Cuffelinks
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This Week's Top Articles

Six factors guide when to sell your winners

Chris Stott

Having sold a 'winner' to realise a profit, many investors then feel frustrated as that company's share price continues to soar. The prospect of foregone gains can be exasperating, leaving investors wishing they'd waited until the price had peaked before selling.

However, this is incredibly difficult to achieve in reality. I can count on one hand the number of times I've sold a stock when its share price had hit its high.

So, when you own a stock that has performed strongly and it looks like it will continue to perform well, when should you sell? As an active, as opposed to a buy and hold, investor, determining when to sell shares is a critical part of our investment process at Wilson Asset Management.

Our approach means we have a tendency to sell before a share price peaks. One example is Ainsworth Game Technology (ASX: AGI). We started buying AGI shares at around 30 cents and selling them at $2.04 before they reached a remarkable $4.79.

Outlined below are some important factors that form part of our investment methodology and inform our decisions to sell our investments, including our winners:

1. Invest with an exit strategy

At the time we invest in a company, we ensure we have a strategy to exit our position. As part of this strategy, we have a clear valuation target for the securities and identify a catalyst we believe will re-rate that company's share price.

In theory, once it has hit our target valuation, we sell. In practice however, this scenario only plays out approximately 5-10% of the time. More commonly, we identify an additional investment catalyst we think will generate further upside and adjust our target valuation accordingly. Such catalysts may include an earnings surprise, or changes in management, regulatory environment, or industry structure.

2. Realise when the company is 'discovered'

Many companies we invest in are initially not well known or understood by the market. This can create a significant opportunity: once the broader market discovers that company's 'story' and recognises its value, its share price may climb. This is frequently a signal to sell as further share price growth may then be constrained. Two factors that indicate a company has been discovered are 1) when large institutional investors join its share register and/or 2) stock analysts initiate coverage of the company.

3. Watch for when the outlook changes significantly

When circumstances or events have an adverse effect on a company's outlook, this is a compelling reason to sell a winner. This is particularly important in the case of small to mid-cap stocks as they are more prone to be affected by one-off events and their share prices can be more volatile. An intimate understanding of a company, its operations and commercial drivers is crucial to identifying such circumstances or events that may impact the business's future prospects.

Until earlier this year, there was considerable enthusiasm in the market for companies leveraged to Chinese consumers and their demand for Australian products, such as vitamins and infant formula. At the time we owned Blackmores (ASX: BKL) and The a2 Milk Company (ASX: A2M), which provided excellent exposure to this trend and both companies had experienced strong share price growth. Based on our research, it appeared there was considerable regulatory risk building for these companies because of changes to online imports foreshadowed by the Chinese Government.

While the market's support for Blackmores and a2 Milk remained robust, we decided the emerging regulatory risk represented a major catalyst to sell so we sold out of both companies. Both remain well managed businesses with strong brand names.

We often form a negative view of a company when the majority of the market is still enthusiastic about its outlook. In our experience, it pays to take a contrarian approach and, as Warren Buffet has cautioned, be fearful when others are greedy.

4. Manage the portfolio re-balancing

When a stock has experienced a meteoric rise, it can quickly become a large proportion of a portfolio. Therefore, selling (or at least selling down) a winner can be a prudent risk-management measure. In the case of small and mid-cap companies, which can be relatively less liquid, we often sell down a position when short-term liquidity is created, for example, after a results announcement.

5. Let winners run

In our experience, there can be wisdom in the often-cited adage, 'let your winners run'. In some instances, a stock has reached our target valuation and there is no further identifiable catalyst to re-rate its share price. However, if we believe there is a degree of momentum in the market, we will maintain our position for a period.

When accommodation operator Mantra Group (ASX: MTR) made its market debut in mid-2014 at $1.80 a share, we invested and set a target valuation of $2.30. When Mantra hit our target price within a few months, we felt the market's enthusiasm would drive its share price higher given there was plenty of evidence that the tourism sector was improving due to the lower Australian dollar. We revised our initial target, maintained our position and eventually sold our Mantra shares at an average of $4.25 earlier this year.

When we started buying a2 Milk at 52 cents, our target price was 75 cents. We felt confident the company would announce an earnings upgrade due to demand outstripping supply. This belief was based on my personal experience of trying to track down a tin of the company's infant formula only to find there was a considerable shortage of supply. a2 Milk subsequently announced an earnings upgrade which surprised the market and saw their share price surge, surpassing our target. We continued to ride the momentum, ultimately selling at $1.68.

Proximity to the market and an understanding of the psychology of its participants can help in assessing whether there is momentum that could drive a company's share price. When a stock reaches a 12-month high, this can be a tangible measure of such momentum. Conversely, a 12-month low can indicate the company has lost the market's support.

6. Never fall in love with a stock

Depending on the investor's objectives, it is important to consider a range of factors when selling a winner. Establishing an exit strategy, developing an in-depth understanding of the company, and insight into the market's view of the stock is imperative.

Above all else, avoid forming an emotional attachment to an investment. Having spent considerable time and energy researching and understanding a company, its industry and its management, it can be difficult not to fall in love with a stock, particularly a winner. Yet an emotional attachment can inhibit your ability to properly evaluate the company and its prospects.

Chris Stott is Chief Investment Officer of Wilson Asset Management (WAM). This article is general information and does not consider the needs of any individual, and WAM may or may not hold some of the investments mentioned.

How rebalancing can help your portfolio (part 1)

Leah Kelly

As with most things in life, it is the less exciting aspects of managing a portfolio such as rebalancing that turn out to be the most important. So what does rebalancing mean? Quite simply, it's repositioning your portfolio back to target weights.

This is the first in a series where we explore different methods to rebalance a portfolio. There are plenty of ways to do this, but here we look at the simplest method – calendar rebalancing. This means rebalancing over a set period of time, and it can be done at different time intervals.

'Set and forget' performs worst in this example

Assume we started in August 1996 with $100,000 to invest and run the analysis for 20 years. We chose four stocks – BHP Billiton (BHP), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Woolworths (WOW). We set our target weights at 30%, 20%, 20% and 30% respectively. This is not about portfolio construction, so for illustrative purposes four stocks is enough.

