Cuffelinks
Connecting investors with ideas

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Until debt do us part, Act 1

Chris Cuffe

'Neither a borrower nor a lender be, for loan oft loses both itself and friend …'

Though written around four centuries ago by William Shakespeare in *Hamlet*, this is a relevant topic for the times we are in today.

When the media latches onto stories dealing with debt, the tone tends to be alarmist. Such news lifts ratings but it doesn't always shed light on the issues at hand. Is the nation drowning in debt? How much is 'too much' debt?

We must always be mindful of which debts we are dealing with – the debt of the federal government; the nation's foreign debt; or the debt of Australian households? Headlines will often comment that debt has reached a certain 'critical' level of GDP (gross domestic product, which is a measure of the annual income of the nation, the value of the goods and services Australia produces each year) and disaster looms. Debts have never been so high. But this is a rush to judgement.

I'm an accountant by training so I like to make sure numbers are in the right spot, be it the profit and loss statement (a period of time measurement) or the balance sheet (a point of time measurement). I think that is how we need to correctly analyse the national debt instead of mixing the concepts up.

What's wrong with debt to GDP?

The ratio of debt to GDP is the commonly expressed measurement that people use to analyse whether a country's debt is too high. But in my view, debt to GDP ratios tend to muddle accounting principles. Debt is a 'stock' item and belongs in a balance sheet. It's a liability. GDP is a 'flow' item; it's what we earn each year. It belongs in the profit and loss statement. To untangle these items we should look at the ratio of debt servicing costs to income, usually called the debt service ratio, and then we can consider the debt to assets ratio. The debt service ratio is easily calculated for most debts. We know what interest payments the federal government must make each year and we know its revenue.

To put things another way, if GDP is the personal equivalent of your annual salary, then should we measure your debts as a proportion of your salary or as a percentage of your assets? More likely we tend to look at your ability to service your debts. What percentage of your salary are your loan repayments?

Those who believe gross debt to GDP or income is a measure of quality should be alarmed at the debt to income ratios of some of Australia's highest-rated companies:

Company	Debt/income (%)
Woolworths	260
BHP	180
Telstra	450
Coca Cola	340
Westfield Retail	260

Income = net profit after tax. As at 30 June 2012

So is our government debt level alarming?

What is the government's debt service ratio and has it been higher in the past? This financial year the debt service ratio (interest payments to income) of the federal government will be 2%. It has been higher, 6.5% in mid-1990s, and it has been lower. But 2% hardly constitutes a crisis. Again we can argue over alternative uses for the interest payments, which will be $7.2 billion, but interest payments have been as high as $9 billion per year in the not too distant past.

When it is breathlessly announced that the federal government will be in debt to the tune of $300 billion sometime this year, it is conveniently forgotten that many people owe money to the government as well. The government's net debt will be around $160 billion this year. This is a large number – and we can argue about how we got there – but is it too much in a 'crisis' sense?

The government's debt to assets ratio (if we use the Australian economy as our asset base) is close to 3% assuming that debt is $300 billion and the nation's assets are conservatively worth around $10.1 trillion or $10,100 billion. When someone says the federal government has saddled each of us with $13,043 of debt ($300 billion divided by our population of 23 million) we can retort with the equally absurd statement that we each have at least $439,000 in assets.

Is our household sector sinking under unbearable debts?

Without doubt some people are deeply in debt and face financial trauma. But there are 8 million households in Australia and not all face crippling debts. Almost 30% of households have no debt at all. Around 60% of household debt is home mortgages, 30% is for investment housing and 10% is 'other personal borrowing' such as credit cards and car loans.

According to the Reserve Bank of Australia and the Australian Bureau of Statistics, the indebtedness of Australian households has risen from $190 billion in 1990 to $1,400 billion in 2012. Household debts as a proportion of household assets have risen from 9% to 18% over the same period.

The household debt service ratio tends to move with interest rates and debt levels. In the mid 1980s household interest payments as a percentage of household disposable income was only 5.5%. It rose to 9% in the late 1980s as interest rates rose and then fell back to 6% in the early 1990s. It peaked again at 13.2% in June 2008 before falling back to 9.8% in December 2012. As a sector, Australian households are not stretched, but there are limits. Some households have already reached that limit. Some have surpassed it.

What about Australia's net foreign debt?

As at December 2012, Australia's net foreign debt stood at $760 billion, of which only 18.3% was government borrowing. Australia's foreign debts are predominantly private. They are the borrowings by banks to lend for mortgages and other lending, plus offshore borrowings by other Australian companies. Annual interest payments on this debt amount to $21.6 billion or 1.5% of GDP.

