Edition 185, 9 December 2016

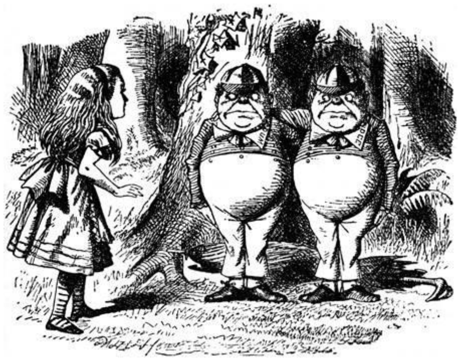
## This Week's Top Articles



# Five questions after Super Scott's Santa surprise

## Diana Chan and Jonathan Hoyle

"*Contrariwise*," continued Tweedledee, "*if it was so, it might be; and if it were so, it would be; but as it isn't, it ain't. That's logic.*"



Treasurer Scott Morrison has delivered the Christmas present to the financial planning industry that it had glimpsed six months ago but was too excited to actually believe – massive new complexity to the superannuation system. The body of Simpler Super has been incinerated, buried and interred. RIP Simple Super. In its place is a labyrinth of new rules that would make Alice wish she had never gone down the rabbit hole. Long live complexity, bureaucracy and tinkering governments. Quite what we have done to deserve this exhilarating Christmas present is a mystery, but we'll take it. The need for superannuation and wealth planning advice just became essential. Whatever next? Taxpayer subsidised advice (as the system is now utterly incomprehensible to all)? We are now prepared, like the White Queen, to believe six impossible things before breakfast.

First, some clarity for the lucky few who have had their superannuation retirement savings subject to hot debate over the past six months. You have some big decisions to make over the next six months. We highlight five questions of critical importance.

**1. Pension, accumulation or outside super due to the Transfer Balance Cap?**

The recent passing of the legislation represents the biggest change to our superannuation system in a decade, with a limit imposed on how much you can save in superannuation and how much you place into a tax-free pension. At least you aren't hit with massive taxes if you withdraw the amount above the Transfer Balance Cap from super.

From 1 July 2017, if you have less than $1.6 million then you will still be able to save for your retirement and make additional personal after-tax contributions much like the current system. However, once you reach the $1.6 million balance, whether it be from capital growth or additional contributions, you will no longer be able to make your non-concessional contributions from after-tax monies.

There are no grandfathering arrangements for those who already have more than $1.6 million in super. If you are a pension member, then the most you can have in the tax-exempt pension environment is $1.6 million. If your pension balance exceeds the Transfer Balance Cap, you will need to transfer the excess back into an accumulation account or remove it from the superannuation environment. There is still an opportunity to hold capital outside super if your marginal tax rate is zero versus 15% in the accumulation phase.

The alternative method applies a proportioning approach where the tax-exempt percentage of the fund is determined by an actuary based on the balance of pension interests to accumulation interests. If you have substantial income-generating assets outside of super, then it may be worth keeping your surplus super assets in the accumulation phase. This is your first major decision.

### 2. Can I still make a large contribution into super?

This depends on when you plan to contribute and how much you already have in super. The non-concessional limits are set to reduce from $180,000 a year to $100,000 a year from 1 July 2017, which means the three year bring-forward cap will be limited to $300,000. To add to the confusion, transitional bring-forward caps will apply if you have already triggered the bring-forward caps in the last two financial years but have yet to utilise the entire cap. Got that?

If you have the capital to consider a large non-concessional contribution, you may wish to act before the end of this 2016/2017 financial year, irrespective of your total superannuation balance. With the upcoming Transfer Balance Cap, individuals under 65 still have the capability to make a non-concessional contribution up to $540,000 within the next seven months (provided you haven't already triggered your bring-forward arrangements). Even if it pushes your balance over $1.6 million, lock it into super now and deal with the pension transfer issue later. **This will be one of the most significant decisions for higher net worth individuals to make over the next six months.** You may even decide to borrow the funds to make one last significant contribution to super. Don't ask us for a unique answer, as it depends on your unique circumstances and, frankly, like the Mad Hatter, '*we haven't the slightest idea*'.