We consider four scenarios; 'Set and forget', monthly, semi-annual and annual rebalancing. We rebalance our portfolio irrespective of what the stock price has done, what we think (or hope) it's going to do and simply buy or sell shares at the calendar end of the period to take our target weights back to our starting position. There is no emotion.

'Set and forget' lets us down here with a final portfolio value of $523,000.

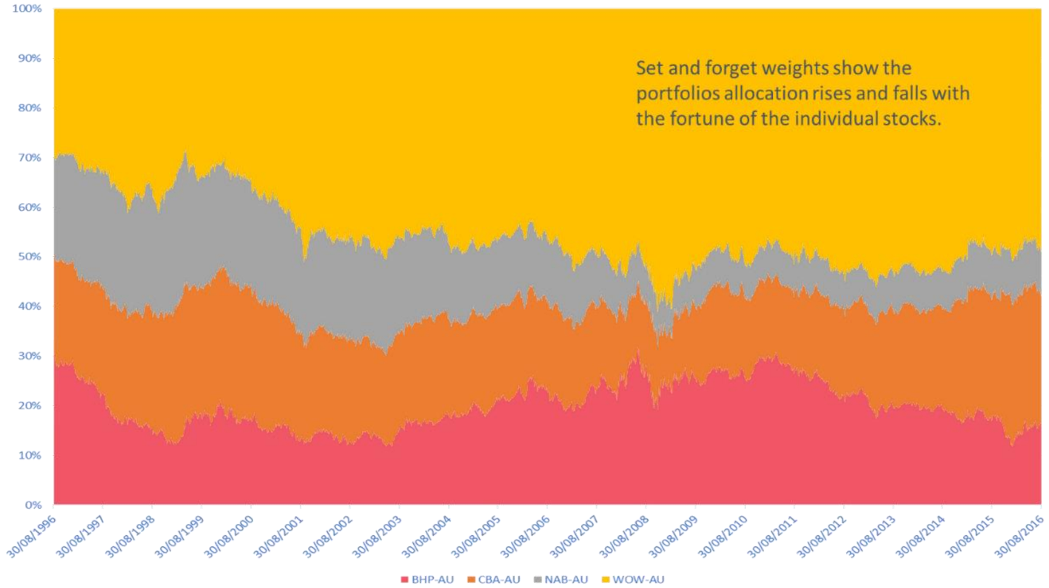
Source: FactSet, Owners Advisory, September 2016

However, simply rebalancing the portfolio (albeit a very simple portfolio) monthly gives a final portfolio value of $587,000, semi-annual rebalancing gives a final portfolio of $545,000, and for this type of portfolio, annual rebalancing adds no value. The total returns for these portfolios are shown in the table below:

	Cumulative	Annual
Set and forget	423.9%	8.63%
Monthly rebalancing	487.5%	9.26%
Semi-annual rebalancing	445.1%	8.85%
Annual rebalancing	423.7%	8.63%

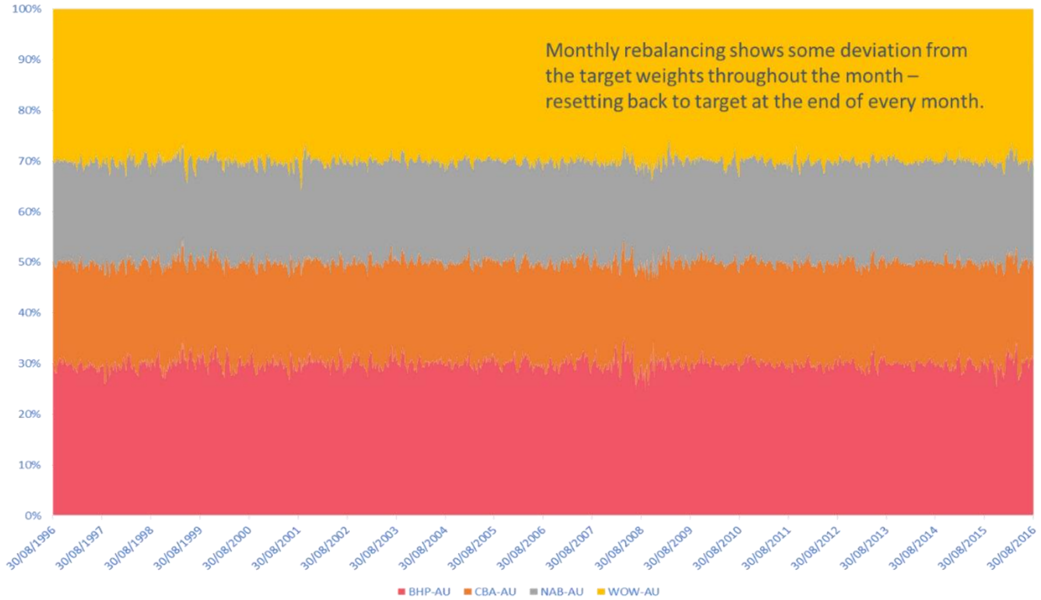
The performance difference from rebalancing is significant, particularly over a long period of time. Why? Let's look at two of these scenarios and the weights through time to show the story.

