Cuffelinks
Connecting investors with ideas

Edition 83, 10 October 2014

This Week's Top Articles

- **Changing of the guards in Asia** *Peter Sartori*
- **Aged care and granny flats come with their own rights** *Rachel Lane*
- **The case for equities in retirement** *Mark Nathan*
- **Investing in car spaces? Park that idea** *Graham Hand*
- **Animal spirits dormant except for coffee and food** *Salvatore Ferraro*

Changing of the guards in Asia

Peter Sartori

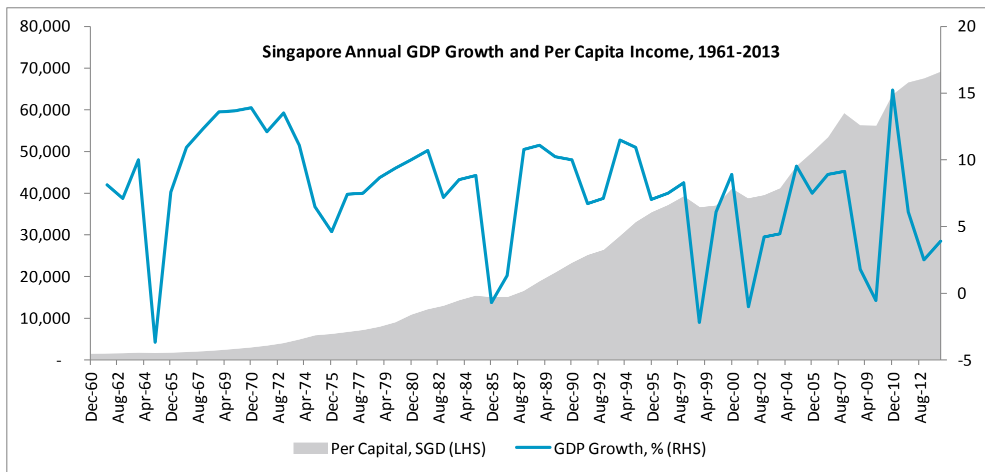
Is political democracy good for economic growth and ultimately, stock markets in Asia? Sound political systems are crucial for economic development and progress. It would be hoped that democracy allows for competition for public office and theoretically, the best people end up occupying the seats of power. Democracy, and the freedom it engenders, should be positive for the country and by extension the stock market. But is it?

This paper does not attempt to answer the question of whether democracy is the best form of political system for every nation, but it does argue that positive fundamental changes in Asia are afoot. Asia's moment is now for the taking and the next 12-24 months will be critical for shaping investors' image from one of a perpetually-emerging Asia into one that has finally emerged.

The first question is how much control is necessary for any given government before policies can be translated into meaningful economic gains. Stable control of government can be highly effective particularly if it stretches for long periods.

Singapore

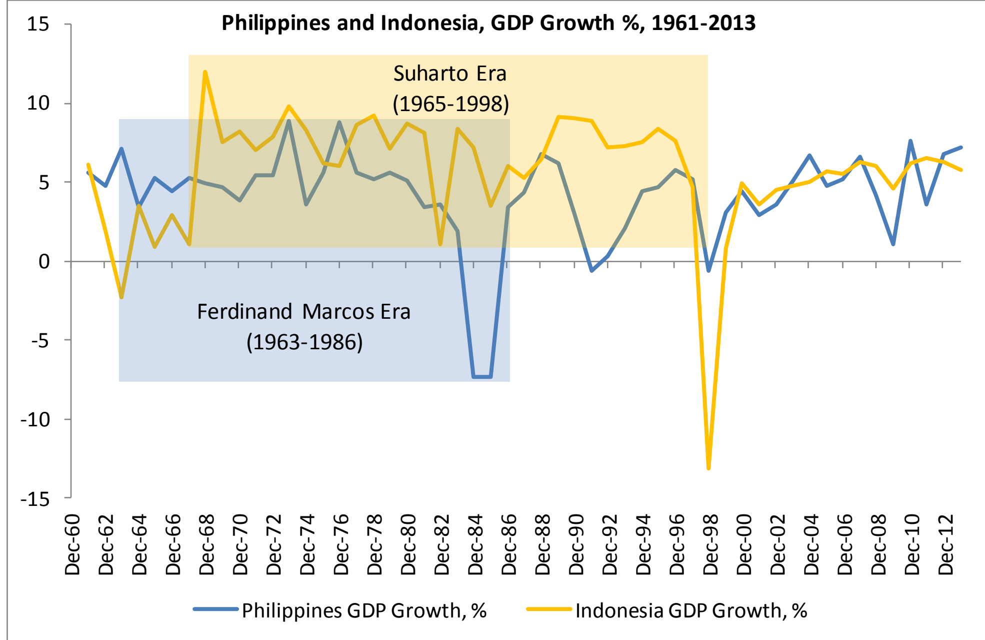
Look at what a single political party over a prolonged period can achieve. In only five short periods was Singapore's economic growth negative over the last 53 years. Per capita income has grown more than 5,000% in the same period.



Source: Bloomberg, 7 October 2014

Philippines

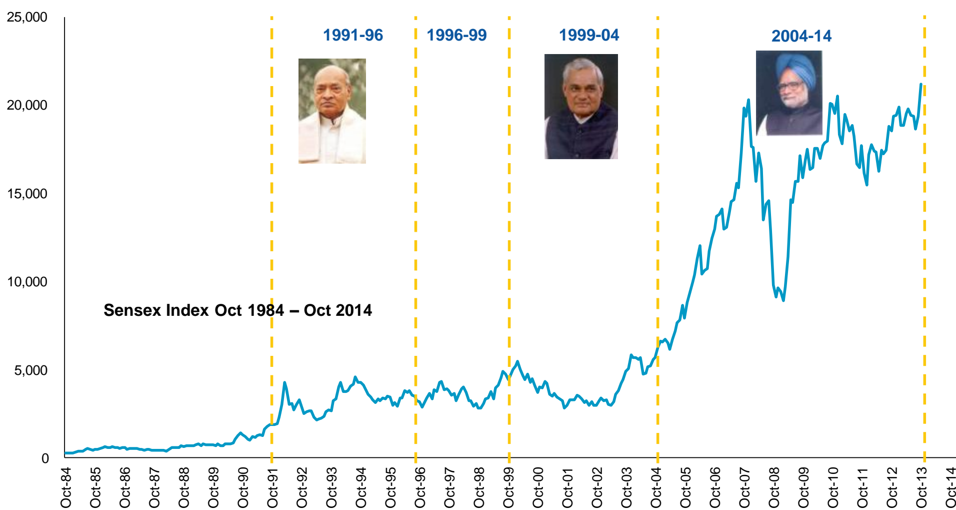
Singapore's neighbours like the Philippines and Indonesia managed to carve out an enviable sustained economic growth path over long periods where political power was absolute (the assassination of opposition leader Benigno Aquino in 1983 and the start of the Asian financial crisis in 1997 effectively marked the end of the Marcos and Suharto regimes, respectively).



