Cuffelinks
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Introduction to the Market Monitor

Ashley Owen

Cuffelinks has added a new feature in 2014 by publishing the Market Monitor. It is a review of the economic conditions in major global markets including growth trends, plus our estimate of long term value across a wide range of asset classes. It will be updated each month. Part 1 of this explanation on how to read and understand the Market Monitor is a brief summary of the complex process we follow. Part 2 provides more detail for those who are interested.

Part 1: Brief summary

The Market Monitor has two major sections:

1. A review of major markets in Australia, Europe, the US and Asia in the prior month, and a comment on the 'Current position', 'Direction/Trend' and 'Pace of Growth'; and

2. A review of each asset class, and a comment on the 'Current position' and 'Long term returns'.

Here is what these headings mean:

1. Major Markets

The regional or country growth looks at current economic growth relative to its long term average. So 3% growth would be very good for Europe but well below par for China. We use terms such as 'below average', 'stagnant' or 'cyclical slowdown' to describe current growth. For example, in the December 2013 report, we describe Australia's current position as 'below average growth rate' with a slowing growth trend.

The 'Direction/Trend' is the direction and trend of economic growth. We use terms such as 'growth slowing' or 'recovering very slowly' etc.

Readers should note that the relationship between economic growth rates and investment returns is often counter-intuitive and is the reverse of what most people expect. We have written about these relationships previously.

2. Asset Classes

The asset classes we review are:

- Shares – Australian, developed markets, emerging markets
- Fixed income – Australian, bank term deposits, global bonds
- Cash
- Real estate – Australian commercial property, Australian residential property

On the Asset Class page, the 'Current position' column is our estimate of the current valuation level of each asset class. We use terms such as 'around fair value', 'moderately overpriced' and 'appears inexpensive'.

The 'Long term returns' column is an estimate of long term returns from current levels of pricing, relative to that asset class's long term 'neutral' return outlook. For example, if shares are super cheap on long term fundamental pricing measures, the long term (10+ year) holding period return from current levels is probably going to be well above the 'neutral' return outlook, so it would say 'above average returns'.

The 'neutral' return outlooks are for multi-decade holding periods, that is, several decades or could be a century. The 'neutral' return outlooks are unconditional (don't depend on current pricing or current conditions) and don't change much or very often. We may revisit the assumptions only every five years or so. The 'current' long term outlook is for a 10+ years holding period and are conditional, as they depend very much on current pricing and current conditions, and they do change significantly, often changes each quarter.

But readers should not assume that something being super cheap with outlook for above average long term returns makes it a current buy or over-weight recommendation. Even though things are cheap, we will sometimes underweight them (eg after mid 2008 shares were very cheap, but we were not buying), and sometimes when things are very expensive and destined for very poor long term returns, we will still overweight them, like US shares over the past two years. Something may look cheap over 10+ years but other factors may make them perform poorly over the shorter term. None of the comments should be considered a current recommendation or financial advice.

Part 2: Additional explanation for those requiring greater detail

1. ‘Neutral’ return outlooks

Our long term ‘neutral’ outlooks are not just extrapolations of historical average returns (which vary greatly depending on what particular measurement period is chosen). This is because structural characteristics that affected the market in the past will not necessarily apply simplistically into the future. Nothing is static, stable or constant in the world.

Long term ‘neutral’ outlooks per asset class:

Real economic growth rates – based on factors including: outlooks for population growth rates, the mix between natural growth and immigration (because they have different demographic and productivity impacts), changes in the ratio of employed to total population (not just participation rates, which has assumed arbitrary age cut-offs), worker productivity growth, money supply growth, supply/demand patterns for consumption, savings, investment.

Cash – based on factors including: outlooks for real economic growth rates, economy-wide inflation rates (not just CPI inflation).

Bonds – based on outlooks for cash plus other factors including: maturity premium, illiquidity premium, credit spreads required, supply/demand for debt, multi-decade structural shifts in global/local inflation/interest rates cycles, supply/demand for capital, international capital flows/controls.

