Cuffelinks
Connecting investors with ideas

Edition 48, 7 February 2014

This Week's Top Articles

- **Economic growth and equity return outlook** *Ashley Owen*
- **The effect of real wage changes on retirement incomes** *David Bell*
- **The F words: an irritating series of dictionary narratives** *Jack Gray*
- **SMSF borrowing for land development is not fertile ground** *Monica Rule*
- **Caveat Emptor? The decline of margin lending** *Roger Montgomery*
- **ASX announces mFund Foundation Members** *Graham Hand*

Economic growth and equity return outlook

Ashley Owen

The outlook for global economic growth for 2014 is improving, but is this a good thing for equity returns?

One of the great myths in financial markets, supported by neat textbook theories, is that economic growth somehow drives (or is accompanied by, or maybe is even caused by) corporate earnings growth, and that earnings growth drives stock prices (or at least that expectations of economic growth or expectations of earnings growth drive stock prices). Or perhaps even that expectations of economic growth drive stock prices directly.

None of these assumptions hold true very often in the real world. There is no statistical correlation between economic growth and stock market returns, either at a global level or in individual countries.

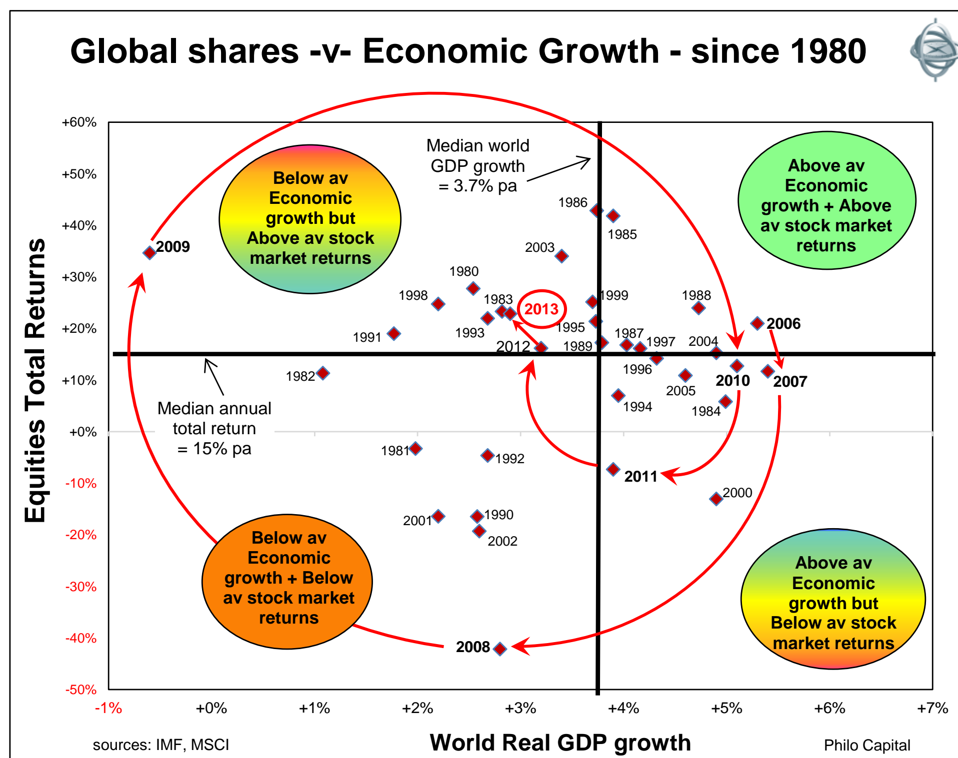
The global picture

Economies are highly interconnected and stock markets are also highly correlated.

Only rarely does *above* average world economic growth coincide with *above* average stock market returns. In only two of the past 34 years since 1980 has this been the case – 1988 and 2006. Also, in only six years has *below* average economic growth coincided with below average stock market returns – 1981, 1990, 1992, 2001, 2002 & 2008.

