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Financial flexibility key to meeting aged care costs

Rachel Lane

The Aged Care Reforms due to commence on 1 July 2014 are designed to create more of a 'user pays' system. On the face of it, people contributing towards the cost of their aged care based on their assets and income and having a market price system for accommodation payments sounds fair and reasonable. However, the reality is quite different.

Firstly, let's look at the group of people the government already classify as financially disadvantaged, known as supported residents.

Under the current system, supported residents are assessed solely on their assets. People with assets below \$45,000 are eligible for full support and cannot be asked to pay an accommodation bond or charge. People with assets above \$45,000 but less than \$116,136 are partially supported and make a contribution towards the cost of their accommodation, with the government providing a 'top up' through the accommodation supplement to the facility.

For example, Shirley is 82 and receives the full pension. Her assets total \$95,000 in cash and personal effects. Under the current system the maximum amount Shirley can contribute towards the cost of her accommodation is \$50,000 as a bond in Low Care (plus a retention amount of \$331 per month) or \$24.04 as a daily charge in High Care. Under the new system Shirley will be assessed based on her assets and her income according to a comprehensive means test:

- 50c per dollar of income above \$24,731 plus
- 17.5% of her assets between \$45,000 - \$154,179.

In Shirley's case, the accommodation charge (or Daily Accommodation Contribution (DAC) under the new regime) would be the same pre or post 1 July.

The issue for Shirley, and many current high care residents, is that once they pay their accommodation charge plus the basic daily care fee and an allowance is made for personal expenses, the cost of living in aged care exceeds their income.

Under the new system, Shirley will have the choice of paying by a lump sum (Refundable Accommodation Contribution or RAC), a daily charge (DAC) or a combination. Calculating the lump sum amount for Shirley is done by taking the daily charge and converting it using the Maximum Permissible Interest Rate, currently 6.63%. The equivalent RAC for Shirley is \$131,984 which she cannot afford to pay and the aged care facility is still required to leave her with the minimum assets amount of \$45,000. So, if Shirley wants to pay by lump sum the most she will be able to pay is \$50,000 and the remaining amount (\$81,984) would be paid by a daily charge of \$14.93. Shirley could also choose to have her DAC deducted from her RAC, but this would have the effect of reducing her assets over time.

I know it's confusing but unfortunately, that's the system.

Now let's look at non-supported residents who find meeting the cost of care difficult. They are not eligible to be supported and don't have the means to pay the market price for accommodation, they are in 'no man's land' financially.

These were probably the same people concerned by stories of \$1 million+ accommodation bonds and believed that a set market price was a means of reducing the amount aged care facilities can charge. The fact is that the only people currently paying \$1 million bonds are those that have more than \$1 million in assets, and in many cases they are receiving a discount from the aged care facility for doing so. There are facilities that have published a market price of \$1 million and more post reform. Whether the market price is \$350,000 or \$1 million, residents who are not eligible to be supported will need to pay it.

Consider this example:

Jack and Jean are pensioners and Jack needs to move into care. Jean will remain living in the family home. They have \$400,000 in investments, a car worth \$30,000 and \$20,000 in personal effects. The market price at their chosen aged care facility is \$400,000 by lump sum (RAD) or \$72.66 daily charge (DAP).

Under the current rules Jack could be asked to pay a maximum accommodation bond of \$180,000 **or** an accommodation charge of \$34.20 per day. Under the current system the aged care facility can charge Jack \$180,000 but still get an average of \$400,000 by charging a person with higher assets \$620,000.

Under the new rules the person with higher assets can only be charged \$400,000, so Jack needs to pay \$400,000 or the equivalent thereof. If he chooses to pay by lump sum his maximum RAD will still be \$180,000 as the assets of a couple are assessed on a 50/50 basis and the facility must leave him with \$45,000. The remainder of his accommodation payment (\$220,000) will need to be paid as a daily accommodation payment of \$39.96 per day. While this measure is designed to 'protect' Jack, it actually puts Jack and Shirley in a situation where they are forced to pay interest at 6.63% when they can only earn interest from their investments at around 4%.

The person that has really been 'protected' is the person with higher assets, who would have paid the \$620,000 bond under the old rules, as now they cannot be charged more than the market price. Because no-one can pay more, no-one can pay less so those who are less well-off will simply need to pay more.

