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US Government has previously defaulted, it's not risk-free

Ashley Owen

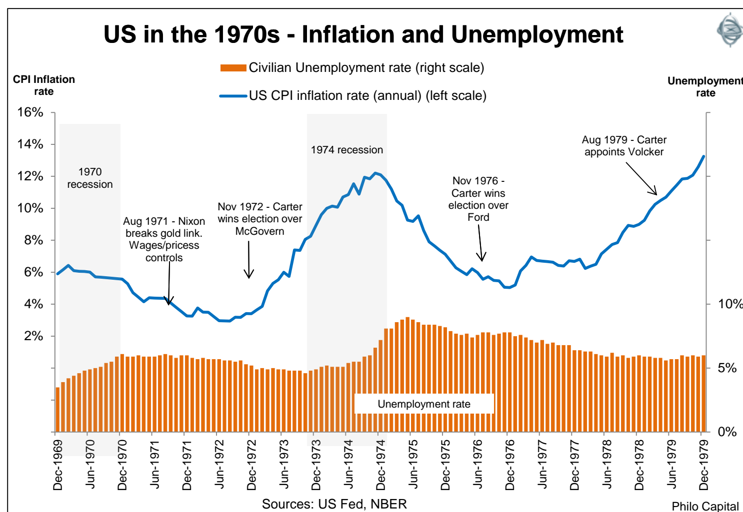
The US Government is teetering toward another debt ceiling crisis, and it is useful to remember that failing to make repayments on government debt is not new for the US.

The US Treasury defaulted three times on its treasury bills in 1979, when Congress didn't legislate in time to raise the debt ceiling. In 1979, they were 'temporary' defaults, and they were rectified within a month, but they did shock people who believed that the mighty US Government would always pay its debts on time. The default crisis was one of the final nails on the coffin for Jimmy Carter and helped pave the way for the 1980s boom under Ronald Reagan and Paul Volcker.

It is also important to differentiate between the more common shut-down, as discussed here last week, and the more serious debt default. That is, failing to meet a payment when it is due.

The 1970s - a dark decade for America

1979 capped off a long dark decade for America. Nearly five decades of Keynesian policies were taking a heavy toll. The first chart below shows the CPI inflation rate and unemployment rate during the 1970s:

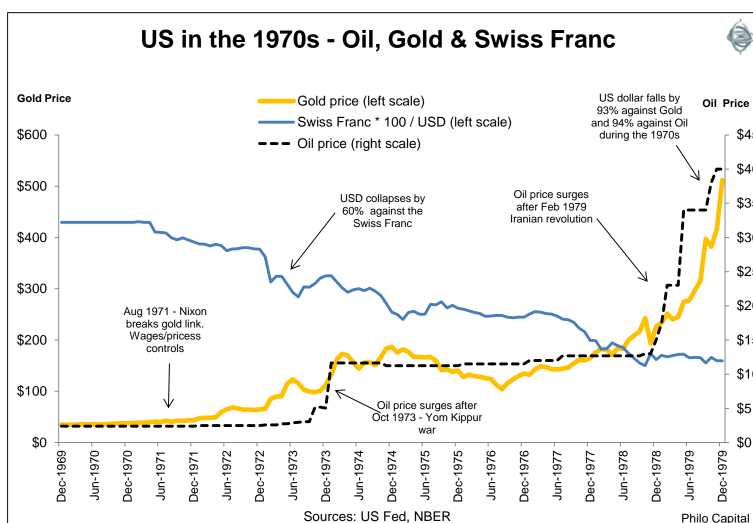


Inflation had started rising in the mid-1960s but it was only recognised as a problem in the early 1970s. CPI inflation peaked at more than 12% pa in November 1974, fell to 5% by end 1976, but then accelerated rapidly in 1978, and kept rising above 10% by March 1979.

The unemployment rate rose above 6% in 1971, peaked at 9% in 1975, but was still 6% in 1979 and rising again. This ran against one of the core tenets of Keynesianism, which held that high unemployment should bring down inflation. The 1970s stagflation – stagnant growth together with high inflation – plus high unemployment levels, showed that the Keynesian model was not working. In the 1970 recession unemployment rose but inflation remained high, prompting Nixon to break the gold standard in August 1971 and institute his 'New Economic Policy' involving prices and wages controls (supported by Paul Volcker, then under-Secretary of the Treasury).

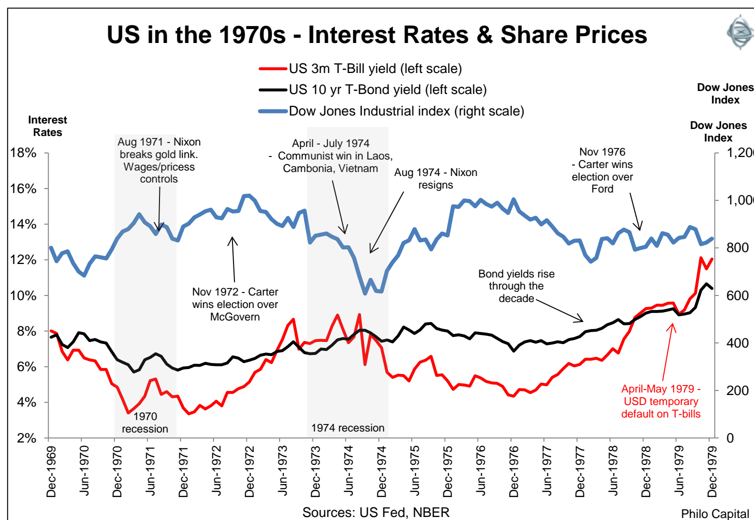
The peak of Keynesianism in America was October 1978 when Congress passed the Humphrey-Hawkins Full Employment Law, specifically stating that fighting inflation was NOT to take priority over reducing unemployment, even though inflation was already in double digits. It was championed by Nobel Prize winner and Keynesian, James Tobin. Tobin had been the architect of Kennedy's 1963 tax cut plan which marked the start of the inflationary era. Tobin championed the Keynesian cause and fought against every attempt to fight inflation, even into the 1980s.

