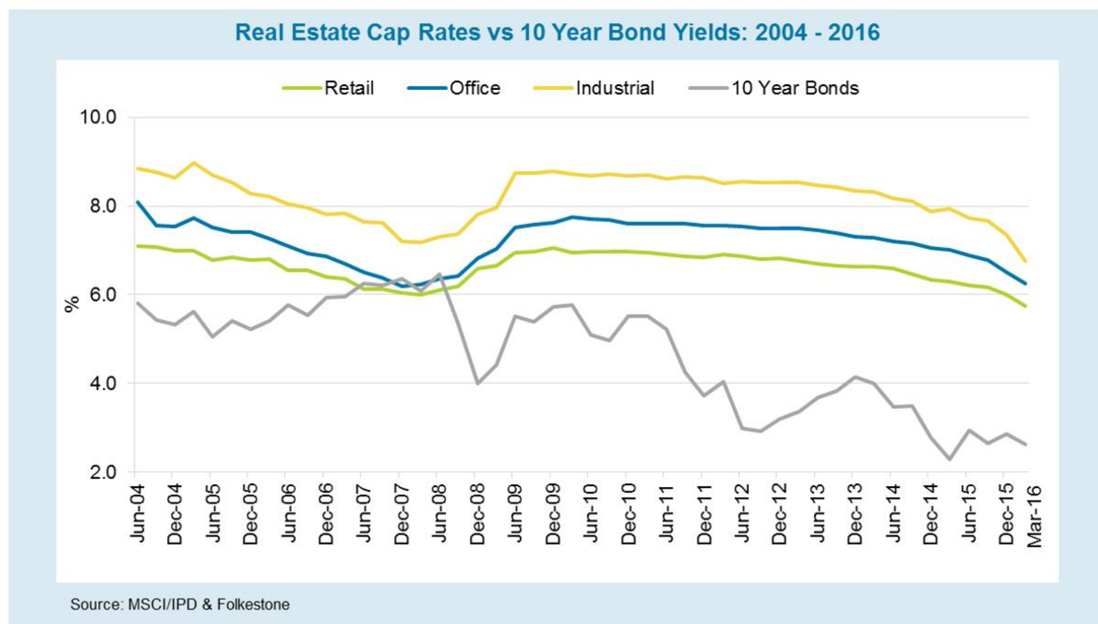
Most of the syndicates in the Index were established between 2010 and 2014 when real estate yields were higher, and hence the relative higher yield they are now generating. As prices of non-residential real estate assets have increased, yields have firmed (see Figure 1). Recent syndicate offers typically have starting yields of between 6.6% and 7.5%. When compared to the cash rate at 2.0% and 10 year bonds at 2.5%, the yields look attractive.

Folkestone does not believe the non-residential real estate sector will fall off a cliff in the next year or so with the exception of those assets in cities or towns reliant on the mining sector (e.g. Perth CBD office). As we recently pointed out in our 2016 Outlook paper,

"We are now seven years into the up-cycle, and we see less upside to many markets than we have in recent years … Easing capital market tailwinds and close to full valuations in some markets will mean that earnings growth rather than yield compression will be the key driver of value creation going forward."

We still see opportunities to invest in unlisted real estate syndicates but it is becoming increasingly difficult to find quality assets at reasonable value. Now is not the time to stretch on price or overcommit to short-term strategies; maintaining investment discipline will be key.

Figure 1 – Real Estate Cap Rates (Yields) in Various Sectors



Understand the asset and fund characteristics

Every real estate asset and fund are different, and investors should examine:

Asset level

- Characteristics of the asset – what is the age, quality and location of the asset?
- Tenant covenants – how good are the tenant covenants and what's the risk of default?
- Lease expiry profile – what is the vacancy, when are the leases due to expire, are they staggered through the term of the fund or do they extend beyond the term of the fund?
- Rent structure – is the asset under- or over-rented compared to the rent level in the market, what incentives have been paid to tenants, when and how are rents reviewed during the lease term?
- Capital expenditure – will the asset require capital expenditure during the term of the syndicate and if so, how will the fund pay for it?
- Market dynamics – what is the prognosis for supply and demand in the surrounding market?

Fund level

- Longer-term yields – don't just focus only on the first year yield published on the cover of the fund offer, remember it's a five to seven-year investment at least.
- Distribution policy – is the fund paying distributions from its cash from operations (excluding borrowings) or capital, borrowings or other support facilities which may not always be commercially sustainable?
- Gearing – what's the fund's gearing level and how does that compare to the bank covenants, and how much buffer is there between the gearing level and the bank's maximum loan to value ratio? How much, if any, of the debt is fixed versus variable? (We will show how changing the gearing can appear to enhance returns in Part 2 next week).
- Fees – what is the fee structure, are they transparent and aligned with investors?
- Manager track record – what is the performance track record of the manager?
- Poison pills – does the fund have a 'poison pill' which requires the manager to be paid by the fund if removed by investors for poor performance?
- Regulatory compliance – does the fund meet the six benchmarks and eight disclosure principles for unlisted property schemes described in ASIC's Regulatory Guide 46 on Unlisted Property Schemes, and if not, why not?
- Treatment of acquisition costs – does the manager write off or capitalise costs?
- Exit strategy – what's the manager's likely exit strategy? More on this in Part 2.

Three points worth emphasising

1. Good real estate managers are asset enhancers

They create value by their ability to manage the asset through the cycle. They don't rely on tricky capital management and financial engineering to deliver returns to investors. They also offer true to label simple and transparent funds with fee structures that are reasonable and aligned with investors. We advocate on-going management fees based on a percentage of net assets (not gross assets) of the fund as the manager is not incentivised to take on higher gearing. A management fee of 1.3% of net assets assuming 50% gearing is equivalent to 0.65% of gross assets. A performance fee is also appropriate so long as the benchmark rewards the manager for real outperformance not just turning up for work.

2. Understand how the manager calculates the NTA of the fund

Some managers capitalise part of the acquisition costs rather than write them off on day one, which means the initial Net Tangible Assets (NTA) is higher. Table 1 shows the initial NTA when acquisition costs are not capitalised and Table 2 shows the impact when costs are capitalised. Instinctively when presented with the two options, an investor may think they are better off investing in the fund adopting option 2, where the NTA looks significantly higher. We (and most of the leading managers) advocate taking the conservative path and writing these costs off on day one which unfortunately results in a lower initial NTA. Managers capitalising costs run the risk that if the value of the asset has not risen by at least the amount of the capitalised costs at the next financial review date, then they will have to be written off at that time, impacting the NTA.

Table 1 - Unlisted Fund - Acquisition Costs Not Capitalised		
Gearing	**50%**	**A**
Property Price / Debt & Equity		
Acqusition Yield	7%	**B**
Annual Net Property Income	3,000,000	**C**
Purchase Price	42,857,143	**C/B = D**
Debt	21,428,571	**D * A = E**
Equity - Asset	21,428,571	**D - E = F**
Acquisition & Establishment Costs		
Acquistion Costs (stamp duty/asset due diligence - 6% of purchase price)	2,571,429	**D * 6% = G**
Debt Establishment - 0.25% of debt	53,571	**E * 0.25% = H**
Acquistion fee - 1.5% of purchase price	642,857	**D * 1.5% = I**
Fund Establishment Costs (legals, tax, accounting)	100,000	**J**
Total Acquisition & Establishment Costs	3,367,857	**G + H + I + J = K**
Fund Equity Required	24,796,429	**F + K = L**
Profit & Loss		
Total Annual Net Property Income	**3,000,000**	**C**
Recurring Fund Costs (registry, accounting, tax, audit etc)	120,000	**M**
Interest - 4.5%	964,286	**E * 4.5% = N**
Management Fee - 1.3% of Net Assets (Equity)	278,571	**F * 1.3% = O**
Total Annual Costs	1,362,857	**M + N + O = P**
Total Net Fund Cashflow	1,637,143	**C - P = Q**
No of Units on Issue - Assume Issued Price $1	24,796,429	**L * $1 = R**
Distribution Yield	**6.60%**	**Q / R = S**
NTA ($)	**0.86**	**F / R = T**
Assumes the asset and debt upfront acquisition costs are not capitalised ie they are written off on day one. As a result, more equity is required on day one which results in a lower yield and NTA as more equity needs to be raised		

Table 2 - Unlisted Fund - Acquisition Costs are Capitalised		
Gearing	50%	
Purchase Price	42,857,143	D
Acquistion Costs (stamp duty/asset due diligence - 6% of purchase price)	2,571,429	G
Debt Establishment - 0.25% of debt	53,571	H
Capitalised Asset Value	**45,482,143**	D + G + H = U
Debt	21,428,571	E
Equity - Asset	24,053,571	U - E = V
NTA ($)	**0.97**	V / L

3. Chasing short-term yield may not deliver the best outcome

Thirdly, unlisted real estate funds or syndicates offer a legitimate investment option for investors where liquidity is not a high priority. But like any investment, investors need to understand the risk and return. The first-year headline yield should not be a priority. Real estate is a long-term investment and chasing short-term yield may not deliver the best long-term investment outcomes.

*Note: The Index tracks the performance of 28 funds with a gross asset value of $3.3bn. These funds own either office, retail, or industrial assets and must have greater than 90 per cent direct property exposure, less than 50% per cent gearing, must not capitalise interest and be an ASIC registered managed investment scheme.

In Part 2 next week, we examine gearing and how an unlisted real estate syndicate generates returns, and the different types of exit strategies.

Adrian Harrington is Head of Funds Management at Folkestone (ASX:FLK). This article is general information and does not address the specific investment needs of any individual.

Can US house price falls happen here?

by Roger Montgomery on 7 April 2016

We have all been reading and listening to the debate about Australian property prices and whether they are going to crash. It's hard to ignore when august journals like *The Sydney Morning Herald* report,

"The Australian real estate market is in the grip of the biggest housing bubble in the nation's history and Melbourne will be at the epicentre of an historic 'bloodbath' when it bursts, according to two housing economists."