### 3. Is segregation of assets still possible?

Yes and no. Curiouser and curiouser! Today, most SMSFs operate under a segregated approach where members could cherry-pick the assets used to support their pension account. This is a useful tax-planning tool where the pension assets have a tax-exempt status and therefore do not pay any tax on the investment earnings or realised capital gains. The alternative method applies a proportioning approach taking into consideration the percentage of the fund that is tax-exempt based on the balance of pension interests to accumulation interests.

From 1 July 2017, SMSFs will no longer be able to use the segregation approach for tax planning purposes if a member's balance exceeds $1.6 million in the sum of any superannuation structure, be it the SMSF, retail or industry funds. This essentially prevents SMSF members cycling assets between accumulation and pension phase in order to maximise tax concessions available when a Capital Gains Tax (CGT) event arises.

On that note, there is the need for careful planning when transferring the excess amount from pension to accumulation before the end of the financial year as CGT relief may be available.

For the impacted members who have assets supporting pensions before 9 November 2016, you may wish to review the underlying assets and 'reset' the CGT cost base before 30 June 2017 to receive tax concessions on the capital gains that would otherwise apply if you had sold the pension asset. You don't have to sell the asset to reset the cost base and apply the CGT relief.

The CGT relief should not be applied to all assets as those currently on unrealised capital losses may be better off to continue carrying the original cost base whilst the assets on large gains, (particularly bulk assets such as property) may benefit from revaluing the cost base before 30 June 2017. If you have an asset sitting on a large gain, it may be worth considering the CGT relief but it is an irrevocable election which means there may be some tax liability when you sell the asset in the future.

### 4. What happened to Transitioning to Retirement (TTR)?

Remember the days where you could access your super at 55 (or older), continue to work, pay less taxes but keep the same cashflow? Well, the government has caught up to all the smart people employing the TTR and salary sacrifice strategy, meaning there is no longer any tax arbitrage from transferring your super balance to a

TTR pension as opposed to retaining the funds in accumulation phase. This is because the 15% tax on investment earnings will continue to apply up until the age of 65 (the magic age where everything becomes unrestricted). If you have a TTR pension, you will need to decide whether to roll into an account-based pension or to roll back into an accumulation account. You'll also need to determine whether you have met the SIS definition of 'retired' (it's not a definition you might expect).

**5. Is it time to switch to an OPP?**

If you don't currently have a financial planner and you are in the group of the so-called '1% of impacted pension members' (we believe Mr. Turnbull would refer to this as a 'post-truth'), then it may be time remove yourself from the DIY nature of managing your SMSF and switch to an OPP.

An OPP (Other People's Problem) is a complex structure that involves the stimulatory process of removing and spending all your excess super balance to take you just above the new assets test threshold of $250,000 and so entitle yourself to the maximum age pension (this strategy sometimes goes by the less familiar term of PQE - the People's Quantitative Easing). This kills two regulatory birds with just the one stone, as the assets test taper rate will double on 1 January 2017 to $3 per fortnight per $1,000 of assets (that is, if you exceed the threshold by $100,000, your pension drops by $300 a fortnight or $7,800 a year). Unless you can find a risk-free way to beat a return of 7.8%, an OPP makes sense.

**Merry Christmas, Mr Morrison**

Whilst it's fair to say that Scott Morrison has cut short the Christmas holidays for financial advisers and accountants, his poster hangs on all our bedroom walls.

It may be worth pointing out that the childcare industry is a warning not an instruction manual. If you make a service so expensive by regulating it to within an inch of its life, and you then have to offer taxpayer subsidies just so that these same taxpayers can afford to use it, you are officially on the road to hell. Or, as Alice remarked, *"if you drink much from a bottle marked 'poison' it is certain to disagree with you sooner or later."*

*"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?"*

We do, Alice. It would be so nice if something made sense for a change.