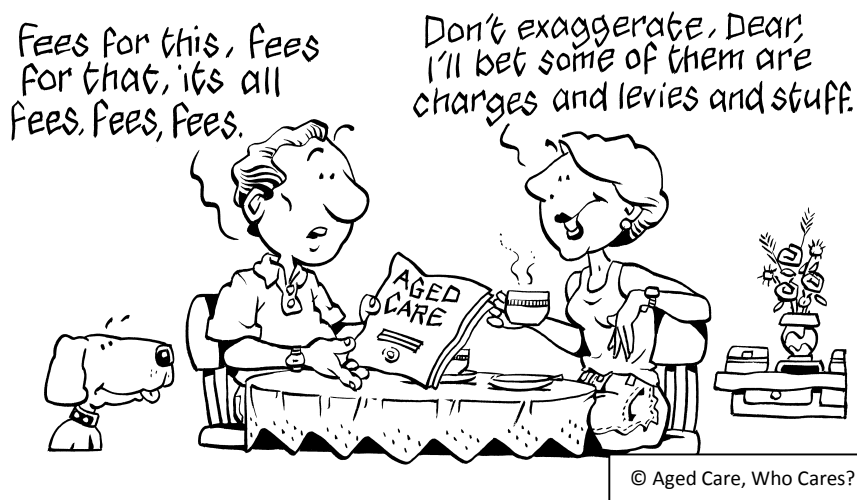
The following example shows how people with greater financial flexibility can achieve a better outcome for themselves:

Fred is currently a part pensioner with a house worth \$850,000, \$500,000 of investments and \$10,000 in personal effects. His chosen aged care facility has a market price of \$450,000 RAD or \$81.74 DAP. The estimated market rent for his house is \$350 per week (net).

If Fred pays for his cost of accommodation by DAP, his cost of care will be \$55,111 per annum. His pension entitlement of \$372.92 per fortnight (\$9,696 per annum) together with his rent (\$18,200) and interest (\$20,000) would leave him with a cash flow shortfall of around \$7,200.

If Fred instead used \$440,000 to pay towards his RAD, paid \$10,000 by DAP, his ongoing cost of care would reduce to \$25,674 and his pension entitlement would increase by \$12,217 per annum. Fred's cash flow would then have a surplus of around \$16,800.

As is often the case, those with 'financial flexibility' will be best placed to meet their cost of care in the most effective way. People who have a house as well as significant assets outside their home will have the choice of keeping the house (and potentially renting it out) and utilising their savings to meet their costs. Structuring assets in this way can enable the person to receive a 'double exemption' on their assets for pension purposes, as the house is an exempt asset (for two years) and the refundable accommodation bond is also an exempt asset. The exemption on the family home (and any rent received) can be extended for an indefinite period where the resident pays at least some of their accommodation payment by DAP while renting the house. From an aged care point of view, the family home has a capped value of \$154,179 unless a protected person lives there. Investments contribute to the means tested fee under both the asset and income tests. Moving investments to a RAD would still have them assessed as an asset but would exempt them from the income test.



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[Australia's default: who do you rescue?](#)

Ashley Owen

[Part 1](#) of this story discussed government debt, both domestic and foreign, and the various ways in which governments can avoid repaying their debts in full, through default, restructure and/or inflation. We also looked at the extraordinarily high levels of Australian government debt in the early 1930s compared to the debt levels of countries in the current government debt crisis.

In Part 2, we look at how Australia's government debt default and restructure occurred, which bond holders were rescued, and which took a 'haircut' on their interest and principal repayments and had to wait decades to get their money back.

Inflation was not an option

For most countries, the easiest way to reduce the real debt burden is via inflation – to repay debts with paper money that is less valuable in terms of its real purchasing power.

Inflation was not an option for Australia in the 1930s depression. Australia was crippled by price deflation as global commodity prices collapsed by up to 50% and more, and unemployment soared to 30%. The government was unable to create inflation despite abandoning the gold standard in January 1930 and devaluing the Australian pound progressively through 1930 and 1931. Instead of inflation reducing the real size of debt and interest payments, price *deflation* did the opposite. It increased the real cost of interest payments and the real size of debts.

The government had already cut wages by 10% in May 1931 and also cut pension payments to save money, and additional cuts were unlikely to be palatable or politically feasible.

On 1 December 1930 and again in April 1931, the government's wholly owned Commonwealth Bank very pointedly and publicly refused to lend it more money to finance the government deficit or infrastructure spending. (The Commonwealth Bank carried out some central banking roles prior to the establishment of the Reserve Bank of Australia in 1959. The Commonwealth Bank's 1930 refusal was the first step down the long road toward the independence of central banking in Australia).

