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Investing in 2017 and beyond

Roger Montgomery

If you are concerned about your returns, you should brace for an end of the residential construction boom. You should also be very cautious about the excessive prices of high-yielding stocks (those paying dividends that are unlikely to grow), and you should be most enthusiastic about high-quality mid cap and small cap stocks that have been punished recently with share price declines of up to 50%.

Let's start with property

Courtesy of UBS and the RLB Crane Index, we recently learned that the residential crane count in Australia skyrocketed by 313% between September 2013 and September 2016. There were more residential construction cranes along the east coast of Australia than across New York, Boston, Chicago, San Francisco, Los Angeles, Toronto and Calgary combined.

Property doyens are selling. Harry Triguboff tried to sell Meriton and the 'For Sale' shingle has been placed on the century-long held Soul Pattinson building in Sydney's Pitt Street Mall by one of Australia's most successful and respected investors and patriarch of listed investment firm Washington H Soul Pattinson (ASX:SOL) Rob Millner. John Symond has listed his waterfront mansion on Sydney Harbour and John Gandel realised a large profit exiting Charter Hall in a $500 million sale.

There has been a stunning growth in the number of practising real estate agents. Australia's population is growing at 1.6% per annum, so the number of real estate agents required to service the population does not need to grow at a rate in excess of this. Yet in 2016, Victoria, NSW and Queensland have experienced growth in the numbers of real estate agents of 8.7%, according to the NSW Office of Fair Trading, Consumer Affairs Victoria, and Queensland Office of Fair Trading.

And notice the preponderance of property developers making the rich lists and in particular the mushrooming number of property developers under 40 who were still at school during the last recession.

According to a UBS survey, more than a quarter of 1,228 Australian home buyers who had taken out a mortgage over the past two years admitted they misrepresented some information on their loan application. Bank shares anyone?

A relationship between residential dwelling commencements and full time employment, produced by our friend and equity researcher Douglas Orr, reveals peaks in commencements have foreshadowed large drops in full time employment in Q3-1999, Q1-1995, Q2-2000, and Q2-2008. There are signs this decline is happening now.

Acutely expensive real estate

Australian residential real estate, despite being on the cusp of oversupply, is some of the most expensive in the world on a house price-to-income ratio basis.

Record prices and oversupply cannot co-exist for very long. At the same time that house prices are rising stratospherically, debt is being accumulated at an alarming rate. Of course mortgage debt to income and mortgage debt to GDP ratios are at records.

There is always, without exception, one common precedent to the vast number of crises the world has experienced — excessive debt accumulation. Quite simply, Australians have taken on more debt, typically to chase more expensive houses, and have less money to pay for it.

John Kenneth Galbraith in *The Great Crash* defined a bubble thus;

"… at some point in a boom all aspects of property ownership become irrelevant except the prospect for an early rise in price. Income from the property, or enjoyment of its use, or even its long-run worth is now academic … What is important is that tomorrow or next week, market values will rise, as they did yesterday or last week, and a profit can be realised …"

Australia's east coast capitals are facing a tidal wave of apartment supply and developers will not be able to sell all their inventory at current prices. Indeed, they are already offering carrots to lure potential buyers. These carrots, such as millions of frequent flyer points, holidays to Asia or 10-year rental guarantees, are forms of discounts designed to preserve the ticket price. As supply increases, however, the discounting will become more aggressive simply because the developers owe their lenders money and need to pay back the loans, many of which have also capitalised interest (something to think about when owning bank shares too).

Investors who borrowed to buy an investment apartment are at particular risk. Take a look at Brisbane where in the first nine months of 2016 just 5200 apartments were completed in the inner 5 kilometre ring from the CBD. Investors who purchased outside that inner ring, five to 15 kilometres from the CBD, have seen aggregate vacancy rates climb from 2.3% to 4.7%. And that number can only keep rising when another 13,000 apartments are due to be completed over the next 18 months. A unit without a tenant has a yield of 0%, and where a mortgage is attached, it could put its owner under financial stress.

Some shares don't look great either

With record levels of mortgage and credit card debt in Australia, we expect there will be some financial stress ahead. We think investors should be cautious on companies like the banks, Telstra, the supermarkets, BHP and RIO. Either they are being disrupted, have challenges to their growth, are cyclical or have increased their payout ratios to such an extent that they are thwarting their own ability to grow future income and dividends.

In a low interest rate environment, purchasing power from fixed income streams are eroded. If bond rates rise, as they have begun to, the outcome for any bond-like security paying a fixed income will be even worse.

What other investments look better?

Over the past year or two, a lack of growth in the banks (credit growth is expected to slow given maturing residential development as well as record mortgage and credit card debt) and resource companies meant large institutional fund managers fuelled a boom in the prices of smaller high-quality growth companies, as they migrated down the market capitalisation spectrum, looking to boost returns. High quality, mid and small capitalised company shares, those with bright prospects and economics, benefitted.

More recently, the perceived prospects of the banks and resource companies have improved and those same institutions, finding themselves underweight, were forced to sell down their holdings in smaller, high-quality growth companies to fund their purchases of the banks, BHP, RIO et al.

As those large institutional funds unwound their positions, we have witnessed corrections, if not crashes, in the share prices of smaller high-quality, high-growth companies. ISentia has declined more than 30% as has APN Outdoor and Vita Group. Healthscope has fallen 32% from a high of $3.14 to a low of $2.15, while REA Group and Carsales are down 27 and 28% respectively from their highs.

Our inability to identify good value earlier in the year resulted in The Montgomery [Private] Fund building cash to more than 30% of the fund's value. This allows it to take advantage of lower prices, and in some cases, the first opportunity to acquire value in a long time.

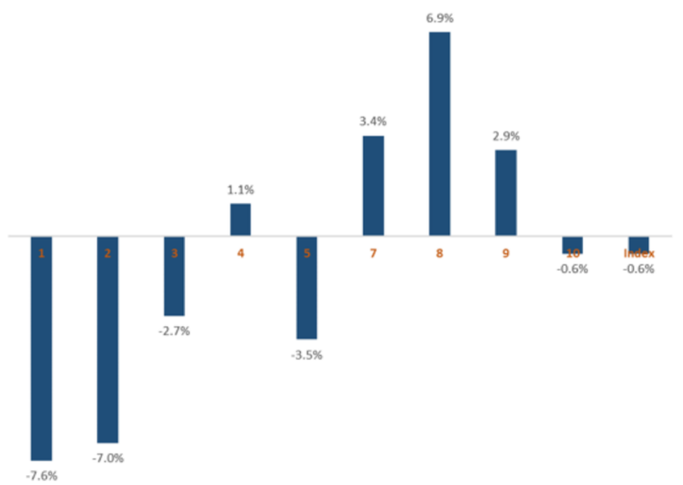
Surprisingly, some companies that score highest on our quality matrix have been the worst performers. Conversely, some of the lowest quality companies – those with no track record of adding shareholder value – have been the best share price performers. This cannot last and the eventual reversal of these trends will deliver more reassuring results.

