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This Week's Top Articles

Tension as diversified portfolios have lost their anchor

Rob Prugue

There's plenty of material in the market about how yields within the aggregate bond indices are either nominally negative or offer negative real returns. It creates problems for investors seeking to achieve a 'CPI+' target just by allocating to traditional OECD government bonds as their portfolio's defensive anchor.

Many Chief Investment Officers at defined benefit superannuation or pension funds wishing to manage their long-term liabilities with a standard diversified portfolio may no longer be able to consider government bonds a strategic asset class. At best, most OECD government bonds could be considered a tactical asset class, one used to buffer the underlying capital during any expected market correction. Their predicament is further complicated by the on/off debate around when meaningful inflation will return.

Where else to invest 'defensively'?

Frustrated by their inability to access traditional government bond yields at CPI, let alone above, an increasing number of professional investors have either increased their risk budgets within their defensive buckets (sounds like an oxymoron), or they've abandoned the underlying bond indices and embraced specific bond issuer risk. In either case, this is indicative of how investors are looking to redefine traditional exposures, albeit while still under the 'defensive' umbrella.

But the risk budget must come from somewhere.

There's always been some friction between bond and equity departments. More recently, much of this friction has come from the fixed income team now consuming a larger portion of the overall portfolio risk budget. Equity teams can come to resent this as they're usually the ones asked to reallocate some of their risk budget to keep the overall bond allocation fixed at a Moses' stone-engraved and highly static 40% level. The fixed income teams push out their risk budgets, while leaving the overall total portfolio risk budget static, and the allocation has come out of the equity teams.

In fixed income, especially for active portfolio managers, this has opened up what was previously a dormant and inactive sphere. What wasn't passively allocated already was predominantly owned by a few big fixed income houses (or in central bank portfolios). Unlike what's been happening within the equity world, many fixed income investors seem to be moving away from traditional passive. But here too, even the big ETF and index providers have been negatively impacted as investors have either favoured high risk fixed income options, or complete benchmark agnostic fixed income portfolios. Liquidity and capacity constraints have played against the massive size of the major fixed income shops.

Either way, yields on OECD medium and long-term bonds remain at levels that make it too difficult to assist in pension liability immunisation, or for any investor seeking low risk CPI+ returns. As long as this continues, investors will be forced to seek out alternatives within a shrinking bucket called Fixed Income.

Portfolios lose their defensive character

Investors will either have to push out their risk budgets (through individual bond purchases or through higher credit risk), or seek out bundled solutions which deliver risk and return metrics traditionally expected of a 'defensive' asset class. Obviously, these moves take portfolios away from their primary role of protecting capital. It's like anchoring a boat with too short a slack, until it ultimately pulls the vessel under water.

Investing a diversified portfolio in this market is not easy. If it was, then economics would be an exact science over a social one.

Rob Prugue is Senior Managing Director and CEO at Lazard Asset Management (Asia Pacific). This content represents the current opinions of the author and its conclusions may vary from those held elsewhere within Lazard Asset Management. This article is for general education purposes and readers should seek their own professional advice.

How to know if 'fake crises' are worth the worry

Don Stammer

'Fake news' has been dominating the media since the Trump Presidential win. Financial markets have a parallel concept we will call 'fake crises'.

A fake crisis is a major sell-off of one or more asset classes brought on by widely-held expectations of an impending disaster, but one that fails to eventuate or has been massively exaggerated.

Unnecessary losses from a fake crisis

A fake crisis can inflict heavy losses on an investor who dumps quality assets at depressed prices during the panic but provides the opportunity for an investor to acquire good assets cheaply.

An outstanding example of a fake crisis in investment markets – the *cause célèbre* – occurred in the early weeks of 2016. The dominant view then was China's economy was 'contracting' and would soon cause a global recession. Commodity prices, share markets and the Australian dollar plunged.

As things turned out, retail sales continued at almost double-digit growth, industrial production expanded strongly, and China boosted demand on a scale the doomsayers had not allowed for. Shares, commodities, confidence and the Australian dollar all rebounded.

Other fake crises in investment markets during recent years

Many examples of fake crises have unnecessarily worried investors, including:

- The initial (but very brief) collapse in share prices following Donald Trump's win in the US presidential election.
- The loss in market sentiment following the Brexit vote in June 2016.
- The 'taper tantrum' in 2013, when bond markets sold off aggressively on the expectation the Fed would mismanage the phasing out of its huge programme of bond purchases.
- The 'sovereign debt crises' in Europe in 2012 and 2013, which were exaggerated and were followed by record low bond yields.
- The widely held fears in the second half of 2011 that the US economy was sliding back into recession.

