Cuffelinks
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This Week's Top Articles

Managing credit risk requires healthy dose of cynicism

Warren Bird

Successful investing is about taking appropriate risks for appropriate rewards to achieve realistic return objectives. If credit risk is not managed properly, it can be potentially disastrous for a portfolio. Managed well, credit risk can provide reliable, attractive income, with good levels of capital stability. This two-part series helps achieve the latter, especially at a time when many investors are switching out of term deposits in search for better yields.

Part 1 provided an overview of credit risk – what it is and why is it important. In this 2nd part the focus is on the key elements of managing credit risk. How can an investor not only capture the additional yield that credit risk provides, but keep that extra return rather than losing it to defaults? Capturing and keeping excess returns is the goal of credit risk management.

Corporate bonds, debentures and the like provide investors with an opportunity to capture higher returns than are paid by the safest investments such as cash or Australian government bonds. Markets have historically priced corporate bonds so that lower credit quality securities pay a higher yield than higher quality assets. AAA and AA rated bonds have normally paid investors around 1% more than similar maturity government bonds, with the spread widening to above 2% for BBB rated securities and more like 4 – 7% on BB and B.

There are more determinants of the yield on an individual bond than just its credit rating, but it's a major influence.

Turning those higher yields into higher returns is the key to sound investment strategy. How can that be done?

Need for a cynical attitude

The simple answer is: avoid the duds. In the ideal situation you will do your research and always make very clever choices so that you never invest in companies that fail.

Credit research is different to equity research. Stock picking in the share market is mostly about looking for the positive stories, searching for upside opportunities for a company's share price. Credit risk rating requires a cynical attitude. There is no 'upside' with bond investing. Either you earn your interest and get the principal back or you incur default losses which could be from small amounts to 100% of capital. That is why credit research has to focus on looking for what could go wrong, evaluating the downside risk. Assessing a borrower's capacity to pay back their debt is very different to evaluating the prospects for growing earnings.

Further, you have to monitor each investment because credit quality can change. It's not good enough to form a view when you buy an asset and then forget about it. Managing credit risk requires that if you detect deterioration in credit quality you think carefully about whether to sell out of that asset before things get worse.

Of course, in reality no one gets every decision right. Even if your research has been excellent, the world can change and a business's franchise unravel. There is also the possibility of fraud. For these reasons, investors have to assume that some companies they believe are of good quality will fail. None of the credit ratings summarised in part 1 has a non-zero probability of default, even AAA.

You have to assume that even the best quality issuer, with the best intentions in the world, could let you down.

Minimise the impact of a bad credit

Therefore, the answer to the question about how to capture and keep the extra returns from credit investing has a second element: 'minimise the impact of the duds on your portfolio'. This requires a high standard of portfolio construction, with an emphasis on diversification, which is the only way to effectively manage credit risk.

What does 'diversification' mean? In essence, diversification of a credit portfolio involves holding a large number of different investments, none of which is a significant proportion of the total.

Let's say you have a portfolio of corporate bonds that provide an average yield that is 1.5% more than a 'risk-free' portfolio – say, a mix of cash and government bonds. If this portfolio is made up of only 10 individual assets, then if one of them defaults you could lose up to 10% of your total portfolio. That wipes out about 7 years' worth of that extra 1.5% per annum in income you had expected to earn.

If, however, you had 100 individual assets in the portfolio and one of them defaulted, your loss would be only up to 1% of your capital. That would reduce your excess return in the year in which it happened to 0.5% above the risk-free return, but the remaining 99 bonds would continue to earn their average yield – close to 1.5% - thereafter. Obviously, if you have even more individual assets, then the impact of any one default reduces further. Conversely, a retail investor will not be able to assemble 100 individual bonds, but the same general risk diversification principle applies.

