Cuffelinks
Connecting investors with ideas

Edition 150, 8 April 2016

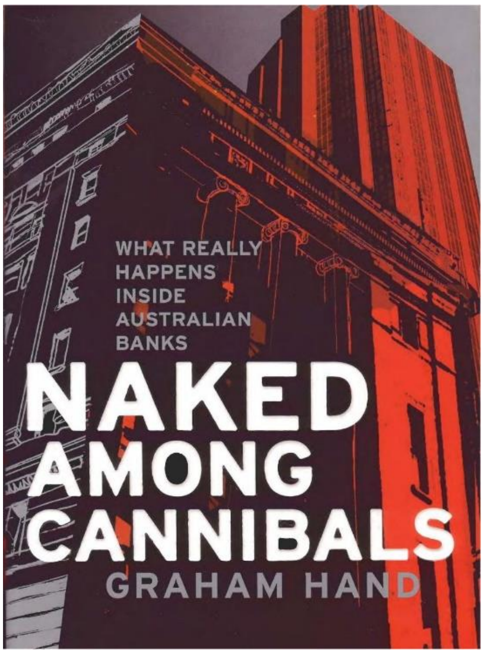
This Week's Top Articles

Culture shock: *Naked Among Cannibals* revisited

Graham Hand

"People of the same trade seldom meet together, even for merriment and diversion, but that the conversation ends in a conspiracy against the public or in some contrivance to raise prices."

Adam Smith, The Wealth of Nations, 1776



Every day in recent weeks, we read about bank culture in the media. It seems everybody from the Prime Minister down is talking about it. At the recent sold-out ASIC Annual Forum, the theme was 'Culture Shock'. Not surprisingly, the most common examples quoted of culture problems were the financial advice and life company scandals at CBA. The Chairman of ASIC, Greg Medcraft, said:

"Inevitably, it is the stories of poor culture and poor conduct in the financial industry which are splashed across the front page of the newspaper, which pop up in our newsfeeds, and which are the subjects of heated discussion on social media sites. This is particularly so in recent times – with financial advice, and now Bank Bill Swap Rate (BBSW) and life insurance, on everybody's minds."

Former CBA Managing Director and Chair of the Financial System Inquiry, David Murray, shot ASIC a cannonball this week when he told a Fairfax Media event on 5 April 2016 that it was:

"... extraordinarily disappointing that ASIC should go down this culture tangent which will do more damage than good … It's anticompetitive, it's inefficient, and to be perfectly candid, there have been people in the world who have tried to enforce culture. Adolf Hitler comes to mind. "

Is that the first time that ASIC and Adolf Hitler have been used in the same sentence? Murray later apologised for the reference.

Then Malcolm Turnbull weighed in with these strong words at a Westpac function on 6 April 2016:

"We expect our banks to have high standards, we expect them always rigorously to put their customers' interests first, to deal with their depositors and their borrowers, those they advise and those with whom they transact, in precisely the same way they would have them deal with themselves. This is not idealism, this is what we expect.

*The truth is that despite the public's support offered at their time of need, our bankers have not always treated their customers as they should. Some, regrettably, as we know have taken advantage of fellow Australians and the savings they have spent a lifetime accumulating. Wise bankers understand that banks need to very publicly demonstrate that their values of trust, integrity, **placing the customers first in every way**, they must be lived and not just spoken about.*

The singular pursuit of an extra dollar of profit at the expense of those values is not simply wrong but places at risk the whole social licence, the good name and reputation upon which great institutions depend." (my bolded emphasis)

Banking versus wealth management

I read the headlines and listen to the wise words about culture from executives apologising for poor treatment of financial advice and life insurance customers with some bemusement. I worked for CBA, State Bank of New South Wales (acquired by Colonial in 1994, which was then acquired by CBA in 2002) and Colonial First State (CFS) for over 30 years. Even when I ran a consulting company, a major client was CBA, and we worked on the merger of the CBA/Colonial businesses.

One of the CBA consulting assignments tells a story of bank culture. CBA wanted to increase the amount of its funding requirements from the newly-acquired asset management business. The bank was the largest issuer of securities in Australia, both short term and long term, and CFS (which had merged with Commonwealth Investment Management to form an investing behemoth) already held billions in CBA paper. We met with CFS cash and fixed interest fund managers to discuss how much more could be placed with the bank.

To say the fundies were uncooperative would be an understatement. They looked at me incredulously. Was I seriously suggesting that the bank now expected the asset management business to invest more in the bank's paper because the bank owned the business? Did the bank really think it could give instructions on where investments should be made? The fund managers said it was their fiduciary responsibility to act in the best interests of their investors, and it was irrelevant what CBA wanted (one of the people saying this was Warren Bird, who now writes for Cuffelinks).

As a banker for 20 years, my first thought was, "Who do you think you're talking to?", followed quickly by, "Do you know who writes the cheques around here?" and similar. I kept the discussions polite and skulked off to plan another approach. That didn't get far either. We bankers were given a lesson in fiduciary responsibility.

Naked Among Cannibals

I had worked in banking since 1979, schooled in the ways of maximising profit with no formal fiduciary or best interest duty to customers. I chronicled my experiences in the way banks price their deposits, loans and fees in a book published by Allen & Unwin in 2001 called *Naked Among Cannibals: What Really Happens Inside Australian Banks*. I was reminded of this recently when Noel Whittaker quoted the book in an article for the Courier-Mail on 13 March 2016. He said,

"Despite the predictable protests from the banks [about rate-fixing and life insurance], there is nothing new in this. In 2001, ex-bank executive Graham Hand published his bestseller Naked Among Cannibals, which contained more than 300 pages about corporate greed and unethical behaviour by Australian banks."

Noel sent this newspaper cutting to me.


MONEY

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Banks are their own worst enemy

NOEL WHITTAKER

THE big banks have been all over the news this week, and for all the wrong reasons.

