Cuffelinks
Connecting investors with ideas

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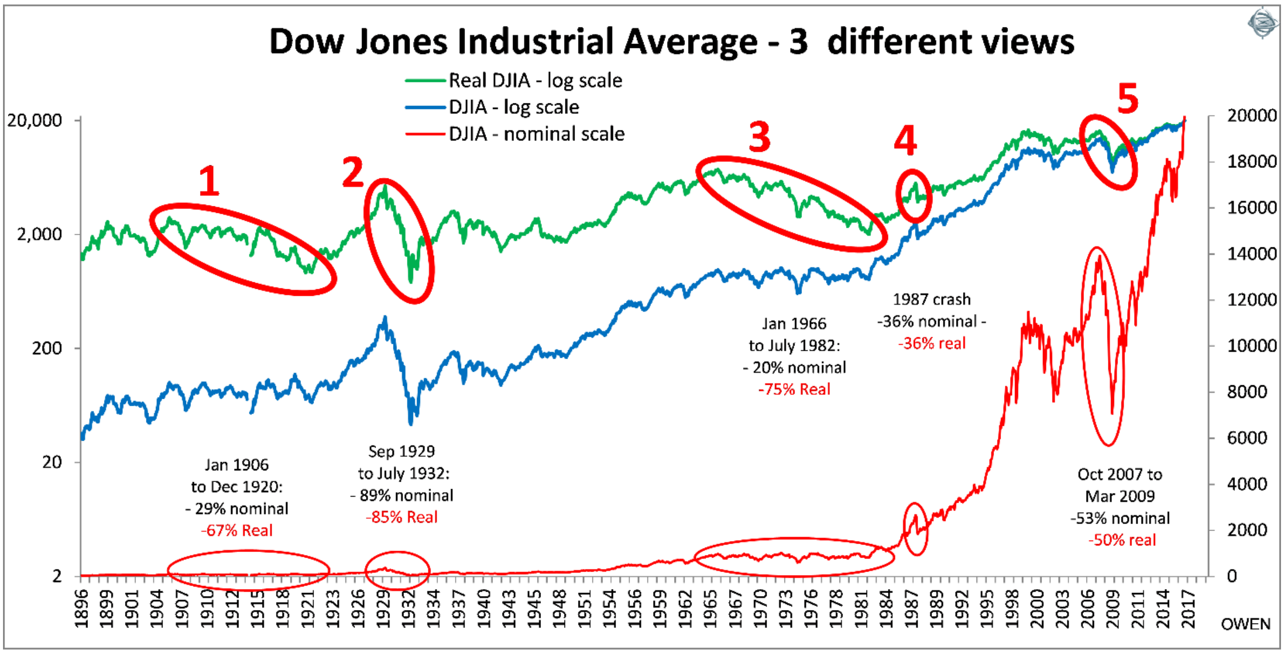
This Week's Top Articles

The Dow hitting 20,000 and what it hides

Ashley Owen

One event that grabbed headlines around the world in late January 2017 was the Dow Jones Industrial Average finally hitting 20,000 for the first time. The 'Dow' is the world's oldest and most widely-followed stock market index but it is also deeply flawed. It only tracks 30 stocks and they are not the largest stocks in the US by any means. The weighting of stocks is almost arbitrary and is based on the nominal share price of each stock and not on their relative revenues, profits, market values or importance. Despite the flaws, it is symbolic and it provides a reasonable proxy for US stocks in general. All other indexes of the US stock market have hit all-time highs recently, so the US market is hot.



Why the Dow is misleading

A nominal index like the Dow hides many sins. The red line on the chart above was widely published last week. It shows the Dow virtually flat for 80 years and then the red line surges in the 1990s 'dot-com' boom, then again in the 2003-07 credit boom, crash in the 2008-09 sub-prime crisis, and finally make the rapid, steep ascent to the summit since 2009.

This traditional view is grossly misleading as it makes the recent cycles appear much more dramatic than earlier cycles due to the nominal scale used in traditional charts (right scale).

We need to add two more lines to see what is really going on. The first is the blue line which is the same nominal index but on a more sensible scale, a 'log' scale (or ratio scale) on the left side. This type of scale shows the cycles in the same light. For example, a doubling or halving of the index appears as the same size change regardless of the level of the index at the time.