Source: Bloomberg, 7 October 2014

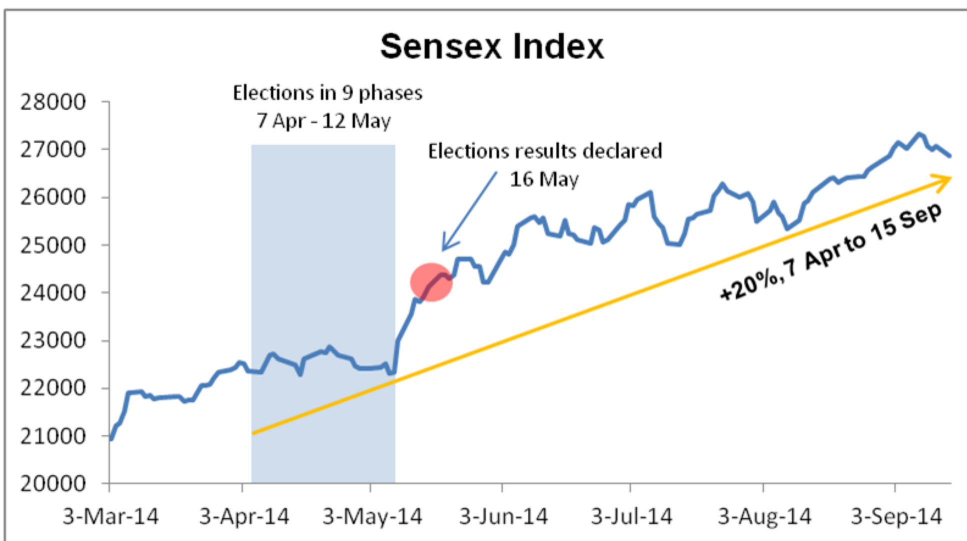
India

India now has the chance to shake off the (now maligned) BRIC moniker and stand on its own. The general election on 16 May 2014 was won by the Bharatiya Janata Party (BJP), the first time in 30 years that a single party has secured an electoral majority. Culture, tradition, religion and politics have conspired through the years and kept India from achieving its full economic potential. Despite the reformist attitudes of leaders such as Narasimha Rao (1991-1996), Atal Vajpayee (1999-2014) and Manmohan Singh (2009-2014), the last 20 years were underwhelming and characterised by political in-fighting and shaky coalitions that consequently eroded the will of the incumbent prime minister.



Source: Axis Capital, 7 October 2014

Can the BJP under Narendra Modi deliver policies that will lift the living standards of the poorest and deliver sanitation to the slums? Market expectations are high. India's Sensex has risen strongly pre and post election.



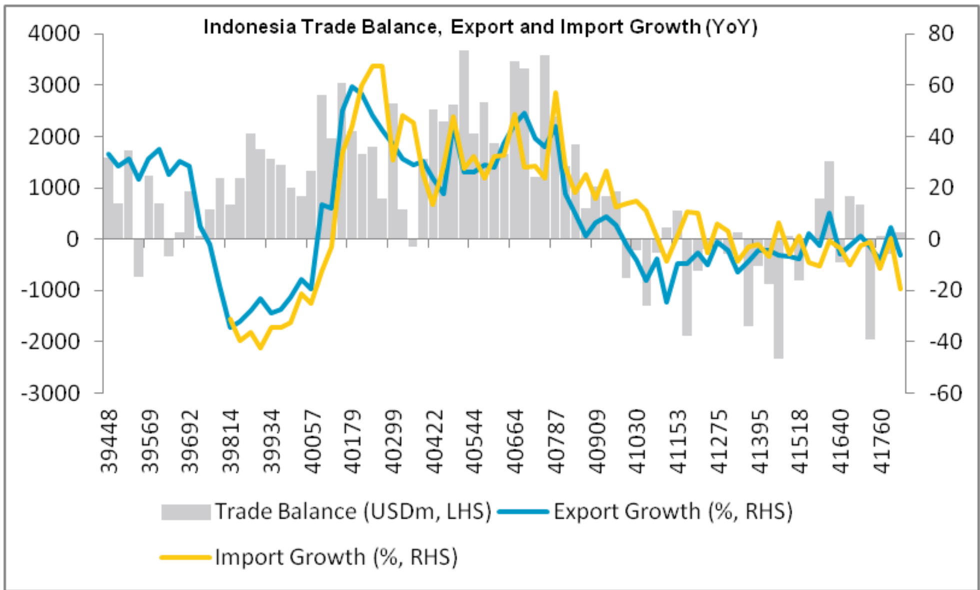
Source: Bloomberg, 7 October 2014

The Modi government has been busy, but catering to 814 million voters will take enormous will and patience. Underscoring the task ahead, the much-needed rail fare hike had to be partially rolled back after the first protests under the new government. Otherwise, the pace of reforms has not faltered. Execution must follow promises in areas such as agriculture, industry, infrastructure and centre-state relations.

Indonesia

In Indonesia, the pace of change has lagged leaving the country 'mired' in the 5-6% GDP growth range. Where did the can-do attitude go? To the critics, outgoing President Susilo Bambang Yudhoyono may have been the first popularly-elected President, but his Vice President and the opposition parties arguably had more power. With 560 members in the DPR (People's Representative Council) and his own party controlling only 10.9% of the seats, imagine the horse trading and one can understand why things move slowly in Indonesia.

When Joko Widodo won the Presidency in July this year after a hastily arranged 'marriage', he inherited an Indonesia underperforming its potential. Its trade balance is hurt by a self-inflicted export ban on certain resources, and fuel subsidies have risen from about 0.7% of GDP in 2007 to an estimated 2.8% this year, costing US$20 billion a year.



Source: Bloomberg, 7 October 2014

Growth risks for Indonesia are rising even if fuel subsidies are rolled back gradually. Exports of both hard and soft commodities are falling while the central bank wages wars on dual fronts: controlling inflation and a currency deemed too weak. Anyone who has been to Jakarta in the last 20 years will have experienced inconveniences due to an inadequate infrastructure that is particularly acute during the rainy season.

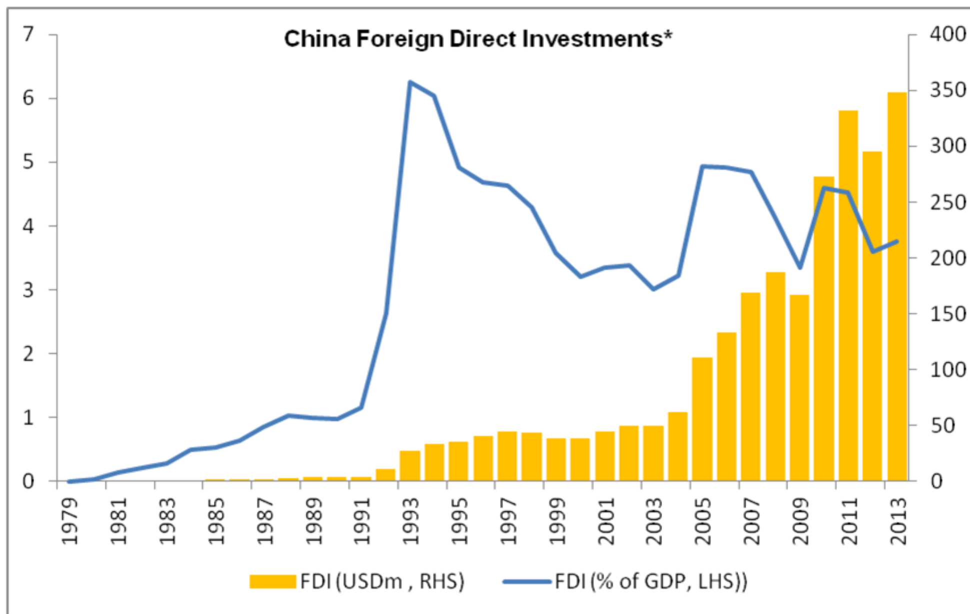
China

In contrast to true democracy, Asia's largest and most powerful nation practises a form of closed-door democracy to choose its leaders. By no means less effective, China's leaders have transformed a largely communist country to the world's second-largest economy in the short space of 36 years. In the beginning, there was Deng Xiao Ping, the pioneer of the Communist-Rule/Capitalist-Run economy. The successful trial run with Shenzhen as a Special Economic Zone, a then fishing town in the 1980s, could well have been the seed of manufacturing in China.

