Cuffelinks
Connecting investors with ideas

Edition 106, 24 April 2015

This Week's Top Articles

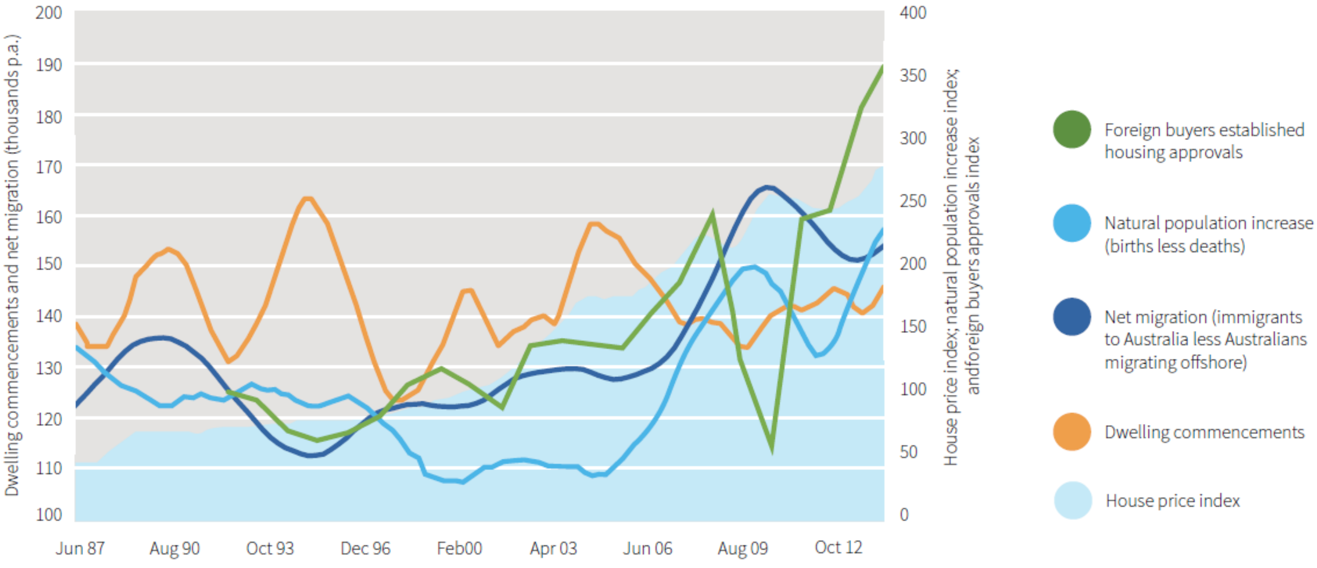
Impact of house price falls on other assets

Craig Swanger

For many years, The Economist and other commentators have claimed there is a 'housing bubble' in Australia. The property sector and Australia's banks say there's not. Given the implications for property and for investors in the banks that are themselves heavily exposed to property, it is an important debate. We briefly lay out both sides of the argument, and then show the impact on other asset classes should there be a correction.

Case against the bubble: supply not keeping up with demand

Chart 1: House prices, Australia 1987-2014, compared to changes in supply and demand



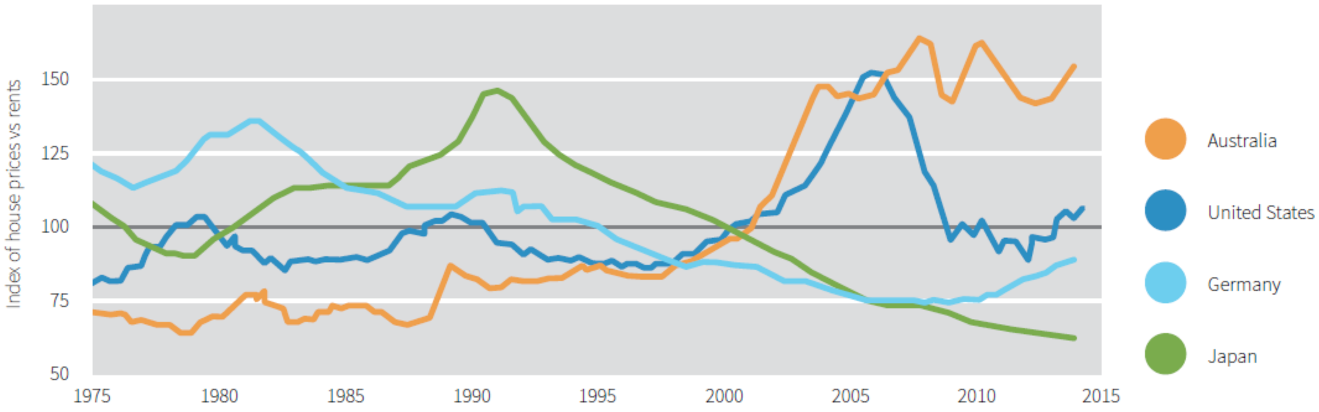
Source: ABS, FIRB, RBA

Several compounding factors can be blamed for the housing price increases:

1. Net migration has been more than double the long-term average since 2005
2. Foreign investment has also doubled
3. Annual increase in population due to births less deaths shifted to new records from 2005
4. Supply inflexibility as dwelling commencements have not increased since the 1980s.

Case for the bubble: fundamentals out of whack

Chart 2: Price/ rent index, various countries, 1975-2014 (higher the ratio, the more expensive the *capital values compared to rental income)*



Source: The Economist

The case against relies more on the idea that Australian housing should comply with some global benchmarks such as those shown above.

Regardless of which of these fundamental ratios are used, Australia comes across as one of the most expensive housing markets in the world:

- Rental yield vs long-term averages – Only Britain and Canada are further from long-term averages than Australia. China is far below Australia on this measure.

- Inflation-adjusted price increases – 'Real' prices in Australia are up 2.8 times since 1975, compared to the US at 1.3 times.

Of course no-one knows whether residential property is due for a strong correction. All you can do is be prepared and not over-exposed to the risk of a bubble, while not over-reacting, putting all your cash in the bank and potentially reducing your income. The key is to ensure you have the means to ride out any downturns without being forced to sell.