We maintain a database covering the entire ASX300, scoring every business in terms of its pricing power, barriers to entry, industry structure, switching costs, and a myriad of other factors. Our objective is to rank businesses by the sustainability of their propensity to create shareholder value by investing incremental capital at rates of return above the cost of capital.

This is a long-term dynamic. Value creation only reveals itself over a number of years and as the business reports growing shareholder equity while sustaining a high return on that growing equity. Over shorter periods, the share prices for good businesses can decline and the prices for inferior businesses can surge, and we believe we are currently witnessing just such a period.

As shown below, the businesses with our highest quality scores (at the left of the chart) delivered the worst returns between 1 August and 22 November, 2016. Meanwhile, the strongest returns have been towards the lower end of the quality scale.

Average Return by Quality Grouping
1 August to 22 November



Group	QDM score	n	Return
1	>0.7	28	-7.6%
2	0.45 - 0.7	33	-7.0%
3	0.27 - 0.4	32	-2.7%
4	0.09 - 0.2	33	1.1%
5	-0.1	44	-3.5%
7	-0.27	21	3.4%
8	-0.36	25	6.9%
9	-0.6 - -0.4	34	2.9%
10	<-0.6	43	-0.6%
Index			**-0.6%**

Just as record apartment prices cannot coexist for long with record supply, high quality and strong earnings growth cannot coexist with poor share price performance for long.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is general information and does not consider the circumstances of any individual.

Discovering the good and the bad among ethical ETFs

Emily Martin

Just over a year ago I started what I thought was a simple idea, to put together some low-cost ethical investment portfolios, readily available online for anyone to invest in. As my focus was low-cost, I thought the best products would come from the wide range of ethical exchange-traded funds (ETFs). By my reckoning there are close to 100 such ETFs globally to choose from, more than enough to construct some well-diversified investment portfolios.

What I discovered in this search is that there are, on the one hand, some great, innovative products available. On the other hand, there are some that are ethical in name only. For me, the due diligence process was a lot more interesting than I expected, and I have shared some of my insights below.

Highlights of the good points

Let's start with the good stuff. In recent years there's been a large increase in the range of ethical ETFs on offer. Of the ones we reviewed, over 25% were created in the past year. This has led to the launch of some specific innovative products, enabling investors to tailor their portfolios to their unique values. These include:

- **UN sustainable development goals:** In September 2015 the United Nations set out 17 goals designed to transform the world. These include eradication of poverty, quality education, gender equality, clean energy, and many more. Blackrock have put together an ETF (ticker MPCT) where investors can access companies that generated at least 50% of their revenue from achieving one of these goals.
- **Gender diversity:** A number of studies have shown that companies with more women on the board perform better than their male-dominated counterparts. If you want to support gender diversity, State Street Global Advisors offer an ETF (ticker SHE) that invests in S&P500 companies based on the number of women on the board and in senior leadership positions.
- **Organic food:** If you love your organic produce and want to align your investments with your eating habits, you could try Janus Capital's ETF (ticker ORGID). This ETF invests in global companies that service, produce, distribute or sell organic food, drinks, and cosmetics.
- **LGBT rights:** Workplace equality is a broader issue than just gender diversity. Denver Investments offers an ETF (ticker EQLT) that invests in US companies that support LGBT equality in the workplace, for example by offering benefits to same-sex couples.

Above is just a sample of some of the ETFs we came across that offer something more than just negative screens. There are also a wide range of ETFs available that do offer the negative screens, excluding tobacco, gambling, alcohol, pornography, and arms-related enterprises.

Highlights of the questionable points

'Ethical' is a widely-used term, open to interpretation by whomever is constructing the ETF, and this project has taught me there are uncertainties when selecting an ethical ETF investment.

Exchange Traded Notes

Barclays offers a variety of ethical Exchange Traded Notes (ETN), such as their Return on Disability ETN. One potential problem with this structure is that the ETN is an unsecured debt obligation of Barclays Bank. The return of the ETN is linked to the Disability US LargeCap ETN Total Return USD Index which tracks the performance of 100 stocks selected based on their support for people with disabilities. This index is managed by the Donovan Group (not Barclays). You need to ensure you are aligning your investments with your values, and accept this is providing funding for Barclays rather than an investment in the companies in the index.

Definitional differences

Index providers use their own definitions that are not consistent among providers. Some examples include:

- **Environmental, Social & Governance (ESG) criteria:** One ESG ETF is not necessarily the same as another, it depends on the index provider's ESG criteria. Even those that rely on the same criteria, such as a MSCI ESG rating, may apply it differently. For example, some ETFs only invest in companies with a minimum MSCI ESG Rating, others consider the rating but do not have a minimum threshold.

- **Fossil fuel free:** Fossil fuels are a particularly tricky area. Some indexes define a fossil fuel company as one that holds fossil fuel reserves, others only exclude those that produce 'more carbon-intensive fossil fuels', while others exclude companies with a 'significant interest in' fossil fuels. It is worth checking the fine print to make sure your fossil fuel free ETF is excluding the companies you want to divest from. MSCI has a guide about different approaches to divesting from fossil fuels, which you can find here.
- **Emerging markets:** Many index providers have a slightly different definition of emerging markets. If there are particular countries that you are looking to invest in, check that they are included in the definition.

Redundant exclusions

UBS offers six ETFs with exposure to different regions, all of which exclude tobacco and controversial weapons (i.e. landmines, cluster bombs, chemical weapons). Yet two of these do not exclude any companies. In Australia, there are no tobacco or controversial weapons companies in the ASX100, so the UBS ETF is exactly the same as a mainstream investment. Similarly, in their Asia APEX 50 Ethical ETF, there are no tobacco or controversial weapons in the top 50 largest companies in Asia, so essentially you are investing in the MSCI Asia Apex 50.

There is nothing inherently wrong with these ETFs, they do follow the guidelines and none of the ETFs include tobacco or controversial weapons. However, while the product is true to the stated exclusions, they are somewhat redundant.