Reducing the impact of any default

The next element of a good diversification strategy is to minimise the risk that if one of your holdings defaults then so will another. You don't want risks that are correlated. For example, if you have 2 or 3 bonds in the same industry in the same country, then if demand for their product dries up there's a good chance that all of them might fail, not just 1 of them. It's better to have both than only 1 (provided the credit quality is similar), but it's even more properly diversified if you halved the weight for both of them and replaced that half with exposures to different industries altogether.

Finally, it is sound practice to have lower limits on the lower credit rated assets. A portfolio of AAA and AA assets can be more concentrated than one that goes down into A and BBB, and it is wise to have even smaller exposure limits on BB and B rated bonds. The probability of default should be inverse to the amount you invest.

The beauty of this is that you don't have to give up return in order to manage risk. 100 bonds paying 1.5% above your benchmark will deliver the same gross return as 1 bond paying 1.5% above your benchmark. But you have a much greater chance of actually earning that 1.5% in a diversified portfolio than a single security investment.

In the world of credit risk, you need to understand the capacity of the obligor to pay what they've promised, then assume that they will let you down anyway and avoid concentrating your portfolio with them. Taking a large number of small exposures is the best way to capture and keep the returns that you are looking for.

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Ben Graham's three most enduring principles

Roger Montgomery

Benjamin Graham was the father of security analysis and the intellectual Dean of Wall Street. I believe Graham was many things, including the father of the many ratios we take for granted in our work as analysts, portfolio managers and investment officers. Perhaps controversially, I also believe he may not have reached some of his conclusions had he access to a computer that allowed him to properly test his ideas.

Having said that, there are many things that Ben said that not only made sense but made significant contributions to investment thinking. And despite the absence of a computer, Graham observed several characteristics of the market that the advent of modern computing has only served to reinforce.

For those grateful for executive summaries, here follows mine on the three most significant contributions Ben Graham made to the body of work on investing.

By understanding, testing and implementing the approaches that flow from a study of Graham's principles, I believe any investor will benefit not only in terms of returns but also in terms of risk mitigation. In Part 2 next week, we will display anecdotal evidence of their truth with graphics using modern computing and the techniques of the development team at Skaffold.com.

The first of Graham's significant contributions is his Mr. Market allegory, introduced in 1949. Mr. Market is of course a fictitious character, created to demonstrate the bipolar nature of the market.

Here is an excerpt from a speech made by Warren Buffett about Ben Graham on the subject:

"You should imagine market quotations as coming from a remarkably accommodating fellow named Mr Market who is your partner in a private business. Without fail, Mr Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains…

Mr Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow.

Transactions are strictly at your option…But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr Market is there to serve you, not to guide you.

It is his pocketbook, not his wisdom that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence."

The implications of this little story cannot be understated. What Graham is saying is that there is a legitimate alternative to the Efficient Market Theory as a model of the way the market behaves and works. He said this before EMT became the cornerstone of every financial services firm that cared about "biggering and biggering and BIGGERING."

Another significant implication is that as investors we should be less focused on price as our guide as we should on value. This challenges the validity of many streams of financial study that have as their root, the price of securities. Think about all the PHD papers and other academic studies that uncover relationships, or validate the power of explanatory variables, but whose concluding evidences are merely price, or some derivative of price. If prices in the short run are determined by those who are merely selling to renovate the bathroom or by events in Syria – events that have no impact on the number of $2 buckets being sold by The Reject Shop – what 'value' can we place on them?

The second great lesson Ben Graham taught gave us the three most important words in value investing; **margin of safety**. In engineering the margin of safety is the strength of the material minus the anticipated stress. Building materials that are far stronger than that required to survive the anticipated stress ensures a degree of comfort.

When it comes to investing, the margin of safety is the estimated value of a share minus the price. The greater the margin of safety, the greater the degree of comfort and more importantly, the greater the expected return. If the price is what we pay, and the value what we receive, then the lower the price we pay, the higher the return.