First, it was ANZ locking horns with ASIC over alleged manipulation of interest rates. Next it was the Commonwealth Bank, who got a bucketing on *Four Corners* last Monday night for unethical and unscrupulous behaviour towards claims on their insurance division, CommInsure. And last Monday ANZ bank stepped into the limelight again, revealing that it had been hit with a $212,500 penalty for breaching responsible lending laws when offering overdrafts.

Despite the predictable protests from the banks, there is nothing new in this. In 2001, ex-bank executive Graham Hand published his bestseller *Naked Among Cannibals*, which contained more than 300 pages about corporate greed and unethical behaviour by Australian banks.

According to mortgage broker Peter Cooper, there are other areas where the banks need to be more

TRUE STORY: Graham Hand has shone a light on corporate greed and unethical behaviour by banks.

bank, to find out how much the break costs will be. The reply from the staff member will almost certainly be that they will need to check with the bank's Treasury Department who

culate the break fee, only four pieces of information are necessary. They are the funding cost, the remaining term of the loan, the balance outstanding and the funding cost when the loan is discharged. The first is al-

Anyone wanting to take a journey into bank culture 15 years ago can read the contents page and first three chapters for free on [Amazon books here]() or purchase the 320 page [eBook version here]().

The irony of wealth management's problems

At the ASIC Forum, a speaker from the floor argued that CBA's cultural problems are caused by its acquisition of Colonial, since the major scandals are not in banking but the wealth management business acquired from Colonial. He conveniently ignored the fact that CBA acquired Colonial in 2002 and has had 14 years to address any cultural problems.

But it's true that it's not the banking activities giving CBA's reputation a beating at the moment. According to Roy Morgan Research, CBA's consumer satisfaction leads the major banks and is near an all-time high, as shown below. It was a distant last 10 years ago before Ralph Norris's 'Sales and Service' campaign kicked off. There is no doubt that dealing with CBA branch and call centre staff is a better experience now than 15 years ago.

While the banks are being investigated by ASIC on BBSW rate-fixing, there is no 'scandal' around the ways banks price their products, as was a focus of my book. The major culture arguments are directed at the wealth management businesses of financial advice and life insurance.

CFS is the wealth management division of CBA and the responsible entity for the funds offered to retail clients, and it manages billions of dollars of assets across all sectors through Colonial First State Global Asset Management. This 'vertically-integrated' structure across the industry is also subject to [review by ASIC](), including, of course, financial advice.

I did not work in either life insurance or financial advice (neither was offered under the CFS brand), so I will confine my comments to asset management and product development in CFS.

The Corporation Act 2001, Section 601FC(1), under 'Duties of a responsible entity' says:

"In exercising its powers and carrying out its duties, the responsible entity of a registered scheme must … (c) act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests."

In the dozen years I worked at CFS, from 2001 to 2012, this responsibility was taken very seriously. It was common for the senior legal representative in meetings to divert management from a preferred course of action because in his view, the action was not in the best interests of clients. There was often a lively debate about how to structure a product or communicate with clients, but someone always made sure the fiduciary duty was front and centre.

Consumer Banking Satisfaction

Source: Roy Morgan Research Consumer Banking Satisfaction Report February 2016, average six-month sample n=25,600

That's the irony for me. Wealth management is taking most of the culture blame, but in my personal experience, in funding, product development and relationship management, the fiduciary obligation was well-understood. It took me some time to appreciate its seriousness as I switched from banking to wealth management.

The Prime Minister is right that the support the government and regulators give the banking system creates an implied obligation to play a social role and consider multiple stakeholders. But his statement that banks should be "*placing the customers first in every way*" will be a cultural anathema for many bankers.

What are examples of bank cultural problems?

There is no legal fiduciary duty in banking, and so 'culture' and 'ethics' must play a greater role in determining appropriate actions. Culture is the combination of beliefs, values and attitudes that guide behaviour. There is no legal person in meetings saying you can't do something because it's not in the customer's best interests.

I sat on the pricing committees of three banks from 1979 to 2001, and we usually priced our products according to what the market could bear. My book details unscrupulous practices to extract extra margins from deposits, loans and fees. I admit I'm no longer as well-placed to comment on the present culture of these committees, so someone else can fill this gap.

In 2003, I presented a Perspectives segment on ABC's Radio National. The text is linked here. The segment was called 'A Banker's Dictionary'. I explained five terms - **entanglement, milking, mating calls, lagging and parasites** - we used in pricing committee which would make any current CEO blush. It's unlikely in these days of political correctness that the terms are still used.

But more important than the words is whether the activities they describe still exist. Even for an outsider, it's possible to demonstrate they do.

To ensure this article does not single out CBA, consider the current Westpac term deposit interest rate schedule, as shown below for 6 April 2016.

The red rates are the 'special' offers. Why is the 3 month rate 2.15% when the 2 month and 4 month rate is only 1.80%? It does not reflect the shape of the yield curve. It is the rate designed to attract new money. No problem so far.

But there's an excellent way to extract more profit margin from customers over time. Until recently, Westpac had the special offer at 4 months. When this deposit matures, the bank will retain the special at 3 months and the 4 month investor will automatically rollover to the lower 4 month rate above. Like all banks, Westpac relies on what we called 'retail inertia'. The majority of investors don't call the bank for a higher rate, they simply allow the deposit to rollover. Then the cycle starts again. As the 3 month depositors who were initially attracted to the special rate approach maturity, the special will switch to 4 or 5 months, and the 3 month people will rollover at a lower rate. Same when the red 6 month rate switches to 7 months, and so on.

Is that fair? Few people want 1.8% for 4 months when 2.15% is available for 3 months, but 1.8% is what most people will be paid.