Surprising inclusions

It is always worth looking at an ETF's holdings if you're considering an investment, and sometimes they may surprise you. For example:

- We came across a couple of ESG ETFs that include Wells Fargo. Apparently they have a very high ESG Score, however many people would expect the large-scale fraud that occurred at the bank to automatically exclude them from an ESG portfolio.
- The iShares MSCI Low Carbon Target Index has a 73% reduction in current carbon emission intensity and a 99% reduction in potential carbon emissions when compared to the MSCI All World Index. This is great, but it should not be confused with a fossil fuel free index as it does contain some oil companies (e.g. Exxon Mobil, Chevron, Caltex).
- An ETF that has a single focus (e.g. women on the board, or fossil fuel free) will invest purely based on that focus. Such an ETF could therefore contain companies involved in tobacco, gambling, or pornography. Don't assume that because an ETF has a single ethical focus it excludes all non-ethical industries.

Emily Martin, CFA, is Chief Investment Officer at Balance Impact. The information in this article is of a general nature only and may contain advice that is not based on your personal objectives, financial situation or needs. A full list of ethical ETFs that were reviewed can be found in the ebook at www.balanceimpact.com.au/ebook.

SMSFs and the pension cap: a case study follow-up

Melanie Dunn

Our recent article set the scene for how SMSFs will need to re-assess their pensions under the $1.6 million pension cap. The comments and questions received highlight the complexity of this reform for SMSF trustees. To further decode the changes, we found there are four key questions regarding these reforms:

- how will member accounts be tracked from 1 July 2017?
- can the fund employ a segregated assets strategy?
- is the fund eligible to preserve capital gains on some or all fund assets?
- how is the capital gains tax relief applied?

To demonstrate the key points, we have developed the following case study:

Case study – Fred and Wilma's SMSF

Fred, aged 68, and Wilma, aged 69, are both fully retired and, as at 7 December 2016, have:

- an account-based pension in the SMSF in Fred's name valued at $1.2 million
- an account-based pension in the SMSF in Wilma's name valued at $700,000
- a defined benefit lifetime pension from his years of work at Slate Pty Ltd which pays him $50,000 per year.

Outside super, they also have a share portfolio valued at $130,000, a cash bank account valued at $20,000 and an investment property valued at $550,000, all in joint names.

These non-super investments produce $32,500 per year from dividends, interest and rent. Minimum payments from the SMSF provide $95,000 on top of the $50,000 from the Slate lifetime pension.

Fred and Wilma are living within their means and will spend only $100,000 this year. The excess is invested in their share portfolio.

1. How will member accounts be tracked from 1 July 2017?

The first step is to determine whether either member is affected by the $1.6 million pension cap at 1 July 2017.

Wilma has a total retirement phase balance today of $700,000. This is not likely to exceed $1.6 million by 1 July 2017 so no change to her account is required.

Fred has $1.2 million in the SMSF in pension phase and the $50,000 a year lifetime pension. To value the defined pension under the new reforms we take the annual payment and multiply it by 16 (this is independent of the age of the retiree). The defined pension is valued at 50,000 x 16 = $800,000. So Fred's total retirement phase balance of $2 million is $400,000 in excess of the cap.

Fred must either commute the excess out of retirement phase back to accumulation, or withdraw it altogether from superannuation. By 1 July 2017, he can only have a maximum of $1.6 million in retirement phase. Since the lifetime pension is non-commutable, he will have to commute the excess from his SMSF.

Wilma and Fred currently have $16,250 each in taxable income each year from their non-super income. Their pension payments are tax free. They currently pay no income tax.

If Fred were to withdraw $400,000 from super and invest it outside super (in joint names) then earnings from those investments would increase the household's taxable income.

Say these produced 5% earnings then this would increase Wilma and Fred's taxable income to $26,250 each. Due to SAPTO and LITO offsets they would also pay no tax outside of super this year. They can receive up to about $58,000 in combined household taxable income before they would need to pay tax.

If Fred transfers $400,000 back to accumulation inside super then a proportion of earnings on all fund assets would be assessable income and taxed at 15%. The tax-exempt percentage would be around 80% for 2017-18 and so if the SMSF also received 5% income on investments then this would produce taxable income around $19,000 and subject to imputation credits the SMSF would pay some tax.

Taking money out of super is irrevocable for Fred and Wilma as neither is able to re-contribute to super. After a few years, as their non-super investments increase due to not spending all of their income, Fred and Wilma expect their taxable earnings to increase and they might start paying more tax than if the assets remained in super.

Fred and Wilma decide to manage their future tax position and leave the excess in superannuation. This will create a new accumulation account for Fred. They decide that this new accumulation account will be created on 30 June 2017 to ensure that Fred's pension balance at 1 July 2017 is no more than $800,000.

2. Can the fund employ a segregated asset strategy?

There is no requirement to segregate assets to this new accumulation account. Indeed, the SMSF will not be allowed to employ a segregated strategy from 1 July 2017 due to Fred having a total retirement phase balance of $1.6 million.

All assets will be unsegregated and from 2017-18 onwards the fund will need to determine the tax-exempt percentage to claim Exempt Current Pension Income (ECPI).

3. Is the fund eligible to preserve capital gains on some or all fund assets?

The fund will have some balances moving out of the pension phase to the accumulation phase as a direct result of the changes. The fund is therefore eligible to apply the CGT relief to reset the cost base of assets to 'lock in' gains earned under the current rules.

Since all fund assets will be affected by the requirement to comply with the $1.6 million cap due to now being unsegregated from 30 June 2017, the fund is eligible to apply the CGT relief on all assets. However, the SMSF does not have to apply this relief.

Segregated pension assets with losses might not apply the relief as losses will be disregarded but can be carried forward if incurred when unsegregated. For segregated pension assets in a gain position this relief will lock in the tax-free gain, with only future gains taxable. Fred and Wilma decide to apply the CGT relief to all assets that are in a gain position when re-valued at 30 June 2017.

As the CGT relief is not automatic, the fund will apply for the relief for each chosen asset in the approved form (regulations forthcoming) at 30 June.

4. How do they apply the capital gains tax relief?

All of Fred and Wilma's SMSFs assets are segregated pension assets from 9 November to 30 June 2017 and are therefore eligible for the relief.

For each asset in a gain position the relief is applied at 30 June. The gain is locked in as tax free and disregarded in the 2016-17 annual return. The cost base of each asset is reset to be the current market value and this is irrevocable. Fred and Wilma decide not to apply the relief to assets in a loss position; the cost base of these assets will not be reset.

If Fred and Wilma had decided to complete the transfer to accumulation prior to 30 June 2017 then an actuarial certificate for the financial year might be required to claim ECPI.

