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If this is the new normal in a low return world … give me more!

Ashley Owen

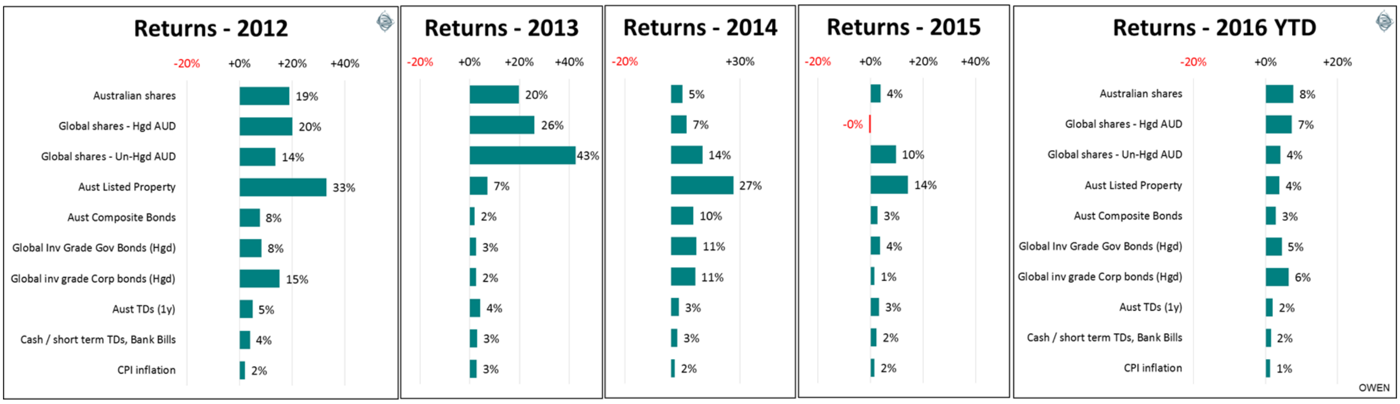
One of the sillier pieces of nonsense bandied about in recent years by so-called experts has been the '*new new normal*' in the '*low return world*'. This wonderful idea was coined by Bill Gross and Mohamed El-Erian, then joint Chief Executives of PIMCO (the largest bond fund manager in the world) in 2011 to spruik their bond fund.

They toured the world in mid-2011 skiting about their decision to sell US Treasuries early that year. It was lousy timing as Treasuries promptly rallied strongly in the European bank crisis and US credit downgrade crisis in mid-late 2011. PIMCO realised their mistake and bought back into Treasuries in 2012 right before bond yields rose during 2012 and 2013. Both were bad calls and Gross and El-Erian were fired (I met El-Erian in May 2011 and questioned him about the ill-timed decision).

But somehow the catchphrases 'new new normal' in a 'low return world' were picked up and repeated ad nauseam by lazy reporters and editors.

The best run of positive returns ever

So what has happened in the five years of supposedly low returns since the start of the 'new new normal, low return world'? Actually, five years of good returns from every asset class!



What is remarkable is that there are no red bars (indicating negative returns) in the above charts. None of the major asset classes suffered negative returns in any of the past five years. This has never happened before for Australian investors, ever.

Never in the history of Australian markets have investors received positive real (after inflation) returns from Australian and global shares and bonds, local cash and commercial property in five consecutive years. (For commercial property returns I used listed property trust returns since 1974).

The best run in the past was for four years from 1925 to 1928. Apart from that, the best investors have done has been two consecutive years of positive real returns from all of the main asset classes: 1944-45, 1997-98, and 2004-05.

Some readers might retort with something like, "Ah yes, but that was just because of quantitative easing and negative interest rates."

Well, not really. In the US, which is still the world's largest market and the one that drives markets in the rest of the world, the Fed scaled back QE during 2014, started reducing the Fed balance sheet in 2015 and 2016 as bonds matured, and then started raising interest rates in December 2015. So the early monetary expansion turned into monetary tightening. In Europe and Japan, the central bankers are backing away from QE and negative rates. On the fiscal front, expansion turned into tightening; the four years of trillion-dollar deficits in the US from 2009-12 has been followed by fiscal tightening from 2013-16. But still the stock markets, bond markets and property markets powered on.