In fact at least half of the time when economic growth was *above* average, stock market returns were *below* average, and at least half of the time when economic growth was *below* average (including in recessions), stock market returns were *above* average.

The following chart shows yearly world real GDP growth and world stock market total returns since 1980:



2013

Last year was similar to several other counter-intuitive years in the recent past. When economic growth *slowed* and was *below* average (and earnings growth was very weak) stock market returns were *above* average. This followed 2012 when economic growth also slowed and was below average, and earnings growth was very poor, but stock market returns were a very healthy 16%.

2011 was also counter-intuitive. Economic growth was *above* average in 2011 (3.9% compared to a 30 year average of 3.7%) but stock market returns were *negative* globally.

Going back further, in 2010 global economic growth was above average but stock market returns were below average, and in 2009 world economic growth contracted in the deepest contraction since the 1930s depression but shares had a great year in 2009, with the world market index returning 29%.

Individual Countries

There is a similar story when looking at cross sectional returns in individual countries in any particular year. For example, in 2011 economies almost everywhere grew (except Japan with its tsunami/nuclear crisis), global economic growth was above its long term average, and earnings and dividends grew strongly, but almost all stock markets around the world were down heavily.

Shares -v- Economic Growth - 2011

sources: IMF, MSCI — Philo Capital

The highest growth economies (China, India and Turkey) had the worst stock market returns. Of the few stock markets that had positive total returns in 2011, only Indonesia posted price gains. In the others (US, Thailand, Pakistan and South Africa) the broad market price index fell, but the addition of dividends helped them scrape into positive total return territory, while Malaysia was flat.

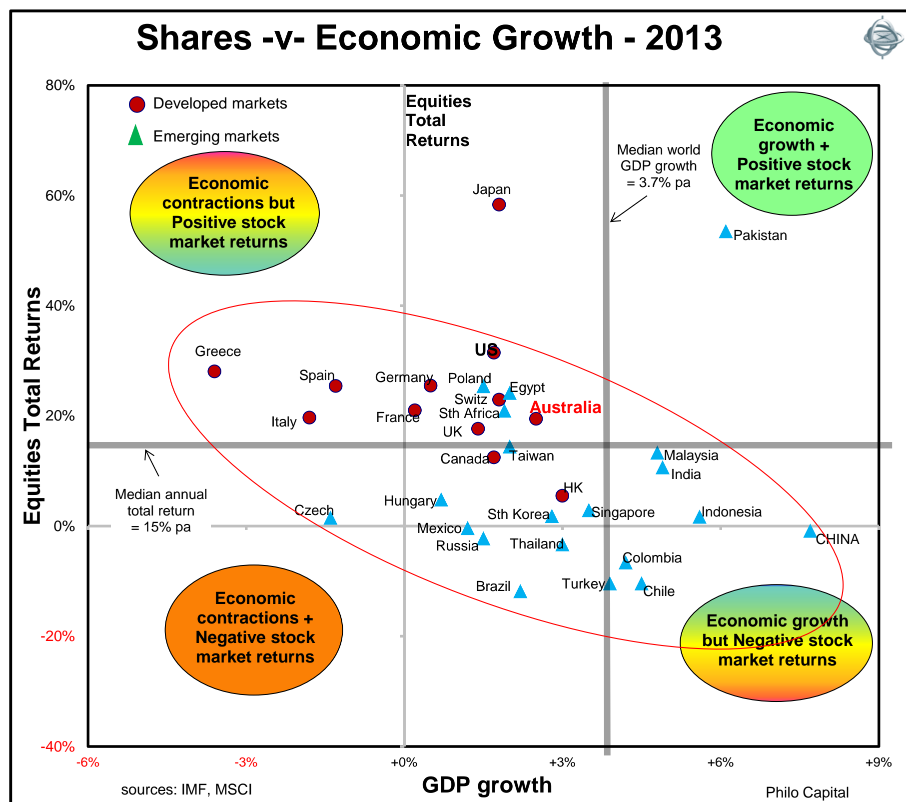
This situation reversed in 2012 when most economies slowed and earnings growth stopped, but stock markets in almost every country boomed.