More level heads suggest that for prices to crash either interest rates need to jump dramatically, or unemployment-inducing economic conditions need to transpire.

Hoping for a bargain

Perhaps because I love a bargain and I am an optimist (a value-investing optimist hopes for lower prices), I have until now been broadly in agreement with those expecting a correction of some magnitude. I was in Malaysia in the 1990's when the skyline was filled with cranes and I was in New York and Florida in 2007. In both cases, overbuilding was followed by a collapse.

Today, I am not sure whether we are due for a significant correction, despite the construction boom in Brisbane, Melbourne and Sydney.

The reason for my more sanguine view is the result of some simple calculations, using ABS data, into the demand and supply picture for Australian property. The weakness in my thesis is that I am

looking at aggregate data rather than city-specific, but aggregate data was all that was needed for some to predict housing price collapses elsewhere in the world.

Factors affecting house prices

Employment, inflation expectations, interest rates, debt-to-income ratios, house-prices-to-income, financial stress measures and the like all influence short-term property prices, but basic demand and supply seem to be the most important influences over the medium term. And given very few people buy property to 'flip' over the short term, it is the medium term we should focus on.

There is merit in looking at household formation as a proxy for demand and construction as our indicator of supply. With the exception of the circa 80% falls in property prices in mining towns in Australia, the most notable real estate price collapse that occurred recently was in the US.

Figure 1 illustrates one of the conditions that preceded the collapse: a sharp jump in the level of construction. According to the US Census Bureau, in the years prior to the GFC, the number of dwellings under construction had risen from 993,000 annually in 2000 to 1.1 million in 2003, 1.2 million in 2004, 1.4 million in 2005 and 1.2 million in 2006.

Meanwhile, according to the US Census Bureau's Current Population Report entitled *Projections of the Number of Households and Families in the United States: 1995 to 2010,* household formation was increasing at about a million per year. In other words, the US was oversupplying dwellings for seven years, and by 2007, possibly a million excess dwellings needed to be soaked up.

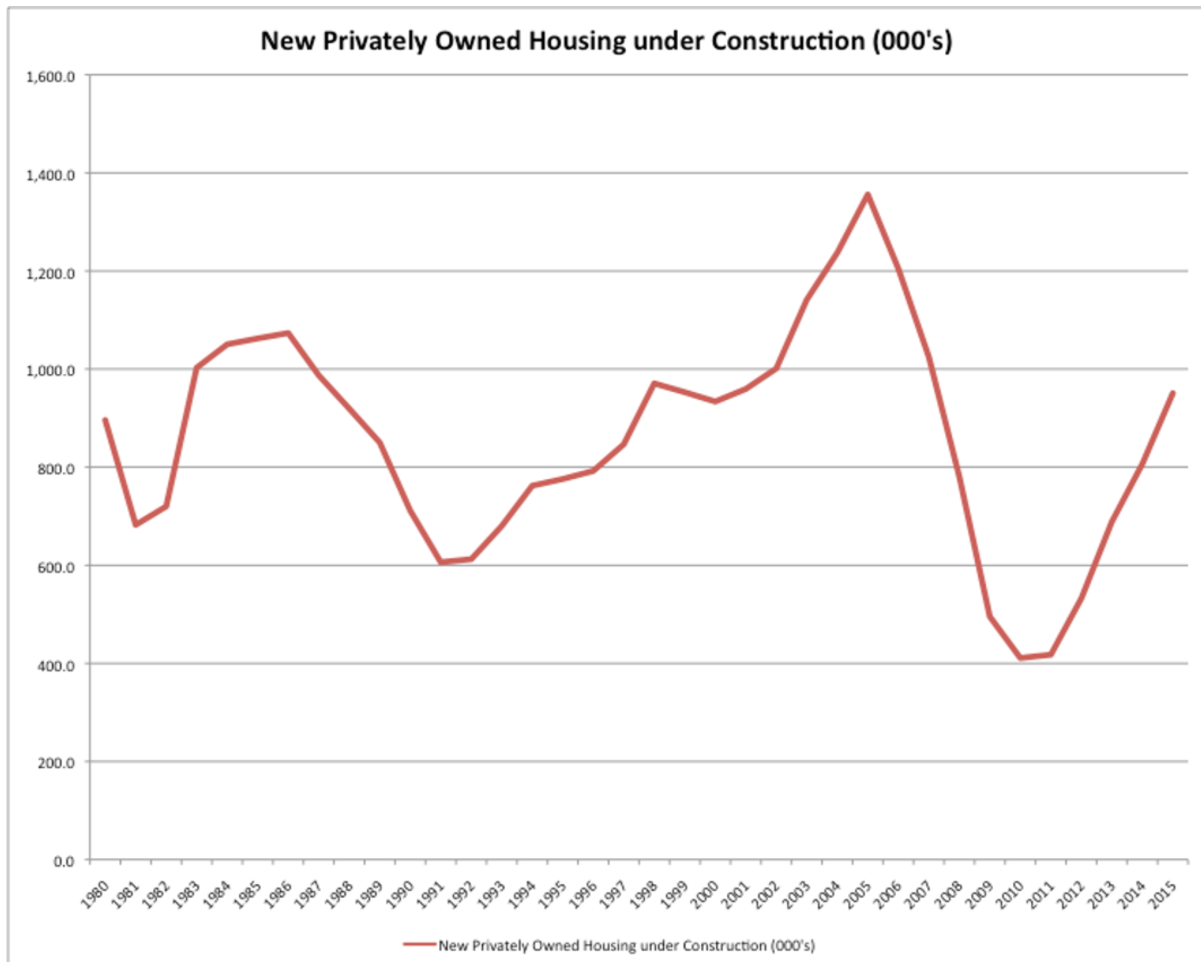
Houses were simply being built faster than they could be occupied. In 2012, Warren Buffett observed as much when he said, "*In normal times, we need about one million or more homes to keep up with household formation.*"

And we know what happened next.

How many residential dwellings are needed in Australia?

In Australia today, dwellings are being constructed at a rate faster than they can be occupied by newly-formed households.

Figure 1. US private housing construction, 1980-2015



Source: US Census Bureau

According to the Australian Bureau of Statistics (ABS) March 2015 report *Household and Family Projections, Australia, 2011 to 2036*, *"The number of households in Australia is projected to increase from 8.4 million in 2011 to between 12.6 and 12.7 million in 2036."*

In other words, household formation is increasing at about 1.6% annually and in 2017 that equates to about 150,000 new dwellings required.

The ABS also reports dwelling units commenced and the construction industry is currently building about 56,000 dwellings per quarter. That's 228,000 per year, a lot more than seem to be needed. More importantly, this has been growing since 2011 when 35,000 dwellings were being constructed per quarter, which was about the same number as the number of new households being formed. It roughly balanced.

So if we assume an average of 47,000 dwellings were constructed per quarter in the years 2012 to the first quarter of 2016, and we add the 18,000 or 19,000 monthly approvals occurring now and project this number for eight months until the end of 2016, we arrive at a supply of 923,000 dwellings. During this period, the number of dwellings required, as estimated by household formation, is 716,249. That suggests an oversupply of about 200,000 dwellings.

At the current rate of household formation, that oversupply could be soaked up in about 18 months, provided construction of new dwellings ceased completely. But of course construction will continue and the oversupply will take longer to be absorbed.

It looks like Australia has a greater oversupply problem than the US did in 2007. The estimated 18 months is more than the 12 months oversupply the US had and after their property market collapse, it took five years before property prices began recovering.

What about sub-prime in the US?

But before we jump to the conclusion that we are due for a crash, keep in mind that our banks have not been extending $700,000 subprime mortgages to Mexican strawberry pickers earning $14,000 per year.

It's reasonable to expect property prices will not rise by much in the next few years and it is certainly possible they could fall. But the falls experienced elsewhere in the world seem unlikely, which means my hopes of a bargain in the next few years may be just that: hope.

However, I am reminded of the inflationary effect on global asset prices from quantitative easing. Cheap and plentiful money injected into the financial system triggered the purchase of assets by institutions migrating away from the safety of cash into (apparently) higher-yielding assets. But the easy money is over, particularly in the US, where the Fed ceased its third quantitative easing programme in October 2014. Since then the amount of money in the system – the US balance sheet – having reached about $US4 trillion (up from $800 billion in 2008), has stopped rising.

Unsurprisingly, the world economy is now slowing. If quantitative easing was responsible for inflating asset prices, the end of QE must surely have the opposite effect. And sure enough, it has.

Since 2014, commodity prices have collapsed. Oil has fallen from $115 per barrel to $40 per barrel and commodities from wheat and corn to copper and cattle have collapsed. Other assets aren't doing too well either, with the US, UK and Australian stock markets about where they were in 2014.

So why are property prices persistently high? One factor is that they aren't traded on an exchange. They're a clunky asset and re-pricing is less efficient as they can take weeks or months to sell and even longer to settle.

And there's a generation of students, and twenty-something-year-old, low-to-middle income earners with multi-million dollar mortgages over property investment portfolios that don't even know what an interest rate is. They aren't strawberry pickers on $14,000 but what will they do if and when rates rise?

Don't worry about rushing into residential property

One thing I'm confident about: the probability of a bargain is higher than the probability of prices running away. There's no need to rush and it may pay to have some cash around rather than a lot of debt.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. *This article is for general educational purposes and does not consider the specific needs of any individual.*

Pleasure and pain: a personal journey buying off-the-plan

by Graham Hand on 20 October 2016

It's 9am on a Saturday morning and a new apartment project is being launched somewhere in Sydney's north. The queue started to form at the display suite hours earlier, and hundreds of anxious buyers crane their necks to see who is ahead of them and to watch for queue jumpers. The display includes a spectacular model of the building, while artist's impressions on large posters show wide curved balconies overlooking gardens and parklands. The strong pre-launch marketing campaign to thousands on the real estate agent's database and heavy advertising have built the enthusiasm into a frenzy. It's a nervous wait, each person knowing they will have only a few minutes to decide whether to lay down a million dollars for a small two-bedder. Does it have the right aspect, is it high enough, how may car spaces? … what, a hundred have already sold in the first hour! I'll take that one!!!

