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Shining a light on dark pools: interview with Seth Merrin

Graham Hand

It may come as a surprise to many retail investors, but not all trades in listed securities take place on the so-called 'lit' public exchanges, such as the ASX. Increasingly, they are moving to the 'unlit' markets, or dark pools, and if you hold managed funds with a large portfolio manager, this could be good or bad, depending on who you listen to. Supporters argue with some justification that execution is improved and costs are reduced, to everyone's benefit and the efficiency of the market. Opponents point to the lack of transparency.

Dark pools are as mysterious to many as their name invokes, and the Australian Securities and Investments Commission (ASIC) is watching. On 12 August 2013, ASIC released new market integrity rules on dark liquidity and high frequency trading. ASIC said, "These final rules aim to improve the transparency and integrity of crossing systems and strengthen the requirements for market participants to deter market manipulation."

A dark pool is an off-market exchange that allows traders to buy and sell large orders without revealing their identity. The primary purpose is to minimise the market impact of an order by not revealing quotes to the market. In theory, they allow institutions to minimise information leakage and execute more efficiently. Most dark pool liquidity is block trades away from centralised exchanges such as the ASX.

Seth Merrin is the founder and CEO of Liquidnet, a global institutional trading network founded in 2001 that connects 750 of the world's leading asset managers, including many in Australia.

Liquidnet opened in Australia in 2008, and some statistics are:

- average daily order liquidity in ASX stocks is about $2 billion (actual daily average ASX turnover is about $5 billion)
- average execution size is $1.8 million (337 times larger than ASX of $5,344)
- 98% of trades at or inside the public bid/offer spread, with 84% at mid market
- Liquidnet represents an average of 47% of the Average Daily Volume when active in a stock, and is active in almost 150 stocks on the ASX.

Here is my interview with Seth Merrin:

Graham. How is Liquidnet going in Australia?

Seth. Australia has been the most successful launch of any country in our history (Liquidnet operates in 42 markets over five continents). It's such a close-knit community with some of the brightest people we find anywhere in the world. People are passionate about what they are doing. Superannuation has made the industry more professional and efficient. There is focus on it as a business and industry. Australians are more engaged with their super as investors, whereas in the US, people 'play the market'. I realise this is a generalisation, but it's what I perceive.

G. Large asset managers match orders between their funds internally before executing the balance on an exchange. Is that like Liquidnet?

S. It's exactly what they should be doing, to avoid transaction costs. The problem that we're solving is that institutional assets are so large that they move the market when they transact. The commission or brokerage they pay is only a small part of the cost. If they can cross internally, fine, but it's usually a small part. Think about the benefits of transacting internally and magnify that massively across the world. Liquidnet brings to the table members all over the world trading in different markets for different reasons. Only through technology can you know there is someone sitting in California wanting to buy an Australian stock and we match that with someone sitting in France or wherever. Bringing lots of different perspectives to the table is what makes a market. A massive amount of assets around the world is what makes for liquidity.

G. The initial stages must have been have been tough, it's all about liquidity.

S. Yes, excruciating. Our initial asset managers said 'don't call us, we'll call you'. But they were educated that they had a problem. Blocks were previously traded through a human intermediary, but when you give someone a block like that, they can only make so many phone calls. They won't call folks in Europe of America. And there was a low probability they would find the other side. But there was 100% chance they would provide information to the market which compromised the deal. Firms like Goldman Sachs and Bear Stearns were built on block trading.

We simply introduced technology. What ebay did to flea markets, we did to block trading, to the institutional world. You need very different tools if you're trading $10 million of stock than $5,000. Every other industry has a wholesale and retail market, that's what we created across the world.

Also, most asset managers are comfortable transacting in their home market. But Australian superannuation funds are growing at 18% a year, just on the equity component, they have to find $100 billion a year of new investment. There are only 2,000 public companies in Australia, that is a major problem for them.

G. And highly concentrated in certain industries.

S. Right. So, it either creates a bubble, or difficulty outperforming, and there are 45,000 public companies around the world. Australian asset managers have to look outside Australia. But global

investing is difficult, learning the rules and regulations of that country, which broker do I use, do I trust them, how do I do it. Then think about a technology solution that allows them to point and click and invest almost anywhere, and we aggregate the liquidity for them in 42 markets. They can look outside their back yard.

