# Cuffelinks
Connecting investors with ideas

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**This week's top articles**



# Sometimes, the best answer is "I don't know"

## Dominic McCormick

***Emma Alberici:*** *Tell us, how much longer do you expect the shutdown to continue and how do you expect it to end?*
***William Kristol:*** *Well, if I knew the answer to that, I'd probably be, I don't know, making bets at Las Vegas, not chatting with you here on Lateline.*

***ABC Lateline interview with William Kristol, Editor, Weekly Standard, 7 October 2013***

The arguments about the US Government shutdown and debt ceiling have been kicked down the road until the first quarter of 2014, but they have not gone away.

In any case, let's examine some of the simple analysis, excessive reliance on history and complacency that has accompanied the discussion of these events by some of the financial media and investment industry. Much of this has just confused investors grappling with how to deal with a complex situation.

Perhaps this is one of those times when William Kristol's "I don't know" should be a more common response from commentators and analysts. Instead, many have been all too eager to provide specific views and investment strategies to play the expected outcomes.

For example, as the US headed to its 1 October 2013 Government shutdown and the ensuing debt ceiling debate, a strategist at a major Australian bank was quoted in the AFR on 30 September 2013 saying, "If there is a legitimate concern about the US Government defaulting on a payment then that is a serious issue and *a US dollar positive*." The mind boggles. So we should all buy the currency of the very country whose Government was about to lay off 800,000 workers, slowing economic growth, and the same country that is threatening to default technically on official debt payments due within a month. In fact, the US dollar was generally weaker against major currencies until debt negotiations began on 10 October.

Part of this is the Pavlovian response of markets to previous 'risk off' periods where the US dollar and bonds tend to rally as supposed 'safe havens'. However, it makes sense to adjust this analysis to reflect the fact that this time it is the US Government that is the cause of the actual 'risk' events that investors may be seeking shelter from.

This over-reliance on history can also be seen in the commentary casually dismissing any negative investment implications from the shutdown and instead seeing it as a buying opportunity primarily because the market went up, on average, in the weeks or months after the previous 17 shutdowns. The fact that the last of these was 17 years ago, the sample size is small and these shutdowns occurred in vastly different economic and investment environments seems to be largely ignored. History can provide useful information but should hardly be used as a definitive guide to the future.

This view was taken further in The Australian on 8 October 2013, "Relaxed investors spot a silver lining", where we were told that many money managers see the shutdown and debt ceiling situation as a "blessing": "Any stock sell-off would be a great buying opportunity" they are saying.

This view seems casually to dismiss two points.

First is the low probability, but still present, risk that the endgame could be a much more adverse outcome than in the past, including a default or US credit downgrade, in which case any stock sell-off would likely be followed by a much bigger sell-off.

Second, even if sensible resolutions happen as expected, taking advantage of prior weakness that has typically only been a few per cent is hardly a great buying opportunity and will ultimately be largely irrelevant to longer term returns. The much more important drivers of such returns include elements such as current market valuations, the course of corporate earnings and monetary conditions, not the historical short term response to previous government shutdowns or debt ceiling debates.

One reason subsequent 'short term' returns were on average better after previous government shutdowns is that markets typically fell through the shutdown period so part of the better than average return was simply mean reversion, especially since these events have so far turned out to have little overall negative economic impact. Further, most of them occurred in the 1980s and 1990s, part of America's largest ever equity bull market.

Further, as one commentator pointed out, the fact that markets have taken a relatively benign view of the shutdown and debt ceiling situation may increase the chance that it turns out worse than expected. In the absence of a market panic, politicians may feel they can drag the situation on with minimal adverse consequences. Only a true crisis in markets, the argument goes, will be enough to push politicians to act and get a responsible deal done. To the extent this is true, reliance on historical events may actually increase the chance that this time is different. These types of feedback loops make analysis of these situations very complex.

So what does this all mean to investors?

First, they need to be sceptical about history and realise that politicians can knowingly or unknowingly lead the world to some pretty disastrous outcomes. Even the low probability, but potentially disastrous, outcomes such as an actual debt default cannot be completely ruled out just because they are so rare. Of course, this is a challenge for investors as it doesn't make sense to make dramatic adjustments to a portfolio to reflect such a low probability scenario.