So much for the Reserve Bank's recent warning of an oversupply of apartments, the inability of many Chinese buyers to settle on earlier purchases, the tightening of lending policies by banks. The Fear of Missing Out (FOMO) drives a market where the developer can name almost any price.

This week, *The Australian Financial Review* demonstrated the differences of opinion. On the same page where it reported 230 first-stage apartments sold out in a few frantic hours in one development, Deloitte Access Economics was forecasting the 'Faustian bargain' of declining prices and bad investments.

My personal experience

In mid-2013, we bought an apartment off-the-plan for our daughter, and she moved into her new home at the end of 2015. This article draws from our experiences during the two-and-a-half years of construction and the subsequent months living there.

For those interested in a blow-by-blow description, we wrote a blog throughout the construction period, starting as the excavators first moved in, all the way to the landscaping. The blog has already received over 70,000 views as owners watched their dreams come to fruition.

The blog is attached here. It covers far more detail than most readers will want, with hundreds of photographs of the building, the anguish of delays, the dealings with the developer and the council and the amazing changes in the

Golden Age's first stage release of its 408-unit Park One project in Macquarie Park sold out in hours on Saturday.

Apartment spree: 'People were snatching, not buying'

Property may become 'worst investment'

Jacob Greber
Economics correspondent

Property looks set to become the "worst investment" over coming decades because of a looming bust in apartment prices and the reality that official interest rates won't stay low forever, says a leading economist.

Describing the nation's economy as trapped in a "Faustian bargain" with low borrowing costs and resurgent commodity prices, Deloitte Access Economics economist Chris Richardson warns that future risks of a shakeout are mounting.

Mr Richardson said buyers had for decades been repeatedly betting "double or nothing" on property, which until now has been a successful strategy. However, it has entrenched an unwavering belief in investing in housing over shares or other assets.

"There comes a point where past performance starts to become a guarantee of

Key points

Economy trapped in a "Faustian bargain", says Deloitte economist Chris Richardson.

There has been an unwavering belief in property investment.

believe will lead to falling prices.

Banks are already cracking down on lending to the sector and analysts are increasingly concerned the long pipeline in apartment approvals over the past two years means supply of new units will continue to grow through the rest of 2016 and 2017. Any reductions in new starts will only become apparent in lower supply from 2018 onwards.

Mr Richardson said everyone in Australia knows that too many apartments are

Source: The Australian Financial Review, 17 October 2016

surrounding area of Pyrmont, Darling Harbour and The Bays Precinct.

This article does not enter the debate on whether it's a good time to buy property or not. Rather, it focusses on the risks and rewards of buying an apartment off-the-plan.

Advantages of buying off-the-plan

The apartment was not bought for investment reasons. It was time for our daughter to move on from the family home, and we needed a particular location, size and design to meet her needs. Some of these comments are therefore not investment-related, although I expect they will have widespread applicability.

1. Enjoying watching the construction

We regularly visited the site as part of creating an historical record of how an old flour mill was being converted into a modern building of 135 apartments. The mill was originally built in 1896 and, after almost a century of operation, ceased production and fell into disrepair. Only three sides of the old façade remained, held up by steel beams, in a prominent location near the gateway to Sydney heading to the west.

We loved the design, the way the new building 'stepped over' the old, retaining part of Sydney's industrial heritage in an otherwise modern structure, as shown below.

The building stands at the top of an escarpment at the edge of Pyrmont/Ultimo, at the end of a narrow road of heritage terraces. It took months to dig four floors of basement parking out of solid sandstone, and then as the building grew, the mill façade had to be 'tied' to the new structure while hoping the old walls did not fall into the massive hole.

This process of photographing the site, communicating with other owners on the blog, watching the surrounding area change and eventually moving in, was an unexpected pleasure. It created a special bond with the building, knowing so much about how it had been created.

2. It's the way to buy a new apartment

For anyone who wants a new apartment, buying off-the-plan is almost the only option. It is possible to wait for a building to be completed and see if some buyers sell or renege around settlement time, but unless there is a major fallout, a minority of apartments come onto the market at this time, greatly limiting the choice. It's unlikely that the pick in the building – the quiet side, the private outlook overlooking the garden, the best view or the location away from the pool and lifts – will suddenly appear. These good apartments need to be grabbed early off-the-plan.

3. It may be possible to make some design changes

We had some specific design requirements, and fortunately the developer accepted with considerable grace our desires to change the internal layout of the apartment. We switched the two bathrooms, redesigned the kitchen and a bathroom, removed a wall from one of the bedrooms and relocated electric switches. No doubt this was an exceptional experience, although more common in top-end apartments. It would have been extremely difficult or expensive to make such extensive changes in an established building, but done early enough in the design and build stage, it was not costly to accommodate. It made the end result a bespoke design instead of the inevitable compromise of an established apartment.

4. Ability to plan the funding of the balance

The 10% deposit allows long-range planning on the funding of the balance. There is no rushing around for finance or a quick sale of assets. Of course, any gains in price for an investor are leveraged by the 100% exposure to the market, the type of gearing not available on other asset classes. This is a double-edged sword, and it is far more likely that prices will fall from this point forwards than it was in June 2013. Even when we were buying, we could feel the early stages of a price surge, although nothing of the coming Sydney stampede. Some apartments in this building were sold prior to settlement for handsome returns.

Disadvantages of buying off-the-plan

Many financial planners advise their clients never to buy off-the-plan due to the uncertainties and inflated costs involved, and anyone going through this method of buying should consider the risks. Over 200,000 apartments are expected to come

onto the Sydney, Melbourne and Brisbane markets by 2018, raising questions about where the demand will come from.

The two main problems experienced in our building were:

1. Uncertainty when it would be completed

When we bought the apartment in June 2013, we were told it would be completed by the end of 2014. The date gradually moved out quarter by quarter until it was a year late. This was not too difficult to manage since our daughter simply stayed with us longer, but it introduces great uncertainty for anyone renting or needing to sell. How long do they rollover their existing lease? When do they put their property on the market? These problems would not occur with an existing property.

You can see in the blog the progress of the building. We visited the site nearly every month, and we asked workers about progress and towards the end, completion dates. The dates gradually slipped by, not due to a dramatic event like flooding or bad weather, but more because of its tight access in an inner city location. The building 'topped out' in August 2014 but it wasn't completed for another 16 months.

Many buyers became worried about the 'sunset clauses' in our contracts. There were news stories about developers rescinding contracts once certain dates had passed, leaving owners without their apartments and developers with massive windfall gains as they resold to new buyers. We settled three months before our sunset clause, and the NSW Government changed the law in November 2015 to prevent this unscrupulous practice.

2. Different product than the one promised

The overall building design delivered significantly as expected, and in fact, the quality of design and finish are probably better. As we were closely involved in the ongoing design of the apartment, there were no surprises.

But other owners had significant issues, such as layouts not as originally specified, walls where windows with views were expected, and some apartments were smaller than the original design. The contract gave the developer the right to deliver an apartment with a size variation of up to 5%, which on a 120 square metre apartment is a significant six square metres. Of course, there have been complaints about fixtures and fittings not being as expected and while these have generally been resolved, there is none of this doubt when buying an existing place.

Some of the surrounding infrastructure, such as the public lift from the property directly to the light rail station, was not completed for another six months, as the council refused to certify it until some issues were fixed. Lend Lease's construction work in Darling Harbour also compromised access to the city for far longer than was originally advised.

The following disadvantages apply more generally rather than in our case.

3. Potential victims of clever marketing

There is a pleasure and excitement in owning real estate that few other investments can match. On the investment side, the marketing highlights negative gearing benefits, capital gains discounts, rental returns. It rarely quotes the correct strata fees as nobody knows what the body corporate will set. Other costs such as council levies, stamp duties and maintenance costs are ignored in the colourful brochure. Instead, the focus is on the shiny new building, the landscaped gardens, the convenient location and the amazing facilities. Many new apartments cost more than established dwellings nearby, where the seller does not have the marketing gloss.

An owner occupier may not be overly concerned at paying 5-10% more to move into a new apartment, but an investor may see lower returns, and anyone planning to sell before settlement will need a strong market to recover the stamp duty and legal costs. The impending supply in eastern capital cities suggests the price performance of recent years will not be repeated.

4. Inability to obtain finance and leveraged losses

While most people buy an apartment with a financing plan, the actual visit to the bank or broker usually occurs as settlement approaches, which may be a couple of years after the original commitment. It is not possible to know the willingness of banks to lend in a particular suburb or on a type of property. The bank will engage a valuer to assess the property value, usually lending around 80% in the current market (this loan-to-valuation ratio has fallen due to worries about future prices). The value is not what the buyer paid, but what the bank could realise on a sale less costs. For example, a property costing $1 million may be valued at $900,000 nearing settlement, and the maximum loan may only be $720,000. The $180,000 (in addition to the initial $100,000 deposit) is a lot to find for someone who was expecting the bank to lend the full $900,000,

and the risk of non-settlement rises. The buyer may face a loss of the deposit, or more if the developer takes legal action.

A valuation firm, WBP Property Group, conducted research on 1,794 off-the-plan sales in Victoria between December 2009 and August 2015 and found half the properties were valued at less than the original purchase prices, with the average loss of $40,000 or 9.4%.

Conclusion

Our experience buying off-the-plan had its highs and lows. We enjoyed writing the blog and watching the building rise from the sandstone, and we now have a unique record of the transformation of part of Sydney's industrial history.

The end product for us has lived up to expectations after we stayed actively involved with the developer. The construction delays were annoying, and I can certainly see the advantages of buying a finished product which gives greater certainty of the outcome.