Equities – based on the outlook for local real economic growth rates plus other factors including: the share of corporate earnings to total earnings across the economy, differences in the mix of listed companies/sectors versus total corporate activity in the economy (eg miners have a small role in Australian economy but have a large share of listed market value of local stock market), equity risk premium required, dividend retention rates, earnings per share growth rates, buy-back rates, returns on equity, differences in the mix of country exposures relative to local economy (eg foreign sales/costs/earnings on local companies), impact of foreign ownership of equities, international equity capital controls/flows.

Real estate – based on factors including: estimates for rental yields, distribution yields, real capital growth, gearing, capex, depreciation, retention rates, interest burden, supply/demand for international capital.

Exchange rates – includes estimates of long term fundamental value (including inflation differentials, current account, reserve backing), and medium term fundamental drivers (including interest rate differentials, supply/demand for currency from trade & investment, current account & capital account structures).

2. ‘Current’ return outlooks

The above long term ‘neutral’ return outlooks for asset classes assume current prices are ‘fair’ – ie not fundamentally overpriced or underpriced.

According to academic finance theory, nothing is ever cheap or expensive – everything is always perfectly fairly priced - every second of every trading day – whether it is at the top of the bubble just before a crash, or immediately after a savage correction. In theory, there are no bargains and nobody ever pays too much for anything.

These theories are nonsense of course. In the real world, pricing is very rarely fair or just. In the real world markets lurch from boom to bust, and the prices of every asset and security in every market swing wildly from over-priced to under-priced and back. They always have and always will,

because markets are driven by humans and humans are driven by wild emotions – fear, greed, herding mentality, and a host of other irrational impulses.

We use a variety of different types of processes and approaches to measure and assess the current level of pricing for the main asset classes each quarter.

3. Asset allocation

Our asset allocation decisions for each asset class are not simply based on whether it is cheap or expensive (eg underweight if expensive, overweight if cheap, etc). Fundamental pricing on long term measures are important inputs to asset allocation decisions, but they are not the only measures considered.

For example, the US equity market as a whole has been significantly overpriced on several long term fundamental measures for a couple of years, pointing to relatively poor long term returns. But that does not necessarily point to poor returns in the short term.

In addition, despite the US market being more expensive on fundamentals than the Australian market (and despite the US experiencing slower economic growth than Australia), the US market has beaten the Australian market by a big margin over the period.

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It's a new year: let's save more, not procrastinate

David Bell

And so 2014 is upon us. Amongst all those resolutions, it is common to have one about finances, especially an intention to save more. But alas, common with resolutions made on many different subjects (health, education, family, lifestyle etc), it often proves hard to implement.

Procrastination in savings decisions is all around us. A well-cited piece of academic research is illuminating. In 2001, James Choi and colleagues surveyed staff at a large US firm. Most of those interviewed (68% of respondents) reported that their current savings rate was 'too low' relative to their ideal rate. Meanwhile, 24% said that they intended to save more by making additional contributions to their pension plans. The researchers then found that only 3% of respondents actually followed through and increased their level of contributions.

There has been much research into and debate about the causes of such procrastination. Reasons include anxiety, not knowing where to start, complexity, the fear of failure, perfectionism, and disorganisation. When it comes to procrastination around financial decisions, and particularly the decision to save more, there are fewer reasons to focus on:

- Myopia and bounded rationality – many people are extremely short-term focussed and put greater weight on what can be enjoyed now rather than what can be saved for and then enjoyed later. In the research literature this is known as hyperbolic discounting and was first proposed by well-known psychologist researchers Kahneman and Tversky in 1979. There is also bounded self-control: the limited willpower of people to execute their plans.

- Complexity – complex decisions tend to be deferred for two reasons. One is that people are anxious about making an incorrect decision. The other is hesitating to commit to the work required to make an informed decision or indeed not knowing where to start. In subsequent research Choi and colleagues found clear evidence that complexity of financial decisions can lead to procrastination.

- Status quo bias and inertia – people may realise that they should change how they act but feel comfortable or trapped in their current behaviour. This effect is magnified if the upfront commitment or effort feels significant. As an example of how this can be overcome in practice, consider how easy weight-loss programmes are to sign up to, generally a simple toll-free phone call.

When it comes to increasing savings, how then can we overcome procrastination? Although not all households are in a position to save more, many are and probably should save more if they wish to avoid a deteriorating lifestyle when retirement arrives.