'Set and forget' weights through time impact performance



Source: FactSet, Owners Advisory, September 2016

'Monthly rebalancing' holds our exposures largely constant through time



Source: FactSet, Owners Advisory, September 2016

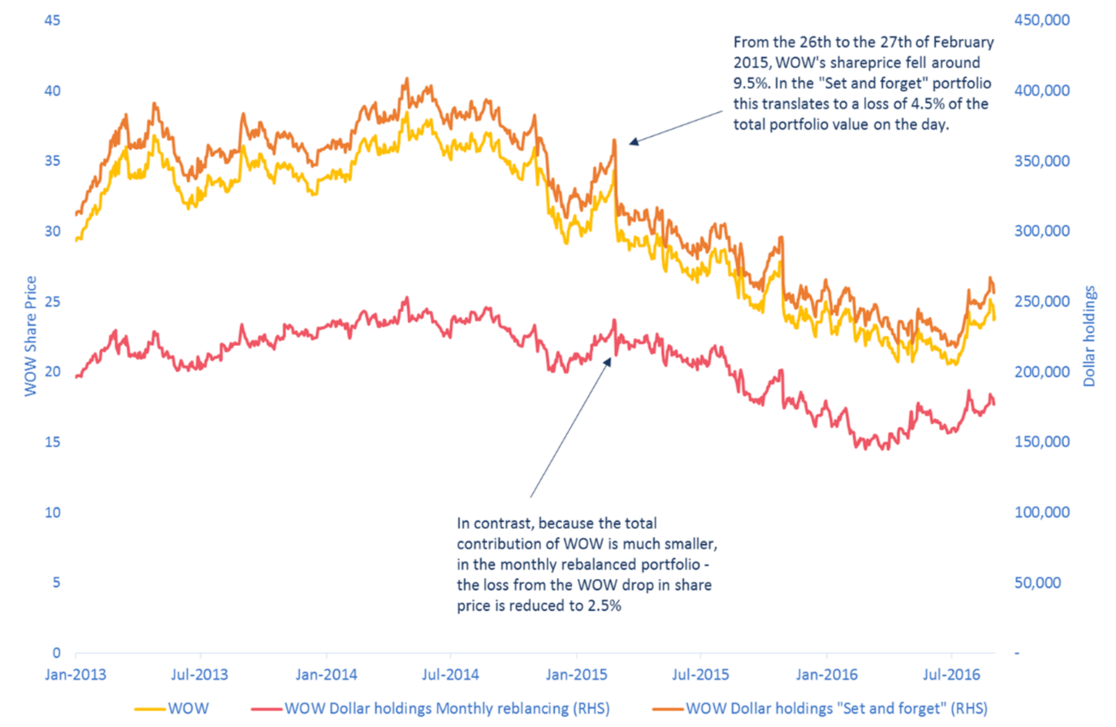
Buying low and selling high

Looking at the weights through time we see that, should we just set and forget, Woolworths becomes a large position in our portfolio. In fact, our dollar holding in the set and forget portfolio increases to over 50% of our portfolio.

In our monthly rebalancing, we begin to see why rebalancing performs the best for a concentrated stock portfolio. By design, we buy stocks when they have fallen below our target weight and we sell stocks when they have risen above our target weight. We are implementing the 'trader's catch-cry' of buying low and selling high simply because we have held true to the weights we started with.

The second reason why rebalancing helps is it is the simplest method of portfolio risk control. Consider WOW: in the set and forget portfolio, we have let our best performers run, which is a very tempting way to manage a stock portfolio. But looking at what happens when WOW reprices reveals the other side of why a rebalancing regime helps overall portfolio performance.

By 2015, in the 'set and forget' portfolio the dollar holdings in WOW has risen to approximately $400,000, as opposed to around $200,000 in the monthly rebalanced portfolio



Source: FactSet, Owners Advisory, September 2016

Woolworths fell 9.5% on 26 to 27 February 2015, costing us 4.5% in the entire portfolio on the day ($30,000 in dollar terms). However, in those portfolios where we have controlled our total exposure to a single stock, we see that while we still suffer a loss, it is only 2.5% of the portfolio's value ($18,000 in dollar terms).

Simply having the discipline to hold shares at predetermined weights can go a long way to adding value to the total portfolio's returns over the long term.

In the next instalment, we look at using the percentage deviation from target weights as our rebalancing trigger to see whether we can improve our overall portfolio performance by being just a little bit more sophisticated.

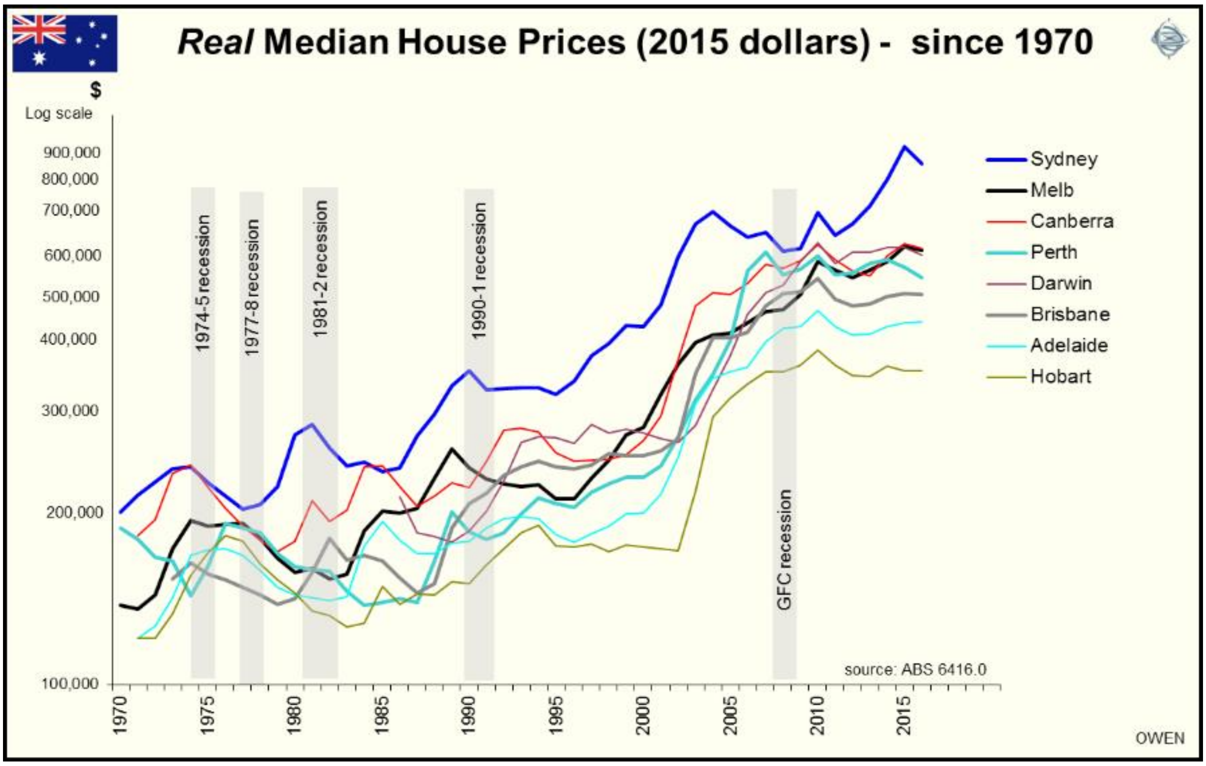
Leah Kelly is Portfolio Manager at Owners Advisory. This article is general information and does not consider the circumstances of any individual.