Graham Hand is Editor of Cuffelinks. Every experience buying a property will be different, and I have deliberately not entered the debate about whether it's appropriate to buy a property for your children, even if you can.

Shane Oliver of AMP Capital has written this research paper on the outlook for Australian housing.

Time and tide should dampen negative gearing proposal

by Noel Whittaker on 22 June 2016

In 1027, King Canute stood by the seashore and commanded the incoming tide to halt. Of course, the tide ignored him and he ended up with wet feet. As legend has it, he leapt backwards, saying: "Let all men know how empty and worthless is the power of kings." Contrary to the common myth, the wise king was not showing off – he was demonstrating to his subjects the limit of his power.

Canute's order to the sea is an analogy for the Labor Party's attempt to make housing more affordable for first home buyers. It simply can't be done. It's ironic that the catalyst for the GFC was President Clinton's idea that housing should be available to everybody. It started with a boom as the American property market became overbuilt, with loans offered to everybody irrespective of ability to pay. It finished with a bust whose reverberations are still being felt around the world.

Australia faces a perfect storm

But the GFC was more than a bust. It triggered collapses in stock markets everywhere, with interest rates around the world falling to historically low levels as central banks try to stimulate their economies.

Australia was not immune, but what has become different here is the growing attack on our superannuation system by politicians and so-called independent think tanks.

So we face the perfect storm. The average Aussie investor has lost faith in the stock market, and they are scared off superannuation because of the adverse publicity and threatened changes. They also know that earning a piddling 2% in the bank isn't the way to go long term.

Consequently, they have invested in the property market. As interest rates fell, making mortgages more affordable, prices started to rise. As always happens, the moment any asset class starts to rise in value, everybody wants to jump on the bandwagon. Yes, that made it tougher for first home buyers, but historically every initiative by governments to make housing more affordable has simply raised home prices further, because more buyers are attracted to the market. Think of the first home owners grant and stamp duty concessions.

On new property, the developer has made the profit

Labor's policy of restricting negative gearing to new homes won't work. It will push unsophisticated investors into new property where the profit has already been made by the developer, leaving the established market for more savvy investors. They understand that the way to make money in real estate is to buy a rundown property on a good block and add value to it. The irony is that they will use the money they can no longer contribute to superannuation as a deposit. This may make the property positively geared from the outset.

Let me quote a case study from Philip, who sent this to me in the interests of a more rational debate about negative gearing.

"I purchased an apartment in October 1987, borrowing 100% of the purchase price using my residence as security. The taxable loss was $7000 a year so my tax refund was in the order of $3,000 p.a. Three years later I paid it off when rates hit 17%. Total tax saved over those three years was around $10,000. After paying off the loan it was positively geared and I was paying $2000 in tax on the net rents.

The property has been positively geared for the last 25 years. Current net rent is $6,000 p.a. and at my marginal tax rate of 32.5% my tax is around $2,000 p.a. So having gained a net tax benefit of approximately $10,000 in the late 80's, I have paid $50,000 in tax since.

The value of the property has risen substantially from my purchase price of $58,500 to a current value of $320,000. But when I sell I will be liable for capital gains tax of $30,000.

Since 1987 I have enjoyed net tax refunds of approximately $10,000 but have subsequently paid $50,000 in income tax and will shortly pay another $30,000 in CGT. The government has made a significant net $70,000 benefit from my investment risk and the subsequent good capital growth will almost certainly eliminate my ability to claim a pension in retirement. This sounds like a great deal for the Government to me."

Limiting negative gearing will be as successful a policy as was holding back the tide for a wet King Canute.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. See www.noelwhittaker.com

8. Fixed interest investing

Are term deposits safe or risky for long-term investors? – Shane Oliver and Paul Clitheroe

Are we going through a 'bond market rout'? – Warren Bird

What do different types of bond yields mean? – Liz Moran

Are term deposits safe or risky for long-term investors?

by Shane Oliver And Paul Clitheroe on 26 May 2016

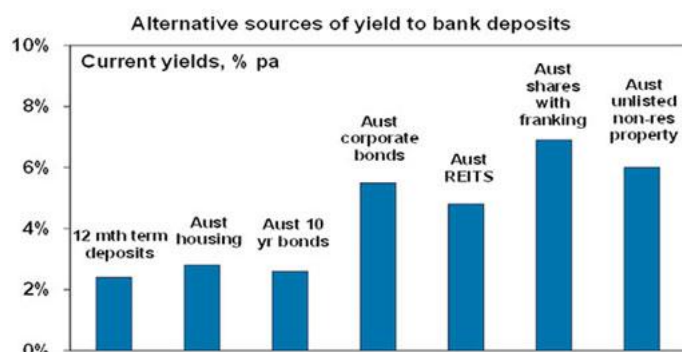
If you're a long-term investor, ironically term deposits are one of your riskier assets. Investors have the potential to receive a higher cash flow from growth assets such as Australian property and shares. In times like the present, a focus on the income an investment provides is important. With interest rates set to remain low or fall further, bank deposit rates – already at their lowest in Australia since the 1950s – are likely to remain low or go lower.

(Shane and Paul provide more views in the video linked at the end of the article).

Beyond day to day cash requirements, the key for investors currently in cash or term deposits is to work out what is most important to them: absolute certainty regarding the capital value of their investment or obtaining access to a higher, more stable income flow at the cost of volatility in the value of their investment. In this, there are several alternative investments to cash.

Alternatives to term deposits for income return (yield)

The chart below shows the yield on a range of Australian investments. Yields on global investments tend to be lower.



Source: Bloomberg, AMP Capital

All of these yields have fallen over the last few years, but many alternatives offer more attractive yields than term deposits:

- Australian Government 10-year bond yields are now around 2.5%. This will be the return an investor will get if they hold these bonds to maturity. They can generate a higher return if yields continue to fall, but they are already very low. Global bond yields are lower, averaging around 1%.
- After the house price boom of the past 20 years, the rental yield on capital city houses is just 2.8% and on apartments is around 4.2% and even lower after costs.
- Corporate debt is an option for those who want higher yields than term deposits but don't want the volatility of shares. For Australian corporates, investment grade yields are around 6.5% or less and lower quality corporate yields are higher. Sub investment grade corporate bond yields in the US are yielding around 9% as worries partly about loans to energy companies have pushed them higher.
- Following the turmoil of the GFC, Australian real estate investment trusts (A-REITs) have refocused on their core business of managing buildings, collecting rents and passing it on to their investors, with lower gearing. While their distribution yields have declined as rental growth has not kept up with total returns of 15% over the last five years, they are still reasonable at 4.8%.
- Unlisted commercial property also offers attractive yields, around 6% for a high-quality well diversified mix of buildings, but higher for smaller lower quality property. And it doesn't suffer from the overvaluation of residential property.
- Unlisted infrastructure offers yields of around 5%, underpinned by investments such as toll roads and utilities where demand is relatively stable.
- Australian shares also fare well in the yield stakes. The grossed up dividend yield on Australian shares at around 6.9% is well above term deposit rates meaning shares actually provide a higher income than bank deposits. In fact, the gap is now back to levels seen during the GFC.

Key issues for investors to consider

All of the alternatives come with a risk of volatility in the value of the underlying investment. In the case of shares the key for an investor is to work out whether they want a stable value for their investment in which case bank deposits win hands down or a higher and more stable income flow in which case Australian shares win hands down.

More broadly, in searching for a higher yield investors need to keep their eyes open. It's critical to focus on opportunities that have a track record of delivering reliable earnings and distribution growth and are not based on significant leverage. In other words, make sure the yields are sustainable. On this front it might be reasonable to avoid relying on some Australian resources stocks where current dividends look unsustainable unless there is a rapid recovery in commodity prices.

Click here to view a video of the authors discussing the ramifications of holding bank term deposits in a low-yield world.

Shane Oliver is Chief Economist and Head of Investment Strategy at AMP Capital and Paul Clitheroe is Executive Director at ipac. This article contains general information only and does not consider the individual circumstances of any investor.

Are we going through a 'bond market rout'?

by Warren Bird on 15 December 2016

The second half of 2016 is shaping up as one of the more negative half years for bond returns on record, especially at the long end of the yield curve. It's not uncommon for financial press articles to refer to what's happening to government bonds as a 'rout', but is it really that bad?

The focus of this article is the US Treasury market, bond yields, and what that means for bond returns.

Since early July 2016, when 10-year Treasury yields traded at an all-time low of 1.36%, the trend has been higher. It was a steady burn for a few months, but the speed of the increase has picked up since early November. This was around the time financial markets started to price in a Trump victory, a few days out from the vote.

As of 9 December, an investor could purchase a 10-year Treasury to yield 2.47%. Of the 1.11% increase over the past five months, around 2/3 has happened over the past four weeks, and an increase of 0.77% over a month is a very sharp move by historical standards; not unprecedented, but far from common.

The chart on the following page shows the history of the 10-year US bond yield since the all-time peak back in 1983. Since then, there have been 10 prior periods (shown by the arrows) where the yield has increased by at least 0.9% over around 5-6 months.