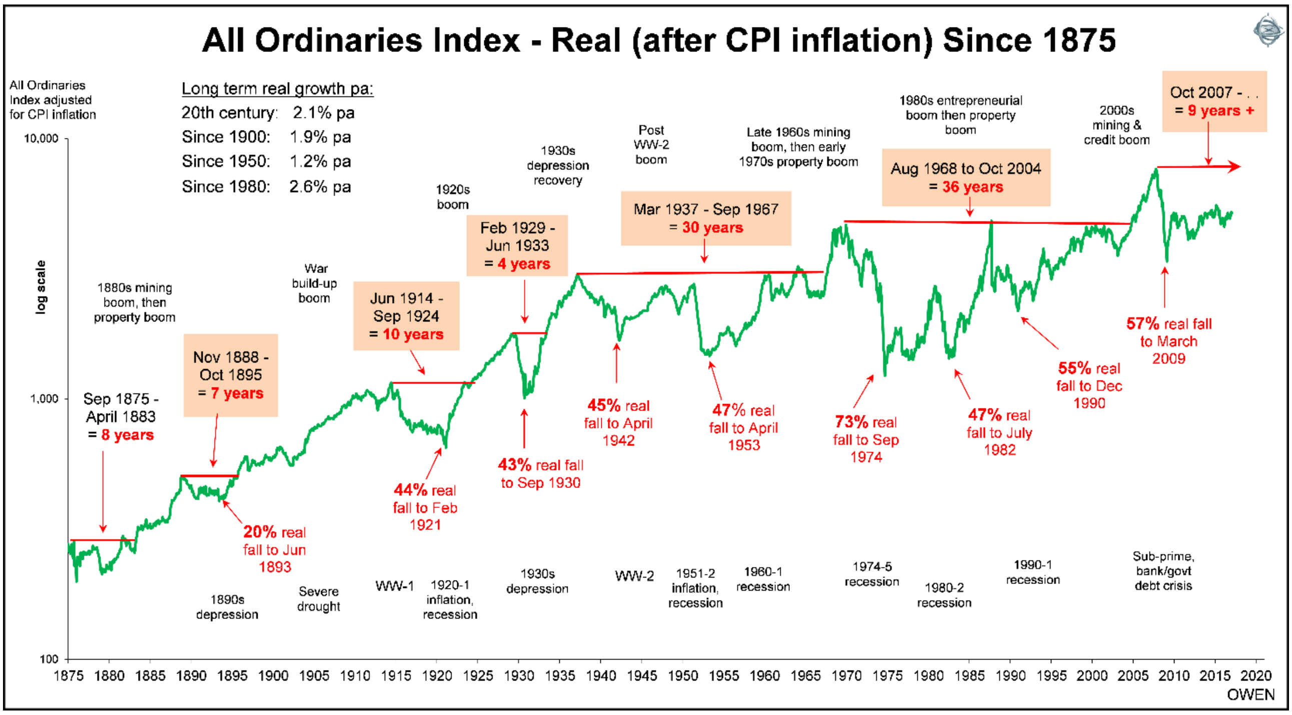
The blue line shows that the 1929-32 crash ('2' on the chart) was much more serious than the 2008-09 sub-prime crash. The index fell -89% in 1929-32, much worse than the -53% fall in 2008-09, but it is almost invisible on the traditional nominal scale chart (red line in lower left).

We also need to add a third line to adjust for inflation (green line, which also uses the left log scale). What matters to investors is the real spending power of their wealth after inflation, and this picture not nearly as rosy. We see that the 'real' index after inflation has only gone from 2,000 to 20,000 in 120 years – that's less than 2% real growth per year on average, which is hardly inspiring. True that doesn't include dividends, but most investors live off the dividends and rely on the capital value increasing in real terms so that dividends can also keep ahead of inflation.

This inflation-adjusted picture also reveals two more bear markets: '1' was the long bear market from 1906 to 1920 when share prices fell 67% in real terms, and '3' was 1966 to 1982 when the prices fell 75% in real terms. Both of these bear markets lasted an agonising 15 years, much longer than the other crashes, and much worse after inflation than the sub-prime crash, the dot-com crash, and the 1987 crash. Inflation cripples returns and lifestyles for many years at a time.