Summary

At 1 July 2017, Fred will comply with the transfer balance cap by having a maximum pension balance in his ABP of $800,000 with the rest of his balance in a new accumulation account. The SMSF will use the proportionate method to claim ECPI from 2017-18 onwards.

Fred and Wilma will record the new cost base of fund assets which applied the CGT relief. When these are realised in the future the capital gain will be based on this new cost base, and the CGT discount will only apply if the asset is realised post 30 June 2018.

If you want to better understand how these key decisions apply to your situation, Accurium has developed a series of flow charts that show you how to apply each decision to your SMSF.

Melanie Dunn is the SMSF Technical Services Manager at Accurium. This is general information only and is not intended to be financial product advice. It is based on Accurium's understanding of the current superannuation and taxation laws. No warranty is given on the information provided and Accurium is not liable for any loss arising from the use of this information.

Super opportunities after 30 June 2017

Noel Whittaker

The new superannuation rules have been passed, but judging by the emails I am receiving, many of you are more confused than ever.

One reader says "It has been widely reported that from July 2017, superannuation contributions will be tax deductible to the limit of the concessional amount of $25,000. Does that mean then the salary sacrifice will no longer apply? Can you please explain how the salary sacrifice and the tax-deductible contributions fit in with each other? Does one exclude the other?"

It's a great question, particularly as it gives me the opportunity to highlight the opportunities that will be available for employees after 30 June 2017.

Every eligible person can claim a tax deduction

Superannuation contributions fall into two categories, concessional, and non-concessional. The former were once called deductible contributions because they came from pre-tax dollars, while the latter were called un-deducted contributions because the funds came from after-tax dollars.

Until 1 July 2017 concessional contributions are capped at $30,000 for people under 50, and $35,000 for those aged 50 and over. Non-concessional contributions are limited to $180,000 a year but in certain cases you can bring forward an extra two years' contributions and contribute $540,000 in one year.

From 1 July, the concessional cap will fall to $25,000 a year for everybody, and the non-concessional cap to $100,000. Furthermore, no non-concessional contributions will be allowed once you hold $1.6 million in pension phase. If you have the funds available take advice about making substantial contributions before 30 June.

It's long been a bone of contention that a self-employed person could make a concessional contribution and claim a tax deduction for it, but anybody who's employer was contributing for them was not allowed the same concession. It was easy to get around for anybody who had a good employer because the concessional contribution could simply be made by salary sacrifice.

There was no logic in the system, and it created an unequal situation whereby an employee who was allowed the salary sacrifice got a better deal from the taxman than an employee who was not allowed to salary sacrifice.

From 1 July, everybody who is eligible to contribute can make concessional contributions up to $25,000 a year and claim a tax deduction. To be eligible you must be under 65. Contributions are also allowed for those aged between 65 and 75 who can pass the work test which involves working just 40 hours in 30 consecutive days.

Salary sacrifice will still be allowed, but it will no longer be necessary to do that to get a tax deduction. Keep in mind that the $25,000 limit includes contributions from all sources including the employer 9.5%. Therefore, if you earned $100,000 a year, and your employer contributed $9,500, your maximum personal contribution would be $15,500.

Case study showing advantages of super

You are 55, earn $98,000 a year plus employer superannuation of $9,310 and have a cash surplus of $15,000 a year. You could invest the money in your own name outside super where earnings would be taxed at 39%, or contribute it to super as a non-concessional contribution where the earnings will be taxed at just 15%.

From 1 July 2017, you will have another option - make a concessional contribution of $15,000. You will lose $2,250 due to the 15% contributions tax but will still have $12,750 working for you in the low tax superannuation environment. Best of all, the tax deduction of $15,000 should get you a tax refund of $5,850 which you could contribute as a non-concessional contribution. This option magically turns your $15,000 into $18,600. That's a return of 24% in the first year.

It's unfortunate that the continual changes have made many people wary of super. As I have said repeatedly, it's still the best money tool available when used in the right places.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance. Noel has bundled together many of his bestselling books in a Christmas Package Special at a discount price, [linked here](). *His advice is general in nature and readers should seek their own professional advice before making any financial decisions. Email:* noel@noelwhittaker.com.au

Are we really going through a 'bond market rout'?

Warren Bird

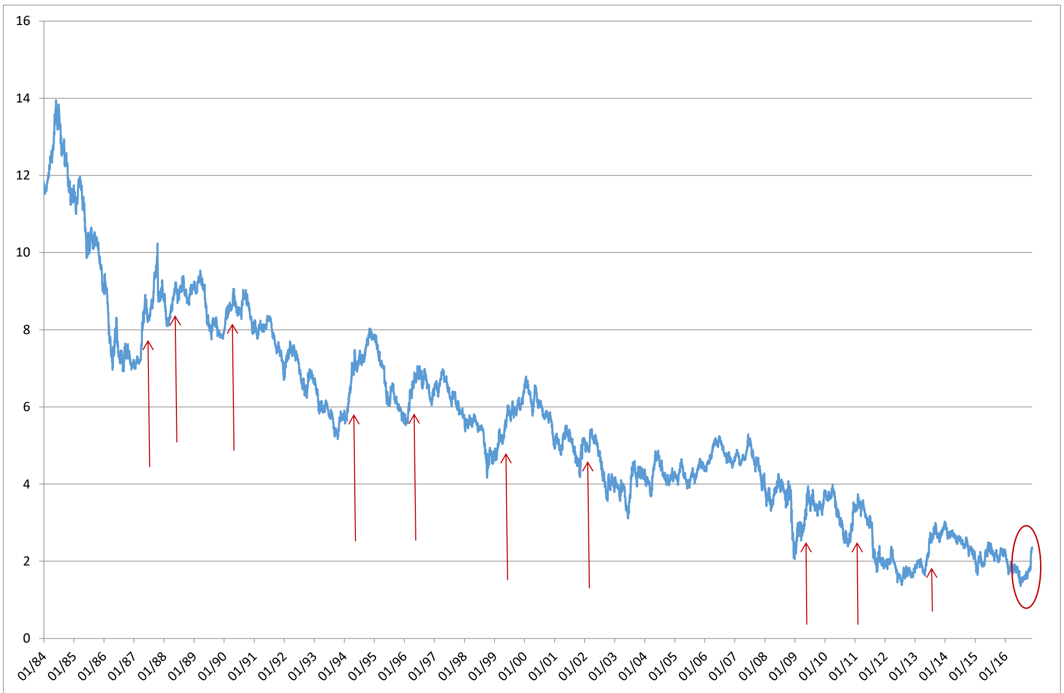
The second half of 2016 is shaping up as one of the more negative half years for bond returns on record, especially at the long end of the yield curve. It's not uncommon for financial press articles to refer to what's happening to government bonds as a 'rout', but is it really that bad?