What impact would such a correction have on other asset prices?

Australians are heavily invested in residential property and so the impact of a property crash is obvious for those assets. But the impact on other investments is just as important to understand. Australia's banks have around 61% of their loan books exposed to residential property, and banks now represent 32% of the ASX 300 and are the top four holdings in the average SMSF portfolio.

Table 1: Shock to Australia's home values: potential impact on other asset values from a material (eg 20%) fall in home prices

Asset Class	Impact	Capital Value	Income
Cash/ Term Deposits	All TDs would be safe	No impact	No immediate change but rates would be lower on rollovers for several years.
Foreign currency eg USD	AUD will slump heavily. In previous downturns of the Australian economy, the AUD has fallen by up to 40%, meaning holding investments in foreign currency will see increases in capital value and income.	Increase with fall in AUD.	Income earned in USD will be worth more in AUD as the exchange rate changes.
Banks – Equities	Bank earnings would be severely impacted, as would their capital ratios resulting in lower dividends, more capital raisings	Expect falls of 40-60%, like 2008, but rebound would be slower	Dividends would have to be cut. In 1991-1993, the banks cut dividends by up to 75%.
Banks – Hybrids	Non-viability clauses don't get triggered until 30-40% falls, but the market will sell them off heavily as the risk of trigger rises	Falls could be as large as 50-80%. During 2008, hybrids sold off 30% and that was prior to non-viability clauses	Mostly unimpacted, some distributions could be deferred/ cancelled
Banks – Bonds	APRA's tests showed that no bank would fail even in their 35-40% fall in house prices.	Falls of 5-15% could be expected due to the credit deterioration of the banks' balance sheets.	Fixed rate bonds: no change. Floating rate would fall with RBA cuts
Equities – Other industrials	Profits from Australian sources would fall heavily.	Falls would not be as extreme as bank stocks, but expect at least 2008 falls, ie 30-50%	Some declines in dividends paid, but far less than banking sector
Equities – Resources	Will be dragged down by the overall ASX, but profits will be far less impacted due to the export earnings and the rising USD.	Smaller than industrials, but still significant falls.	Likely to be flat, but could even rise due to higher USD.
Other industrials and resources – bonds	Highly leveraged companies dependent upon domestic earnings will be stressed. Other industrials can be expected to meet obligations.	The lower RBA cash rate will push up bond values. High yield bonds likely to fall in value where credit quality is stressed.	Income can be expected to be unimpacted for most bonds. Floating rate notes will see lower income, but there are very few of these.
Equities - Global *(hedged, impact of currency considered above)*	If caused by a slowdown in China, global equities are likely to fall too, albeit by far less.	0-20% fall (as the most likely cause of an Australian recession is a problem in China)	no impact
Global corporate bonds	Unlikely to be impacted unless linked to the same cause.	No impact, unless held in foreign currency, in which case gains would be likely	No impact, unless held in foreign currency, in which case increased income (in AUD) would be likely
Hedge funds	Genuine hedge funds will be either unimpacted or will profit from the higher volatility	Small positive impact likely (0-10%)	No impact
Property – listed or unlisted	A residential property market fall of this magnitude will result in lower retail spending and lower rental growth for commercial and industrial properties.	A 20% fall in residential values will cause 15-30% in other property sectors. Falls in property investment values then depend upon the leverage	Rental income will fall with the fall in the economy. Leveraged property trusts will put distributions on hold as they have to pay interest on loans before paying any distributions
Property debt securities, eg RMBS	Even "B" rated RMBS notes will withstand a 20% fall in home prices.	Little to no impact. Credit risk will rise, so lower rated notes will lose some capital value, but will be offset by	Little to no impact

Views on the direction of Australia's property market are mixed. Fundamentals should point to a fall in prices in the medium term, but Australia's unique geography and high immigration constantly defy economic fundamentals. In the face of such uncertainty, it is prudent to stay the course but ensure that you are prepared for the unlikely scenario of, say, a 20% fall in real house prices and that this won't have a material impact on your lifestyle.

Craig Swanger is Head of Markets at FIIG Securities Limited. This article is for general education purposes and does not address the specific circumstances of any individual.

Sydney residential market – a bust in the making?

Adrian Harrington

This article was prompted by questions on the Sydney market from one of our readers, Bruce:

I would be most grateful if one of your experts could shed some light on the current housing market in Sydney. As a SMSF investor in the pension phase, I am struggling to understand what is happening. Auction clearance rates over 85%, properties regularly selling before auction or 10-15% over their reserve, the industry arguing that there is an under supply of accommodation and the State Government forcing Councils to approve more dwellings to increase Sydney's population by another 25%. Is it similar to the Dutch Tulips or the South Sea Bubble? Or can we draw on the experience of nation-wide housing bubbles in Japan, Ireland and the US to understand the localised phenomenon of Sydney?

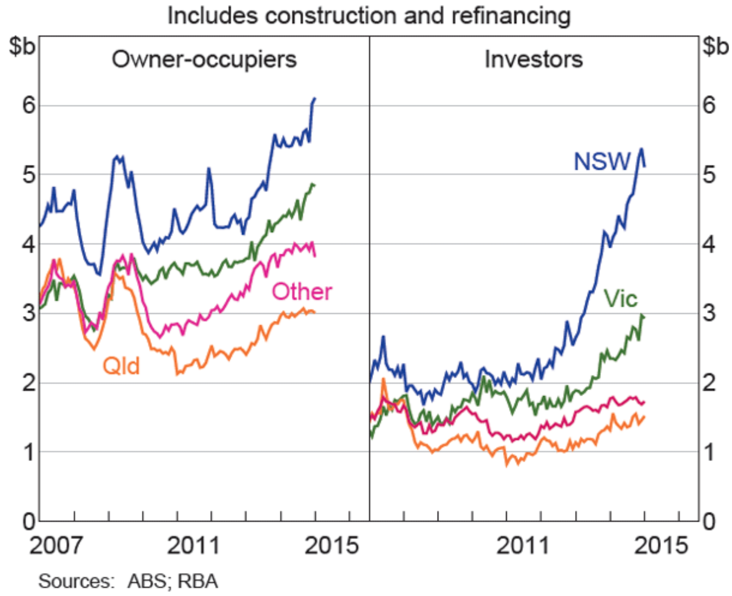
In our IT connected world, why do people want to pay a huge premium to live in Sydney? Has there been a fundamental shift in the inherent value of Sydney to make it as valuable as London, New York or Tokyo? As the family home is the most tax-effective investment you will ever make, does this encourage taxpayers to invest in larger and more expensive properties? What is the outlook for property if wages remain stagnant and the number of people in employment remains the same? How will people be able to service these huge loans without the benefit of rising incomes?