*Diana Chan is Head of Compliance and Jonathan Hoyle is Chief Executive Officer at* Stanford Brown*. This article is general information and does not consider the specific circumstances of any individual and is based on a current understanding of the legislation.*

## The impact of an SMSF member becoming disqualified

### Peter Hogan

The impact of a trustee/member of an SMSF becoming bankrupt is significant for the individual, the SMSF and other members of the fund, yet little is generally understood about this unfortunately common occurrence. When bankruptcy occurs, the focus centres on the personal assets of the individual who has become bankrupt, their business assets and structures they control or have an interest in, while the impact on their SMSF is often ignored.

So what is the effect of an SMSF trustee becoming personally bankrupt?

**Bankruptcy and the superannuation legislation**

When a trustee/member of an SMSF becomes bankrupt, they fall under the provisions covering 'disqualified persons' in the Superannuation Industry (Supervision) Act (the SIS Act). A person is a disqualified person if they are an undischarged bankrupt, that is, insolvent under administration.

This has particularly serious consequences for the bankrupt individual and action must be taken as soon as the issue is identified.

This is because the individual commits an offence if they act as trustee of their SMSF knowing they are a disqualified person, and a failure to resign immediately as a trustee of the SMSF exposes them to penalties that range from the most serious, being two years' imprisonment, to a strict liability offence, or 'on the spot fine' of 60 penalty units, currently worth $10,800.

**What happens to their SMSF?**

While an individual bankrupt must resign as trustee, they do not immediately need to cease to be a member of their SMSF. By resigning as trustee, their SMSF will no longer technically satisfy the definition of an SMSF for the SIS Act. However, that definition gives such an SMSF a period of six months where it is deemed to satisfy the definition.

During this six months, the bankrupt individual and any other trustees must address the trustee structure of the SMSF and bring it back in line with the definition. This is most obviously achieved by the bankrupt individual rolling over their SMSF money into another superannuation arrangement where they do not have any obligations to act as trustee.

**Can someone act as trustee on behalf of the individual bankrupt?**

The SIS Act envisages that someone other than the member can act in that member's place as trustee in specific circumstances. So, for example, a parent or guardian can act as trustee in the place of a child (who is under a legal disability). A person who has been granted and accepted an Enduring Power of Attorney (EPOA) by a member of an SMSF can act in the place of that member, for example, where they have lost capacity due to illness or old age.

However, the SIS Act is equally prescriptive when it comes to members who are disqualified. The legislation specifically prohibits a person with an EPOA of the disqualified person acting as trustee of the SMSF on behalf of that person.

The bankrupt individual has no option but to remove themselves as a member of their SMSF within the six-month period.

**When does the six months start?**

The SIS Act sets out that the six-month grace period, where the SMSF is deemed not to fail the definition of an SMSF, starts from the time it no longer satisfies the definition and so would otherwise cease to be an SMSF.

In these circumstances, this would be from the time the bankrupt individual resigns as trustee of their SMSF. At this time, they are still a member of their SMSF but are no longer a trustee.

**Can anyone else be treated as a disqualified person?**

There is a range of other circumstances which spell the end of an individual's involvement with their SMSF, regardless of whether the person is an individual trustee or a director of a corporate trustee.

Indeed, the problems for other members of an SMSF are even worse for an SMSF with a corporate trustee, as any director who is individually found to be a disqualified person and so is ineligible to continue as a director of the corporate trustee, also taints the corporate trustee. Under the definition of a disqualified person, the corporate trustee itself becomes a disqualified person, even where the majority of directors are not disqualified persons.

A change in the trustee structure is forced upon the whole SMSF because of the disqualification of only one director. The disqualified person must cease to act as director of the corporate trustee immediately.

In addition to an undischarged bankrupt, a disqualified person in the case of an individual includes where:

1. A person has been convicted of an offence of dishonest conduct
2. A civil penalty order has been made in relation to the person under the SIS Act, or
3. The Commissioner of Taxation has made an order that the individual is not a fit and proper person to be a trustee of an SMSF.