Australian house price rises slow, while US recovery continues

Ashley Owen

House prices in Australia suffered only about half of the declines seen in the United States during the GFC. They then resumed their climb in 2012, fuelled by cheap debt courtesy of 12 interest rate cuts by the Reserve Bank of Australia since November 2011.

The chart below shows real house prices (i.e. after inflation) in the major capital cities over the past 45 years.



Prices have fallen in each of the major economic contractions, but have generally moved steadily upward for more than a century. Growth in house prices has been driven largely by steady population growth (mostly from immigration) in each of our main cities, a feature that is unique in the world.

Rises softening but support remains

House prices have started to soften in all the major markets over the past year. The local economy is heading for a slowdown with the end of the mining boom and the upcoming end of the housing construction boom, but there are several factors that should provide some support for house prices:

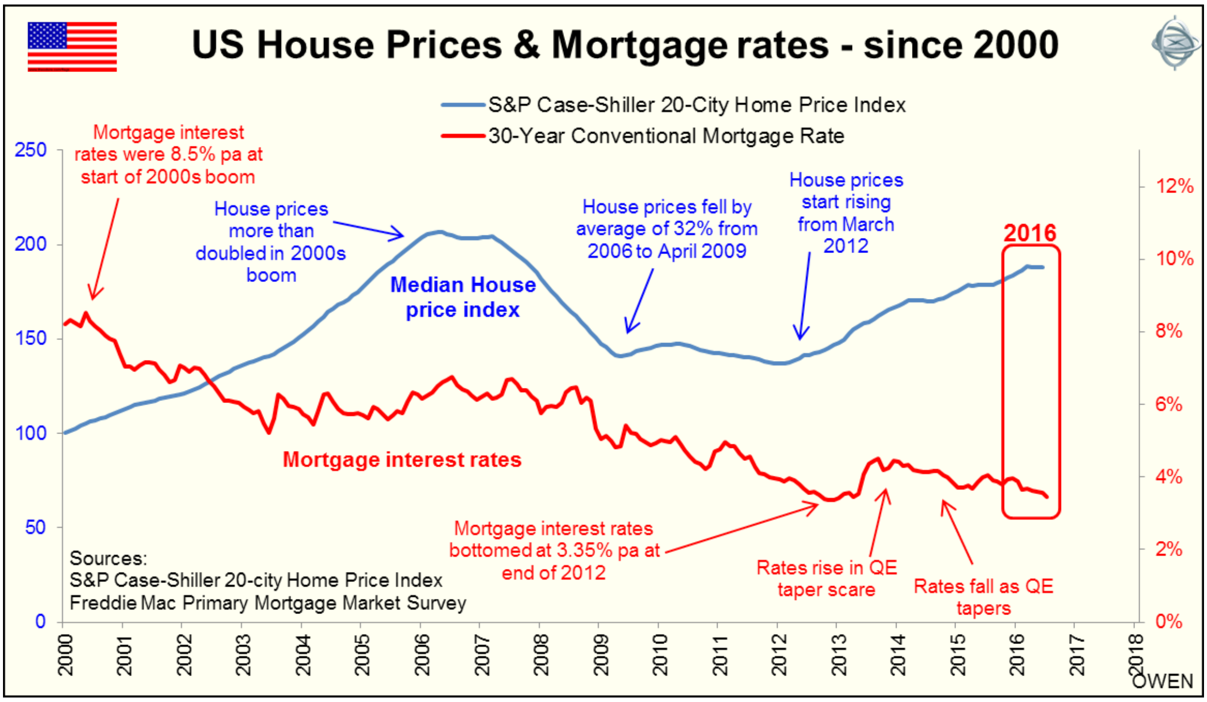
1. Interest rates are low and more cuts are on the horizon
2. Banks remain keen to keep lending on housing (but little else)
3. There is a seemingly never-ending flood of cashed-up immigrants (and locals) looking to buy here
4. Potential changes to superannuation rules may encourage more investment in the family home, which is likely to remain free from capital gains tax.

The high rise apartment market, however, is another story altogether. In the coming year or so we will probably see many thousands of high rise unit buyers in Melbourne and Brisbane lose money (and even lose their main houses as well) as they struggle to obtain finance to complete their purchases at boom-time prices.

US housing – recovery on track

Readers often ask why I pay so much attention to bond markets. One reason is that they are critical to the US housing market (unlike in Australia) and that in turn is an important driver of the US economy, which is still the engine of world growth and investment markets.

The US housing finance bubble was the underlying cause of the 'sub-prime' crisis that triggered the deepest US and global recession since the depression of the 1930s. It is also central to US economic recovery. House prices across the US more than doubled during the 2000s boom but then crashed by more than one third on average in the bust, with many cities suffering declines of 60% or more. Prices have been recovering steadily since early 2012. The key has been mortgage interest rates, which have come down from 8.5% in 2000 to below 4% since 2012.



Most Australian mortgage interest rates are variable and driven by short-term interest rates, so mortgage borrowers here are directly hurt by cash rate hikes. But the US market is different. Most US mortgage rates are fixed for up to 30 years and linked to long-term bond yields.

Because of this, as the Fed raises short-term rates in the coming years, long-term bond yields (and with them mortgage interest rates) may stay relatively low. Even when economic growth and inflation rates do rise (which they surely will in time), there is a good chance that each Fed rate hike will dampen expectations of future inflation and work to keep long yields relatively low.

Ashley Owen is Chief Investment Officer at independent advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities.

Why bother with hedge funds?