Australian shares – are we there yet?

Here is the same chart for Australian shares, using the All Ordinaries index and its predecessors, adjusted for Australian inflation. Using only the real (after inflation) line shows the cycles more clearly. The long picture is similar to the US, with the price index growing by just 2% per year in real (after inflation) terms.



The sub-prime crash in 2008-09 was not unusual in the scheme of things. Contrary to the media hype at the time, it wasn't a 'once in a century' event or even 'once in a lifetime' event, we have had several declines of similar or worse magnitude, one every decade or so.

Our 'big one' was the crash from 1968-74 because we had a much bigger speculative mining bubble in the late 1960s and then a huge debt-fuelled property construction boom in the early 1970s. The All Ordinaries index took 36 years to recover its real value. That's a long time to wait before seeing any real growth!

Inflation adjustment changes the story

The All Ordinaries index at 5,675 today is just 5% higher (after inflation) than it was at the top of the mining boom on 6 January 1970. Most people who were lured into the speculative mining stocks of the day lost the lot. But what about those who avoided the speculative stocks and thought they were staying safe by buying big blue chip stocks instead? The so-called blue chip stocks are barely breaking even (after inflation) even today after nearly 50 years!

The big stocks that dominated the index back then are the same companies today. Bank of NSW (now Westpac) is just ahead of its 1968 peak price, but ANZ and NAB are still behind. BHP and Woodside are just above water but CRA (now Rio) and Santos are still well behind. CSR, QBE and Lend Lease are all below their 1960s peaks.

Sure they have paid dividends along the way, but unless we want to keep working all of our lives, the aim is to live off the dividends and see the share price (and dividends) grow ahead of inflation. Timing is everything. If we follow the crowd and the media hype and buy at the top of a boom we could be waiting many decades to get back to square one before we can see any real growth.

The main lesson from the Australian and US charts is that big crashes occur frequently and they can take decades to recover in real terms after inflation. It has now been nine years since the top of the last boom, and prices are still a long way from square one. The aim is to avoid panic buying in boom-time frenzies, and avoid panic-selling at the bottom when things look darkest.

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The dramatic tale of two hybrids, CBA VII versus VIII

Rosemary Steinfort

With talk of another hybrid issue by CBA's Colonial to boost its tier-one capital ratio, it is timely to review previous issues, especially on the back of the hybrid overload from the big banks in 2016.

It's remarkable that within only 18 months, CBA issued a hybrid with a margin of 2.8%, then another at a much wider 5.2%, an extraordinary difference for a security with the potential for no (ie perpetual) maturity. The two issues represent the recent peak and trough of the margins.

Issuing bank hybrids (also known as preference shares or capital notes) instead of ordinary shares is attractive to banks to boost tier one capital without dilution of shares and earnings ratios.

Retail investors have actively sought hybrid securities in the past few years in response to the low-rate environment, especially hybrids issued by the big four banks. After some weakness in prices in recent years, hybrid securities have recovered to a healthy degree, but some remain below their face value, particularly CBA PERLS VII (ASX:CBAPD) issued in 2014. This is in stark contrast to the follow-up CBA PERLS VIII (ASX:CBAPE) issued in early 2016 that has traded at a premium since listing, reaching a high of $108.25 on 10 January 2017.

What happened to PERLS VII?

CBA PERLS VII was issued at the peak of hybrid issuance and due to demand was issued at the lower end of the margin above the Bank Bill Swap Rate (BBSW). The margin was a record low of 280 basis points (2.80%). The issue, which raised around $3 billion, was oversubscribed due to retail demand, with investors receiving a franked yield of around 5% pa based on BBSW at the time. Retail investors have viewed hybrids as a fixed interest-type source of income, higher yielding than bonds and cash, and with lower volatility than the underlying shares.

However, PERLS VII have traded as low as $85.29 (issued at $100), generating massive capital losses for anyone who sold for a security many considered price stable. It has since recovered to around $95.