On 30 April 1931 the NSW government defaulted on interest payments due in London. Then on 30 June the Commonwealth government's account in London had run out of money and the Bank of England had to make an emergency bail-out loan so that Australia could pay maturing treasury bills on the London market. With more payments due in August, the government had to decide who not to pay.

Who do you rescue - your own citizens or foreign bankers?

There was no way out for the government. Tax revenues were falling, welfare costs were rising, foreign debt markets had closed their doors on Australia, local domestic savings were drying up, banks wouldn't lend to the government and even the Commonwealth Bank refused to lend it more money. Something had to give. Interest payments were falling due and maturing debt needed to be repaid or refinanced.

In the end, the government decided that Australian domestic bond holders should suffer losses to ensure that the London bankers were paid in full on the foreign debt owed in pounds sterling. This was an extremely controversial and hotly debated topic at the time. With local unemployment rates running at 30% and wages and pension already cut, the government decided that ordinary 'mum and dad' bond holders should suffer even more losses so that 'greedy' London bankers would get paid in full!

There were several reasons for this decision. The first was a widespread and deeply held sense of national pride - to restore our international reputation, and to restore Australia's credibility and ability to borrow on international markets.

As it was so controversial, a national referendum was held on the issue. 97% of domestic bond holders who voted in the referendum effectively volunteered to take a loss on their bond holdings so that the foreign creditors wouldn't suffer any losses, for the good of the country and its international reputation. This was most unusual. Usually countries choose to repay their own citizens in full and let foreign creditors take a loss.

A second reason was that it was our duty as a loyal colony to do everything we could to repay our debts owed to the mother country, just as it was our colonial duty to send our troops off to help Britain in the two World Wars.

A third reason was that the government policy was effectively being run by the London bankers, in Sir Otto Neimeyer, the Bank of England's representative sent to clean up our finances, and the Chairman of the Commonwealth Bank, Sir Robert Gibson, whose policies reflected those of the London bankers.

The lesson is that if most of a government's debt is owned by foreigners, then foreigners control the agenda. Japan today has astronomical levels of debt - similar to Australia in the 1930s - but at least it controls its own agenda because almost all of its debt is owned internally by Japanese government departments, pension funds and individuals.

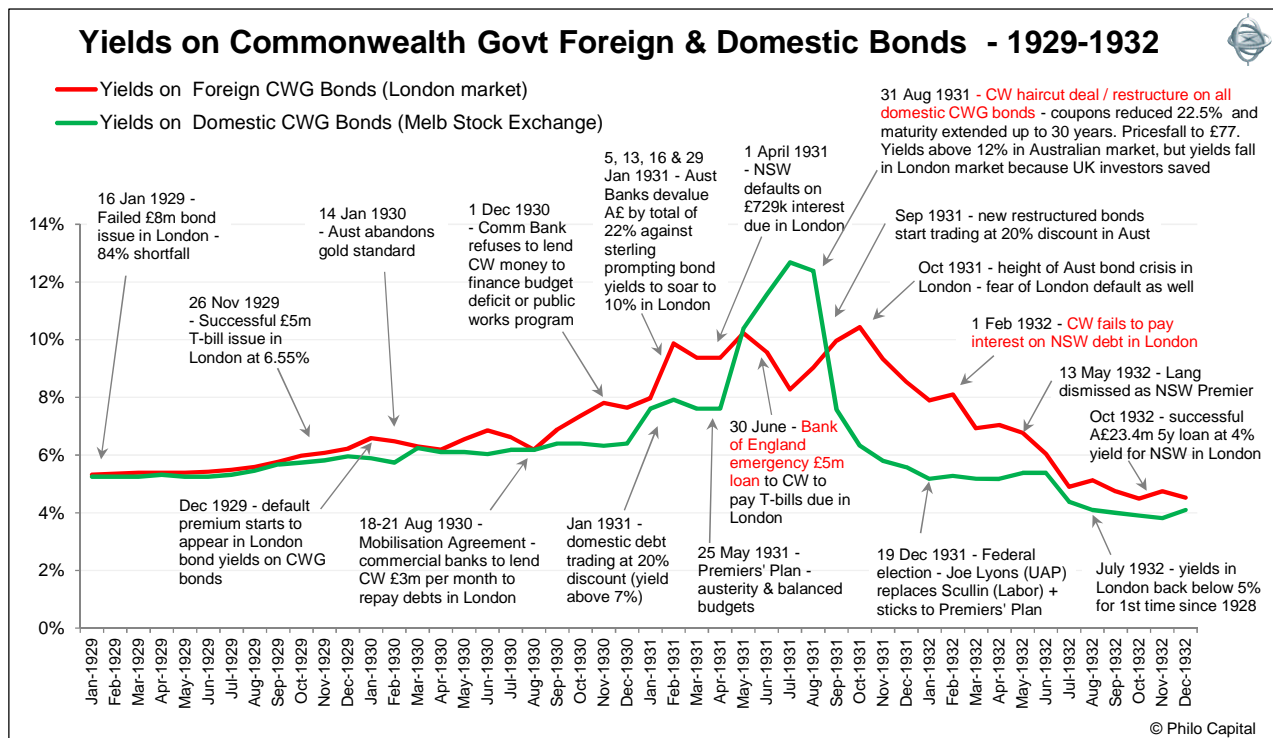
In contrast, most of the US government's debt is owned by foreigners (as is half of Australia's current debts), led by China, and so the US runs the risk of losing control of the agenda if and when its debt problems escalate to crisis levels. In the 1980s we saw escalating nationalist trade and currency disputes between Reagan and Nakasone when the US became the world's biggest debtor nation with Japan controlling the debt, and we are seeing similar trade and currency tensions escalating today between the US and China.