Shares -v- Economic Growth - 2012

sources: IMF, MSCI — Philo Capital

Nearly all stock markets were up in 2012 while economic growth was patchy. US growth was sub-trend, and Europe drifted in and out of recession, with significant contractions in the PIIGS, but equities boomed across these markets. The highest economic growth rate was in China, which had one of the worse stock market returns. The worst economy was Greece, which had one of the best performing stock markets.

2013 was a repeat of this counter-intuitive pattern.



Aside from the two outliers, Pakistan and Japan (for peculiar local reasons), every other major country fell into a band that stretches from top left to bottom right on the chart, with poor economic growth and good stock market returns (top left segment), or good economic growth and poor stock market returns (bottom right segment).

Once again China enjoyed the highest economic growth rate but suffered negative equity returns. Greece, Spain and Italy suffered the deepest economic contractions but enjoyed high equity returns.

If economic growth and stock market returns were positively related, the band would extend from bottom left to top right, but this is not how it works in most years in the real world.

2014?

Today there is a widespread assumption that the outlook for 2014 for improving global growth to a historical average of around 3.6% should be positive for equity returns.

We do not assume that improving economic growth rates will lead to, be caused by, or accompany, good equity returns, as most market economists and equity market strategists do. Instead we view the current consensus outlooks for improving economic growth to around average or trend (ie healthy, or 'normal') global growth in 2014 more as a possible warning sign of poor returns.

It pays to think independently and study real world outcomes instead of blindly following convention, market myths and textbook theories.

Ashley Owen is Joint Chief Executive Officer of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.

The effect of real wage changes on retirement incomes

David Bell

The annualised inflation rate reached 2.7% at the end of the December 2013 quarter, which was higher than expected. Shortly after the inflation figure was announced, *The Australian Financial Review* ran a headline, "Real wages 'have to fall'", a view put forward by a number of economists and business leaders. This argument was given publicity despite modest real wage growth over the last year. Wages grew in real terms by only around 0.5% in the 12 months to 30 September 2013.

The topic of real wage growth often prompts the airing of strongly held views about global competitiveness and long term economic prospects. Less discussed is the fact that real wage growth directly impacts retirement outcomes.

Real wages and competitiveness

Real wage growth (that is, pay rises in excess of inflation) can be good or bad. High real wage growth is dangerous if it does not reflect productivity gains. It may be dangerous even if it does. For example, productivity improvement in a specific industry might be driven through a technology available worldwide, but some competing countries may use the technology to reduce product cost rather than increase wages.

Real wage growth has ramifications for long term international competitiveness. If Australian real wages are higher than in countries providing competing goods and services, then logic suggests we will lose business to those countries. In the short term, real wage growth is pleasurable as we have more to spend now. However it is likely to catch up with us if it is not supported by productivity growth as our country loses competitiveness. This could affect us in many ways – for example, a sustained period of our businesses struggling to compete globally, poor stock market performance, a prolonged period of adjustment to future wage growth and employment, and a weaker dollar and associated reduction in purchasing power. However these things are difficult to predict and put a timeframe around.

Replacement ratios in retirement

Real wage growth directly affects retirement outcomes in a couple of ways: dollar outcomes and replacement rates. I like the concept of replacement rates: the ratio of post-retirement cash flow to pre-retirement income. I adjust the pre-retirement income for tax and savings, so what we have is a ratio of how much we have to spend in retirement versus consumption when working. To summarise:

$$Replacement\ Ratio\ (adjusted) = \frac{Cashflow\ in\ retirement}{Consumption\ whilst\ working}$$

A high replacement ratio would be desirable, but forecasting replacement ratio outcomes is complex and difficult. Treasury has a huge model and some industry participants also have advanced ones. I developed one for a thesis and have written about it in Cuffelinks (see May 16, 2013 issue). Importantly, projected outcomes will differ across the population. I follow Treasury's approach and use forecasts for different income quartiles.