Not a day seems to go by without at least one new headline pointing to a Sydney housing boom. We are often asked why the Sydney market is so strong, how much longer the growth can persist and will it ultimately end in tears. Unfortunately, there are no simple answers.

Most people are quick to point to record low interest rates as the root cause of the Sydney housing boom. With cash and term deposit rates not much higher than the inflation rate, investors are being forced to look elsewhere for yield, and housing (not to mention the blue chips stocks such as the banks and Telstra) appears to be a key beneficiary.

The RBA has pointed out in its March 2015 Financial Stability Review that the " *… the composition of new mortgage finance remains skewed to investors … and investor housing loans in NSW have increased by 150% over the past three years and now account for almost half of the value of all housing loan approvals in that State" (Figure 1).*

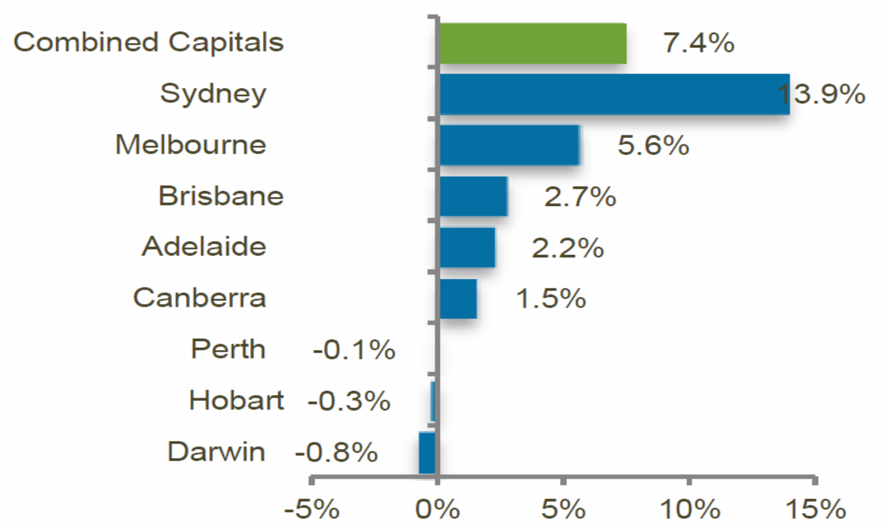
Figure 1: Housing loans by state: 2007 – 2015



However, low interest rates and heightened investor activity are not the sole drivers of the Sydney housing boom, otherwise we'd be in the midst of a housing boom across Australia which, as the latest house price figures from CoreLogic RP Data ([Home Value Index]) confirm, we are not.

Sydney's home values were up 13.9% in the year to March 2015 – the only market to record double digit growth. Melbourne was the next best performing market with an annual increase of 5.6% (Figure 2). Surprisingly, Perth, Hobart and Darwin all recorded declines in value of 0.1%, 0.3% and 0.8% respectively.

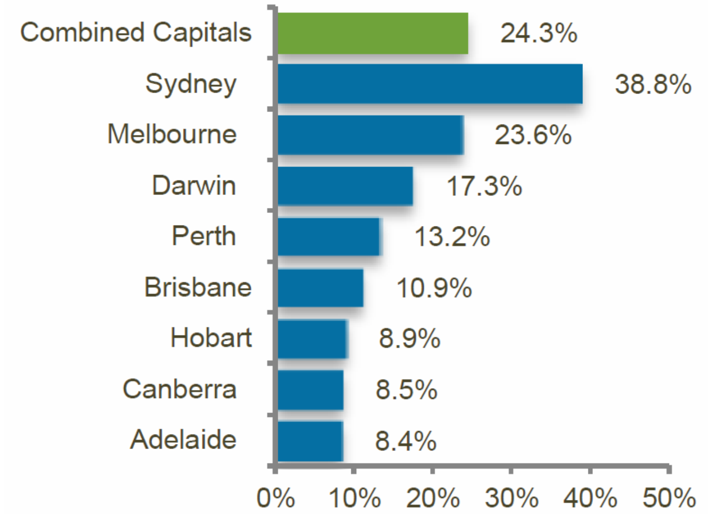
Figure 2: Annual change in dwelling values: March 2015



Source: CoreLogic RPData

Looking at home value changes since the last market trough, again price growth has not been uniform across the country (Figure 3). Sydney home values have increased by 38.8%, Melbourne's are up 23.6%, Perth's are up 13.2% and Brisbane at 10.9%. Hobart, Canberra and Adelaide have all recorded single digit growth of 8.9%, 8.5% and 8.4% respectively.

Figure 3: Change in dwelling values since the trough to March 2015



Source: CoreLogic RPData. Note that the 'trough' is at different times in different cities.

Therefore, there must be other factors at play that are coming together driving the strength in Sydney house prices. No wonder the RBA has a dilemma. The RBA needs a stronger housing market to offset a downturn in the resource sector yet only Sydney and Melbourne seem to be responding.