Despite the high profile of these enduring two lessons, I believe there is a third observation of Graham's, which is equally important. Fascinatingly, with the benefit of computers, we can also demonstrate that Graham was spot on.

Graham was paraphrased by Buffett in 1993:

"*In the short run the market is a voting machine - reflecting a voter-registration test that requires only money, not intelligence or emotional stability - but in the long run, the market is a weighing machine.*"

What Graham described is something that, as both a private and professional investor, I have observed myself; in the short term, the market is a popularity contest – prices often diverge significantly from that which is justified by the economic performance of the business. But in the long term, prices eventually converge with intrinsic values, which themselves follow business performance.

Next week, we will compare intrinsic value and share prices for some major Australian stocks to illustrate Ben Graham's enduring principles.

Roger Montgomery is the founder and Chief Investment Officer at The Montgomery Fund.

Are rising oil prices bad for Australian shares?

Ashley Owen

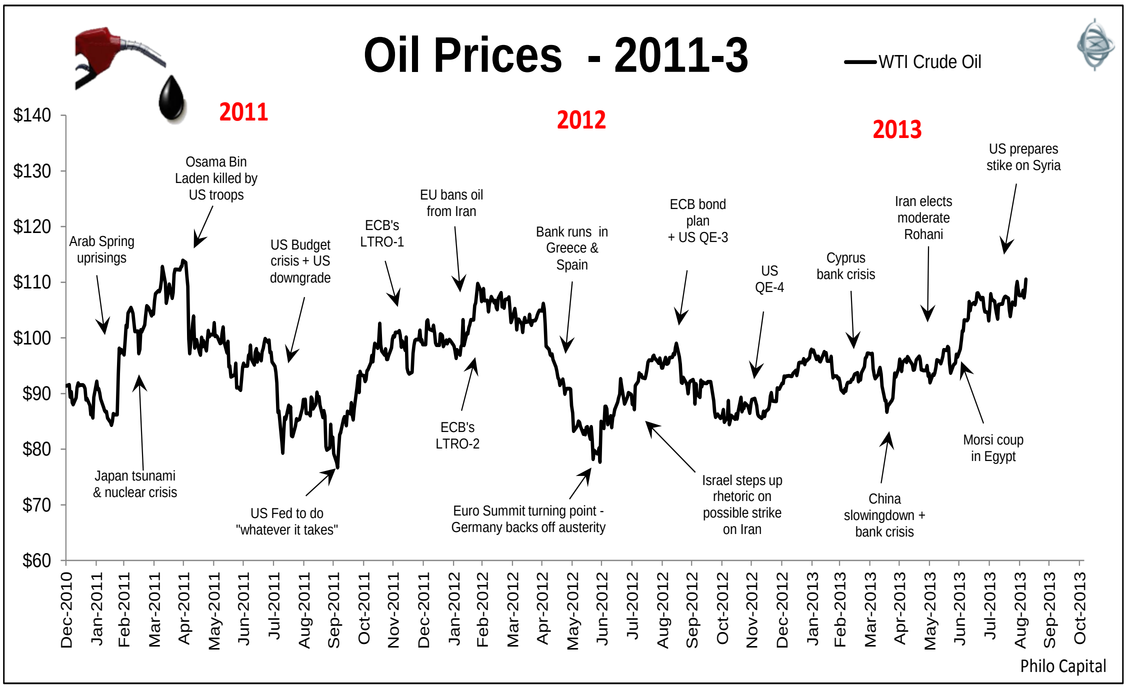
There is a popular myth that rising oil prices are bad for stock market returns but is it just a myth or is it supported by fact? In theory, rising oil prices should hurt corporate profits, and therefore share prices, for two main reasons. First, virtually all goods and services sold by companies have an oil component in their cost structure (mostly in the form of transport costs) and so corporate profit margins should be squeezed by rising input costs that aren't able to be passed on instantly to customers. Second, higher oil prices take money out of the pockets of consumers and businesses, money that could otherwise be spent on buying goods and services from companies.