New foreign debt is created each year if the demand for loans in the economy outstrips the nation's savings. The difference is made up by borrowing offshore and results in what is known as the current account deficit.

National issues such as debt levels and current account deficits should not be treated lightly, but neither should they be demonised. Public policy must encourage saving and we must retain the confidence of offshore capital markets. If the global financial crisis taught us anything it was that confidence and trust can evaporate overnight, leaving those with excessive debt badly exposed to financial trauma.

To paraphrase another saying, there are only two certainties in life: debt and taxes.

Thanks for the assistance of Hans Kunnen, Chief Economist at St George Bank and formerly Head of Investor Markets Research at Colonial First State and Chief Economist at the State Bank of NSW.

Until debt do us part, Act 2

Ashley Owen

The US is facing a serious government deficit and debt crisis. Republicans and Democrats are fiddling at the margins while the debt pile grows progressively larger with each delay and short term quick fix. America has faced worse economic, financial and political crises in the past – in the 1890s, 1930s and even in the 1970s. Each of these crises brought about radical changes in policy and proved to be major turning points in America's economic and financial history, and in each case the US economy and markets survived and prospered.

Our focus is on markets, not just economies, and in each crisis markets recovered, starting right from the middle of the crises when all hope seemed lost and pessimism was greatest.

Should the government impose strict 'budget austerity' to 'balance the budget'? Or is the solution even more 'deficit spending', even more debt, and seemingly endless 'money printing'?

- There is no one right or wrong set of policies that work at all times and in all situations. Inflationist full employment targeting, deficit spending and government intervention sounded like a good idea in the 1930s depression but economies collapsed in a mire of high inflation, high unemployment and stagnation in the 1970s (although it is probably unfair to sheet home the malaise of the 1970s to Keynes).
- Hard money policies of money supply targeting, deregulation and freer markets sounded like a good idea after the 1970s. Inflation was brought down and the economy and stock market boomed, but trade deficits and foreign debt soared. Low interest rates and deregulation produced a string of asset bubbles and collapses culminating in the sub-prime crash and sovereign debt crisis (likewise it is probably unfair to blame the current crisis on Hayek and Friedman).
- Severe economic, financial and political crises provide the catalyst for radical policy changes but, even when they are successful, often contain the seeds of the next crisis.
- Trying to balance the budget through piecemeal budget cuts and/or tax hikes generally just makes the deficit and debt worse, as tax revenues fall and welfare spending rise in the resultant slowdown, as was the case in 1936-8 globally and more recently in the UK and the PIIGS. It is also politically unpopular and hard to sustain in the face of popular backlashes.
- Generally it requires a very serious crisis in order to provide the catalyst and the political mandate for radical change. It generally requires either a deep external devaluation (large-scale currency depreciation, which is not possible with a fixed currency like the Euro or a strong currency like the US dollar) or deep internal devaluation (savage cuts to spending, wages and working conditions).

Should the government go even further and create budget surpluses to actually 'pay off the debt'?

- Governments are not like individuals who need to pay off debt and create a surplus to fund retirement after income has ceased. On the contrary, governments, like companies, are perpetual and can carry a level of debt forever as long as the debt is used to finance proactive assets that will generate tax revenues that exceed the cost of the debt. Great nation-building projects like transport and energy infrastructure would qualify, but borrowing to pay welfare, government administration or the military would generally not.
- Even the Clinton budget surpluses in 1998-2000 did not actually reduce the level of government debt. The last President to actually reduce the level of federal government debt was Herbert Hoover in the 1920s boom.
- There is plenty of money in the US and plenty of scope for governments to collect more of it in tax revenues. The Clinton surpluses were achieved thanks to the 1990s dot com boom, but the dot com boom was a relatively profitless boom. US companies today are many times more profitable and today's profits are cash profits, not the largely artificial cashless profits of the late 1990s.

- Trying for surpluses without radical reform will probably only lead to larger surpluses and more debt in the short term. Surpluses are generally only achieved from recessions after a deep crisis and radical reform.

What if the US government defaults on its debt?

- The US government has already missed payments on interest and maturing debt in the past (three times in 1979), and it has been forced to shut down departments before (in 1995 and 1996). In fact, these events turned out to be critical, but they were shrugged off by markets at first. They triggered real action, such as the 1979 defaults providing the last straw for Carter to hire Paul Volcker, and the 1995-6 shut downs being the catalyst for co-operation between the White House and Congress that produced three years of budget surpluses in the late 1990s.
- If such missed payments are selective and temporary, they are likely to be brushed off by markets as they have been in the past. The government has plenty of ways to come up with cash to keep the current process of short term delays and quick fixes going for some time yet.
- The sooner it escalates into a major crisis the sooner radical action will be need to be taken, and the sooner the real problem can be tackled and solved.

