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Super contributions a \$1 million opportunity again

Graeme Colley

The increase in superannuation contribution caps from 1 July 2014 means a couple can put more than \$1 million into super on one day for the first time since the 'transitional cap' arrangements of 2007. It dilutes the argument that it is no longer possible to build a large superannuation balance, as **a couple may be able to place up to \$1,150,000 into super next year.**

The imminent increase in super contribution caps is great news for many. The general concessional contributions (CC) cap will rise from \$25,000 to \$30,000 and for anyone who turns 50 or older during the next financial year their CC cap will be \$35,000 (this higher cap previously only applied to those 60 and over). It all goes that bit further in attaining an adequate amount for retirement. For the over-50s, a one-off \$5,000 compounded at 7% per annum gives about \$14,000 in a member's retirement benefit at the end of 15 years.

Watch for early trigger of 'bring-forward' rule

The non-concessional contributions (NCC) cap also increases because, irrespective of age, it is six times the general CC cap. From 1 July 2014 the NCC cap will increase from \$150,000 to \$180,000. The 'bring forward' rule is unchanged, where a fund member under the age of 65 is allowed up to three times the NCC cap (\$540,000 from 1 July 2014) over a fixed three year period where the total NCCs in the first year of that period are greater than \$180,000. **That gives \$1,080,000 in NCC caps per couple. Add to this the \$70,000 of CCs gives \$1,150,000. In fact, a couple could also invest up to \$370,000 by 30 June 2014 (\$300,000 NCC, \$70,000 CC), or \$1,520,000 in a few months.**

While this sounds great there are a few trips and traps, especially for those who have already triggered the 'bring forward' rule or will trigger it in the lead up to 30 June. In the majority of cases the 'bring forward' rule is triggered intentionally to maximise NCCs over a short period in the lead up to retirement. But when the 'bring forward' rule is triggered unwittingly it can create a number of difficulties with excess

NCCs being taxed at 46.5%. Unfortunately, the relatively new rules relating to the refunding of excess contributions apply only to CCs and not NCCs.

Once the 'bring forward' rule is triggered the NCC cap is fixed for the three year period based on the NCC cap applicable in the first year. If this has taken place on or before 30 June 2014, the maximum aggregate amount that can be contributed over the three years covered by the 'bring forward' rule is \$450,000. Access to the higher NCC cap will not be available until the fixed three year period has been exhausted. If NCCs are made based on the increased cap or if an excess occurs for any reason the excess will be calculated from the current fixed cap.

This can be illustrated as follows: Christine will turn 65 in December 2014 and plans to retire. In February 2014 she makes a NCC of \$170,000 to her superannuation fund. The 'bring forward' rule is automatically triggered so she now has access to a higher NCC cap of \$450,000 for the 2013/14, 2014/15 and 2015/16 financial years. However, as she can only make contributions to her fund until retirement she has just \$280,000 left under the now fixed NCC cap. If she had only made NCCs of \$150,000 in February 2014 and delayed the additional contributions until 1 July 2014 she could have invoked the 'bring forward' rule under the increased NCC cap. Instead of \$450,000 she could have accessed a NCC cap of \$540,000 starting in the 2014/15 financial year plus the \$150,000 cap in the 2013/14 financial year. **This differential of \$240,000 would make a massive difference if Christine wanted to contribute more to her super prior to retiring.**

Complex rules relating to excess contributions

Another factor impacting on the NCC caps are the rules relating to excess CCs that have applied since 1 July 2013. Excess CCs are automatically included in a person's assessable income and taxed at their marginal tax rate less a 15% tax offset (for tax paid by the super fund) plus an excess CC charge (similar to the ATO's shortfall interest charge). The ATO will allow a person to decide whether they elect to receive a refund of up to 85% of any excess CC to assist in paying the associated tax debt. The refunded amount is then removed from the NCC calculation for that year. However, if no election is made the excess counts towards the NCC cap and if this leads to the NCC cap being exceeded an additional tax of 46.5% will apply to the excess. If the highest marginal tax rate applies, this would result in excess CCs being taxed at 93% plus the excess CC charge.