Recent events affecting oil prices

Oil prices collapsed from a menacingly high $145 per barrel in July 2008 to just $30 by December 2008 as the world plunged into recession in the global financial crisis. From early 2009 prices rose back to around $100 and they are on the rise again. The oil price rises since 2008 have been driven by continued relatively strong demand from the big emerging markets, the economic recovery in the US, and now the tentative recoveries in Europe and Japan. Dramatic events in the Middle East have also played a critical role.

The first chart shows the benchmark West Texas Crude oil price since the start of 2011. Oil prices rose dramatically when the Arab Spring uprisings started to gather pace in early 2011. Disruptions to oil supply lines were relatively minor, and the spikes in oil and gold prices reflected more fear than reality. Tunisia, Egypt and Libya are relatively minor oil producers, but Saudi Arabia and Iran are the critical players to watch.

The Iranian nuclear stand-off worsened with the EU embargo from the start of 2012 and tensions escalated further when Israel started talking up the possibility of a military strike on Iran in August of that year. Iran is critical as it can close the Strait of Hormuz to oil traffic very quickly – cutting off 25% of world supply (compared to only around 5% that passes through the Suez Canal and pipeline). If either Saudi Arabian or Hormuz supplies are disrupted, oil prices could spike up to $200 or even higher very quickly. Higher oil prices would threaten the weak economic recoveries in the US, UK and Europe.



Iranian tensions eased substantially with the landslide election of moderate leader Hassan Rohani in the middle of June of this year. However only a couple of weeks later the military ousting of the Egypt's elected leader Mohamed Morsi in early July caused oil prices to shoot up again.

In Syria the nascent Arab Spring uprising was resisted by the incumbent Assad regime with increasingly brutal force in the worsening civil war there. It now seems increasingly likely that the US, with or without multilateral support, will make a military strike. This would no doubt send oil prices even higher still.

Impact of oil prices on Australian shares

What does all of this have to do with Australian share prices? Should Australian investors be fearful of rising oil prices?

Contrary to the popular myth that rising oil price are bad for share prices, the fact is that most episodes of rising oil prices in in the past have been accompanied by *positive* real returns from shares, even severe oil price spikes.

For example, oil more than doubled in price during five calendar years over the past century: in 1973, 1974, 1979, 1999 and 2009. In the cases of 1973 and 1974, real returns from Australian shares were -32% and -36% respectively in those years but oil prices were not a major factor. At that time Australian inflation rates were already above 10%, and Whitlam's debilitating credit squeeze and dollar revaluation program were already underway even before the Yom Kippur crisis sent oil prices skyrocketing at the end of 1973. The share price falls in 1973 and 1974 were primarily a result of the combined impact of the collapses of the twin booms - the speculative mining bubble and the debt-fuelled property finance bubble, together with a severe domestic political crisis and fiscal and monetary policy errors.

In the other three out of the five years when oil prices more than doubled, Australian shares generated very strong real returns:

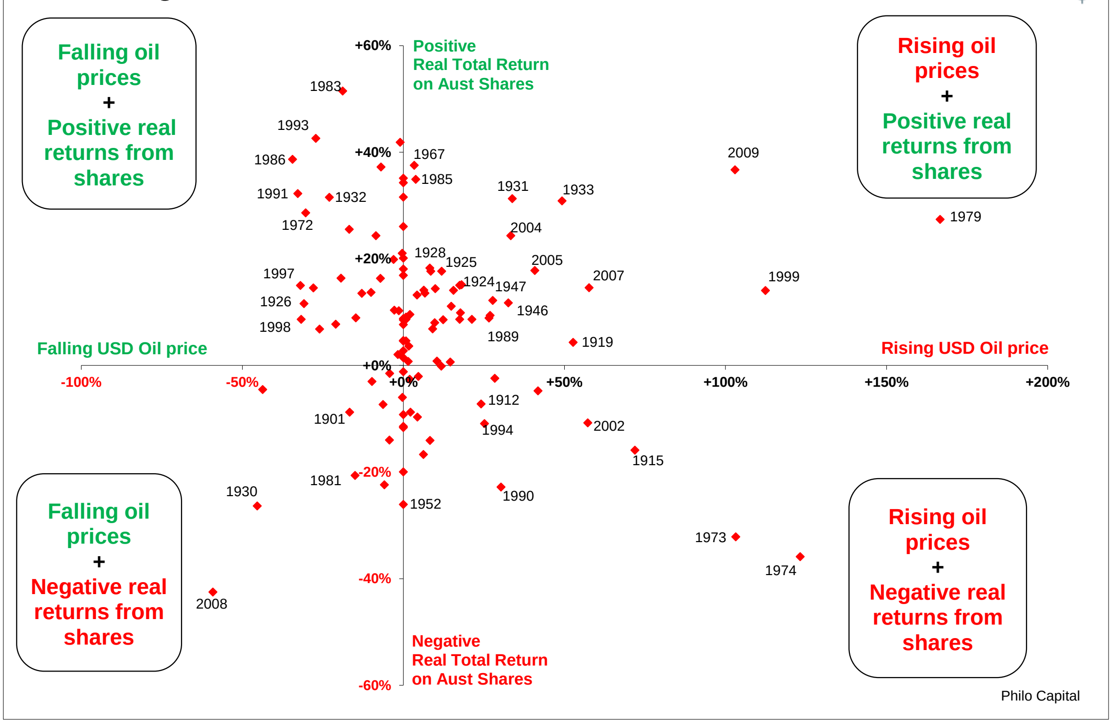
- +27% from shares in 1979 - when oil prices more than doubled with the Iranian revolution
- +14% from shares in 1999 - when oil prices more than doubled during the dot com boom

- +37% from shares in 2009 - when oil prices more than doubled in the rebound from the sub-prime crash

In fact many of the *best* years for Australian shares have been years in which oil prices have *risen* sharply, including 1924, 1925, 1931, 1933, 1945, 1946, 1947, 1978, 1979, 1989, 1996, 1999, 2004, 2005, 2007 and 2009.

A century of returns and oil prices

The following chart shows real total returns from the broad Australian stock market index (including dividends and after CPI inflation) for each year since 1900, together with the change in oil price during the year.



Change in Oil Price -v- Real total returns from Australian Shares

Oil prices rose in 56 of the 112 calendar years since 1990 up to the end of 2012 (the right hand two segments of the chart). In those 56 years of rising oil prices, the broad Australian stock market delivered positive real total returns in 40 (or 71%) of those years.

Further, in the 23 years since 1900 in which oil prices rose by more than 20%, Australian shares generated positive real returns in 14 (61%) of those years - 1911, 1917, 1919, 1931, 1933, 1947, 1979, 1989, 1996, 1999, 2004, 2005, 2007 and 2009 .

Rising oil prices may sound scary to investors, but if we go beyond the popular myth and look at the facts, we see a very different picture.

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Sir Michael Hintze: to whom much is given, much is expected

Graham Hand

In the Forbes List of Australia's 50 Richest, the names in the top 20 are probably well-known to most business people. Packer, Lowy, Triguboff, Rinehart, Forrest. At number 16 with an estimated US$1.55 billion is Sir Michael Hintze. The main reason for Hintze's relatively low profile in Australia is not only because he lives in the UK and is active in their arts, politics and media rather than ours, but he has made his money in the rarefied atmosphere of alternative investments.