Another feature of the 1970s was oil. Oil prices had gone from $3 per barrel at the start of the 1970s, but prices trebled after the Yom Kippur war in October 1973 and then nearly doubled again from late 1978 to early 1979 following the Iranian revolution.



The once mighty US dollar – the symbol of American dominance in the world – collapsed during the 1970s. By 1979 the dollar had lost half its value against the Deutsche Mark, lost two-thirds of its value against the Swiss Franc, and a third against the yen. The problem was that the lower US dollar was not helping US manufacturers and exporters as it should in theory. The economy was stagnant and the US was starting to lose out to Japan and Germany in quality and efficiency. The Japanese had taken the lead in small cost-effective fuel-efficient cars while Americans were still making giant gas-guzzlers that Americans couldn't afford to run. Factories were closing down in America's 'rust belt' and new ones were opening up in the new southern 'sun belt', financed by Japanese money and run by Japanese management. This came as a rude shock to many Americans troubled by what they saw as the rise of Japan and the loss of American economic dominance and sovereignty.

Interest rates were also at crippling levels. By 1979, yields on 10 year Treasury bonds had risen to above 9% for the first time ever in US history, and short term interest rates were back up above their 1974 peaks and heading for 10%.



Shareholders suffered badly in the 1970s. Share prices were no higher in 1979 than they had been 10 years earlier, but in real terms after inflation, prices had fallen by an average of 50% over the decade.

Domestic politics plunged to new depths with the Watergate scandal and Nixon's impeachment and forced resignation in 1974. In foreign affairs it was also the peak of a bad decade for America. They had lost the enormously expensive and unpopular Vietnam War to the Communists, and in February 1979 the US were also kicked out of Iran when the US-backed Shah of Iran was overthrown by the Ayatollah Khomeini's Islamists.

Then in February, China was on the march, invading Vietnam over Vietnam's occupation of the Spratley Islands and its invasion of Cambodia. Meanwhile, with America out of the Middle East, the Soviets were gearing up to march into Afghanistan.

To cap it off on 28 March 1979, there was a nuclear leak at Three Mile Island in Pennsylvania, which put the fear of nuclear fallout into Americans on the densely populated East Coast. Federal Reserve Chairman Arthur Burns had let inflation run out of control during his eight-year reign, so Jimmy Carter replaced him with Bill Miller in 1978, but Miller just made the situation worse. As a committed Keynesian he opposed interest rate rises, increased money supply to increase inflation and devalued the dollar in an effort to assist US exporters. The US dollar collapsed in 1978 and the US government was forced to borrow from the IMF and start issuing US Treasuries in foreign currencies for the first time. This humiliation caused a crisis in the Carter administration and Carter himself descended into despair and self-doubt.

It seemed that everything that could go wrong for America had gone wrong. This then was the environment in which the 1979 defaults occurred.

The debt ceiling - again

In April of 1979, Congress failed to legislate to reach a deal in time, and the Government hit the debt ceiling. Without the ability to borrow more it had to decide who not to pay. It could 'close down the government' and stop paying employees or suppliers, or it could stop paying interest and maturing principal on its debts – Treasury bills, notes and bonds. It chose the latter.

In the 1979 defaults, the US Government didn't treat all its creditors equally. Most Treasury bills, notes and bonds are held by banks and other financial institutions like insurance companies and pension funds, with a small minority held by individuals. In 1979 the government chose to repay the main institutional creditors in full, out of fear of triggering a banking crisis, but chose to default on 6,000 individual investors.

On 26 April 1979, the US Treasury defaulted on $41 million of maturing Treasury bills. They were paid 20 days late on Thursday 17 May 1979 after the Government found some money. Then again on 3 May 1979, Treasury defaulted on another $40 million. These were also paid 14 days late. Then again on 10 May 1979, Treasury defaulted on yet another $40 million of maturing T-bills. These were also paid on 17 May.

Treasury refused investors' demands to reimburse the $325,000 in lost interest on the late days and so investors were forced to sue the US government in a class action (*Claire G. Burton v. United States, US District Court, Central District, California, D 79, 1818LTL (Gx)*). Unfortunately the Court threw out the investors' claim by relying on a 1937 Supreme Court ruling that, "*interest does not run upon claims against the Government even though there has been a default in the payment of principal*". (*Smyth v. United States, 302 U.S. 329, 1937*). It came as a shock for Americans to discover that not only had the Government defaulted on its debts, but there was a decades old judicial precedent establishing that it didn't legally owe interest when it failed to pay on time!

