Cuffelinks

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This Week's Top Articles

Some challenges ahead for 2015

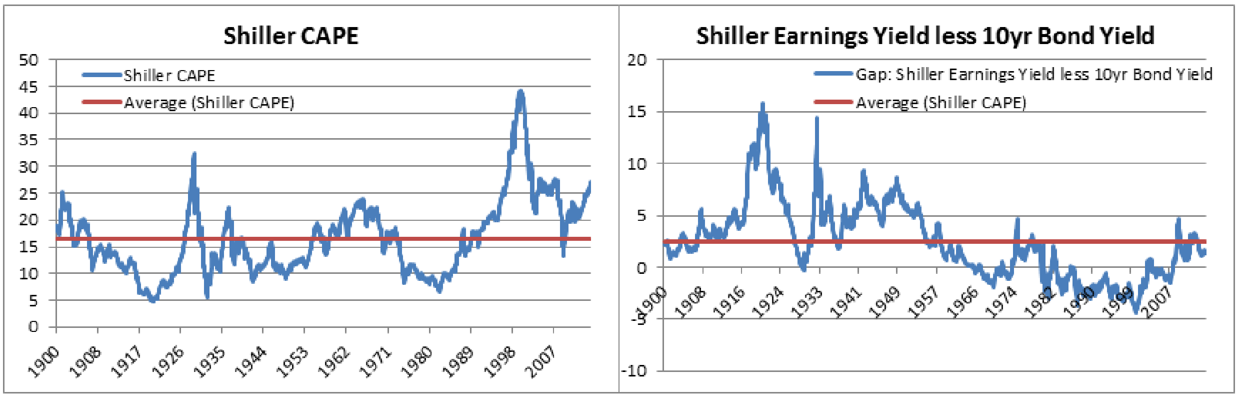
David Bell

It has been another challenging year for superannuation, including for industry regulators, market professionals, fund administrators and trustees managing an SMSF. We have seen the completion of the Financial System Inquiry (FSI) as well as mixed economic and market conditions. Here are three challenges I am most focused on heading into 2015.

1. Are equity markets cheap or expensive?

For anyone involved in investment management, the issue of whether equity markets are cheap or expensive is nearly always front of mind. How can the issue of valuation not be clear-cut? The answer is simply that there are many definitions of value. Key for me is whether we should put more emphasis on outright or relative (to other asset classes) value measures.

There are many charts (including the one at left below) which consider outright asset class value. A simple example is a price-to-earnings ratio (Shiller's well-known CAPE) which at present suggests that equities look expensive. The alternative relative value (to bond yields) approach, presented in the right chart below, suggests that equities are offering a premium above bond yields close to their long term average.



Source: Robert Shiller, Yale University

Many market participants focus on outright value measures, yet the relative value approach has merit as it focuses us on where the best return on capital is available. When the two approaches contrast, we are faced with determining whether a market is good value or not.

2. Financial literacy and the Standard Risk Measure

I've previously raised concerns about the ability of APRA's Standard Risk Measure to inform the public of prospective investment risk (see Cuffelinks article *Is APRA's Standard Risk Measure helpful?* for more detail). This statistic was devised in consultation with industry bodies ASFA and FSC and has recently returned to the forefront when Pauline Vamos, CEO of ASFA, commented in her keynote speech at the ASFA Conference that they acknowledge there has been criticism and they are open to ideas of a better measure (for a good summary of Pauline's speech see *Sustainability of the super system in a time of disruption*).

Who will be using and relying on this information and will they benefit?

- For the financially illiterate (meaning those who don't understand compounding, inflation and time value of money), a measure of risk will not really help them – they need education and advice. The financially illiterate likely make up the majority of the population (potentially 60% as explored in *Do clients understand what advisers are saying?*)

- No single industry professional worthy of the title 'professional' would rely on a single measure of risk. They would consider risk in many different ways through both quantitative and qualitative lenses.

It is hard to identify the beneficiary of the limited information provided by the Standard Risk Measure. Perhaps the real leadership opportunity for industry bodies such as ASFA is to be firmer in their feedback to APRA that such a measure can make the uninformed feel dangerously well-informed. The risk section of a PDS could clearly state that one should consider all facets and dimensions of risk and the Standard Risk Measure should not be the sole assessment of risk.

3. Super funds and post-retirement design

The FSI made recommendations regarding a retirement outcomes focus (for Cuffelinks' summary of the Final Report see *David Murray moves the goalposts*), such as:

- seek broad political agreement for the overall objectives of superannuation, since super does not have a consistent set of policies
- super funds should provide retirement income projections for members to improve engagement
- trustees of super funds should select a comprehensive income product for retirement (CIPR) for their members, effectively pooling risk to ensure income throughout retirement.

The first point is well made. The FSI has established its own baseline objective:

"To provide income in retirement to substitute or supplement the Age Pension."

Unfortunately what is missing here is specific guidance as to the trade-off between the level of income and the variability and security of that income. Some of the models used by academics are highly relevant; the question is whether regulators and industry could understand these powerful but complex models.

Retirement outcome modelling is full of variability which is difficult to model – variability in return outcomes and mortality outcomes are just two of many sources (see *How much variability exists in retirement outcomes?* for further discussion). However without such a tool (which I call an 'outcome engine'), we cannot deliver on the final two points listed above in a fully-formed manner.