There are ways in which the industry can help overcome some of these road blocks. Here are a couple of case studies which I found interesting:

- In a 2012 paper the economist Felipe Kast and colleagues conducted some savings experiments amongst micro-entrepreneurs in Chile. In the first experiment they created self-help peer groups to encourage individuals to stay on track with their savings plans. Savings activities (frequency and amount of deposits) were discussed at group meetings. Those who were involved in the group made 3.5 times as many deposits and saved twice as much as the control group (who also said they wanted to save more but were not assigned to a self-help group). This type of result may not surprise – consider the positive influence of peer groups in areas such as fitness, weight-loss and alcohol abuse.

  In the second experiment the researchers replaced the peer group model with a programme of simple text message reminders. This was also successful, about 80% as successful as the peer group model.

- In 2004, the researchers Richard Thaler and Shlomo Benartzi created a savings programme in the US entitled “Save More Tomorrow”, which was subsequently patented and given the trademarked acronym “SMarT”. This programme was designed to increase the member contribution rates to pension funds and has been successfully rolled out (now via the authors’ relationship with Allianz) across many pension funds worldwide.

  The essence of the SMarT programme is that plan members pre-commit to allocate a large portion of any future pay rises to increasing their contribution rate. There are three important steps to SMarT that can nearly be thought of as behavioural ‘tricks’.

  Firstly, members pre-commit to increasing contribution levels well before they receive any pay rises. This means there is no immediate pain or change in consumption levels, thus getting around some of the myopia and bounded rationality issues discussed above.

  Secondly by pre-committing the status quo position is now reversed. Their starting point is that they are a member of the SMarT programme and, while they can exit whenever they like, they tend not to.

  Finally because the increased savings levels are funded out of pay rises, they do not anticipate a reduction in income and lifestyle changes (ie remove the issue of loss aversion). Note however that they probably will in reality experience some impact on lifestyle, because pay rises usually partly offset inflation.

> The SMarT programme has been extremely successful. In the first example, rolled out across employees of a mid-sized US manufacturing firm, 80% of those who signed up remained in it until the fourth annual pay rise, and their contribution rates rose from 3.5% to 13.6%.

These types of solutions, which help create savings discipline, have applications across the financial planning and the superannuation industries. Perhaps similar models exist already but I have not come across them in Australia. Indeed the opportunity for super funds is obvious: why wait until beyond 2020 to lift member contribution rates to 12% when most of the industry already acknowledges that 12% plus is an appropriate rate?

I also expect that savings club structures could even create greater association with the super fund itself. This is all part of the bigger issue of how far the role of a super fund extends. Surely there is a strong argument that helping members to work around known behavioural biases would be a valuable benefit.

Of course, it goes without saying that I would have written this article sooner but…

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The ten commandments of small business

Bruce Montague

The elders gathered at the base of Mount Sinai and were impressed by the two stone tablets, but one had a question. "Moses, these commandments are very good, but where is the instruction book for small business?"

I spent 15 years toiling in the dealing rooms of major financial institutions, then in 1994 started my own company working in the small business sector. In the subsequent 20 years, here is some of what I've learnt.

1. The buck stops here

The owner is responsible for everything that occurs in the business and with complete control comes complete responsibility.

2. Just fix it

When things go wrong, and they will, the first course of action must always be to solve the problem and ensure that the parties involved know what is happening and what is being done to address any grievances. When this has been achieved, it's time to examine the causes. Rather than immediately apportioning blame, work to adapt systems to avoid the issue recurring.

3. It's not a job

As a business owner, you are an investor expecting a reasonable return for the risks you have taken on. You manage the business and allocate your resources as productively and efficiently as possible but don't think of it as a job. It's an investment decision and you create jobs for your employees who you expect to do the daily work.

Being able to delegate is an essential skill for the small business owner otherwise you'll be too busy to focus on your strategy.

4. Have a plan

When you establish a business your bankers, accountants and lawyers will all want to see and dissect your written business plan. Blue sky projections and ambitious cash flow assumptions won't wash. Once the business is up and running the business plan needs to be maintained and reviewed. I do this six monthly and try to take into account as many 'big picture' issues as possible. Too often I've seen plans that haven't been fully thought through and the consequences are never pleasant. Keep asking 'what if?' until the potential outcomes are understood.