When the money market opened on Friday 27 April 1979, the day after the first default, T-bill yields spiked up by 50 basis points and this default premium on US T-Bills remained even after the default was rectified the next month. This demonstrates that the US Government has indeed defaulted on its debt (at least temporarily), and that US T-bills are not 'risk-free', but are prone to a credit default premium in their pricing.

This was the end for the Carter administration. Carter threw in the towel in his televised 'malaise' speech on 15 July 1979, in which he succumbed to the national sense of hopelessness:

> "*… I realize more than ever that as president I need your help… We are confronted with a moral and a spiritual crisis…..It is a crisis of confidence. It is a crisis that strikes at the very heart and soul and spirit of our national will. We can see this crisis in the growing doubt about the meaning of our own lives and in the loss of a unity of purpose for our nation. The erosion of our confidence in the future is threatening to destroy the social and the political fabric of America*". (http://www.youtube.com/watch?v=KCOd-qWZB_g)

Carter's admission of defeat and despair marked the nadir for the American post-war prosperity and the end of the grand Keynesian dream that had dominated political and economic thought since Franklin Roosevelt's election in the depths of the 1930s depression.

Recovery from 1979 crisis

But all was not lost. The dark days of 1979 turned out to be just before the dawn of a new era for America. Jimmy Carter removed Bill Miller after just 18 months as Fed Chairman and installed Paul Volker in his place. Following Volcker's confirmation on 6 August 1979, he set about immediately to switch Fed policy from Keynesianism to Monetarism, as advocated by Friedrich Hayek, Keynes' arch

rival, and Milton Friedman. Volcker instituted a new policy that clearly elevated the low inflation goal above the low unemployment goal, and focused the policy tools on tight control of the money supply to bring down inflation.

Meanwhile across the Atlantic, the UK had suffered a similarly debilitating and demoralising 1970s – with stagnant growth, high inflation, high unemployment, high interest rates, high tax rates and negative stock market returns and a humiliating IMF bailout. Following the 'winter of discontent', a series of bitter industrial disputes and strikes under Labour, British voters elected Margaret Thatcher's Tories in the 3 May 1979 elections in the largest electoral swing seen in Britain since 1945.

To Carter's credit, he honoured his promise to let Volcker increase interest rates until he brought down inflation, even though it triggered a deep double-dip recession that began in 1980. The Fed discount rate peaked at 13% in Feb 1980 and T-bill yields peaked at 16% in March when inflation peaked at 14.6%, as the economy dived into recession and the unemployment shot up to double digits.

In conditions like these, and also the Iranian hostage debacle, it is hardly surprising that the November 1980 Presidential election was won by Ronald Reagan in a landslide victory. Volcker, Reagan and Thatcher led the macroeconomic revolution in the 1980s, towards smaller government, lower tax rates, privatisation of industries and deregulation of markets. It resulted in lower inflation, lower interest rates, lower unemployment rates, a return to economic growth, and ultimately victory over communism.

1979 was the turning point and the start of the 1980s which saw the victory of monetarism and market capitalism over state-directed Keynesian, socialism and communism. In China, Deng Xiao Ping turned his back on communism as an economic system and started down the capitalist road, and within a decade the Soviet system and communist eastern bloc had completely collapsed.

Another US default on Treasuries in the coming weeks is not out of the question. It would be a temporary default, like the 1979 episodes, and not a complete rescheduling like Greece. The US has plenty of money, the problem is primarily one of politics, not insolvency. Another default may be enough of a shock to get the parties together to work on real solutions. It may provide the catalyst for the next great era of growth and prosperity, as happened in 1979.

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FOMO is driving residential property prices, not yields

Graham Hand

There's a confluence of events boosting Australian property prices, especially in Sydney, but none is more pervasive than the Fear Of Missing Out (FOMO). All investment markets are driven by sentiment, and when it's impossible to pick up a newspaper without the latest story on 85% auction clearance rates and smashing of reserve prices, potential buyers change their mindset. They may have trudged from one open house to another in 2012, waiting for the no-compromise property, but now they are jumping in before prices rise further. According to RP Data-Rismark, prices in Sydney were up 5.2% in the September 2013 quarter and 10% since the start of the year, multiple times the rise in average weekly earnings.

A common technique used to promote properties is to quote the current gross yield. Purchase price $700,000, rent $700 a week, that's $36,400 a year or 5.2%. Even better, many inner-city apartments can become part of a short-term apartment letting scheme, like a long-stay hotel. Room rates might be as high as $300 a night during a major event, $200 at other times. That's double the weekly rent of a lease. It's a no-brainer.

It's only when the off-the-plan property settles a year later, or time comes to select an agent and a decent tenant, that many investors face a harsh reality check. The costs are always greater than expected.

The confluence of forces which is creating the competitive forces behind FOMO includes:

- various first-home buyer schemes and stamp duty exemptions
- investors moving money out of cash and term deposits into the one growth asset class they believe they understand and is not volatile
- Asian buyers, especially Chinese who are restricted in owning property in their own country. Asians love property and Australia is seen as more stable than Europe or the United States. They often have children studying here.
- SMSFs are the new players, and although the amounts are not high in absolute terms (only about 3% of SMSF assets are residential property and three-quarters of property assets are commercial), it's a new competitive influence.
- other residential property investors (local non-super) who have regained confidence at a time when unemployment remains low and financing has never been cheaper.