Fake crises generally follow the same pattern. Investors always have a lot of things to watch and to worry about. From time to time, concerns develop, sometimes without justification. A momentum builds up. Many investors come to uncritically accept data or comments that support the majority view while ignoring the countervailing facts. Maybe some hedge funds will 'short' assets or asset classes, expecting to buy them back during the crunch at lower prices. Research reports may be released full of gloom and doom to support the portfolio positions the hedge funds have taken up.

Managing reactions to a fake crisis

The best way I know of working out whether a crisis will create prolonged pain or be short-lived is for the investor (perhaps through his or her adviser) to create two lists on the outlook for the relevant market or markets. One list would show the worries. The other list would set out the positive or counter-balancing influences. The investor can then take an on-balance view appropriate to their risk tolerance.

This approach can be applied to any or all investment markets. Let us try it on the current outlook for the Chinese economy.

China: negatives and positives

Negatives:

- The huge build-up in indebtedness by Chinese governments (at the national and regional levels) and by property developers.
- The potential for bad debts of banks to blow out.
- The excess capacity in heavy industry.
- The risk of a surge in capital outflow causing a run on the Renminbi.
- The slow pace of reform among state-owned enterprises.

Positives:

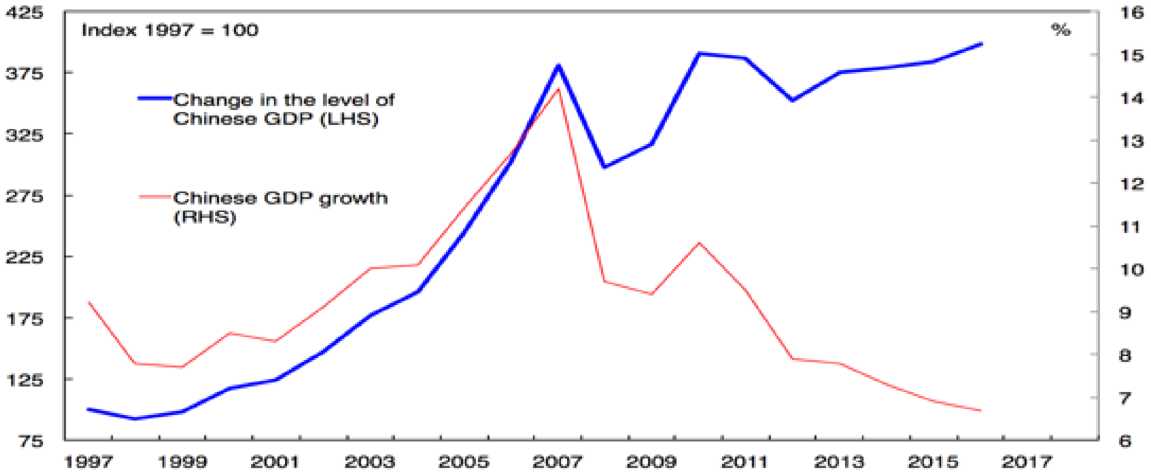
- China has a high level of saving.
- The increased debts are mostly owed domestically and not to lenders abroad.
- International reserves still stand at US$3 trillion.
- For many years there will be a high level of building construction for the urbanisation program.
- To date, the move to a more market-determined exchange rate mechanism is working well.

Buy, sell, do nothing?

In my view, a reasonable on-balance assessment is that the pace of expansion in the Chinese economy will slow a little, both cyclically and in trend terms, in the next couple of years. The risks of recession are low but there will be recurring big swings in investors' confidence in China's economic conditions and prospects.

China's growth has moderated from a rate of 14% in 2007 to 7% in 2016. But in absolute terms, the year-by-year expansion in the Chinese economy has remained impressively large, and that is what matters for both global growth and the Australian economy.

China: Absolute change in GDP is impressive, despite slowing % growth in GDP. Source: Bloomberg



Fake crises can materially impact investor returns if it leads to panic selling, so a calmer and more systematic approach is called for to avoid overreacting to the noise.