Consider member projections first; all member projections at present, even those provided by ASIC, are primarily focused on expected outcomes. This means the projection information provided to individuals (many of whom may be financially illiterate) is roughly 50% likely to be achieved (or 50% likely to not be achieved). Is that an appropriate basis on which to provide such information? For me this type of information on retirement projections has eerily similar shortcomings as the Standard Risk Measure…

The design of the CIPR will be a less than perfectly-informed decision by trustees in the absence of a highly-specified outcome engine to assist with the decision making process. Most trustees would have to rely on gut feel to make their decision on the most appropriate CIPR specification. The post-retirement product space is constantly evolving, but without a powerful outcome engine to assess the benefits of innovations, I feel trustees will be left exposed.

FSI complexity is in the implementation

The recommendations around retirement outcomes in the FSI have merit but implementation will be complex. A simpler solution would have been an additional regulatory requirement for super funds to have an outcome engine which considers all relevant sources of retirement outcome variability in place as a component of their product design processes within three years.

There is a real leadership opportunity for super funds to bring the appropriate skills into their businesses to develop their own outcome engines. While I have previously discussed this issue (see *'Outcome engines' should be the heart of your business*) the FSI Report only confirms my belief that outcome engines will be a top three business issue for the leading super funds for the next five years. This is one of the best opportunities for worthwhile collaboration between industry and academia.

Wishing everyone all the best for the festive season and 2015.

David Bell is Chief Investment Officer at AUSCOAL Super. He is working towards a PhD at University of New South Wales. This article is general in nature and does not address personal investment issues.

The 'big question' for asset allocation

Ashley Owen

The holiday season provides a rare opportunity to ponder the 'big questions' in life. Since my professional focus is asset allocation and how investment markets work, it gives me a chance to think about the one 'big question' that has fascinated and puzzled me for 30 years.

Where have we been, where are we going?

The 'big question' is not about asset classes and how they work. Asset markets have been fine this year. While most commentators were nervous all year wondering where to invest, since every market appeared to be over-priced, for me it was more a question of what not to invest in. Stock markets globally have provided benign to moderate returns with low volatility, plus a nice extra boost to returns from our falling dollar. Bonds and real estate markets have also done well in Australia and around the world. With just about every asset class generating benign to moderate returns or better, and with relatively low volatility, the main asset class we were underweight was cash, which lost money in real terms after inflation.

Forming views on the outlooks for markets and asset classes in the coming year is critically important of course. There will be plenty to think about over the holiday break: US rate hikes, China's lending binge, Japan's stimulus programmes, European fiscal deadlock, America's government funding crisis, global banking reregulation, the shale revolution, OPEC's declining role, Russia's expansionist plans, ISIL and the west's reaction to it, Iran's nuclear ambitions, China's rising territorial disputes in East Asia, political fragmentation everywhere, and so on. Studying the likely impacts is fascinating and all-consuming for me. It is all I think about all year.

It is difficult enough as it is, but that is *not* the 'big question' for me.

The 'Big Question'?

As an asset allocator, the single 'big question' for me has nothing to do with China or Europe or the US, or oil or share prices. The 'big question' is this:

> *If every long term investor in the world has pretty much the same goals for their investments, and if they all have access to pretty much the same investments globally, then why are there so many different and completely opposite views on how to use those same investments to achieve the same investment goals?*

Long term investors share the same goals

Let's look in a bit more detail. Just about every long term investor in the world has the same main goals they want to achieve from their investments:

- Protection of capital
- Preservation of real value after inflation
- Reasonably reliable regular income stream (either now or in the future)
- Careful real growth

By 'long term' I mean several decades, multi-generational, or perpetual. These four fundamental goals are the same for all types of long term investors - from perpetual charitable funds and endowments, institutional pension funds, right down to individual self-managed retirement funds. I spend my life talking to managers and trustees of long term investment funds, from $100+ billion pension funds to mums and dads who run their own retirement funds of a few hundred thousand dollars, and I have found that their objectives all boil down to these four fundamental investment goals.

Long term investors have access to the same investments

These days everybody – from a $1 trillion dollar fund to my kids' savings funds – can access countless markets via their on-line broker accounts. Anybody can buy any security on any market in just about any country from just about anywhere.

Even 'wholesale' funds like hedge funds, private equity, venture capital, etc can be accessed in small parcels in numerous forms and structures. Large 'lumpy' assets like office towers, shopping centres, power stations, electricity grids, airports, toll roads and rail networks can be accessed by unitised or listed securities in hundreds of markets around the world. All are available online with a few clicks of a mouse or taps of a finger on a screen – from anywhere in the world.

One initial reaction might be to say, "That's not really important or relevant because Australian (or German or Vietnamese etc) investors have Australian (or German or Vietnamese etc) investment goals and should only be worried about Australian (or German or Vietnamese etc) returns and Australian (or German or Vietnamese etc) inflation, and therefore they only need Australian (or German or Vietnamese etc) assets.

I am often asked why investors in one particular country need to worry about global returns, global inflation and global investments?

In the case of Australian investors the answer is simple. Most people want to maintain the global spending power of their money in order to maintain their real standard of living. In Australia, almost everything we buy and use every day is imported, so we need to maintain the spending power of our money in terms of items we buy from global markers. Those few things that are made in Australia (mostly fresh food) are made with imported machinery. In addition, if people want to travel in future they need to maintain the global spending power of their money.

So even local investors need to think about their goals in global terms and think about how they can achieve their goals using the same universe of global investment available to everybody everywhere.