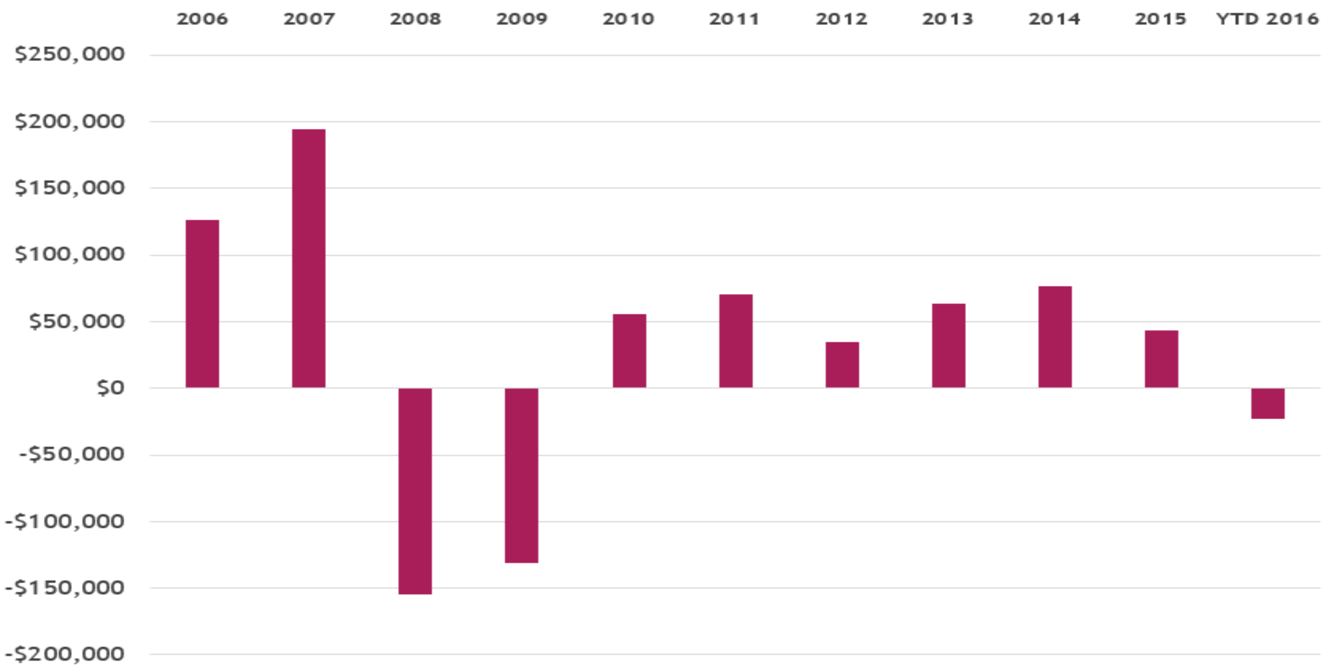
Craig Stanford

If you read the typical hedge fund headlines, you'd think institutional investors were abandoning them in droves. Common issues cited include subdued performance and high fees. In this article I discuss hedge fund performance, the role they play in multi-asset portfolios and how we manage hedge fund investments.

It's intriguing to hear about well-known investors redeeming their hedge fund assets for performance reasons, and I'm curious about their expectations and whether they were reasonable.

Given there is a huge range of hedge funds available, it also makes me wonder if the investor had any constraints (perhaps related to resources, experience, fees or liquidity) and whether these were consistent with their expectations of the hedge fund manager. Perhaps their liquidity or fee constraints prevented them from hiring better hedge fund managers. The fact is that many hedge fund investors are pleased with their chosen hedge funds and that net flows from institutional investors have been positive for many years, with the exception of the last few months. Recent reports from Barclays (*Coming to Terms*) and JP Morgan (*Institutional Investor Survey*) confirm that, as a group, institutional investors continue to allocate more to hedge funds despite what the headlines would have you believe.

Net asset flows (US$M) to hedge funds, 2006 to 2016



Source: Alternative Investment Management Association (AIMA) and HFR.

The role of hedge funds

So what role were hedge funds expected to play in a portfolio context? Did investors expect them to have a negative correlation to equities all the time (to decrease their equity risk), or did they want a highly concentrated equity manager that increased their exposure to equities? It is important to have this well framed at the outset and to understand the associated costs.

If an investor wants a fund that is guaranteed to produce positive returns during equity down markets, are they willing to sacrifice option premium any time the market advances? The benefits we expect from hedge funds include capital preservation, lack of equity correlation during difficult market events and access to otherwise unavailable return streams.