This is illustrated in the following example. Maurice is nearing retirement and turned 60 on 1 January 2014. As he has just sold a property, he decides to make a NCC of \$150,000 and increases his salary-sacrificed amount to \$35,000. However, in line with his employment agreement Maurice's employer pays a premium of \$5,000 for a superannuation-based insurance policy. This had not impacted Maurice in the past as he did not salary sacrifice the maximum amount.

During the 2013/14 financial year Maurice has excess CCs of \$5,000 which will be taxed at his marginal tax rate (46.5% including the Medicare levy) plus the excess CC charge. If he chooses not to receive a refund of the excess CC the resulting NCC excess will trigger the 'bring forward' rule and he will not be able to access the higher caps that apply from 1 July 2014. If over the next two years Maurice continued to make NCCs of \$150,000 per year, the original CC excess of \$5,000 would be taxed an additional 46.5%, making a total of 93% tax, or \$4,650.

However, if he elects to receive a full refund of the excess it will not be counted against his NCC cap (the 85% refund is grossed up to take into account the 15% tax paid by the fund, so the NCC cap would not be breached). This would allow Maurice to access the increased NCC cap in the 2014/15 and subsequent years of up to \$540,000 if the 'bring forward' rule operates.

Using the 'bring forward' rule before 30 June 2014 will mean missing out on the benefits of the indexation of the NCC cap and could result in high rates of tax if an excess NCC is made. Superannuants should ensure the most favourable options are taken, and the numbers add up nicely in the right circumstance.

Graeme Colley is the Director, Technical & Professional Standards at SPAA, the SMSF Professionals' Association of Australia.

Beware of the curse of liquidity in the share market

Noel Whittaker

Stock markets have been bouncing around recently, as conflicting reports arrive about the situation in Ukraine and the effect of possible sanctions. The optimists are seeing any dip in the market as a great opportunity to jump in and buy, while the most extreme of the pessimists are forecasting we are on the brink of another major war.

Having observed the behaviour of markets for more than 50 years, I've long given up making forecasts. There has never been a time when the pessimists weren't with us, but most of them remind me of a stopped clock – right twice a day.

I will certainly be looking at buying opportunities if the market falls, but it is vital for anybody considering investing in shares to understand that volatility is the price we pay for liquidity. Only shares offer the opportunity to buy and sell in small parcels with minimal cost, and have the proceeds in your bank account in five days.

To help individuals understand the way stock markets work, investment guru Warren Buffett used his recent annual newsletter to tell the story of a farm he has owned since 1986. Unless you are a short term trader, in other words a gambler, Buffett believes you should treat your share portfolio in exactly the same way as you would your real estate investments.

"Those people who can sit quietly for decades when they own a farm or apartment too often become frenetic when they are exposed to a string of stock quotations," Buffett said. "For these investors, liquidity is transferred from the unqualified benefit it should be, to a curse." He argues that the goal of the ordinary investor should not be to pick winners: they should simply hold a diversified portfolio and stick with it.

Buffett compared the fluctuations in the share market as akin to an erratic neighbour leaning over the fence screaming out offers for his land every day.

"Imagine a moody fellow with a farm bordering on my property who yelled out a price every day at which he would either buy my farm or sell me his – and those prices varied widely over short periods of time depending on his mental state. If his bid today was ridiculously low, I could buy his farm ... if it was ridiculously high I could either sell to him or just go on farming."

Let's translate that to our local market. Let's say you owned a blue chip share XYZ Limited that was selling at \$40. The company is highly profitable, paying increasing dividends, is well managed, and is a market leader. Suddenly, due to the possibility of war in Ukraine, Wall Street tumbles, traders all around the world panic and sell, and our market drops 3%. Of course, shares in XYZ will fall too, and you may wake up to find your \$40 share is now worth \$39.

As far as XYZ is concerned, nothing has changed. The business is as strong as ever, and 99.5% of investors are happy to sit tight and enjoy the growing income stream. Only a desperate few panic and sell and take a loss, just because the market in general reacted to events that happened thousands of miles away.