The focus of this article is the US Treasury market, bond yields, and what that means for bond returns.

Since early July 2016, when 10-year Treasury yields traded at an all-time low of 1.36%, the trend has been higher. It was a steady burn for a few months, but the speed of the increase has picked up since early November. This was around the time financial markets started to price in a Trump victory, a few days out from the vote.

As of 9 December, an investor could purchase a 10-year Treasury to yield 2.47%. Of the 1.11% increase over the past five months, around 2/3 has happened over the past four weeks, and an increase of 0.77% over a month is a very sharp move by historical standards; not unprecedented, but far from common.

The following chart shows the history of the 10-year US bond yield since the all-time peak back in 1983. Since then, there have been 10 prior periods (shown by the arrows) where the yield has increased by at least 0.9% over around 5-6 months.



In other words, history tells us we can expect a long bond yield rise of the magnitude we've seen in 2016 on average once every three years.

Of course, this rising trend may not yet be over. The 1.11% rise posted so far could turn into more, so what does history tell us in this regard?

History repeats, but how often?

Not surprisingly, history does not provide much clarity. Even if there were a regular pattern, a sample size of 10 is nowhere near enough to draw firm conclusions. However, there isn't a regular pattern. Half of the previous 10 occurrences of at least 0.9% increases petered out around this level. If those histories are repeated, then this 'rout' is just about done and dusted.

The other half, however, continued for varying lengths and to varying degrees. If these histories were to repeat, then there's a way to go yet before we reach the peak in this cycle for US yields. The following table summarises those episodes.

Start (trough)	End (peak)	Total yield move (%)	Duration (Months)
Dec 86 6.95	Oct 87 10.20	3.25	10
Oct 93 5.17	Nov 94 8.02	2.85	13
Oct 98 4.20	Jan 00 6.70	2.50	15
Dec 08 2.05	Jan 09 3.95	1.90	7
May 13 1.60	Dec 13 3.00	1.40	7

The impact on bond prices and returns

Of course, when bond yields rise, bond prices fall, at least initially (every bond matures at par, whatever happens today or tomorrow). When the time period over which this happens is short enough, total returns can become negative as well.

The recent yield increase translates into a decline in the capital value of the 10-year Treasury bond since early July of 10.0%. Here we have a living, breathing instance of the usual example that's used to explain what 'modified duration' means. That is, if you get a yield move of 1% you multiply the duration to get the price change. In this case the yield move was a little bit more than 1%, but with the modified duration of the current 10-year bond at around 9.2 years, the maths follows.

Adding back the interest that's been paid and accrued, the total return on the bond over the past five months has been -9.4%.

Using data for the Bank of America Merrill Lynch 10-15-year Treasury index, the total return on this index over the past five months has been -8.6%. This ranks as the third worst return over a similar period in the past three decades. It was outdone only by 2013's 'taper tantrum' of -9.9% and the -9.1% from the yield rebound in 2009 that followed the Lehman collapse.

The reason a yield move that has already occurred 10 times has resulted in a total return among the worst few in history is mostly because of the starting yield. When 10-year bonds have risen by about 1% in the past, they've been paying 4%, 6% or higher interest returns. That provided a larger positive contribution to the total return over any five-month period than July 2016's 1.4% yield. Low yields also mean longer bond duration, which magnifies the impact of a given yield change. For instance, in a 6% yield environment, the 10-year bond's duration would have been around 7.5 years instead of more than nine years. So a 1% yield change today means an additional 1.5% in capital value adjustment.

What does this mean for Australian bond investors?

Most Australians hold a portfolio that is more of a composite of domestic government, semi-government and corporate bonds. Their portfolio at July's low point was yielding 2% and has seen an increase to around 2.6%. That's a much more moderate change than has taken place in the 10-year Treasury market. Also, the local market has a significantly shorter duration of about 5.3 years. Therefore, broad Australian bond market indexes over the past five months have returned a much more moderate -3% or thereabouts.

Furthermore, the one-year returns for 2016 will be positive. The broad market index seems likely to come in at around +3%, so still above cash. This is because the sell-off in the second half of 2016 followed a rally in the first half of the year.

End of the bull market?

What we've witnessed over the past few months could well mark the end of the so-called '30-year bull market in bonds'. The possibility that yields will continue to trend higher, back to pre-GFC levels where 10-year Treasuries paid investors 4% or more, is not objectionable. It would be fantastic if that happened, because it would mean that the healing of world economic fundamentals, so badly damaged over the past decade or so. It would mean that bond markets were experiencing rising returns – short term capital pain, yes, but rising reinvestment into a higher-yielding environment that will produce better long-term outcomes than the low yields we've seen during 2016.

However, it's still far too early to call the end of the 'lower-for-longer' scenario. Just because bond yields have risen from their all-time lows doesn't mean they've broken out of the historically low trading ranges of the past few years. They might do that, but they haven't yet.

Warren Bird is Executive Director of Uniting Financial Services, a division of the Uniting Church (NSW & ACT). He has 30 years' experience in fixed income investing. He also serves as an Independent Member of the GESB Investment Committee.

Can the bond markets help the affordable housing crisis?

Adrian Harrington

Affordable housing plays an important role in the welfare of lower income households. Yet spiralling house prices in recent years and the limited supply of quality affordable housing is placing significant pressure on these households.

The affordable housing problem needs urgent attention. In 2013-14, approximately 31% (2.7 million) of Australian households were in the rental market. Around 47% (1.3 million) of these were classified as lower income households (ABS). According to the Productivity Commission, in June 2015 there were about 190,000 households on the waiting list for social housing, of which about 66,000 were deemed to be of 'greatest need'. Social housing costs state and federal budgets more than $10 billion per year.

A major step forward in addressing affordable housing supply recently occurred when the federal and state treasurers agreed to the recommendations of the Affordable Housing Working Group (AHWG) at the Council on Federal Financial Relations (CFFR).

Alternative financing models

The AHWG was charged with investigating innovative financing models aimed at improving the supply of affordable housing, with a particular focus on models that attract private and institutional investment at scale into affordable housing. The AHWG canvassed four possible innovative finance models:

- a housing bond aggregator (see below)
- a housing trust
- housing co-operatives
- social impact investing bonds.

The AHWG took 78 submissions from interested parties including community housing providers, banks and welfare agencies, the majority of which advocated a housing bond aggregator as a priority.