Term	$5,000 <$10,000	$10,000 <$20,000	$20,000 <$50,000	$50,000 <$100,000	$100,000 <$250,000
1 < 2 months	1.80%	1.80%	1.80%	1.80%	1.80%
2 < 3 months	1.80%	1.80%	1.80%	1.80%	1.80%
3 < 4 months	2.15%	2.15%	2.15%	2.15%	2.15%
4 < 5 months	1.80%	1.80%	1.80%	1.80%	1.80%
5 < 6 months	1.80%	1.80%	1.80%	1.80%	1.80%
6 < 7 months	2.20%	2.20%	2.20%	2.20%	2.20%
7 < 8 months	1.80%	1.80%	1.80%	1.80%	1.80%

It's very profitable. The interest savings on billions of dollars of term deposits rolled over at a saving of 0.35% are worth millions of dollars a year in extra revenue. Banks watch the maturity pattern by term of original lodgement and set the special rates where the least number of rollovers will receive the higher rate. We called this 'milking' the deposit, although I doubt such a pejorative term is now acceptable.

For the record, CBA now places maturing term deposits into a Term Deposit Holding Facility (earning a rate of 1% for amounts between $10,000 and $99,999) until instructions are received from the client. You can judge whether this is a fairer policy.

Banks also know that the more a customer is 'entangled' in an account, the less likely they are to leave. The best examples are at-call (cash) transaction accounts which link to direct debits to pay electricity bills, loan repayments, credit card balances etc, and direct credits receiving interest, salaries, dividends, etc. These accounts are so entangled that the client cannot face the paperwork of changing to another bank or product. So why would the bank bother paying a decent interest rate on the balance? Most money in at call or cheque accounts receives negligible interest despite all banks or their subsidiaries having more attractive deposit products. Shall we tell the client to switch to the online account that pays 3%? Are you mad?

There are many examples like these: slowly lagging cash rate reductions into lending rates but passing on increases quickly, or charging interest rates on credit cards of over 20% (which have so many embedded direct credits and debits that it's hard for people to leave). And the mysterious calculations of early repayment fees on fixed rate loans, as previously described here.

My book goes through the evidence in a far more systematic way for any bank board member who wants to explore how much these practices are in the past or the present.

Why is wealth management the target?

So why is CBA permanently in damage control around wealth management more than banking? Why is every bank having problems in these businesses, such as ANZ placing wealth divisions under the control of retail bankers and stepping away from wealth platforms?

There's no simple explanation. The financial advice failures were exposed by the GFC when people who had been placed into inappropriate products (such as clients of Storm Financial) lost a lot of money. With some exceptions, the complaints were due to the loss in value of the investments. If the market had continued to rise, little would have surfaced. Who would be complaining about leveraged exposure in a booming market? However, no depositor in an Australian bank has ever lost money, because the Reserve Bank and the government always steps in. The deposit guarantee during the GFC is an example. There is less for bank customers to complain about than losing half your money in a managed fund.

I'm not excusing the bad practices in financial advice or life insurance, but rather, pointing out that in my experience, there are at least as many cultural and behavioural shortcomings in banking, beyond the rate-fixing, rogue traders and occasional account-skimming we read about.

Without a specific fiduciary duty or best interest test, bank behaviour is determined by the ethics and the culture, and that's incredibly difficult to measure and judge. As David Murray said when asked how effectively banks are embracing culture:

"Not very well at all. I think that we're in a process now of sorting this out. In the public mind, it's all to do with ethics, but ethics is a necessary but not sufficient component of solving the problem."

To my banking friends who hate me writing this, remember that whistleblowers are now meant to be revered, not reviled. Culture, apparently, has changed.

Graham Hand is Editor of Cuffelinks and comments from any current member of a bank pricing committee are most welcome. And anyone else.

The resilience of airports

Gerald Stack

Airports have become important assets in most infrastructure funds, and investors should consider whether the fundamentals will ensure the strong past performance is likely to continue in the future.

Since the development of commercial aviation during the post-World War II era, passenger volumes at major commercial airports have grown at multiples of GDP over any medium-term period. This growth reflects many underlying factors including increasing wealth, real reductions in the cost of air travel, developments in aircraft technology and improvements in international airspace regulation.

Global passenger growth is illustrated in Chart 1 below, showing the fairly consistent growth of airline passenger volumes since the mid-1960's and more recently, this measure has grown by 62% over the last 10 years [Airbus, 2015]. More importantly, the chart illustrates the resilience of air travel to external shocks and the speed of the recovery to a long term upward trajectory.

High quality airports benefit from a near monopoly stream of passengers from which they are able to generate both aeronautical and commercial revenues. Regulation is structured to allow the aeronautical operations (including passenger, landing and ancillary fees) to earn returns in line with the cost of capital, whilst there are typically no restrictions placed on the returns that can be generated from non-aeronautical operations, such as retail, parking and commercial property.

Stock example: Aeroports de Paris (ADP)

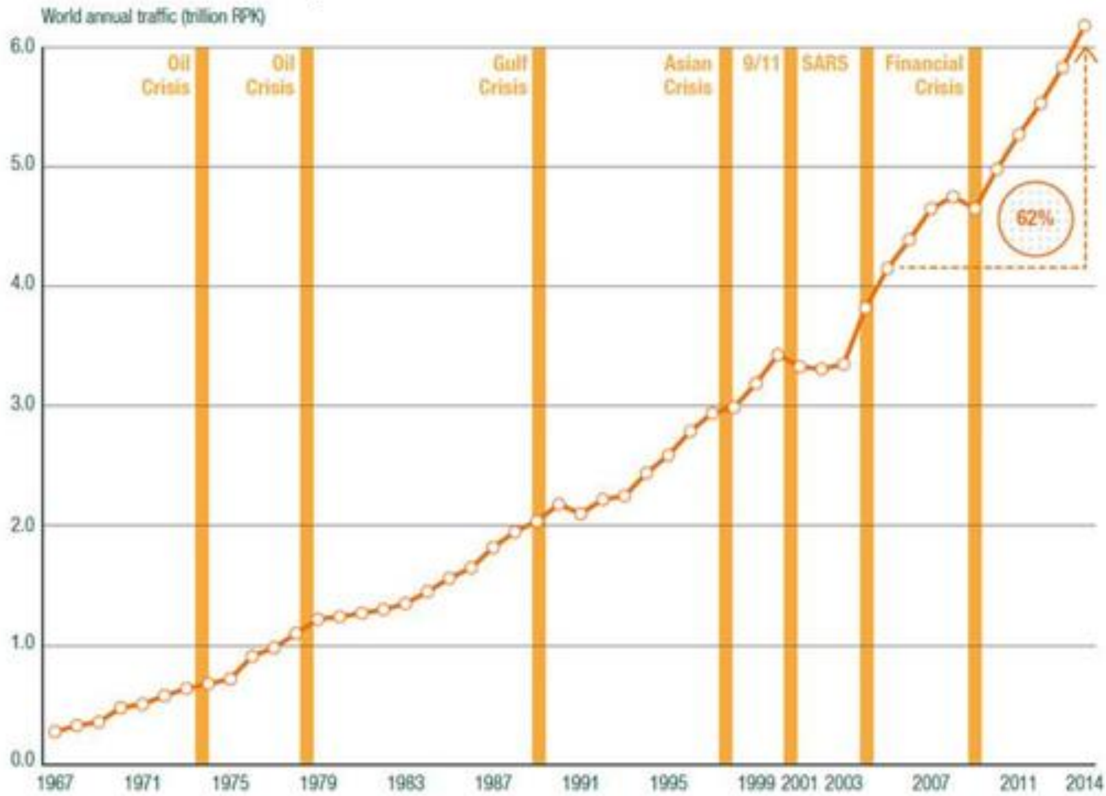
AÉROPORTS DE PARIS
The world is our guest