No investment offers the growth potential, ease of ownership, or tax concessions of shares. Buffett's phrase 'the curse of liquidity' is a new one to me, but it sums up markets perfectly. Every investment decision you make will have advantages and disadvantages. The downside of liquidity is that you can be tempted to sell just because you can.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. Email: noelwhit@gmail.com

A material shift from production to distribution

Roger Montgomery

There is a fundamental change occurring in the global production of basic materials. The Asian economies, hungry for growth, are combining access to cheap labour and cheap energy on a massive scale. The result? An oversupply of materials, which is destabilising the Australian market.

The production of basic materials, such as petrol and cement, is a capital-intensive exercise. Historically, these materials would be supplied by a handful of local companies that would build the infrastructure at great cost, and in return, enjoy monopolistic pricing power. As a result, the producers of basic materials in Australia have been relatively sheltered from the rising powers in Asia due to distance.

But with global shipping rates decreasing and the Australian currency remaining relatively strong, Australian production has become uncompetitive. The giants of Australian industry, which enjoyed favourable market dynamics for decades, are faced with the reality that their business models must fundamentally change – and fast.

Let's first look at the impact on the Australian fuel market, which was traditionally dominated by BP, Shell, Mobil and Caltex. The companies would import crude oil from Africa or Singapore to produce petrol or diesel in their onshore refineries.

Singapore was traditionally the only refiner to export to Australia in volume, but in the past five years there has been considerable investment in the region. Because fuel is refined in accordance to universal standards, a wide range of commoditised products can now be sourced from anywhere in the region – Japan, Taiwan, China, Korea, India.

For Australian refiners, it is now more economical to convert existing refineries into import terminals. Not only does this outsource the risk of production (which can be very volatile), but the lead time is reduced from months to weeks.

Caltex made the decision in 2012 to restructure its supply chain and focus on distribution. It is likely that it will import all of its product within ten years. Due to its global reach, Shell has chosen to direct its resources to exploration. It has since sold its Australian petrol stations and refineries, but will retain ownership of its aviation fuel business and grease plants in Brisbane. There are reports that BP is also considering the sale of its refineries in Queensland and Western Australia.

The same shifts are occurring in the region's cement industry. The main producers in Australia are Adelaide Brighton, Boral and Cement Australia. In the early days, each player had invested in a particular state due to the natural monopoly afforded to capital-intensive cement production. This limited competition skewed the bargaining power in favour of the resident-producer, and so competitors would be forced to accept the terms of their interstate counterparts when supplying product outside of their primary markets.

But in the past decade, there has been a dramatic shift in the global cement market, which is described by Boral in its 2013 Review. Ten years ago, 95% of cement was produced in Australia, while 5% was imported. In 2013, 70% of cement was produced in Australia, and 30% was imported. This trend is likely to continue, as Australia's demand for cement is 10 million tonnes a year, while China is producing 2.15 billion tonnes a year.

This has dramatically changed the economics for the local incumbents. Like the fuel refiners, the incumbents are focused on shifting their value chain to the distribution of building materials, rather than production. Boral has converted its production facility in Victoria to an import facility. Adelaide Brighton has invested in Malaysia to source product from overseas. Cement Australia also has plans to build import facilities, and has recently terminated a major contract with Adelaide Brighton in South Australia as a result.

So where will the value lie as these major players transition from production to distribution? Does this create investment opportunities?

Typically, distributors aren't compelling value propositions because they don't control the product, which means it is difficult to exercise pricing power. But this dynamic may in fact be favourable to the incumbents, as they change from a volatile, capital-intensive business, to a model that is characterised by steadier cash flows.

Sustainable value will be dependent upon the companies' bargaining power with suppliers. In the case of Caltex, the company has favourable bargaining power with suppliers given the number of mega refineries in the region. If Caltex can build an efficient operating model, this may provide enough protection to withstand the Asian advances in the medium term. But given how rapidly the global market is changing, the landscape may be very different in another ten years.