Second, context matters. In 1980 the debt ceiling was under $1 trillion. Even as late as 1996 it was under $5 trillion. Today it is $16.7 trillion. Future debt ceiling debates are likely to become more difficult and dangerous as debt heads towards 100% of GDP. Indeed, the current situation may focus greater ongoing attention on the long term unsustainability of the US fiscal situation despite the consensus view that any real danger still seems some years away. This could have a real and enduring impact on markets even beyond a current deal, especially since a deal on the debt ceiling is likely to be short term only.

Third, if US stocks represent good buying today it cannot simply be because they have fallen a few per cent recently in reaction to news about the shutdown or debt ceiling. Sure, strong short term rallies should be expected when deals are done. But attractive long term stockmarket returns rely on more than just a short term bounce on the reversal of bad news. Such returns will come because, amongst other elements, stocks are currently trading at reasonable or cheap valuation levels, because of good earnings in the future and because of a favourable future monetary background. Currently, there are question marks on all of these.

Markets are not attractive or unattractive from a long term perspective based on how they are reacting to the major news events of the day. While these may be important for day to day swings – and such swings may be large - they rarely are the big driver to long term returns unless, of course, the worst case low probability outcomes occur. Focusing only on debt and shutdown as a selling or buying catalyst may miss changes in other important longer term drivers to returns.

Finally, when it comes to US politicians don't expect them to be rational or always go down a predictable path. The words of Winston Churchill are relevant, "We can always count on the Americans to do the right thing, after they have exhausted all the other possibilities."

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# An insider's view of the last financial crisis

## Warren Bird

On *The Guardian* newspaper's website, there is a timeline of the Global Financial Crisis. It starts, not as many would expect when Lehman Brothers filed for bankruptcy in September 2008, but a year earlier. 'The day the world changed' was 9 August 2007 when BNP Paribas froze redemptions on three of their funds because they could no longer value the assets held in them. Those assets were backed mostly by sub-prime mortgages in the US and a crisis of confidence had engulfed that market.

For people involved in the money, fixed interest and credit markets, the stresses in the financial system from August 2007 until 2009 were almost unimaginably intense. I don't think many Australians have ever understood what was happening. To this day I encounter people who look back on, for example, a relatively mild pull back in stock prices in September 2007 and wonder what all the fuss was about. Let me explain.

While not predicting the severe events that eventually unfolded, I'd been concerned all through 2006 that credit markets were taking on more risk, but pricing it too cheaply. Sub-prime mortgages were just one example of this, and by early 2007 it was obvious that this market was in trouble. Arrears were rising rapidly, which isn't surprising since the loans were to people who by definition couldn't afford them. This wouldn't have caused problems for structured products built on sub-prime quality if house price inflation had come to the rescue, as was naively assumed would always be the case. But house prices had been falling for nearly two years, taking away the 'get out of jail free' card. Refinancing of delinquent loans became almost impossible and several origination firms went bankrupt.

Credit markets were still priced for a benign economic environment. It was generally expected that the sub-prime crisis could be contained to structured securities and the financing units of some of the banks. However, Phil Preston, who was a senior member of my team, wrote in March 2007 that "the impact on the finance sector should be modest *unless* one or two more events hit markets in quick succession, in which case there is a risk of withdrawal of liquidity, price spirals etc."

By July 2007, that 'unless' started to become reality. Credit rating downgrades became more commonplace, especially for financial corporations. Credit spreads widened sharply that month and concerns were beginning to extend beyond those that were directly involved in the US housing and sub-prime markets.

Then came August 2007 and the BNP announcement. This required fund managers to assess carefully their exposures to BNP; it also led to questions being asked about the quality of the balance sheets of all financial institutions.

One of the things that became all too apparent during this time was that the Australian corporate bond market was far from being Australian! I clearly remember facing the Investment Committee of one superannuation fund in late 2007 and being asked, "So tell me again why the travails of an American home loan lender are giving my Australian bond fund such grief?"

That American lender was Countrywide, and their story provides a snapshot of the events of this turbulent time.