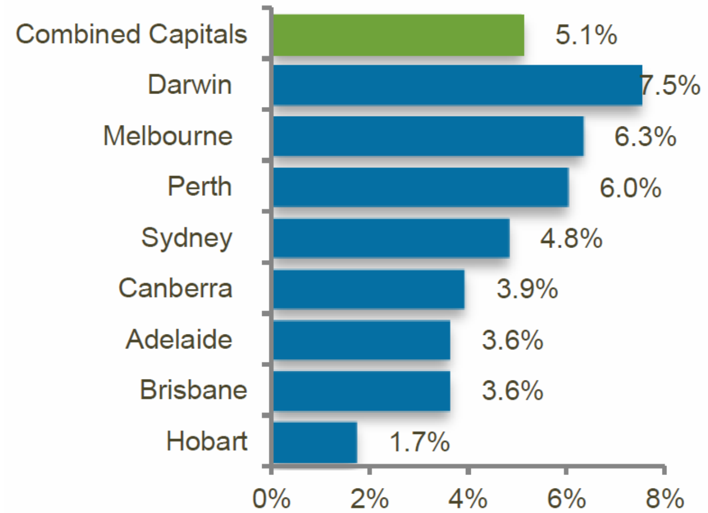
Why is Sydney out of step with the rest of the county?

There are seven other factors worth considering:

1 Price catch-up

We need to go back and review the price performance of Sydney over the past ten years to put the recent price movements into a longer term perspective. According to CoreLogic RP Data, Sydney's annual price growth over the past decade has been relatively subdued at just 4.8% putting Sydney well behind Darwin at 7.5%, Melbourne at 6.3%, and Perth at 6.0% (Chart 4).

Figure 4: Average annual change in dwelling values: 2005 – 2015



Source: CoreLogic RPData

Sydney housing market did not perform that well in the mid 2000's and there has been a degree of catch-up between 2012 and 2014. However, the strong market has continued into 2015 and it appears that certain parts of the Sydney market are now overshooting.

2 Fear of Missing Out (FOMO) syndrome

When investment markets (whether property or equities) are running hot there is the natural human physic to jump on the bandwagon commonly known as the fear of missing out syndrome. This is certainly alive and well in Sydney and is partly responsible for fuelling the current price exuberance.

3 Demand and population growth

Sydney is experiencing a population explosion. Annual population growth averaged 1.3% between the early 80's and mid 2000's but in recent years has been running at higher levels. According to ABS Regional Population Growth statistics, in the year to June 2014, Sydney's population increased by 84,200 to 4.84 million – an increase of 1.8%, and above the national average of 1.6%.

Population growth is a combination of international migration, interstate migration and natural growth (births less deaths). Australia's is running very high international migration levels. Net international migration (arrivals less departures) in the year to June 2014 was around 213,000 – of which 73,300 located in NSW (most whom would have located in Sydney).

When it comes to interstate migration, the level of outflow of residents from NSW to other states has slowed considerably in recent years. In the year to June 2014, there was a net loss of just 6,857 residents. Back in 2004-2005, NSW recorded a net loss of 26,321 people. This means a higher proportion of Sydney residents are now staying, putting further pressure on the demand for housing.

The recent growth in Sydney's population is set to continue. The NSW State Government is forecasting positive growth for metropolitan Sydney of 1.6% on an annual basis out to 2031 - this equates to population growth of 1.575 million over the 20 year period to 2031, or growth of 78,775 per annum. Therefore, at the current (2011 Census) rate of 2.7 people per household across Sydney, an additional 29,177 new dwellings are required per year to match demand based on past household formation rates.

4 Supply

We simply haven't been building enough houses in Sydney to meet this demand – and this is putting upward pressure on prices.

In the past 5 years, there have been 195,920 dwelling commencements in NSW compared to 272,243 in Victoria – that's a staggering 28% less dwellings built in NSW [*ABS – 8752.0 Building Activity*]. In 2011, commencements totalled just 33,433 in NSW compared to 54,606 in Victoria. In 2014, commencement levels were up 47% on 2011 levels, however at 49,313 commencements NSW was still lagging Victoria with 58,330 commencements.

Despite recent efforts by the Baird Government to speed up the release of land, Sydney's land release program has generally lagged. Sydney also has a convoluted planning process that leads to significant delays and risks in the development process, which adds to the cost of development (higher financing costs and statutory costs such as rates and land tax) which ultimately gets passed on to the price of land and housing. Victoria has a much more transparent planning system and this is one of the key reasons Melbourne has been better able to respond to demand and kept the price of land well below that of Sydney.

Decisive action by both State Government and the 43 councils in Sydney (that is way too many but I'll leave a discussion of Council rationalisation for another day) is required to remove roadblocks and reform the planning system to bring onto the market much-needed new housing supply.

5 Cost of land provision

The cost of providing the basic raw material – land – in Sydney is higher than any other Australian city due to planning delays as noted above and infrastructure charges. According to the HIA – Core Logic RPData Land Report for September 2014, the median residential lot value in Sydney was $320,000 compared to $220,000 in Melbourne.

Historically, the NSW state government covered the cost of providing infrastructure for new housing from general tax revenue. Over recent decades, state policies have shifted toward user-funding of infrastructure, which has meant a significant increase in the private cost of development.

Urbis [*National Dwelling Cost Study for the National Housing Supply Council - 2011*] estimates that in 2010 total government charges (excluding GST) levied on Sydney developers was approximately $60,000 per greenfield dwelling, and between $20,000 and $30,000 per greenfield dwelling in other cities. For infill developments, total government charges levied on developers for greenfield developments are approximately $20,000 to $25,000 per apartment in Sydney and Brisbane and around $10,000 per apartment in Melbourne and Perth.

6 Fragmented land ownership and geographic constraints

The ownership of land on the urban fringe of Sydney is highly fragmented. As Sydney grows, having multiple owners on the fringe makes it more difficult and costly to amalgamate and bring large parcels of land to market.

Unlike Melbourne, Sydney is geographically constrained on all four boundaries by nature which is limiting the release of cheap land on the urban fringe. Some could argue that is a good thing as it prevents even further urban sprawl. But the simple fact is less land availability means higher land prices.

7 Foreign investors

Foreign investor activity in the Sydney market has been rising, reflecting a global search for yield, a lower Australian dollar and the increased interest in Sydney from Asia, particularly China.

It is true that in certain parts of Sydney foreign capital is driving prices higher. Some inner city apartment markets and the higher price point suburbs such as Point Piper in the east and Mosman in the north have witnessed strong price gains off the back of foreign buyer demand.