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

Caveat Emptor: LICs versus ETFs

Question from Chris Eastaway:

Am I able to request a topic be discussed? I am interested in knowing more about the differences between index ETF's and passive LIC's. More specifically I would be keen to see someone who can crunch the numbers look into how the LIC capital gains tax laws and subsequent higher levels of dividend franking compare to the lower franking received on ETF's.

Over time, does this make a large difference to income one would expect to receive (assuming the investor held the stock for the very long term)?

LIC provider, Wilson Asset Management, and ETF provider, Market Vectors, provide a response.

Chris Stott, Chief Investment Officer and Portfolio Manager, Wilson Asset Management.

In answering this question, I'll start by pointing out that I don't believe there are such things as 'passive' Listed Investment Companies (LICs). One of the key differences, and benefits, of LICs is that their investment portfolio is managed by a professional investment manager providing the opportunity to outperform the market. There are some LICs that are managed more actively than others, but no LICs are passive. Wilson Asset Management is an active investment manager.

LICs provide investors with the opportunity to invest in a managed portfolio of investments through a company structure listed on the Australian Securities Exchange (ASX). LICs provide investors with exposure to a diverse portfolio of shares and cash. Investors can buy and sell shares in LICs 'on market' like shares in other listed companies.

LICs vs ETFs

There are four key ways LICs differ from Exchange Traded Funds (ETFs):

1. Corporate Structure and Governance

The structure of an LIC differs significantly from the structure used by an ETF. As their name suggests, LICs use a company structure which requires them to comply with the Corporations Act and various governance principles. ETFs use a trust structure. The Board of an LIC is required to act in the best interests of its shareholders and its various statutory obligations give investors the opportunity to communicate with the Board and Management, for example through Annual General Meetings. The listed company structure provides investors with a high degree of transparency and accountability.

2. Performance

A LIC's pool of assets is managed professionally by a fund manager, either internally or externally. The fund manager applies their investment expertise and has the opportunity to add value to investors by outperforming the market. LICs such as Australian Foundation Investment Company, or AFIC, (ASX: AFI) and Argo Investments (ASX: ARG) have outperformed the market over several decades. On the other hand, the performance of an ETF will only ever track an index, not outperform it.

3. Franked dividends

LICs can pay investors fully franked dividends derived from its investee companies and additional franking credits from any tax paid from its company profit. An ETF can only pay investors dividends from the underlying investment companies (flow-through dividends). This means that over time as a LIC investor, your after-tax income can be significantly enhanced by the use of franking credits, depending on where those shares are held and your applicable tax rate.

4. Shares can trade at premium or discount to Net Tangible Assets

Like other listed companies, shares in LICs can trade at both a premium and a discount to their Net Tangible Assets or 'NTA'. This provides investors with the opportunity to exploit occasions that the LIC's shares trade at a discount to its NTA. For example, a LIC's shares trade at \$1.00 each however, its NTA is \$1.20 per share - the LIC is trading at a 20% discount to its NTA. In the future the value of the underlying assets may trade at a premium to its NTA. In contrast, units in ETFs can only ever be bought and sold at the value of the assets.

Michael Brown, Director, Market Vectors Australia/ Van Eck Global

ETFs and LICs have a lot of similarities. They are both collective investment vehicles. That is, an investors' money is pooled with the money of other investors to create a large diversified portfolio that can be professionally managed.

Unlike mainstream managed funds, ETFs and LICs can be bought and sold on the ASX through a stockbroker. This is a quick and convenient way to transact and is as cheap as the cheapest broker you can find. The management costs in ETFs are generally lower than the costs in mainstream managed funds. This is also the case for the older LICs but you have to be careful. Some newer LICs have some of the highest costs in the market.

ETFs and LICs also have their differences. For a start, ETFs are a newer phenomenon in Australia that many investors are still discovering. LICs have been around for decades. One of the big LICs advertises that it has been investing for over 80 years.