After the CBA PERLS VII transaction, headwinds included:

1. **Interest rates cycle bottoming**: Rising rates highlighted the low issue margin of 2.8%, creating concern that CBA may decide not to redeem the PERLS at first opportunity due to their inexpensive funding source.
2. **CBA high share price**: There is the risk of the high price of CBA shares at the time of the issue falling closer to the 50% of the price level used as the benchmark which prevents conversion into shares. Then the PERLS become perpetual.
3. **CBA high dividend yield*:*** CBA's gross dividend yield at the time was 7.7% pa compared to the yield on PERLS VII of say 5.4% pa, so the yield pickup increased the appeal of shares compared to hybrids.

What changed with PERLS VIII?

In early 2016, PERLS VIII raised a much lower amount of $1.45 billion despite the margin of 520 bps (5.2%), an incredible change from two years earlier. The initial return of 7.5% pa (5.2% above BBSW) compared well with the gross dividend yield on CBA shares which was 8.08% pa at the time. The yield pickup of 58 bps for shareholders was much smaller than the previous PERLS issue.

When the PERLS VIII was announced, the trading margin was below other bank hybrids' margins in the secondary market with shorter maturities. CBA was also worried that the poor experience on PERLS VII would weigh on their return to the market but the bank was buoyed by a pre-market offer by Unisuper to take 20% of the issue. Pricing at a healthy 5.2% margin to allay concerns, the demand was strong although the size was not large. The institutional appetite drove CBA's confidence that levels had reached a point where risk was rewarded, and the issue has traded strongly above par since launch.

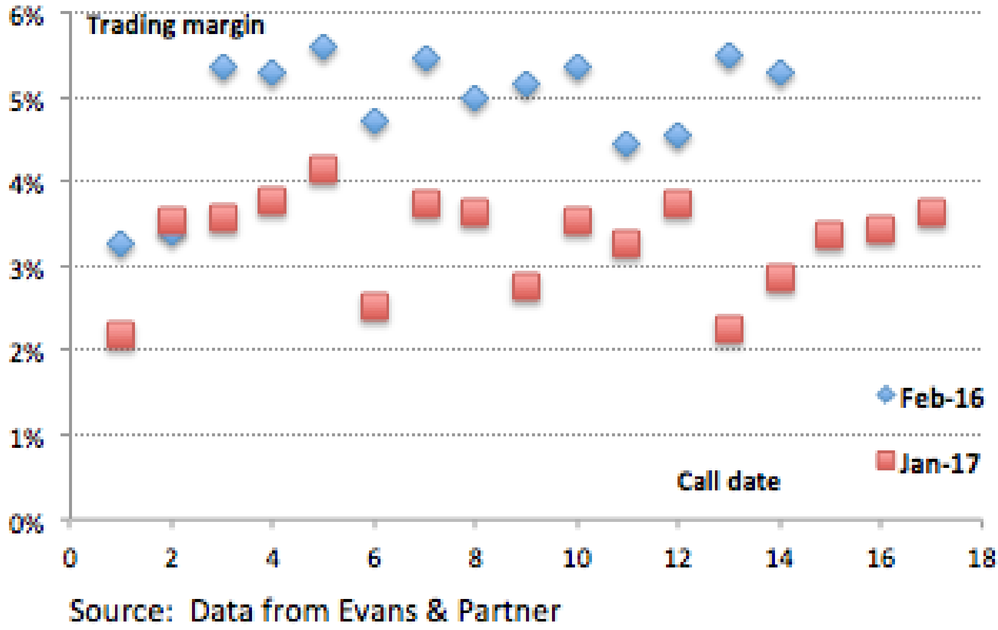
Why retail investors like hybrids

Retail investors have been active purchases of bank issued hybrids, due to:

- **Need for income:** People living off their savings have a strong appetite for sources of income, and SMSFs in particular have moved strongly into hybrids.
- **Replacement for banks shares:** Hybrids have lower price volatility than underlying shares, and recently more comparable gross yields.
- **Brand recognition:** Investors feel comfortable investing in securities issued by the Big Four banks.
- **Accessibility:** Trading on the sharemarket increases the appeal compared to some other income sources.

Widening of margins over 2015 drove down prices, reaching a low (maximum margin) at the start of 2016. Hybrid prices in the secondary market have since been rising (i.e. margins falling, see chart below) and are closer to where they were trading pre-GFC (trading margin is yield to maturity less relevant swap rate).