A disqualified person in the case of a corporate trustee includes a company where:

1. A responsible officer (including a director) of the corporate trustee is a disqualified person
2. A receiver has been appointed in respect of property owned by the company
3. A provisional liquidator has been appointed in respect of the company, or
4. It has begun to be wound up.

A disqualified person must notify the Commissioner of Taxation immediately and in writing that they are a disqualified person. Failure to do so can result in an additional fine of 50 penalty units, currently $9,000.

**Fixing up the trustee structure**

Apart from removing the disqualified person from acting as an individual trustee or as a director of a corporate trustee, and also removing them as members of the SMSF within the six-month window, there are limited options available to a disqualified person to remedy or have their disqualified status waived.

A person who is a disqualified person due to an earlier conviction for dishonest conduct can apply to the Commissioner of Taxation to have their disqualified status waived in particular circumstances. The Commissioner will consider where the offence is of a less serious nature involving a custodial sentence of less than two years' imprisonment or a fine of less than 120 penalty units (currently $21,600), the length of time since the offence occurred and the age of the applicant at the time.

There is, however, no opportunity to waive the disqualified status in circumstances where the person is an undischarged bankrupt or has had a civil penalty order made against them under the SIS Act.

Equally, a company which has had a receiver or liquidator appointed or has began to be wound up has no opportunity to remedy that situation other than to be removed as trustee of the SMSF.

Once a person is a discharged bankrupt and so is no longer insolvent under administration, they are free to again act as an individual trustee or director of a corporate trustee of an SMSF.

**Bankruptcy of an SMSF member must be addressed**

A member of an SMSF cannot ignore becoming a disqualified person, and they must act to avoid a custodial sentence or fine. With only limited options to address the situation, the best course of action is to resign immediately as trustee or director and roll over to alternative superannuation arrangements which do not involve any trustee obligations.

*Peter Hogan is Head of Technical at the peak industry body, the* SMSF Association*. This article is general information and does not consider the specific circumstances of any individual.*

## What do the different types of bond yields mean?

### Elizabeth Moran

Bonds seem like a simple investment. In their most common form, you lend your money to a company or a government, and in return they pay you interest on set dates and return capital at maturity (assuming there's no default). There may be added complexity when quoting a yield, for example, when bonds and hybrids have call dates.

There are four different ways to quote a yield:

1. Yield to maturity
2. Running yield
3. Yield to call
4. Yield to worst.

Yield to maturity is a total return calculation where investors plan to hold the bonds until maturity, while running yield projects income for the coming year. However, yield to maturity may not always provide the best insight into the expected return of a bond, especially if there is a call date or there are multiple call dates.

A call date gives the bond issuer the option to repay the investor but it is not an obligation. As some bonds have many call dates, there can be a range of yield to calls, which makes yield to worst the most important measure for investors.

The yield to worst for callable bonds is the lowest possible return for that bond, but there is upside potential if the company chooses not to repay at this date. Yield to worst may be substantially different to yield to maturity or yield to call. Further, as the price of bonds change, so too does the yield to worst calculation.

**Four types of yields**

**1. Yield to maturity (YTM)**

The yield to maturity refers to how much a security will earn if it is held to the date of its maturity.

It is the annualised return based on all interest payments plus face value or the market price if it was purchased on the secondary market. Most bonds are issued with a face value of $100, but as they are tradable investments, the price will move up and down depending on a number of factors.

Yield to maturity includes any capital gain or loss if the purchase price was below or above the face value. For this reason, the yield to maturity is considered the most important measure for bullet (non-amortising) bonds or those with a hard maturity date and no call dates, as it provides a point of comparison with other securities. In this case, yield to maturity is the same as yield to worst.