Australia's debt restructure 'haircut' deal

Following the successful national referendum, the Commonwealth legislated to mandate a Greek-style debt restructure deal in which all domestic (Australian) holders of government debt took a 'haircut' on their bond holdings. Interest on all bonds was reduced by 22.5% and repayment of principal was delayed for up to 30 years.

The big default occurred on 31 December 1931 when the Commonwealth defaulted on (failed to pay) interest and maturing principal on all of its domestic bonds. The compulsory Conversion Bill did not become law until January 1932 after it was ratified by the States.

The following chart tells the story through bond yields. It shows market yields on Australia's long term bonds between 1929 and 1932, together with the key events leading up to, during, and following the haircut restructure. The green line shows market yields on domestic (Australian pound) debt, and the red line shows yields on Australia's foreign debt owed in British pounds.



From December 1929, yields started to rise on bonds trading on both domestic and foreign markets, reflecting a fear of possible default creeping into investors' minds.

Yields on domestic bonds reached almost 13% in July 1931, just before the default. With general price inflation running at 10% deflation this equated to real bond yields of around 23%, which was similar to Greece's March 2012 haircut deal on Greek bonds.

Yields on domestic bonds fell immediately when certainty was restored with the haircut deal, just as they did in Greece.

However, yields continued to rise on Australia's foreign bonds in the London market, due to fears that Australia would have to mandate a restructure of its foreign debt as it had done with its domestic debt. Foreign investors were given a further scare when the Commonwealth government failed to pay interest due on NSW debt in London on 1 Feb 1932. This was a relatively 'minor' default, but still technically a default, quickly rectified.

Yields in both markets started to fall steadily during 1932 after the conversion was put in place and after Joe Lyons replaced Jim Scullin as Prime Minister. By July 1932, yields in London were back below 5% for the first time since 1928 and in October the Commonwealth did a successful raising for NSW in London on a yield of 4%. Confidence was restored and the crisis was over.

In part 3 of this story we look at the investment returns achieved by bond investors before, during and after the debt default and restructure. The outcomes are rather surprising.

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Diversification lessons from the GFC

Harry Chemay

In [part 1](#) of this trilogy we reviewed the work of Harry Markowitz and William Sharpe, whose ideas shape our understanding of diversification, the foundation stone on which modern portfolio theory sits. In part 2, we look at risk in a diversified portfolio, and how well diversification performed in Australia during the Global Financial Crisis.