ADP is the owner and operator of the Paris airport system. This includes both Charles de Gaulle and Orly Airports. In 2014 these airports handled 92.7 million passengers, making it the second largest system in Europe after London.

Key points on Paris airports:

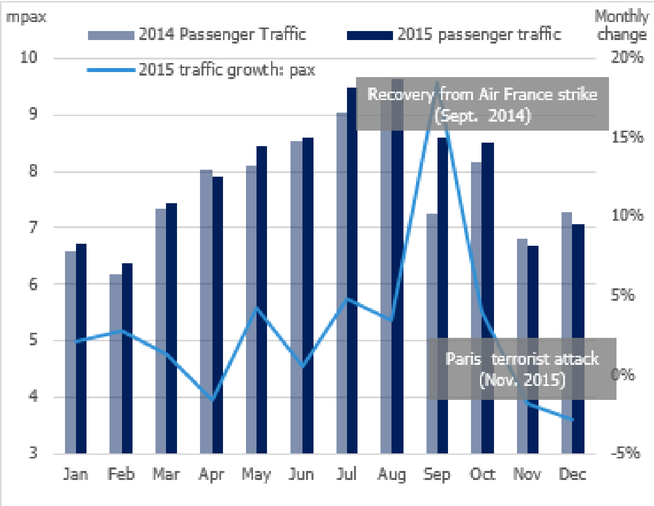
- Passenger traffic at the Paris airports was up 3.0% over 2015
- This was despite the shock of Paris seeing its second terrorist attack in November 2015
- Chart 2 (next page) shows the very material impact of the terror attacks in November 2015 (with drops of around 4% in traffic for November and December)
- However, by January 2016 passenger traffic had recovered back to 0.9%, with Air France and ADP both reporting that volumes are back to usual
- This is a clear demonstration of the resilience of airports and the ability to bounce back from short-term passenger shocks

Chart 1: Air travel has proved to be resilient to external shocks.



Source: ICAO, Airbus, GMF 2015. RPK = Revenue Passenger Kilometre

Chart 2: Monthly change in ADP traffic.



Source: Aeroports de Paris

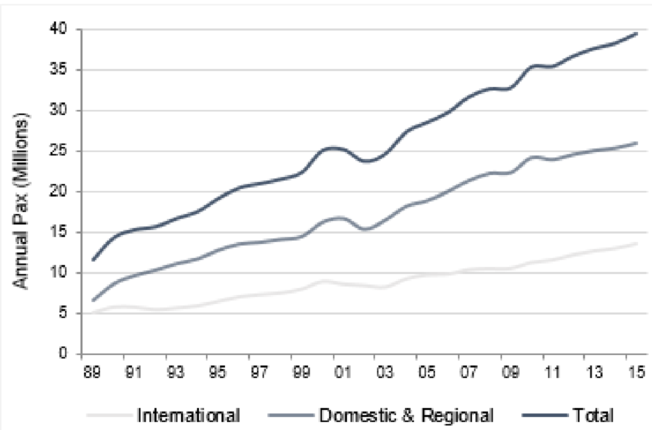
Stock example: Sydney Airport (SYD)

SYD is owner and operator of the Sydney domestic and international airports. In 2015 SYD handled approximately 40 million passengers. The long-term resilience is equally evident with SYD as illustrated in Chart 3 below.

Key points on Sydney Airport:

- The notable external shock within the Australian context was the collapse of Ansett Australia in 2001. Ansett was Australia's second largest domestic airline.
- The rising middle class, particularly in Asia has been contributing to strong passenger growth

Chart 3: Resilient growth across all economic cycles.



Source: Sydney Airport

In summary, airports form a core part of Magellan's definition of infrastructure and have, over time, delivered robust financial performance and generated healthy returns for investors. We believe that airports remain a global growth sector and offer an attractive balance of regulated and competitive earnings potential.

Gerald Stack is Head of Investments and Portfolio Manager of the [Magellan Infrastructure Fund](). He is also Chairman of the Investment Committee and has extensive experience in the management of listed and unlisted debt, equity and hybrid assets on a global basis. This material is for general information purposes only and must not be construed as investment advice. It does not take into account your investment objectives, financial situation or particular needs.

Debt is the biggest risk on China's horizon

Craig Swanger

There is an alarming rise in Chinese corporate debt and a steep rise in the early warning signs of creditor distress. China's corporate debt has been the driver of China's overall steep increase in debt to GDP. Global debt to GDP ratios have risen since the GFC, but in most other countries it is the government sector behind the rise, particularly in Europe and Japan. China is a special case as the governments often own the corporations, making the use of loans between state and corporations a greater risk to China's overall economy.