It opens opportunities for improving asset allocation. In traditional asset allocation, we have a certain amount in cash, bonds, equities. The real opportunity is looking around the world at different levels of risk and return, which is what asset allocation is about. Look at Europe, Asia, Africa. It gets you away from benchmark hugging, generating pure alpha as active managers have to earn their fees. That is where asset allocation must move. We've seen a lot of money move to Europe, not because it's a great growth story, but because their share prices have been beaten up. Whereas Asia is a growth story worth some percentage of your assets.

G. How do the public exchanges respond to your business? Is the ASX a friend or competitor?

S. When we first started coming, they saw us as a competitive threat. But over time, they all tried to create their own version of what we've done, and they've all failed. But they understand, they are the pricing mechanism, that is sacrosanct, but they've never been good at dealing with large quantity price discovery. They've never really catered to large institutions, so they understand we are complementary. They are price discovery, we are quantity discovery, together we serve both markets more efficiently.

Their real competitors are their major customers, where major banks and brokers have set up their own internal matching engines everywhere around the world, and the exchange has become the execution point of last resort.

G. Are there any issues about loss of liquidity on the main exchanges?

S. Not due to Liquidnet. We've never been a competitor. There are two major issues on the minds of regulators all over the world – high frequency trading and dark pools. So why were dark pools invented in the first place? They were invented for institutions who need the anonymity, they need the size, and a better price. Over time, internal engines of investment banks have created maybe 50 dark pools in the US, but the execution size is lower than on the major exchanges, and that's wrong.

So regulators are drawing a line in the sand and saying if you're going to trade in the dark, you have to do something that complements the 'lit' exchange. That is, size, price, or something. Canada and Australia were the first to introduce regulations to control the spread of dark pools. ASIC said you must price improve, and most volume has migrated back to the lit exchange.

G. Liquidnet operates a dark pool, but what do you think of the description?

S. We don't like associating Liquidnet with the term 'dark pool'. We're a quote-crossing network. We don't provide quotes. The difference in what we do versus dark pools is that we are a block execution venue, we don't do small trades. It's a myth that dark pools are executing at prices away from the exchange. Note that 99% of Liquidnet's transactions globally are within the current bid/offer and 85% are done at mid. The trades are reported instantly into the ASX. There's been this misconception about whether the trades get reported, and they certainly do. The reality is that the large block trades were never done on the public exchange anyway, they were done in the broker offices using broker interaction. We introduced execution efficiency.

G. I perceive as an industry outsider that some people confuse dark pools with high frequency trading (HFT). Is this an issue?

S. I don't see that confusion but I'm too close to the industry to judge. Certainly, HFTs trade a lot in the dark, and regulators are concerned about manipulation, such as executing in the dark and manipulating prices on the public exchanges. But the average investor maybe thinks this whole thing is bad for them, that it further rigs the system against them.

HFT is a big structural issue. Many 'for profit' exchanges are encouraging as much HFT as possible because they earn commissions, but they have to understand that exchanges were created as the capital formation centres in their country. It's a place where companies can raise money for expansion and growth and where investors can exchange their shares efficiently. HFTs don't invest in IPOs or secondary placements, they don't increase efficiency of institutional trading.

Let me explain why this is an issue. We still have a confidence problem in the equity market, but over the long term, that's where the money will come. We saw a trillion dollars leave equities and go into fixed income during the financial crisis, but it will come back into equities over time. The bulk of that money is now up for grabs. It will flow into the best, most efficient opportunities. If there are regulatory hurdles, if trading is easier, if regulations are more standard (I think ASIC is doing a fantastic job, this is an easy market to transact in), whoever gets their act together will see the capital flows. For example, India looks like such a fantastic country to invest in, but there are such constraints on transacting for foreign capital, that the capital will not go there. If, for example, Indonesia gets it rights, they could generate massive capital flows. Every government is trying to attract foreign capital. Here's a trillion dollars, go get it.

G. You're a high profile critic of high frequency trading. Are you winning?

S. The ASX has shone a spotlight on it before it gets out of control. If it's 30% of turnover, as it is here, then it's fine. Anytime you cross over the 50%, as in the US, then the market changes from retail and institutional investors that care about the correlation between price and the underlying fundamentals. If you cross the threshold, you go from an investors market to a speculators market. In the US, we have done nothing about it. We're good at talking, not solving.