Don Stammer has been investing for over 50 years, including long periods with Deutsche Bank and ING. He writes a fortnightly column on investments for The Australian and has advisory roles with Altius Asset Management and Stanford Brown Financial Advisers.

Changes needed to improve retirement for women

Bob Deutsch

The average superannuation balance of women at retirement is about 60% of the average balance for men. According to a December 2015 ASFA research paper, for those with superannuation (excluding persons with a nil balance), the average balance for males was around $135,000, while for females it was around $83,000.

The gap is driven by a number of factors which include:

- the lower workforce participation rate of women compared to men
- a disproportionate representation of women in part-time and casual employment
- the gender pay gap itself
- interrupted working lives due to, amongst other matters, having children, and
- the disproportionate amount of unpaid caring work undertaken.

Bleak retirement prospects

The problem is most acute for women who are way behind the level of superannuation required for a decent retirement and are currently in their early 50s with no realistic prospect of improving their super balance. The prospect for a reasonable retirement looks bleak indeed.

To add insult to injury, the age at which men and women will be able to access the age pension is progressively being increased to 67 years of age.

The consequence is that a woman now aged 60 without work will need to rely on the Newstart Allowance until she reaches the age of 67 when she may be entitled to the age pension. While men can be similarly disadvantaged, as a broad cohort, women will be in a far worse position.

Measures to address the super shortfall

To address this problem, The Tax Institute is broadly supportive of measures whereby the Federal Government would:

- make a non-concessional co-contribution of $1,000 for all single women on a matched 2:1 basis where total assets held in superannuation in the name of the woman is less than $100,000
- provide an opportunity for women who have had interrupted work practices to make catch up concessional contributions (a version of this will operate from 2019/20)
- make modest changes to the anti-discrimination laws to give a clear legal basis to schemes introduced by companies to provide higher superannuation payments for female employees
- provide for the age pension to be made available to single women who have total superannuation of less than $100,000 from the age of 60
- provide a $1,000 per year superannuation contribution for an unpaid voluntary carer, whether male or female.

Two companies, ANZ and Rice Warner, have created schemes that are specifically targeted to benefit women. For example, ANZ's female staff can be superannuated by the employer to the tune of an extra $500 per year in contributions. That is a step in the right direction but more needs to be done.

None of these ideas would come cheap, but the nature of the problem is acute and it should be addressed as a matter of urgency.

Bob Deutsch is Senior Tax Counsel at The Tax Institute*. The Tax Institute is hosting a* one-day forum in Sydney *on 16 August 2017 where expert presenters will debate how to improve key areas of Australia's tax system.*

Disruption supports small company growth opportunities

Andrew Mitchell

This month marked the 10th anniversary of the launch of the original Apple iPhone. It was another reminder of how dynamic the global investment landscape has become in recent years. While Apple investors cheered the launch of the smartphone device, it would be difficult to think that they, or even founder Steve Jobs, would have appreciated at the time just how significant the device would be to some industries over the following decade.

The iPhone underpins market growth

The market capitalisation (cap) for Apple, already growing well on the back of the refreshed Mac and iPod offerings, was at US$105 billion at the time of the launch. A decade later, the business commands a market cap of more than US$750 billion. The equity value generated to shareholders over that period cannot be entirely attributed to the iPhone, but its introduction would prove to be a critical inflection point for both Apple and a multitude of other industries in bringing the internet into the consumer's pocket. It is estimated there are over 700 million active iPhone users globally, while more than half of the entire world's population has access to an IOS or Android smartphone device.

Opportunities and threats of new technology

Investors today are increasingly challenged by both the opportunities and threats that new technologies bring to established business models. The investment management community needs to continually review and re-test the potential for a company to be disrupted by an emerging entrant or identify an inherent opportunity in new business models. With more sophisticated technology, globally-connected communities and a venture capital industry that is willing to fund untested business strategies, the rate of change and the consequences of those changes continue to increase dramatically.