Will it ever get the economy growing again?

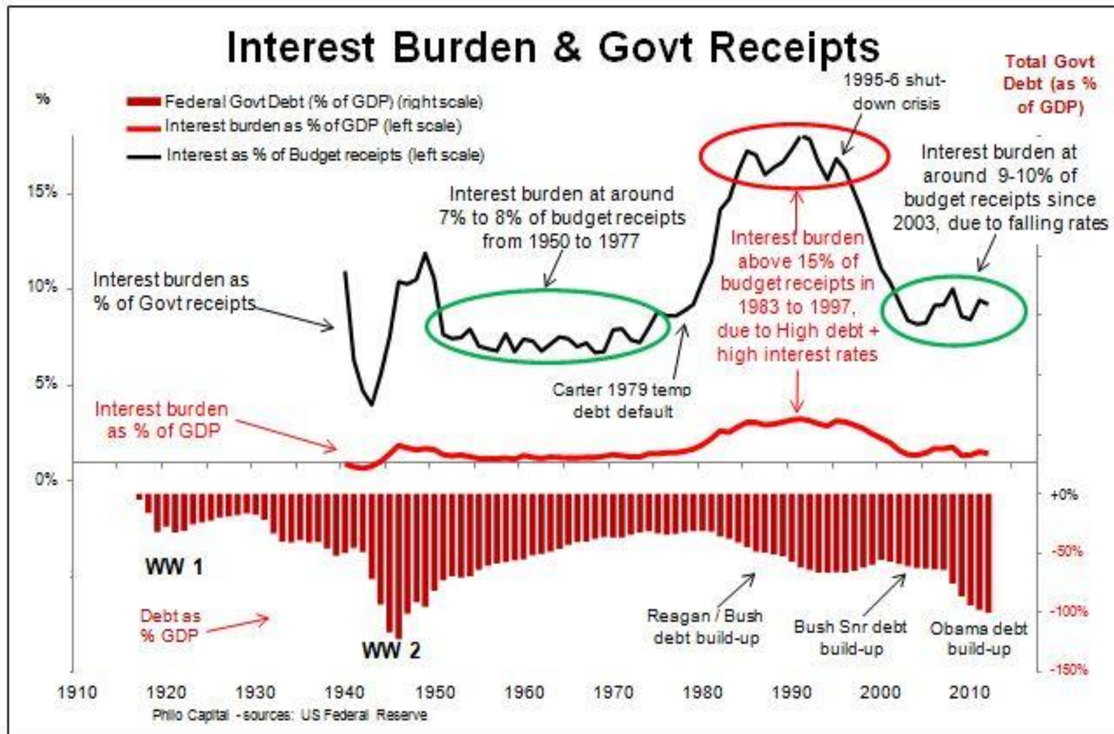
- Yes, the US has suffered far more severe economic contractions and financial crises in the past. Markets rebound out of the depths of the crises when pessimism is greatest and all hope seems lost.
- But radical policy changes generally require a severe crisis to provide the catalyst and the mandate for action.
- The fact that the current debt situation is only moderate and manageable means that, if the politicians can grow up and co-operate, there is time for the flood of cheap and plentiful money to translate into growth in confidence, spending, production and jobs.

Is the current level of debt too high or unsustainable?

- No. The interest burden on the government debt is only moderate. Interest costs have been running at around 9-10% of budget outlays since 2003, despite the rising debt level. This is around the same interest burden from 1950 to the late 1970s, and so should be entirely manageable. The share of budget outlays has remained flat despite rising debt levels because national output and tax revenues have also been rising.
- Likewise, interest cost as a percentage of GDP is between 1.5% and 2%, similar to what it was in the 1950s to the late 1970s.
- In real terms after inflation, the interest paid on government debt ($230 billion) is lower than it has been since 1984, and is 35% lower than it was at its peak in 1996.
- Even four years of trillion dollar deficits since 2009 did not increase these debt servicing

ratios, because interest rates remained low and the economy grew.

- However, as the economy improves and the Fed winds back and even reverses the bond-buying programs, yields will rise and the cost of refinancing treasuries will rise, so the clock is ticking on solving the problem.



US government debt is manageable

In summary, the US government deficit and debt problem is large but not insurmountable and is it mainly a political problem. The acrimonious point-scoring in Washington may well continue to flare up into occasional crises that are likely to include temporary defaults on interest and maturing principal, government shut-downs, selective late payments to creditors, and more credit ratings downgrades, as they have in the recent past. Most are unlikely to rattle markets seriously, and have been brushed off by markets in the recent past.