This article looks at some of the specific drivers of corporate debt in China such as property, shadow banking and local government debt. But before we do that, here's some further context on the world debt situation.

State-owned enterprise default

The most recent default, Dongbei Special, is a little-known steelmaker, but provides a great example of significant issues for the Chinese economy and therefore for Australian investors.

Dongbei Special is a state-owned enterprise that defaulted on USD131 million in debt underwritten by China Development Bank, another state-owned enterprise, on 28 March 2016. It owes a further USD150 million in short-term notes issued outside the banking sector, through shadow banking channels. A default of a local government-owned enterprise is rare, but likely to become an increasing problem particularly amongst parts of the economy, like steelmaking, that have been artificially propped up by government support and lending.

Global context

During the period 2007 to 2015, global debt (excluding banks) grew by around USD28 trillion. Nearly 33% of this was from China, and most of that was from the household and corporate sectors. A further 25% came from European governments and another 12% from the Japanese government.

The impact of these jumps in indebtedness was to rapidly increase the total debt ratios for these economies, but China's growth in debt, albeit very steep, has only brought it in line with the US and Australia. Europe on the other hand has raced ahead of the US and China, and while still trailing Japan today, has already reached Japan's total level of indebtedness in 2004.

Given the current pace of growth in these economies, Japan and Europe are the greatest concerns. The US has had relatively little increase in total debt despite the massive government fiscal and monetary stimulus programs run during that time, simply because households and the corporate sector deleveraged over the same period. Figure 1 shows the pace of growth in China's indebtedness.

Chinese debt is not unusually high in terms of its Total Debt to GDP Ratio. It is more or less the same as Australia. But recent growth rates have been very high and rising, and we need to question the sustainability of that credit growth and therefore China's overall economic growth.

If Chinese growth stalls, there will be an immediate, negative flow on to the AUD, our share market, and particularly, resource stocks.

Pace of growth in China's corporate and household debt

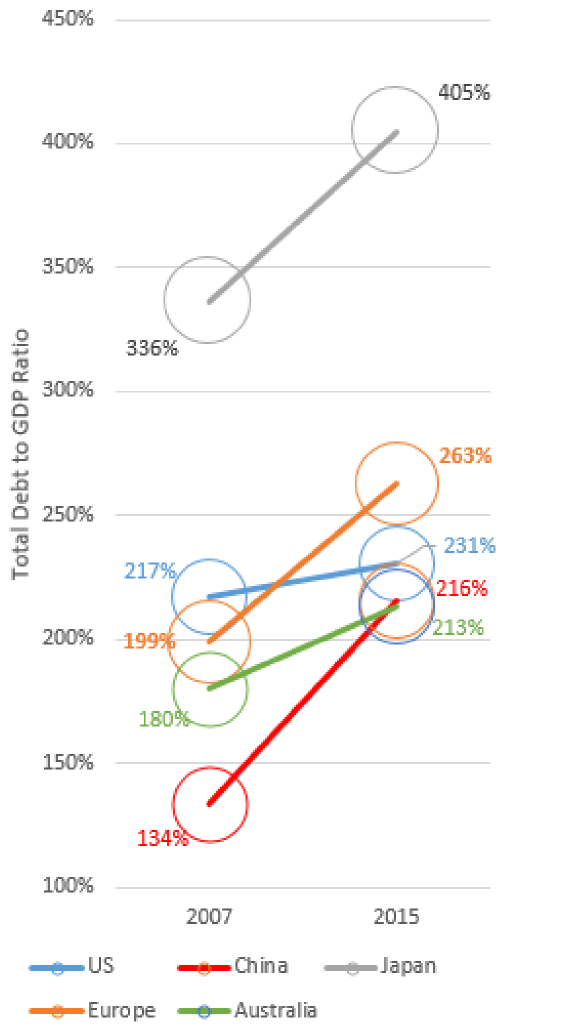
There are three primary causes of the sudden growth in private sector debt in China over the past eight years:

1. Property development

An estimated 45% of all Chinese debt is related to property. The mix is shown in Figure 2. Property construction alone represents 14% of all debt, and it is important to understand who the key lenders are to this sector.

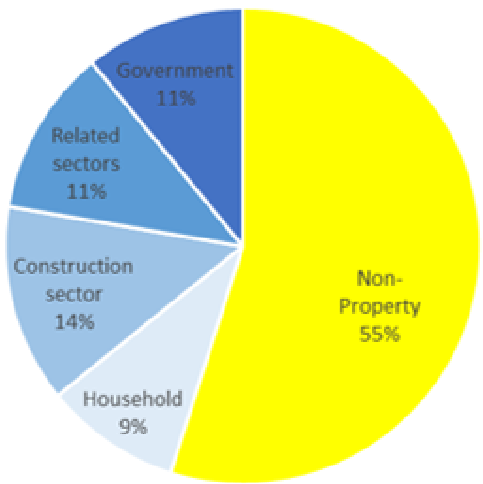
China shows a very high level of overdevelopment, particularly in Tier 3 cities where the average time

Figure 1: Change in Total Debt to GDP Ratios (Govt, Corporate and Household) 2007 to 2015



Source: McKinsey & Company, 2015; World Bank, 2016; Federal Reserve

Figure 2: Property-related debt (in blue) in China is nearly half of all debt (2014 data)



Source: McKinsey & Company, 2015; National Bureau of Statistics, China, 2016 to sell developments is around 40% above historic levels.

The unusual figure in this chart is the 11% of total debt that is owed by local government entities for property or infrastructure projects, far higher than any other country.

2. Household exposure and shadow banking

Household debt has grown from USD1.0 trillion in 2007 to USD4.4 trillion in 2015. Mortgage debt makes up USD2.1 trillion of this, but small business related loans have jumped from $0.3 trillion to $1.4 trillion over the last eight years.