Diversification and superannuation governance

All Australian superannuation funds must adhere to the investment strategy operating standard embedded within legislation which (in part) states that the trustee of a super fund must:

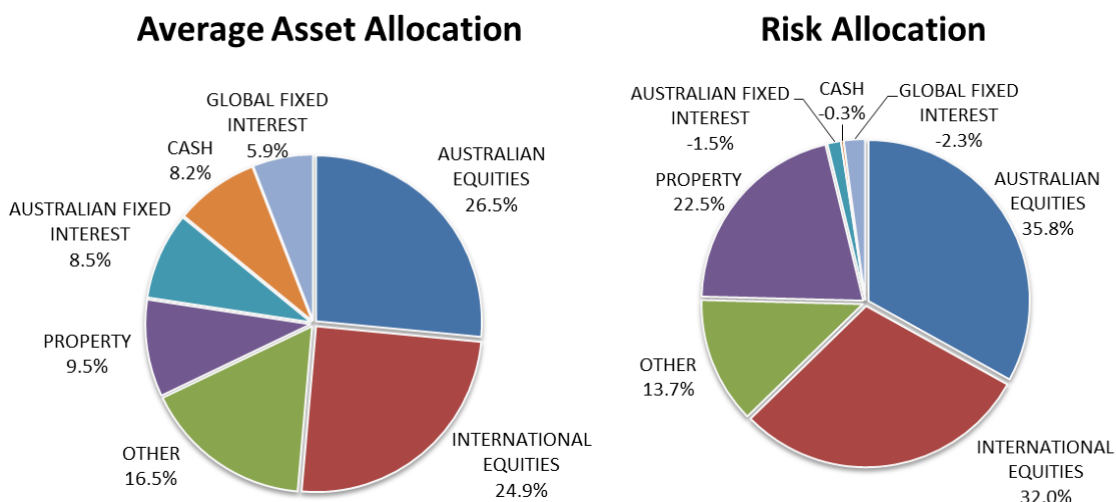
"...formulate, review regularly and give effect to an investment strategy that has regard to...the risks involved...and the likely returns from...the entity's investments, [as well as]...the composition of the entity's investments as a whole, including the extent to which they are diverse or involve exposure of the entity to risks from inadequate diversification."

The Markowitz/Sharpe language of expected (likely) returns, risk and diversification is explicitly included. As every superannuation trustee is legally obliged to meet the above operating standard, it applies equally to the 300-odd APRA regulated super funds as to some one million individuals who are trustee-members of SMSFs.

A 2007 government-funded financial literacy study found that whilst 55% of people considered potential returns when making financial decisions, only 34% considered risk and return together. More worryingly perhaps, only 5% considered diversification. How therefore should we assess our exposure to "risks from inadequate diversification"?

Diversification by capital and by risk

In the previous article investment diversification was illustrated with reference to a pie chart for the average default APRA-regulated superannuation option. The current average default option holds some 61% in property and equities, 22.5% in cash and fixed interest and 16.5% in alternatives strategies. The chart from Part 1 is reproduced below left.



The chart on the right indicates how much each asset class contributes to total portfolio volatility (based on monthly data for the ten years ending December 2013). Australian equities, whilst comprising 26.5% of capital, contribute almost 36% to portfolio volatility. International equities and Australian property likewise add more to portfolio risk than their respective capital allocations. Alternative strategies, taken together, are the only growth-like asset class that contributes less to portfolio volatility than to capital allocation. [Editor's note: The risk and volatilities contained within the alternatives asset class varies widely depending on what alternatives are used.]

In the average default super option today equities and property account for some 61% of capital, but more than 90% of portfolio volatility. To determine why, one first needs to understand the effect of asset co-movement.

Correlation – the key to diversification

The objective of intelligent diversification is to find investments that do not move together in response to the same stimulus, but will in aggregate provide a satisfactory return. Asset co-movements are generally measured either by covariance or correlation. A correlation coefficient is always bounded by -1.0 and +1.0. Risk is effectively nullified if a portfolio consists of two assets with a correlation of -1.0, similar to sound waves of equal but opposing amplitude. A correlation of +1.0 implies two assets with perfectly synchronous movement, providing no risk reduction benefit at all.

Harry Markowitz's key insight was that *if* you could accurately forecast the return and risk of each security in a portfolio and their various correlations, you could create a diversified portfolio *optimised* between risk and return based on your risk tolerance. In determining what he called 'relevant beliefs', Markowitz suggested reviewing historical statistics and adjusting these for "factors or nuances not taken into account by the formal computations". In other words, the best guess as to what might happen in the future is that which has occurred most frequently in the past, adjusted for any 'relevant beliefs' as to future market movements.