Despite the hype surrounding foreign investment, the November 2014 House of Representatives' Standing Committee on Economics report on foreign investment in residential real estate concluded:

"..that foreign investment is not causing the market distortions that have been advocated in some quarters, particularly for first home buyers. This is because foreign investment levels are not large enough to do so overall and because overseas buyers mainly operate at a different price bracket from first home buyers and buy different types of properties."

We should not forget that a significant component of this international investment is going into new development which is in turn contributing to the increase in supply. The report on foreign investment in residential real estate also concluded *"The housing supply issues that have been on-going in Australia would worsen if foreign investment was curtailed. One of the likely outcomes of any restriction on foreign buyers could therefore be further price increases – the opposite to what some in the community believe would occur if foreign investment was further restricted"*.

The RBA, which has also downplayed the role of foreign investment in driving house prices, concludes that foreign purchases *"… are for new, high-density, inner-city properties, as well as properties close to universities. Furthermore, the properties they purchase tend to be valued well above the average national sales price. In contrast, most purchases by first home buyers have been for established homes that are priced well below the national average"* The RBA goes on to say *"….and it is, in many ways, not surprising that house prices have gone up, because interest rates are very low, and, as I said, population growth, now at 1.7 per cent a year, is reasonably robust. Those two things help to explain why house prices have gone up."*

Foreign comparisons

Finally, we are increasingly bombarded with overseas commentators pointing out Australian, and in particular Sydney, housing is amongst the most expensive in the world. Whilst on most raw measures it is, one thing these commentators often forget to take into account is our geographic location.

Australia is one of the most urbanised nations in the world, with 80-85% of the population living within 50 kilometres of the coast and 67% living within our capital cities. If we compare the prices of Australia's capital cities to other global coastal cities, Australian cities are not that different to other countries. However, when compared on a country-by-country basis Australia looks expensive because the analysis does not allow for the price differential between coastal and inland locations. Of the top 10 least affordable cities in the world, of which Sydney is one, only London is not a coastal city (Table 1).

Table 1: 10 Least affordable major metropolitan markets: 2015

Rank: Least Affordable	Affordability Rank (Out of 86)	Nation	Metropolitan Market	Median Multiple
1	86	China	Hong Kong	17.0
2	85	Canada	Vancouver, BC	10.6
3	84	Australia	Sydney, NSW	9.8
4	82	U.S.	San Francisco, CA	9.2
4	82	U.S.	San Jose, CA	9.2
6	81	Australia	Melbourne, VIC	8.7
7	80	U.K.	London (GLA)	8.5
8	79	U.S.	San Diego, CA	8.3
9	78	N.Z.	Auckland	8.2
10	77	U.S.	Los Angeles, CA	8.0

Source: Demographia – 11th Annual Demographia International Housing Affordability Survey: 2015

Conclusion

There is no question that rising prices, auction clearance rates consistently above 80% and falling yields, are pointing to a Sydney housing boom. It is not sustainable but we don't expect a major price correction for the reasons we have outlined above. Rather we would expect the rate of price growth to slow during the remainder of 2015.

There is no doubt that when the Sydney housing market starts to lose momentum, some investors will be left holding a very expensive but low yielding asset with a lower-than-expected rate of capital gain.

Prospective investors will be wise to use some caution when considering an investment in the Sydney market. Just as we pointed out earlier, the national housing market is not homogenous, nor is it within the Sydney market. Sydney is a diverse market accommodating many different buyer preferences and price points. There are certainly pockets now where prices have run too hard and above fair value and that is where the risk concentrations are being built up. Investors should focus on housing that is well located around good public transport hubs, educational facilities and retail centres.

One caveat on our outlook. With the ratio of disposable income to household debt at record highs, the Sydney market will respond swiftly to any perception of interest rate rises, any contraction in global banking liquidity or government intervention. On the latter point, we welcome the recent moves by APRA and ASIC to increase their surveillance of home lending by banks, especially to investors. Prudent lending is critical to ensuring the strong Sydney market does not end in tears.

Adrian Harrington is Head of Funds Management at Folkestone Limited (ASX code FLK). This article is general information and does not consider the personal circumstances of any investor.

Index funds invest in the bad and the good

Roger Montgomery

Here's a pithy marketing one-liner for you: 'Most active fund managers underperform the index'. Combine the argument with the removal or mitigation of structural biases towards fee-paying products and a massive business has emerged in index funds and index ETFs.

The promise of diversification, a low cost and access to overseas markets are the top three reasons for the popularity of index funds, but their growth and popularity belies the fact that broadly diversified cap-weighted equity index funds guarantee 'average' returns for a generation of investors.

As passive index investing becomes ever more popular, the arguments that justify the switch from active to passive management weaken and then break down. Retail investors are none-the-wiser, and trust those recommending this approach because it's cheap.

Tellingly, they are cheap

Index investing, in particular when it is directed to cap-weighted equity indices, is dumb investing. When Warren Buffett recommended index investing to the masses, he made the point that it suits the 'know-nothing investor'. That is, the investor who has no interest in understanding or valuing a business.

If you are reading Cuffelinks, you are not a know-nothing investor. And if you are an advisor, your clients are relying on you and paying you to be a 'know-something investor'. There are plenty of reasons to avoid index investing and the ETF structures used to promote them, but those reasons haven't hampered their growth.

ASX-listed ETFs are at a record high of over $17 billion and according to the January 2015 *'Australian ETF Review*, ETF trading activity also broke the record for the largest month-on-month gain in funds under management as growth reached $955 million. Meanwhile, the number of exchange-traded products trading on the ASX exceeds 100 and the number of ETF investors in Australia grew by 46% in the 12 months to October 2014, to 146,000. More than 180,000 investors are expected to have adopted the structures by the end of calendar 2015. Meanwhile the number of financial advisers employing ETFs has reached the record level of 7,000.

Of course strong market performance is having a significant impact on index investing's popularity. The adoption rate can reasonably be expected to be highest when the market is at a crest and lowest when the market is on its knees – precisely the opposite of a successful investment strategy.

While exchange-traded and index funds have been heralded as one of the most important financial innovations during the last decade, promoters fail to warn investors of their limitations.