5. Listen

Advice comes from many quarters and good advice can be lost in the noise of information and opinion that is thrown at you. There's the advice that you pay for from professionals like accountants, lawyers, bankers, financial planners and so on that is necessary and often contains gems. But remember that the Titanic was designed by professionals. There's the advice from people in the industry that have been there and done that and survived and that too can be valuable.

I also like to listen to the little voices, the suggestions you hear from staff, warnings you hear from customers and ideas you read or pick up in the media.

6. Let's be friends

I'm talking about friends in business and contrary to what many think you do have friends in business. I had one business with a competitor up the road and I always wondered how well he was doing: he would pinch my staff, put on aggressive special offers and install expensive equipment. One day I saw him in the street and asked "how's business?" and he told me. There were no real surprises but he recommended a new machine to me which I bought. He was far more cooperative than I expected.

Industry groups and networking programs can both be helpful but taking a leaf out of the books of the two major retail chains or the four major banks you can see that they are not trying to kill each other but rather coexist happily.

7. Be honest, especially with yourself

Honesty in business can be a rare commodity so when you see it, be grateful. I find that the more brutally honest I am the simpler my life becomes. If I am honest with myself it helps with my planning. If something isn't working, the hardest thing can be to admit it and change things but to do otherwise won't help at all.

I also believe in running a 'favour bank', that is, helping others in business or as an employer in the knowledge that when I need some help it will be forthcoming. The more I put into the favour bank the more I find people will trust me.

8. Avoid jealousy and greed

It is natural to want more and in business you don't plan not to grow. Expanding your reach and increasing your profit is the name of the game but keep this in perspective. The retail giants are unlikely to feel threatened by your presence. Greed is not necessarily good. If your aim is to run a small business, then don't become a smaller one by trying to become too big. I have found that

having more than six people reporting directly to me just crowds out the day with endless interruptions. Decisions that can be made without your involvement should be.

9. Be adaptable

Business plans like the superannuation tax laws can be changed at any time. Events can necessitate a complete rethink of the most basic plans - just ask Captain Chesley B. Sullenberger whose US Airways flight 1549 had a change of flight plan that turned a night landing in Seattle into a splashdown in the Hudson River.

10. Remember to rest

Small business takes 24/7 to a level not seen in corporate life. It really does, to an extent few in corporate life can appreciate. The difference is that not only is it your money and your business but usually it is your family and your house at stake. Now that you are self-employed you don't have entitlements like annual leave, sick leave, leave loading etc. It is vital to remember that you are in business to improve your quality of life not to sacrifice it, so take those holidays and make time for your family.

Life as a small business owner can be highly rewarding, not only financially but because you are your own boss and hopefully your destiny is in your own hands. But the extent to which the All Ords has significantly outperformed the Small Ords in recent years shows smaller is not always better.

And since the camel traders, carpet sellers and falafel makers at Mount Sinai did not send Moses back up the mountain for the small business commandments, you'll have to make do with mine.

Bruce Montague is Director of Exeyco Pty Ltd, and has managed small businesses for 20 years. Any religious references are for illustration only and not intended to offend.

Shared home equity worth a look for retirees

Alastair Peattie

The Baby Boomers are rushing headlong towards retirement and beyond, but a yawning gap between lifestyle expectations and what their savings pools will provide is increasingly evident. The asset in which most have a disproportionate percentage of their wealth, the family home, commands a high level of underutilised equity when it could offer so much more to fund retirement lifestyles.

Innovation to develop more efficient financing solutions for the retirement savings sector has never been more in need, and the market is responding with interesting products.

The damage from the GFC continues to have an impact on retirees. While most investors were well aware that equity markets would not keep rising forever, few expected they would unravel as much as they did. Poorly timed market exits and entries and interest rates falling to record lows have seen many investment portfolios significantly diminished in value and investors struggling to rebuild value. Risk aversion has become the safe option, keeping investors out of the market and missing out on the benefits of the recent recovery.

There is more pressure at the other end of this funding gap. Increased longevity as a result of medical advances means our retirement savings need to last longer. According to the ABS, in 1960 average life expectancy for males at birth was just 69, whilst today, men can expect on average to live to 81, and women can look forward to living even longer, until 86. On current trends, every 10 years that passes delivers two additional years to fund in terms of life expectancy.