These are the numbers I produced at the end of 2011:

Earnings Multiple	0.75	1.0	1.5	2.5
Average Replacement Rate Ratio	81.1%	68.4%	56.0%	61.0%

Table 1: Projected replacement rate outcomes. Note 'Earnings Multiple' refers to income as a multiple of AWOTE (a measure of average earnings across the population).

Table 1 shows that replacement rates look higher for low income earners compared to higher income earners. This is because they receive the age pension but their current incomes are low and to live on even less would be difficult. Higher earners experience lower replacement rates but they can probably live with this as their pre-retirement incomes are higher.

Note the slight quirk here. Very high (top quartile) earners have a higher expected replacement rate ratio than the third tier. Why? In my modelling, you have to earn a very high income to save beyond paying down your mortgage, and the third (second top) tier earners run the risk of feeling wealthy but experiencing a retirement outcome well below their expectations.

Wages and retirement income

Real wage growth has two direct effects on retirement outcomes.

First, it pushes up age pension payments, which are indexed to whichever is the greater: wage growth, inflation or the age pensioners living cost index. Wage growth is expected to be the highest and this pushes up pensions. About 80% of the population is forecast to receive at least a part age pension at some point, and of these, half will receive full pensions.

The second effect is the level of wages against which we compare our outcomes (the main part of the denominator in the replacement rate equation). If we experience high real wage growth then, all else being equal, retirement savings and hence retirement income potential will grow at a slower rate relative to wages.

People will be affected in different ways, depending on incomes. The table below explains some of the sensitivities.

Earnings Multiple	0.75	1.0	1.5	2.5
Real Wages +0.5% pa	0.8%	0.5%	0.0%	-2.5%
Real Wages -0.5% pa	-1.1%	-0.4%	0.7%	2.7%

Table 2: Altered real wage growth levels (base case assumption of real wage growth was 1.5% pa) and associated changes to projected replacement rate outcomes.

Table 2 shows that low income earners will experience better replacement rate outcomes if real wage growth is high, because of higher age pensions. Their replacement rate would be just under 1% higher. It is the top quartile income earners who lose out if real wage growth is high: their replacement rate would be around 2.5% lower. Note, though, that this is relative to their working life income levels, which would be higher under a high real wage growth scenario, so don’t worry too much for the higher income earners.

To sum up, increasing real wages doesn’t seem a bad scenario in terms of the direct impact on retirement outcomes. Don’t forget however that higher age pensions (resulting from higher real wage growth) are funded by the government and it must raise this money from somewhere.

This analysis only considers the direct effects of changes to real wage growth, but there could be secondary effects. For instance what if high real wage growth led to loss of competitiveness and a prolonged period of poor market performance? While this is a large call to make, it is interesting to consider the impact.

Earnings Multiple	0.75	1.0	1.5	2.5
Investment Returns +0.5% pa	3.3%	3.3%	4.6%	7.6%
Investment Returns -0.5% pa	-3.0%	-2.8%	-3.5%	-6.2%

Table 3: Altered long term investment returns (base case assumption of long term investment returns was CPI + 4.75% pa) and projected changes to replacement rate outcomes.

Table 3 shows that changes to investment return assumptions have a much greater impact on replacement rate outcomes than changes to real wage growth. Your super fund may actively manage this risk in its investment strategy. In fact, some large super funds benefited last year from shifting allocations from Australian shares into global equities.

In summary, real wage growth does pose a direct threat to retirement financial outcomes, but it is the indirect effects, particularly around international competitiveness and investment returns, lurking in the shadows that create greater concern.

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

The F words: an irregular, irritating series of dictionary narratives

Jack Gray

F stands for …*

Financial system, that is already far too large and powerful. Former US president Eisenhower's prescient warning about the rise of the Military/Industrial Complex would today be about the danger of the Military/*Financial* Complex instead. Finance has become too important to be left to financiers. Countries need financial systems that provide savings, credit, insurance and pensions, but limited and controlled lest other nations end up like Britain – a *rentier* society producing few real goods and services and where talent is sucked into unproductive finance. The UK politician Peter Mandelson rightly recognised that "we need fewer financial engineers and more real engineers."