On top of all that, we've had a steady stream of 'sell everything' panics along the way that have provided sensible long-term investors with great buying opportunities, such as:

- the Greek defaults
- a couple of bond yield spikes
- a 'flash crash' or two
- the Cyprus banking collapse
- the US 'fiscal cliff' crisis
- the shut-down of the US Federal government because it couldn't pay its bills
- the violent unwinding of the Arab Spring uprisings across the Middle East
- the rise of ISIS
- the fracturing of political structures into radical right and left wing parties across the world
- the collapse of commodities prices causing a string of bankruptcies in oil, gas and steel industries
- the slowing of China
- stagnant or weak economic growth in Europe, Japan and just about everywhere else in the world
- a currency war between all of the main central banks in the world
- a series of escalating military tensions in the disputed waters off China
- another Chinese stock market bubble and bust
- the rise of nuclear threats in Iran and North Korea
- deep recessions in Russia and Brazil
- a plethora of pathetic Prime Ministers in Canberra, plus
- a good measure of Brexits and Trumps to boot!

And every asset class did well through it all.

If this is the '*new new normal in a low return world*', then I want more of it!

It is another reminder for investors to ignore the chatter of fund spruikers, so-called 'experts' and the financial media in particular and focus on the facts. Bring on 2017.

Ashley Owen is Chief Investment Officer at independent advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.

Ten ways to generate new investment ideas

Chris Stott

Generating ideas and gathering information is an ongoing process for our investment team. At Wilson Asset Management, we analyse data from a broad range of sources available to any investor with a keen market interest and a desire to learn. In fact, investors now have an unprecedented amount of information available to them to expand their knowledge base. We generate our investment ideas predominantly from the following 10 sources:

1) Media

The media provides a wealth of information on individual stocks, market themes and economic trends. Our investment team starts each day reading media reports that include local and international news.

Valuable media sources include newspapers (The Australian Financial Review and The Australian), radio (Ross Greenwood's Money News on 2GB), television (Sky Business News and CNBC) and online platforms (Cuffelinks and Livewire). Market data provider Bloomberg, which is universally used by institutional and professional investors, has free daily email alerts and newsletters available on its website.

2) Market tables and price movements

After the market closes each day, we review share market tables to identify companies with share prices that have reached 12-month rolling highs and lows. In our experience, when a price hits a 12-month high, it can indicate a degree of momentum (particularly in a bull market) that will drive it higher. Conversely, if a company hits its 12-month low, this is often a sign of fundamental company issues and the price is likely to fall further.

If a company reaches its one-year high and we are not already invested, this can be a trigger for us to review the business. Similarly, a sharp share price increase also creates a compelling reason to investigate that stock further.

3) Word of mouth

While company executives can provide a biased perspective, personal and business contacts with knowledge of a company or industry can be more objective. Some of our most illuminating investing insights have come from personal and professional connections such as family, competitors, sell-side analysts and other fund managers.

4) Stock brokers

Stock analyst reports provide valuable and well-researched business insights. If a company is covered by sell-side research analysts, we spend considerable time analysing their reports along with understanding the consensus forecasts. Once we've determined what the market anticipates the company will earn, we build this into our modelling.

5) Directors buying

As a general rule, a company's directors know more than others in the market. Therefore, directors buying shares is a very strong signal about the business. The announcement of a Change in Director's Interest Notice revealing a company director has substantially increased their holding may prompt us to examine the company further.

6) Observations of a business

Everyday observations can also offer insights into a company. To my wife's frustration, a visit to a shopping centre becomes a fact-finding mission including quizzing retail staff. Apple's share price languished for many years until after the release of its portable media player iPod. Around this time, the casual observer would have witnessed thousands lining up to buy the iPod and an increase in foot traffic at Apple stores, however this strong demand was not reflected in Apple's share price. Apple subsequently sold 55 million iPods, generating US$9 billion in revenue and spurring the share price.

7) Life experiences, behaviours and preferences

Our own life experiences, behaviours and preferences, and those of the people around us, can also reveal a consumer trend, or structural industry change, that leads us to an investment idea.