Only radical change would make sizeable inroads to the budget, on the tax side and on spending. Generally only a cataclysmic crisis is enough to provide the political mandate for wholesale and radical changes to spending patterns and tax structures. Given the moderate interest burden of the current level of debt, the most likely outlook is that game-changing cataclysmic event may be many months or years away.

The most serious threat to markets will be the fallout from interest rates rising. Rising interest rates are unlikely be caused by credit spreads and default fears if the deficit and debt situation were to deteriorate further. (Japan has more than double the debt levels and interest burden but interest rates are less than half those in the US).

Rising interest rates are more likely to be caused by a return to inflationary expectations as the economy improves, and this will most likely improve the deficit position significantly as tax receipts rise and welfare spending falls.

Another turning point, with focus on reregulation and control

The US is far better placed than the UK, Europe or Japan, in regard to both the current deficit and debt situations and also the longer term outlooks for growth and market performance.

America has experienced three great turning points in fiscal and monetary policy over the past 140 years and each arose out of the depths of a cataclysmic crisis - the 1890s depression, the 1930s depression and the end of the 1970s. Out of each crisis was born a brand new era of growth and prosperity for Americans and for investors.

But the policies and ideas that gave rise to the recovery from the 1970s crisis and drove the economy and markets for the past 30 years came crashing down in the current crisis. It is likely that America is now standing at the edge of another great turning point, as many of the underlying assumptions, conditions and policies of the past 30 years are unwinding and reversing.

De-regulation is returning to re-regulation, as the idea of small hands-off government is returning to more government influence. Central bank independence is returning to influence and control by governments and politicians. The focus on defeating inflation is returning to deliberate positive inflation targeting, and free capital movement is returning to capital controls. Tax cuts are returning to tax hikes, and free and open access to unfunded pensions and welfare 'entitlements' are returning to the ideas of user-pays and contribution.

It is not our role to opine on what is right or wrong. No set of policies or ideas works forever in every set of conditions, as we have seen. It is our role to study the actions and reactions of policy makers and participants that affect markets, to understand and assess likely implications and consequences, and to adjust investment portfolios to ensure preservation of capital and sustainable real growth.

Ashley Owen is Joint Chief Executive Officer of Philo Capital Advisers and a director of Third Link Investment Managers.

UNPRI ready to go to the next level

Fiona Reynolds

Responsible investment is one of the biggest investment trends of the 21st century. In part, this is driven by the realisation that the world around us is changing rapidly. Food, water and energy security, natural resource scarcity, climate change, human rights, labour standards and demographic change have all become material issues for companies, while the financial crisis highlighted the need to foster long-termism within financial markets and improve the alignment of interests across the investment chain. Investment policies and processes now need to evolve to capture a broader range of risks and opportunities, over longer periods of time, than ever before.

Fortunately, a global network of like-minded organisations trying to figure out what all of this means for investment risk and return already exists. Supported by the United Nations, the goal of the Principles for Responsible Investment (PRI) Initiative is to increase understanding of the relevance of environmental, social, and governance (ESG) issues for the investment community and encourage investors everywhere to be more active owners of the companies in their portfolios. By implementing the PRI's six Principles and putting responsible investment into practice, some 1,200 signatories to the PRI around the world are at the forefront of creating a more sustainable financial system and helping to prevent the next financial crisis. Never before has the role of the investor in creating an enabling environment for the growth of a sustainable economy been so important. And that's why, earlier this year, I took up the post of Managing Director at the PRI in London.

On many measures, the PRI has been very successful since its launch in 2006. Signatories manage combined assets of USD $34 trillion, or nearly one-fifth of global capital. It has greatly increased the level of transparency around the activities and capabilities of its signatories. In 2011, nearly 550 of them completed the PRI's annual reporting and assessment survey outlining how they are putting the Principles of ESG incorporation, active ownership, transparency, collaboration, and disclosure into practice. It has also fostered greater collaboration between investors and supported their engagements with companies and policymakers on ESG issues on a scale simply not possible before. Over 2011/12 alone, signatories contacted more than 1,300 companies via the PRI's clearing house platform to encourage them to improve their performance or disclosure on ESG issues.

Australian investors are naturally very attuned to environmental and social issues and it should come as no surprise that the PRI's Australian network, managed by the Australian Council of Superannuation Investors (ACSI), is one of its largest and fastest growing, with 125 signatories and counting. One quarter of these are superannuation funds, so yours may be among them.