But let's take a look at the harsh reality check facing many of these exuberant buyers, considering the costs of purchase and owning an apartment with either short-term or long-term rents:

1. Stamp duty. Stamp duty varies from state to state at about 3-4%. On a $700,000 property in New South Wales, stamp duty is about $27,000. Imagine transaction costs of that amount in the share market. The efficient allocation of equity capital and efficient trading would be compromised.
2. Legal costs, loan establishment fees, valuations, building inspections, etc. Let's call it $5,000.
3. Mandatory furniture package for short-term rentals. Need to set a high standard for someone paying up to $300 a night, so full package for a 2 bedroom serviced apartment say $40,000.
4. Apartment leasing agent. Between 6% and 15% of gross income depending on the type of leasing plan.
5. Body corporate administration fees. These are often deliberately understated during the selling period, but there are four killers to watch for: 24 hour concierge, swimming pools, lifts and gymnasiums. Then there's gardening, fire services, cleaning. A decent building and apartment will cost at least $2,000 a quarter to maintain all these services. No point paying a million for an apartment and not maintaining the building.
6. Body corporate sinking fund. Again, depends on what is agreed by the body corporate but set for future major capital expenditures, such as repairs or repainting the entire building. Say another $1,000 per annum.
7. Council rates. Although charged on the 'unimproved capital value' of an apartment rather than the land value of a house, it could easily be $2,000 a year on a $700,000 apartment.
8. Water, electricity, gas. Usually paid by the tenant on a longer lease but by the owner in a short term apartment scheme, rising rapidly and maybe another $2,000 a year.

9. Vacancy. Long-term leases allow 4 weeks a year, short-term depends on the success of the managing agent or apartment scheme operator. May need to discount rates to compete, especially in winter. Assume short-term occupancy is healthy at 75%.

10. Apartment cleaning. A 2-bedroom apartment leased for a few days might cost $120 to clean, giving an annual cleaning bill of over $10,000 (assuming apartment rented for 270 nights a year for 3 nights each time, that's 90 cleans). There's no choice to clean it yourself, it's all part of the apartment scheme.

11. Travel agents commission. Short terms pay online services such as wotif.com 10% of the rental, and similar for travel agents. Assume paid on half of rentals.

12. Replacement of furniture and equipment. The short-term agent will say that the apartment looks tired and needs a complete refit. Not all tenants are neat, tidy and careful. Some will have raucous parties, kick a door, smash a vase. After a few years, the sofa will be disgusting, the carpet filthy and the mattress stuffed. Expect to replace the furniture at least every five years, and probably the entire kitchen and bathroom every 10 to 15 years. Everything in the apartment will need replacing regularly, plus painting and air conditioning. Cost per annum, say $10,000 (ignored in the table below to avoid double-counting with original cost).

13. All the other stuff. Where do we stop! There's a linen fee, pay TV, PABX, credit card fees, advertising, insurance and postage fee. The agent charges $20 to replace a light bulb, $15 to adjust the TV, $200 to fix the dishwasher, using tradesmen who have a far closer relationship with the agent or building manager than the owner. The apartment will be better maintained than the owner's home. Call it $2,000 a year on short-term leasing.

At this point, faced with all these costs, administration and paperwork, the apartment owner draws on two sources of comfort: tax savings and capital gains.

First, tax savings. If the property is negatively geared, there is a deduction against other assessable income. Other costs make the tax deduction even higher. What many owners fail to recognise is negative gearing is a polite way of saying 'loss'. A loss is still a loss, even if tax reduces the size of it. Furthermore, tax is paid in an SMSF at only 15% in accumulation stage or nil in pension phase, so the tax savings are far less than a high marginal tax-paying individual.

Second, capital gain. It is irrelevant to someone buying today that prices are up 10% this year. All that matters is the future. Buy an apartment for $700,000 and sell it for $750,000 a year later and there won't be much left over to pay for all the hassle. It costs most of the gain to buy, finance, repair and keep it. It's easy to believe that property prices are one-way traffic, but Sydney has only just recovered in real terms the prices from 2004. That's almost a decade with no real growth. It's as convincing to make a case for prices falling in years to come – rising interest rates, increasing unemployment, historically high price-to-rent ratios – as it is to bank on capital gains.

Table 1. Illustrative returns from a 2-bedroom apartment

Cost item	**Up front cost**	**Annual short-term**	**Annual long-term**
Purchase price	$700,000		
Stamp duty	$27,000		
Legal, inspections, etc	$5,000		
Furniture package (only for short-term rental)	$40,000		
Rental income (short-term 365 X $180 X 75%, long-term 48 X $700)		+$49,275	+$33,600
Apartment leasing agent (Gross rental X 13% or 7%)		-$6,406	-$2,352

Body corporate administration fee		-$8,000	-$8,000
Sinking fund fee		-$1,000	-$1,000
Council rates		-$2,000	-$2,000
Water, electricity, gas services		-$2,000	-
Apartment cleaning (short-term, assume 90 times pa)		-$10,800	-
Travel agent/online commissions, 10% on 50% of rent		-$2,464	-
Other costs (linen, pay TV, maintenance and repairs)		-$2,000	-$1,000
Purchase cost short-term	$772,000		
Purchase cost long-term	$732,000		
Net income (ignoring interest cost on loans)		$14,606	$19,248
Net income/purchase cost		**1.9%**	**2.6%**

Ignores tax and depreciation effects, including land tax.