Economic progress was strong under Deng and continued with his successor Jiang Ze Min. Unfortunately, by the late 1980s and early 1990s, China was beset with bloated state-owned enterprises (SOE). The Tiananmen Square episode in 1989 was compounded by the systematic elimination of inefficient SOEs and an estimated 90 million jobs leading to a softer period of growth.

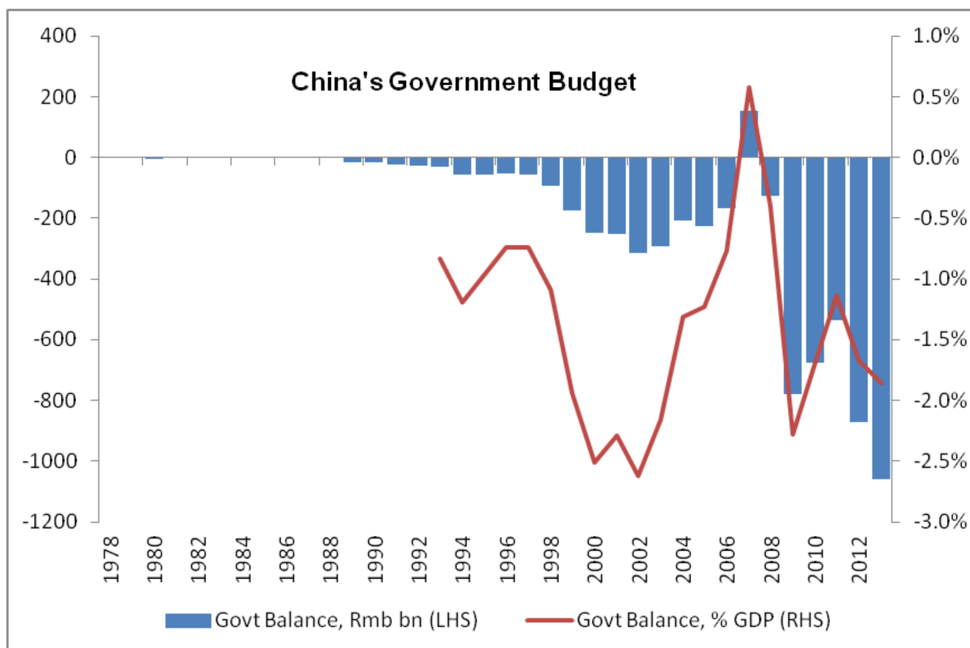
Source: Bloomberg, 7 October 2014

This proved temporary as the lure of cheap labour and favourable tax concessions were too attractive, resulting in a continuation of foreign direct investments.



*Source: Bloomberg, World Bank, 7 October 2014. * Sum of equity capital, reinvestment of earnings, other short and long term capital as shown in the Balance of Payments.*

This golden era of high economic growth admittedly led to an over-zealous policy response in the midst of the GFC. In an attempt to preserve growth, employment and to shield its economy, the central authorities moved forcefully with both fiscal and monetary policy initiatives. The fiscal stimulus plan amounted to a staggering 14% of GDP in 2009.



Source: Bloomberg, 7 October 2014

That overhang is no doubt a source of China's current problems in property and trust loans.

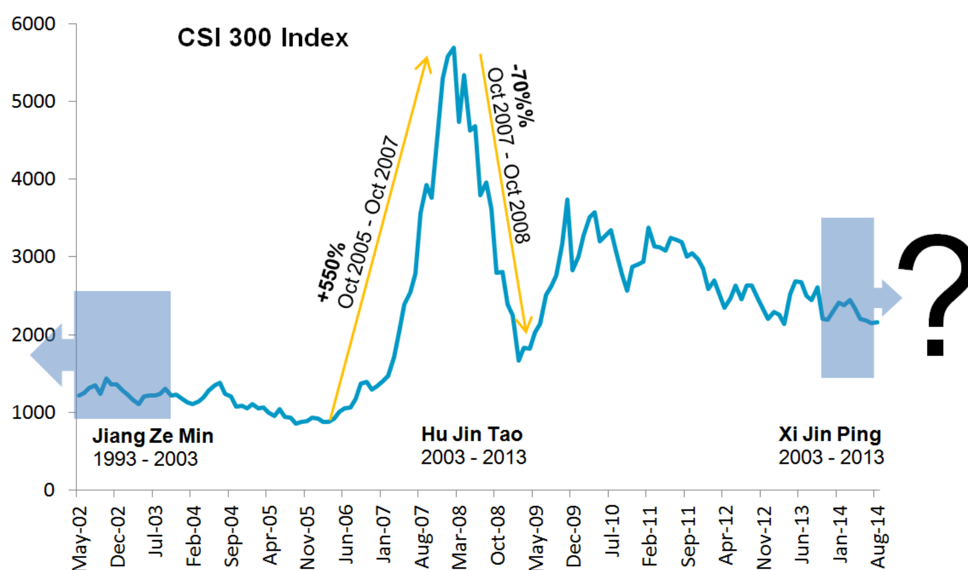
The changing of the guards in 2013 ushered in a leader that traces his parentage to the Communist Party. His ascension is complete and absolute. Xi Jin Ping is the only person to concurrently hold the highest office of the party, state and military, within his first term of office. He moved quickly to eliminate corruption leaving virtually no office untouched. As the Chinese proverb goes "cut the weeds and dig up the roots – to stamp out the source of trouble" (zhan cao chu gen).

The focus is on the long-term structural problems of China. Examples include financial and capital market liberation, an aging population and gender imbalance, labour mobility, bloated state-owned sector and pollution.

While armchair commentators from afar and talking heads will argue incessantly about China's property sector and shadow banking, we suggest that market mechanisms are already at work with some property-related companies and trust products in trouble.

Despite outstanding issues, there are many investment opportunities in China. SOE reforms (think Sinopec selling its retail business) and the government's gradual abdication of healthcare to the private sector (Ikang Healthcare Group) are examples. If the era of Xi is borne of both a recognition and desire for change, the short-term pain in cleaning the slate will give way to more sustainable growth.

China's recent and present leaders have made and will make an impact on advancing the country, including opening up of its economy and guiding and nurturing it during turbulent times. But we can't overlook the period when China's stock market enjoyed its best performance … and worst decline.



Source: Bloomberg, 7 October 2014

Hu ruled over a period of upheavals from natural disasters (earthquakes and floods) to the man-made financial crisis. Under his watch, the local stock market rose a staggering 550% in the space of two years and subsequently gave back 70% of that gain over 12 months.