Taking the Markowitz approach, the following risk (standard deviation) and correlation statistics compare each asset class with the diversified default option portfolio shown in the above pie chart:

	Cash	Aust Fixed Interest	Global Fixed Interest	Aust Equities	Global Equities (UH) [#]	Aust Property	Alternatives (UH) [#]	Diversified Portfolio
10 Year Risk (pa)	0.41%	2.74%	2.88%	13.63%	11.48%	9.44%	7.71%	6.73%
10 Year Correlation	-0.24	-0.17	-0.25	0.82	0.87	0.74	0.56	1.0

[#] UH – Currency unhedged

The statistics above reveal why the risk allocation chart differs so markedly from the asset allocation chart. In a portfolio where growth assets dominate, the high volatility of equities and property imposes an outsized influence on total portfolio risk; an influence that low volatility cash and bonds cannot overcome despite the risk dampening effect of their negative correlations.

All the above is wholly consistent with William Sharpe's pricing model, which holds that higher risk must accompany higher expected returns in order for capital markets to clear. But what of diversification during the GFC? Did it fail when needed most?

Diversification and the GFC

Let's examine the correlation of Australian equities to other asset classes below:

Timeframe	Cash	Australian Fixed Interest	Global Fixed Interest	Australian Property	Global Equities (UH) [#]	Alternative Assets (UH) [#]
10 years to Dec 2013	-0.27	-0.38	-0.20	0.67	0.48	0.05
2007 – 09	-0.36	-0.44	-0.24	0.73	0.56	0.08
2008	-0.10	-0.48	-0.47	0.79	0.59	0.36

[#] UH – Currency unhedged

The movement of growth assets did indeed become more synchronous during the GFC. That Australian and global equity correlations increased in the midst of such a downturn should not have surprised. The increased correlation between Australian equities and Australian property was, at the time, less expected and was a result of listed property trusts (A-REITs) having become more equity-like in the years leading up to 2007.

Placing \$10,000 in each of the following on 1 January 2008, generating index returns with no contributions, withdrawals, fees or taxes resulted in the following capital value changes by year's end:

Cash	Australian Fixed Interest	Global Fixed Interest	Australian Property	Australian Equities	Global Equities (UH)#	Alternative Assets (UH)#	Diversified Portfolio
\$760	\$1,495	\$1,343	-\$3,196	-\$3,892	-\$2,492	-\$833	-\$1,976

UH – Currency unhedged

The above data dispels the notion that diversification's protective qualities disappeared completely during the depths of the GFC. Whilst capital loss was greatest in equities and property, the diversified portfolio's weighting to these assets was partially offset by strongly positive cash and fixed interest returns, and by lowly-correlated alternative asset strategies that fell only marginally by comparison. Rumours of diversification's death during the GFC appear to have been greatly exaggerated.

Where to now for diversification?

Diversification works in theory and it appears to hold up in practice. Where it is found wanting is in the assumptions it makes of the average investor's ability to form 'relevant beliefs' as to risk, returns and correlations. Here modern portfolio theory appears somewhat detached from human behavioural reality, as I commented in the Cuffelinks article: [The Harry Markowitz Interview, Part 2: Retail financial advice](#).

The concluding article in this trilogy will incorporate aspects of investor behaviour by considering an alternative approach to diversification in retirement planning.

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The author would like to acknowledge Matthew Drzewucki, Investment Analyst at Equisuper, for his assistance in the analytical work involved in preparing this article.

The total portfolio volatility analysis was conducted using monthly index returns for the period January 2004 to December 2013. Risk allocation is the historic co-variation between each asset class and the total portfolio, expressed as a percentage of the aggregate variance of the portfolio.

The following indices were used as asset class returns: Australian equities – S&P/ASX 300; Australian property – 50% Mercer/IPD Australia Property Fund Index and 50% S&P/ASX 300 A-REIT; International equities – MSCI World (ex-Aust) net AUD unhedged; Australian fixed interest – UBS Australia composite bond index 0+ years; Global fixed interest – Citigroup world government bond index AUD hedged; Cash – UBS 90 day bank bill index 0+ years; Other – 33.33% Cambridge Associates Australian Private Equity & Venture Capital index, 33.33% MSCI world infrastructure net AUD unhedged, 33.33% HFRI hedge fund composite index gross AUD unhedged.

The prospects for investors in India

Casey McLean

The largest election the world has ever seen has been run and won in emphatic style. India will be governed by Narendra Modi's Bharatiya Janata Party for the next five years after his coalition scored the biggest election win in 30 years, securing 61% of the seats. Voters tired of corruption, bureaucracy and slowing growth have ousted the Ghandi dynasty, whose Congress Party had dominated politics since independence. Such a strong mandate will be an inflexion point for India's growth story, which has been hamstrung by bureaucracy for the last five years.