Of course, any of these assumptions can be varied (including using lower rents and higher costs), but the net rental yield from residential investment, ignoring interest costs, is around 2% to 2.5%. Rents do rise over time, but not much in real terms, and so do costs.

There's a decent chance the day the apartment is bought, when the thrill of owning a property is matched by dreams of income and capital gains, is the highlight of the investment. After the calculations, paperwork and administration are done, taking phone calls from agents saying the toilet needs fixing quickly becomes tiresome.

Like any investment, residential property must be the right asset bought at the right price and the right time, not anywhere based on the need to get into the market quickly due to FOMO. It might be that the recent price rises have already delivered the best returns for some time.

Why we overlook lifetime annuities

David Bell

In my previous article on annuities, I explained that a life annuity is the only financial instrument or product that can give an individual a fixed income for life. So annuities sound like an attractive proposition, particularly if individuals are assumed to be rational and seek to smooth out consumption over their lifetimes. This proposition is even more attractive when we consider the higher payments due to the mortality premium.

And yet we see little voluntary investment in annuities in Australia or overseas. There are rational and behavioural reasons for this annuity puzzle. I will discuss the rational reasons here, and explore the behavioural reasons in my next article.

While this is an area of much research (I have drawn on work by Jeffrey Brown in the US and domestic researchers Michael Sherris, John Evans and Susan Thorp), reasons can also be drawn from industry experience.

The main reasons a person may sensibly choose not to annuitise include:

1. Cost – Many regard annuities as poor value. It is a difficult claim to make with confidence: the 'money's worth' of annuities is a complex calculation. Money's worth calculations compare the value of the expected payments from an annuity with the cost. This may sound simple but it isn't. For instance, it is hard to choose a discount rate and estimate life expectancy.

Much of the research points to annuities offering less than fair value (that is, a money's worth ratio of less than 1). This shouldn't surprise, as annuity providers must put capital aside and target acceptable shareholder returns.

This is not the end of the story. Annuity providers are exposed to adverse selection. This is a phenomenon whereby the life expectancy of those who choose to annuitise is actually higher than that of the broader population. This could be simply because those who are wealthy and seek financial advice often live longer. However it could also be because people who believe they have a longer than average life expectancy find annuities attractive. This is known as adverse selection.

The only way annuity providers can allow for this is through pricing. Research has shown that if 'money's worth' calculations are based on the life expectancy of the annuitised population, then money's worth is much closer to fair value.

Interestingly, even when prices are less than fair, the models suggest that individuals would still benefit from investing in annuities.

2. Age pension – Australians already have (conditional) exposure to a life annuity: the age pension. However the rational models suggest that full annuitisation is beneficial and can't explain why people with different income levels choose not to annuitise (as the age pension will provide varying replacement rates across the population).

3. Default risk – Life companies have defaulted in the past. For instance, we saw several US life insurers fail in the early 1990s, including Executive Life Insurance, Mutual Benefit Life Insurance, and Confederation Life Insurance. APRA requires that life companies keep aside enough capital to withstand the events of the next year with a 99.5% probability of sufficiency. These standards could be thought of as a 0.5% chance of default (obviously life companies could hold more than the minimum capital, further reducing the risk of default). This may sound like a small risk, but if we consider that someone annuitising at 65 could live for another 30 years, then the probability of default over the annuitant's lifetime becomes 15%. And there is always the possibility that risk models fail to correctly estimate risk (surely not!). Unlike previous articles on credit investing, which have emphasised the benefits of diversification, it is difficult to diversify annuity provider exposure in Australia.

4. Bequests – For those with strong bequest intentions, full annuitisation is not rational. However partial annuitisation could be a rational choice.

5. Irreversibility – Typically annuities are irreversible contracts (though innovation by groups like Challenger has led to the introduction of exit clauses for reasonable time periods). The irreversibility takes away flexibility, which is difficult to value. An irreversible contract is not undesirable in the context of default risk and bequest motive issues previously outlined.

6. Deferral may be optimal – In the previous annuities article, I explained the concept of the mortality premium, which makes life annuities more attractive. Basically, because not everyone in the insured pool is expected to survive to the next period, a life insurer can afford to make higher payments compared with those received from the underlying securities (typically fixed interest securities).

   Now consider the case where the probability of dying in the next period (say a year) is very low; the mortality premium associated with that first year will be low. The potential risk adjusted return from deferring annuitisation and instead investing in equities may be positive, so it may be rational to defer annuitisation. However this does not mean that we should not

invest in annuities at all – there will come a point where the marginal mortality premium exceeds the risk-adjusted return expectation of the alternative investment.

7. Incomplete markets – We may not be offered the most attractively featured annuity products at reasonable prices. There are two broad reasons for this, as noted in the Henry Review: supply issues and barriers to innovation. Supply issues include the lack of market support for the hedging and sharing of mortality and longevity risk, and the availability of long-dated (particularly CPI-indexed) fixed income securities. Barriers to product innovation consist of the red tape burden imposed by various regulators. Deferred annuities are a case in point. They are interesting products from a financial planning perspective that are in effect ruled out by their tax treatment (proposed government changes could fix this problem).