Despite this progress, there is still a long way to go before responsible investment can truly be considered mainstream. We know that the way the market currently works, through the investment chain from asset owners via investment managers to companies, does not always serve the true long-term interests of the millions of ordinary Australians who save through super funds or insurance products. The financial crisis gives the responsible investment community an opportunity – indeed a responsibility – to address sustainability challenges more strategically than it has done to date.

The responsible investment community needs to lift its sights and become more engaged with the nuts-and-bolts of the investment chain, the portfolio-wide implications of ESG externalities, and the stability and health of the market as a whole. Portfolio turnover, performance monitoring periods, benchmarks, fees and real long-term alignment of interest between asset owners, asset managers and companies all need to be part of responsible investment's territory.

To inform this re-tuning of the investment chain, we need to understand far better how long-term externalities and market failures such as climate change will impact whole portfolios, across asset classes, and how investors can respond. The objective here is to ensure that the whole investment chain is focused consistently on long-term value creation. This should ensure that far greater account is taken of environmental and social sustainability issues than at present.

We also need to explore how far it is in investors' *financial* interests to encourage policy action to bring externalised sustainability costs on to companies' books. For some years now investors have supported strong government action on climate change. We need to strengthen work on climate change, and explore applying the same principle to other issues. All this will not in itself change investors' fundamental objectives, but it will significantly increase the overlap between investors' long-term financial interests and environmental or social objectives as seen from the public interest perspective.

Finally, we need to address the functioning and stability of the financial system as a whole. The overriding purpose of superannuation funds and other long-term savings institutions is to deliver financial security in retirement to millions of ordinary people. To do this, these investors depend on markets that are stable, well regulated, transparent and fair. As we have seen, poor governance of the market as a whole can be hugely damaging to long-term investors' interests. At the policy level, a small number of the largest asset owners are already engaging actively with policy makers and regulators on the new market frameworks that are being put in place in response to the financial crisis. The more institutions become involved in work of this kind, the greater the chance that the re-modelled financial system will be fully aligned with their interests.

This agenda calls for a whole new level of vision and courage from the responsible investment community. We need to apply existing research insights and experience better, develop new tools, re-engage with the leadership levels within investment institutions, collaborate more effectively, and be bolder in allocating resources.

Fiona Reynolds is Managing Director of the Principles for Responsible Investment Initiative, based in London.

Consider a LIC before you bite into equities

Graham Hand

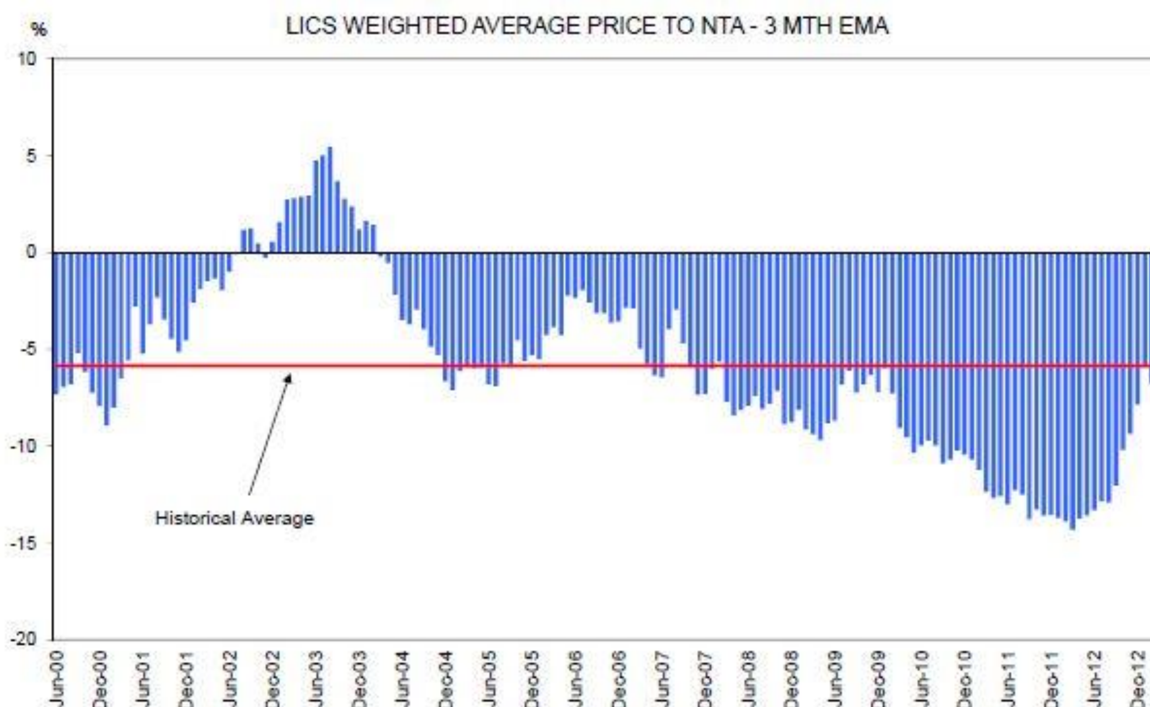
All unlisted managed funds are sold at their net asset value (NAV). Imagine if one day, Asgard, BT and Colonial First State all sent a note to their advisers saying that as a special One Day Sale, their funds would be sold at a 20% discount to NAV. Like buying CBA at $52 when it's trading at $65, or BHP at $28 instead of $35 on the market. Advisers would be forwarding emails and preparing new Statements of Advice for clients before they'd finished their morning coffee. Even if clients made no greater allocation of money to the market, they would switch from other investments to this one-off bargain.