Under the Congress Party, red tape strangled growth and stalled critical infrastructure projects. Gross domestic product (GDP) growth slowed from 11.4%, annualised, in the March quarter 2010 to the latest reading of 4.6%, whilst recent inflation, as measured by the Wholesale Price Index, has averaged 7.9%. Structural impediments that widened the twin deficits also meant India's reflexivity with the global economy increased.

India now has the opportunity to move from a period of stagflation to become a self-fuelled growth story independent of the global economy. Investors and locals alike appear universally positive that Modi's pro-growth and reform platform can reverse the previous policy paralysis and quickly return GDP growth to the 6-7% level. Such goals appear achievable through infrastructure investment, clearing growth bottlenecks and productivity gains from the power and oil sectors, which should help to revive consumer sentiment. Additionally, with only 2.5% of India's exports being raw materials to China, the growth trajectory should be unaffected by any slowdown in Chinese investment. All of this makes India a compelling case to be the best performing market in Asia on a three- to five-year view. However, it is not without its challenges.

A growth rate closer to 8% will require difficult supply side reforms. But here Modi has some runs on the board. As Chief Minister for Gujarat during the last 12 years, Modi has put through reforms, courted foreign companies, developed infrastructure, built free-trade zones, irrigated agricultural land, increased the operating efficiency of state companies and reduced poverty. Agriculture was a key focus that had significant success with crop yields increasing by 30 to 300% during the last decade. The net result is that Gujarat has had GDP growth of 10.4% per annum during the last five years compared to 6.4% per annum for the nation.

In his first month in office, Modi has not put a foot wrong, providing the market with incremental evidence that his policies are not just talk but will be actioned and perhaps at a faster pace than expected. Measures executed thus far include reducing cabinet numbers by 38% ("minimum government, maximum governance"), creating a fast-tracked project approval process, establishing a 'bad bank' to manage public sector banks' non-performing loans, removing foreign direct investment limits in the defence sector and even easing tensions with neighbouring countries by inviting all heads of states to his inauguration.

Foreign investor inflows have been strong, having been starved of alternatives in emerging markets. Inflows year-to-date amount to US\$20.4 billion, more than 1.67x the total inflows of 2013. However, the flows are still slightly skewed towards bonds as opposed to equities. Equity inflows still have potential to significantly increase, driven by rotation out of bonds as well as fresh inflows. During the last two years, the average foreign equity inflows amounted to 15.9% of the market cap, more than double the 7.8% received year to date.

Anecdotal evidence suggests the bulk of the flows have come from Asian equity funds and a small portion from global emerging market funds. Global equity funds are yet to enter the market, having been unwilling to take a bet on an election outcome in a country that is just 0.7% of their benchmark. Now that the election win is confirmed, they need to see evidence that the policies are being put in place. The key evidence of this will come in the form of the Union Budget to be delivered in early July.

But do not expect a V-shaped recovery in the economy. Structural issues take time to resolve. Stalled projects need financing to restart, fiscal discipline will require tightening and monetary policy still remains

tight. The budget in particular is difficult to forecast with a long list of potential policies and Modi's recent declaration that he needs to take "harsh decisions and administer some bitter medicine".

The biggest near-term risks to the recovery are oil prices and a weak monsoon. With India importing about 80% of its oil requirements, a supply shock from the recent Iraq conflict may send oil prices higher whilst restraining global growth and depreciating the rupee. This would have significant current account implications as well as affecting the government's ability to remove subsidies and deregulate the sector. A weak monsoon, as predicted by El Nino conditions, will also constrain near-term growth in an economy where two-thirds of the population is rural.

Longer term, the rupee remains a headache for policy makers. High inflation relative to trading partners and no growth in the share of world exports suggests the rupee should be weaker yet it is appreciating driven by inflows. As a result the currency is now estimated to be 6.4% overvalued in real effective exchange rate terms. Inflows are currently limited to portfolio inflows and remittances from foreign workers. However, if foreign direct investment regulations are relaxed, as they have been in the defence sector already, inflows could accelerate creating additional appreciation pressure. The Reserve Bank of India (RBI) seems to have learnt from its mistakes in the post-Global Financial Crisis period when it let the currency appreciate to the point where it caused economic stress. The RBI appears to have drawn a line in the sand around the Rs58 per US dollar level which they appear committed to defending.