Last year, I tried to buy a tin of a2 Milk infant formula only to find there was a considerable shortage. This experience demonstrated demand for the product was vastly outstripping supply. This insight was the catalyst to investigate The a2 Milk Company (ASX: A2M) and subsequently invest in it.

8) Company meetings and site tours

Company meetings and visits offer insights into a business such as the quality of management and its culture – both are critical factors to our evaluation of a company (for more, see ['Why bother with company visits?']). Our meetings may also generate investment ideas. For example, an executive's remark that a certain competitor is giving them a 'run for their money' could prompt us to investigate that competitor business as a potential investment.

Any investor can contact a company and ask to meet the CEO or other executives and, while access to executives at larger companies may be limited, micro and small-cap companies should welcome interest from potential shareholders.

Retail investors may also have the option of listening to earnings results teleconferences, giving them the opportunity to interpret the executives' tone, as well as their words. Larger companies often host investor days for shareholders.

9) ASX announcements

We have found previously undiscovered investment gems through our regular scan of ASX company announcements. Company announcements can be a particularly good source of micro-cap investment ideas during reporting season.

10) Ask a lot of questions

Having a fascination with the market and an inquisitive attitude are indispensable attributes for investors. In my experience, the most successful investors ask a lot of questions and are driven to gain an in-depth understanding of a company, trend or investment theme.

It's possible to generate a worthwhile investment idea, or a piece of information that leads to one, from a vast range of sources. Some brilliant investment ideas arise from a single, but valuable, insight while others are spawned from a combination of insights. Constantly gathering insights to develop a broader knowledge base and being alive to potential investment ideas is key.

Happy hunting!

Chris Stott is Chief Investment Officer of Wilson Asset Management. Disclaimer: Listed Investment Companies managed by Wilson Asset Management invest in A2M.

Asset test changes create questionable advice

Gordon Thompson

From 1 January 2017 the asset test taper rate for eligibility for the age pension is increasing from $1.50 to $3.00 per fortnight for every $1,000 in assets held above the threshold. This has led to some rather dubious analysis and advice suggesting that clients may be better off getting rid of their assets to maximise their age pension entitlement.

The reasoning goes along the following lines:

- if a retiree's assets exceed the new threshold by $100,000, their age pension will be reduced by $300 per fortnight or by $7,800 per annum
- so for a retiree to be better off, they need a return of at least 7.8% on their $100,000
- if they can't achieve a return of 7.8%+, then they are better off placing that $100,000 outside of the asset test. They can do this by spending it on renovating the family home, a holiday, pre-paying funeral expenses or gifting the money to children and grandchildren (within the permitted limits).

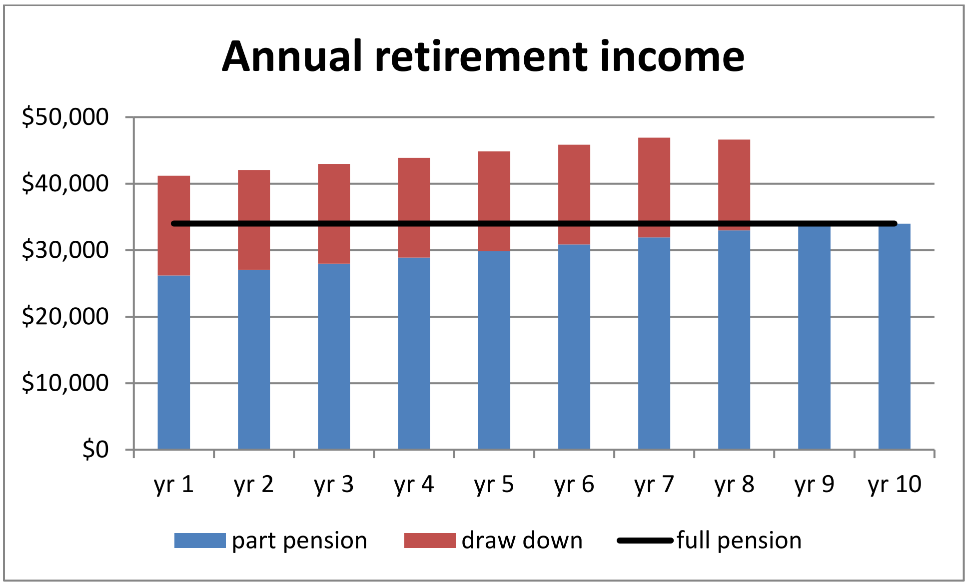
The ability to draw from capital

This analysis, and the advice flowing from it, is questionable as it ignores the impact on the retiree's annual 'income' from drawing down their capital. The goal of a retirement income strategy should be to maximise the retiree's sources of cashflow over time. This can be achieved by drawing down savings in combination with a part pension rather than exhausting savings to be eligible for the full pension.