For example, the Qantas June 2021 fixed rate bond was issued at a yield of 7.5%, and is currently offered at a premium to face value price of $114.05. The current yield to maturity is 4.07% compared to the coupon rate of 7.5%. This means that the effective return over the life of the security, if bought today, would be 4.07%, taking into account the current premium price of the security.

*The calculation assumes all coupon (interest) payments can be reinvested at the yield to maturity rate.*

**2. Running yield (RY)**

Another measure to compare bond returns is the running yield. The running yield uses the current price of a bond instead of its face value, and represents the income an investor would expect if they purchased a bond and held it for a year. It is calculated by dividing the coupon by the market price as shown below.

$$\text{Running yield} = \left(\frac{\text{annual dollar interest paid}}{\text{market price}}\right) * 100\%$$

For example, the same Qantas bond shown above for the current market price (also known as the capital price) of $114.05 paying a coupon of 7.5% on the face value ($100) gives a cashflow of $7.50 a year. Given this return is achieved at a premium to face value of $114.05, instead of $100 face value, the actual return will be less than 7.5%.

Using the equation above, the running yield would be 6.57% ($7.50/$114.05 x 100 = 6.57%).

*As the bond price increases, running yield decreases, and as the bond price decreases the running yield would increase.*

**Note that running yield does not incorporate any capital gains or losses. As such, institutional investors do not view this as a particularly useful way to analyse bonds.**

**3. Yield to call (YTC)**

Many bonds are callable at the company's option before the final maturity date. That is, the bonds can be repaid early. For example, subordinated bonds issued by banks and other financial institutions often have call dates, which may be five, 10, 20 or more years until final maturity.

The company has the option but not the obligation to repay at the call date. With some bonds, the call dates continue after the first call date and every interest payment date thereafter until maturity. With others, there may be only an annual opportunity.

If a particular bond's price rises above par and is at a premium, the chances of an early call may increase. Theoretically, the company can then issue new bonds at a lower interest rate, although the early call price may also be at a premium under the original terms and conditions.

Investors trying to work out the possible returns on callable bonds need to assess the range of returns available, including various yields to call and the yield to maturity to get a sense of what is possible.

For example, property developer Sunland has issued a fixed rate bond due to mature on 25 November 2020. It is currently trading at a premium of $2.50, so that yield to maturity is 6.82% per annum. But it has two call dates, as the table below shows.

**Sunland fixed rate bond purchase price $102.50**

| Date | Yield (p.a.) | Description | Price paid to investor |
|---|---|---|---|
| 25/11/2018 | 7.60% | First call | $103.00 |
| 25/11/2019 | 7.07% | Second call | $101.50 |
| 25/11/2020 | 6.82% | Maturity | $100 |

*Source: FIIG Securities*

*Prices accurate as at 28 November 2016 but subject to change*

In this case, yield to maturity is the same as yield to worst (see below), both offer the lowest return of 6.82% per annum.

What is key is that as the price of the traded bond changes, so too do the yields. If the purchase price of the bond increased from $102.50 to $106, then the yields would change, as shown below. The lowest possible return is no longer yield to maturity but rather yield to first call.

**Sunland fixed rate bond purchase price $106.00**

| Date | Yield (p.a.) | Description | Price paid to investor |
|---|---|---|---|
| 25/11/2018 | 5.76% | First call | $103.00 |
| 25/11/2019 | 5.80% | Second call | $101.50 |
| 25/11/2020 | 5.84% | Maturity | $100 |

*Source: FIIG Securities*

*Prices accurate as at 28 November 2016 but subject to change*

4. **Yield to worst (YTW)**

Yield to worst tells what the lowest yield would be if the company calls the bond at the worst possible time for the investor, or if it chooses not to call the bond, delivering a lower yield than if they had called it.

We view this as the superior way of measuring yields, as bonds are there to offer investors downside protection. As such, the YTW is the lowest yield an investor can expect if the company or government does not default.

Yield to worst could be the same as yield to call if the first call is the worst outcome for the investor; it could be the same as yield to maturity if the investor is worst off when the company chooses not to call at all; or it could be lower than both of them where the investor is worst off if the company calls on the second or subsequent call date.