It's not surprising then that their key recommendation was the establishment of a financial intermediary to aggregate the borrowing requirements of affordable housing providers and issue bonds on their behalf (the bond aggregator model). The AHWG argues that the bond aggregator model "*offers the best chance of facilitating institutional investment into affordable housing at scale, subject to the provision of additional government funding."*

By providing cheaper and longer-term finance for community and affordable housing providers, the AHWG believes this model has several benefits:

- it enables affordable housing providers to refinance their existing borrowings and finance new developments at lower cost and longer tenor
- it creates a market for private affordable housing investment that both normalises and expands capital flows to the industry

- it best addresses the barriers of return and liquidity by providing an instrument that is understood by sophisticated investors as a fixed income investment
- due to its financial profile, it can be easily traded in a secondary market and would be seen as an attractive low-risk financial product.

The UK offers a template

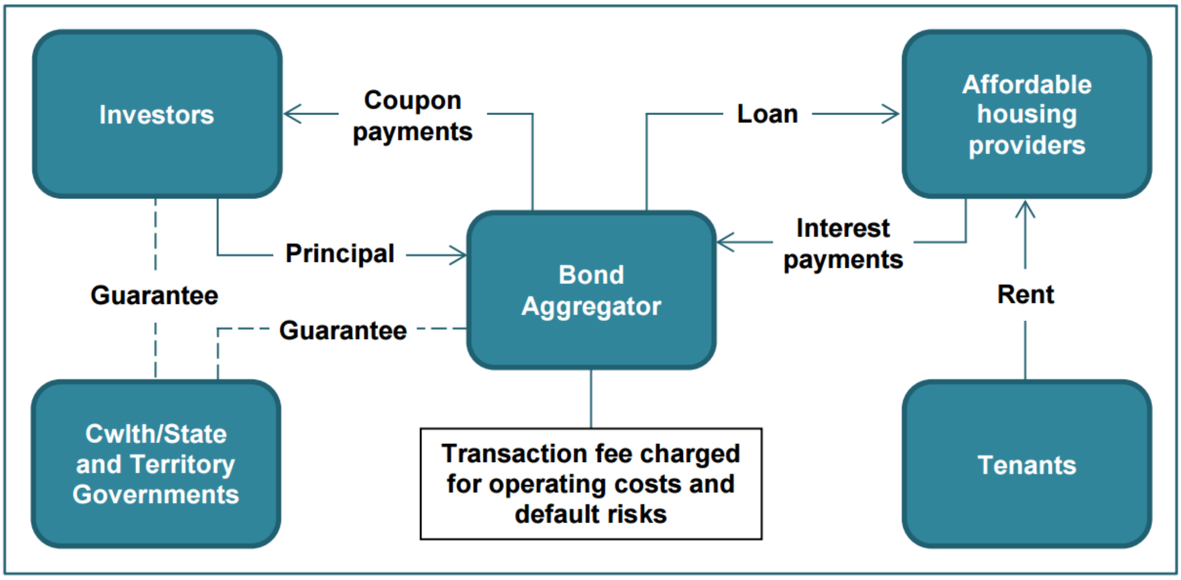
The bond aggregator model has been successfully implemented in the United Kingdom. The Housing Finance Corporation (THFC) has, for more than 30 years, been on-lending predominately long-term debt, obtained from bond issues (public issuance and private placements) and bank loans including funding from the European Investment Bank to over 150 individual housing associations throughout the UK.

THFC has an 'A' credit rating from Standard and Poor's and a total loan book of more than £4.2 billion.

How would a housing bond aggregator operate?

A housing bond aggregator model requires the establishment of a specialist financing intermediary, whose function would be to liaise with affordable housing providers to determine the amount of debt they are seeking to raise. The intermediary, or entity acting on its behalf, would then source these funds in aggregate from wholesale markets by issuing bonds to investors. The funds generated would then be loaned to the relevant housing providers in return for ongoing interest payments (Figure 1).

Figure 1: A Housing Bond Aggregator Model



Source: Affordable Housing Working Group

The design of any bond issued to finance affordable housing will be critical. The AHWG identifies four key items that would need to be decided upon:

- the type of bond and its coupon payment (fixed or indexed to inflation)
- the term of the bond (between 25 and 40 years would best match the lifespan of housing investments, however Australia has traditionally had a much shorter tenor bond market)
- the loan to valuation or interest coverage ratios used for lending purposes
- whether any government guarantee is provided, as well as which level of government issues the guarantee, the size of the guarantee and whether it is transitional or ongoing.

Can house bonds have an impact?

The simple answer is yes. How much depends on the demand for credit by affordable housing providers and the appetite of institutional investors. The AHWG estimates that if the bond aggregator simply allows the refinancing of the existing debt of community housing providers (estimated at over $1 billion) at cheaper rates it could result in an increase in their borrowing capacity by over 65% or an additional $765 million. If this amount was to be reinvested into new affordable housing it could fund the construction of up to 2,200 new dwellings, assuming an average dwelling cost of $350,000 and no increased equity requirements.

The AHWG also acknowledges that the bond aggregator can't solve the affordability problem entirely. It notes the importance of a variety of complementary reforms, including nationally consistent regulation of community housing providers, planning and zoning regulations, and taxation and concessions.

While there is some way to go, the signs are encouraging. The treasurers at CCFR agreed to the establishment of a taskforce to design the exact mechanism and report back to the heads of treasuries by mid-2017.

Adrian Harrington is Head of Funds Management at Folkestone *and one of the Federal Government's representatives on the* Australian Housing and Urban Research Institute *(AHURI).*

Investors should tap strengths of service providers

Doug Morris

Buying food from a shop is so simple that it's something we take for granted. If it were the same experience as investing, it would be far more complex.

Instead of taking say, a carton of eggs to the checkout, imagine having to first ask the farmer if they're free-range or caged, the grader for the size and quality, the Food Standards Board for nutritional information, and (finally) the shop for the price.

Investors face a similar proposition every day. Crucial information such as performance data, tax reporting, share dividends, corporate actions, and cost bases are spread across online brokers, share registrars, investment platforms, wraps, and even old-fashioned spreadsheets.

Bringing these pieces together can leave investors with a heavy administrative burden which may ultimately weigh down performance.

It is not a new problem, but many previous solutions have forced investors to pay excess fees for bundled, inflexible products or lumped them with simplistic performance methodologies which leave much to be desired.

Investors need to understand each provider's strengths, and ultimately sidestep their weaknesses, if they want to solve this puzzle.

Missing pieces in a broken chain of service

Consider what each traditional service provider delivers.