Vastly different, divergent and opposing strategies

With the *same goals* and access to the *same investments* globally, then I would have thought that there would be some widely-accepted views or strategies as to how to use those investments to achieve those goals. But there are not. Far from it.

It is not as if there are two or three or even a handful of basic strategies for building the 'perfect' investment portfolio. There are hundreds of different types of strategies. It makes no sense to me.

For example, this year I talked to the head of one of the largest pension funds in Korea and they have an allocation of 90% global bonds, of which 70% were government bonds, with the balance being in short term securities, and no shares whatsoever were allowed in their investment mandate. I talked to a sovereign wealth fund in Europe that invested only in bonds, real estate and cash.

I spend a fair bit of time talking to family offices in Asia (mostly Chinese billionaires who have large multi-generational investment funds away from their business wealth) that have a huge range of asset allocations, from 100% cash to 100% precious metals, plus dozens of different strategies in between.

In one of the largest and deepest markets of all – the US charity and endowment market - there are several regular publications that spout an extraordinary array of weird and downright wacky investment strategies each month. All the funds have the same spend rule each year, the same perpetual investment horizon and the same fiduciary obligations, but with an amazing range of investment strategies and approaches.

Australian investors, including wealthy families, charitable funds and retirement funds, have a pronounced liking for Australian shares and an unusually negative predisposition to foreign shares, but New Zealand funds and individuals have always favoured foreign over local shares. I frequently come across Australian wealthy family and retirement fund trustees who are often wedded to a default allocation of 100% Australian shares, and I have a hard time convincing them to diversify into anything else. At the same time I talk to Asian pension funds and billionaire family offices that will not touch shares at all.

Investment management is not a profession yet

If I had leaking plumbing and I called 100 plumbers to fix it, they would all turn up with pretty much the same set of tools in their tool bag and they would probably have one or two different ways of fixing the same problem with the same set of tools. If I had a broken leg or a brain tumour and 100 medical professionals looked at the problem, they would all be armed with similar sets of tools and methods and potions. The 100 professionals would probably come up with perhaps three or four fundamentally different approaches to address the same set of symptoms.

However if I ask 100 long term investors how to achieve the common set of goals listed above, I would get dozens of completely different and opposing strategies. There would be 100 different asset allocations, and little in the way of considered, reasoned supporting arguments or evidence that they are likely to work.

It is not as if this is a new field. Investment markets, and the idea of managing long term investments, have been around for hundreds of years. The more time passes, the greater divergence of strategies. This is what puzzles me intellectually, and it also worries me deeply because peoples' life savings and their future livelihoods are at stake.

Given the extraordinary range of different strategies, the chance that their money is invested in the right way to achieve their goals is quite small, and the chance their money is invested in other inappropriate, harebrained, or downright bad strategies is quite high.

Complexity is not the reason, but nothing is more complex than the human body. Even after hundreds of years of scientific endeavour and effort, scientists have little idea how the human body actually works. We only let a surgeon loose on patients after more than a dozen years of extremely intensive training, and there are detailed rules, procedures and protocols that must be followed. With investing, just about anybody with a hot idea is allowed to manage money.

It does not look like a profession, such as plumbers or surgeons. It looks more like an experimental free-for-all where anything goes until it blows up!

This then is the 'big question' for me as an investor and asset allocator and what I will have time during the holidays to ponder. Over the years I have realised there are a couple of reasons for this conundrum, and I promise to share these with you in the new year, as well as any other blinding insights gathered this year.

But for now, I wish all readers a happy and healthy holiday break.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is for general educational purposes and is not personal financial advice.

How much can SMSF trustees really afford in retirement?

Doug McBirnie

SMSF trustees aren't simply hard-working people with the knowledge and means to take control of their financial future. Their ranks are full of Machiavellian schemers who stoke property price booms and plot 'unfair' ways to use the super tax concessions.

So say some of the more sensational and misinformed media coverage of the last 12 months.

In the face of such regular hysteria, we thought it would be worthwhile taking a sober look at whether SMSFs are meeting their primary purpose – to provide their members with a sustainable income in retirement.

Fortunately, the results of our SMSF Retirement Insights research paper reveal that those who take responsibility for managing their superannuation are more likely to enjoy a comfortable retirement.

Reason to be confident about retirement

Our research estimated the savings needed by a couple in their SMSF to fund a comfortable retirement for life. The ASFA Retirement Standard (as at 1 October 2014) suggests that a couple would need to spend around $58,128 each year throughout retirement to enjoy a comfortable lifestyle.

Given the considerable risks inherent in providing sustainable retirement income from a lump sum of savings, these risks must be allowed for when modelling retirement. Rather than make simple projections based on fixed assumptions, our research modelled 1,000 different possible return sequences to identify what level of savings is required to provide a high likelihood of success. The scenarios allowed for a large variability of investment returns, inflation and lifespans for retirees. Spending was assumed to increase each year with inflation and the couples' SMSFs were assumed to hold a broadly balanced investment portfolio. Our calculations also allowed for trustees' entitlements to the age pension when eligible and any tax obligations that arose.

The results give an estimate of the level of savings needed to sustain the ASFA comfortable level of spending for life with 80% confidence. We then compared the required level of savings with the actual fund balances in two-member SMSFs in Accurium's database of over 60,000 SMSFs.