ETFs offer a high level of transparency. The net asset value is published each day and an estimated value is available via the ASX updated at least every 15 minutes during trading hours. ETFs also publish full details of the portfolio each day.

The trickiest part of the comparison is the franking credits and tax payments. Here is a simple example. A fund receives \$100,000 in fully franked dividends and \$100,000 in unfranked dividends. Harry the Investor owns 1% of the fund.

If the fund is an ETF everything flows through. It distributes \$2,000 to Harry, made up of \$1,000 in franked dividends and \$1,000 in unfranked dividends.

If the fund is a LIC, the LIC needs to pay 30% tax on the unfranked dividends. It then declares whatever dividend its board deems appropriate. If we assume it chooses to pass on all of the dividends it receives, Harry is only going to receive \$1,700 in cash because of the tax that had to be paid. The offset to this is that the \$1,700 dividend from the LIC is fully franked.

After Harry receives credit from the Tax Office for the franking credits, he is in the same position whether the fund was an ETF or LIC. The steps are different but the final outcome is the same (with timing differences).

Market Vectors provided this table comparing LICs and ETFs

LICs cover a wide spectrum of investment styles. The comparison to ETFs is most useful where the LIC's investment style comes closest to that of ETFs. To keep things simple, this analysis is restricted to that subset of LICs whose investment style has a very low turnover in their portfolios. These are also the LICs with the lowest costs.

Differences in Investment Outcomes	
ETFs	Low Turnover LICs
To be allowed to call itself an 'ETF' on the ASX, the fund has to track an identified index, making it an 'index fund' or a 'passive fund'. There are no experts predicting which shares are going to outperform other shares.	The LIC applies investment expertise to construct a diversified portfolio that can be held for the long-term without needing high turnover.
The choice of index will result in a diversified portfolio with particular characteristics, usually starting with a choice of the country or the industry being invested in. There is a wide range of choice.	The LIC will typically be a broad portfolio of Australian shares (although there are some global equity LICs).
The ETF is open-ended meaning that units are created and redeemed in response to the demand for the fund. See below for how the ETF mitigates the tax consequences of this turnover.	The LIC is closed-ended. There is no regular creation or cancellation of shares. If and when the board of the LIC considers it appropriate, there can be a rights issue, placement or buy-back. This contributes to low turnover.
When investors buy and sell on the ASX a market maker takes the other side of the trade. The price that the market maker offers is the net asset value (NAV) of the fund plus or minus a small spread. The NAV is published each day and an indicative NAV (called an 'iNAV') is updated at least every 15 minutes during trading hours and available via the ASX and the ETF issuer's website.	The price that the LIC trades at on the ASX is set by the market. The net asset value of the fund is only published once a month after the end of the month. The LIC often trades at a significant discount to NAV but this discount fluctuates and is not known at the time. Sometimes a LIC will trade at a premium to NAV.
Tax legislation forces the ETF to distribute all of its income each year. Some ETFs do this annually, some six-monthly and some quarterly. For any ETF, the distribution amounts will not be consistent from period to period because they will reflect the irregular times that dividends are received during the year.	The LIC only distributes income when its board declares a dividend. Typically this will be done six-monthly. Investors will receive a smooth stream of franked dividends.
Differences in Tax Outcomes	
ETFs	Low Turnover LICs
The open-ended structure means that portfolio turnover can be increased by the redemption of units. The ETF will distribute the capital gains that are generated to the market-making institution that is redeeming. This turnover therefore does not impact ordinary investors.	The closed-ended structure means that there are no redemptions of shares creating portfolio turnover and capital gains.