Again on a standalone basis this is not out of line with the rest of the world. Household debt in Australia, for example, is 113% of the GDP, in the US it is 77%, in Europe around 70%, and in Japan 65%, compared to just 38% in China.

What is more concerning is the household sector's exposure to the property sector through 'shadow banking'. Shadow banking simply refers to finance providers that typically take deposits from households and lend to businesses, including property developers, such as the debenture finance companies in Australia and New Zealand, such as Westpoint.

Shadow banking now accounts for USD6.5 trillion including around USD4.5 trillion from households, and is growing at twice the pace of the banking system and three times government debt growth rates. Again a slowdown in property would severely damage the economy, this time through consumer confidence and spending.

3. Local government debt

Local government debt has increased by 27% per annum since 2007 compared to 11% pa growth for central government debt. Local government debt now sits at USD2.9 trillion or around the same debt as the entire German government. More than 70% of this relates to property, as above. The key concern for these local government entities is the reliance on land sales to repay the debt, meaning that if the property cycle suddenly slows, many of these entities will be forced to refinance, placing considerable stress on the banking system, as much of this debt is via financing vehicles funded by the banks.

Strategy

For Australian investors, this emerging debt situation must be watched carefully throughout 2016. It is becoming the largest threat to the Chinese economy. China's health in turn is the largest threat to the Australian economy, its currency and its equity market. Investors looking to hedge their own wealth against a shock to the Chinese economy can either shift risky assets into safe harbour assets such as infrastructure bonds or equity; or they can place some of their Australian dollar positions into USD or GBP positions to profit from the falling AUD that would most likely follow any increase in risk relating to China's indebtedness.

Craig Swanger is Senior Economist at FIIG Securities Limited, a leading fixed interest specialist. This article is general information and does not consider the circumstances of any individual.

Each year, FIIG Securities produces its Smart Income Report on the economic outlook and macro trends, and the 2016 version can be obtained on request, linked here.

Family home no longer the sacred cow

Rachel Lane

On 1 January 2016 the government changed the *aged care means test* for people who choose to keep and rent their former home, such that the rent is now included. However, the home, and any rent received, are still exempt from the calculation of *pension entitlement* where the resident is paying a Daily Accommodation Contribution (DAC) or a Daily Accommodation Payment (DAP) … for now.

An example of home and rent assessment

We have already seen the impact of the change. The most interesting was a couple where the husband had been living in care for some time and his wife moved into the same facility this year. They decided to keep and rent their home to assist in meeting the cost of care.

The husband is paying a DAP and moved into care prior to 1 January 2016. He meets the rent exemption criteria so his half of the rent was not included when calculating the means-tested care fee. Paying a DAP also meant that the rent and the asset value of the house remain exempt when calculating pension entitlement. Because his wife is no longer living in the home, he has $159,423 of the house asset value included in the calculation of his means-tested care fee.

The wife entered care in 2016 and so her half of the rent is included in the calculation of her means-tested care fee together with the capped asset value of $159,423 for the house. As she is also paying a DAP, the asset and rent will still be exempt for pension purposes.

This is certainly different to the way in which assets and income of a couple have been assessed historically, but changing means tests is something we can expect to see more of as the government tries to manage the expense of an ageing population.

Further changes are coming

In fact, the next round of changes could be less than a year away. The government's Mid-Year Economic and Fiscal Outlook (MYEFO) included a policy decision to include rent from the former home in the calculation of *pension entitlement* from 1 January 2017. The current asset test exemption on the value of the home where the home is rented and aged care accommodation costs are paid on a periodic basis would also be removed.

Beyond this we are only a hop, skip and a jump away from having some or all of the family home included in the pension assets test. Of course that's easy to say but hard to do.

The difficulty lies in two issues:

1. the fact that house prices across the country vary widely, both from one capital city to another and between cities and regional areas, and
2. how people will get access to the capital tied up in the family home to provide themselves with the cash flow they need.

Let's say the government included the value of the home in the pension assets but increased the asset test thresholds by $500,000.

In Sydney, Melbourne, Brisbane and Perth where the median house price is above $500,000 pensioners would see a reduction to their entitlement, with the most significant reduction being in Sydney where the median price is currently around $885,000.

In Adelaide and Hobart where the median price is below $500,000 some people would be able to exempt the full value of their house and some of the assets outside, potentially receiving more pension than they do now. The median house price in Hobart is only $350,000.

Accessing capital in the home

From the point of view of accessing the capital in the home, most people naturally think of reverse mortgages. But many reverse mortgage products are not available to people under the age of 70. The few products that enable people to borrow from the age of 60 typically set the amount someone can borrow between 15% to 20% with an increase of 1% each year thereafter. Let's say the person was 65 with a $750,000 house.

The current Pension Loan Scheme (where people can 'top up' their pension to the maximum entitlement by creating a debt with the government secured by the home) may prove to be much more popular. The current interest rate for the Pension Loan Scheme is 5.25% with interest compounding fortnightly.

It is not an easy problem to solve, but a solution will be found and as always there will be winners and losers.

From an aged care perspective, removing the exemptions that apply to the family home and any rent is likely to encourage residents to pay for their cost of aged care accommodation by lump sum. In fact, beds that have a higher price Refundable Accommodation Deposit (RAD) may become the bed of choice as residents try to preserve capital and maintain their pension entitlement. Unfortunately for the rest, this is likely to create upward pressure on prices.

Rachel Lane is the Principal of [Aged Care Gurus](#) and oversees a national network of financial advisers specialising in aged care. This article is for general educational purposes and does not address anyone's specific needs.

Top technical queries driven by legislative change

Minh Ly

Every month Challenger receives hundreds of calls from financial advisers. Most recently, questions about how new and upcoming changes to social security means testing may affect their clients have dominated the calls.

These are the top three topic areas from adviser queries:

1. Assets Test changes

What's changing and how does it impact my clients?

From 1 January 2017 the Assets Test lower thresholds increase (Table 1) and the taper rate will double from $1.50 to $3 per $1,000 of assets per fortnight. The higher thresholds allow clients to hold more assets before their pension starts to reduce under the Assets Test, which can lead to higher pension entitlements.