Countrywide was one of the US home lenders that had ventured into the sub-prime loan market. We were keeping a close eye on their credit quality as they had an A$ bond maturing December 2010. In late 2006 the bond was trading at around 0.35% over swap. By March 2007 it had widened out to 0.55% over, then in July the market's assessment of their risk spiked and the bond was marked out to 1.0% over swap. The trend continued, and by early September the Countrywide bonds were at 2.7% over swap. In reality these prices were probably just market guesses; I doubt a real market for Countrywide bonds actually existed at that time. As we'd cautioned in March, liquidity was being withdrawn.

After the BNP Paribas announcement, Countrywide debt jumped to 3% over swap. It was a vicious circle for them - as the extent of the sub-prime problems became better understood and that market declined even further, the willingness of other lenders to refinance them diminished. By the end of 2007 they were at more than 10% over swap.

Of course, the price of the bonds plunged - from around par in late 2006 to 69 cents a year later. Even though Countrywide was only a very small member of the UBS Composite Bond Index, its price decline was enough to have a sufficiently negative impact on the returns of the market that it needed to be mentioned in client reports.

In the end, Countrywide bonds recovered. The company was bought out by Bank of America in early 2008, when the US was still trying to engineer bailouts of troubled lenders. Their A$ bonds matured on 16 December 2010 at par value – that is 100 cents in the dollar. Anyone who'd had the courage to buy them three years earlier did very well!

**Concluding comment**

A chain of events followed BNP Paribas' announcement in August 2007. From the collapse of Britain's Northern Rock later that month, to the rescue of Bear Stearns by JP Morgan in March 2008, then eventually to the failure of Lehman Brothers, Washington Mutual, Wachovia, AIG and many others in the US and elsewhere later that year, the train wreck that we now call the Global Financial Crisis hit us all. Confidence in the global banking system was shattered.

During this period even the big four Australian banks became reluctant to lend to one another, due to a lack of confidence that anyone knew how badly exposed to problems your counterparty might be. The Reserve Bank of Australia, along with all central banks globally, injected massive liquidity, imposed new rules regarding security for central bank loans to the banks and cut interest rates to stave off a complete failure of the inter-bank lending system on which the economy stands. Governments either guaranteed or bought out banks to avoid their demise. Contrary to some opinion, all of this was not just whining by banks wanting tax payer bailouts, but a genuine fear that the world was such a toxic place that no credit could be trusted any more.

I believe I stand on solid ground in saying this. I was part of the system, having to grapple with the questions it posed about what to do with the funds that our clients had entrusted us.

In the end we held to the view that governments would respond to restore confidence and at least buy time for the world economy to recover. They did this in spades and although it's been anything but smooth sailing since, the alternative is too awful to think about.

US Congress has temporarily addressed the debt ceiling issue this week. People must have confidence in the financial system and need a risk-free asset they can trust.

*Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management until February 2013. His roles now include consulting, serving as an External Member of the GESB Board Investment Committee and writing on fixed interest, including for KangaNews.*

# What did you do during the GFC, Daddy?

## Graham Hand

Five years ago this week, the Rudd Government launched its first stimulus spending package to ward off a recession, and placed a guarantee on bank deposits as money was flowing out of regional banks and small financial institutions at the height of the GFC. It followed the collapse of Lehman Brothers on 15 September 2008, and Wayne Swan said that at the IMF meeting held at the time, he could see the "fear in the face of the delegates".

So we've seen fifth anniversary newspaper stories recalling the traumatic events of the crisis, and the former executives of Lehman, JP Morgan, US Treasury and Bank of America have appeared in television specials, explaining their role in saving the day while all around them panicked.

In fact, the GFC started a year earlier in the global credit markets, but the equity markets ignored it. With hindsight, everyone had the chance to exit shares at elevated prices with plenty of notice, as the credit markets were screaming for all to see, in every part of the world.

It hit the borrowing programme I was managing a full 13 months before the Lehman crisis.