So I give a lot of kudos to this market. ASIC brings the industry in with consultative papers, they're thinking about the problems. Contrast that with the SEC (US Securities and Exchange Commission) that holds panels which are very public, it's a cartoon they put on, it's meaningless. In front of the cameras, they read politically correct statements and nothing happens. Australia has done a lot of things right from a regulatory and market structure perspective.

G. That's interesting, because locally, we do a lot of criticising ASIC.

S. Good, keep it up, then come to the United States where the grass is certainly not greener.

G. Why only equities and not bonds, repos, money market for Liquidnet?

S. It's all about focus. Our strategy is to put down a global footprint, and we've done that by focussing attention, time and money. We have to create a critical mass of liquidity in each country. It's taken 12 years, 750 of the largest asset managers around the world as clients, we want to solve more of their problems. We only enter a business when we can improve efficiency. We are looking at other asset classes, but there are unlimited debt instruments around the world, and we can't apply the same business model.

G. I was thinking more about the domestic money market which executes the same way as it did 20 years ago, by phone calls from banks to investors. It's a generic product, a major bank certificate of deposit.

S. It does not take much technology to create a disruptive event. Everything we do is a global opportunity to make markets more efficient, but one thing at a time.

G. What's next for Liquidnet?

S. Our mission is to make markets more efficient. If you think about public companies, it's a nightmare every time they want to buy and sell stock, for example, to do a buyback. They have to call an investment bank and put a human in the middle. Those companies want our members around the world at their table. They have fiduciary obligations to shareholders to get the best price, and it's great for our members.

The other area is private companies. Our members have not invested in private companies, but if you take a look at the trend towards large IPOs. Look at Twitter, floating with $15 billion of value. Our members have missed out on $15 billion of alpha. Or Facebook with $100 billion of alpha. It's pre-IPO where the value is. Our members are reading about these companies staying private for longer, going public at high valuations, so we want to institutionalise the ability to invest pre IPO. Not start ups. Real companies with real revenues with real prospects. The start ups are for venture capital. We're bringing a massive source of capital to invest, which dwarfs venture capital. But at the moment, it's not an institutional asset class.

Analysing the black box of general insurance

Roger Montgomery

Insurance companies have a reputation for being 'black boxes' when it comes to their earnings. The reported profit that any insurer can make is largely an accounting construct; that is, actuaries are required to estimate the profile of claims that policy holders are expected to make in the future. Insurers also use rather unique terminology in their financial statements, and the combination of these two factors may deter investors from considering insurers as viable investment opportunities.

Insurance companies can generally be divided up into two main business flows: underwriting, which is the practice of writing and collecting premiums on insurance policies, and paying claims on some of the policies; and the investment of those premiums – also known as the 'float' or reserves.

Underwriting is relatively easy to understand if you think about it from your own perspective. You pay an insurance company money to cover you for the risk of something undesirable befalling you. The amount you pay to the insurance company is the premium, which is usually invoiced annually.

Thousands of customers pay premiums, but not all of them will make a claim on their policies. Insurers attempt to make a profit from collecting and aggregating premiums, paying commissions and expenses for marketing, and then paying a portion out in claims.

If an insurer makes a loss on its underwriting division (that is, when the claims ratio plus the expense ratio exceeds 100%), it is still possible for it to make a profit after the investment of its float. Because these reserves are intended to reimburse policy holders soon after they make an authentic claim, insurers must hold them in assets that provide minimal risk, such as fixed income or short-term cash deposits. Insurers also have shareholders' funds at their disposal, which they usually invest in riskier asset classes such as equities.

You can get a sense of how these main drivers are inextricably linked; an insurer must have a keen awareness of the risk profiles of its policy holders to price its policies correctly. There is an art (and a fair bit of luck) in pricing premiums, and sustainably growing the customer base while also earning a profitable margin. And overlaying this is the fact that like seats on a plane, the insurer is

generally selling a commodity. And then there are black swan events – those that even the best actuarial mathematicians cannot predict. For example, many commentators are predicting that climate change may intensify the frequency and cost of weather related events.

Insurers also have to contend with fraudulent claims, those that end up in court and take years to resolve and produce unknowable cost profiles, and at times, irrational pricing by competitors. It is interesting to note the major Australian retailers, Coles and Woolworths, are following the lead of their British peers in using risk related information from their considerable customer databases to actively promote car and home insurance.