However, the increased taper rate reduces pensions at a faster rate once assessable assets are above the new Assets Test thresholds, with the largest reduction in pension entitlements (estimated in Table 2) occurring at the new lower asset cut-off thresholds (Table 1).

What about other considerations that I should be mindful of?

- Pensioners who lose their entitlement (and their pensioner concession card) will be provided with the Commonwealth Seniors Health Card (CSHC) without the need to satisfy the CSHC's Income Test.
- A reduced pension bonus (for those who are registered) as the amount of the pension bonus is based on the retiree's means tested Age Pension entitlement at the time of claim.
- A grandfathered account-based pension (ABP) becoming deemed where the client's pension entitlement reduces to nil. When combined with the capping of deductible amounts for defined benefit pensions from 1 January 2016, the additional deemed income from the ABPs can lead to higher levels of assessable income.

What strategies can help?

To help enhance outcomes for their clients, advisers have been considering a combination of Assets Test friendly investment strategies. One strategy is the use of a lifetime annuity to support ongoing cash flow requirements and to help improve pension entitlements over the retiree's lifetime. Other strategies include gifting within allowable limits; appropriate valuation of personal assets; funeral bonds up to $12,250; prepaying funeral expenses; and contributing funds to a spouse's super fund who is under pension age.

2. Removal of the rental income exemption

What's changing and how does it impact aged care residents?

New residents entering residential aged care from 1 January 2016 no longer have rental income from renting their former home excluded from their aged care income assessment.

Prior to 1 January 2016 where the former home was retained, rented out and the resident was liable for a periodic accommodation payment, the rental income

Table 1: Assets Test lower and cut-off thresholds

Assets Test lower and cut-off thresholds	Lower thresholds (as at 20/03/2016)	Cut-off thresholds (as at 20/03/2016)	Lower thresholds (from 01/01/2017)	Cut-off thresholds (from 01/01/2017) *
Single, homeowner	$205,500	$788,250	$250,000	$547,000
Single, non-homeowner	$354,500	$937,250	$450,000	$747,000
Couple, homeowner	$291,500	$1,170,000	$375,000	$823,000
Couple, non-homeowner	$440,500	$1,319,000	$575,000	$1,023,000

** Source: www.scottmorrison.dss.gov.au, Fairer access to a more sustainable pension*

Table 2: Estimated maximum pension reduction

Pensioner status	Estimated maximum annual pension reduction *
Single, homeowner	$10,042
Single, non-homeowner	$8,190
Couple, homeowner	$14,467
Couple, non-homeowner	$12,615

** Source: www.scottmorrison.dss.gov.au, Fairer access to a more sustainable pension* was not assessable when working out their means tested care fee (MTCF).

While this strategy is still available to aged care residents from 1 January 2016 and continues to be beneficial from an Age Pension perspective, the rental income will no longer be exempt for aged care. This will generally lead to an increase in assessable income and the resident's aged care fees.

What can people do in response?

Where this leads to the sale of the home, clients may seek advice on investments that specifically address their aged care needs. Some recent product innovations are now available which can help provide residents with regular cash flow and estate planning certainty.

Where the home is retained (e.g. occupied by a family member or previous carer), additional strategies might become critical. These can include deducting daily accommodation payments from lump sum accommodation payments, accessing equity in the home or seeking assistance from family members.

3. Estate planning for income streams

My client has died, what happens next?

The death of one spouse can have implications on the surviving spouse's social security pension as they will be assessed using the single rate of pension and Income and Assets Test thresholds. As income stream products are fundamental to retirement income planning, the Centrelink and estate planning implications of these income streams on death are also critical.

Where an income stream reverts to a reversionary beneficiary, the assessable asset value of the income stream for Centrelink purposes will also pass to the beneficiary. For ABPs, this is the account balance, while for non-account based income streams such as annuities, it is the reduced asset value, worked out as:

Purchase price less (deduction amount x term elapsed)

The Centrelink/Department of Veterans' Affairs assessment of these income streams will generally not change on reversion. That is, the income stream's deduction amount remains unchanged and only the amount that exceeds the deduction amount is assessed as income. ABPs which commenced after 1 January 2015 or where grandfathered status has been lost, will have their income assessed using the deeming provisions.

In cases where the income stream pays a lump sum death benefit and is paid to a person other than the spouse, it will not form part of the surviving spouse's assessable assets.

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The value opportunity in Australian equity

Dr. Philipp Hofflin

Two interrelated topics have been occupying much of our thoughts in recent months. The first is the deep discount currently available in many areas of the market, including in energy and mining stocks. The second is the underperformance of 'value' as an investment style over recent years.

The opportunity in resources

The current valuations of some of the major resources stocks present an opening to buy high-quality companies at levels well below our assessment of their intrinsic worth. The major miners represent value even with commodity prices expected to be lower for a considerable period.

We were resources 'bears' at the height of the commodity boom, but since then there has been dramatic de-ratings of commodity share prices. In 2010, resources companies were significantly overpriced, but this has since reversed due to a dramatic decline in resources prices relative to the S&P/ASX 200 Index.

In our valuation process we calculate a fair value for all stocks. This fair value is calculated over three years, assuming all stocks trade at our valuation in three years' time. Using our methodology in 2010, we estimated that resources stocks were almost two and half times overvalued. Today, however, this same is trading at a 33% discount to fair value.

Or looking at it another way, as of the end of January 2016, the approximate 11% weight of resources in the Index is the lowest in 50 years (we have adjusted the financial weight to allow for the listings of CBA, AMP and IAG and added in Telstra, but not adjusted for changes in News Corp, to make the comparison as meaningful as possible). Even allowing for the bounce in March 2016, resources are still trading at the lower end of the historical ranges today.

Does this low resources weight not only reflect cycle low prices, but also the declining importance of mining in a more diversified economy? In reality, the reverse is actually true, in the sense that from 1967 to today mining exports as a percent of GDP have risen, particularly over the last ten years, as Asian demand has grown faster than the local economy.