In the early evening of Thursday, 9 August 2007, I received a phone call at home from a Citibank dealer in London. For many years at Colonial First State, we had been issuing short term notes in the Euromarkets to finance the largest geared fund in Australia, and some notes routinely rolled over almost every night. It was an excellent source of inexpensive funding, sometimes swapping into Australian dollars at below the domestic bank bill rate – amazingly cheap for equity leverage. We posted issuing levels at the end of each Australian day and the London dealers at investment banks like Citi and Warburgs could transact at those spreads without further reference. At the time of the call, we had over a billion dollars on issue in Europe, and this night, $50 million was maturing.

"We can't rollover your paper this morning. There are no bids in the market," said the Citibank dealer.

At first, while unusual, this was not alarming, as pricing levels between issuer and dealer are subject to negotiation and posturing. I asked for more details, and said we were willing to pay a few points more if necessary.

"You don't understand," he said. "It's not a matter of price. There are no bids on anything".

And that night, now over six years ago, the GFC started. I immediately turned on my lap top, and a quick scan of financial websites confirmed what had spooked the market. BNP Paribas had suspended redemptions on three of its money market funds, and to quote them, "The complete evaporation of liquidity in certain market segments of the US securitisation market has made it impossible to value certain assets fairly regardless of their quality or credit rating … We are therefore unable to calculate a reliable net asset value (NAV) for the funds."

The US sub-prime crisis had come to Europe. The entire billion dollars of notes matured over the following months without a single rollover at any price. If ever confirmation was needed of the merit of diversified funding sources, this was it. No institutional borrower should ever forget this.

Initially, there was no way of knowing if the crisis would last a week or a year. The remaining $4 billion of our $5 billion borrowing programme was onshore in Australia, including short term notes issued into the market and direct bank lines. Although these sources proved more resilient for a well-established local borrower, there was a massive transfer of negotiating power to lenders and investors. A cash manager like Tony Togher in Colonial First State suddenly became far more powerful, with tens of billions of cash from his funds to dole out to desperate borrowers.

A year earlier, banks had been calling at our doors to lend as much money as we wanted, and we even had one major bank wanting to fund the entire multi-billion dollar facility. The margin on billions of dollars of bank debt for a geared fund reached a low of 0.40%. After the crisis hit, the banks had their own funding problems, both in quantity and price, as short-term wholesale facilities could not be rolled over. For a long time, banks would not even lend to other banks.

Many long-established bank relationships disappeared. Suncorp Metway wanted its money back as soon as possible as they withdrew from corporate lending. Bank of America significantly reduced its facility, and only retained a small amount after much persuasion. Westdeutsche Landesbank was in a dire state in its home market and left Australia completely, never to return. HBOS plc withdrew and BNP Paribas was no longer interested in lending. All banks demanded major increases in lending margins, which more than tripled to over 1.30% as facilities matured. Many of the foreign banks who had been useful competitors to the major banks for corporate borrowers had to focus on funding problems in their own country.

While in our case, the major banks continued as supporters, they withdrew loan facilities from thousands of corporate customers across the country. They were preserving their own funding and reducing lending as the market remained in crisis mode. Banks are the plumbing that makes liquidity in the financial system flow, the transmission mechanism through which the government and regulators operate, and the banks were frightened.

It's easy to forget what fretful times these were, and how many thought the entire system was about to collapse. Meetings between borrowers and lenders were tense and we used every method we could imagine to retain our funding. We even threatened that Colonial First State fund managers would withdraw their cash from the banks, although we had no power to make it happen. It was a bluff. All borrowing spreads widened dramatically, and note issuing programmes collapsed. Australian banks focussed heavily on building domestic funding bases, and the spread between term deposit and bank bill rates rose to levels never seen before.

And yet, while debt markets were in turmoil, equity markets remained strong for many months, with a high on 12 October and another rally to similar levels on 7 December, as shown below. It was an extraordinary disconnect. Either the bond market or the equity market was wrong, but we were not sure which. I recall talking to bond manager, Warren Bird, at the time (see previous article), who was surprised by the rising equity markets, which he believed did not appreciate the stresses that the credit markets were signalling.

**S&P/ASX200 from January 2007 to October 2013**

Source: Google Finance.