Tracking an index creates much lower portfolio turnover and consequential capital gains than an actively managed fund.	The investment style of these LICs keeps the portfolio turnover and any consequential capital gains very low.
Capital gains arising from the portfolio will be entitled to the tax discount because the ETF is a Managed Investment Trust under the tax legislation.	Capital gains arising from the portfolio will be entitled to the tax discount because of specific legislation for LICs. This only applies to the low turnover LICs. High turnover LICs do not get this benefit.
Franking credits from the portfolio flow through to investors. There is no tax payable by the ETF.	Franking credits from the portfolio flow through to investors. If the LIC receives unfranked dividends or other income, the LIC pays tax and that tax is passed on to investors as a franking credit.
The distribution for the ETF will be divided into many components as though the investor held the portfolio themselves.	The dividend will typically be fully franked, possibly with a component that is entitled to the CGT tax discount.
Other Differences	
ETFs	Low Turnover LICs
An ETF is typically a unit trust and this has been assumed in the above analysis. Some global ETFs are classes of shares in foreign ETF companies.	LICs are companies.
Most ETFs are governed by the ASX's AQUA operating rules. Certain global ETFs are governed by a subset of the ASX's main listing rules.	LICs are governed by the ASX's main listing rules.
Under the Corporations Act, ETFs that are unit trusts are regulated by ASIC as registered managed investment schemes. These are the same rules that apply to mainstream unlisted managed funds.	Under the Corporations Act, LICs are regulated by ASIC the same as other companies.

Source: Market Vectors 2014.

The size of the financial sector and its contribution to economic growth and productivity

Ron Bird and Jack Gray

A Submission to the Financial System Inquiry (FSI)

Governments seem to like financial markets, usually giving the impression that more is always better. We see frequent calls for the development of capital markets, support of various kinds provided by Government, bail-outs, and funding for research. It is often unclear whether this affection is driven more by the employment and tax revenue generated, the associated prestige, or the contribution the financial sector makes to economic growth. This submission addresses the latter consideration: the relationship between the financialisation of the economy and economic growth. This was a clear priority of Government when establishing the FSI which it "charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australian economic growth."

Early theoretical analysis regarding the direction of the relationship between the financial system and economic growth was mixed. Hicks (1969) argued the financial system was critical to the industrialisation of England and Schumpeter (1912) contended that a well-functioning banking sector is fundamental to technological innovation. On the other hand, Robinson (1952) declared that "enterprise leads and finance follows", while Lucas (1988) saw economists "badly over-stress(ing)" the role of financial factors in economic growth. Empirical analysis starts with Goldsmith (1969) who in a criticised study found a positive relationship between financial and economic development. The criticisms were addressed in several subsequent studies with the main conclusion of the Goldsmith paper being maintained (e.g. King and Levine, 1993; Gertler and Rose, 1994; Roubini and Sala-i-martin, 1992). In a 1997 review paper Levine concluded that "the preponderance of theoretical reasoning and empirical evidence suggests a positive, first-order relationship between financial development and economic growth."

By 1997, the financial sector in the US, and in most other developed countries, was already in a sharp growth phase when measured by almost every relevant metric. Its share of GDP grew from 2.8% in 1950 to 4.9% in 1980 to 8.3% in 2006 (Greenwood and Scharfstein, 2013), while according to the National Bureau of Economic Research, its share of total corporate profits grew from 14% in 1980 to almost 40% by 2003. Philippon and Reshef (2013) found that salaries in the financial services industry were comparable to other industries until 1980 but have increased dramatically since then so now salaries in the finance industry are on average 70% more than those in other industries. This growth in both the size and the salaries of the finance sector is referred to as 'the financialisation of the economy.' The first to really question whether this has been for the betterment of the economy was Rajan (2005) who at the Jackson Hole Symposium suggested that the development of the financial system was causing economies to be more risky. In a subsequent book (Rajan 2010) he argued that the propensity of the system to reward risk-taking would result in the economy proceeding from bubble to bubble.