Free markets, of which there are none and should be none. Adam Smith's hallowed name is called on to justify so-called free markets, yet he well understood that if left to their own devices, markets will ineluctably result in collusion and corruption. Markets are, as the US finance writer Richard Bookstaber argues, a "demon of our own design" and we *must* learn to manage and control them lest they distort society even further.

Fines, more of which should have been levied on Wall Street's denizens, along with prison terms. J P Morgan did eventually pay a fine of US$13.8 billion (a dollar for every year of the universe's existence) but only after delaying it long enough to see many householders, the potential beneficiaries of these payments, go bankrupt.

FVA, a 'correction' to the price of derivatives, is the latest piece of creative accounting from, you guessed it, J P Morgan. 'Funding Valuation Adjustment' is a fiddle none seem to understand and fewer respect. The *Financial Times* rightly called it "a new earnings-distorting acronym in an industry plagued with them."

Fees, eternally problematic, and made more so by simplistic instructions such as "you should only worry about after-fee performance". Though true, that finesses the fact that (base) fees are certain and controllable, while performance is uncertain and at best only partly controllable. Low signal/noise ratios and information asymmetry ensure that the quality of financial products and investment strategies cannot be assured. So, as with high-priced *haute couture* fashion, lower fees will be interpreted as signalling lower quality. Indeed, investment banks do put their fees *up* when demand falls … and it works.

Fashion, drives decisions in our industry and for the same reason it does in the rag trade, because paradoxically we like to be with the crowd and yet show that we are ahead of it. Hedge funds have yet to promote themselves as a fashion statement, but it will come to pass. Rely on Oscar Wilde to pithily capture another human absurdity, "Fashion is a form of ugliness so intolerable we have to alter it every six months."

Fixed income, technically and mathematically far more interesting than equities, yet before the 1990 movie *The Bonfire of the Vanities* made bond traders fashionable, bonds were boring and traded by eternally pessimistic nerds. This raises two intriguing (to me) inter-related questions. First, is the asset class, swamped as it is with derivatives, effectively immune to the corrosion of diseconomies of scale? Second, to what extent do the prognostications of investment management giants such as PIMCO and BlackRock actually influence the Fed's decisions? About 20 years ago James Carville, an adviser to then president Clinton, said that he wanted to be re-incarnated not as the president but as "the bond market" so he could then "intimidate anybody." (See Financial system.)

Fallacy, of composition is something that is frequently heard yet infrequently exposed. A common instance, much used by business leaders, is the assertion that "industry must cut costs" (code for reducing wages), which ignores how one firm's costs are another's revenues. So the net effect of such cuts is a weaker overall economy. Keynes' paradox of thrift is of the same ilk: it is prudent for each person to be thrifty, yet if we all are "enterprise will surely fade".

Fiddling, an identifiable, common source of failure for investment strategies. Generally, for most organisations and strategies, fiddling destroys value but can be fun and reassures our guardians that we're doing something. In most other areas of human endeavour, activity is seen as the true path to adding value. Investing is uniquely different. Its default stance should be "don't just do something, sit there."

* **F** also stands for **F**antasy, **F**idelity, **F**alse, **F**unds, **F**ear, **F**ailure, …

Click here to read Jack's previous dictionary article 'The C words' in Cuffelinks on 8 August 2013.

Dr Jack Gray is a Director at the Paul Woolley Centre for Capital Market Dysfunctionality, Faculty of Business, University of Technology, Sydney, and was recently voted one of the Top 10 most influential academics in the world for institutional investing.

SMSF borrowing for land development is not fertile ground

Monica Rule

The ability of SMSFs to borrow money for investments and especially property has led to many client enquiries on how the limited recourse borrowing arrangements (LRBA) operate under the superannuation laws.