Releasing some of the equity tied up in the family home is worth considering as a means of bridging this funding gap, but it is surprising how little this is used. According to RP data, residential housing is the largest single asset class in Australia worth about $5 trillion or over three times the value of all listed Australian equities. Yet in a report commissioned by the Senior Australians Equity Release Association (SEQUAL) in September 2013 entitled, "Australia's equity release market – an opportunity being missed", Deloitte reported the total reverse mortgage market, by far the most common form of equity release, was valued at only $3.5 billion, with an average loan size of $84,000.

A reverse mortgage essentially allows home owners to borrow against the value of a residence, to deliver either a lump sum or an income. Repayment of this loan occurs when the home is eventually sold, vacated (typically on moving into a retirement village) or the last surviving owner passes away. Until then, which can take a long time, the interest capitalises to the loan balance.

Reverse mortgages have their shortcomings. While base interest rates are currently low, lending margins remain high, with reverse mortgage rates generally over 7% compared with normal mortgages around 5%. Retirees also have to overcome their own concerns and those of the next generation that a reverse mortgage is tantamount to selling the family jewels. However, Deloitte argues that a growing number of older Australians are finding the benefits of reverse mortgages in allowing them to travel, renovate homes or enjoy new found freedom.

Downsizing is one obvious alternative option for releasing home value, however such a move is often emotionally unpalatable, disruptive and the transaction costs are high.

Another area of home equity release called 'shared equity' is growing, including various products called shared equity mortgages, home reversion and shared appreciation mortgages.

Shared equity enables homeowners to sell a percentage of their residence to receive cash or an income today and on eventual sale or death, the loan settles. The borrower (retiree) forgoes some of the capital appreciation and the lender (investor) earns it instead. There are many permutations of this structure to balance the borrower and lender risk/return dynamics, ranging from a rental stream on the sold portion to a variation of a call option structure to redistribute the risk/return between access and ownership. These products may reduce some of the interest cost compared with reverse mortgages, especially the unexpected consequences of long term compounding. The amount owing on a loan will double in 10 years compounding at 7%.

There are also products where, in exchange for the receipt by the owner of an income stream, the investor is given the option to purchase the home at an agreed price based on certain trigger events. An example may be on a home worth $700,000, an investor pays $1,250 per month for the right to acquire the home at this agreed value when the owner dies or otherwise leaves the property. The investor has to accept that the owner may live for another 25 years or more. The owner receives an income stream and a predetermined price for the rest of their lives. Combinations of shared equity and income are possible.

The shared equity market is not yet deep, but there are compelling reasons for it to develop:

- life companies, superannuation funds and insurance companies seek increased diversity and long dated assets to offset risk. A portfolio of residential property via shared equity is typically long dated and it offers attractive portfolio diversity.

- entry to the Australian residential property market has always suffered from affordability challenges. Shared equity could be a partial solution to this vexed problem, delivering an effective 'rent and buy' programme, or a lower entry cost. Apart from this, governments seeking to ease the funding burden from providing social housing could also benefit by attracting investor funds to the sector, albeit with some continuing government support.

- from the retail investor perspective, creating an asset that derives a return linked to Australian residential property has a wide appeal. Authorised deposit taking institutions could offer would-be home buyers a savings product as a means of accumulating deposits. It would give the 'negatively-geared investment property' market some competition that is not constrained by size, and that delivers the same benefits as conventional property investments without the need for a large capital commitment, concentration in a single asset or maintenance costs.

Shared equity offers compelling and complex opportunities. As retirees want to fill the gap between income and expenditure in retirement and the trend towards self-funded retirement continues, the time seems increasingly right to deliver a more efficient solution for retirees and investors around an underutilised asset, residential property.

Alastair Peattie is a former General Manager of CBA Institutional Bank. He has had a long career in financial market and funds management, and is the former Head of the Financial Institutions Group of CBA's Institutional Bank.

Who said these famous investment quotations?

Here's a bit of fun to start the new year. The answers are on the Cuffelinks website here.

1. "Pundits forecast not because they know but because they are asked."

2. "My two rules of investing: Rule one – never lose money. Rule two – never forget rule one."