But it cannot happen. Unit prices must be calculated at NAV, as defined in product disclosure statements, and adjusted for small transaction costs, the same price is used for buyers and sellers. Sellers would not be happy to sell at a 20% discount. When 'retailing' managed funds, you can't run 'specials'.

Yet that's what happens regularly in the Listed Investment Company (LIC) space. Some of the best names in the market, often holding large cap portfolios, at times can trade well below their NAV. Just consider what 20% means in the world of investing. It's 2,000 basis points. A fund manager would run a highly successful business if they could outperform the market by 2% per

annum for 10 years. Investors switch from active to passive managers to save 50bp in fees every year, and here's 2,000 basis points on the table.

The current estimated discount to NTA of the major LICs on the ASX is:



Source: Patersons Securities Limited. As at 21 March 2013. EMA = Exponential Moving Average. This graph is based on the pre-tax NTA of 30 of the largest and most liquid LICs in Australia. Other graphs which choose another group of LICs may produce different results. For example, the ASX estimates the weighted average sector discount to pre-tax NTA is currently only 3%, or unweighted (simple average) of 8%.

Alternative ways to gain 'market' exposure at lower cost

Disappointment with active management, including relative (worse than the index) and absolute poor performance, has encouraged many investors who want equity exposure to consider alternatives to traditional managed funds. LICs are one of them.

There are three trends most often cited as evidence of the move from paying for active management:

1. The rise of Exchange Traded Funds (ETFs). In Australia, the vast majority of ETFs are index funds, some with fees less than 10bp per annum, a fraction of the active management cost. Investors know they cannot control the returns, but at least they can minimise the costs.

2. The growth of index and quasi-index funds within traditional managers. When markets struggle, fund allocation is increasingly driven by financial advisers wanting to show their clients their advice fees are justifiable by reducing costs on the asset management side. Index options on their favourite platform cost as little as 40bp, or slightly higher for non-capitalisation indexes such as those offered by Realindex in Australia (which already has over $5 billion under management).

3. The move into SMSFs. Almost a million trustees have decided to manage their own money, and only 14% of their $500 billion finds its way into traditional managed funds. A decade ago, in June 2004, SMSFs held only $39 billion in listed shares, but now the amount is almost $200 billion.

Each of these moves is driven by the desire to reduce costs and control investments, but they all have one thing in common: they pay full freight for the assets they buy.

Trading levels of LICs

Cuffelinks is not a stock-picker and does not provide individual stock recommendations. There are many factors to consider when buying a suitable LIC, as described below. The ASX produces a monthly report on LIC premium and discounts to NTA, showing the full range of 60 LICs on the ASX, as shown here.

The total market cap of LICs on the ASX is over $20 billion, so it is a decent size for investors to consider, and three times the size of the Exchange Traded Fund (ETF) market. There are three LICs with a market cap over $2 billion, and many over $200 million. The largest LICs often have the smallest discounts, because they are well-known and respected, and investors buy them when the discounts become historically wide. Some smaller LICs have large discounts, but there may be particular factors which warrant this: a highly concentrated portfolio, poor performance history, high costs relative to size. The biggest discount does not equal the best opportunity.

For a liquid, diversified, high quality fund offered by a reputable manager, LICs available at a discount are like a free gift for a long-term investor, who does not need to sell at a time when the discount remains. Is there a compromise in asset or fund manager quality? Putting aside the debate about whether any active manager can consistently outperform the market, some of the most respected asset managers in Australia ply their trade managing LICs - Geoff Wilson of Wilson Asset Management, Sam Kaplan of Ironbark, John Murray of Perennial, John Abernethy of Clime. There is as much chance that these guys will outperform the market as anyone in a managed fund, yet there are many times when their LICs trade at a discount to market.