Many SMSF investors believe they can borrow money to purchase vacant land and build a residential house on it. Some are even considering purchasing a property (i.e. house and land) with the intention of demolishing the existing dwelling and building a new house or rezoning to build residential units.

Under LRBA, the borrowed money can be used to purchase a single acquirable asset as well as to cover expenses related to the purchase, such as conveyancing fees, stamp duty, brokerage and loan establishment costs.

Borrowings can also be used to pay for expenses incurred in maintaining or repairing the asset to ensure its financial value is not diminished.

However, the borrowings must not be used to improve the single acquirable asset.

An SMSF trustee **CANNOT** enter into a LRBA to purchase a single acquirable asset that is:

- vacant land, then use some of the borrowed money to build a residential property on the land. This is because the building of the residential property would be an improvement to the single acquirable asset.

- vacant land, then use money accumulated in the SMSF to build a residential property on the land. Although you can use money in the SMSF for improvements, you cannot change the nature and character of the single acquirable asset so that it becomes a different asset. The property acquired under a LRBA will no longer be vacant land.

- a property consisting of a house and land, then use some of the borrowed money to demolish the existing house and build a new house on the land. Again, this is because the borrowed money is used to improve the property.

- a property consisting of a house and land, then decide to use the money accumulated in the SMSF to demolish the existing dwelling, rezone the land and build new units on the land. This would also be treated as an improvement to the single acquirable asset.

If a trustee wants to develop anything on vacant land purchased under a LRBA, demolish, rezone or build a new dwelling where it would amount to changing the nature and character of the acquired asset, then the loan under the LRBA must be fully repaid prior to making any improvements or changes.

The reason for this law is because improvements would fundamentally change the nature of the asset which is being held as security for the loan, and potentially increases the risk to the SMSF in the event of a default on the loan by the SMSF. Remember, the lender only has recourse to the asset which the borrowed money has been used for. If the lender seeks repayment of the unpaid loan, and the SMSF is not in a position to make any additional payments on the loan, the lender could seize the asset acquired. If that asset happens to have a brand new house sitting on top of it that's going to be a big problem for the SMSF.

Monica Rule worked for the Australian Taxation Office for 28 years and is the author of 'The Self Managed Superannuation Handbook – Superannuation Law for Self Managed Superannuation Fund in Plain English'. *She now runs her own business focussed on SMSF and superannuation education and consulting.*

The decline of margin lending

Roger Montgomery

One of the features of the equity market bull run into 2007 was rapid growth in margin lending. Between January 2000 and September 2007, the total amount of outstanding margin loans in Australia grew from around $6 billion to over $40 billion. While this still did not represent a large fraction of the total capitalisation of the Australian market (around 3% of the total in 2007), it was a significant development for the retail end of the market.

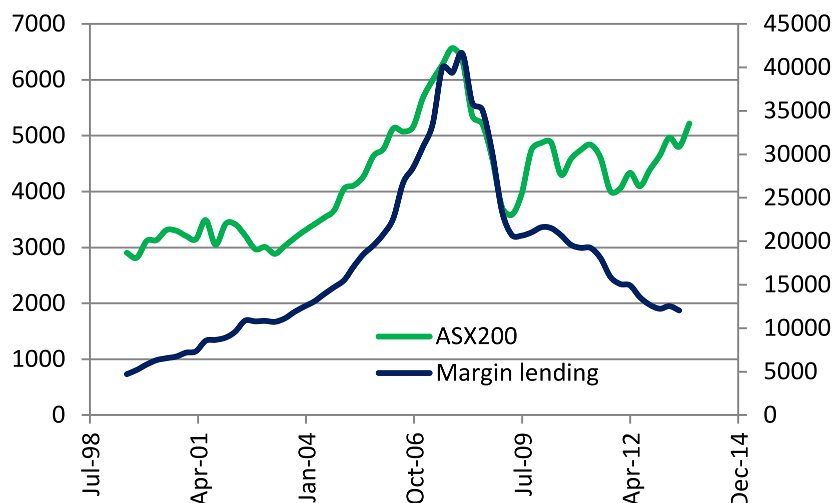
When the equity market plunged during the GFC, so too did the volume of margin lending. In March 2009, total margin lending had shrunk to around $20 billion.