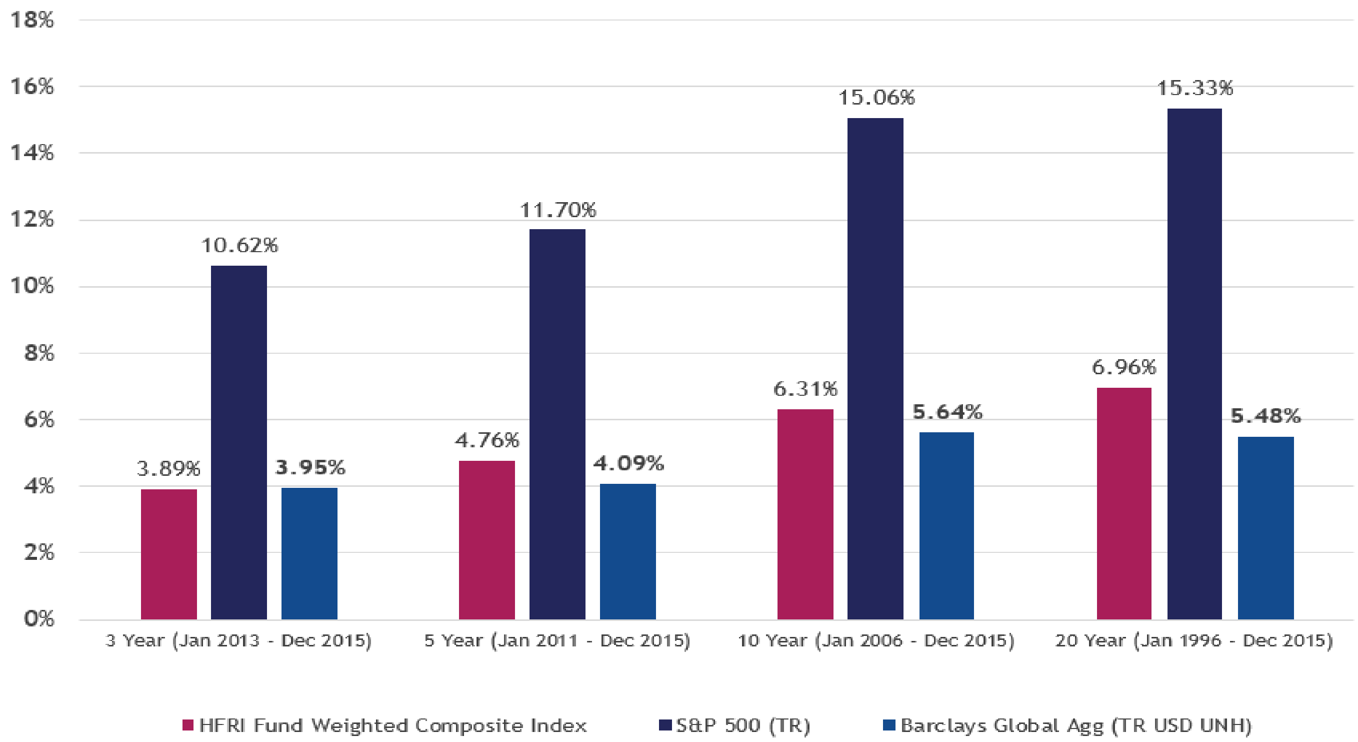
We often see a direct comparison of returns between hedge funds and equities, normally with a headline along the lines of 'equities outperform hedge funds', but never the reverse. This of course could be true at any time, but does it really matter? It is worth bearing in mind that hedge funds invest across many different asset classes and target exposure levels that are quite different to equity indexes, so comparing them to any single asset doesn't make much sense, even though it does make a good headline.

Direct comparisons also fail to take into account the different types of risks inherent in each investment. You rarely read extended stories about equities outperforming bonds, for instance, because most people understand that the risks involved in each are quite different, so it makes little sense to compare them. To this point, I find it surprising that a large number of investors think that hedge funds in aggregate are riskier than equities even though any research I have seen would point to a well-managed portfolio of hedge funds being substantially less risky than equities (in terms of capital preservation and volatility).

While we think of risk as multi-faceted, highly subjective and impossible to reduce to a single number, for the purposes of this study we'll use volatility as a risk proxy because it has gained wide support from investors. On this basis, since 2009 we have seen a decrease in the volatility of most hedge fund returns and current levels are 20% below the average of the past 15 years. Equities on the other hand are currently running at volatility levels approximately 20% above the average for the same time period.

Additionally, hedge funds in aggregate display a far lower level of volatility than equities due to their active risk management. The graph below shows the significantly lower volatility of the hedge fund composite index than the main equity index.

Annualised volatility of hedge funds, S&P500 and global bonds.



Source: AIMA Research

There is a widely held but largely incorrect view that, due to the use of techniques such as shorting and leverage, hedge funds are riskier than traditional long-only equities. These techniques create different risks, but that doesn't necessarily make hedge funds any riskier. There may be individual funds that are riskier than equities, but the vast majority of hedge funds use these techniques to reduce, not increase their risk. Of course, the results will vary among managers due to their skill in applying the techniques, but in aggregate hedge funds are substantially less risky than equities using almost any commonly accepted measure of risk.

US stocks have outperformed hedge funds in recent years, but longer-term performance going back decades shows hedge funds delivering significant outperformance, especially on a volatility-adjusted basis. At certain times it is normal for hedge funds to underperform equities, but over time their ability to protect capital during tough times can result in their outperformance. We continue to believe that investors and financial advisers should reconsider the role and benefits that hedge funds can play in a diversified investment portfolio.

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Gold can play a role in SMSF portfolios

Jordan Eliseo

Physical gold has been one of the best-performing assets this year, rising 20% and currently sitting at about $1,750 per troy ounce. This continues a strong run dating back to the turn of the century, with the precious metal appreciating close to 9% per annum over this period.

Yet despite these solid returns, gold is barely on the radar of most investors: less than 0.5% of total global pension fund assets are held in gold. In Australia, demand from SMSF trustees is rising, though it's coming off a very low base. According to ATO data and recent asset allocation statistics from SuperConcepts, less than 1% of SMSF funds hold 'other' assets, of which physical gold is a small component.

With prices near their highs, some investors feel they've missed the opportunity to profit from this cycle, though banks like UBS are upgrading price forecasts and JP Morgan stated that gold had entered 'a new bull market' earlier this year. No one can be sure how long it will last, though the average bull market lasts for just over five years, recording gains of 385%, according to the World Gold Council.

Trading and storage

Physical gold can be bought and sold 24 hours a day, with trading premiums of less than 1% of the value of the metal, depending on which products, volumes and bullion dealers you choose.

For SMSF trustees, it is best practice to stick to investment grade cast bars, rather than coins and tablets, which come with higher trading costs.

Gold can be stored in three different ways:

- Pool allocated metal: investors buy a claim on a pool of physical gold managed by a bullion dealer on behalf of all investors. There are no storage costs associated with this method.
- Secure storage: investors buy an actual physical bar (or bars) that they own. Annual costs for this range from 0.75% to 1% of the metal's value.
- Private vaulting: physical bars are stored in the investor's own vault. This can be done for as little as $252 per year, which works out at just 0.25% on a $100,000 investment.

Volatility and income

Price volatility and lack of income are legitimate concerns that any gold investor must be comfortable with. The volatility of annual returns for Australian dollar gold over the past 15 years has been around 12%, higher than that of traditional defensive assets like bonds, though lower than the volatility that equity market investors have endured over the same time period.