In this world, he is a hedge fund legend, with a life story that should be made into a movie. At the recent Alternative Investment Management Association (AIMA) conference in Sydney, Sir Michael Hintze gave some fascinating insights into the mind of a successful hedge fund manager. His firm, Convertible Quantitative Strategies (CQS), is a global multi strategy asset manager, and Bloomberg recently ranked the CQS Directional Opportunities Fund third in its list of 100 Top-Performing Hedge Funds. Hintze invests in non-traditional opportunities that 99% of investors never see, as shown by some of his funds:

- long short relative value asset backed securities fund
- global convertible bond arbitrage fund
- long short credit fund
- rig finance fund (for the construction of rigs and other oil and gas infrastructure)
- long only European loan fund investing in senior, mezzanine and second lien loans.

What type of background does it take to run a leading hedge fund with US$12.5 billion under management and over 250 staff around the world? A remarkable one. Hintze was born in China in 1953 to Russian parents, who made their way to Sydney, where he was raised and educated. He considers himself an Australian. He holds a BSc in Physics and Pure Mathematics and a BEng in Electrical Engineering, both from the University of Sydney. He also holds an MSc in Acoustics from the University of New South Wales and an MBA from Harvard Business School. Hintze told his Sydney audience that he borrowed most of the money to finance his Harvard MBA. He worked at Salomon Bros, Goldman Sachs and CSFB before moving to London and setting up CQS in 1999.

And for good measure, before he started his finance career, he served for three years in the Australian Regular Army as a Captain in the Royal Australian Electrical and Mechanical Engineers. Hintze was knighted in June 2013 in recognition of his philanthropic work for charities and the arts, and he is a major supporter of the Conservative Party in the UK.

The types of funds CQS manages requires it to monitor global trends in everything imagineable, especially geopolitical, monetary and fiscal risks. The CQS website would win no awards for simple English, but when he says his strategy is a "*collaborative multi-disciplinary approach seeking adjacencies across all areas in which we invest*" (ouch, my head hurts!), you gain insights into the arbitrage and risk management process which has driven his success.

In fact, Hintze says he has invested $20 million "of my own money" on his risk management systems, and claims this has created a competitive advantage in liquidity management, execution and nimbleness. No doubt major competitors have invested far more in their systems, but it does show how the game has changed over recent years, creating problems for the small hedge fund manager who wants to compete by outsourcing administrative, settlement, trading and risk measurement functions to third parties.

What were some of the insights Hintze gave in Sydney?

- He is paid to take credit and arbitrage risks but he soon realised that significant operational risk must also be managed. A hedge fund must be operationally resilient.

- His major successes have come from ”bespoke alpha-generating products”. Institutional investors are looking for different sources of alpha, and their use of hedge funds will grow.
- The biggest trading risk is when correlations between markets go to 1, as this makes it more difficult to hedge risk.
- Increasing regulation is the most significant change he's seen in the industry, followed by the availability of liquid derivatives. Regulators have long viewed hedge funds with suspicion, and have encouraged far greater disclosure.
- There is massive moral hazard from expecting central banks to bailout the financial system every time there’s a major problem. Central bank intervention has been so heavy that there are fewer normal signals in the market now - what is the risk-free rate on government bonds when there’s massive intervention? It should be much higher.
- China’s leaders are smart and well-educated and benefit from a 10 year political cycle, but the country is still sorting out problems with corruption, shadow banking, pollution and clean water.
- There are 17 members of the Eurozone (those countries which have adopted the Euro), which gives many opportunities for credit trading on the short side.
- Europe’s biggest problem is not the small countries like Greece and Cyprus, but France. It has fiscal and taxation problems it does not want to face.
- He is optimistic on US prospects, driven by a good housing recovery, low-priced energy due to shale gas and strong demographics. The United States does not have high standards of building for homes in many places, and 300,000 houses a year fall apart. This creates a lot of ongoing employment for less skilled workers.
- One million Australians are working overseas, and there are two reasons many do well: Aussies are willing to have a go, and they have a global perspective. It’s surprising how often he encounters Australians in senior positions in overseas countries.
- There is also some advantage working and living in Australia, because you are outside of the daily noise and chatter, able to think about things more.
- Philanthropy is a big deal. There is an obligation on those who have done well to give back. **“To whom much has been given, much is expected.”** Make a difference.
- The main things that worry him are the long tail risks (a technical definition of long tail risk is the risk that an asset or portfolio of assets will move more than three standard deviations from its current price, potentially compromising the best risk management techniques).
- To date, we have had little inflation because labour costs have not risen, and the velocity of money is down. But the massive growth in central bank balance sheets increases inflationary risks, and his risk management tries to remove rate risk from their portfolios.
- Government spending has been good for equities and bonds, but what about our children?