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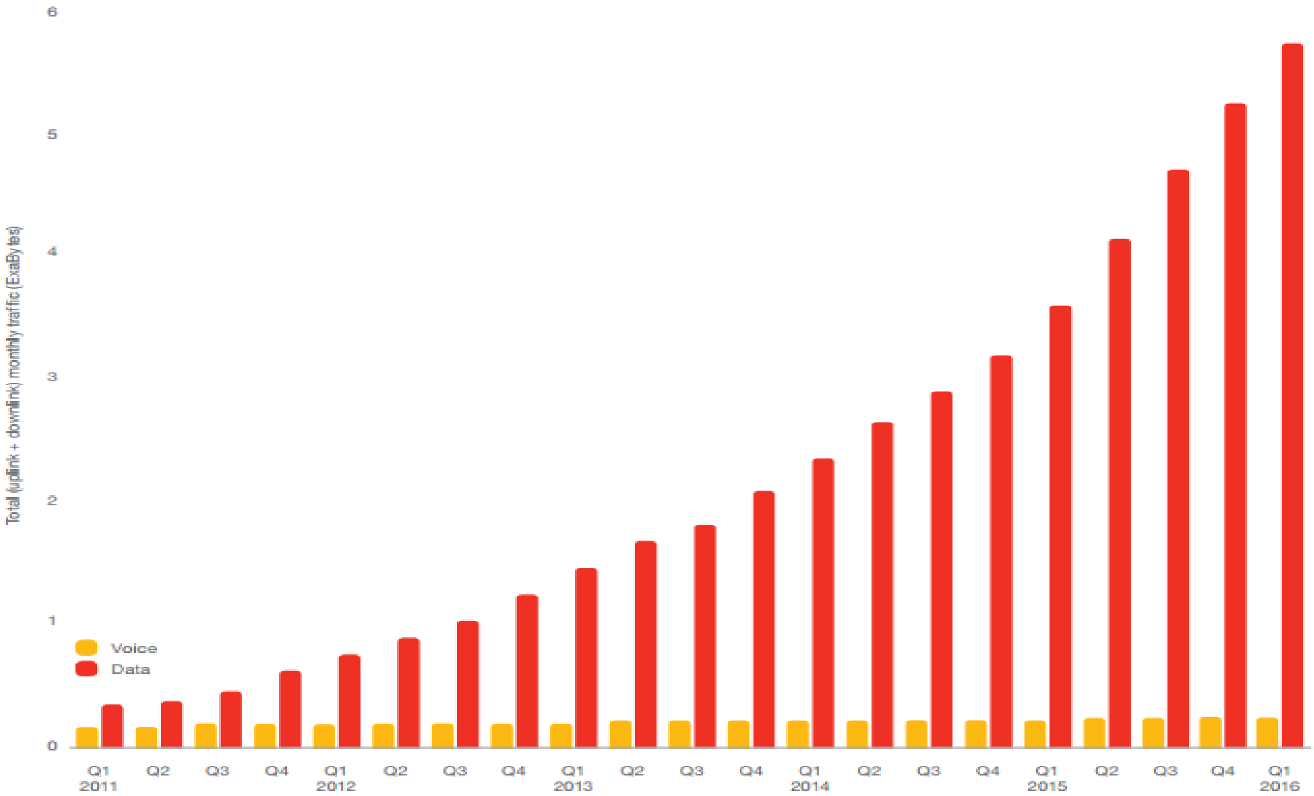
In the iPhone's case, the impact from its introduction extended well beyond smartphone unit sales and broader industry market share. Entire industries have been created as a result of ready and easy access to the internet on a personal device. Telco operators, for one, have been huge beneficiaries from significant growth rates in data usage. Telstra, for example, has experienced a nine-fold increase in Australian mobile data consumption in the last five years alone, a trend that has been equally replicated on the global stage.

Global mobile data usage vs voice 2011-2016



Source: Ericsson Mobility Report 2016

The smartphone also paved the way for an entire wave of new app-based business models such as Uber, SnapChat, WhatsApp and Spotify, all dependent on smartphone functionality. Using the latest available private valuation data, those four companies alone now have combined equity value of about US$120 billion, which is higher than Apple's total market cap at the time of the launch.

The hyperbole is seemingly endless, from the enormous subsequent growth in active users for social media heavyweights Facebook, LinkedIn and Twitter to the estimated US$70 billion in earnings generated by the global app developer community since the launch of the Apple App Store in 2008. These are entire industries and companies that did not exist less than 10 years ago and for investors that were able to recognise the opportunities early, the returns have been exceedingly profitable.

Casualties are left in the wake

Momentous change also often brings with it inevitable casualties, where the products and companies that are unable to adapt are often ruthlessly left behind. In the iPhone's case, manufacturers of digital cameras, personal GPS products and older-world mobile phones were unable to recover from the onslaught of multi-media smartphone devices. At the time of the iPhone's release in 2007, Blackberry held about 50% of the mobile phone market in the US, with the company's market cap peaking a year later just shy of US$80 billion. Ten years on, the company now trades with a market cap of US$5 billion.