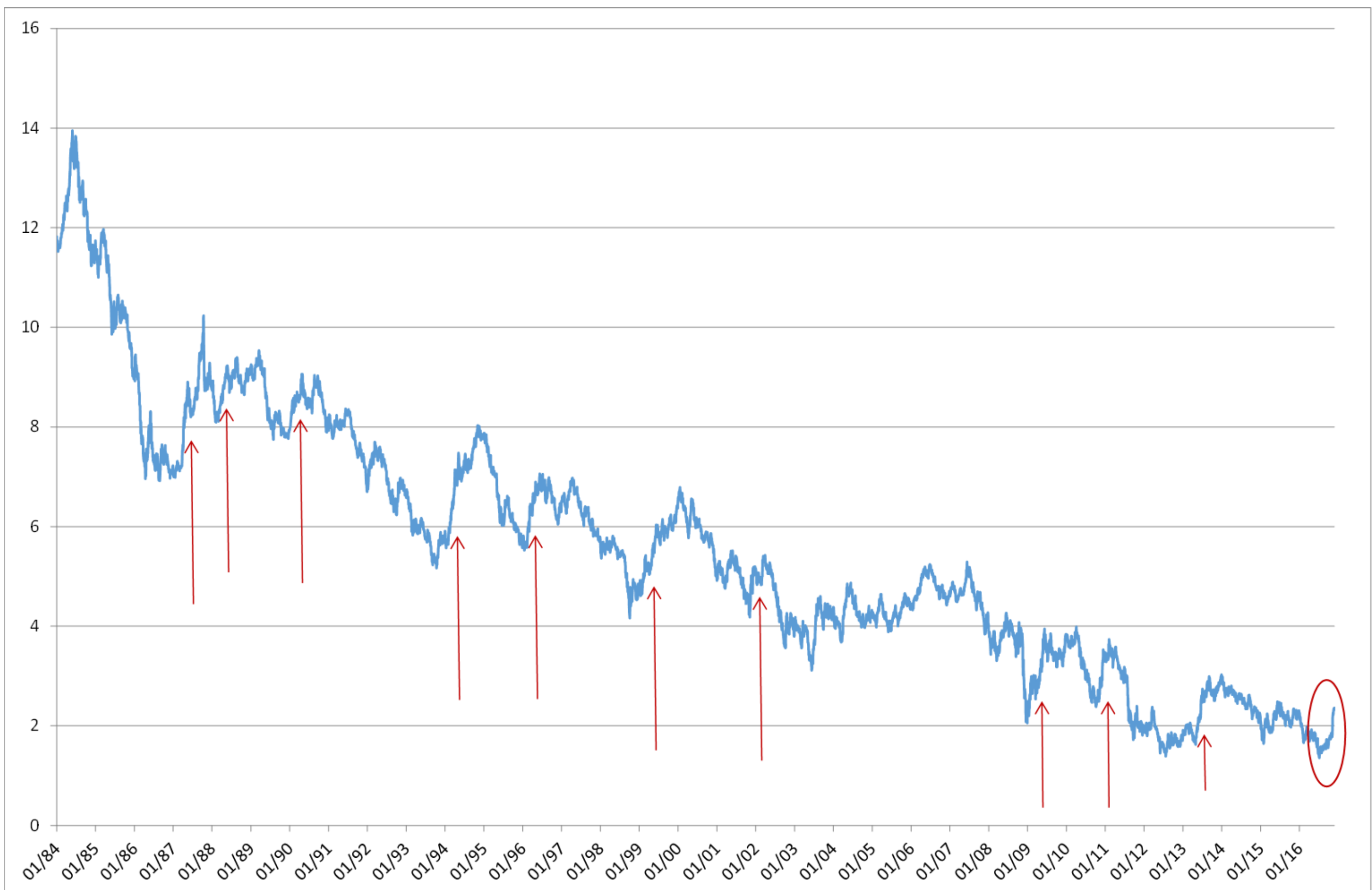
In other words, history tells us we can expect a long bond yield rise of the magnitude we've seen in 2016 on average once every three years.

Of course, this rising trend may not yet be over. The 1.11% rise posted so far could turn into more, so what does history tell us in this regard?

History repeats, but how often?

Not surprisingly, history does not provide much clarity. Even if there were a regular pattern, a sample size of 10 is nowhere near enough to draw firm conclusions. However, there isn't a regular pattern. Half of the previous 10 occurrences of at least 0.9% increases petered out around this level. If those histories are repeated, then this 'rout' is just about done and dusted.

The other half, however, continued for varying lengths and to varying degrees. If these histories were to repeat, then there's a way to go yet before we reach the peak in this cycle for US yields. The following table summarises those episodes.



Start (trough)	End (peak)	Total yield move (%)	Duration (Months)
Dec 86 6.95	Oct 87 10.20	3.25	10
Oct 93 5.17	Nov 94 8.02	2.85	13
Oct 98 4.20	Jan 00 6.70	2.50	15
Dec 08 2.05	Jan 09 3.95	1.90	7
May 13 1.60	Dec 13 3.00	1.40	7

The impact on bond prices and bond returns

Of course, when bond yields rise, bond prices fall, at least initially (every bond matures at par, whatever happens today or tomorrow). When the time period over which this happens is short enough, total bond returns can become negative as well.

The recent yield increase translates into a decline in the capital value of the 10-year Treasury bond since early July of 10.0%. Here we have a living, breathing instance of the usual example that's used to explain what 'modified duration' means. That is, if you get a yield move of 1% you multiply the duration to get the price change. In this case the yield move was a little bit more than 1%, but with the modified duration of the current 10-year bond at around 9.2 years, the maths follows.

Adding back the interest that's been paid and accrued, the total return on the bond over the past five months has been -9.4%.

To compare this with history, it's easier to use data for a bond index, such as the Bank of America Merrill Lynch 10-15 year Treasury index. The total return on this index over the past five months has been -8.6%. This ranks as the third worst return over a similar period in the past three decades. It was outdone only by 2013's 'taper tantrum' of -9.9% and the -9.1% from the yield rebound in 2009 that followed the Lehman collapse.

The reason a yield move that has already occurred 10 times has resulted in a total return among the worst few in history is mostly because of the starting yield. When 10-year bonds have risen by about 1% in the past, they've been paying 4%, 6% or higher interest returns. That provided a larger positive contribution to the total return over any five-month period than July 2016's 1.4% yield. Low yields also mean longer bond duration, which magnifies the impact of a given yield change. For instance, in a 6% yield environment, the 10-year bond's duration would have been around 7.5 years instead of more than nine years. So a 1% yield change today means an additional 1.5% in capital value adjustment.

What does this mean for Australian bond investors?

Most Australians hold a portfolio that is more of a composite of domestic government, semi-government and corporate bonds. Their portfolio at July's low point was yielding 2% and has seen an increase to around 2.6%. That's a much more moderate change than has taken place in the 10-year Treasury market. Also, the local market has a significantly shorter duration of about 5.3 years. Therefore, broad Australian bond market indexes over the past five months have returned a much more moderate -3% or thereabouts.

Furthermore, the one-year returns for 2016 will be positive. The broad market index seems likely to come in at around +3%, so still above cash. This is because the sell-off in the second half of 2016 followed a rally in the first half of the year.

End of the bull market?

What we've witnessed over the past few months could well mark the end of the so-called '30-year bull market in bonds'. The possibility that yields will continue to trend higher, back to pre-GFC levels where 10-year Treasuries paid investors 4% or more, is not objectionable. It would be fantastic if that happened, because it would mean that world economic fundamentals had healed, after being so badly damaged in the last decade or so. It would mean that bond markets were experiencing rising returns – short term capital pain, yes, but rising reinvestment into a higher-yielding environment that will produce better long-term outcomes than the low yields we've seen during 2016.

However, it's still far too early to call the end of the 'lower-for-longer' scenario. Just because bond yields have risen from their all-time lows doesn't mean they've broken out of the historically low trading ranges of the past few years. They might do that, but they haven't yet.

Warren Bird is Executive Director of Uniting Financial Services, a division of the Uniting Church (NSW & ACT). He has 30 years' experience in fixed income investing. He also serves as an Independent Member of the GESB Investment Committee.

What do different types of bond yields mean?

by Elizabeth Moran on 8 December 2016

Bonds seem like a simple investment. In their most common form, you lend your money to a company or a government, and in return they pay you interest on set dates and return capital at maturity (assuming there's no default). There may be added complexity when quoting a yield, for example, when bonds and hybrids have call dates, so let's look at the different types of yield.

There are four different ways to quote a yield:

1. Yield to maturity
2. Running yield
3. Yield to call
4. Yield to worst.

Yield to maturity is a total return calculation where investors plan to hold the bonds until maturity, while running yield projects income for the coming year. However, yield to maturity may not always provide the best insight into the expected return of a bond, especially if there is a call date or there are multiple call dates.

A call date gives the bond issuer the option to repay the investor but it is not an obligation. As some bonds have many call dates, there can be a range of yield to calls, which makes yield to worst the most important measure for investors.

The yield to worst for callable bonds is the lowest possible return for that bond, but there is upside potential if the company chooses not to repay at this date. Yield to worst may be substantially different to yield to maturity or yield to call. Further, as the price of bonds change, so too does the yield to worst calculation.

Four types of yields

1. Yield to maturity (YTM)

The yield to maturity refers to how much a security will earn if it is held to the date of its maturity.

It is the annualised return based on all interest payments plus face value or the market price if it was purchased on the secondary market. Most bonds are issued with a face value of $100, but as they are tradable investments, the price will move up and down depending on a number of factors.

Yield to maturity includes any capital gain or loss if the purchase price was below or above the face value. For this reason, the yield to maturity is considered the most important measure for bullet (non-amortising) bonds or those with a hard maturity date and no call dates, as it provides a point of comparison with other securities. In this case, yield to maturity is the same as yield to worst.

For example, the Qantas June 2021 fixed rate bond was issued at a yield of 7.5%, and is currently offered at a premium to face value price of $114.05. The current yield to maturity is 4.07% compared to the coupon rate of 7.5%. This means that the effective return over the life of the security, if bought today, would be 4.07%, taking into account the current premium price of the security.

The calculation assumes all coupon (interest) payments can be reinvested at the yield to maturity rate.

2. Running yield (RY)

Another measure to compare bond returns is the running yield. The running yield uses the current price of a bond instead of its face value, and represents the income an investor would expect if they purchased a bond and held it for a year. It is calculated by dividing the coupon by the market price as shown below.

For example, the same Qantas bond shown above for the current market price (also known as the capital price) of $114.05 paying a coupon of 7.5% on the face value ($100) gives a cashflow of $7.50 a year. Given this return is achieved at a premium to face value of $114.05, instead of $100 face value, the actual return will be less than 7.5%.