We can compare two scenarios. The first scenario is where a retiree spends the $100,000 (such as on a house) to reduce their assets and be eligible for the full aged pension. In the second scenario, they keep the $100,000 invested, drawing down $15,000 each year until the amount is exhausted. For simplicity, this example ignores any drawdown of assets held below the asset test threshold levels.

The following chart compares both scenarios. The first scenario (spending the $100,000 immediately) is shown by the straight black line on the chart. This is the full aged pension for a couple of approximately $34,000 per annum (and perhaps more with energy cost supplements). This is in current dollar terms so the amount does not change over time with inflation.

The second scenario (drawing down the $100,000 over time) is shown by the columns on the chart. The blue section of the column is the part pension that the retirees receive after the reductions for the asset test (note for couple home-owners the income test will only have a greater impact on the pension once assets above the threshold level fall below about $27,000). The red section of the column is the additional income the couple receive each year by drawing down $15,000 from their savings. Assuming an investment return of inflation + 4% per annum, the $100,000 capital not spent on the house provides an income stream of $15,000 per annum for seven years and in year eight the couple can draw down about $13,500.



Not spending on the family home provides higher income

Drawing down their $100,000 as an income stream of $15,000 per annum will, in combination with a part pension, provide a materially higher annual income and standard of living compared with spending their $100,000 in year 1 to maximise their entitlement to the aged pension. Of course, the family home has not benefitted from the $100,000 capital spent on it, but nobody knows how much that has improved its value (which may well go to the beneficiaries of the estate).

The faulty reasoning involved in spending the $100,000 in year 1 is a classic example of mental accounting bias. This bias places a different value on a dollar of income and a dollar of accumulated capital in being able to support a retirees' lifestyle. In this example the retirees have placed a greater value on the ability to access an additional $7,800 in aged pension in year 1, over the $15,000 in additional income from drawing down their accumulated savings.

Gordon Thompson CFA is Senior Manager, Platforms, at Perpetual. This article is general information and does not consider the needs of any individual.

Caveat lender, and consistency in law

Donal Griffin

In our legal firm, we have noticed numerous clients helping their children financially to enter the property market. Family loans can have complexities and there are potential risks if the loan is not documented properly. Most clients have taken our advice and documented their arrangements as loans, however we also advise them to review their actions as they should not be regarded as 'set and forget' transactions given that the law has a statute of limitations in each state and territory.

In addition, it is important that the conduct is consistent with the documents for them to be effective. Otherwise, a disappointed spouse of your child could claim that the loans were not authentic, merely a sham.

Family arrangements may not always turn out well

The recent case of Bircher & Bircher and Anor (2016 FamCAFC 123) is instructive. A son had written mortgage documents regarding two loans he received from his father. The documents seemed to be properly drafted. However, it seems that 'the wife' (as the cases refer to female spouses in the Family Court) claimed that the loans were almost too well drafted so as to arouse suspicion. The judge observed that the husband detailed conversations he had with his father "it would seem, with a great deal of particularity in … affidavits". A schedule produced by the father was "entirely self-serving".

The original judge was not impressed by any of the parties and said both "were plainly unhealthily interested in making money through means other than just getting a job and working".

Much was made in court of the fact that a witness to each of the mortgages was the father's administrative assistant, and later his wife.

Similarly, the conduct of the loan was examined closely. No explanation was provided for why the initial agreement of a flat interest payment was changed to compound interest. Purported expenses were added to the loan balance but there was no agreement as to this arrangement. While the initial judge found that the loans were real and that the interest was properly sought, the Court of Appeal found that the judge needed to establish the terms of the loan and the evidence to support it.