Dangers of popularity

As index investing grows in popularity, so does the blind purchase and sale of large baskets of shares with no regard for their underlying fundamentals. How such an approach to equity investing can be recommended to an investor requires careful examination. Most dangerously, as index investing grows in popularity so too does the divergence between stock prices and fundamental values.

Three risks for index investors increase – the risk of permanent capital impairment, volatility, and the certainty of average performance.

Index investing is justified on the basis that the market is efficient and stock prices always reflect fair values. Therefore index investors ride the coat-tails of analysts who have done the work to determine values and disseminate that information. As the number of index investors increases, so does the amount of blind buying and selling. This 'squeezes out' sensible value-based investing and reduces the influence of the narrowing pool of analysts required to establish the valuations the efficient-market-index-investing proponents rely on.

More frequent periods of greater divergence between price and fundamental value will occur, and in those periods, active managers have the opportunity to make much larger returns for their clients.

As index investing grows in size so does the ability for marginalised active managers to outperform. The argument that passive beats active – the reason for the migration to passive forms of investing – weakens.

In the long run, sensible investing beats blind investing

I have frequently used the following example to make the case for smart active investing.

In 1919 Coca Cola listed on the NYSE at US$40 per share. A year later the stock was trading at $19.50, the result of rising sugar prices and a perpetual contract Coca-Cola had with its bottlers to supply syrup for $1 per gallon. What would have happened if a single share of Coca-Cola was purchased in 1919 at $40 and held through all of the frightening subsequent economic and financial developments, including the subsequent decline to $19.50 in 1920, then through the great crash of 1929, the subsequent depression of the 1930s, World War II, a baby boom, dozens of other wars and skirmishes, an oil crisis, assassinations, the fall of the Berlin Wall, innumerable recessions, booms, busts and scandals, as well as a war in Vietnam, two in Iraq and the market crashes of 1974, 1987, 2000 and the Global Financial Crisis?

Holding that single share, accepting all of the subsequent stock splits and reinvesting all dividends, would now equate to over 252,000 shares and the investment would have a market value, at $US40 per share, of over US$10 million.

It goes without saying that there would have been many periods and windows where the S&P500, the Russell 2000 and the Dow Jones indices outperformed the share price of Coca Cola. Indeed over the last two years the S&P500 has returned 35%, while Coca Cola has returned negative 5%. And over the last five years, the S&P500 has returned more than 72%, while Coca Cola has returned 50%.

But over the very long run - the period over which investing in a slice of a business makes perfect sense - sensible value investing in quality businesses will beat an index. The index is forced to be in both high and low quality companies. A $40 investment in the S&P500 index in 1919, is now worth just $540,000, compared to the $10 million for Coca Cola.

Australia is replete with businesses generating poor returns

Many advisers and commentators despair that the S&P/ASX 200 price index remains below its all time high, some eight years later. And yet, without thinking about why this is the case, they advocate index investing.

The reason the index remains below its high despite an unprecedented amount of artificial, and temporary, support from low interest rates, is that the index is dominated by businesses generating poor returns on shareholders' equity capital. Mediocre businesses generate mediocre returns on shareholders' equity, and over time, share prices reflect this, ensuring small minority shareholders receive a return similar to that of a 100% owner of the business.

As an example, I have previously explained the terrible performance of Virgin Australia over the last decade. It has required massive capital injections, holds $1.7 billion of debt and the share price is a quarter of its level ten years ago. An investor in Virgin shares would have experienced a proportional economic calamity over a decade to the individual who owned the entire business. Every large cap Australian index fund has paid the consequences of this poor investment.

But airlines aren't the exception. A cursory examination of share price performances for many so-called 'blue chips' reveals many equally disappointing performances. Companies like AMP, NAB, Boral, Leighton, Lend Lease, BHP, Rio and Telstra might have paid dividends but their capital return has been disappointingly flat to negative over a number of years, even over a decade or more in some cases.

These blue chips make up the major cap-weighted stock indices and it is the blind buying of these diversified and cheap indices through index funds that will ensure their investors receive similarly mediocre returns.

Final thoughts

The blind buying of mountains of stocks simply because they are in an index will drive misprising that active managers can rely on to outperform the same index. As more investors flock to the index, the argument trotted out that most active fund managers fail to beat the index will become less true, if not false. The hitherto reason for investing in the index breaks down, just as active managers reward their investors with greater outperformance over the long run.

And keep in mind that it isn’t true that most managers underperform their benchmarks after fees. In Australia the vast majority of active small cap managers beat their index. Their index is full of junior mining exploration companies that lose money or dilute, with frequent capital raisings, the ownership of the company for incumbent shareholders. Simply exclude those companies from a portfolio, buy the rest, and hey presto, you’re beating the index over the long-run!

Poor quality companies aren’t the exclusive domain of small cap indices. There are rubbish companies in every index. Cap-weighted indices are constructed by aggregating the performance of companies based usually on their size or on what they do. They aren’t selected because they are highly profitable at what they do. And they aren’t selected because they are expected to produce strong share price performances over the long term for their investors.

Indices were not originally designed as investments but simply as a measure of the market's activity. A cap-weighted index is not constructed with the intention of producing a solid long-term return for investors. And that’s worth remembering when ‘investing’ in an index.

Roger Montgomery is the Chief Investment Officer of The Montgomery Fund. This article is for general education purposes and does not address the specific circumstances of any individual.

Income-seekers: these 'myths' could come back to haunt you

Christine Benz

It’s late in a decades-long bond rally, and it’s safe to say that the current, ultra-low interest rate environment is messing with our heads.

Who, at the outset of 2014, would have guessed that bonds would put on such a rally? And fewer still predicted that long-term government bonds – deeply unloved by most investors for their extreme sensitivity to interest rate changes – would be one of the best-performing categories, gaining more than 20% in the US in 2013 and 12% in Australia. With interest rates so low, you need to whip out an electron microscope to see the yield on your core bond fund, never mind cash. Low interest rates have left many income-oriented investors scrambling for yield and given rise to a lot of questions. If interest rates rise, where should bond investors go for insulation? Will individual bonds, dividend paying stocks or cash be safer than the core bond funds that so many investors have been counselled to hold?