Since the mid-2000s, an increasing amount of analysis has been undertaken that further questions whether the growth of the financial system has worked to the betterment of anybody other than those working in the industry. In perhaps the most telling study, Cecchetti and Kharroubi (2012), (2013) confirm that the development of the financial system is critical for economic growth in developing economies but that large and fast growing financial sectors have a clear negative impact on productivity and economic growth. They conclude that "big and fast growing financial sectors can be very costly for the rest of the economy . . . draw(ing) essential resources in a way that is detrimental to growth at the aggregate level". Talented people are perhaps the most crucial of the essential resources drawn away by the finance sector's glamour and compensation. As the former UK Minister Peter Mandelson argued, "We need more real engineers and fewer financial engineers." Orthangazi (2008) found a negative relationship between financialisation and real investment which he put down to the latter being crowded out by the increasing size and profitability of financial investment. Beck (2013) is led to similar conclusions, while even Glenn Stevens (2010) has questioned "whether all this growth (in finance) was actually a good idea; maybe finance had become too big (and too risky)." In a more explicit direction ISA (2013) questions the efficiency of the Australian financial sector by measuring the extent of capital formation

attributable to finance. In 1990 for every dollar of labour and capital deployed in the financial sector about \$3.50 of capital formation could be attributed to the sector. By 2012 that had collapsed to \$1.50.

A number of researchers have examined the putative benefits of financialisation. Philippon (2013) finds that despite technological advances which one would expect to translate into lower costs for financial services, unit costs have actually increased over the last three decades and are higher now than they were in 1900. Philippon, Bai and Savov (2013) examined whether the much greater spending on price discovery in line with financialisation has resulted in “better” prices and consequently improved allocative efficiency. They found that despite a four-fold increase in expenditure and a large decrease in the costs of information processing, there is absolutely no evidence of pricing in markets having become more informationally efficient. Along the same lines, Malkiel (2013) found that despite US fund management fees rising 141 times between 1980 and 2010, there has been no improvement in pricing in equity markets or evidence that it has translated into value added for clients. Other deleterious impacts of financialisation include increasing distortions in income distribution (Bakija, Cole and Heim, 2010), Piketty (2014), and the exacerbation of agency costs in corporations (Krippner, 2005).

We leave the last word to two industry luminaries: Adair Turner and Paul Volcker. Turner sees “no clear evidence that the growth in the scale and complexity of the financial system in the rich developed world over the last 20 to 30 years has driven increased growth or stability.” Volcker, when commenting on the relationship between financial innovation and economic growth, claimed that the ATM was the only financial innovation to have improved society.

In summary, we query the proposition that bigger is necessarily better when it comes to the financial system. The mantra of the Paul Woolley Centre is that we do not need a *bigger* financial sector, what we need is a *better* financial sector. We encourage the members of the FSI to steer clear of the fallacy that size is positively related to performance and encourage them to ponder the evidence that financial systems in developed economies have grown beyond the point where they make a positive contribution to either economic growth or to those they are presumed to serve. It would be a bad starting point to presume that the Australian financial system is currently doing a good job. The starting point of the analysis should be to assess its effectiveness and to highlight where it is falling short and why. We doubt that sufficient insight is available from existing studies. We encourage the Inquiry to commission studies along the lines of the papers referred to above. We are happy to discuss these matters further with members of the FSI.

[*\(The full list of references is included under the article on the Cuffelinks website\).*](#)

Professor Ron Bird, Professor of Finance at both the University of Technology Sydney (UTS) and Waikato University, and Director of the Paul Woolley centre at UTS and is an ex fund manager.

Dr. Jack Gray, Adjunct Professor at UTS and Director of the Investment Roundtable. He is an adviser to pension funds in Australia and overseas and is an ex fund manager.

Bank dominance causing a misallocation of capital

Michael McAlary

The macro and micro economic reforms of successive Australian governments over the past 30 years are widely acknowledged as having provided the foundations of our continuous economic growth. The structural changes occurring across the Australian economy and throughout the developed world driven by outsourcing and offshoring, technological improvements, the internet and emergence of China, India, etc. give a great imperative to the Financial Services Industry Inquiry (Inquiry) to make recommendations that will support Australia’s future economic growth.

The Inquiry's terms include: "Recommendations will be made that foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users."

What is the role of an ADI?

It is imperative that everyone has confidence in our financial institutions, particularly Approved Deposit-taking Institutions (ADIs/banks). ADIs are mobilisers and allocators of capital, and therefore enablers to sustainable economic growth. They provide a critical enabling function, just as other infrastructure companies do.