8. Risk-sharing in couples – Couples effectively insure each other through bequests. However even in this context, life annuities still have a role to play among rational decision makers.

9. Financial advice models – Some suggest that financial planners who use planning models that rely on trailing commissions may be less likely to recommend life annuities. But I'm sure this statement cannot be applied to all financial planners.

So overall there are many reasons why a rational individual may choose not to invest in annuities. It should be pointed out that academic researchers have considered each issue and found that, in most cases, no reason carries enough weight on its own to justify excluding annuities altogether (although deferring or partial annuitisation may make more sense than full annuitisation in some cases).

And so the annuity puzzle remains for researchers, though many market practitioners can probably find enough cause to be put off annuities in the reasons listed above. Researchers are still determined to find behavioural explanations for the lack of annuitisation, and I will explore some of these reasons in a subsequent article.

David Bell's independent advisory business is St Davids Rd Advisory. David is working towards a PhD at University of NSW.

China beyond the myths and stereotypes

Rick Cosier

I first visited China in 1991, and travelled over much of the country, from Kashgar in the west to Beijing in the north-east. It was a fascinating experience, as even though I had missed the Mao era it was still 'old China'. It was a grimy place with unhygienic city centres. Local party despots ruled and talent was wasted in meaningless jobs.

I visited China again in 2007. In the intervening years, entire city centres had been bulldozed. Residents were forcibly relocated to high rise blocks. Mistakes were made. Suzhou, once described as the Venice of the East, had become unrecognisable.

I had read many articles that focussed on Western style indicators such as growth, inflation, unemployment and manufacturing. I had also heard that China was building cities that nobody lives in and roads that lead nowhere.

So I returned again last month to see China again, and to ascertain whether clients should be increasing their investment in Chinese companies, or in companies that do business with China.

However, I found myself thinking that these investment questions were inextricably linked to much wider economic, political and sociological issues.

Is the West the best?

Western-style capitalism has just created the biggest global financial meltdown in history. Even though some say the worst is over, many Western nations are burdened with massive debts and southern Europe faces record unemployment and social unrest. The population in most developed economies is ageing to such an extent that it is difficult to see how governments will have enough workers paying tax to fund pensions, health and welfare.

The ability of Western economies to solve these massive issues is hamstrung by the fact that governments serve for such short terms. The new Coalition Government in Australia may only have three years in office to make a meaningful contribution, and for the first nine months, it will be saddled with an obstructionist senate. Obviously, no such problem exists in China.

I believe that economists and investment managers view China through 21st century Western spectacles. Is it reasonable to judge a country on the same parameters as a mature economy? China is undergoing an industrial and technological revolution that has not been seen since Britain and America industrialised in the 1800s.

The Chinese are subject to stereotyping - they are rude, they can't manage people, they're not innovative … but these stereotypes can obscure the truth.

Think long term

Let's address the 'can't innovate' stereotype first. Anyone who has travelled on the German-built Maglev train from Pudong Airport to Shanghai cannot fail to be impressed. It could travel the 56 kilometres from Campbelltown to the Sydney CBD in just seven minutes. It runs at up to 430 km per hour using magnetic levitation propulsion.

It strikes me that Chinese city planning and infrastructure strategy is diametrically opposed to Australia's and much more sensible. Let me give you two examples. First, until recently, Shanghai had separate railway stations serving the north, south and west. Fares were cheap but the trains were crowded and slow. Their solution was to build a station on the outskirts of the city and run super fast trains. The people now have a choice. They can use the old network at low prices or pay more for a faster, more comfortable trip.

This strategy has been amazingly successful. Trains to cities like Nanjing are almost completely full. It's a similar story with the Pudong Airport link. Either you can catch the super fast Maglev for 40 yuan ($7), which takes seven minutes to reach the outskirts of Shanghai, or you can use the slower metro for just 7 yuan. Contrast that with Sydney Airport where services have been outsourced (sold) to a company that cares more about profit than about providing services. Airport bus services have been stopped and roads diverted or closed. There is a choice between an expensive cab fare and an expensive train fare.

The second example is that the Chinese recognised long ago that they had to expand outwards if they were going to cope with population expansion. They are building new, tasteful buildings; they have planted trees and shrubs and grass. Meanwhile, the NSW government is adopting a 'medium density' housing solution based on knocking down houses and building units. It scars our suburbs, exacerbates our road and infrastructure problems and lowers our quality of life.

Obviously, China's methods are not faultless. Was the 1990s destruction and the forced relocation justified? Was the 'one child policy' really necessary? What about the human rights issues and corruption? The Chinese would probably argue that they had no choice. Democracy and unrestrained capitalism in a country with 1.3 billion people was never going to work. Many would starve. If you have any doubts, read about the industrial revolution in Britain. In 1801, only a quarter of the 9 million population of England and Wales could be described as urban. By 1850 the population had nearly doubled and was mostly living in towns. By the 1911 census, the population of England and Wales had exploded to 36 million. Cities grew unabated. Rich people got richer, and the poor had a miserable life.

Imagine an uncontrolled Chinese population rising at the same rate as it did in 19th century England. That would mean four billion people in a country made up in large part by desert and mountains. Imagine uncontrolled growth and pollution in Chinese cities.