Bank hybrids trading margins, 2016 versus 2017



The dangers of fixed interest-like returns, but not fixed interest

Many new bank hybrid issues are 'additional tier one' (AT1) designed to be 'perpetual' instruments as required by the Australian Prudential Regulatory Authority (APRA). Hybrids differ from bonds and should not be considered a fixed interest replacement, as they do not have a fixed maturity, and distributions are discretionary. Hybrids do exhibit fixed interest-like returns, but in a falling market, can show equity-like volatility (CBA hybrids lost around 40% of their value during the GFC).

A better description for hybrids is 'equity-paying income'. The equity part is the fact that holders of the securities would share in the losses if the company faces severe financial difficulties, and the fixed interest aspect refers to the regular distribution and limited upside if the company exceeds profit expectations.

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Lessons for roboadvice in Centrelink debacle

Graham Hand

'Robo' has rapidly become the prefix of choice for anything to do with automated or robotic. The biggest local political story of the Australian summer was the use of Centrelink's computers to chase overpayments to welfare recipients. It was a 'robo-debt' campaign, featuring 'robo-assistants' to answer questions. An estimated 169,000 robo-debt letters had been sent by January 2017, with over a million more expected in coming years. It was a political fire-storm with thousands of the least wealthy Australians receiving debt notices in the days around Christmas.

The problem was not the attempt to curtail the burgeoning welfare budget. That is a necessary step at a time when 11% of the population draws a full or part age pension, and increasing numbers will continue to do so for decades to come. The problem was the method. The Centrelink computers were sending out 20,000 debt letters a week, the same number previously sent out each year.

Computers replaced humans

Centrelink usually relies on self-reporting for welfare claims, with clients maintaining their own records on the MyGov website with checks at personal meetings in Centrelink offices. If a client found some temporary part-time or casual work, then nothing for a few months, this could be explained across the desk and adjustments made accordingly. By taking account of the wider set of circumstances, verified personally by humans, there were fewer reported breaches.

Centrelink offices are crowded places at the best of times, with long waiting lines where clients take a number as if they are buying bacon pieces from Woolworths. They wait an hour or two to be called, even if they have an appointment, and sit in front of an officer who is obliged to ask a wide range of questions. What have you done to find full-time employment? Have you looked for voluntary work? How many hours of part-time work have you done? Let's update your assets and liabilities, and have you gifted any money to anyone? The client then signs the form as a legal document, verifying everything is accurate.

It is much like a financial adviser collecting data for a Statement of Advice.

The downside of this personal, more equitable approach is the massive cost of Centrelink officers sitting across a desk chatting to each person. Instead, in the robo-debt campaign, Centrelink trawled through the income records of its clients at the Australian Taxation Office (ATO). The government argues it is the only way to claw back overpayments in the age pension, budgeted at $1.1 billion. Amid the claims and counterclaims, it's likely that a minority of the letter recipients owe a debt.

The relevance to roboadvice

Roboadvice comes in many shapes and sizes, and we already have robo 1.0, 2.0 and 3.0 as new developments occur every week.

In the enhanced versions, call them 2.0 and 3.0, robo is an adjunct to a full-service offering, a more efficient way to collect data and record preferences as part of a complete face-to-face relationship. Elsewhere, digital services advise clients on a range of investments available to meet their risk tolerance and goals in a more cost-effective way, offering market commentary and delivering alternatives to a wider audience than traditional advice affords. A human is available for a chat.

In the US, the leading robo-advice providers have recognised this need as they move beyond the basic robo. According to FinancialAdviserIQ (a Financial Times service):

"New York-based Betterment, an early pioneer in online investment advice, says it's joining a growing number of fund providers and independent wealth managers who are turning to 'real-life' advisors to help manage client accounts.

On Tuesday Betterment launched two new services*. Its 'plus' offering charges 0.4% and lets clients of its basic 'digital' platform make one call a year with a human advisor. The all-robo option's fees are being streamlined to 0.25% a year.*

Betterment also says it's now going to provide a 'premium' service for 0.5% where clients can call human advisors on an unlimited basis during weekdays. To boot, the company says each advisor will be fully licensed and expected to hold CFP designations."

What about robo 1.0?

However, the version most people identify as 'roboadvice', the fully 'automated or robotic', remains robo 1.0, a relatively simple end-to-end investment sales platform. These basic robo models ask a few questions about risk, income and assets, and recommend a simple, ETF-based portfolio.