The yield to worst for an investor purchasing the USD Broadspectrum fixed rate bond at its current offer price of $106.25 is that the company calls the bond at the first possible opportunity (resulting in a yield of 3.6%). There is an opportunity for upside if the company does not repay at the expected first call date. The best return is 6.33% per annum at maturity, but it's likely the company will repay early and refinance in a cheaper market.

**Broadspectrum USD fixed rate bond**

| Date | Yield (p.a.) | Description | Price paid to investor |
|---|---|---|---|
| 15/05/2017 | 3.60% | First call | $104.19 |
| 15/05/2018 | 5.25% | Second call | $102.09 |
| 15/05/2019 | 5.61% | Third call | $100 |
| 15/05/2020 | 6.33% | Maturity | $100 |

*Source: FIIG Securities*
*Prices accurate as at 28 November 2016 but subject to change*

Bond investing can be simple when held to maturity, no calls are involved and there's no credit default, but it's important for any investor to know which yield is being quoted whenever they buy or sell a bond.

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## SAFs can provide powerful estate planning solutions

### Julie Steed

A small APRA fund (SAF), which is essentially an SMSF with a professional trustee, can provide valuable estate planning solutions for families with particular needs. In this article, we outline two strategies where an SAF may assist families in second (or subsequent) marriages and those caring for intellectually disabled children.

**The SAF blended family strategy**

With one in three marriages ending in divorce (according to the ABS in 2013), it's no surprise that the number of blended families in Australia is rising. Those who remarry are often keen to ensure their new spouse will be well looked after if they die. However, there is also often a strong desire to leave assets to children from previous marriages. This can be particularly important when people remarry later in life and do not have any subsequent children.

Using the SAF blended family strategy, a super death benefit can be paid as a pension to a second (or third) spouse (known as the pension beneficiary) throughout that spouse's life. Then, when that spouse dies, any remaining capital is returned to the original deceased super member's estate and the capital is distributed to their children or other superannuation death benefit dependants (the remainder beneficiaries).

**Documenting the death benefit design**

The strategy requires a special purpose superannuation trust deed that supports the death benefit design to be included as part of the super fund.

Members make a written binding determination to the trustee confirming the identity of the pension beneficiary and the remainder beneficiaries. The binding determination also includes the calculation method of the maximum pension benefit to be paid to the pension beneficiary.

**Calculating the pension**

The pension is calculated as a multiple of average weekly ordinary time earnings (AWOTE), which is currently $1,516 (as at November 2016) or $78,832 per annum. The use of AWOTE provides a strong indicator of purchasing power and provides members with a sound basis for determining their spouse's future income needs.

For example, if a member wanted their spouse to receive an annual pension of $100,000 they would currently select an annual pension of 66 times AWOTE ($1,516 x 66 = $100,056 per annum).

The annual pension payment will be adjusted as at 1 July each year to reflect the updated AWOTE figure. The multiple of AWOTE will not change. The only other determination in calculating the annual pension amount is that the minimum pension required by superannuation law must always be paid. If the multiple of AWOTE chosen by the member was less than the minimum annual pension required by law, the higher minimum would be paid.

The pension beneficiary can vary the annual pension payment between the superannuation minimum pension amount and the amount previously determined by the member. However, the pension beneficiary cannot elect an annual pension payment above the amount pre-determined by the member.

The pension beneficiary cannot commute or roll over the pension payment, however they can forfeit their benefit and have it passed to the remainder of the beneficiaries at any time.

**On the death of the pension beneficiary**

Following the pension beneficiary's death, any remaining balance is paid to the remainder beneficiaries. The payments can be made directly to the beneficiaries or may be paid to the original member's estate and distributed via testamentary trusts.

In a SAF, the professional licensed trustee is an unrelated, independent and unbiased party.

While the blended family strategy outlined in this article is available in a SMSF, the concern for many people is that if there is friction between the second spouse (often also a member of the SMSF) and the children from previous marriages, things may not go to plan.