Our results show that the majority of SMSF couples have sufficient savings to be able to afford the ASFA comfortable spending level if retiring at age 62 or older. The table below shows the savings needed when retiring at different ages and how these compare to actual SMSF balances:

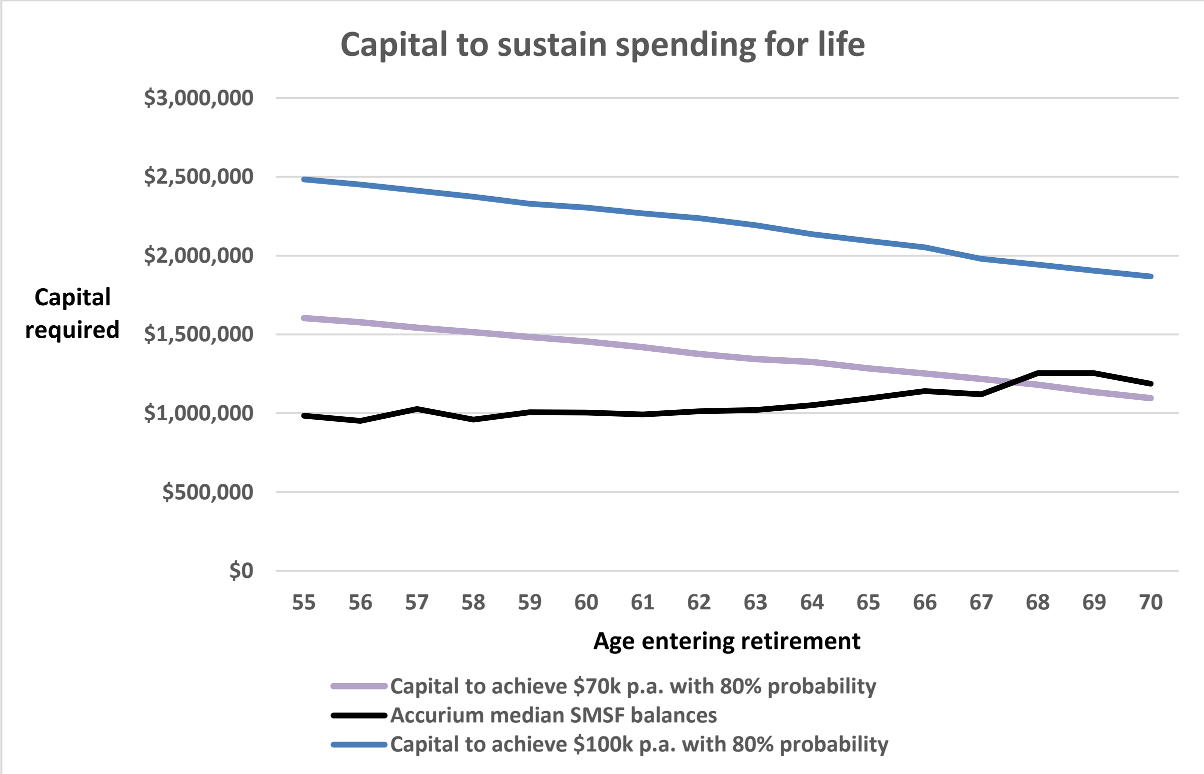
Retired couple's age	Assets needed to support spending of $58,128p.a. with 80% confidence	Median SMSF assets	Proportion of SMSFs with sufficient assets
55	$1,199,000	$985,000	41%
56	$1,164,000	$952,000	41%
57	$1,138,000	$1,027,000	44%
58	$1,104,000	$959,000	43%
59	$1,053,000	$1,007,000	48%
60	$1,032,000	$1,005,000	49%
61	$998,000	$993,000	50%
62	$954,000	$1,013,000	53%
63	$926,000	$1,021,000	54%
64	$894,000	$1,051,000	58%
65	$849,000	$1,093,000	61%
66	$836,000	$1,141,000	63%
67	$789,000	$1,120,000	64%
68	$770,000	$1,255,000	68%
69	$761,000	$1,254,000	71%
70	$739,000	$1,188,000	70%

Results are based on Accurium's retirement adequacy model. Median SMSF balances are used to better represent the typical SMSF (as averages are heavily skewed by a relatively small number of funds with very large balances).

Aspirational SMSFs need to be careful about retirement

Given that $58,128 per annum is below the average full-time Australian working wage, it is worthwhile asking whether wealthy SMSF trustees might aspire to a higher standard of living in retirement. A 2012 survey of Financial Needs and Concerns of SMSF Members asked trustees 'what level of income they required to live comfortably in retirement'. Over 50% of respondents said they required an income of $70,000 per annum or more and 25% said that they need at least $100,000 per annum.