Risks involved in such loans

The case reveals the risks involved for the person making the loans. Quite apart from reputational risk, the court found that, as the parties did not have substantial assets and the husband and father failed in the appeal, they should pay the wife's costs. The costs order was made joint and several so the father may well have had to pay all of the costs of that hearing.

The matter was sent back to the Family Court for a trial on the evidence about the loan. These cases are not cheap to run and it remains to be seen who will be asked to pay the costs of that hearing.

The lesson here is that you need to have clear loan documents that reflect an agreement that is carried out and have the other spouse as a party to the loan.

With respect, we beg to differ with Shakespeare: neither a borrower nor a lender be, *unless you document the loan properly and administer it in accordance with those documents.*

Donal Griffin is a Principal of Legacy Law, a legal firm specialising in protecting family assets.

Some active managers succeed while the majority struggle

Alan Hartstein

The active versus passive debate rolls ever onwards, and Cuffelinks has published many articles from both sides of the debate. For example, Chris Cuffe has explained how he picks active managers that have outperformed the index over the years, while we have reported in the past on the S&P Indices Versus Active Funds (SPIVA) Australia Scorecard.

According to S&P's latest report to June 2016, the majority of active Australian equity and bond funds continue to consistently underperform their benchmarks.

However, while it's not pretty overall for most active managers, there are sectors where active does well, and it's possible to identify active opportunities even in sectors where passive managers are more successful overall.

The report evaluated the performance of 608 Australian equity funds (large, mid, and small cap, and A-REITs), 294 international equity funds, and 66 Australian actively managed bond funds over one, three, and five-year investment periods.

SPIVA's annual scorecard is now in its 14th year and serves as "the de facto scorekeeper of the active versus passive debate", the report states.

"There is no consistent trend in the yearly active versus passive index figures, but we have consistently observed that the majority of Australian active funds in most categories fail to beat the comparable benchmark indexes over three- and five-year horizons," the report adds.

Flat year, flat funds

In a year in which the S&P/ASX200 was almost as flat as a pancake, registering only a 0.56% gain, Australian large-cap equity funds posted an average return of 0.09%, with close to 60% of them underperforming the S&P/ASX 200. Over the five-year period, 69% of funds in this category underperformed the benchmark.

Large-cap funds were not alone. The majority of ASX equity funds underperformed benchmarks over all three time frames. International Equity, Australian Bond, and A-REIT funds were the worst performers over the three time frames.

A-REITs big relative underperformers

A-REIT funds recorded an average return of 22%, lagging the S&P/ASX 200 A-REIT benchmark by 2.5% over the 12-month period of the report. The majority of funds lagged the benchmark, with 87.5%, 93.1%, and 92.4% underperforming over the one, three, and five-year horizons respectively.

Adrian Harrington, head of funds management at Folkestone Limited, said success as an active A-REIT fund over the long run depends on the management and their investment approach. The smaller conviction-based funds don't worry about benchmark weights and are not bound, like bigger A-REITs, to invest in ASX200 companies. The top six managers in the A-REIT sector outperform the index, usually because they manage high-conviction funds. Smaller funds can invest in individual companies based solely on merit.

The larger funds, he said, had actually been victims of their own success: "They have so much money that they're bound by rules which prohibit them from stepping far outside the high market-cap property stocks. Westfield and Scentre comprise 36% of the index, while the top eight stocks comprise 80%, so it's very highly concentrated. Those funds have to hold a certain percentage of Stockland or Mirvac stock in their portfolios, regardless of whether they like them as investments or not."

"The index has nearly a 60% exposure to retail shopping centres, which is ok in boom times but in reality represents a higher investment risk during periods of more normalised returns. We've got one of the highest non-indexed weightings in the sector."

Mid and Small-Caps outperform over longer term

The majority of ASX Mid and Small-Cap funds lagged their indexes over the shorter one and three-year periods, but a healthy 62% outperformed the benchmark over the five-year period by an average of 3.6%, and some by a far more significant margin.

Glennon Capital Managing Director Michael Glennon said he was not surprised by the longer-term result. "Small cap managers understand markets and businesses and they have a feel for momentum. To invest solely in small caps you need to understand what the market has an appetite for and what is behind a company's growth story."