It is the seller of the LIC who is leaving the value on the table. For a LIC that has moved to a significant discount to its NTA, it is the past investors who have already underperformed, effectively losing more than the market, and have given up on the investment before value is restored. The LIC that listed at $1 may now be trading at 80 cents while the NTA is still $1. Investors have lost patience, sold and gone into term deposits. It leaves the door open for those who want long-term equity exposure at a discount.

What if the discount increases, and the LIC falls in relative price even further? Consider buying more. What if the discount is removed or it trades at a premium? Sell, or settle back and enjoy the dividends, knowing there has been a capital gain as well. What if it does not move? Keep holding the investment - remember, we are talking about investors who want exposure to the market. This is a cheap way of doing it, and for a long term holder, it does not matter if the discount is not removed. The portfolio delivers superior income along the way, because the yield is higher due to the lower entry price.

Tax and distribution structure

LICs are companies and payment of dividends is determined by the directors, and does not depend on current year's profits. If a LIC has retained earnings and remains solvent, a dividend can be paid. This differs from managed funds which must pay out all income, including realised capital gains, to unitholders in the tax year it is earned. However, most major LICs focus on paying healthy, consistent dividend yields knowing their investors have chosen them for this feature.

The NTA of a LIC is usually quoted in both pre-tax and post-tax terms. For example, some LICs have deferred tax assets from realised losses after the GFC, which can reduce future tax liabilities if gains are made. In this case, the post-tax NTA may be significantly higher than the pre-tax NTA, but realisation of the value of the asset depends on future profits. Others estimate the tax liability on unrealised gains. Investors should consider the tax components built into the NTA.

LICs usually pay tax on their net taxable income at the company tax rate, and they receive franking credits. They may also receive the benefit of LIC discount capital gains status on some of their capital gains, whereby shareholders are paid a fully franked LIC discount dividend. The investor may be entitled to claim a tax deduction equal to 50% (or 33% for super funds) of the LIC discount capital gain. The extent to which this applies varies greatly between LICs.

Other risks and advantages

The biggest advantage for LICs is that they are closed-end, meaning they cannot face redemptions and become forced sellers, as may happen with a poorly-regarded managed fund, especially in a bear market. This allows the manager to focus on the portfolio without worrying about losing funds unexpectedly. Many managed funds were caught out in the GFC as their investors rushed out of equities, and they added to the selling pressure even when prices were low and falling.

The main disadvantage is that the manager of a LIC is running a publicly listed company as well as an investment portfolio, and has to deal with shareholders, annual meetings, reporting, continuous disclosure, etc. While administrative functions can be outsourced, the manager is the face of the company, like the CEO, and if there is any threat of corporate action such as a takeover (not uncommon in the LIC space), the diversion of time is considerable. Many fund managers would prefer to concentrate on managing money, and some of the best names in the industry do not operate LICs. One high profile manager told me that after a couple of years managing a LIC, and being subject to continuous threat of takeover and complaints about the discount to NTA, he would never go back to the structure. Another said they spent more time managing enquiries about their small LIC than the rest of their large unlisted funds combined.

In summary, the 60 LICs listed on the ASX worth $20 billion cover Australian and international shares, private equity, absolute returns, global resources and some 'specialists'. They vary in size from almost $6 billion to $1 million, which can have a material impact on fees and expenses. They have different policies around distribution of dividends, availability of franking and tax effect.

When the opportunity comes along to buy one of the long-established names, with a well-diversified portfolio run by a respected manager, who distributes franked dividends with a modest management fee, and available at a discount, then it's the nearest thing to a free lunch the equity markets will give to an average punter.

Price statistics in the (un)real estate market

Rick Cosier

On 23 March 2013, I noticed a couple of properties in the Manly Daily scheduled for auction. In the Sun Herald the following day, there were four pages on property with wonderful news about excellent auction clearance rates and lots of happy smiling faces. No mention of the two Manly properties.

A couple of days later, I ran into a friend who lives opposite a house in Roseville that was on the market. "Has it sold yet?" I asked. "Yes", she said. "Last Thursday, but they accepted less than they wanted". Strange, I thought, I can't remember seeing that result in the paper. So I went to the library and read through the Manly Daily, the North Shore Times and the Sun Herald for the weekend of 23 and 24 March. Here is what I found out.