Xi is undoubtedly using his new broom to sweep clean some litter. The determination to write a new chapter for China is matched by an unparalleled command of power. China bears should be afraid especially as the market has been marking a bottom for the last two years; still a substantial 60% from the high point reached in 2007.

The mechanisms facilitating government change may not be as important in Asia as the western press makes it out to be. A case in point is the current military junta in Thailand. Self-appointed in a bloodless coup, the Junta has made progress where previous governments have failed miserably. For many years, Thais have had a dysfunctional government. Was it the democratic process that stymied economic progress in Thailand? And economic progress or not, many people consider democracy as a fundamental freedom. We are seeing demonstrations in Hong Kong from thousands of pro-democracy protesters rallying against government plans to limit electoral changes promised for 2017.

Conclusion

We come to the conclusion that firstly, we should be careful drawing casual relationships based on Western values. And secondly, the value of a stable government cannot be overestimated. Absolute power? Perhaps it is instructive to quote former US president, Gerald R Ford:

"A government big enough to give you everything you want is a government big enough to take from you everything you have."

Was China's ascension to a global power one born of a democratic process? Why is India, the oldest and largest democracy in Asia, still stuck at a per capita income of US$1,500 which is lower than the likes of Zambia, PNG, Sudan, Mongolia? Alas, we do not have an answer for this. All we know as investors is to pay close attention to any changes at the top regardless of how that change is affected.

Peter Sartori is Head of Asian Equity at Nikko Asset Management Asia.

This article is for information only with no consideration given to the specific investment objectives, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment.

Aged care and granny flats come with their own rights

Rachel Lane

When most people hear the words "aged care" they think "nursing home". This is normally quickly followed by the words "Not me!" Aged care decisions, whether they are for yourself or a loved one, are complex and the choices are far more diverse than simply stay at home or move into an aged care facility.

This article is the first in a three-part series examining the different legal and financial arrangements that people enter into – sometimes without realising – in meeting their need for care.

"*Mum's happy in her own little granny flat*" sounds like the perfect arrangement, with Mum or Dad or both enjoying their own private space within a property occupied by an adult child who is close at hand to help. But such an arrangement embodies significant legal and financial implications that can impact the cost of residential aged care if required down the track.

Many people think of a granny flat as a small self-contained unit built in the backyard or semi-detached to the main home. However, a granny flat and with it a granny flat 'right or life interest' can also be established within an existing home. Often this occurs when a parent moves in with their children and the children modify the home to enable the older person to receive assistance and move around safely.

What is a 'granny flat right'?

A granny flat right is typically an arrangement made in a family where accommodation is provided in exchange for a payment or transfer of assets. Under social security laws, individuals can transfer assets in excess of the gifting limits in exchange for a right of occupancy in a residential property.

There are generally three ways in which a granny flat right or life interest is established:

1. The parents sell their home and pay for a self-contained unit to be built on the children's property or cover the cost of modifications to the existing home.

2. The parents remain living in their home and have the children move in to provide companionship and care and transfer the title of the home to the children.

3. Both the parents and the children sell their existing homes and purchase a new home in the children's names.

Note: If the parents retain or have ownership of the property, a granny flat right or life interest has NOT been established.

The amount someone pays for a granny flat right will determine their homeowner status and whether the amount paid is exempt for pension purposes. It will also determine their eligibility for rent assistance. If the amount paid is less than $146,500, they are considered a non-homeowner, the amount paid would be assessable and they may be eligible for rent assistance. The opposite is true if they pay more than $146,500 – they are deemed to be a homeowner, the amount paid is exempt and they would not be eligible for rent assistance.

If the former home is sold and exchanged for the granny flat right, then pension entitlement would remain unchanged as the asset position remains the same. If the proceeds from the sale of the home and other assets are used to purchase the granny flat, then pension entitlement would likely increase. However there are limits and once exceeded the amount above the limit will be treated as a gift.

How much is too much?

Generally speaking the amount paid for a granny flat right or life interest is considered to be the market price. This is because they are family arrangements and it can be difficult to place a value on them. However, a reasonableness test will be applied if:

- Someone transfers the title to their home (or purchases property in another person's name) and transfers additional assets.
- Someone pays for the cost of construction and transfers additional assets.
- It is considered that the person is establishing a granny flat right to gain a social security advantage.

The reasonableness test amount is calculated by multiplying the combined annual couple rate of the pension (on the date the right was established) by the relevant conversion factor. The relevant conversion factor is available from Centrelink and will depend on the age of the person (or the youngest member of the couple) next birthday. For example, the relevant conversion factor for someone who is 79 next birthday is 10.25, and so the reasonable test amount is 10.25 x $33,488 = $343,252.

Complexities often overlooked

While the idea of the family looking after their ageing members is certainly not a new concept, the complexities of such arrangements are often overlooked. What will happen if the children wish to go on holidays? What will happen if the parent's care needs change and they cannot be safely looked after in the home? Who should pay for the cost of care? Will the parent make a contribution to household expenses such as food, utilities and insurance? Of course if the living arrangement continues for many years it may be necessary to consider what the consequences would be if the adult children divorce or if one of those caring for the parent became ill or passed away. While the obvious answers to increasing care needs may be to seek assistance through care packages, respite stays or even permanent residential aged care, often these options have never been discussed and contradict the parent's expectations.

Because in many cases the purchase of the granny flat right is coming from the sale of the family home (or the transfer of the home) disputes often erupt amongst siblings who, although happy to concede that they are unable or unwilling to look after their ageing parents, have a vested interest in the family home as the largest asset in the future estate.

For people who think that residential aged care will be required in the future it is important to be aware: if someone needs to vacate a granny flat within five years of establishment for a reason that could have anticipated at the time the granny flat right was established, the value of the granny flat right can be considered a deprived asset. This means that both the asset value and the deemed income can be assessed for determining the accommodation payment and the means tested care fee payable to the aged care facility.

Rachel Lane is the Principal of Aged Care Gurus and oversees a national network of financial advisers dedicated to providing quality advice to older Australians and their families. You can read more about Granny Flat Rights and Life Interests in the book "Aged Care, Who Cares; Where, How and How Much?" by Rachel Lane and Noel Whittaker.