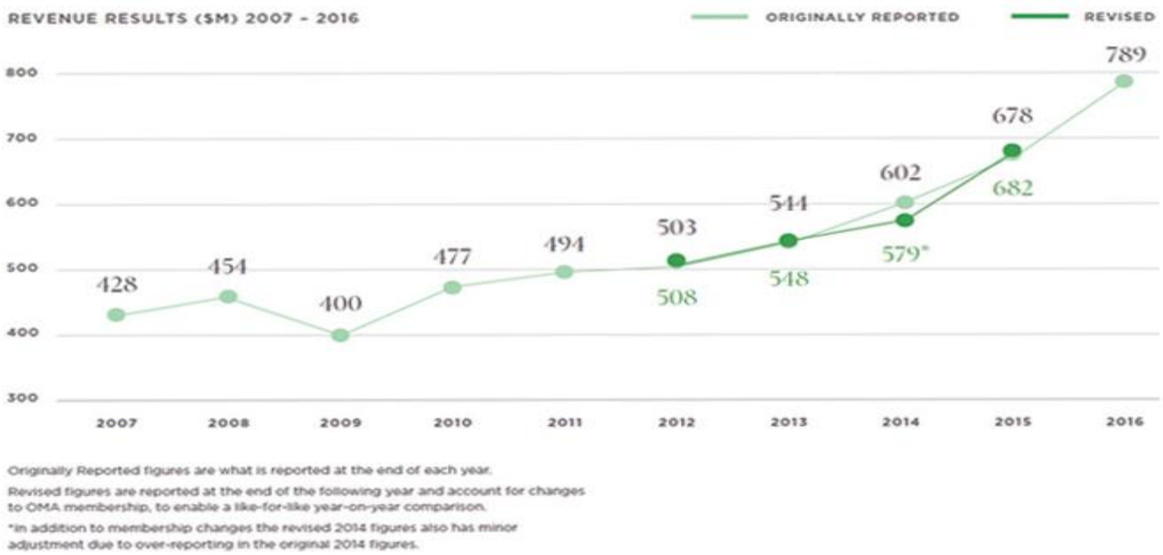
Small and mid-cap providing opportunities

In Australia, there are ample opportunities to identify businesses that can benefit from emerging structural changes. While the larger cap end of the market tends to skew more toward older-world business that will likely view disruption as a threat, the emerging small and mid-cap company space has provided investors with opportunities to benefit from rapid and broad-based change.

The recent move by small and large businesses to host IT infrastructure in the cloud, for example, has created enormous tailwinds for the providers of external data centres and IT services. Where businesses once located their IT systems and servers on their own premises, cloud technology enables this function to be outsourced. NextDC (ASX:NXT) is a large provider of data centres and has seen its revenue more than double over the last three years.

For outdoor advertising, the introduction of digital screens and electronic billboards single-handedly revitalised an industry that before 2012 looked devoid of any meaningful growth. The 'Out of Home' media industry in Australia has seen revenues grow by more than 50%. After an initially shaky start to listed life, the share price of Ooh! Media (ASX:OML) has almost doubled since its ASX listing in December 2014.

OML revenue growth over ten years



Source: Ooh! Media Limited 2016 Annual Report

The opportunities available from new technologies and new markets have also extended into the more traditional primary industries. The fortunes of dairy and infant milk formula provider A2 Milk (ASX:A2M) may have been less stellar without the emergence of cross border e-commerce retail websites (Tmall, JD.com) that opened up an entirely new market into China. A2 Milk generated just NZD$42.2 million in group sales in 2011 while that figure is expected to grow to above NZD$540 million at the coming FY17 results.

In an economic and corporate landscape that continues to evolve at an increasingly rapid rate, investors need to balance the threats of change to traditional business models with the opportunities available for new ones. One of the real pleasures of investing within the emerging companies space is the variety of businesses and industries available to leverage to these emerging trends.

Andrew Mitchell, Portfolio Manager and Co-Founder, [Ophir Asset Management.](#) This article is general information that does not consider the circumstances of any individual.