3. "The four most dangerous words in investing are: 'This time it's different.'"

4. "Go for a business any idiot can run because sooner or later, any idiot probably is going to run it."

5. "If you owe the bank $100, that's your problem. If you owe the bank $100 million, that's the bank's problem."

6. "Markets can remain irrational longer than you can remain solvent."

7. "The stock market is filled with individuals who know the price of everything, but the value of nothing."

8. "I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful."

9. "October. This is one of the particularly dangerous months to invest in stocks. Other dangerous months are July, January, September, April, November, May, March, June December, August and February."

10. The stockmarket has reached what looks like a permanently high plateau."

11. "Money is better than poverty if only for financial reasons."
12. "Conventional wisdom teaches that it is better to fail conventionally than to succeed unconventionally."
13. "The markets generally are unpredictable, so that one has to have different scenarios. The idea that you can actually predict what's going to happen contradicts my way of looking at the market."
14. "In investing, what is comfortable is rarely profitable."
15. "For I don't care too much for money, for money can't buy me love."
16. "Diversification is a protection against ignorance. It makes very little sense to those who know what they are doing."
17. "I am not worried about the deficit. It is big enough to look after itself."
18. "You must not only learn to live with tension, you must seek it out. You must learn to thrive on stress."
19. "You never count your money when you're sittin' at the table. There'll be time enough for countin', when the dealin's done."
20. "In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value."

Thanks to Select Asset Management for this instructive list of quotations. Your Christmas parties must be great fun.

Epilogue: Death duties, where angels fear to tread

Ramani Venkatramani

Not unexpectedly, my November 2013 *Cuffelinks* article suggesting that death duties be considered as a public finance tool attracted some strong criticism. I am grateful for all the comments. In retrospect, I concede the label 'death duties' would repel many. A more accurate description would be 'inheritance tax'. I had meant the terms interchangeably.

I respond to the comments below:

- They complicate asset-rich family business succession through forced sales. Multiple deaths during a short period are even worse.

  As pointed out in the comments, insurance is the obvious solution. Accrual accounting will treat the related cost as an ongoing business expense, amortised as net worth is built up. This is no different really from the way family needs would be financed pursuant to the breadwinner's death: insurance or asset sales. With prudent planning, fire sales can be avoided through holding a proportion of liquid assets.

- It is an appalling tax, as elders will worry about it in their twilight years. Pre-empting it during one's lifetime by gifts risks leaving the donor without money, or dependent on recipients. A harrowing example of the commentator's great grandmother was cited.

  As I had explained, the dead cannot be taxed, only those left living. Individual examples are always painful. Those who accumulate wealth would be accustomed to taxes on income, and most cope by only considering the post tax component for meeting their commitments (e.g., a worker focusing not on gross but net cash flow). The taxation of capital gains is similar, when an investor would take into consideration the net-of-tax gain.

- Superannuation imposes inheritance tax indirectly, by levying 15% (plus medicare) on benefits paid to non-dependents such as adult children. The tax can be avoided by paying the benefits during the member's lifetime.

  I am unsure if this is an argument for ('we already have it, so why the fuss?') or against ('shock horror, the dreaded tax lurks in unlikely corners'). Regardless, for inheritance tax to be effective and fair, it should be accompanied by suitable anti-avoidance measures. Circumvention through prior gifting would be obvious. Centrelink already claws back certain gifts in calculating age pension.

- The dichotomy inherent in taxing earned income in full, capital gains in part but exempting gambling and inheritance is inequitable.

  To encourage a strong work ethic, as a principle, unearned income (inheritance, gambling and capital gains) should be in principle taxed in preference to earned income from personal exertion. The current attitude towards inheritance tax offends the principle. The worsening dependency ratio (workers to total population) demands a review, to transmit appropriate behavioural signals.

To sum up, a strong case against considering the tax has not been made as the economy balances the many competing factors on the demand and supply side. Any introduction has to be tested against real income, capacity to pay, progressiveness and the inevitable challenges of transition. I adored the suggestion that death duties give an extra incentive for living longer. Medico-actuarial researchers, take note. The economies of the world struggling with improving longevity have now stumbled upon the 'killer' rationale – literally speaking - for introducing an inheritance tax.

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