The case for equities in retirement

Mark Nathan

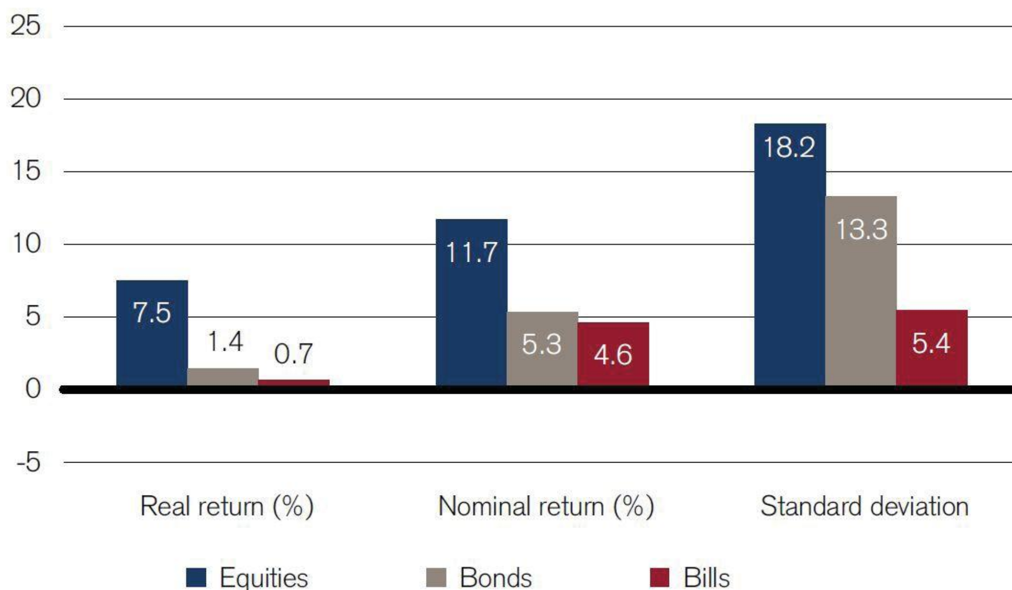
Conventional wisdom suggests that as you approach retirement you should move your savings into conservative, income-producing investments rather than leaving them in growth assets. Indeed there is merit in constantly reviewing your mix of assets but the average life expectancy of a male retiring at age 65 is around 18.5 years and a female 21.5 years. In fact, around 1 in 4 men retiring at age 65 will live at least another 25 years (to age 90), while 1 in 3 women will live past that milestone.

Many retirees' greatest financial risk will be outliving their savings and having to rely on an unpredictable public pension. This paper illustrates that if they can live with the added volatility, retirees may be better off maintaining a significant allocation to growth assets, in particular shares, rather than switching wholly to more conservative asset classes such as cash, bonds or annuities.

Long term performance of equities and fixed income

Shares are well known to offer the potential for higher returns than more stable asset classes, offset by the likelihood of higher volatility. This has been the historical experience. Chart 1 shows that the average nominal equity return over 110 years was 11.7% compared with bonds 5.3% and bills 4.6%.

Chart 1: Long term performance of different Australian asset classes 1900-2010

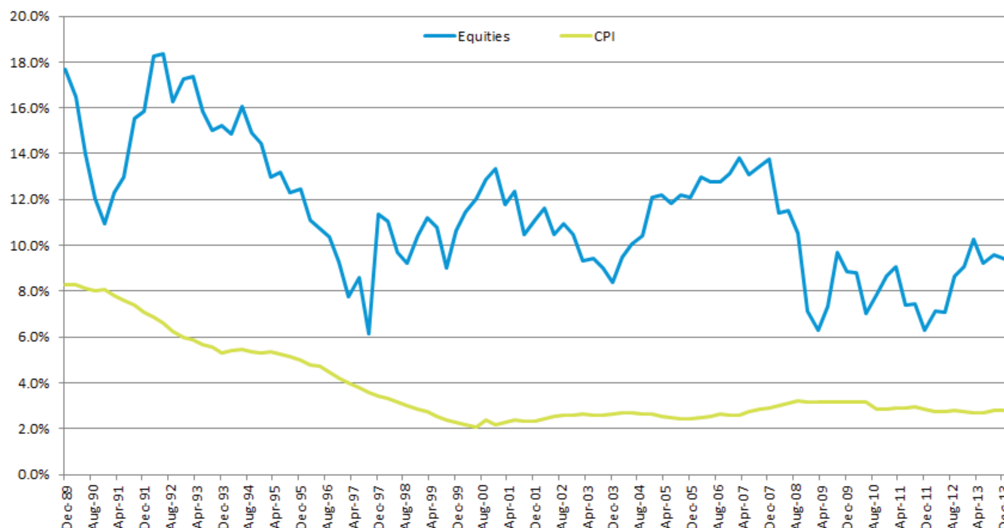


Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2010. Past performance is not a reliable indicator of future performance.

Shares as an inflation hedge

Australian shares have been one of the better inflation hedges over long periods of time. Chart 2 shows the rolling performance of Australian shares measured over 10 year periods. Over all rolling 10 year periods since 1980, shares have delivered positive returns and have outperformed inflation.

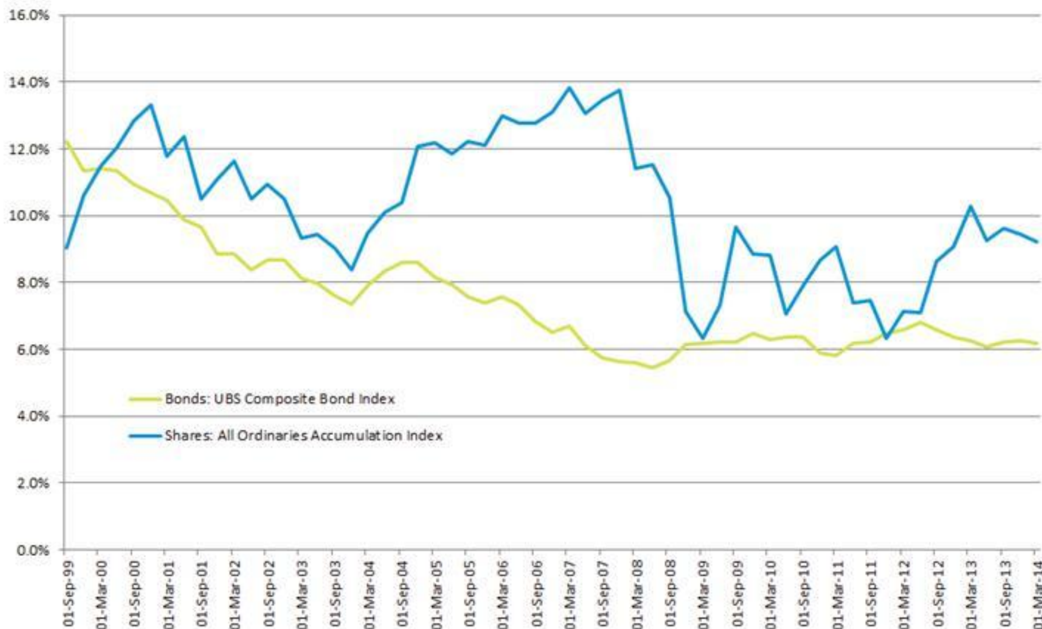
Chart 2: Rolling 10 year performance of Australian shares versus inflation (CPI)



Source: Iress (XAOAI, ACPI).

The back data for the bond market indices is more limited, but Chart 3 shows 10 year rolling performance of Australian shares relative to Australian bonds (Australian Composite Index). Over most periods, shares have been superior. We note however that bonds are likely to have done better than shares for a period prior to the commencement of this chart due to the compression in bond yields that took place in the late 1980s, combined with the poor performance of shares due to the crash of 1987. But over the 101 years to 2001, shares have been a better inflation hedge than bonds as real returns, on average, have been better for shares than bonds.