Using the equation above, the running yield would be 6.57% ($7.50/$114.05 x 100 = 6.57%).

As the bond price increases, running yield decreases, and as the bond price decreases the running yield would increase.

Note that running yield does not incorporate any capital gains or losses. As such, institutional investors do not view this as a particularly useful way to analyse bonds.

3. Yield to call (YTC)

Many bonds are callable at the company's option before the final maturity date. That is, the bonds can be repaid early. For example, subordinated bonds issued by banks and other financial institutions often have call dates, which may be five, 10, 20 or more years until final maturity.

The company has the option but not the obligation to repay at the call date. With some bonds, the call dates continue after the first call date and every interest payment date thereafter until maturity. With others, there may be only an annual opportunity.

If a particular bond's price rises above par and is at a premium, the chances of an early call may increase. Theoretically, the company can then issue new bonds at a lower interest rate, although the early call price may also be at a premium under the original terms and conditions.

Investors trying to work out the possible returns on callable bonds need to assess the range of returns available, including various yields to call and the yield to maturity to get a sense of what is possible.

For example, property developer Sunland has issued a fixed rate bond due to mature on 25 November 2020. It is currently trading at a premium of $2.50, so that yield to maturity is 6.82% per annum. But it has two call dates, as the table below shows.

Sunland fixed rate bond purchase price $102.50

Date	Yield (p.a.)	Description	Price paid to investor
25/11/2018	7.60%	First call	$103.00
25/11/2019	7.07%	Second call	$101.50
25/11/2020	6.82%	Maturity	$100

Source: FIIG Securities
Prices accurate as at 28 November 2016 but subject to change

In this case, yield to maturity is the same as yield to worst (see below), both offer the lowest return of 6.82% per annum.

What is key is that as the price of the traded bond changes, so too do the yields. If the purchase price of the bond increased from $102.50 to $106, then the yields would change, as shown below. The lowest possible return is no longer yield to maturity but rather yield to first call.

Sunland fixed rate bond purchase price $106.00

Date	Yield (p.a.)	Description	Price paid to investor
25/11/2018	5.76%	First call	$103.00
25/11/2019	5.80%	Second call	$101.50
25/11/2020	5.84%	Maturity	$100

Source: FIIG Securities

Prices accurate as at 28 November 2016 but subject to change

4. Yield to worst (YTW)

Yield to worst tells what the lowest yield would be if the company calls the bond at the worst possible time for the investor, or if it chooses not to call the bond, delivering a lower yield than if they had called it.

We view this as the superior way of measuring yields, as bonds are there to offer investors downside protection. As such, the YTW is the lowest yield an investor can expect if the company or government does not default.

Yield to worst could be the same as yield to call if the first call is the worst outcome for the investor; it could be the same as yield to maturity if the investor is worst off when the company chooses not to call at all; or it could be lower than both of them where the investor is worst off if the company calls on the second or subsequent call date.

The yield to worst for an investor purchasing the USD Broadspectrum fixed rate bond at its current offer price of $106.25 is that the company calls the bond at the first possible opportunity (resulting in a yield of 3.6% per annum). There is an opportunity for upside if the company does not repay at the expected first call date. The best return is 6.33% per annum at maturity, but it's likely the company will repay early and refinance in a cheaper market.

Broadspectrum USD fixed rate bond

Date	Yield (p.a.)	Description	Price paid to investor
15/05/2017	3.60%	First call	$104.19
15/05/2018	5.25%	Second call	$102.09
15/05/2019	5.61%	Third call	$100
15/05/2020	6.33%	Maturity	$100

Source: FIIG Securities

Prices accurate as at 28 November 2016 but subject to change

Bond investing can be relatively simple when held to maturity, no calls are involved and there's no credit default, but it's important for any investor to know which yield is being quoted whenever they buy or sell a bond.

Elizabeth Moran is Director of Client Education and Research at FIIG Securities, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any individual.

9. Other good stuff

Should much of our financial advice be outlawed? – David Bell

The most important advice of my career – Graham Hand

Stranded: too old to work, too young for the pension – Barry French

Six challenges for robo-advisers – Paul Resnik

An interview with Chris Cuffe – Kirsty de Garis

Should much of our financial advice be outlawed?

by David Bell on 4 August 2016

Recently, a person named David Blake implied that almost all financial advice given today should be outlawed.

You often hear outlandish claims from people less than fully informed on financial advice, but David Blake does not belong in this category. His views should be respected and his claims taken seriously by advisers, directors and executives of advice firms, and investors in considering how they are advised.

Who is David Blake?

David Blake's career straddles both academia and industry, and he's been highly successful in both. Completing his PhD in 1986, Blake is Professor of Pension Economics at Cass Business School, City University London, Director of the Pensions Institute (which he founded in 1996), and Chairman of Square Mile Consultants, a training and research consultancy. He is also: the co-founder with JPMorgan and Towers Watson of the LifeMetrics Indices; Senior Research Associate, Financial Markets Group, London School of Economics; Senior Consultant, UBS Pensions Research Centre, London School of Economics; and Research Associate, Centre for Risk & Insurance Studies, University of Nottingham Business School.

To say that he is well qualified to voice a strong opinion on this topic is an understatement.

What did he say?

Blake led the production of a report by the Independent Review of Retirement Income (IRRI) in the UK, released in March 2016. The report was far reaching, but his recommendations regarding financial advice were especially relevant:

"The use of deterministic projections of the returns on products should be banned."

('Deterministic' effectively assumes the average outcome will be achieved and it is only this outcome that is communicated).

"They should be replaced with stochastic projections that take into account important real-world issues, such as sequence-of-returns risk, inflation, and transactions costs in dynamic investment strategies."

In short (on reading the full document), there are two important elements of this recommendation. The first is that advice needs to consider all of the key risks, most of which fall into two main groups: investment and mortality risk. The second is that the analysis of outcomes needs to be stochastic rather than deterministic. This simply means that the range and associated likelihood of outcomes are presented, something that can be quite hard to model in practice.

By suggesting that any advice that doesn't meet these standards should be outlawed, Blake means that offering a deterministic prognosis represents dangerously misleading information.

How does this apply to the Australian advice industry?

This recommendation is produced in a UK environment and policy setting. However, Blake has shared his views at conferences in Australia and they appear to be universal.

Does the financial advice provided in Australia meet the standards recommended by Blake? The broad answer, unfortunately, is no. Most of it has similar failings to the advice provided in the UK: namely it doesn't account for the major risks to financial outcomes, particularly mortality risk, and it tends to assume an average outcome such as 7% per annum over a defined period.

This is largely a failing of the advice industry rather than the advisers themselves (though they should push hard for the tools they need to deliver quality advice), and most of the major financial planning software fails to address the issues raised by Blake.

Additionally, the majority of roboadvice offerings appear to fail to meet the standards set by Blake. While many provide stochastic reporting it is largely based on one or two investment risk factors (which are relatively easy to model) while ignoring mortality risk. In this respect, roboadvice appears to be at a crossroads – will it represent high-quality online advice that takes full advantage of systems

designed in a clean-sheet-of-paper environment, or will it simply consist of smart graphics wrapped around basic advice tools?

Regulators are not likely to rush to implement Blake's recommendations in the near term. However, the advice industry has been called out by a universal claim from a highly respected thought leader. It remains to be seen if there's sufficient motivation out there to significantly raise the bar regarding the standard of financial advice. It's also unclear if leaders with appropriate skillsets can move the industry in the right direction going forward.

There is no denying that developing tools, and using, interpreting and communicating the output are challenging areas. In my view the primary management challenge is twofold: overseeing the technical issues while successfully communicating complex issues to clients.

Facing the challenge

I've been to industry conferences where I sometimes lose confidence that this challenge can be met. One such conference left me aghast, the spirit of the day evolving as follows: *'Modelling needs to consider all risks and be stochastic'* and *'It is challenging to communicate more complex modelling to people who are not financially trained'* to *'This is too complex and we should stop talking about all this stochastic stuff'*.

Many other industries develop complex products which are explained effectively to consumers; consider for example the technology in cars and medical treatments. Too hard to explain cannot be an excuse for not innovating.

If you consider the following alternative lines for inclusion in a statement of advice, the motivation for change becomes clearer:

1. In developing your financial plan we assume that you will die with 100% certainty at the age of X and that markets will perform exactly Y% each year.

Or

2. In developing your financial plan we have considered the possibility and likelihood of you dying at different ages and have considered a large range of possible scenarios for investment markets, which we all know are difficult to forecast.

It is obvious to me which approach represents superior advice. Dismiss this article if you like, because regulatory-led changes are unlikely, but you do so at your own risk. The poor quality of advice provided to individuals all around the world, including Australia, is a fundamental challenge to an important service industry. At some point it will become a strategic issue. Some people will see the opportunity to improve an important service currently being delivered at sub-standard quality. Others will see the opportunity to profit by innovating. Whatever the motivation, I look forward to seeing our advice industry meet David Blake's standards.

David Bell is Chief Investment Officer at Mine Wealth + Wellbeing. He is working towards a PhD at University of New South Wales.

The most important advice of my career

by Graham Hand on 4 February 2016

It's almost impossible to rise into the senior executive ranks of a major company without the ability, or at least the willingness, to speak in front of a large audience. Junior managers should take every chance offered to them to practice with any group, and actively create such opportunities. Confidence in front of a crowd can make or break a career.

How does this reconcile with the oft-stated statistic that fear of public speaking is usually at the top of surveys of greatest fears, even higher than the fear of death? It's claimed that as many as 75% of people have glossophobia, a fear of public speaking.

So for a moment, let's ignore investing and talk about breathing.

This brief note is not comprehensive advice on how to improve at public speaking, but simply to give you one A4 piece of paper that I received about 30 years ago which significantly improved my management of stage fright. I have revisited this document many times over the years and given it to people I have employed or mentored.