5 considerations for SMSFs investing in residential property

John Chauvel and Adam Smith

Residential property has long been a popular asset class for Australian investors who enjoy a high degree of comfort from tangible investments they can touch and feel. This contrasts with financial assets, such as shares and bonds, which have a paper value based on the market's interpretation of their value, a process best described as the action of the 'invisible hand'. It is therefore surprising to see only 4% of SMSFs' $636 billion in total assets invested in residential property (according to the ATO).

Rather than vilifying SMSFs that borrow to invest in residential property, we should welcome the stability provided to the market and a source of long-term rental stock.

There are positives and negatives associated with SMSFs investing in residential property which are unique to SMSFs. Let's look at five of these factors in more detail.

1. In it for the long term

A long-term appreciating rental income stream is ideal for SMSFs. If a residential property is acquired during accumulation phase, when income is not so important, by the time the fund enters pension phase, the rental stream should have appreciated to a level more suitable for a self-funded retiree. For example, if an SMSF purchases a property today at a net yield of 3% and the property value appreciates at a long-term rate of 6% pa, the net annual rental yield (pre-tax) after 20 years would be 10% based on the original purchase price of the property. This type of return needs to be compared to other investments available such as finite and discrete returns offered by fixed income (including term deposits) and equities, which also a have a tendency to appreciate in the long run.

'Long-term' is the critical assumption here. While in the short term, yields and property values will go up and down, over the long term, they are likely to revert to their means. The good news for SMSF investors is they should be truly long-term investors, usually accumulating over a 30-40-year period.

Residential property is a good investment over such a long-time horizon because of its utility value. We don't know if people will be buying iPhones in 30 years' time, but we do know they will need somewhere to live. Few individual stock or bond investments can provide this level of long-term utility.

2. Maintaining diversification

Concentration risk poses the biggest challenge to SMSF investors. If the median dwelling price in Australian capital cities is over $600,000, there are few SMSFs in the early stages of accumulation that would have enough capital to invest in residential property, let alone justify such a high allocation to a single asset. In fact, 57% of SMSFs have assets in excess of $500,000 and most of these will be in the latter stages of accumulation or in pension phase. This means they will be less inclined to make long-term investment decisions requiring a 20 year+ time horizon.

Also, while the residential property market is relatively liquid, transaction costs are high, including stamp duty and agent fees, and liquidation periods long. Again, the best hedge for this risk is having a very long-term investment horizon. The best way to establish a long-term investment horizon, without running into concentration risk, is to borrow.

Borrowing utilises someone else's capital to purchase an asset. In exchange for a capped return, the lender gets priority over the borrower for the repayment of their capital. An SMSF with $700,000 in assets intending to purchase a property for $500,000 could borrow $200,000 and maintain diversification and liquidity with the remaining $400,000.

3. The downside to borrowing

Borrowing doesn't make a bad investment good, but it can make good investment bad. Leverage on the upside is good, but on the downside it can be bad, particularly if an investor is forced to liquidate an investment due to an inability to meet interest and principal repayments. Liquidating on the downside can reduce the value of an investment to zero, even if the investor thinks its value in the long run will recover.

This is the risk that plagues highly-leveraged households when they find one or more breadwinners temporarily out of work and no longer able to service a mortgage. This is the biggest systemic threat to the Australian housing and financial markets, not prudently leveraged residential property investment.

A prudently-managed SMSF should not have a problem with leverage, particularly if it maintains diversified assets that generate income. In the event of servicing stress (i.e., an extended period of vacancy or negative cash flows after debt servicing), the SMSF should have other assets that provide income or liquidation potential to generate cash flow to service the debt.

4. Limited recourse loans

The net effect of prudent borrowing by an SMSF allows it to consider a long-term investment early in its accumulation phase when it is most prepared to make long-term investment decisions. The requirement (by law) for the SMSF to borrow on a limited recourse borrowing arrangement (LRBA) also allows the fund to make a considered leveraged investment decision without compromising its other assets.

It's not that an LRBA is the only way for an SMSF to gain access to leveraged property. An SMSF can invest in a pooled-property managed investment scheme that is leveraged. The trade-off is flexibility and cost. At the very least, the ability for an SMSF to make a direct leveraged property investment provides healthy competitive pressure to ensure these schemes are priced fairly and offer a good service to investors.

5. Effect on housing market

Finally, what impact will SMSF borrowing and investing in residential property have on housing affordability and market stability?