Chart 3: Rolling 10 year performance of Australian shares and Australian bonds

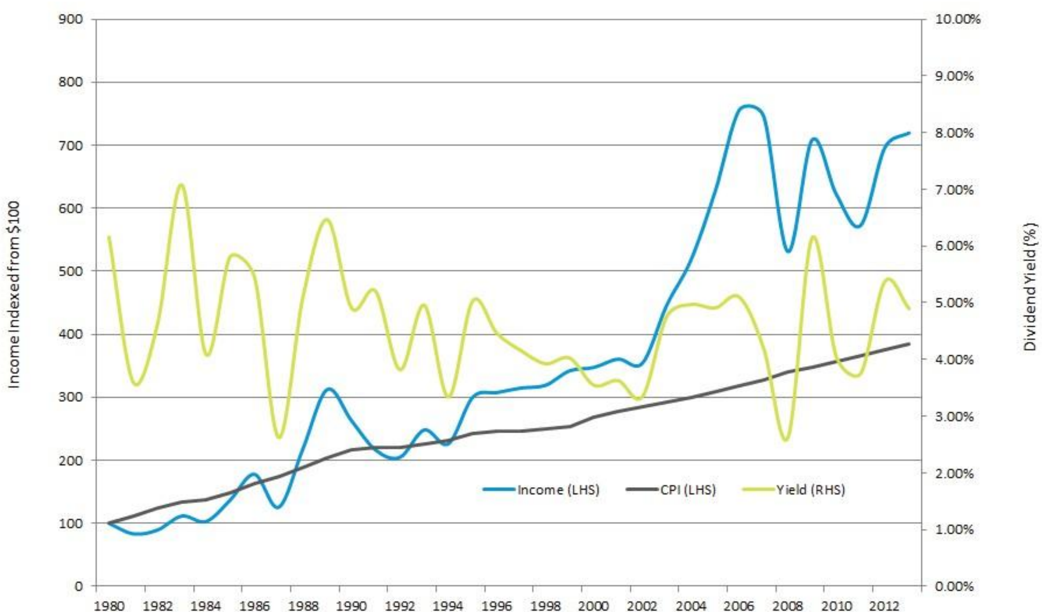


Source: Iress (XAOAI, SCPALL).

Can shares provide an adequate stream of income?

Dividends, while they have been volatile at times, have generally grown at a faster pace than living costs measured by CPI. Chart 4 excludes franking credits which are a cash benefit for Australian residents investing in Australian shares on top of income growth and capital return. When living off a combination of capital and income, an equity portfolio can serve investors well.

Chart 4: Dividend income, dividend yield and CPI (1980-2013)



Source: Iress (XAOAI, ACPI).

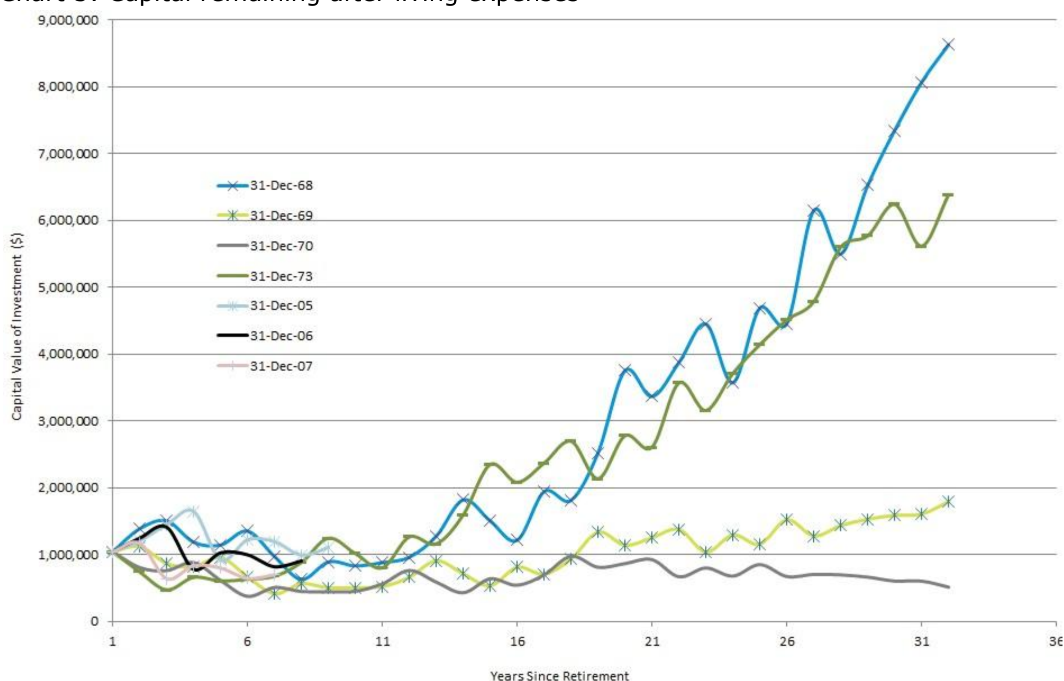
The Association of Superannuation Funds of Australia (ASFA) has suggested that a couple currently needs $57,665 per annum to retire with a comfortable lifestyle. We estimate that to avoid reliance on a pension for at least 25 years, a retiree will need a current starting balance of at least $1,043,794 (assumes 2.5% inflation and 5% investment return per annum. No income tax is included). To consider whether an equity portfolio can support retirement, we have modelled equity funds for 25 year retirement periods

starting in each years from 1965 to 1989 (1989 is 25 years ago) and for partial periods from 1990 to 2007 with full allocation to equities at the start.

In our analysis, we use the ASFA starting balance and retirement income stream noted above, instead of discounting both numbers back to the start of each retirement period. This effectively scales the starting capital and income requirements equally, such that the dollar values are more comparable between retirement years. In years where the dividend stream does not provide the required inflation-adjusted income stream, shares are sold to meet that income objective. Essentially, if you didn't run out of capital, you met your retirement income requirements. Our analysis shows that in many cases your estate would have ended up with far in excess of your starting capital, allowing you to leave a financial legacy for your family.

In Chart 5 below, we look at some of the retirement outcomes that generate both large positive and large negative capital outcomes. There are some outcomes where the initial capital is substantially eroded via draws on capital in order to maintain income levels. This chart includes some more recent experiences incorporating the GFC, but we have not allowed for potential income from aged pension entitlements. In each case, including the worst experience, initial equity investments would have sufficiently funded a retirement income for at least 25 years, and in many cases provided an additional capital legacy.

Chart 5: Capital remaining after living expenses



Source: Arnhem Investment Management. Past performance is not a reliable indicator of future performance.

Retirees might find this capital volatility too unsettling and are unlikely to take solace from the fact that holding all retirement funds in equities would have historically funded one's retirement. Indeed, we have little doubt that those retiring in 1973 would not have had the resolve to maintain an equity portfolio, after seeing their retirement nest egg halve in just two years.

It should also be noted that this modelling assumes that spending power (inflation) increases by 2.5% each year. Australia has however, experienced two periods of inflation well in excess of this, in the early 1950s and the 1970s/early-1980s.

Would an equity portfolio have been able to maintain the real purchasing power while funding retirement through such extreme events? Based on historical equity market performance, the starting balance of $1,043,794 and starting income of $57,665 as used earlier can accommodate inflation of up to 3.5% in all but one retirement year (1970). Lifting starting capital to $1,200,000 would see a retiree manage with inflation of up to 5% in all years. However, they would have needed a far higher starting balance to maintain real purchasing power at the rates of inflation experienced in the 1970s.