With cheque book in hand, the second spouse could disappear with the money. While the children would have recourse for breach of the trust deed provisions, locating the spouse and commencing legal proceedings could be a lengthy and expensive process.

**Intellectually disabled adult children**

SAFs can also provide members caring for intellectually disabled children with effective solutions for asset protection and financial care after both parents die. Often this involves planning for the care of an intellectually disabled adult child in their 50s or 60s.

Superannuation funds can provide tax-effective death benefit pension payments to intellectually disabled adult children, who, unlike non-disabled children, are not compelled to commute their death benefit pensions at age 25. The impediment of the disabled person (or their legal personal representative) needing to be a trustee is removed when using a SAF because, unlike an SMSF, a SAF has a professional trustee.

Following the death of the parents, the superannuation in the SAF can be paid as a tax-effective income stream to the intellectually disabled adult child.

The strategy works the same as the blended family strategy, however, rather than pre-determining a pension amount for the disabled person, the income is determined in consultation with family and carers and based on the person's individual needs.

The existence of the professional trustee can also ensure that the disabled person continues to receive ongoing needs (medical, lifestyle, housing and financial) once the parents have died. Further payments can also be made from the pension to meet additional medical and lifestyle requirements.

**Conclusion**

A SAF can provide an effective estate planning tool for blended families who wish to provide for a second spouse during their lifetime and also wish to leave assets to children from former relationships. They can also provide peace of mind for families caring for disabled children.

Costs associated with managing a SAF are summarised in the Cuffelinks article, *The other self-managed super funds*.

*Julie Steed is Senior Technical Services Manager at Australian Executor Trustees. This article is general information and does not consider the circumstances of any individual.*

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## What Buffett said on inflation and equity investing

### Stephen Ross

US Senate Majority Leader Mitch McConnell (the Turtle to fans of *The Daily Show*) has been largely responsible for one of the least productive periods of recent US law enactment. Stagnancy in the Senate was the weapon used against President Obama. McConnell has also stated that some of President-elect Trump's proposals, including a trillion dollars in new infrastructure spending, are not priorities for Senate Republicans. Regardless, the market currently only has infrastructure spending in its sights.

**Rates rising on inflation expectations**

US stocks experienced an historically high intra-day move on the night of the US election. US futures at one point were almost 'limit down' (a market rule of a maximum of -5%). However, it took just 49 minutes of morning trading for stocks to move positive before finishing over 1% higher for the day. What happened? The perceived wisdom prior to the election was that stocks would fall heavily if Trump was elected, but in hindsight maybe traders had their 'Brexit' hedge on this time. They weren't going to get caught short again.

So stocks are now higher and bonds are selling off as the market now believes Trump's investment plan can create growth. But a closer inspection of bond yields reveals that it's not so much growth the market is expecting but inflation (and a slightly higher default risk as Trump has had six companies go bankrupt); 30-year bond yields are spiking, delivering the largest percentage rise in yields ever.


With all this market volatility it's easy to get caught up in the emotion of the moment. The smart investors, however, are looking at the fundamentals, which are the ultimate driver over the medium to long term.

If the market is right and inflation is due to rise, how should this affect stock prices? Intuitively one might think stocks should be protected from inflation's taxing effects because companies own real productive assets, but Warren Buffett delivered an important lesson on this topic almost 40 years ago.

In 1977, *Fortune* magazine published an article by Buffett titled 'How inflation swindles the equity investor'. In summary, the article highlights the following points:

- conventional wisdom that stocks would retain their real value despite inflation didn't eventuate
- stocks, actually, are similar to bonds in economic substance in that they pay what turns out to be a 'sticky' coupon
- share returns on capital has averaged 13% over 10-year periods since the end of WW2, regardless of the inflation rate
- this 13% return on equity has historically translated into about a 10% annual return for investors as stocks tend to trade at 1.7x equity value

- while the yearly high and low over this period was 14.1% and 9.5%, average returns showed no signs of moving higher than average in inflationary years
- stocks are still riskier than bonds as the '13%' return moves around a little year to year
- stocks are also riskier as they are 'perpetual' instruments – meaning there is no future maturity date where your capital is repaid to allow a renegotiation of your return
- the only way to earn better returns over time is via five earnings levers: (1) turnover, the ratio of sales to total assets employed (2) cheaper leverage, (3) more leverage, (4) lower taxes and (5) wider margins.
- there is no fundamental reason for return on capital to rise in response to higher inflation.