China's system has worked relatively well. Its cities are not as grimy as they once were. Practically no-one spits in the street anymore, and I hardly saw anyone smoking. This is an incredible change in behaviour. Beijing looked polluted in 2008, but I didn't see much evidence of serious pollution on this trip. The other noticeable factor was that the traffic wasn't all that bad, and urban planners seemed to have ensured there were still bicycle lanes. I sense a desire to close Sydney CBD bike lanes. If China had as many cars per head as Western nations, the result would be 550 million cars and over 1 billion cars in the future.

What I witnessed on this trip seemed to be responsible government – state-controlled capitalism with centralised planning and social welfare programmes. It doesn't conform to Western economic theory and political ideology and it can be a ruthless regime, but it seems to be working for the majority. The question is – can they keep it going?

What will the future look like?

Most dictatorships go off the rails eventually. Think Stalin, Hitler, Africa and South America. Also, as economies develop, people become dissatisfied with government intervention. Already, many of the educated Chinese people I spoke to thought the government too intrusive.

And China is a difficult place to do business. Contracts are frequently broken or ignored. Economic statistics are unreliable. Corruption still appears to be a major issue.

In 50 years' time, will China resemble America, Europe, Japan, Korea or something different? Should you be investing in Chinese companies or in countries and companies that could benefit from China? Or should you stick with companies that you know more about? I was never going to answer all these questions in one trip, but I left with more confidence in the future of China than I expected.

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The dynamics of the Australian superannuation system

Deloitte Australia

The Australian superannuation system is the fourth largest in the world and is a source of pride for government and those working in the financial services industry. It provides the country with an enormous pool of investible funds that offer the potential to generate wealth and prosperity for our ageing population.

The Australian system, for all the praise bestowed on it, is as yet still to achieve its founding and most important objective: to deliver an adequate income in retirement to average Australians. Some of this shortcoming is explained by the youth of the system. Many Australians now approaching retirement have only received super for a limited portion of their working lives. The system is still maturing.

Nevertheless, our projections suggest that we are still a long way from achieving this central goal. Current policy settings, including the projected increase in the Superannuation Guarantee contribution to 12%, will not of themselves deliver the level of lifestyle to the majority of those retiring over the next 20 years that we, as a nation, are aiming to achieve.

The industry post GFC to 2013

The superannuation system, as measured by a pool of assets, looks healthy. You would be forgiven for imagining that the effects of the Global Financial Crisis (GFC) have been left far behind. The $1.1 trillion held in the immediate aftermath of the GFC has increased to $1.6 trillion, and funds are posting good annual returns. Yet, a closer examination of the last five years paints a much more complicated picture, and suggests that the Australian superannuation system has been under more pressure than many commentators think. Over this period:

- Benefit payments out of the superannuation system have increased materially
- Contributions into the system have reduced
- Growth of post-retirement assets in the system has been less than predicted

It has been a tough time for self-funded retirees and for those older Australians who have lost their jobs. Low interest rates may be popular politically, but they strike directly at the living standards of retirees, forcing those people to dip into their retirement savings to a greater extent than they had previously intended in order to make ends meet. When this occurs at a time when those savings themselves suffered negative returns, the effect can be particularly damaging.
The last five years show how much pressure the Australian superannuation system has been under.

Growth will likely continue over the next 20 years

The continuing growth of superannuation assets is underpinned by compulsory contributions, and the prospect of the return of more 'normal' investment returns. In our calculations we have assumed that this also leads to a reduction in payments out of the system as retirees take the benefit of tax concessions and are able to draw down their account balances more gradually as they rely more on investment income.

Our projections show the pool of assets growing to $7.6 trillion by 2033, or in real terms from less than 100% to approximately 180% of GDP over the next 20 years. The government has stated its intention to defer the increase in the Superannuation Guarantee by two years. This will reduce assets by only 1% over the next 20 years.

Assets in the accumulation phase

This is where the bulk of assets are, and where we see the most public and fierce competition for members. We expect the competition to intensify even further as funds release their MySuper

offerings and campaign for default status under the Fair Work provisions that have been put in place over the past few months, assuming indeed that superannuation default status remains an industrial issue.

The rate of growth is more than sufficient for all industry participants to grow, even if some lose market share.

Industry funds would appear to be in the box seat. As matters stand they dominate default fund status under modern awards and we expect them to become the single largest pre-retirement segment sometime around 2023. Personal retail products will also grow, reflecting the strength, brand and distribution networks of the banks.

We will learn much over the next year or so. The Stronger Super and FOFA reforms have dramatically changed the competitive landscape. At first blush these changes might be thought to favour industry funds. However it is not that simple.

Many retail funds have been burdened by significant embedded advisor fees that have allowed the industry funds to compete as the low cost option. Suddenly, this is no longer the case. Costs of MySuper and choice products will likely bunch much closer together and foster competition on other dimensions – performance, insurance, services, and brand.

The battle for individual customers is something that the banks and life insurers are long experienced at. In contrast, the industry funds are on a steep learning curve.

The post-retirement challenge

The growth in post-retirement assets is likely to be slower than in the past. The last five years shows that post retirement assets can be quickly drawn down during periods of economic adversity.