Conclusion

This analysis highlights the value of incorporating a significant equity weighting in an asset allocation during retirement years. We show that equities can deliver superior income outcomes and are a good hedge against inflation. In addition, by choosing an equity portfolio which invests in companies that deliver growing dividends, financial circumstances may be better than if conservative 'yield' strategies are the sole focus. Returns from equities will be more volatile, and while they ought to form a meaningful part of post retirement income, they should also be balanced with lower volatility assets.

Mark Nathan is Managing Partner at Arnhem Investment Management

This document is produced for general information only and does not constitute financial product advice, nor a recommendation to acquire any financial product. You should seek your own professional advice in relation to any financial product referred to. The full research paper is linked here.

Investing in car spaces? Park that idea

Graham Hand

Every time a state government or local council announces a reduction in the number of car spaces required for apartment construction, there's a flurry of excitement about the value of existing parking spaces. At a cost of less than $50,000 a space, surely this is a great way to enter the property market with no tenants to trash the joint. It's just a block of concrete, how difficult can it be?

A week ago, the NSW Government released a draft change in planning laws allowing apartments within 400 metres of a transport hub to be built without parking spaces. Cue the articles on the rising competition for spaces. *The Australian Financial Review* (AFR) ran the headline, *"Supply shortages fuelled by new planning laws means capital gains and attractive yields"* (27 September 2014, page 29).

Not one mention of a minor inconvenience: the Parking Space Levy. It's a damn annoyance for anyone selling a parking space so why bother with it? Well, simply because it applies to all investments in off-street car spaces in a 'leviable district'. The levy is a whopping $2,260 (indexed to CPI) in the City of Sydney, North Sydney and Milsons Point. It's a more manageable $800 (also indexed) in Bondi Junction, Chatswood, Parramatta and St. Leonards. Click on any of these locations to see the relevant map, and it's surprising how far the locations extend. Sydney includes Pyrmont, Ultimo, Walsh Bay and parts of Chippendale and Surry Hills. Note there is an exemption if it is not an investment, that is, if the owners live in the same building or an adjoining one.

Owners of individual car park spaces, such as the significant recent release near Sydney Airport, may heave a sigh of relief that they are not currently caught. But every state government is looking for new revenue sources. For example, a few months ago in May 2014, the Congestion Levy Act 2005 for Melbourne expanded the levy boundary, and all off-street parking in the expansion area will be leviable at $950 a year from 1 January 2015 (also indexed to CPI).

The AFR even quoted some healthy return numbers. Be still my beating heart. The owner of a parking space in Surry Hills can ask $80 a week. If the parking space cost $50,000, the yield would be 8.3%. How many of these can I buy?

There are three costs this calculation ignores, and the parking space levy is the highest. There are also council rates and strata fees. Yes, although nobody has to collect the garbage for a 15 square metre block of concrete, there are still roads and council offices to pay for.

Out of the 52 weeks at $80 a week income ($4,160, let's ignore any agent's fees or vacancy rates, it's bad enough without a complete reality check) comes $2,260 of parking space levy. A typical City of Sydney annual levy for a car space is $650 a year (including stormwater charge) while strata fees are

about $920 a year. Those three costs total $3,830, leaving $330 return on the $50,000 investment, or 0.7% pa. Remember, that's without paying any borrowing costs.

Of course (said the agent), there's always capital gain. When the City of Sydney announced an increase in the Parking Space Levy from $950 to $2,000 in 2009, the value of parking spaces in some suburbs dropped 25%. The levy started in 1992 at $200, and the suburbs were extended beyond major CBDs in 2000.

With government of all colours desperate for income, does anybody seriously expect any of these levies or levy boundaries will shrink? No, they will rise each year.

Like every real estate investment, the gross yields quoted by agents are only part of the picture, and when it comes to Sydney car spaces, the levy is a cost you can't park to one side.

This article is general information only and is not a substitute for professional personal advice.

(Graham Hand presented at this week's SMSF Owners' Alliance Technical Workshop, giving his insights on SMSF portfolio construction. If you are interested to learn more about SMSFOA and receive regular updates you can become a Registered Supporter for free at www.smsfoa.org.au.)

Animal spirits dormant except for coffee and food

Salvatore Ferraro

Glenn Stevens has drawn the line in the sand over the past six months, first by observing that entrepreneurial risk taking has been absent then imploring businesses to abandon their cost and capital discipline to embrace pro-growth strategies.

Analysts should therefore be looking for signs of a revival in the corporate sector's animal spirits as a guide to the date of lift-off in the Cash Rate. Regrettably, the recently released credit aggregates showed that business credit was flat in August and only 3% higher than a year earlier, confirming that the corporate sector remains reluctant to lift gearing against the backdrop of the new capital discipline.

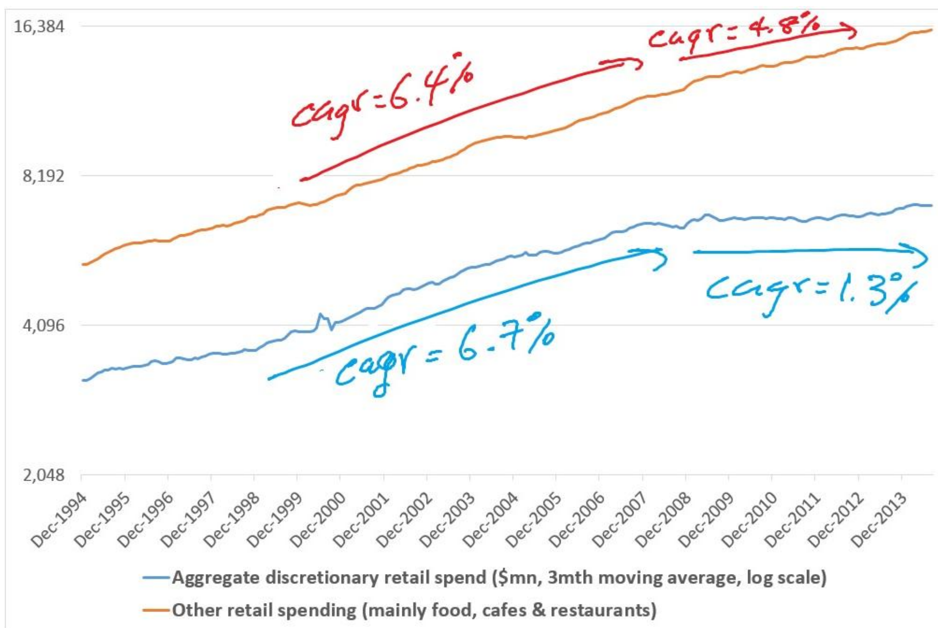
The Reserve Bank Governor's anxiety is understandable considering the imminent investment cliff in mining and energy over the next two years as the construction of LNG processing plants approach completion.

But does Mr Stevens seriously expect the non-mining sectors to ramp up their investment intentions at a time when they face persistent revenue headwinds? Unfortunately, the RBA continues to under-estimate the power of monetary policy to revive the corporate sector's animal spirits, to boost company revenues and lift expectations of growth in nominal GDP.

The ongoing weakness in consumer sentiment and the recently released August retail trade data suggest that the consumer's animal spirits also remain dormant. To put the retail trade survey in context, by excluding items such as services, petrol, motor vehicles and utilities, it accounts for less than one-third of total household sector spending.