Several attributes of an SMSF investor differ from other investors and even households aspiring to enter or upgrade residential property by borrowing.

1. The SMSF trustee should make an economic, rational decision to purchase an asset that will generate a long-term appreciating income stream to fund the retirement of its members. A long-term economic decision is less influenced by short-term yields and housing prices. This creates more stability for the housing market.
2. The SMSF is not driven by tax distortions like negative gearing and capital gains tax that drive other investors. This means the SMSF investor is less likely to drive house prices higher than their true economic value.
3. The long-term investment horizon and financial stability of SMSFs mean they are less likely to be short-term opportunistic or forced sellers of property. This reduces systemic risk and creates greater market stability.
4. SMSF investors increase the amount of housing stock available to renters, which increases housing affordability. This may reduce the incentive for households to move from rental to borrowing and owning where the household may become more financially vulnerable.

SMSFs make up a small part of the demand for residential property, but they are more likely to have a stabilising impact on the market than a negative impact on housing affordability.

John Chauvel is a former debt capital markets banker and current fintech entrepreneur. Adam Smith is a Director of The Super Group, an SMSF advice and administration provider. As far as he knows, Adam is not related to the famous economist whose 'invisible hand' analogy was referred to above. This article is general information that does not consider the circumstances of any individual.

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Making it easier to transfer death benefit pensions

Mark Ellem

In my previous article, I discussed how a surviving spouse can receive a death benefit pension and how the new transfer balance cap operates. This second article focusses on other features of death benefit pensions.

How is a death benefit pension taxed?

If the deceased or death benefit pension recipient was aged 60 and over, the recipient, for example a surviving spouse, receives the pension tax-free. If the deceased and the death benefit pension recipient were both under age 60, the pension is taxed as follows:

- Tax-free component of pension - 0% tax.
- Taxable component of pension – taxed at personal tax rates, plus applicable levies, e.g. Medicare, less a 15% tax offset.

The 15% tax offset only applies while the pension is classified as a death benefit pension.

Can you transfer a death benefit pension to another fund?

To transfer any pension from one fund to another, you must stop or fully commute the pension back to accumulation phase, rollover the accumulation monies and commence a new pension in the new superannuation fund.

It is not uncommon for a surviving spouse to move their death benefit pension to another superannuation provider. The death benefit pension may be commenced or the pension may revert on death from an SMSF. If the surviving spouse does not wish to continue with the SMSF, they may transfer the pension to another non-SMSF provider. Under the previous rules, the surviving spouse had to wait until the expiration of the 'death benefit period' before affecting the transfer to the new superannuation fund, to avoid the nasty tax outcome.

However, even after waiting for the 'death benefit period' to pass, once the death benefit pension was transferred to the new fund and a new pension commenced, the new pension will have lost any link to being a death benefit pension. Consequently, if the surviving spouse was under age 60, the taxable component of the pension was assessable, but with no 15% tax offset.

How has the 1 July law change helped?

Prior to the new law starting on 1 July 2017, if a surviving spouse under age 60 elected to receive a lump sum death benefit payment, rather than a pension, they needed to fully commute the death benefit pension to a lump sum within the 'death benefit period', otherwise tax may have been levied.

From 1 July 2017, it is possible to roll over death benefit entitlements to other funds without having to wait for the expiration of the 'death benefit period'. Once the amount has been rolled over it will continue to be recognised as a death benefit superannuation interest and must be used to commence an income stream from the recipient fund or cashed out as a lump sum. This allows a beneficiary to rollover a death benefit pension to a fund of their choice, including a SMSF. It retains the concessional tax treatment associated with a superannuation income stream death benefit (i.e. tax offset equal to 15% of the taxable component for those under age 60).

In effect, the 'death benefit period' was abolished from 1 July 2017. No longer will this period need to be taken into consideration when deciding on whether to fully commute a death benefit pension or transfer it to another superannuation fund. In essence, once a death benefit pension, always a death benefit pension. Further, the only way you can cease a death benefit pension is to commute it, either partially or fully and remove it entirely from the superannuation system as a lump sum benefit payment. That is, from 1 July 2017, you cannot commute a death benefit pension back to the accumulation account of the surviving spouse. However, as it will retain its character as a death benefit pension when commuted by a surviving spouse, the lump sum will be received 100% tax-free, no matter how long after the original member's death or the age of the surviving spouse.

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