Like the better-performing smaller A-REITs, Glennon said small-cap funds are not constrained by weightings and can pretty much invest in whatever they like. "The companies we invest in can potentially double their market caps in a relatively short space of time, whereas a $25 billion fund is not likely to grow to $50 billion in just a few years."

International equities, bonds poor relative performers

The S&P Developed Ex-Australia LargeMidCap recorded a return of 0.9% over the 12-month period. However, international equity funds posted an average loss of 2.1%, and 80.7% of those funds underperformed the benchmark. Over 90% of international share funds underperformed the benchmark over the three and five-year periods.

The average return of international equity funds consistently lagged the S&P Developed Ex-Australia LargeMidCap by more than 2.6% in the three and five-year periods.

The S&P/ASX Australian Fixed Interest Index gained 7% in the 12 months to June, while Australian bond funds recorded a smaller average gain of 5.6%. Some 89.5% of funds underperformed the benchmark, while 92.2% and 88.7% of funds lagged the benchmark over the three and five-year periods respectively.

Funds merging and liquidated

Five per cent of Australian funds from all measured categories merged or were liquidated over the year ending in June. International equity funds disappeared at the fastest rate (6.9%).

ASX funds had an overall survivorship rate of 78.4% over the five-year period. Bond funds had the highest rate of survival (83%), while international equity funds had the lowest, with more than a quarter either merging or being wound up.

Alan Hartstein is Deputy Editor of Cuffelinks.

Seniors tax and moving money outside super

Graham Hand

It's not safe to assume any current tax regulation will stay the same forever. The Seniors and Pensioners Tax Offset (SAPTO) rules are suddenly in the news, after the Grattan Institute published a paper called 'Age of entitlement: age-based tax breaks'. Grattan noted that seniors pay less tax due to the combination of SAPTO, a higher Medicare levy threshold and higher rebates on private health insurance. These age-based tax breaks mean that the proportion of people over 65 paying tax has halved in the last 20 years, placing strains on the Commonwealth Budget.

No certainty about taxation rules

One of the difficulties in planning and saving for retirement is there is no certainty about the future rules. The superannuation regulations are notorious for constant tinkering, despite government assurances otherwise. While many despair at the recent superannuation changes which will increase taxes on large super balances from 1 July 2017, this new debate on SAPTO, levies and rebates shows far more budget outcomes are on the table for review.

The Australian Taxation Office issues a guidance on qualification for SAPTO. Eligibility for this tax offset requires meeting conditions relating to income and age. A qualifying couple can earn up to $28,974 each (or a combined income of $57,948) without paying income tax, while the amount for a single person is $32,279. There are also energy supplements worth even more. Above these amounts, usual income tax rates apply.

The tax-free income potential is important when considering the merits of leaving money in superannuation. During the 'accumulation stage', super funds (including public and self-managed super funds) pay income tax at 15%. It is only when the money is in 'pension stage' that the income tax rate drops to zero. These relatively low rates make superannuation an efficient savings vehicle for anyone on higher marginal tax rates. For example, a person earning $100,000 will pay a tax rate of 39% (including Medicare Levy of 2%) on each extra dollar. If this person can salary sacrifice (up to defined limits) into super rather than the money going into personal income, the tax saving is significant at 24% (39% minus 15%). This is the best option for many people, insulating income from higher personal tax rates.

Choice whether to leave money in super

Retirees who satisfy the 'condition of release' rules and can access their super face a decision. They can leave their money in the pension phase of super and not be subject to tax, but the super system is subject to the vagaries of rule changes. More problematic, their estate may need to pay a 17% death tax on the taxable component of super paid to non-dependants (such as their adult children). This is a potentially large and avoidable tax.

Alternatively, they could take their money out of super, and invest in their own names and pay no income tax if they stay below the limits including the benefit of the SAPTO thresholds. At the moment, there are no death taxes outside super.

Every person's circumstances are different, but there should not be an automatic assumption that money should be locked in superannuation when a retiree has a choice to access the money. It's worth obtaining professional financial advice to check personal calculations.

As the latest debate on the SAPTO rules indicates, the only sacred cow remaining in the Australian taxation system is probably the exemption of the family home from various social security and capital gains tests. And it's about time that was somewhere on the list.

Graham Hand is Managing Editor of Cuffelinks. This article is general information and does not consider the circumstances of any individual.