While it is true that gold will never provide income, traditional investments like term deposits also provide little income at the moment, and frustration with record low interest rates is forcing investors to look at alternative assets.

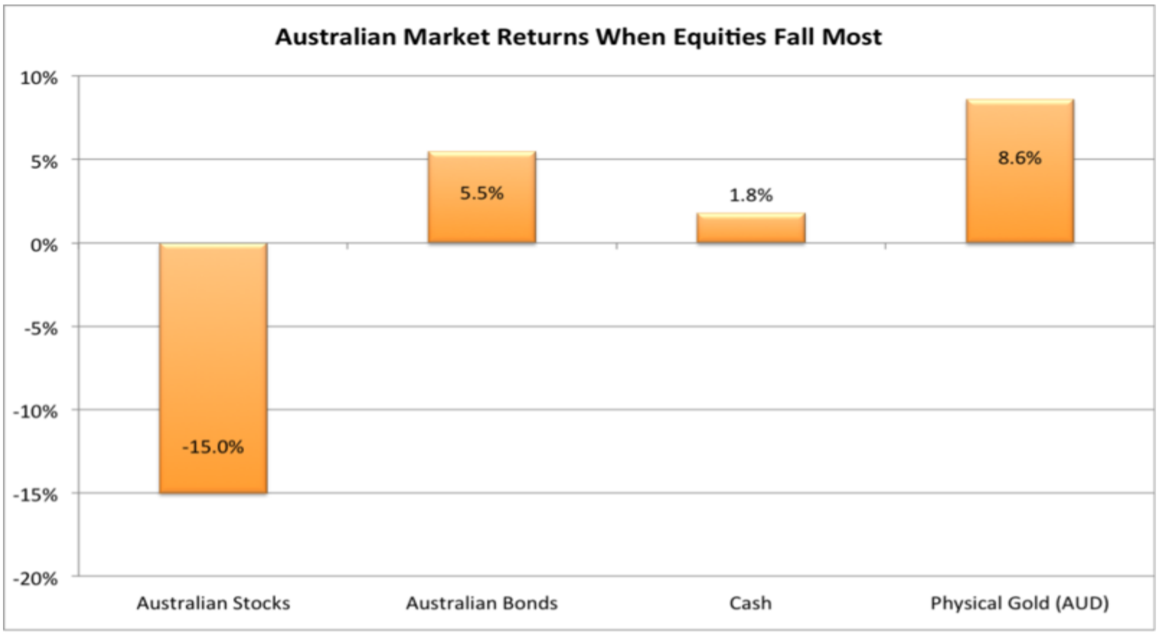
There are no guarantees, but if history is any guide, gold is one of those alternatives where prices tend to rise fastest in low 'real' interest rate environments, like the one we are in today. The 'real' rate of interest is calculated by subtracting the inflation rate from the official overnight cash rate set by the RBA, and is currently sitting at just 0.5% in Australia (1.5% RBA rate minus a 1% CPI rate as at the end of June 2016). Since 1971 (when gold prices became free floating), the yellow metal has recorded average annual price gains in excess of 20% in years when the 'real' rate of interest was below 2%, outperforming both stocks and bonds in the process.

Hedge against equities

Gold historically performs strongly whenever the ASX is falling. In our book, *Gold for Australian Investors*, we analysed market returns for a variety of asset classes over a more than 40-year period, again starting in 1971. That study (inspired by a Q3 2015 research piece from AQR Capital Management, titled *Good Strategies for Tough Times*) found that physical gold was the best performing liquid asset in the 10 worst performing quarters for global equity markets.

This is captured in the chart below, which highlights the average performance for gold, as well as the average performance of Australian stocks, bonds and cash in those calendar quarters where global equity markets fell most.

Australian market returns when global equities fall most (calendar quarters since 1971)



Source: Gold for Australian Investors, Global Financial Data.

Obviously no one wants their shares to fall, but it does makes sense to have insurance against it happening, especially in an uncertain economic environment. Whether gold is the highest-performing 'risk off' asset in years to come remains to be seen.

Central banks and emerging markets

SMSF trustees should be aware that the gold story is not all about rising demand from Western investors seeking a hedge against equities, or a cash alternative due to low interest rates. Gold prices will also benefit if consumers in emerging markets continue buying, with demand from these regions highly correlated to rising disposable incomes.

Central banks are now buying more than 500 tonnes a year, yet developing market central banks still hold less than 5% of their foreign exchange reserves in gold, versus a nearly 20% average for their advanced market counterparts.

No one can be sure what central banks will do next, but with over US$13 trillion in negative yielding sovereign debt, gold could become more attractive to emerging market central banks. Ken Rogoff, ex Chief Economist for the International Monetary Fund, stated in May this year that emerging market nations should increase their pace of gold accumulation, as the metal is both 'highly liquid' and 'low risk', both key criteria for reserve asset managers.

Jordan Eliseo is Chief Economist at ABC Bullion. This article is general information and does not consider the circumstances of any individual.

Compulsory super will not be enough to avoid full pension

Rick Cosier

There has been much Cuffelinks coverage of the government's proposed superannuation changes. Whilst this is a pressing matter now, it is disguising the major issues facing us in the future.

According to the ABS, there were 3 million Australians aged 65 or over in 2015. The National Commission of Audit statistics show that 2.4 million people claimed the age pension in 2014, with over half of them receiving the full pension. By 2050, the ABS figures indicate there will be about 8 million Australians aged 65 and over.

It is widely assumed that most of these people will be self-supporting because of the super guarantee charge (SGC). I would suggest this may be extremely optimistic.

Reality at the coalface

I am the listed financial adviser on a number of workplace superannuation plans. Five of them have a relatively young workforce where the average member age is 30. The average super balance is about $30,000 and the average salary is around $60,000. The 9.5% SGC creates $5,700 of annual super contributions. If their salary rises in line with CPI, and the SGC percentage doesn't change and they do not make any additional contributions, how much super will they have by 2050 if we assume an average annual return of 7.5% (which is optimistic, and it's likely to be far less)?