The document, 'The 10-Second "Mini-Tranquilizer" Exercise', is linked here.

It is a quick breathing skill from a 'biofeedback' expert, Dale M. Patterson. Print it out and keep it.

I will let the advice speak for itself, except to explain where I found its application useful.

What insight did this simple breathing exercise give me?

Like most people, in the early part of my career, I felt nervous before a presentation to an audience. Even when I gave monthly updates on the structure of the bank's balance sheet and risk to the board, talking about the same subject to the same group for several years, the nerves would usually kick in. It was uncomfortable rather than debilitating, inducing pacing the corridor to ease the tension, although if I were not as well prepared as I liked, it was worse. The first few minutes of the talk were crucial. Once the presentation was in full swing and the questions came, confidence and momentum increased and the focus on the subject took care of the rest.

Good public speaking involves developing a range of skills, and there's no substitute for quality material, practice and preparation.

But here I want to focus on this simple breathing exercise I discovered at a management training course with an emphasis on public speaking.

Without attempting to cover the subject comprehensively, here's the key insight: normally, we think of the brain controlling the body. For example, the brain tells the arm to lift, and it lifts. But here, the flow is the other way, the body sends a message to the brain. It's a small part of what is known as 'biofeedback', which Wikipedia defines as:

"a process that enables an individual to learn how to change physiological activity for the purposes of improving health and performance."

By breathing deeply as described in the exercise, the body sends a signal to the brain that there is no threat and to stay calm. The brain does not switch off, it simply becomes aware that the 'flight or fight' feeling does not need to kick in so strongly. In a way, the body starts to control the brain.

Combined with a range of other techniques, I hope this simple exercise does for you what it did for me. It's important to feel some level of adrenaline rush before a speech because it heightens your awareness and shows you care. Just keep it under control.

And maybe pass this on to your family, friends or colleagues. It might be the best help you can give them, even if it's only for the wedding day speech.

Graham Hand is Editor of Cuffelinks and his career has spanned almost 40 years up to Managing Director level. As a disclaimer, he admits he knows little about the subject of biofeedback, but he is far more comfortable speaking in public than he used to be.

Stranded: too old to work, too young for the pension

by Barry French on 2 June 2016

After a career spanning business, software analysis and the Arts, and now in my late 50's, a few years ago I decided to reinvent myself as a financial planner. I studied and started applying for jobs. Over many years, even if I made it to the interview stage, I have been amazed to hear the excuses as to why I am not suitable. My favourite is "too creative". I believe ageism is the real issue.

Eventually, I secured a one year casual contract with a major dealer group looking after their

existing superannuation and insurance customers, which I finished in February 2016.

The plight of the 'renting transitionals'

In dealing with these customers, it became evident that there is a particular group of people who are being ignored by both our political and financial classes. I call them the 'renting transitionals'. They are in transition between mature-age (50 years-of-age upwards) and age pension age. Not only are they in transition between jobs, but crucially, they do not own their own homes. Surviving on the age pension as a non-homeowner is a topic for another day.

With the superannuation system still evolving into maturity, when these renting transitionals, especially women, lose a job, they do not have sufficient funds to support themselves to preservation age, let alone pension age. Even when they can access their super, perhaps under the 'hardship case' provision of release or a Transition to Retirement pension, it is insufficient to pay for both rent and food. The money won't last the distance.

For those that qualify, the Newstart Allowance for a single person is only $13,717 per annum, which will not cover basic living expenses, and any income earned reduces the Allowance.

Home ownership is a massive issue

Many financial commentators quote the ASFA Retirement Standard as the benchmark for living standards. Their latest annual budget for a 'modest' standard is $23,797 for a single person, and $43,184 per annum for a 'comfortable' retirement. The crucial qualification is:

"Both budgets assume that the retirees own their own home outright and are relatively healthy."

I have a colleague who was made redundant after working for Arts and Heritage organisations for many years. The recent cuts to the Australia Council do not come without personal consequences. The types of jobs she has held mean her income has been low, she has been unable to buy a house, her super balance is accordingly smaller and at age 59, she has not been able to find another job. The loss of manufacturing jobs and the downturn in resources and construction have hit others hard. My colleague is increasingly isolated and losing confidence which in turn affects her chances of employment. It causes profound stress, depression and suicidal thoughts.

Now her TTR pension may also be subject to 15% earnings tax further affecting its longevity.

What do we do? This is not an issue that will go away for older workers. It is not that they do not want to work. Often people employed in the Arts are working extremely long hours that are usually underpaid, and they rely on other jobs to get them through. Income protection policies, while highly desirable, are out of the reach of these low income earners. Newstart (again, if they qualify) is a form of entrenched poverty. If it was maintained until their other earnings reached a liveable wage, it may be useful.

Council of the Ageing SA Chief Executive, Jane Mussared, recently said:

"Home ownership was a bedrock for older Australians. Our pensions are low by OECD standards but were propped up by high ownership levels and low mortgage levels. (Federal MP) Mark Butler talks about home ownership rates being in free fall among older people. Put in a period of unemployment prior to aged pension, low levels of super, low earnings over a lifetime and high levels of caring responsibilities and we have a looming problem."

What do large institutions say about employing older people?

Nearly every major corporation has a public policy on the need for diversity in the work place. Often, there is a heavy focus on gender balance, pushing other diversity issues such as age, disability and religion into the background.

It is common for a policy to state that the company's employees should reflect the characteristics of its customers. This ensures an empathy with customer problems, leading to greater understanding and hopefully, business retention. For example, the Commonwealth Bank has a microsite devoted to sustainability and the need to 'reflect community diversity', stating:

"The Australian community is diverse, dynamic and culturally rich. It is also changing as the population ages and we become more economically and culturally entwined with our Asian neighbours. As one of Australia's largest employers, with a nationwide branch network, it only makes sense for our workforce to reflect the diversity of the Australian community."

"Diversity is an essential element of the Commonwealth Bank Group's new strategic vision: to excel at securing and enhancing the financial wellbeing of people, businesses and communities. A key area of focus over the next 12

months will be further developing our response to the challenge of age diversity."

A good place to start on age diversity would be employing the number of older people in proportion to the number of older people among CBA's customers. Now, that would be a big number!

What else can be done?

Luckily, I have sufficient funds and my own home. I will shortly complete my Advanced Diploma in Financial Planning and will continue to look for full-time work. Failing that, I will retire if the government starts taxing my modest transition to retirement pension. The renting transitionals are not so fortunate.

Do we need an education campaign reminding 40-year-olds that they may need to provide for themselves without government assistance from anywhere between the ages of 50 to 70, before the likely age pension kicks in?

We need solutions beyond standard income protection policies. For low paid workers who are aging, many of these favourite insurance solutions do not present themselves. Are there new affordable 'Living Wage Mutual Income Protection' insurance policies that could be designed for this demographic?

The alternatives to taking action are mental health issues and homelessness affecting potential workers who do not have the resilience of youth to tide them through. I worry about that my colleague may be among the growing number of older women who experience homelessness for the first time later in life. Older, single women are vulnerable as they may lose their jobs early, lose a spouse or be discriminated against in the housing market. As Jane Mussared said:

"It is your mother, sister or grandmother that is at risk of being forced to sleep rough."

I would dearly like to hear how we help people get through this period until they can at least qualify for the age pension. Have you survived a similar period? How are advisers helping clients with this potential problem?

Barry French has a BA and is currently completing an Advanced Diploma in Financial Planning. He formerly worked as Technical Support Manager for an international software company. His passion is to provide financial services and education to people in the Arts and the 80% of people who receive the least advice and probably need it most.

Six challenges for robo-advisers

by Paul Resnik on 17 December 2015

We believe robo-advisers will be paradigm-changing, but that doesn't mean they have a free pass to success. They must overcome six significant challenges if they are to evolve into profitable financial services businesses:

1. Changing perceptions of financial advice

For a large group of consumers, investment advisers are self-interested and greedy, financial markets are rigged and corrupt and their money is better off being self-invested into real estate, gold and other real assets. This widely-held perception of the finance industry is deserved.

There have been far too many financial services scandals that prove these theories, from an outright fraud like Bernie Madoff through to a local adviser churning an unsophisticated client through a procession of high brokerage-fee products. Meanwhile, the global markets collapse of 2008 left many investors wary and untrusting of the entire financial market framework. They would rather buy real estate that they can see and touch.

The financial advice industry has failed to make a convincing argument to justify its value to consumers. The industry has struggled with the intangibility of advice, the potential uncertainties of outcomes should markets crash and perceptions of greed among the people running the 'system'. The impact is that most people don't want to pay for financial advice.

2. Establishing trust

In financial planning, human interaction has traditionally been vitally important. As many a salesperson knows, selling something that is intangible requires the establishment of trust. This is problematic, because trust in the planning industry is low.

Trust is defined as "a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behaviours of another" (Rousseau, Sitkin, Burt, & Camerer, 1998).

Repeated surveys around the world show financial advisers sit towards the bottom of the trust ladder. How do robo-advisers show they are trustworthy? To show you are trustworthy, you must display the behaviours that will lead people to trust you.

Three important requirements are:

- Competence in the matters in which competence is claimed and required
- Reliability, by doing the things as expected and promised, and
- Honesty and transparency in dealings with customers.

To convince the broad public that it can be trusted, a robo-adviser will be required to invest in processes and marketing to tell the story of how and why they are trustworthy.

Established brands and the large end of town already have customer bases into which to market to achieve scale while also having the marketing budgets and communication channels needed to attract new business to a robo-adviser.

3. Advice and guidance gaps

'Advice gaps' arise when people who could benefit from financial advice do not receive it because:

- Their level of assets is too low to viably warrant the attention of a financial adviser, or
- They are not prepared to pay a fee to receive advice.