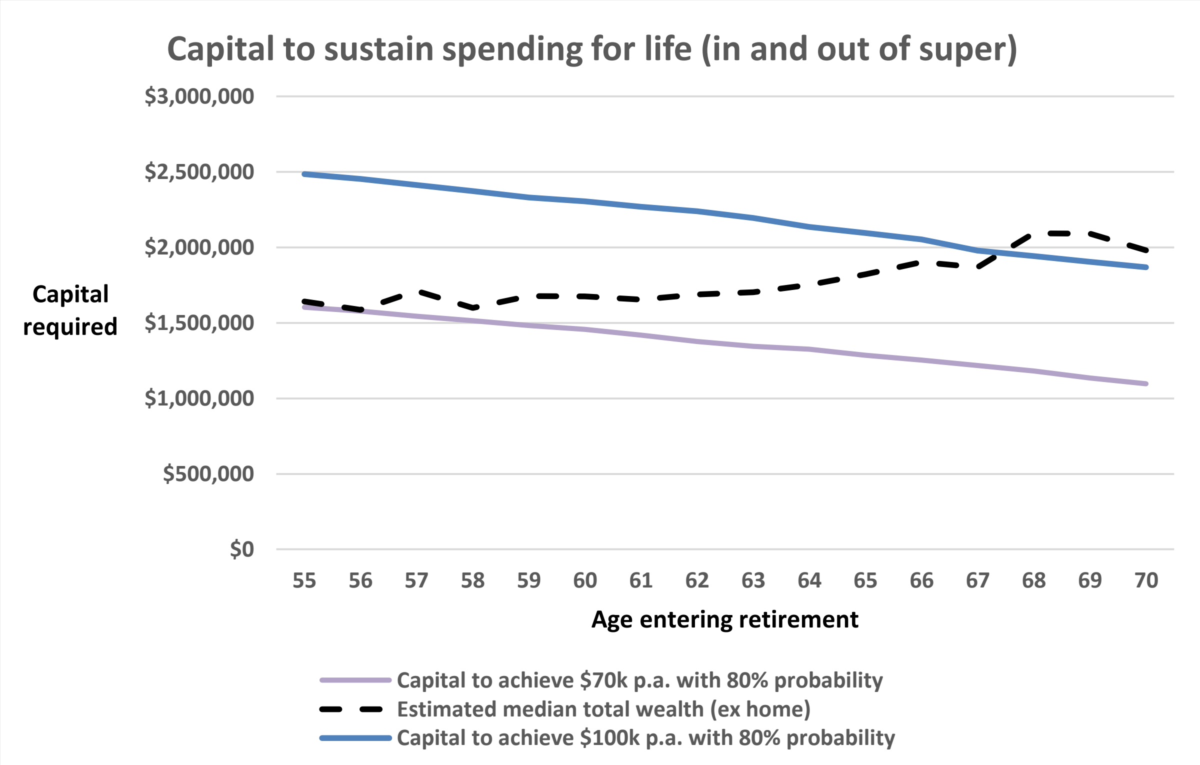
To see how well placed SMSFs are to support these higher aspirations we calculated the amounts required in savings to confidently sustain these levels of spending throughout retirement. We compared these calculations to the fund balances in our database with the following results:



Our analysis indicates that, based only on the median SMSF balances, typical SMSF couples cannot afford to retire on $70,000 per annum until age 68. The median balances in our database are never sufficient to confidently sustain a $100,000 per annum spend throughout retirement. That said, perhaps some trustees' do have realistic expectations as around a quarter of 65 year old couples do have sufficient assets in their SMSFs to support a budget of $100,000 per annum.

Savings outside super

Of course, savings held in superannuation only tell part of the story. Many SMSF trustees hold significant savings outside of their funds, indeed Investment Trends' 2014 SMSF Trustees Survey suggested that on average only 60% of trustees' total wealth (excluding their home) is held in their SMSF. Based on this information, we estimated the median total wealth of SMSF trustee couples at each age and compared this to the amounts needed to sustain higher spending levels in retirement. The results (shown below) paint a much rosier picture with the typical couple likely to be able to afford $70,000 per annum even when retiring as early as age 55. However, the estimated median total wealth is not sufficient to be confident of affording the more generous $100,000 per annum retirement budget until age 68.



Modelling retirement risks

The figures above make a number of assumptions about typical SMSF trustee couples, for example, that they are the same age. The figures start to form a guide around the level of savings that retirees need, in order to confidently support their desired lifestyle throughout retirement. However, all of their individual circumstances also need to be taken into account including the actual age of each spouse, their investment mix and cash flow plans. Modelling should allow for the key risks facing retirees – market, inflation and longevity risks. We believe that this can only be done effectively using stochastic or probabilistic modelling that looks at a wide range of possible future scenarios.

Risk in retirement goes much further than asset allocation. Retirees need to understand and be comfortable with the level of risk they are taking with their retirement spending plans. Our research assumes SMSF trustees would prefer an 80% probability of their assets lasting for life. Some retirees may be willing to accept different levels of risk and modelling should allow for this.

The full paper 'Accurium SMSF Retirement Insights' is available for download at www.accurium.com.au.

Doug McBirnie is a Consulting Actuary at Accurium. This information is factual and is not intended to be financial product advice or legal advice and should not be relied upon as such. You should seek appropriate professional advice before making any financial decisions.

Four dangerous high yield credit myths

Jonathan Rochford

It is often difficult to distinguish investment facts from myths, with only a subtle difference between the two. Many high yield investors assume the past will be a good indication of the future. This article explains how a failure to correctly understand the past has led to common but dangerous myths about high yield credit, with the actual triggers and warnings signs of a downturn in credit markets explained.

Myth 1: Equity markets lead debt markets, so sell high yield when equities start to sell-off

I can partially agree with the statement that equities generally lead credit, perhaps even the majority of the time. But when times get really tough, it's all about who gets paid first and that means debt leads equities. In mid-2007 concerns about falling US house prices were becoming mainstream although few had figured out just how widespread the damage from subprime-related problems was going to be. The first of the subprime-linked fund bailouts and closures occurred in June 2007. By July, the cancer had spread from subprime to credit generally. In the space of a few days, the cost of credit default swaps (a form of credit insurance) sharply increased after years of consistently falling. This marked the turning point for credit. The rest of 2007 was a time of increased credit spreads and greatly reduced liquidity.