According to the Colonial First State superannuation calculator, a person with this background (let's call him Joe) will accumulate $343,000 in today's dollars in 2050 when he is age 63. Will Joe carry on working? An ABS study in 2012–13 (the Multipurpose Household Survey) found that the average age at retirement for recent retirees (those who had retired in the previous five years) was 61.5 years. The study also found that the average intended retirement age for current workers was 63.4.

My experience is that until their late 50s, most people envisage working to 65 and beyond. By the time they reach 60, practically everybody is counting the days to retirement. At that age, hardly any of them were still in well paid, full-time jobs. Consequently, finishing full-time work at 63 is a realistic outcome.

Still rely on the full age pension

Let's say Joe is married to Josephine who is the same age. It is unlikely that Josephine will have accumulated the same amount of super as Joe. According to the Workplace Gender Equality Agency, in 2015 the average woman retired with 53% less super than the average male. ABS stats confirm these percentages. On this basis Joe and Josephine will have a combined balance of about $500,000 in super at age 63.

Let's assume they live in their own home, have a small amount of cash and no other assets. The Association of Superannuation Funds of Australia (ASFA) reckons that a couple needs $59,160 a year for a comfortable lifestyle. Joe and Josephine can't claim the age pension until they are 67 so if they don't have any non-super investments, part-time work and drawing down on their super are the only options for the four years after retirement. If we assume they can both find part-time work earning $20,000 a year (on which they will pay no tax), they need to draw down $10,000 a year each from their super to achieve the ASFA target.

If they do this, they could still have $500,000 super by the time they fully retire aged 67. At this stage, they will receive about $15,320 a year in age pension based on the new assets test rules scheduled for introduction on 1 January 2017. If they fund the remaining $43,840 a year ASFA target from their super, their age pension will steadily rise until they are about 76 when they qualify for the full age pension of $31,200 a year.

The only way that Joe and Josephine will not be a burden on the state and draw a full pension is if they make salary sacrifice contributions or accumulate assets outside super. The number of 30-year-olds that salary sacrifice is virtually zero. Generally speaking, they have much more debt than previous generations. They start work later, get married later, have children later, and buy a home later. The result is that as they progress through life, cash flow gets less and less.

In my experience, hardly any households comprising two workers, children and a mortgage have a spare dollar. Loan repayments, child care costs and spending patterns suck it all up. In this environment, it is difficult to see how they can make significant contributions to super to supplement the SGC. Worse still, many households are already dependent on some kind of lump sum injection to pay off their debts when they retire.

When are politicians going to wake up to the fact that it is going to be impossible for the budget to finance 8 million Joes and Josephines to receive the full age pension at age 76. The benefits of superannuation need to be explained and marketed to a disbelieving nation. The continuous negative publicity is doing great harm, and it will not end well.

Rick Cosier is Principal of [Healthy Finances Ltd](). This article is general information and does not consider the circumstances of any individual.

Unconventional monetary policy is now conventional

Anne Anderson

The speech delivered by Janet Yellen, Chair of the Federal Reserve, on 26 August 2016 at the Jackson Hole symposium titled *The Federal Reserve's Monetary Policy Toolkit: Past, Present, and Future* offered a unique insight into how the Fed (and by implication how other global central banks) will conduct monetary policy in the years ahead.

'Equilibrium' cash rate lowest in 50 years

There is a need to build policy resiliency and flexibility, which is especially important with the equilibrium or normal real cash rate materially lower than it has been over the 40 years leading up to the GFC. In practical terms, the normal real cash rate is where inflation is seen to be stable and output on average is close to potential. It is entirely plausible the normal real cash rate is now close to zero, compared to around 2.5% in the past. Significantly, the result is that the scope to raise nominal interest rates to levels that prevailed in past cycles will be very limited and unnecessary given the future prospects for growth and inflation.

The subdued medium-term growth and inflation outlook reflects weaker employment and productivity outcomes inhibiting consumption, a lack of attractive projects for capital investment, and demographic factors such as declining population growth. In some countries such as Japan and across Europe, the issue is more acute and this is where official cash rates have been moved into negative territory. There is strong evidence that negative rates have arrested a steeper decline in output and growth than otherwise – especially in the absence of the political and economic power to expand fiscal policy when sovereign debt burdens were so high.

Janet Yellen has messaged several important thematics shaping the Fed's thinking, including the future monetary policy framework which will include an expanded monetary policy toolkit. There is no going back to the conventional and simple adjustments to the policy cash rate. The so-called unconventional monetary policy measures will remain in scope for years to come. This means central banks will have much larger balance sheets, they will continue to use forward guidance, make targeted asset purchases and, as required, change the level of interest rate paid on excess reserves banks hold with the central bank.

Negative rates counterproductive

By its omission, it may be concluded that the US toolkit does not contemplate negative official cash rates. There is mounting evidence that negative rates adversely impact bank profitability which could ultimately weaken the stability of the financial system and at its extreme becomes a tax on savers. In parts of Europe, depositors are paying banks to leave their money on deposit, with a potential adverse impact on investor and consumer confidence. It can encourage distortions in other asset prices as investors hunt for yield.

We are also seeing a divergence in approach across central banks in the tools employed. This reflects a few factors – including weaker inflation and economic performance and the way the credit channel operates in different economies. For example, the European Central Bank, having moved to negative rates and purchased significant proportions of the European sovereign debt market, are now buying corporate debt. This reduces the cost of corporate borrowing by driving yields lower. Yellen's speech alluded to this approach: the ability if required to expand the types of assets purchased to be added to the toolkit. The Bank of Japan seems set to continue its expansion of balance sheets and further moves into negative rates, although clearly mindful of unintended consequences.

Even if rates rise, the peak will be very low

So where does this end? Not any time soon because there is no real alternative. Rates are set to remain very low for a long time with punctuations of volatility but not a sustained rise. We continue to look for a handoff to fiscal policy and even a recognition that some bank regulation is a disincentive to capital investment and inhibits the free flow of capital. For the Fed, a further policy tightening is likely before end 2016. Yellen refers to the asymmetry of risks and that there is no pre-set path. The Fed's approach will be gradual and data dependent. The nominal Fed funds rate peak in this cycle may be as low as 2%.

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