Finally, changing interest rates affect both the discount rates used to estimate future claims and the expected return generated by insurers' reserves. Central banks around the world have dramatically cut short-term interest rates in an effort to stimulate their respective home economies. However, with green economic shoots starting to emerge, the focus has now turned to reducing this quantitative easing, and the yield for long-dated bonds has gradually increased since mid-2012. Some analysts argue that higher long term interest rates may be positive for insurers with a short duration portfolio, or a short claim cycle. Higher rates will also increase the discount rate actuaries use to assess claims profiles, and in turn this should have a positive impact on underwriting profits.

(Prior to its collapse in 2001, HIH Insurance was one of Australia's largest general insurance companies. Readers interested in the inner workings of this general insurer as well as a chronicle of arrogance, ignorance and self-delusion should read the 2005 book *Other People's Money*, by the journalist, Andrew Main).

Obscure terminology and the challenges posed by climate change, black swan events and fraudulent claims make many investors wary of looking on insurance companies as viable investments, even though insurers themselves hold their reserves in minimal risk assets. Indeed, they are difficult to analyse and subject to more unexpected external forces than most companies. Just as running the company is part science and part art, there's a fair bit of luck involved in making a good investment decision.

Roger Montgomery is the Chief Investment Officer at The Montgomery Fund, and author of the bestseller, 'Value.able'. Within the Australian general insurance sector, The Montgomery Fund owns QBE Insurance Group.

My personal perspective on 10 years of the mining boom

Ashley Owen

This year marks the 10-year anniversary and the conclusion of my big plunge into mining stocks. Starting in September 2003, I bought into about a dozen mostly speculative mining and mining-related stocks, to add to my existing BHP holding.

Great speculative mining booms occur about once every 30 years or so in Australia. Before the 2000s boom, the last big one was in the late 1960s. I will probably be old or long gone before the next big speculative mining boom comes along, and so it was good to experience one first hand.

Buying into hope and hype

Following China's entry into the World Trade Organisation in 2001, it took me two years to bring myself to buy mining stocks because of my fundamental dislike of their business model. Digging up rocks and loading them onto the nearest ship while other people in other countries use their brains to turn our rocks into useful things, then buying those useful things back at a thousandfold mark-up with money borrowed from foreigners, seems to me like a dumb idea. That's Australia's main export business model. Add to that the potentially enormous costs of remediating the giant holes in the ground and the environmental issues that are left behind.

So it took me two years to bring myself to buy rock diggers and, worse still, speculative explorers that hadn't even found rocks to dig up yet. I also bought several mining services companies with the idea that they would benefit from a possible mining boom even if the mining companies themselves didn't make money, as almost all miners don't.

Let's be clear. It was not investing, it was speculating, as most of the companies I bought had little or no revenues. Some had little more than hope and hype. It was a gamble that China would hold together politically after the 1989 Tiananmen Square crisis and not go down one of many disastrous paths it had taken before - like the 'Great Leap Forward' in the late 1950s or the 'Cultural Revolution' in the late 1960s to mid-1970s. It was a gamble that the handover of power from Jiang Zemin and Zhu Rongi to the new team of Hu Jintao and Wen Jiabao would be smooth and untroubled.

It was a gamble that the Chinese economy and social fabric would survive the massive banking insolvencies after the bad debt binges in the 1990s. It was a gamble that mining commodities prices would somehow arise from their slumber after going nowhere during the 1980s and 1990s (and indeed falling in real terms over the past century). It was a gamble that China could successfully undertake what would turn out to be the biggest construction boom in the entire history of human existence.

It was also a gamble because I knew the history of mining booms and busts in Australia and I knew of the extraordinarily high failure rate of Australian mining stocks.

Miners and explorers - the great Aussie gamble

Australians love a gamble and one of their favourite ways to have a punt has been on mining stocks. From the early days of the first stock exchanges in the Australian colonies right up to the present day, the majority of stocks listed on Australian stock exchanges have always been mining stocks (or explorers actually). The vast majority of them have never produced a cent in profits nor paid a cent in dividends.