Despite its narrowness, it represents an invaluable guide to consumer sentiment because it includes durable goods - such as PCs, washing machines etc - that households tend to buy when they are feeling optimistic and secure about their financial future.

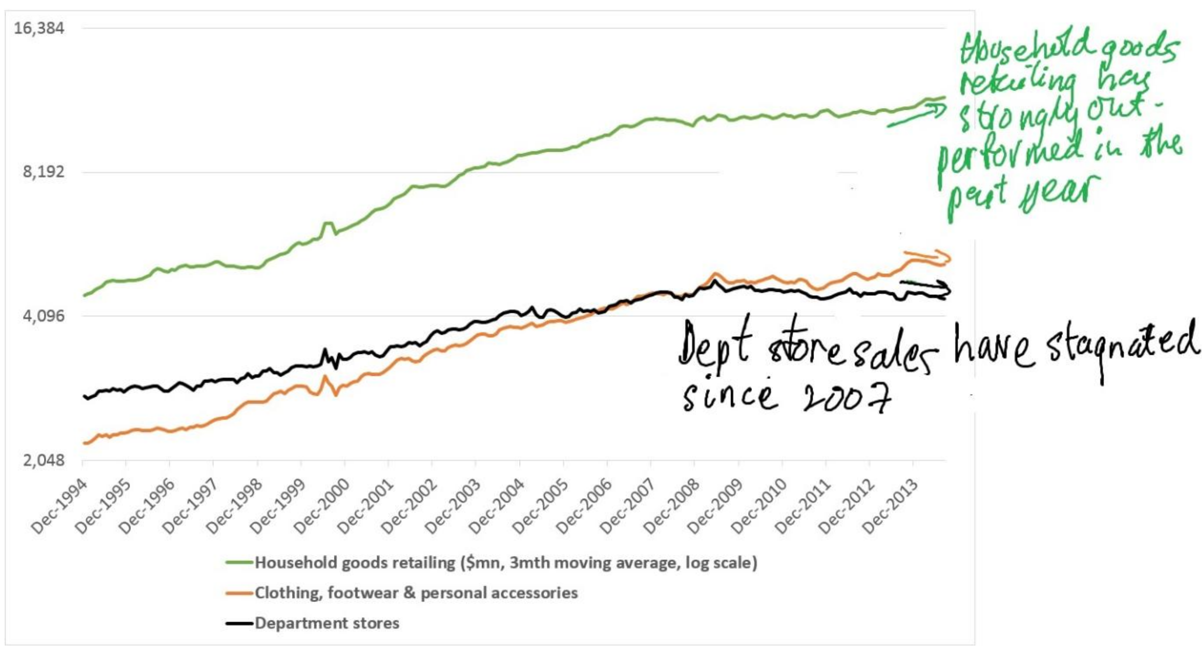
I have further narrowed the survey to capture the three categories that listed discretionary retailers are most exposed to: household goods retailing; clothing, footwear & personal accessories; and department store sales. The chart below shows that discretionary spending across these three categories in aggregate has almost come to a standstill since the end of 2007 after growing at a strong compound annual rate of almost 7% in the preceding decade.



In contrast, the other components of the retail trade data - mainly spending on food as well as cafes & restaurants - has also slowed over the past seven years, but this has been more moderate. Clearly, discretionary retailers have been more exposed to revenue and competitive headwinds than consumer staples.

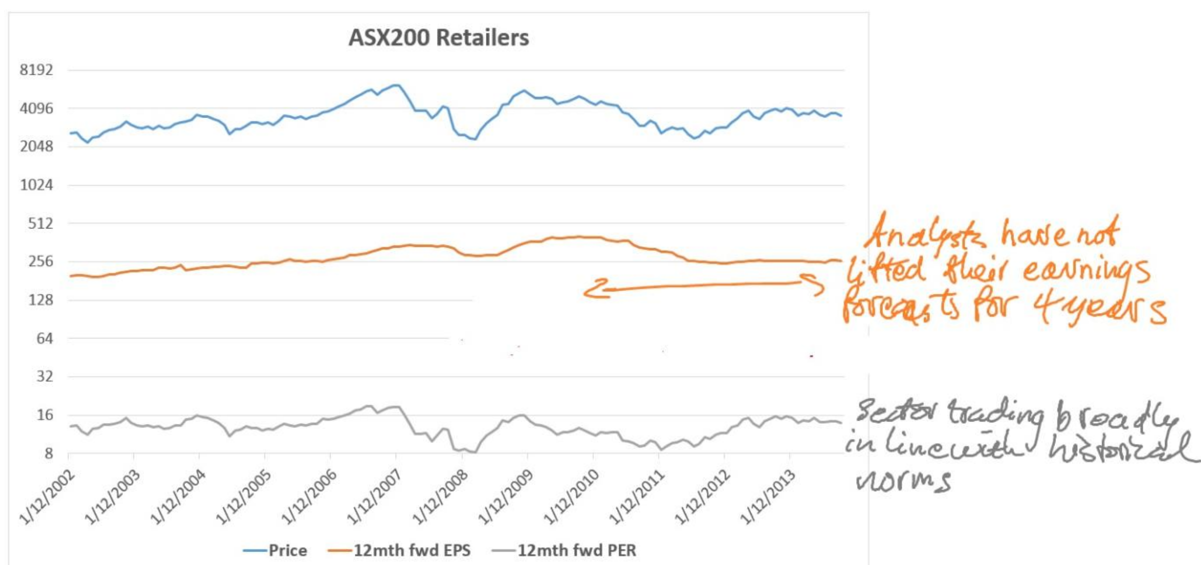
Persistently weak labour market conditions have not helped, with aggregate hours worked remaining stagnant for three years as companies continue to undertake restructuring and trim costs to offset anaemic revenue conditions.

Growth in all three components of discretionary spending have materially slowed since the financial crisis, but department store sales has remained the laggard (see chart below). In the past year, household goods retailing has lifted at a time when department store sales and spending on clothing, footwear & personal accessories has gone backwards.



The consumer's dormant animal spirits and intense retail competition (particularly from e-tailers) are reflected in the fact that sell-side analysts have not lifted their EPS projections for the discretionary retail sector for over four years now (see chart below). Indeed, the sector's forecast profitability is at the same level it was in 2005. This has been the lost decade for Australia's discretionary retailers. Valuations are

not compelling at current levels, with the sector trading slightly above its historical median of 13 times twelve month forward earnings.



The consumer environment has deteriorated in recent years thanks to weak labour market conditions and increased job insecurity. This has been reflected in a decline in permanent incomes due to a lift in the discount rates that households apply to their future income stream. Little surprise that households have undertaken balance sheet repair and lifted their savings rate.

The revenue headwinds that have beset discretionary retailers are unlikely to change given intense competition from e-tailers and the RBA's timid approach to monetary policy. As with its attitude towards entrepreneurial risk taking, the RBA continues to under-estimate the ability for monetary policy to revive the consumer's animal spirits.

Discretionary retailers need to accept that a cautious consumer represents the new normal for now, and that trimming costs, lifting productivity and consolidating without undermining their service offering represents the most effective way to offer better returns to their long suffering shareholders.

Salvatore Ferraro is founder and principal of the independent financial consulting firm, Evidente.

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.