However, banks should not be producers of real economic growth in their own right. Nevertheless of the top 30 companies listed on the ASX, ten are financial institutions. Combined they contribute approximately 27% to Earnings Before Income Tax (EBIT) of the index and CBA, Westpac, NAB and ANZ are ranked in the top 5 by market capitalisation. Arguably, in the long run the size of these metrics is not sustainable.

Comparatively, only 3 of the top 30 companies in a combined Dow/NASDAQ index in the United States are financial institutions (Bank of America, JP Morgan and American Express), ranking 14th, 19th and 30th respectively. They contribute 12% of EBIT.

In Australia, over the past 30 years, the Materials sector, including BHP and a wide range of commodity-related industries has declined, the Industrials sector has all but disappeared whilst the financial services sector has doubled its share of the economy.

The US economy shows a very different picture. In the 1980s, the largest American companies were in the Materials and Industrials sectors, and like Australia, these sectors are now significantly smaller. However, unlike Australia these sectors have not been replaced by financial services. The USA has produced global IT corporations, such as Microsoft, Apple, Oracle, Google, Yahoo, Amazon, Facebook, LinkedIn, Twitter and Cisco Systems and pharmaceutical and biotech companies like Merck, Gilead Sciences and Pfizer, that through innovation are helping to transform the US economy. Unfortunately, Australia has not followed suit as there is only one health technology company (CSL) and no information technology companies in our top 30.

Optimum size of financial services sector

In July 2012, the Bank for International Settlements (BIS) published a study on the banking systems of 22 countries over a 30 year period. Its findings were that if a financial services sector was either too small or too large in terms of share of Gross Domestic Product (GDP), then it was an inhibitor to economic growth.

More recently the US Bureau of Economic Analysis revised down the real output of the US financial services sector from 7% to 6.4%. A percentage of this figure reflects the fact that the USA is a global financial centre, so for Australia, which is at best a regional centre, the figure should be smaller.

These indicators point to Australia's financial services sector being too large, and it must shrink or the economic pie must grow substantially to return it to equilibrium.

Prior to the GFC there was an implicit Federal government guarantee of the ADIs. With the GFC, the implicit guarantee became explicit. Even though the retail depositors' guarantee has been reduced from \$1,000,000 to \$250,000 per depositor, in the mind of the public the Federal government will always step in to save an ADI. Moral hazard needs to be addressed by the Inquiry.

Misallocation of capital

Investment decisions are made for a variety of reasons using a range of quantitative tools and techniques. A frequently used starting point when considering investments is to compare expected returns to the risk free rate of a Commonwealth Government Security (CGS).

However, if you had the choice between investing in bank shares compared to a CGS since the GFC on a risk/return basis, there has been a compelling case to choose shares:

- both are effectively guaranteed which neutralises the equity risk premium
- bank shares pay fully franked dividends that are tax-effective, but there is no equivalent tax relief on CGS income
- there is a capital gains tax discount on equity investment price gains
- the public has become accustomed to bank profits and return on risk adjusted capital increasing regardless of the economic environment while companies in other sectors produce mixed results.

So from a simple investment perspective, bank shares provide a substantially and arguably better 'risk free' return than government bonds. However, there are other factors that are significantly adding to the misallocation of capital:

- a triangulation occurring as the largest fund management companies are owned by the major banks, and they are investing either directly in their own shares or other bank shares, or indirectly through ASX indices
- compulsory superannuation is turbo charging the direct and indirect investment in bank shares as the major fund managers must invest the money
- retail investors, including SMSFs, understand the returns they can achieve from owning bank stocks and are buying bank shares instead of bank term deposits.

This cycle is unhealthy and risky and the obsession with financial services is resulting in a misallocation of capital. The market can't self-correct for this, hence a circuit breaker is required.

Current framework needs changing

The current financial framework needs changing. In formulating its recommendations, the Financial System Inquiry should consider outcomes that would further reduce systemic risk without creating unnecessary impediments to Australia's economic growth.

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