According to the North Shore Times, 1502 properties were on the market with 439 scheduled for auction and 1063 for sale. In the Manly Daily, the figures were 1674 in total, 261 for auction and 1413 for sale. The auction clearance rate was 78%, which RP Data described as "auction properties that sold on or prior to auction this week." As the auction clearance rate is widely used as a barometer for the health of the property market, the message appeared to be that the property market was getting its mojo back.

Flicking through the Manly Daily, I noted that there had been 21 auctions scheduled for 23 March, christened 'Super Saturday'. In the following day's Sun Herald there were 313 auction results listed. 193 successfully sold the property at auction, 79 were sold prior to auction and the remaining 41 were either passed in or had vendor bids.

Three questions sprang to mind.

First, if the percentage of properties going to auction is less than 30% of all the properties on the market, why are we looking at auction clearance rates to gauge the state of the market?

Second, if 40% of the properties included in the auction clearance rates were actually sold prior to auction, then why are they included in the auction clearance figures? I have experienced 'sold prior' myself. We scheduled an auction for a unit we wanted to sell. Many people inspected the property but with a few days to go, the agent told us there was really only one potential bidder. His advice was that going ahead with the auction in that environment could be disastrous. It was highly likely that no-one will bid, and worse still, the solitary prospect may realise they were the only game in town. When the agent ended up negotiating a pre-auction price with the buyer, we were very relieved. Including a sale like this in the auction clearance figures is completely misleading.

Third, how come there were only 313 auction results listed in the Sun Herald when there were 700 advertised in the North Shore and Northern Beaches alone? I was surprised to see that not one property was sold in Roseville, Lindfield, Killara, Pymble and Gordon. And none of the 21 advertised Northern Beaches auctions were listed either.

However, there was a photograph of one of the Roseville properties on page 5, under the headline "Super Saturday lives up to its name." Next to the photo of the property were some figures: 1985 $235,000, 2013 $1.75 million, 644% rise.

Very impressive, except for two major issues.

First, the property hadn't actually sold, it was what the vendor was hoping to achieve. And second, the current vendor bought the property for $1.89 million in September 2010. Instead of a 644%

profit, if they sell at their asking price they will realise a loss of more than 12% if costs and stamp duty are factored in, assuming they did not spend any money on renovations or improvements.

So why did none of the 21 advertised Northern Beaches auctions appear in the following day's Sun Herald? The data came from Australian Property Monitors, and they told me they didn't receive the information from the real estate agents in time to pass it on to the Sun Herald.

Manly Daily and North Shore Times source their information from RP Data, and RP Data also supplies the Sunday Telegraph. What did the Sunday Telegraph publish, I wonder?

The Sunday Telegraph on 24 March had published over 750 auction results, more than twice as many as the Sun Herald, including two thirds of the Manly Daily auctions. In contrast to the Sun Herald, 18 of the 21 Manly Daily auctions were reported. 10 were passed in, 3 were withdrawn, 3 sold prior to auction and 2 sold on the day. That's not my idea of a successful 'Super Saturday'. And why did the Sunday Telegraph report more than twice as many auctions as the Sun Herald?

Eventually, all results find their way into the Valuer General's office, and you can find out exactly how much a property sold for by logging on to various internet sites. Some of these sites try to assess what a property is worth, and sometimes they are pretty accurate. However, sometimes they are incredibly wide of the mark. For example, one of these sites had a house in Roseville valued at between $1.83 million and $1.94 million, and claimed it was a 'good guess'. Er, not quite. Happily for the owners, it sold for $2.65 million last week.

What about the property industry's use of median prices to measure the state of the market? The 'median' is the middle price with as many prices below it as above it, which is not the same as the average price. This means that the measurement of how the market is performing is entirely dependent on the performance of the few houses around the middle. This can create massive distortions in what is actually happening.

And what nobody factors in to the price performance is the cost of renovations. Not much reward from buying a house for $500,000, spending $250,000 on extensions and selling it for $800,000 a year later, but the statistics will show a 60% per annum improvement. When someone buys a Commonwealth Bank share, they don't have to pay for a new roof on their local branch from their own pocket.

I am left with an uneasy feeling about how property prices are recorded and reported. Contrast my findings with the availability of information about sharemarket prices and performance where bid, offer and sale prices are published instantaneously, and the entire history of selling prices and volumes is available at the push of a button. The market is regulated by the ASX, and investors can be reasonably assured of what is going on.

When someone buys shares they are usually investing a relatively small amount of money in a liquid, transparent market. But when someone buys a property they are investing a huge sum of money in an unregulated marketplace that is illiquid and opaque. Residential property is the biggest asset class in Australia, worth about $4 trillion or almost three times the value of all listed companies. Buyers and investors deserve a better understanding of what is actually happening with prices.