Australians have always been happy to punt on the stock they discover for 1 or 2 cents per share, hoping it will shoot up to $100. There are very few ways in which an ordinary worker can hope to turn a small bet into a fortune – the lotteries, the pokies, the races, and mining stocks. Dot com stocks had their day in the sun in the late 1990s, but the prospect of making a fortune with mining stocks has been around for nearly 200 years since the first copper mine boom in Kapunda and Burra in South Australia, well before the gold rush in Victoria.

In every mining boom, hundreds of new companies are hastily thrown together to harvest money from the pockets of 'investors' (ie punters) caught up in the mining fever. Unfortunately most of the money raised in every mining boom has been lost – either pocketed by promoters, siphoned off by brokers, or simply wasted looking for minerals that are either never found or are found in too low grade to mine profitably.

In every boom the vast majority of mining companies run out of money and collapse, leaving only a small number that survive and sometimes prosper.

Western Mining

One very rare example of success (but only for those investors who got the timing right though the various phases of its life) was Western Mining. It was one of the hundreds of new gold stocks floated in the 1930s gold boom, and one of the few to survive more than a few years.

Western Mining was funded by a group of London investors in 1933 to explore for gold in WA in the gold price boom triggered by the Sterling and US dollar devaluations against gold in the depression. It found commercial grades of gold in Kalgoorlie and then moved progressively into other minerals, including bauxite in the 1950s, nickel in the 1960s, uranium, oil & gas, phosphates, copper, and finally back to gold.

Western Mining was rare in that it managed to make enough money out of several of these booms, and the management then had the unusual foresight and courage to recognise when each boom was over and then to move on in search of the next one. It was a hot gold stock in the 1930s gold boom, a hot bauxite stock in the late 1950s, it was the original hot nickel stock in the late 1960s nickel boom even before Poseidon. Western Mining's discovery of nickel at Lake Lefroy near Kalgoorlie in 1966 kicked off a wild nickel boom. Then it reverted to being a hot gold stock (or rather lukewarm by that time) in the late 1970s gold boom.

Western Mining's share price hit a peak of $19 per share in 1969. The late 1960s nickel boom collapsed in the early 1970s, the late 1970s gold boom collapsed in the early 1980s, and the prices of all commodities including gold, oil and industrial metals fell heavily in the 1990s. Even at the top of the gold bubble in early 1980, WMC only reached $3.50 per share. It reached a peak of $12 at the top of the 1987 stock market boom, but it then collapsed by 84% to just $1.92 in the October 1987 crash.

In 2002 the company was split into WMC Resources, which was taken over by BHP Billiton for $7.85 in cash - a loss of more than 50% for those who bought in the late 1968s boom, and that's before inflation. The remainder was renamed Alumina, which is still listed today and worth around $1 per share. Those investors who bought Western Mining shares its heyday in the late 1960s mining frenzy are still waiting to get their money back after 45 years! It had a great run, and fortunes were made in each of the booms, but the trick is to get out when prices are high and not hang on in the forlorn hope that 'this time it's different'.

Western Mining was very rare in that it survived as long as it did. BHP is another example but it diversified into several other industries beyond mining for much of its life, which included manufacturing behind high protective barriers until they were dismantled in the 1980s and 1990.

BHP shares peaked at £413 in February 1888 at the top of the late 1880s/early 1890s silver and lead mining boom. That's $34.70 in today's dollars in real terms after CPI inflation and after accounting for all of the spits and changes in capital structure over the years. People who bought BHP shares at the top of the 1888 mining boom had to wait 75 years for the share price to recover in real terms after inflation. BHP is still only $36 today as I write this in October 2013, some 125 years later!

These then are the reasons why it took me two years to finally bring myself to buy mining stocks in 2003, when you almost couldn't give away mining stocks, they were so unpopular.

Selling decisions

Making buy decisions is hard enough, but I find what and when to sell even harder. Fortunately several of the stocks I bought were taken over in the 2007-08 mining boom and so those decisions were made for me. Others I sold in the boom because of the crazy prices offered, and I finally sold the remainder this year (although I retain BHP and Rio Tinto shares).

Ten years was a great run and the gamble paid off. There was a lot of luck involved. Most stocks went through the roof, but that's what happens in a speculative bubble. You use the money you can afford to lose. My best stock was Fortescue Metals (FMG), which was little more than hope and hype when I bought in September 2003 for 27 cents per share (or 2.7 cents adjusted for the 10:1 split in December 2007). I had seen Fortescue founder Andrew Forrest take shareholders for a wild ride in Anaconda Nickel in the 1990s (from a safe distance, not as a shareholder) so I knew it was going to be a rollercoaster ride in Fortescue. The difference was that prospects for iron ore in the 2000s looked a whole lot brighter than nickel did in the 1990s (nickel prices halved in the 1990s), so I bought some shares. I sold most of the shares in 2007-08 and the rest recently.