In the US, the desire to maximise planner profits makes accessing a financial planner high compared with the rest of the world. US advisers focus almost exclusively on what would be regarded as high wealth clients in the rest of the world.

In the UK, financial advice is generally more readily available to the middle classes – what might be termed the 'mass affluent'. The dollar figure required to access a basic service is driven significantly by the regulatory framework. Ironically, rules that were introduced to protect consumers now deny many of those people any service at all as the costs of regulatory compliance are too high to make them financially viable clients.

It is, perhaps, a logical conclusion to see robo-advisers as the solution to the advice gap as they have scalability and can service customers at low cost. Some people see robo-advisers 'democratising' financial advice, making it available to all.

By definition, those in advice gaps have lower investable asset balances, which means, per customer, lower income for the robo operator. Robo-advisers need profitable clients, but to acquire them as clients they need to invest serious marketing money, which is why existing big players have advantages over new entrant start-ups no matter how well funded. The exception is perhaps those providing a B2B robo white-label platform for existing distributors.

4. Economic influences

Around the world, wealth is being squeezed into upper economic groups, with corresponding falls in income and wealth for the middle and lower economic groups.

The loss of the middle range investor means that an increasing number of service providers are marketing to a shrinking pool of affluent investors, albeit that each of those customers comes bearing a larger pool of assets.

At the same time, there might be increased demand for robo-advisers that focus on providing budgeting tools and cash-flow forecasting, as these issues are of more significance to lower economic groups than questions of investment.

5. Cost of acquiring clients

Robo-advisers need clients to operate and the cost of acquiring (CAC) clients in financial services is high.

To us, this is the elephant in the robo-adviser room that is seldom discussed – which we believe is a strategic failure of the highest order.

Acquisition costs include the costs of initially finding a prospect and then converting those prospects into clients, with the inevitable attrition rate that those conversions incur. When total costs are compared to clients gained the results can be surprisingly high. Lucian Camp calculates the cost

of acquiring a client in the UK to be around £200 (US$312).

This cost is beyond the means of many advisory firms, which is why they grow slowly – largely through word-of-mouth referral. In the past, they might have relied on product manufacturers and distributors to provide them with marketing support. Under new regulations in the UK, such supports are now largely no longer possible. But they continue to thrive in the US marketplace. In a world where former specialties have become commoditised, being able to make a financial product or service no longer makes you special as it once did.

Where, in the past, you may have been able to extract an economic rent because you occupied a position of advantage, market forces have now equalised you. Today, the ability (knowledge) and capacity (cash-flow) to quickly market financial products to scale is what separates successful financial services businesses from the 'also-rans'.

It does not matter if you arrive at the marketplace with a better mousetrap if that trap is hidden where the mice cannot find it. Cheese – in the form of marketing, advertising and promotion – will help to attract them. But cheese isn't cheap. Robo-advisers are very good at servicing customers, but do nothing to attract customers.

6. Behavioural biases

It is human nature to want it now. But it is also human nature to make plans for the future, including saving money. Of course, the two natures quickly come into conflict. You want a holiday now – but spending the money will reduce your pension in 30 years' time.

More often than not your 'present' self will defeat your 'future' self. The future loss is so far away that it is diminished, but the present benefit is NOW! "Pack your swimsuit, honey, we are going to the beach."

There is good reason to believe that robo-advice systems might do a much better job than human systems at helping people confront and manage this 'present-day' bias, by allowing them to visualise the impact of financial decisions made now projected into the future.

As ever when there are challenges, those who are successful will find new solutions and build the scale critical for success, while many others will fall by the side.

Paul Resnik is a co-founder of FinaMetrica, which provides psychometric risk tolerance testing tools and investment suitability methodologies to financial advisers in 23 countries.

An interview with Chris Cuffe

by Kirsty De Garis on 14 June 2016

Over the course of a career in wealth management spanning more than 25 years, Chris Cuffe has cultivated his own personal brand of wisdom. Be it building a business from a staff of three to a 1500-strong team or working in the not-for-profit sector, Cuffe's signature approach in a high-pressure environment is to play the slow game. Perhaps it's this attitude that's also enabled him to weather a few storms.

"I do two things essentially: help people make money and help people give money away," he says. On the money making side, Cuffe is chairman of UniSuper, Australia's fourth-largest super fund. He's on the board of Global Value Fund and an unlisted financial management company. He advises three separate families on investing, and has established Cuffelinks, a web site and newsletter read by 30,000 subscribers each week. "It's been phenomenally successful," Cuffe says.

Balancing his commercial interests, Cuffe is founder of Australian Philanthropic Services, supporting wealthy families and individuals who seek deeper engagement in philanthropy. He finds it immensely rewarding. "If you ever get the opportunity to start something in life and it comes off, you get a great deal of satisfaction," he says. He also runs an Australian equity fund – Third Link Growth Fund – that uses a collection of hand-picked fund managers. The fees he earns from Third Link Growth Fund, Cuffe gives to charity. "The whole idea was to create something that investors

value, get above average returns if I could achieve that. And at the same time, be able to give to the not-for-profit sector. Plenty of investors would invest in it because it's a good investment, but plenty of investors also like where the fees are going," he says.

Finally, Cuffe works with Primary Ethics, a NSW-based education initiative in primary schools. "It's for the kids who, for whatever reason, don't go to the one hour a week of structured religious education," he explains. "They now have an alternative which they never had in the past. It's a very well-structured ethics class: world-class content that's been developed over a long time."

In a career that's seen some ups and downs, Cuffe views his professional life in bright colours. "I look at the world as just swirling opportunities," he says. "And depending on your character, whether you're able to just try and grab one of those, and give it a go, is probably the true meaning of being an entrepreneur… I would have no regrets about [taking] the same journey, but there was a period some years ago when I was roasted in the press."

Cuffe is referring to the 2003 Commonwealth Bank disclosure upon his exit from Colonial First State, of more than $32 million paid to him following CBA's acquisition of the wealth management business. At the time, it was said to be the largest payout to anyone in business.

"I was the front page of every newspaper in Australia, and every current affairs and news bulletin for about a week in early 2003," Cuffe recalls. "There were all sorts of misleading connotations. It was a very uncomfortable period of time for me and my family. But you know, the flip side of that… after the wounds had healed a bit, suddenly a lot of people knew me. On balance, I think they knew me for good things."

So what did the experience teach him about being a high-profile person in business? "I always think reputations in a career sense are very fragile," Cuffe says. "A reputation builds up like drops going into a bucket of water: slowly, the water fills. But you can kick the bucket over and kill the reputation in five seconds if you're not careful. I've been lucky to have a following of people who have some admiration for what I'm doing. I always feel very grateful for that."

Cuffe's investment strategy is a long-term one. "I just don't care at all about three months, or even three years," he says. "I'm aiming at five years minimum. Probably longer." His reason for this approach is simple. "Investment markets go up and down all the time. A lot of fear and greed drive it. It takes a while to see proper strategies come through and judge them clearly." Cuffe's sympathies also lie with CEOs in the corporate world, pressured to account for short-term results. When analysts, fund managers and press are nipping at the heels of corporates to reveal and explain quarterly results, he says, "It completely bastardises what a good corporate should be doing. They should be planning long-term."

How best to structure a company at different stages of growth provides a challenge that has always interested Cuffe. Colonial First State, he says, was "a journey of continual re-adaption. The way you configure a company with 20 people is different from 100 people, is different from 1,000 people. You've got to adapt your leadership style, depending on the size and stage of the firm." Good leadership is paramount. "People are going to watch you as the leader or the boss. You set the tone; it's vital to walk the talk. I believe in calling a spade a spade. [Then] if something's wrong, you've got the environment where people are encouraged to tell you bad news… Praise people, give them a lot of rope, plenty of trust." That's how a company builds culture.

"You can't manufacture culture," he warns. "You can't put a sign on the wall and say, 'We are that'. People will work extraordinarily enthusiastically and hard for you if they understand where things are going and they feel a part of it and are appropriately rewarded in both a monetary and non-monetary sense." How does he describe non-monetary reward? "Keep them informed. Tell them what's going on," Cuffe says. "Regular staff updates. Once a quarter at Colonial we would get everyone together in a room. By the time I left, I'd hire out Darling Harbour for 1,500 people. And it was to tell them what happened last quarter. We'd have staff awards, people up on stage recognised by their peers. It is so, so important. I think people sometimes underestimate the importance of that." For larger businesses in various locations, he's a fan of webinars.

The fast-moving digital landscape is impacting financial services as well, with the arrival of robo-advice. Cuffe embraces robo-advice as an opportunity to make advice accessible to more people moving forward. Robo-advice can bring costs down, doing what he calls the "donkey work": capturing basic information about a client. But the human element, he insists, won't become redundant. "The actual valuable advice bit will never be replaced by a machine," he says. "It's a funny commodity, money. [Clients] need someone to hold their hand, to explain what's going on."

For Cuffe, money management is a slow game. "A lot of the results of good money management doesn't come out for years," he says. "It's like going to the gym … the future benefit as much as today's benefit." When meeting with a potential client, Cuffe is quick to emphasise this approach. "The more mature you get, you realise there are no short cuts. Patience is really important … Slow money is better than quick money. Slow money should have fewer accidents." Nonetheless, he believes the investment world improves all the time. "Every now and then there's a cleansing, there's a bit more law, these days more education is required," he says. "All that's got to be good… With our level of patience, some people want it to be perfect now. But we're getting toward it."

Patience is much of the reason why Chris Cuffe places such value in great wealth advisers: for him, it's a question of professionalism. Training, maturity and real world experience go a long way to building an outstanding financial adviser. "Some grey hair genuinely helps!" he says. A knack for explaining investment terms in plain English doesn't hurt, and an adviser should always work for their client, not themselves. "The best thing many advisers could do is spend time with great advisers and learn the difference between competent and excellent," Cuffe suggests.

Kirsty de Garis is a freelance writer. This article was first published on Macquarie's Smart Practice *blog.*

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