Equities continued to rise before peaking in October 2007 in the US and November 2007 in Australia. This was some sort of twilight zone, as two correlated assets classes were having completely different experiences. It all changed early in 2008. The credit problems of Babcock and Brown, Allco and Centro were now front and centre for equity investors. Burnt by these three and others, equity investors started to dig for information about the amount and terms of the debt owed by their other equity holdings. In 2007 and 2008 short sellers routinely targeted companies who were suspected of having a substantial portion of their share register backed by margin loans. This pattern has repeated in 2014 with short sellers targeting the iron ore miners and mining service providers, particularly those with a higher cost of production and with higher levels of debt.

Since June this year, US high yield markets have pulled back meaningfully. They are now a fair way from their peaks, unlike US equities which are still setting record highs. Credit investors have become more discerning with a good number of high yield deals withdrawn, repriced or stuck with the underwriters. No one can definitively say whether this is an early indicator for equities like it was in 2007. What can be said with confidence is that fewer companies are now able to make easy gains from dividend recapitalisations and refinancing debt to lower their interest costs. This means that the tailwind for equities of the last two years provided by cheap debt has either stopped or become a headwind.

Myth 2: High yield debt won't sell-off until default levels increase

The 'Minsky Moment' (a sudden collapse in asset prices) is typically not triggered by investors rationally forming a view that asset prices are too high and voluntarily deciding to sell. Rather, it is the withdrawal of the availability of credit that precipitates the collapse. The withdrawal of credit stops new buyers entering the market and turns the most leveraged holders of assets into forced sellers. Once the spiral of forced selling begins, where one round of forced selling pushes down prices and in turn creates more forced selling, it typically takes two or more years to fully run its course.

After asset prices and credit availability begin falling, borrowers find they can no longer rollover their existing debt and the wave of defaults starts to build. Defaults always lag the fall in the availability of credit and debt prices typically decline one to two years in advance of the main cluster of defaults. Those waiting for defaults to increase before selling are likely to find that prices have moved below 90% of face value by the time they begin to contemplate selling. Many holders then become trapped by a sunk-cost mentality, not willing to sell for a loss even if the near term prospects seem grim. Avoiding being caught in this position is a key part of managing the credit cycle. Keeping an eye on the fundamentals of credit and the bullishness of lenders is the best way to be alert for when the availability of credit starts to turn.

Myth 3: Default rates won't rise until after interest rates rise

Many will point to the rise in the Federal Reserve rate in the US as a turning point for subprime lending as borrowers that were paying very low interest rates reset to much higher levels. There's two problems with assuming that this pattern will always repeat.

Firstly, as the response to the previous myth makes clear it is the withdrawal of credit that matters most. The counter factual is that if US interest rates had not started to rise in 2004 the boom might have lasted for longer but it would have come to an even uglier end. Interest rate increases can force the hand of leveraged borrowers in the long term, but in the medium term most leveraged borrowers are insulated by fixed rate debt or swaps used to lock in their cost of debt. It is only as debt approaches the maturity date that borrowers must take action. The smart lenders take action early, before either interest rates or credit spreads rise and the hand of borrowers is forced.

Secondly, Japan has had very low interest rates for the last 20 years, yet the pattern of defaults and restructurings has still played out. Asset prices have fallen, even though potential buyers could theoretically obtain finance at very cheap levels. The simplest explanation is that asset prices had overshot fair value and needed to return to levels based on fundamentals. Cheap debt has arguably done little to stop what was an inevitable correction. Investors can take away from Japan's experience that when the fundamentals are bad, low interest rates might slowdown but cannot stop an inevitable correction.

Myth 4: Lending with easy covenants isn't a big deal

Some research since the last crisis suggests 'covenant-light' loans performed slightly better than full covenant loans. However, there's a key factor missing from the analysis. Last time around, covenant-light loans were not the majority and were almost always made to companies that had both (1) a low expectation of earnings volatility and (2) a strong sponsor. Lenders were more relaxed about covenants when a borrower was considered relatively stable and had owners with deep pockets. This time around covenant-light lending is the majority and it seems almost any borrower can get a covenant-light facility if they are willing to pay a little more.

Covenant light lending is a big deal as it makes loans act more like bonds when it comes to default timing and recovery rates. Strong covenants lower the probability of payment default (failure to pay interest or principal on time) and increase the recovery rate if a terminal default occurs. From the lender's perspective these two impacts are both a very big deal.

Covenants are an early warning system on increases in credit risk. Well set covenants force the business owners to renegotiate the terms of their debt with lenders when credit risk exceeds specific tolerances. Lenders have the opportunity to demand a partial or full repayment of debt whilst the business still has meaningful equity value and an ability to attract new equity. Also, underperforming borrowers with covenants lose control of their businesses to bankruptcy or administration processes earlier, reducing the amount of value destruction. Well-covenanted and secured lenders on average recover 60-80% of their debt after a terminal default compared to 30-40% for bondholders.

Conclusion

As with most areas in life, the most believable credit myths are the ones that contain some truth. Savvy credit investors will ignore these myths and prepare for a potentially more difficult future.

Jonathan Rochford is Portfolio Manager at Narrow Road Capital. This article has been prepared for educational purposes and is not meant as a substitute for professional and tailored financial advice. Narrow Road Capital advises on and invests in a wide range of securities.