The answers aren't clear-cut, which in turn leaves plenty of room for confusion. Here are a few of the myths that are swirling around income-producing securities. Granted, not all are out-and-out falsehoods; some of them may hold up in certain situations. But at a minimum, investors shouldn't accept them without first thinking through their own situations, especially their time horizons.

Myth 1: if rates are going to rise, you're always better off buying individual bonds than bond funds

This one comes up a lot, and it's not as though there isn't some truth to it. If you buy an individual bond at the time of issuance and hold it until maturity, you will get your money back in the end, as well as your interest payments along the way, assuming you bought the bond from a creditworthy issuer.

By contrast, you won't always get the same amount back from your bond fund that you put in. For example, say you put money into a long-term bond fund and interest rates shot up by two percentage points between the time of your purchase and the time you sell. It's very likely the bonds in the portfolio would have declined in value over your holding period, even if the yield on your fund perked up. (Of course, the opposite can also happen; rates can go down, as they did in 2014, and the bond fund holder may see his or her principal value grow, even as the fund's yield has declined.)

For some investors, that may seem like an out-and-out indictment of bond funds, especially given the likely rising long-term direction of interest rates. But while buying and holding individual bonds may help you circumvent one type of risk that the bond fund holder would confront head-on, you could still face an opportunity cost, which is also a risk.

If rates rise and you're determined to not take a loss on your bond, you're stuck with it until maturity. Meanwhile, as the various bonds in a fund's portfolio mature (and even if they don't), the bond fund can take advantage of new, higher-yielding bonds as they come to market. That helps offset any principal losses the fund incurs as rates go up.

Individual bond buyers can do something similar by building bond ladders, purchasing bonds of varying maturities to help ensure they can take advantage of varying interest rate environments. But it may take a lot of money to both ladder a bond portfolio and obtain adequate diversification across varying bond types. And by the time the investor does, the portfolio may look an awful lot like – you guessed it – a bond fund. Individual bond buyers may also face sizable trading costs. Of course, an individual may still opt to buy individual bonds rather than a bond fund but it's not true to say that doing so is automatically less risky than buying a fund. It's a trade-off.

Myth 2: high dividend-paying stocks are safer than bonds

In a related vein, some investors have dumped bonds altogether, supplanting them with high dividend-paying stocks. As well as the dividend stream, they may also gain some capital appreciation if the stock increases in value over the holding period and the company may also increase its dividend.

But as with buying individual bonds, there's a trade-off. Of course, stocks, even high-quality dividend payers, have much higher volatility than bonds, making them poor choices for investors who may need to pull their money out in less than 10 years. Moreover, stocks won't be impervious to interest rate increases and because investors increasingly have been using dividend payers as bond substitutes, they may be vulnerable to selling if rates head up and bonds become a more compelling alternative. Finally, it's worth noting that companies can cut their dividends in times of distress, as was painfully apparent to many dividend-dependent investors during the financial crisis.

Myth 3: cash is safer than bonds

This one, of course, technically is true. If you have money you can't afford to lose because you're going to use it next year to pay a big bill, it's best not to nudge out on the risk spectrum and into bonds. That holds true regardless of the prospective direction of interest rates.

But if your time horizon is longer, sinking too much into cash means you're virtually guaranteed to lose money once inflation is factored in. Investors might say that they'll steer their bond money to cash for only so long as it takes interest rates to go back to more meaningful levels and the threat of an interest rate shock has subsided. But how will they know when that is? As with any market inflection point, there won't be clanging bells letting you know it's OK to get back into bonds. Instead, a better strategy is to match your time horizon to the duration of your bond holdings: very short-term assets in cash, intermediate-term assets (with a time horizon of, say, three to 10 years) in core bond types and long-term assets in a diversified equity portfolio.

Christine Benz is Director of Personal Finance at Morningstar. This article was first published by Morningstar and is reproduced with permission. The information contained in this article is for general education purposes and does not consider any investor's personal circumstances.

Retirement catches most people unplanned

Graham Hand

Few issues in retirement planning have received more attention in recent years than life expectancy and longevity. Most people can expect to live to 90 or 100 years, which could mean 30 years in retirement, financed by either a meagre government pension or personal resources.

It's understandable that people do not worry about retirement savings while in their 20s and 30s, and even into their 40s with children and mortgages to worry about. But research on Australian retirement by three academics, Julie Agnew, Hazel Bateman and Susan Thorp, leads to the following conclusion:

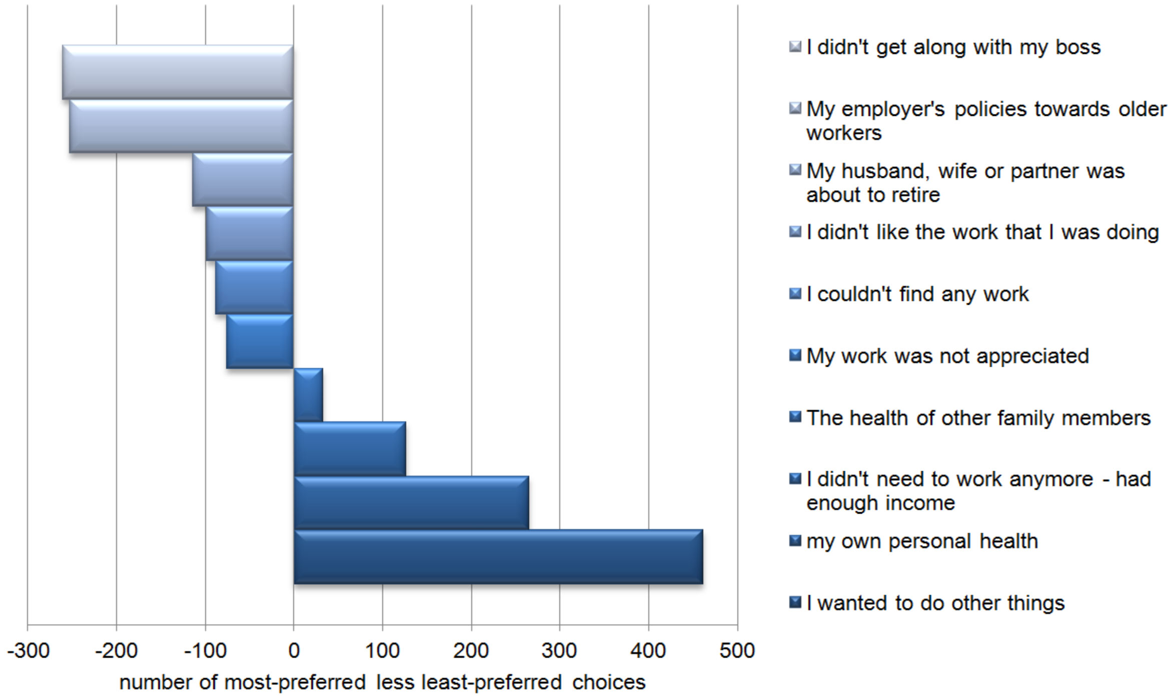
We find that more than half of Australians in their 50s and 60s have not planned key aspects of retirement. A small minority have detailed and advanced plans. In addition, expectations around these issues and actual realisations may not be well matched.