This makes intuitive sense. With the value of collateral sharply diminished, and confidence at reduced levels, it's no surprise that margin lending levels fell sharply. What's more interesting is what has happened since then.

As the chart below shows, since the bottom of the market in March 2009, equities have made good headway. While still not at pre-GFC levels, they have delivered healthy returns in recent years. Total margin lending, however, has continued to slide towards $10 billion, even as confidence has been returning to the market.

Chart 1. ASX200 and total margin loans outstanding

Source: Reserve Bank of Australia, statistics table D10, Margin Lending



To our way of thinking, this is a healthy development. Some reasons to be wary of margin lending include:

- it tends to be an expensive form of funding. Margin lending only benefits the investor where the return on the equities exceeds the cost of the debt. With the long run average return on equities running at perhaps 11% per annum, there isn't much room left after paying interest rates close to 8%

- this benefit disappears altogether if margin calls force you to sell at the wrong time. After a significant fall in share prices, the most successful investors tend to be the ones buying. Often, they are buying from margin borrowers, who have no choice but to sell

- debt funding of any sort tends to bring with it sleepless nights. A cool head is a prerequisite to good investment decisions, and when things get challenging, high levels of debt are a menace to good order.

At Montgomery, we sit in the far corner of the room. We use no leverage, and usually have a material part of our funds sitting in cash. We also avoid investing in companies that have material debt on their balance sheets. This absence of leverage helps foster a steady approach to our decision-making when market conditions become challenging, as they often do.

It is unlikely we will change our attitude towards debt any time soon, but if we were to wake up one day and decide that some leverage would be good, it is unlikely to be a margin loan.

It will be interesting to see what happens to the margin lending industry from here. We expect that having learned some of the above lessons the hard way, investors who do gear into shares are increasingly doing so by borrowing against residential property. Provided gearing levels are kept to prudent levels, this type of borrowing is likely to deliver a much better experience for borrowers. Nevertheless, if markets continue to rise, it is likely that investors will become more adventurous and margin lending may return, with its higher cost of borrowing.

Over time, of course, a new generation of investors will emerge. Without the benefit of first-hand experience of the GFC, they may embrace margin lending as a shortcut to wealth. When that happens, we will be checking our valuations closely, probably starting to count the rows to the nearest exit.

This cautious approach will no doubt cause some investors to miss out on heady gains. However, patience is a great virtue in investing. On the road to wealth there are many shortcuts that offer themselves to the unwary, and for long-term investors, it's wise to think carefully about these shortcuts, or avoid them altogether.

Roger Montgomery is the founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'

ASX announces mFund Foundation Members - who's in and who's out?

Graham Hand

Last week's article on the ASX's new managed fund service was not only widely read, but received many comments. They are worth reading to give the perspective of others in the industry.

One comment suggested the range of fund managers would be modest, and "does not seem like there will be critical mass of unlisted funds or brokers supporting it".

ASX has been able to counter this. It released a statement on mFunds, but more important, provided for the first time the list of Foundation Members, linked here.

It's an intriguing list, as much for who's out as in. As well as major platform providers such as AMP and Macquarie, there's an impressive list of established fund managers such as PIMCO, Schroders, UBS, Zurich and Tyndall, as well as many boutiques. It is estimated the managers represent one-third of retail managed funds.

Equally notable, who is not there. BT, Colonial First State and Perpetual are obvious absentees, as well as boutiques such as Magellan and PM Capital. Some of these are conscious decisions to 'wait and see', while others are still working on the technology solutions.

The ASX also made it clear that the number one target for the initiative is SMSFs.

Disclaimer

This Newsletter is based on generally available information and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider obtaining financial, tax or accounting advice on whether this information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.

For complete details of this Disclaimer, see http://cuffelinks.com.au/terms-and-conditions. All readers of this Newsletter are subject to these Terms and Conditions.