A Christmas fireside chat

Roger Montgomery

As we wrap up 2014 and position ourselves on the blocks of 2015, it is worth considering how investors and consumers might behave. With Australia's official cash rate already at 2.5% and having been there for 16 months, is another 25 basis point (0.25%) drop sometime next year going to get you off the couch? Our funds have performed well this year but it will be the more challenging months ahead that determine whether we can continue to deliver.

In simple terms you only need to know a few things. Will the economy grow faster or slower than the majority is expecting? Will inflation be higher or lower than most are currently expecting? And are high quality stocks with bright outlooks cheaper than our estimated valuations of them? These are the big questions because at other times there isn't really any 'variant perception' to help generate easy outperformance.

Consumer confidence has crumbled in the last couple of months. It's even worse today than when the last survey suggested confidence was at a three year low. CEO's are telling us this. If low rates were going to stimulate anyone into action, they should already have done so, and another 25 basis point cut will not make any difference to consumer behaviour.

Let's turn briefly to mining and mining services. As the iron ore price drops, thanks to increasing supply and declining rate of growth of Chinese demand (China's rate of growth in GDP is forecast by the US Conference Board to fall to 5.5% and then to 3.5%) the impact is felt in job losses. As miners shelve projects and investing intentions slump, and as the higher cost producers close, workers are forced to start looking for work. Inevitably these new jobs will be on lower pay, as the mining boom saw salaries and wages soar for many workers.

And what are CEO's telling us? We've had a car packaging company and a travel agent chain say that "it's tough", we had Rio tell investors the near term outlook was "challenging" and we've had rumours of Myer and DJ's bringing forward their Christmas sales. This could reset consumer spending habits, and destroy the second spending boom that boosts retailers' full year profits after the Christmas avalanche.

Hard to find compelling investments in most sectors

Why is it that low interest rates aren't stimulating consumption? I think the reason is relatively uncomplicated. Those low rates have stimulated many to buy real estate, and irrespective of whether the purchase was for living or investment purposes, the consumer has geared up. And that's a very different possibility to the usual 'wealth effect' we expect when house prices have been rising.

More recently John Borghetti at Virgin said: "Where there is uncertainty people go and hide in corners, and I think that's what we're seeing now in terms of spending … There's not much hope out there at the moment."

From an investment perspective, deteriorating prospects from the mining and material sectors has now infected retailing including travel. That takes out large sectors of the Australian equities market from our universe due to unattractive economics and prospects. The Financial Sector, dominated by the banks, may also be impacted in the near term, not only from weaker credit growth but also from the prospects of more punitive capital and mortgage risk weighting ratio requirements.

That doesn't leave many other sectors from which to select outstanding investment candidates.

What about energy? The collapse of the higher-cost-junk-bond-issuing energy companies spreads volatility and fear further into the 'high yield' markets and then down along the risk spectrum. It's the first stimulus-infected bubble to burst and it is happening as we speak. Rates on high yield bonds were at just 5.6% only a few months ago when Janet Yellen said in Washington that she saw "pockets of increased risk-taking". Today those junk bond yields have jumped to over 9%.

And it's not just individual junk bond issues and their issuers that are being hammered. Entire countries are affected by the oil price slump. Venezuela, Nigeria, Columbia, Sudan, Iran and Libya are all impacted adversely. Evidently, Nigeria's government revenues are funded by oil to the tune of 70% and oil represents half of Columbia's exports.

Contagion. According to Goldman Sachs the high yield (junk bond) index is approximately 17% represented by energy debt issuers. This is significantly higher than the 4.4% exposure in 2006. Deutsche Bank reckon $550 billion of new bonds and loans have been issued by energy companies since 2010 and J.P. Morgan estimate that 12-40% could default.

Little scope to ease rates further

The longer the Fed holds its benchmark lending rate near zero, the greater the risk of more bubbles forming and then inevitably popping. Perhaps the most successful navigator of market and economic cycles has been Ray Dalio, who in early December 2014 noted that we're currently in a "good environment" for owning stocks and that "we are in a mid-part of the cycle", adding "We are long equities." That is somewhat encouraging but in describing the signs to watch out for in the US he, inadvertently perhaps, warned investors in Australia what the next year or so might look like. Dalio noted that when the need for interest rate easing arose, already low rates would render few tools available to deal with it. At that point "asset prices are going to start looking top-heavy."

And for Australia, that point might just be now.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. The article is general information and does not address personal financial needs.

What the weekly reader polls revealed in 2014

Leisa Bell

If you have participated in any of our polls during the year, thank you for your involvement. Some readers may not have seen the final results, so we have reproduced them all here. They show a readership of diverse opinion in some areas, but united in many others. I particularly liked how only 9% of respondents were optimistic enough to think that the Socceroos would progress beyond the first round of the World Cup.

Overall we have observed a mistrust of government, a desire to improve the system and make it fairer, that there's no crystal ball, concern for our future wellbeing, an aversion to complexity, a sense that people need to be protected from themselves (but also have financial freedom) and a healthy level of scepticism.

See how your opinion fared in our poll summary on the website. As our website continues to change and evolve, we will be ceasing the poll for the moment.

Leisa Bell is Deputy Editor of Cuffelinks.