One thing is clear. Those Australians with substantial super at retirement are overwhelmingly voting to put their money into their own Self-Managed Superannuation Funds (SMSF). And they often establish their SMSF when they leave employment by transferring their benefit out of their corporate, industry or retail fund.

Institutional funds, whether they are industry or retail funds, have not yet been able to compete with the attraction of SMSFs. We anticipate that this will become the real battleground over the next decade. In fact the battle has started with some of the largest industry players introducing the ability for fund members to invest directly in shares and fixed term assets, as well as an increased emphasis on after-tax returns, and the introduction of new investment options targeting the income needs of retirees. It is a battle worth winning.

Retirement adequacy: the big issue

The central role of superannuation is to help Australians maintain an adequate and comfortable standard of living in retirement. We know that as of 2013 most retiring Australians do not have nearly enough super. Currently 81% are still forced to, at least partially, rely on the government aged pension to supplement their income.

And there are forces at work that will make it tougher for the super system to deliver this fundamental objective.

The population is ageing.

The number of Australians over the age of 65 will increase by 75% over the next 20 years (from 3.3 million in 2012 to 5.8 million in 2032), and at a much faster rate than the working population. The implication for government is clear. There will be proportionately fewer working Australians available to fund those in retirement.

Australians are living longer. Since World War II the average time in retirement has increased by almost 50% as we see the results of medical advances. Even so, this still understates the financial

impact of the issue. As an increasing number of Australians live into advanced old age we see dramatic increases in the cost of aged and palliative care.

The big issue for government is what should be done?

Increase contributions

It is trite to suggest that we can address adequacy by increasing superannuation contributions. The reality is that those most likely to have insufficient superannuation are those least able to divert current income into savings. We provide examples using averages that suggest an additional contribution of the order of 5% to 7.5% of salary would be needed to allow the typical current 30 year old to retire comfortably on their super.

It is not going to happen. We see only some evidence to suggest a widespread capacity for Australians to make sustained voluntary super contributions, and certainly nowhere near the amount required.

Allow/encourage Australians to work longer

The Federal Government has already moved to increase the pension age to 67. Recent changes also allow Australians to continue to have contributions paid into super at older ages. Other countries are moving in the same direction, and it makes sense.

There is a doubly positive impact on the person's standard of living in retirement. The extra time spent in the workforce increases the superannuation that the person accumulates. At the same time the period spent in retirement is reduced by the extra time working.

We have performed calculations assuming that Australians work an extra two and five years. At an individual level the impact is clear. There is a materially greater ability to live at a more comfortable standard to an older age. For the system as a whole we see the accumulation of a substantially greater pool of assets. If retirement is deferred by two years there is an extra $400 billion in the system in 2033, and if deferred by five years the pool of assets increases by a full $1 trillion from $7.6 trillion to $8.6 trillion.

Longevity risk

The long standing weakness in the Australian superannuation system is that individual Australians accumulate a lump sum balance in their superannuation account throughout their working lifetime with the aim of using that lump sum to deliver an income during their retirement.

The system breaks down on a number of fronts:

1. Some draw directly on their super to pay off debts and/or to maximise their ability to draw on social security

2. Some die before their super is exhausted but on their death any remaining balance is moved out of the system

3. Some outlive their superannuation and ultimately are forced to rely on social security.

Lifetime pensions address these inefficiencies by pooling longevity risk. Un-needed assets held in respect of those who die at younger ages are made available to support continuing income payments to those who live to advanced age.
We are not the first to point out the benefits of pensions vis-à-vis lump sums. We also understand that it is an enormous challenge for our politicians. The conventional wisdom is that Australians are devoted to their lump sums and will not countenance any government that even thinks of changing things. Nevertheless, the impact of not pooling longevity risk is hugely underestimated.

Calculations we have undertaken suggest that if Australia moved to a genuine lifetime annuity or pension system then, other things being equal, we would reduce the amount of assets needed to

fund adequate retirement benefits by about 15%.

Let us be clear. The fixation on maintaining lump sums in retirement means that one dollar in six is effectively wasted even if we accumulated precisely enough to provide an adequate income over average life expectancy for each individual Australian.

This is a substantial amount in a system that is already $1.6 trillion. It is an enormous amount in a system that is expected to grow to well over $7 trillion in the next 20 years. We know that a move away from lump sums in retirement must occur and needs to be addressed sooner rather than later. Our political leaders need to enact legislation to enable this to happen irrespective of potential short-term ramifications.

Concluding comments

Our 2013 report into the Dynamics of the Australian Superannuation System confirms much of the inherent strength of the system. Certainly, growth in the body of assets, underpinned by the compulsory Superannuation Guarantee contribution, is certain. Our calculations show assets increasing to a total of about 180% of our national GDP over the next 20 years.

This is a huge sum of money. Competition for a slice of the industry is intensifying. The major protagonists are the largest industry funds and the wealth management arms of the banks and the life offices. In the past, the battle between these segments has resembled class warfare and been dominated by cost vs. advice vs. service.

Our belief is that the Stronger Super reforms will change the competitive landscape with much greater emphasis in the future being on product design, transactional efficiency of back office operations, and the ability to simply and cost-effectively engage with individual members, as well as the use of brand, distribution, and consumer marketing to win and retain customers.

The full report, The Dynamics of the Australian Superannuation System, is attached here.

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