My returns from several of the companies could have been significantly higher had it not been for some selling errors. I sold some too early and others too late, although it helps that they were bought in the early stages of the boom.

Speculating versus investing

There is still money to be made in mining stocks, but it is generally not at the speculative end of the market. Mining booms generally occur in three stages. First there is a commodity price surge when speculative explorers tend to do best - but only if they find something, or at least report that they find something. This was in 2003-2007. This first phase is usually triggered by a rise in demand (this time China) and also by the fact that mining investment had been virtually non-existent during the previous couple of decades since the last boom during which the low commodities prices from the last glut of production made exploration and development uneconomic.

The second stage is a construction boom, when engineering and mining services companies tend to do well. This was during 2006 to around 2010-11.

Finally, there is a production boom and the companies that prosper are the lowest cost producers, usually large scale and diversified. Commodity prices fall as supply increases when new mines start producing, costs rise, the higher cost producers get squeezed but the lowest cost miners prosper. Most of the holes in the ground end up being abandoned, boarded up or flooded with water.

I still hold shares in BHP and Rio Tinto, which are low cost, high volume producers that are likely to survive even if commodity prices fall, as they are likely to do as new supply comes on stream in the coming years. They are held as parts of well-diversified, long term, multi-asset class portfolios.

It is one thing to reminisce about speculative booms but they are few and far between, and the trick is to get in early when they are deeply unpopular. Never buy into the hype at the top of the boom - that is when you should be thinking about selling, not buying.

In the meantime investors need to be very careful with their long term wealth and this requires investing prudently, not gambling or speculating. Speculating is fine if done with money you can afford to lose, and kept well away from long term portfolios. Speculating is for buying beach houses, boats and Bentleys. If it doesn't work out it doesn't matter. On the other hand, long term portfolios are what investors and their families are going to have to rely on for the rest of their lives, and that calls for 'investing', which means sensible diversification and disciplined risk management.

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RBA on FX risk, super diversification and watching SMSFs

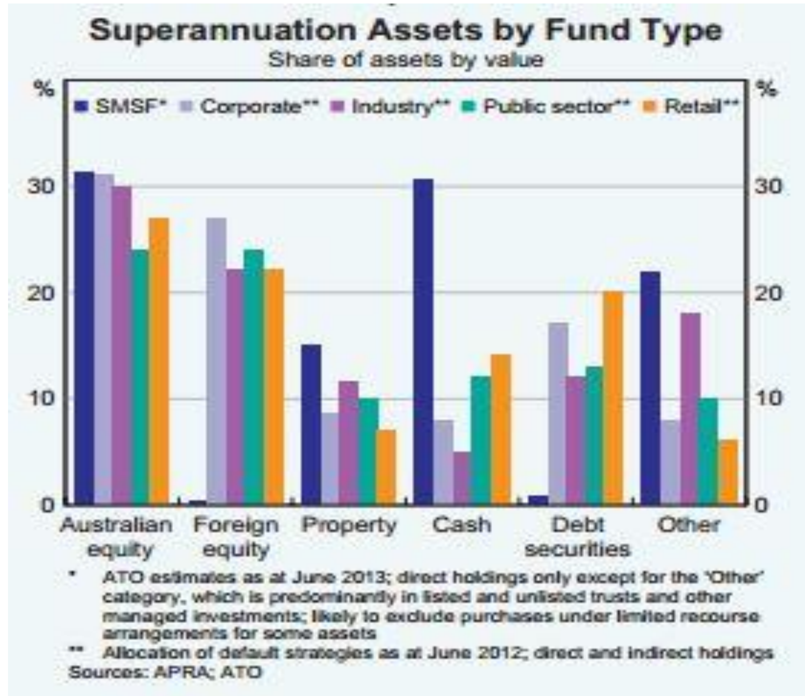
Graham Hand

Inside the University of Technology in Sydney is the Paul Woolley Centre for the Study of Capital Markets Dysfunctionality (that name is quite a mouthful, Paul). It is gaining a global reputation, and its annual conference held last week was attended by bankers and academics from around the world. Its main role is to evaluate the extent to which the financial services industry does an efficient job for clients and the economy.