Work, Money, Lifestyle: Plans of Australian retirees, [JASSA Finsia Journal of Applied Finance, 2013]

A minority choose their own retirement date

The survey asked 920 Australians aged between 50 and 74 years about their knowledge, values and plans around retirement age. The majority of not-yet-retired had done virtually no planning for the transition to retirement, perhaps because they expected to decide for themselves when they would stop paid work. However, of those who were already retired, only 40% said they decided their own retirement date, while 60% were either forced to retire or encouraged out of the workforce, as shown in Figure 1.

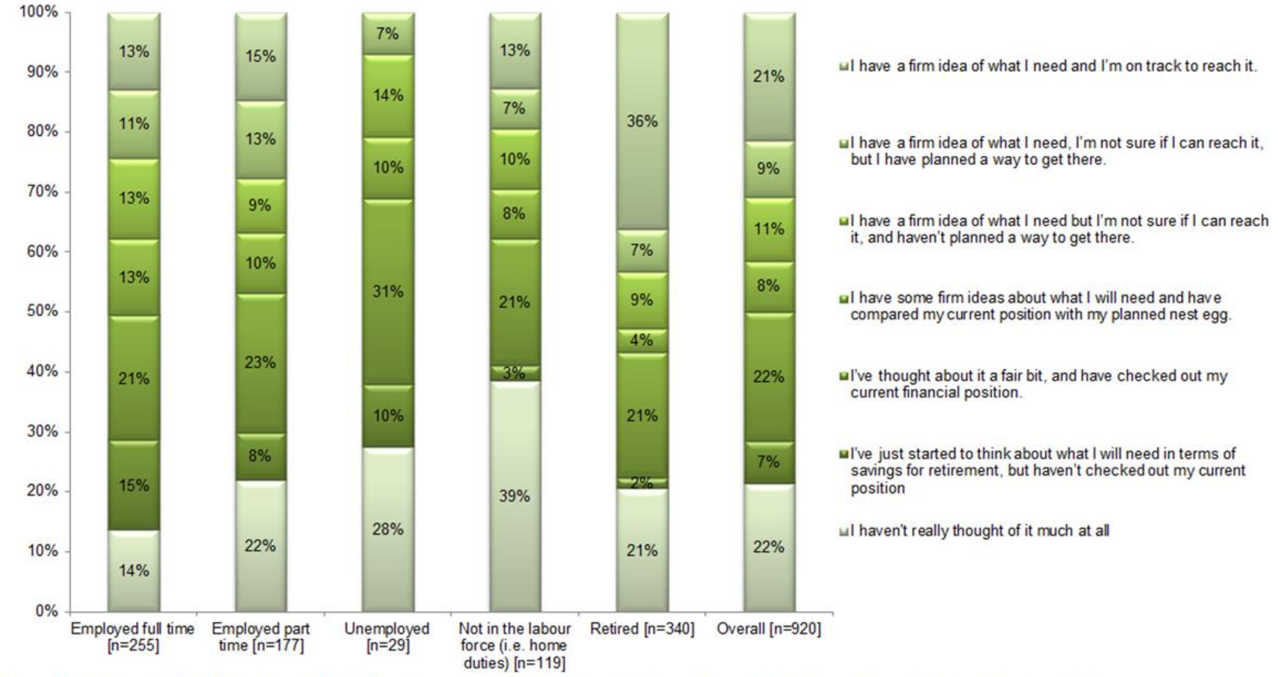
Figure 1: Relative ranking of reasons for retirement by already-retired people



(The bar lengths are determined by counting the number of times people ranked the reason as 'most important' and then deducting the times when it was ranked 'least important'. Survey respondents were shown sets of statements listing the reasons for retirement and were asked to choose the one that most applied to them and the one that least applied to them).

As Figure 1 shows, the most important reason to retire was 'I wanted to do other things', but factors beyond the retirees' control, including personal health and unwelcome work environment, were major factors in retirement. As the authors state, *"The likelihood that events outside one's control determine retirement planning makes advanced financial preparation more critical."*

Figure 2: Financial planning by labour force status, % of sample



Notes: Responses to 'Which of the following statements best describes your thoughts about the financial aspects of retirement?' by self-reported labour force status.

Only 48% of Australians aged 50 to 65 years have attempted to work out how much money they will need for retirement. About one in three has a firm plan on how they will reach their retirement needs. It's not surprising then that about half of pre-retirees expect their standard of living to decline in retirement.

Activities and lifestyle

The survey also revealed that about 40% of pre-retirees had given little thought to what they might do in retirement. For those who made plans, travel and leisure activities were priorities. Those who had already retired reported carer responsibilities and volunteering had been more important than anticipated. Of those who had returned to work, most said it was for work enjoyment rather than needing the money.

So while there is generally a lack of planning for retirement, Australians are looking forward to more travel and leisure. Let's hope they've got the money to enjoy those retirement years, because there will be far more years than most of them expect.

Graham Hand is Editor of Cuffelinks and has worked in the finance industry for 38 years.