I'd urge you to read this article for its invaluable lessons in clear and understandable terms. It will also put you one up on many professional investment managers who are still to learn Buffett's inflation and stocks message. While stocks remain preferable to bonds in a higher-inflation environment, they are still negatively impacted. Higher inflation hurts all investment returns, it's just a matter of to what degree.

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## Exchange traded products in 2016 and a look ahead

### Justin Arzadon

With the silly season upon us, it's the perfect time to reflect on 2016. It's been a big year for Exchange Traded Products (ETPs) in Australia and around the world, and it's worth looking at likely developments as we move into 2017 and beyond.

**Australia**

At the beginning of the year, the ETP industry had about $21.4 billion in assets under management (AUM) across 169 funds. As at the end of October 2016, the industry had grown to over $24.4 billion in AUM across 199 ETPs. An impressive 30 funds have been launched this year as at October end. There are currently 5 ETPs that have over $1 billion of AUM in the local market.

There have been some major shocks to the global markets in 2016, but the Australian share market is marginally higher than at the beginning of 2016 and may finish even stronger if the late momentum carries on until the end of the year.


*Source: Bloomberg*

In addition to the 16% AUM growth in ETPs for the last 12 months to October 2016, we also saw record high trading activity levels, up 18% on the previous year. The three biggest increases in AUM occurred across Australian equities, international equities and fixed income products. Strong inflows have continued in reaction to President-Elect Trump's business-friendly stance and expansionary fiscal policy. There were very little outflows overall for the year, but what did flow out was mostly Asian equites (ex-Japan).

**Global**

The global ETP industry also produced stellar results for the year to date, although obviously on a much larger scale. According to ETP industry researcher, ETFGI, global ETP assets reached a record US$3.4 trillion at the end of the Q3 2016, about 10% larger than the global hedge fund industry (US$2.9 trillion), and experienced 32 consecutive months of net inflows.

In the first three quarters of 2016, ETPs saw net inflows of US$238 billion, which is down slightly from the US$252 billion gathered at the same point in 2015. Fixed income ETPs gathered the largest net inflows YTD with US$101 billion, which is a record level of YTD net new assets and significantly above the prior YTD record of US$64 billion set in 2015. After fixed income, the next biggest categories for inflows were equity ETPs with US$86 billion, and commodity ETPs with US$37 billion.

As at the end of October 2016, there were 6,526 ETPs (+511) issued by 284 providers, being traded on 65 exchanges across 53 countries. These international numbers are truly mind-boggling.

**The future**

Over 2017, the Australian ETP market is likely to see growth in:

- Factor based products: not exactly active, and not just passive, these ETPs weight by factors other than market cap with the intention of producing alpha by breaking the link between price and weight.
- Hedged exposures: whilst the AUD has proven resilient over the year, not dropping close to most analysts' expectations, money has been made being unhedged. In regions such as Europe and Japan, equity markets have historically performed best when their currency is falling, so it is prudent to take a look at exposures hedged and unhedged and select what suits. More options will allow exposures both hedged and unhedged in the Australian market.
- Active exchange traded managed funds: with the success and acceptance of these products in 2016, many more active managers will consider them in 2017.
- Fixed income products: despite new products, there is room for more with different types of risk.

It was a year of ups and downs for markets generally, but ETPs continued to grow in size and range. Australia has a lot of catching up to the rest of the world in the variety of ETPs, so expect many new products in 2017.

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