	Registry	Online Broker	Platform/Wrap	Spreadsheet
Performance reporting				
Automatic updates				
Tax reporting				
Cost base				
Dividend data				
Open investment choice				
Low fees				
Low administrative burden				

1. Online brokers: the transaction hub

Online brokers play a key role for investors: they represent a direct window into the world of listed securities. They democratised share trading in the 1990s by slashing trading costs and, over the years, have expanded their offering with greater volumes of research and trading ideas.

Today, almost 6 million Australians own shares directly, according to the ASX, and 635,000 investors placed at least one share trade through an online broker in the 12 months to November 2015, according to Investment Trends. Online brokers make money when investors trade and maintain high cash balances. This is a key driver for the massive volumes of research and trading ideas they release and why they only offer minimal performance and tax reporting capabilities. One drives profits while the other drives costs.

Online brokers are a transaction hub rather than a performance and administrative hub. Typically, the profit/loss figures they provide fall down in two key areas: they don't include dividends and they ignore how long investors have held their investment. These misleading performance measures can be hundreds of percentage points away from common benchmarks used to compare a portfolio.

2. Share registrars: tracking what you own

The main function of a share registry, such as Link Group and Computershare, is to keep account of who owns what shares.

This is a crucial function but one that is performed on behalf of listed companies, which pay for the service. Share registrars provide a range of functions to companies such as paying out declared dividends, as well as administering employee share schemes and annual general meetings.

A share registrar's focus is on serving the needs of companies rather than those of share investors. Investors can typically see the number of shares they hold (but not the original purchase price), dividends paid, and set up a dividend reinvestment plan. However, their investor-facing websites leave much to be desired and lack critical information such as true performance data and tax reporting.

3. Wraps and platforms: the advice portal

Wraps and platforms dominated the advice industry for many years. They offered a simple way for financial planners to sell a restricted range of managed funds while bundling in a range of fees such as platform, advice and volume rebates.

Many of the funds management products on platforms were from related parties, raising conflicts of interest: were they sold because they were the most suitable investment or because they raised profits for the parent company?

Platforms and wraps remain popular although, with much conflicted remuneration now banned, the industry is slowly moving away from product-led advice towards goals-based advice.

With less certainty about the strength of future investment returns, fees have also attracted more attention. Many investors have realised that percentage-based platform fees may outweigh any administrative and reporting benefits and have looked for cheaper solutions.

4. Spreadsheets: the most basic solution

Investors often intuitively fall back on the most basic technology of all: spreadsheets. They spend substantial time manually updating trades, share prices, dividends, and costs from service providers (often including multiple online brokers and share registrars). They then attempt to calculate performance and tax data, which is a process prone to error.

Many investors remain trapped in the past and identifying effective solutions remains a key challenge for them.

The rise of technology

Each provider in the investment chain has an important role to play but it is only now, with the rise of low-cost, cloud-based technology, that investors have an opportunity to use each to its full potential.

New service providers acting as a hub can now automatically receive useful data from each service provider, perform complex performance and tax calculations, and send it to others, such as accountants and advisers.

The most effective technology-based service providers also share a range of other attributes not commonly seen in the financial services industry.

They are highly flexible and easily accommodate investors' widely varying assets and choice of service provider. They provide excellent value for money by charging a flat dollar amount rather than a percentage of funds.

Investors who can intelligently employ this type of fintech can build stronger portfolios by cutting their administrative burden and revealing a true picture of investment performance.

Doug Morris is the CEO of Sharesight, an online portfolio tracking system used by self-directed investors and advisers.

Super alternative overcomes access and investment limits

Neil Rogan

On 23 November 2016, the Government's superannuation reforms announced in the 2016/2017 Budget finally passed the Parliament. The changes are designed to "improve the fairness, sustainability, flexibility and integrity of the superannuation system", according to the Treasury. The Government also intends to enshrine the objective of superannuation in legislation, "to provide income in retirement to substitute or supplement the Age Pension."

How the new rules will lead to less in super

Without debating the merits of the changes, the new regulations target wealthier Australians who used the upper limits of the contribution caps to place large amounts in the tax-advantaged system. The argument is that well-off Australians are using generous tax breaks in super to accumulate more wealth than they need for retirement, often with a view to transferring it to the next generation.

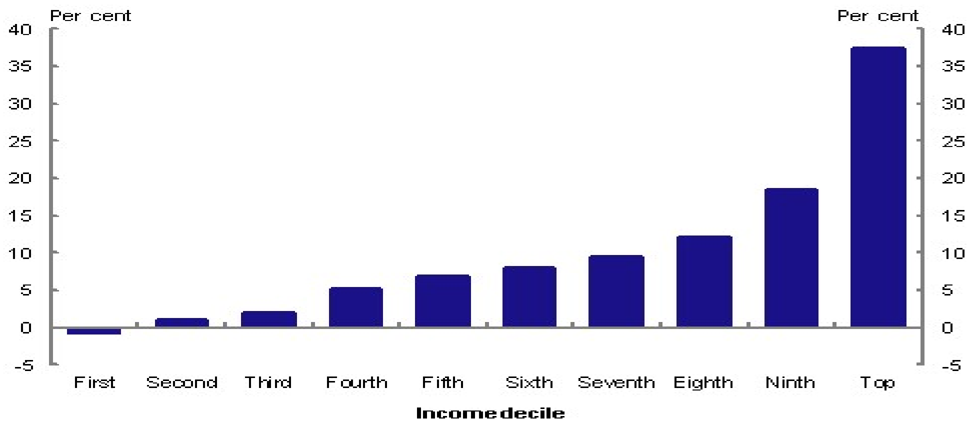
The major changes that will reduce super balances when implemented from 1 July 2017, are:

1. The $1.6 million cap on the amount of super which can be transferred into a tax-free retirement account (previously no limit)
2. The annual concessional (before tax) contribution limits of $25,000 (previously up to $35,000)
3. The annual non-concessional contribution cap of $100,000 (previously $180,000)
4. The threshold where an extra 15% tax (total of 30%) is paid on concessional contributions is anyone earning $250,000 or more of 'income for surcharge purposes' (previously $300,000).

Potential for further changes

The Labor Party has other versions of how superannuation and contributions should be legislated, called its 'Fairer Super Plan'. Criticism from politicians and social equity groups such as ACOSS on the ongoing generosity of super will continue. The most commonly used table from the Murray Report (below), shows that about 38% of the tax advantages of super go to the top 10% of income earners. This will change under the new rules but not significantly for a long time.

Share of total superannuation tax concessions by decile



Source: Financial System Inquiry, Final Report, page 138

Investors seeking certainty and flexibility in a tax-effective environment will increasingly consider alternatives outside of super. There are various options which may assist in minimising or deferring tax, including creating a private company to hold investments, or forming a family trust, but for high income earners, one of the more tax-effective, flexible and cost-effective options may be an investment bond.