This simple robo approach is most exposed to the Centrelink comparison. They use an algorithm to select a suitable portfolio, but it's based on a cursory glance at the overall circumstances of the investor. The process leads to a product sale without knowing if it is suitable for the long-term goals of the client which comes from a detailed discussion of personal circumstances.

In the Centrelink analogy, the algorithms look at a small part of the overall picture with a strong potential for incorrect assessment. The automation delivers snapshot 'advice' to the masses who cannot afford to see a full-service planner.

As Wade Matterson of leading consultants, Milliman, said in late 2016:

"Many automated advice providers are simply replicating the increasingly outdated traditional advice process, which places an investor's risk tolerance at its apex and delivers product-led solutions … a more nuanced approach to risk profiling will include different components such as risk aversion (the flip side of risk tolerance), risk capacity (the financial ability to endure losses) and risk need (the amount of risk needed to likely achieve goals)."

Examples of potential robo shortcomings

Consider some examples of the shortcomings of many roboadvice processes:

1. Mortgage versus super

The basic robo models do not deliver financial planning, but rather simple online investment selection. Most cannot answer basic 'advice' questions. Advice does not start with which ETF to invest in, but questions such as:

"Can you tell me whether I should pay off my mortgage or invest the money into super?"

2. Coverage of the full picture

Imagine you meet a financial adviser and ask how you should invest $20,000. You tell her that you have total investible assets of $2 million, you own your home, you expect to retire in five years and you are reasonably risk tolerant. What type of portfolio should be assigned to the $20,000?

Based only on this information, it does not matter. Without knowing how the other $1.98 million is invested, or more about long-term goals and income needs, who cares how $0.02 million is allocated? The human adviser should address the preferred outcome for the entire portfolio.

Most of the robo 1.0 models only ask a few questions about risk tolerance to determine how much of the $20,000 to allocate to riskier assets (equities, property) versus defensives (term deposits, bonds), and then recommend a portfolio. There is no recognition that it might be allocating even more to an asset class that is already overweight in the rest of the portfolio.

3. Imbalance in Australian indexes

A major selling point of most online investment products is the low cost (although this often disguises all the expenses). To meet a price point, the portfolios usually consist of index ETFs. But there is a problem in Australian indexes.

The local market is heavily weighted to a few companies, mainly banks. In fact, the Financials Index excluding property trusts (ASX:XXJ) comprises over half of the S&P/ASX200, with the big four banks making up 30%. Some 'value' or 'dividend' ETFs have 75% allocated to financials. Not only does performance depends on one highly leveraged sector, but it's likely that investors already hold the major banks directly in the rest of their portfolio.

A warning not a failing

In time, improvements in technologies such as artificial intelligence and data mining will take roboadvice to another level. The robo 3.0 models already provide human planners with tools which show clients the outcomes of various choices, and the human element remains important.

Often, the adviser is as much a coach and educator as a financial planner. It will be a while before the online roboadviser shows that level of empathy, as Centrelink is finding as it rolls out its robo-debt and robo-assistants.

Graham Hand is Managing Editor of Cuffelinks.

Graham will be speaking at the Australian Shareholders Association's 2017 Securing Your Investing Future Conference in Melbourne on 15 May with his session: *Is there an Uber awaiting wealth management?*

A robo response: digital wealth advice will engage at all levels

John O'Connell

Graham's Centrelink/robo analogy raises a valuable point that if the fact-find has deficiencies, then the outcome is likely sub-optimal. I think the analogy is a bit too harsh in that the Centrelink issue was a 'behind the screen' data matching problem. That is, it didn't ask the end client for any input about their current circumstances. However, there is no reason why a computer interface can't ask the relevant questions, it simply relies on the smart minds coding the programme to be given the right instructions. The first versions of digital wealth managers (robo 1.0 if you like) do have online fact-finds that engage the client (albeit there is a range of depth to these).