It’s highly likely that Sir Michael Hintze has a close perspective on every major geopolitical event in the world, with inside sources making many of them unique. Although there is little doubt that Hintze is personally fascinated by global politics, society and business, the type of funds he runs means that every major event is a potential trade. Without in any way making a moral judgement on him, he cannot help but see every conflict, every natural disaster, every border skirmish and every political battle in the context of the positions in his funds.

A few examples snuck out as the conversation turned to world events. Both India and Pakistan have tactical nuclear weapons, as opposed to strategic. All it needs is for some crazy lieutenant to take matters into his own hands, even if there is no central policy desire to do so. Oh, that would destroy a major food basket, what are the implications for agricultural commodities? Or if the Syrian crisis extends to Israel, what will happen to that very successful country? There’s an opportunity to trade Israeli Credit Default Swaps.

And that’s what’s required to run a global credit arbitrage fund. Have a global view, watch every part of the world, know what is happening everywhere. There is a potential trading opportunity in every major conflict, in the same way there’s a potential personal obligation in every worthy cause.

At the end of his keynote interview, Sir Michael was invited to stay for lunch. He agreed, then added, “But I won’t be able to stay long. I’ve got things to do.” Nobody in the room doubted it.

The politicians we voted for, the politicians we deserve

Geoff Walker

Although *Cuffelinks* is an investment forum, many of its followers may be interested in electoral systems, especially after the controversial Senate election results.

Contrary to the great weight of 'informed' expert opinion, there is a straightforward argument that the Senate election results did indeed reflect the views of the voting public.

In a normal Senate election, half of each state's 12 senators are elected, with the whole of the state being regarded as a single electorate. To be elected, a candidate must achieve a quota of votes, which, when there are six candidates, is 1/7th of the total formal votes cast +1. The mathematics works out that effectively there are 6.9999 quotas of votes in each state. After six candidates have been elected, each with 1 quota, there will be insufficient votes remaining to elect any further candidates and the counting concludes.

Particular derision has been directed by psephological elites, major-party apparatchiks and opinion leaders at the Australian Motoring Enthusiast Party which gained a Senate seat in Victoria starting from a primary vote of 0.51% of votes cast, or 0.0356 of a quota, and the Australian Sports Party which gained a seat in Western Australia starting from a primary vote of 0.22% of votes cast, or 0.0155 of a quota.

What such expert opinion ignores is that not only does the Senate voting system (and indeed any preferential system) allow voters to express their preferences for parties, but also it allows them to express their preferences AGAINST particular parties.

In any electorate there is a spectrum of voting motivation. Some voters want to vote for a particular party and don't care about other parties. Other voters not only want their preferred party to win, but also want to stop other particular parties from winning. An example of this has been seen in recent years where the major parties have put the One Nation party last on their how-to-vote cards. And still other voters' primary motivation is to stop another particular party or parties from winning a seat, not caring greatly who wins otherwise.

One element that has worked in favour of the major parties in past Senate elections has been the fact that minor party voters (and the minor parties themselves) tended to be undisciplined in their preferences beyond their primary vote. This left frustrated those voters who wanted nothing to do with the major parties ('A plague/pox on both your houses!'). In this election we've seen the minor parties become much more strategic in their preference arrangements.