Tax and flexibility of an investment bond

Investment bonds are technically life-insurance policies with a nominated life insured, and a beneficiary. In investment terms, they operate like a tax-paid managed fund. Investors choose from a range of investment options, depending on their goals. These range from growth portfolios (higher risk) which typically include more equities, to defensive portfolios (lower risk) which usually invest in cash and fixed interest.

An investment bond is tax-paid, because the earnings from the underlying investment portfolio are taxed at the company rate of 30% within the bond structure. Investors do not receive distributions as they are re-invested, and do not therefore need to declare the earnings from the bond in their personal tax returns. In the case of investment portfolios which contain equities, the tax rate may be further reduced by franking credits.

If an individual's personal taxable income is at least $37,001 p.a. the tax paid on any additional personal income will be greater than on investment bond earnings rate. At this threshold, the marginal tax rate increases from 21% to 34.5%, higher than the 30% on investment bonds.

There is no limit to the amount which can be placed in an investment bond in the first year, and additional contributions can be made each year, at up to 125% of the previous year's contribution.

Funds can be withdrawn at any time, however, if they are left in the investment bond structure for 10 years, the entire proceeds of the bond (original investment, additional contributions and earnings) are tax paid. The investor does not need to include them in their tax return, and they can be distributed as a lump sum, or as a tax-paid income over time. And because an investment bond is in fact an insurance policy, with a life insured (this can be the same person as the bond owner), on the death of the life insured, the beneficiary of the bond will receive all proceeds of the bond tax free, regardless of how long the bond has been held.

The proceeds fall outside of the bond owner's estate, and pass directly to the beneficiary. This makes investment bonds ideal estate planning tools, or an effective way to transfer wealth from one generation to another.

Super remains the most tax-effective long-term investment structure for most Australians, but access to super money is restricted until a 'condition of release' is met. This generally means the investor can't withdraw the money until they have reached a 'preservation age' and retired. Preservation age is 55 for an investor born before 1 July 1960 but increases up to age 60 for those born after this date. Earlier access may be allowed in exceptional circumstances, such as permanent disability.

Saving for education or estate planning purposes

By contrast, investment bonds can be used as savings for children or family members to fund education expenses or the cost of raising a child, and are often used by grandparents to finance the future needs of their grandchildren. The bonds bring simplicity in managing the tax that applies to a child's income, and may be assigned to a child in the future (subject to parental or guardian consent) without tax or legal complications. The child has the option to continue holding the investment bond without affecting the original 10-year tax period start date.

An investment bond's life insurance component enables tax-effective estate planning and simple wealth transfers external to a will. It gives the life insured significant flexibility and control in determining beneficiaries of any 'death maturity' payments.

In superannuation, death benefit tax concessions apply only to dependents of the life insured. However, an investment bond's death benefits can be directed tax-free to any nominated beneficiary, including adult family members, or the estate. How long the bond has been held does not impact the tax-free status. This flexibility may reduce the risk of disputes over estates and enable benefits to be paid more quickly.

Neil Rogan is General Manager of Centuria Life's Investment Bond Division. Suitability of investment bonds will depend on a person's circumstances, financial objectives and needs, none of which have been taken into consideration in this document. Prospective investors should obtain professional advice before investing.

The market loves growth stocks – until it doesn't

Robert Miller

In light of the recent misfortunes suffered by high-profile ASX growth stocks (Bellamy's, Estia Health, and iSentia Group to name a few), it's worthwhile seeing if there are any obvious lessons investors can take with them into 2017.

Growth stocks by their nature tell a story that provide some justification of their future earnings potential. These stocks can dazzle as their stories unfold, but it's important to remember the other side of the trade when things don't go as planned.

High profile growth stocks volatile

Firstly, from a risk perspective, investors will benefit from being aware of how a growth stock will compare with the wider market. Beta is the measure of the volatility of a security versus the market. It can provide an indication of how volatile or 'wild' the ride might be, from both positive and negative sides. For example, if growth Company A has a market beta of 1.5 it is likely to be 50% more volatile than the market. That is, if the market goes up 1% then Company A should rise 1.5% and if the market falls by 1% Company A should fall by 1.5%.

Secondly, the cliché 'up the stairs down the elevator' is particularly relevant when looking at growth stocks. Put simply, a company is more likely to go from overvalued to undervalued far more quickly than from undervalued to overvalued. Growth stocks are either undervalued or overvalued but rarely fairly valued. We know the higher the price the higher the risk, yet our FOMO (fear of missing out) may cause us to jump into a growth stock, chasing and in fact promoting the 'paper profits' seen by the earlier investors.

On the flip side, our apprehension may cause us to sell out at a large and sudden discount even though the risks of the business are provided at a large discount.

Market has a short memory

If you ask the question (assuming business fundamentals remain) would I have been happy to buy stock at a 30% discounted price on the way up, shouldn't I be considering buying it now?

The market tends to have a short memory and is always willing to be swept away by the next big growth stock. If we take a look back to calendar year 2015, the top 10 performers in the All Ordinaries Index produced an average return of approximately 400% (if you exclude resource companies, the top 10 performers returned an average of approximately 275%). Leading the charge were the market darlings, Bellamy's and Blackmores, which had P/Es of 140 and 80 respectively during that time. The market is forward looking to a current P/E on a growth stock so it will invariably look high, but these figures also provide a sense of relativity to the general market P/E range of 15-17.

If we look at those **same** performing stocks in calendar year 2016 (so far), the return of the non-resource top 10 market darlings from 2015 is -18%, excluding one which has gone into liquidation. Of those which have produced negative returns, the average is -35%. A company reinvesting for growth means quite often you don't have a dividend yield to soften the loss, and an investor that arrives late to the party can often end up with negative returns quickly.

Here are four lessons to keep in mind before investing in growth stocks:

1. have a price level of where you think the stock is either undervalued or overvalued and write it down so you don't forget
2. don't ignore a company's beta - the higher the beta, the higher the risk of a larger pullback
3. chasing someone else's paper profit is not a sound investment decision
4. if you're caught up in a large correction, take your time to weigh the options in the context of undervalued vs overvalued. Has the bubble burst or is this an opportunity to buy at a price you could only have dreamed of a few days ago?

Robert Miller is a Portfolio Manager at NAOS Asset Management. NAOS runs two LICs ASX:NCC and ASX:NAC. This article is intended as general information and does not consider the circumstances or investment needs of any individual.