Not all miners are created equal

Within the resources sector, we currently favour large diversified miners with cost advantages. In contrast, companies with high cost structures or high leverage may face greater stress during the post-China boom downturn. Junior miners and mining services companies generally have both higher debt levels and more volatile earnings.

This view is not based on any recovery or strong bounce-back in commodity prices. We have factored in the next couple of years of severely depressed commodity prices followed by a reversion to long-term equilibrium. The major miners remain cheap even if commodity prices remain lower for longer.

However, the major miners represent just a small part of the overall opportunity set. The kind of valuation distortion we have highlighted is available in other sectors and with other companies as well. We believe we are in an unusual period of history where the market is not focusing on 'value'.

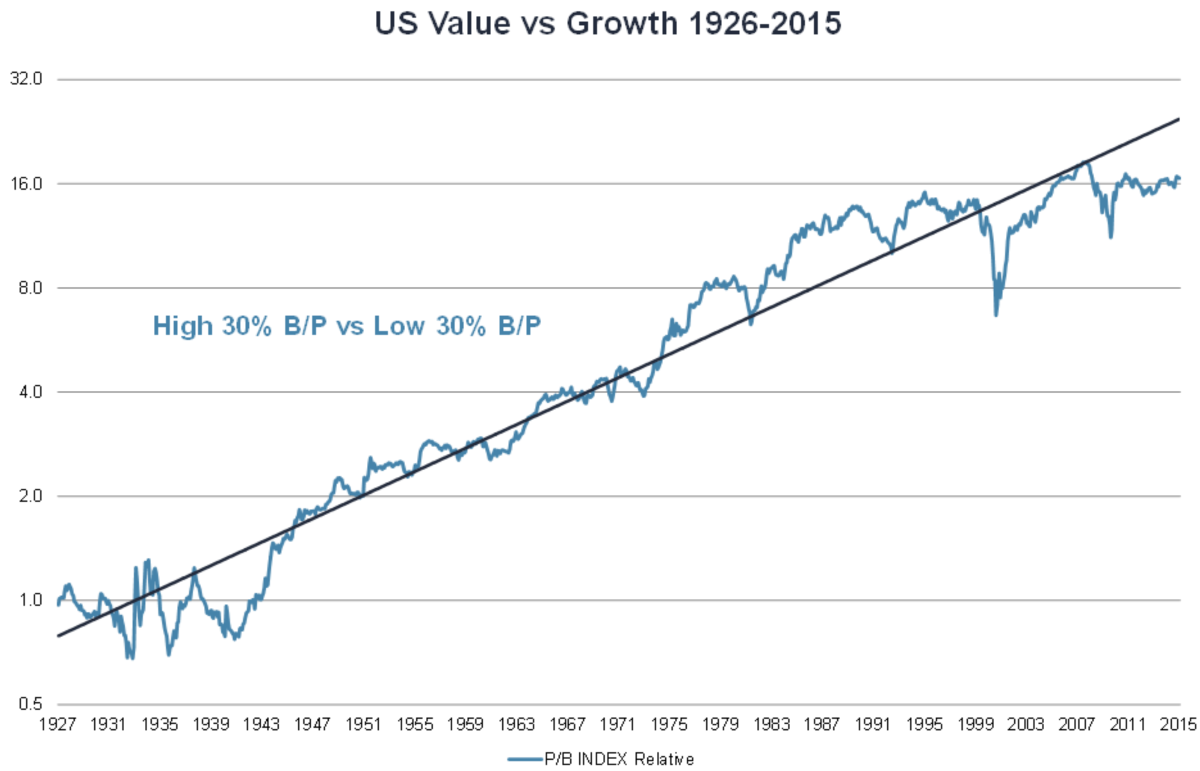
Valuation matters, now more than ever

For the purpose of illustrating this point, we will define 'value' as low price/book value stocks, and 'growth' as high price/book value. Put simply, 'book value' is a company's assets minus its liabilities, broadly giving the equity value or net worth of the business.

Historically, over the long term, buying companies based on cheap valuations has led to better returns. Since 1927, the cumulative return of the lowest 30% price/book value US stocks (a common measure to assess the cheapest stocks) has been 16 times higher than those with the highest valuations (Exhibit 1).

However, in recent years, in a reversal of the long-term historical trend, cheap securities (or companies with high dividend yield, low price-to-earnings multiples, or low price-to-book ratios) have significantly underperformed expensive securities in

Exhibit 1 - Value outperforms growth in the long run



Source: Kenneth French, Lazard. For the period July 1926 to November 2015 using data defined in Kenneth French's library.

Australia and around the world. Investors seem to have prioritised possible earnings growth and recent positive market performance (driven by momentum factors) over traditional value fundamentals.

Bouncing back

The good news for value investors is that while there are periods when value can underperform the market, it has always bounced back. In fact, historically, the best periods for value investing have been in the years following poor value returns.

In the recession year of 1990, the market sold down cyclical stocks to very low levels, which led to a long period of high value returns during the recovery. From 1998 to March 2000 the market inflated the prices of tech stocks and sold down so-called 'old economy' stocks to low levels, setting up dramatic outperformance for valuation-driven investors over the next four to five years. By June 2008, the valuation of mining stocks reached high levels, and these mining stocks subsequently collapsed. The unravelling of these price distortions enabled many value managers to outperform their benchmarks by a considerable margin in the years that followed.

We believe this cycle will ultimately be no different. When value metrics return to favour, value managers should be well placed to benefit given the valuation discrepancies currently in the market.

A company's valuation matters and it is going to matter even more after the market has ignored it for a considerable period of time. Making decisions that go against those of the market is not always easy, yet sometimes sentiment does give the long-term valuation-driven investor the investment equivalent of a long hop down the wicket for a cricketer. Now is one such time.

Dr. Philipp Hofflin is Portfolio Manager and Analyst in the Lazard Australian Equity Team. This article is general information and does not address the needs of any individual.