Let's have a look at how the Senate votes were counted in Victoria, enabling the Australian Motoring Enthusiast Party to win one of the six seats available. The primary votes fell thus (expressed as quotas, rather than as numbers of votes or percentages of the total vote):

Party	Quotas	
Liberal/The Nationals	2.8204	
Australian Labor Party	2.2821	
The Greens	0.7474	
(9 minor parties)	0.8411	)
Australian Motoring Enthusiast Party	0.0353	) 1.1500
(21 minor parties)	0.2736	)
	6.9999	

From first preferences the LNP and the ALP were each able to win two seats. At that point the exhaustive process of progressively eliminating at each count that candidate with the lowest number of votes and distributing those votes via preferences to higher-up candidates began.

At that stage the critical point to note was that the number of first preferences cast for minor parties was greater than 1 quota, or 1.1500 to be precise. For these votes to translate into a seat for the minor parties it would be necessary to ensure that as few votes as possible (and definitely no more than 0.1500 quotas) leaked to the major parties. After 28 more counts the quota position was (with four of the six seats already allocated):

Party	Quotas		Leakage gain/loss
Liberal/The Nationals	0.8554		+0.0350
The Greens	0.7780		+0.0306
Australian Motoring Enthusiast Party	0.3965	)	)
Sex Party	0.3443	) 1.0827	) −0.0673
Palmer United Party	0.3419	)	)
Australian Labor Party	0.2838		+0.0017
	2.9999		

It can be seen by comparison with the table of primary votes above that the minor parties were able at this stage to contain preference leakage to less than 7% of a quota, leaving them, or, at least, one of their number, still in the running for the last quota and Senate seat.

At this stage the ALP's third candidate was eliminated and, not surprisingly, 99.5% of those votes flowed to The Greens, giving them a quota. Then 99.8% of The Greens' votes in excess of those required for that quota flowed to the Sex Party, widening its lead over the Palmer United Party and even putting it marginally ahead of the Australian Motoring Enthusiast Party. The Palmer United Party was therefore eliminated with its votes flowing entirely to the Australian Motoring Enthusiast Party, giving rise to the penultimate position:

Party	Quotas	
Liberal/The Nationals	0.8570	
Australian Motoring Enthusiast Party	0.7385	) 1.1429
Sex Party	0.4044	)
	1.9999	

The Sex Party was then eliminated, but rather than a full distribution of its votes, the rules provide that counting would cease once a sufficient distribution has occurred to give whichever party the last quota. Of the Sex Party's votes actually distributed, 88% flowed to the Australian Motoring Enthusiast Party, giving it a comfortable win over the Liberal/Nationals for the last quota and Senate seat in Victoria. A hypothetical full distribution assuming the same ratio might have seen the Liberal/Nationals end with 0.9 quotas and the Australian Motoring Enthusiast Party with 1.1.

What this result has shown is that, provided there are sufficient voters who want to see no party or coalition with an outright majority, minor parties are indeed in a position to secure that outcome as long as they can keep preference leakage to the major parties tightly staunched.

And if this leads to a hung Senate, so what? Without an outright majority, parliament then needs to work as it should, by talking (the word 'parliament' comes from the French 'parler' – to talk), ie by negotiation and compromise, rather than by 'to the victor the spoils'.

Whereas the experts would have us believe that the system has failed because "how could a party possibly be legitimately elected with less than 1% of votes", many would say that the system has worked because it has enabled the minor party voters, 16% of the electorate in Victoria, to deny that seat to a major party, even if the minor party that did win it wasn't their first choice.

(All figures in this article are based on data from the ABC's election website http://www.abc.net.au/news/federal-election-2013/results/senate/ as at Thursday 12 September 2013).

Geoff Walker is an actuary, whose 40-year career has spanned life insurance, superannuation, banking, funds management and consulting. In the late 1970s he was returning officer for the Victorian Branch of the AMP Society Staff Association, which he claims gives him authority to speak on matters electoral!