At the conference, the presentation by Dr Luci Ellis, Head of Financial Stability Department at Reserve Bank of Australia, was particularly interesting for anyone looking at Basel III, and the relationship between regulations and market efficiency. The speech is on the RBA website, here**.**

My interest was on superannuation and SMSFs, and I asked Dr Ellis this question:

At the moment, there is an extraordinary coincidence in Australia that three macro statistics are all approximately the same at about $1.6 trillion: total assets in superannuation, market capitalisation of the ASX and the GDP of Australia. However, all forecasts are that superannuation will grow far quicker than the other two. Do you see any implications for financial stability, and particularly, that too much superannuation money will chase too few Australian assets in future (SMSFs hold 30% of their assets in direct Australian equities but a tiny amount of their assets in international shares, in which institutional funds place about 25% of their assets).



Source: Reserve Bank of Australia, Financial Stability Review, September 2013.

Dr Ellis: I think that's a really interesting question and as you look at the Financial Stability Review that we put out last month you'll notice that actually we beefed up our superannuation section, not just about self-managed but about funds management more generally. The growth of superannuation in Australia is a development that we did not fail to notice, and consequently we're very alert to what that might mean for different responses of asset dynamics and what that might mean for credit growth and so forth.

I'm not sure I buy that the fact that there's only so much ASX will mean that somehow everyone's constrained because other things will adjust. Firstly there isn't actually an investment mandate to superannuation funds that they must only invest in the ASX rather than equity in other countries, and you know we're a small part of the world.

So I think the important issue there is the capacity of superannuation funds to manage FX risk. And so you need a deep and liquid hedging market to make that happen, you need an FX swap to make that happen. Now the good news is Australia has a very deep and liquid two-sided FX swap market, because you've got banks borrowing offshore in foreign currency, they don't want foreign currency, they want Aussie dollars. So they want a swap one way, and you've got a combination of Kangaroo bond issuers and Australian funds managers investing off shore so the fund managers have got a foreign currency asset and they want an Australian dollar asset. And so there's a natural two-sided market for these swaps.

And the global investment banks are involved, they're sitting in the middle intermediating this risk transfer and you know it's a very stabilising system to be able to do this. A lot of countries do not have the privilege of being able to access global capital markets without it blowing up in their face from FX risk, which is what we saw in the Asian crisis.

So I guess my answer is other things will adjust and part of that will be the investment mandate of super funds will be more diverse, and that's probably a good thing. There will still need to be deep and liquid FX swap markets, there will need to be good risk management in super funds.

One of the interesting points - and this comes down to the box we wrote on self managed super in the Financial Stability Review - where we noted that self-managed super had about the same

allocation to domestic equities as other kinds of super funds, but they've got almost no allocation to foreign equities. In some sense, maybe one of the issues is there's going to be a trade-off between managing your fund and having more control and actually having a diversity of allocation.

But that's kind of in the realm of speculation; I think that the answer to your question is other things will adjust.

What to watch when you're focussed on financial stability

Dr Ellis was also asked about the risks to financial stability at the moment, and she highlighted SMSFs and property. It was fascinating to hear her rules-of-thumb on what the regulator watches.

Dr Ellis. We have explicitly said in the Financial Stability Review that self-managed super funds are not a near term risk to financial stability. What I would emphasise here is if you want two rules-of-thumb to know what to do about financial stability analysis:

- one is take a closer look at things that are growing quickly
- second is follow the spruikers.

And the fact is that self-managed super funds have certainly been a target for a lot of advertising at the moment, promoting what is essentially a very concentrated and leveraged asset in their super funds. You could end up with quite a deal of asset concentration, that's certainly a sort of investor protection issue. I've learnt over the years that investor protection issues are often a signal of a potential but not definite financial stability risk further down the track.

Our observation … is that most of the property that's in self-managed super is actually in commercial real estate, there's a number of tax reasons for that, but the residential side is growing quickly from a very low base. So what we said in the Financial Stability Review is this is a new source of demand that wasn't previously there, self-managed super funds didn't have scope to contribute to demand for residential property. It's an additional source of demand dynamic that we're going to keep a good eye on in the future.

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