The collapse of Lehman Brothers was not until 15 September 2008, over a year later. Merrill Lynch was rescued by Bank of America, and the US Federal Reserve bailed out JP Morgan Chase and AIG, which in turn saved Goldman Sachs. So much for the free market bastions of Wall Street.

In this week where the debt-paying capacity of the greatest credit in the world, the US Government, has been in doubt, it's worth recalling these events of six years ago, and the importance of confidence in the global financial system. There was a severe loss of funding for businesses needing money to grow and employ people, banks stopped dealing with each other and governments around the world had to step in and guarantee their banks. The financing problem is far from solved, and it has spread to some of the (formerly) best sovereign names in the world.

While countries can borrow to save their banks, who can borrow to save the countries? I expect that six years from now, we'll still be trying to sort out the mess.

# Behavioural reasons why we ignore life annuities

## David Bell

In Cuffelinks 32, I explained that life annuities have merit for people who seek to smooth their consumption over a lifetime of unknown length. And yet we find little annuitisation in Australia or around the world, and so we have an 'annuity puzzle'. In Cuffelinks 34, I explained some of the rational challenges to annuities, but well-respected academics such as Jeffrey Brown find it difficult to accept that the lack of annuitisation can be explained solely by rational reasons. In this article I outline a number of behavioural reasons why people may not purchase life annuities.

This article heavily references Jeffrey Brown's work in *"Rational and Behavioural Perspectives on the Role of Annuities in Retirement Planning"* but much of this stems from broader behavioural finance research by the likes of, among many, Richard Thaler and Sclomo Bernartzi, and ultimately, Nobel Prize winner Daniel Kahneman.

**Complexity and financial literacy**. There are many research papers which demonstrate the lack of financial literacy across the population. Lifecycle modelling is highly complex and most people would not be capable of making an accurate assessment of retirement needs, even if they have reasonable levels of financial literacy (though of course they may seek advice). Uncomfortable that a decision is beyond their understanding, an individual may be anchored to the status quo (inertia), namely the default option. This has greater resonance when the active decision to purchase an annuity is one which is not always reversible, though some life annuity contracts now allow an exit within a fixed time period. For super fund money the default option is typically an allocated pension product but one can quite easily redeem and take a lump sum. A life annuity is nowhere in sight when it comes to default retirement solutions.

The power of defaults cannot be underestimated. Defaults, depending how they are framed, can potentially be interpreted as a recommendation by the company. And defaults often persist for individuals because to move away requires an active decision. An example is the Swiss pension system where an annuity is commonly the default at retirement (with an ability to take a partial and sometimes full cash lump sum), and annuitisation rates are extremely high.

**Mental accounting and loss aversion**. In US focus group research, people viewed the purchase of a life annuity as 'gambling on their lives'. This doesn't fit with the rational reasons for purchasing life annuities, namely the guarantee of an outcome and the removal of the risk of unknown lifetimes. In effect, Brown suggests that the mindset of consumers with respect to annuities is behaviourally influenced rather than completely rational.

Brown suggests that an individual may view insurance differently to an economist. Where an economist views an insurance contract as a way to manage a risk, an individual may frame an insurance contract as a payment to counter a bad event. Yet many people may not view living a long time as a bad event and thus not view annuities attractively. Surely education and advertising can successfully frame the bad event as living a long time without sufficient means.

**Regret aversion**. Consider the scenario where someone purchases a life annuity and then discovers they are terminally ill. Not only are they distressed about their life coming to an end but they will also have great regrets that they purchased a life annuity. The fear of experiencing this regret may be a deterrent to annuitise.

**Loss of control.** This can be considered in a rational framework (annuitisation leads to a loss of liquidity as one exchanges wealth for an income stream) but also from a behavioural perspective. Brown refers to psychology literature on the 'illusion of control' where greater control over the financial future is gained from accessible wealth. My feeling would be that the rational reason (loss of flexibility, counterparty exposure etc) is a stronger reason which can be explored further.

**Framing**. Framing refers to how information is communicated to us, and how it affects the decisions we make. A simple example could be a treatment for serious illness, where one description may be "taking this treatment will give you a 30% chance you will live", while another is "taking this treatment will leave you with a 70% chance of death". The way annuities are framed may impact upon their level of acceptance. Unfortunately for annuity providers, they may inherit existing views of annuities which could be negative and take a while to re-set broad understanding.