In the short term, the market may have run too far too fast. The rally has lifted all cyclical stocks indiscriminately, and the market is overbought on most metrics. There will be some lag between a pickup in corporate earnings, with most companies suggesting the impact will not be felt until next financial year. With the market likely to become more discriminate and a lack of catalysts ahead of the budget, there could be some consolidation in the near term. Investors should use this opportunity to position for a multi-year growth story.

Stocks and sectors that will have the greatest benefit in the new growth cycle will be those that have suffered the most in the down-cycle. This includes areas such as capital goods, infrastructure, cement, property, auto and banks. Sectors to avoid are telcos as competition increases, IT services and pharmaceuticals if the rupee appreciates and the defensive consumer staples.

Casey McLean CFA is an Asian Equities Portfolio Manager/Analyst with AMP Capital.

Respect for markets and judging High Frequency Trading

Miles Hellyer

AQR Capital Management marked its tenth year of operations in Australia with a series of thought-provoking presentations in June. Over the ten years, Australia and New Zealand have grown to become AQR's largest client base outside of the US, representing nearly one sixth of the firm's total assets under management. Among the presenters were two of AQR's principals, David Kabiller who spoke on what makes a good investment strategy and Michael Mendelson on the misconceptions of High Frequency Trading (HFT).

Long term optimism and short term paranoia

Kabiller, who heads up Client Strategies for AQR, oversees client relationships, business development and strategic initiatives. In his presentation, Kabiller said that "long term optimism and short term paranoia" is a core element of a good investment strategy. He discussed AQR's development and the lessons from his experience that he brings to investors.

According to Kabiller a 'depression era mentality' and a respect for markets and competition are things that inform a sound investment strategy. Investors must have the discipline to follow their chosen path while having the humility to adapt. He also spoke of AQR's desire and curiosity to understand markets.

AQR has itself experienced a short-term crisis while working towards a long term goal. Founded in 1998 during the tech bubble, AQR saw their portfolio lose nearly 40% from 1998 to 2000 before rebounding with 79% growth until 2001. Kabiller said that the lesson to be taken from this volatile period is to maintain a great respect for markets and competition.

In his presentation Kabiller also touched on diversification and its importance in today's market. He referred to a "very big retirement problem in the world", suggesting that too many people still have undiversified investment strategies. He believes that people should have a respect for the market in aggregate and work to have a better understanding of risk and return sources.

Kabiller suggests that an allocation to hedge funds is necessary for diversification as they are not as reliant on economic health as other traditional assets. He did, however, warn investors to be wary of hedge fund managers using leveraged strategies with high beta as these funds have a greater risk of being at the mercy of a falling market.

High Frequency Trading shouldn't cause panic

Michael Mendelson showed his support for High Frequency Trading (HFT) while speaking at AQR's seminar.

Mendelson said that markets have been under more criticism than ever before but defended HFT for the liquidity it brings to the market. He believes that the technology used by high frequency traders and the nature of their strategies have lowered transaction costs for investors and been largely beneficial.

Mendelson addressed the misconceptions of HFT, stating that high frequency trading is a strategy and not low latency technology. Furthermore, he made a point to mention that quantitative and algorithmic trading is not high frequency trading.

In reference to Michael Lewis' new book '*Flash Boys*' which has recently brought some negative media attention to high frequency traders, Mendelson states that the claims made by Lewis about the profits of high frequency traders are greatly exaggerated and that the reality is a US\$1.1bn annual profit for the industry as a whole.

Mendelson condemned what he called the 'salacious criticism of markets' and said that the negative publicity directed at high frequency traders has largely stemmed from people who have had their business model disrupted.

When asked about how investors can be certain that high frequency traders aren't accessing information on the way to the exchange Mendelson responded, "it would be illegal" and he would find it hard to believe that traders who wanted to remain in the market would risk it.

Mendelson did point out however that investors don't live in a market that is free of problems. For investors who wanted reassurance from their fund managers, he suggested that they ask managers what they are doing to protect themselves from systems risk and to ensure that they understand the markets they are trading in.

While concluding, Mendelson urged people to resist any proposals by governments, regulators or exchanges to introduce transaction taxes as these would be detrimental to investors worldwide. As well as simultaneously taxing banks and hurting high frequency traders, they are ultimately a tax on all investors.

Miles Hellyer is the founder of Chalk Marketing, a Sydney-based marketing agency.

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