Fund Performance Snapshot

SG Hiscock & Co's SGH20 Fund

Cuffelinks normally runs the Fund Performance Snapshots without seeking input from the fund managers, given the report uses independent data. However, the five-year period covered by this Snapshot shows it has not been the best time for relative performance by SGH20. Longer periods show the fund in a better light. We invited Stephen Hiscock to provide his comments:

"Due to SGH20's benchmark unaware strategy, it has a structural underweight to Australian Banks, REITs and Financial Services which comprise approximately 46% of the ASX300. This creates an index that is highly sensitive to the interest rate cycle in Australia, and SGH20 believes investors need more diversification than the ASX300 currently provides. This lack of diversification, combined with the dividend growth philosophy of the fund, rather the more traditional dividend yield philosophy, saw the 2013 year as extremely challenging for the style bias of SGH20.

Despite the recent underperformance, SGH20 has still materially beaten its benchmark by more than 3% pa over the past 10 years and should be seen as a long term investor seeking sectors with structural growth tailwinds, thus the ability to take large positions away from the ASX20 (ie the top 20) should stand SGH20 in good stead over the medium term, notwithstanding the challenging period over 2013."

How to understand the report on the following page

The Sector Exposure shows the weighting of the portfolio to particular industry sectors at different point over the last five years.

The Performance Breakdown (Sector Based) separates the Total Annualised Return over five years of 3.04% into Style (3.98% pa) and Stock Selection (-0.94% pa). The Stock Selection component is the excess return of the Fund over the Style.

The Excess Performance Breakdown (Sector Based) of -3.78% pa over this period is the amount the Fund outperformed the ASX300 index, divided into Timing of -2.86% pa and Excess Selection of -0.92% pa. The Excess Selection is the Selection component of the difference between the Fund and the benchmark.

The Style Analysis section does the same calculations based on Style (eg growth or value) rather than Sector.

For a more comprehensive explanation with worked examples provided by TTA and MPI, see the Fund Performance Snapshot section of our Education Centre (on the Cuffelinks main menu). All quoted returns are per annum.

Fund reports and data for the Performance Snapshot provided exclusively to Cuffelinks by:

mpi MARKOV PROCESSES INTERNATIONAL

TRADING TECHNOLOGY AUSTRALIA

MORNINGSTAR®

SGH20

Performance Snapshot   As of November 28th, 2014

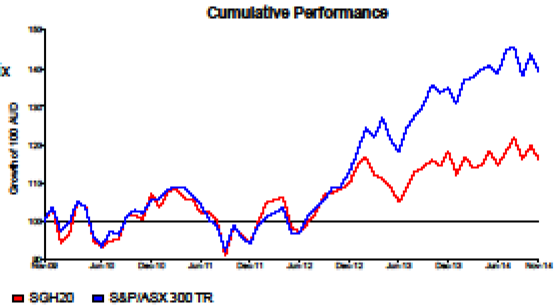
Performance Summary

- Fund has underperformed the Australian stock market as a whole over the last five years.

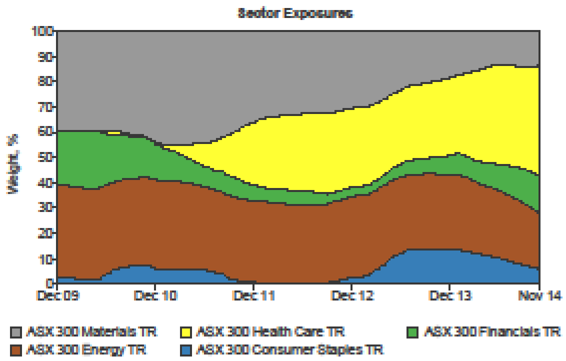
- Sector attribution shows that the fund behaves as if it is a mix of five sectors; Healthcare, Financials, Materials, Consumer Staples, and Energy.

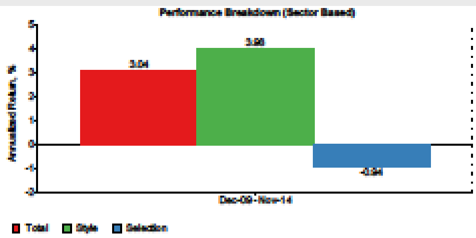
- Analyzing the fund's excess performance based on sector exposures, we see that the fund has underperformed performed due to both selection and allocation.

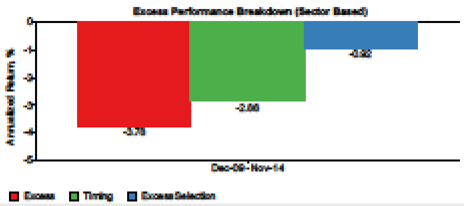
-Style Analysis shows that the fund has a growth style bias, moving over time to be in the mid-cap range.



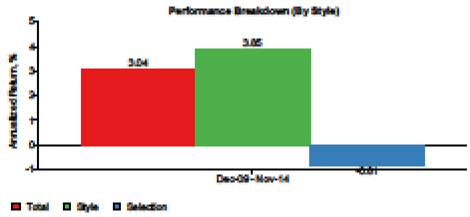
Sector Analysis

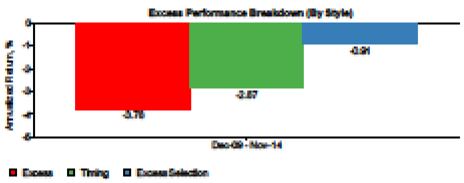






Style Analysis





Past performance does not guarantee or indicate future results. Analytics are presented for informational purposes only and do not constitute an offer or recommendation to buy or sell securities or to engage an investment manager. Mutual fund results do no reflect the deduction of sales loads. Market indices included are a general source of information and may not be the designated benchmark to evaluate an investment's performance.

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