And so the annuity puzzle remains unsolved – there remains no seminal piece of research which reconciles why a product which has theoretical appeal does not gather significant market acceptance. Further work is needed on both rational and behavioural reasons, as well as the interaction between the two. While behavioural research always sounds exciting, in my experience it is easier to display the direction of an effect more than quantify its impact.

In the meantime addressing obvious rational impediments (eg. irreversibility, money's worth transparency, supply side impediments, barriers to product innovation, and the issue of counterparty risk) as well as continued focus on the way the product is framed to individuals (managing the risk of living a long time poor) can only improve the small signs of growth in life annuity sales in the Australian market.

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

## Are you getting the most from your age pension?

## Alex Denham

While conducting a client review last week, I came across a strategy that might have some application for others. The story also has some good lessons about investing for the long term.

**The background story**

Let me tell you about Paul. At age 62, Paul received a $550,000 inheritance from his mother and came to us for advice in 2007. By October 2007, the advice was complete and he made a $450,000 non-concessional contribution to a superannuation account in a wrap service and immediately invested in a portfolio of direct Australian shares (the All Ords was about 6,650 at the time) with some allocated to cash.

By March 2009, with the world in the full grip of the GFC, at age 64, the super fund balance was $292,056 (All Ords about 3,100). He had not made any further contributions. Paul needed income, so he started an account-based pension, staying invested for the transition. The share portfolio did not need to be sold down and re-bought. You can do that with a wrap service, one of the many reasons they can be an interesting alternative to an SMSF.

Through the subsequent years, Paul's share portfolio, although prima facie down in value, continued to pay dividends. The account's share portfolio generated enough dividends supported by the cash allocation to meet all fees and the pension payments. He wasn't forced to sell down the shares, nor did he sell down out of panic.

Fast forward to today. Paul's account balance is back up to $360,000 (All Ords about 5,200), and he has received $117,000 in pension payments along the way. If he had panicked and sold down all his shares to cash, it would be a very different story for him.

Paul remained focussed on the dividends and being an investor in the businesses he owned a share of. He was invested in good companies in important industry sectors, with strong balance sheets making strong profits and paying reliable dividends. If a company no longer met those criteria, he listened to advice and then and only then would he sell to reinvest into companies that did.

**The Income Test kicker**

Paul is married and claims a part age pension assessed under the Income Test. Account-based pensions are not deemed for the Income Test. (In the May 2013 Federal Budget, the Labor Government proposed to 'deem' new account-based pensions that commenced on or after 1 July 2015. At the time of writing, no legislation has been drafted, and the Coalition Government's stance on this issue is unclear). The pension income drawn is assessable by Centrelink; however, it is reduced by a 'deductible amount'. This deductible amount is calculated as the purchase price divided by the member's life expectancy at the time of purchase. For Paul, this formula worked out to be: $292,056 / 22.85 = $12,781

With Paul drawing an annual income of $36,000, Centrelink assessed him as receiving $23,218 assessable income from the account-based pension, and that was really hitting his and his wife's age pension benefits.

Now that Paul's account balance has come up again, and his life expectancy is lower because he's aged a few years (it is now 15.49 years), we have decided to re-set the account-based pension so that the deductible amount formula is now: $360,000 / 15.49 = $23,241.

Of the $36,000 a year he is drawing, Centrelink will now only count $12,759 and as a result his age pension income will go up by as much as $172 a fortnight.

How does he re-set his account-based pension? He just rolls from his current account to a new account-based pension in the same wrap service. Again, in his case, there is no selling down of investments to then re-buy them (and in the process incurring brokerage charges). With his wrap account, the shares he already owns are transferred to his new pension account: it's just a matter of paperwork. You can do that with a wrap service, and you can also do it within your SMSF.

With the markets recovering, if you are a part pensioner assessed under the Income Test and have an allocated or account-based pension, check with your adviser to see if it's worth re-setting the deductible amount to improve your Income Test. It's a quick and easy calculation with great ongoing potential benefits.

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