Robo 1.0 as a 'fund of funds'

The robo 1.0 advisers are a 'fund of funds' approach via an online interface. Fund of funds investment models have been around for decades (in human form) and the robo 1.0's that I have seen are simply a better – that is, rigorous, lower cost, and convenient – approach to what was previously done via pencil and calculator. Think of it as applying statistics to what was previously predominated by 'gut feel', much like the Oakland A's Billy Beane's approach to using statistics in the selection of baseball players to drive the A's to the top of the league (popularised in the Michael Lewis book, Moneyball). This approach of statistics and rigour to selection is now widespread across professional sports because it worked.

Robo 1.0 sits as a viable alternative to consider alongside any other fund manager choice. At its core, it uses the power of passive indexing and academic research that shows up to 90% of portfolio volatility is explained by asset class selection. It concentrates on diversification across asset classes, and within an asset class, via the index fund (or more likely Exchange Traded Funds or ETFs) selection. It is relatively safe and dependable for those who take a 'set and forget' long-term approach to their portfolio.

One of the drawbacks of this approach is the fact that you need to liquidate your current portfolio, and send the money to the robo to invest into the underlying basket of ETFs (a fund of funds structure). This liquidation means incurring any relevant capital gains taxes. This is perhaps why the client skew is heavily toward millennials. They are early in their investment journey where this capital gains hurdle isn't such a barrier to adoption.

Robo evolution, technology and humans

You shouldn't think this is the end of the robo technology story. Consumers of all services are increasingly comfortable with the benefits technology can bring. It is perhaps better to view the 'robo' industry through the lens of the mobile phone industry. Robos are probably past brick phones and are up to at least flip phones, not yet at, but rapidly heading toward, smart phones (remember even before the iPhone 7 came six generations of iPhones!). Technology moves forward and looks to solve consumer pain points.

The digital wealth advice (robo) industry is evolving as well. It is rapidly moving more to 'human augmented advice' rather than resting on its laurels at fund of funds via ETFs. This means it is moving to a process-automation approach, and this approach is best delivered through a hybrid model – human assisted digital wealth advice rigour if you like. This model is exemplified by Vanguard in the US where they have had overwhelming success. The client numbers and funds onto their platform via their human assisted approach is testament to this.

Others such as Schwab, Merrill, UBS, Raymond James and even Wealthfront and Betterment have either launched or announced plans to launch human adviser assisted 'robo' offerings into the US market. Yes, human augmented is most likely where it all starts to really impact the industry. The Vanguard Personal Advisor Services model is delivered via a call centre approach rather than traditional face to face meetings. Smart phone video call technology is accelerating this trend. It includes the cost efficiencies of an ETF approach, but coupled with the ability to interact with a human for that 'sounding board', confidence and discussion regarding specific personal nuances.

The Vanguard approach still has the limitation of being a fund of funds model, so the liquidation on entry issue isn't solved. The best of breed will be those that can handle legacy assets, in other words, look at a current portfolio as it stands and give advice about how to 'fix it up' whilst minimising costs. Think of it as the mass customisation of portfolio advice, or individually-advised accounts at scale. Computers are excellent at this sort of problem solving, especially when boundaries are set by a human operator.

In my opinion, the reason for the human-augmented model success is the blending of a lower cost with the ability for the human adviser to perform the role of investment and planning coach. Often this is as much about psychology of the investor, which the industry is now calling 'gamma' (ie beta = market risk, alpha = selection risk, gamma = emotive risks, or the behavioural biases that affect your investing. Computers are methodical, they don't do gamma well (except in sci-fi movies).

Where do I think the industry will get to?

Like everything in business, the winning approach is the one that produces the most convenient customer experience of the desired quality at the lowest price point. The 'experience' a consumer wants in advice varies over time depending upon the advice needs. Sometimes it is just portfolio rebalancing, at other times it is more strategic around estate planning, tax strategies or establishing investment vehicles.

I expect to find the professional practice of the future to include all three levels of engagement under one roof. Online 24/7 self-serve for simple matters I can do myself, video call for when I feel comfortable but want a sounding board, and face-to-face for when I have a complex issue and I want to talk through scenarios.

At all three levels the core will be an 'advice engine' (the robo) that does the donkey work (hat tip Chris Cuffe for that term) of number crunching cost effectively.

Digital wealth advisers (the politically correct name for 'robos') will be an integral part of the future – just like smart phones – but that future is also most likely to be embedded into a human assisted overlay. People engage best with people.

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Negative gearing doubts and ATO watches home purchasers

Rob Simeon

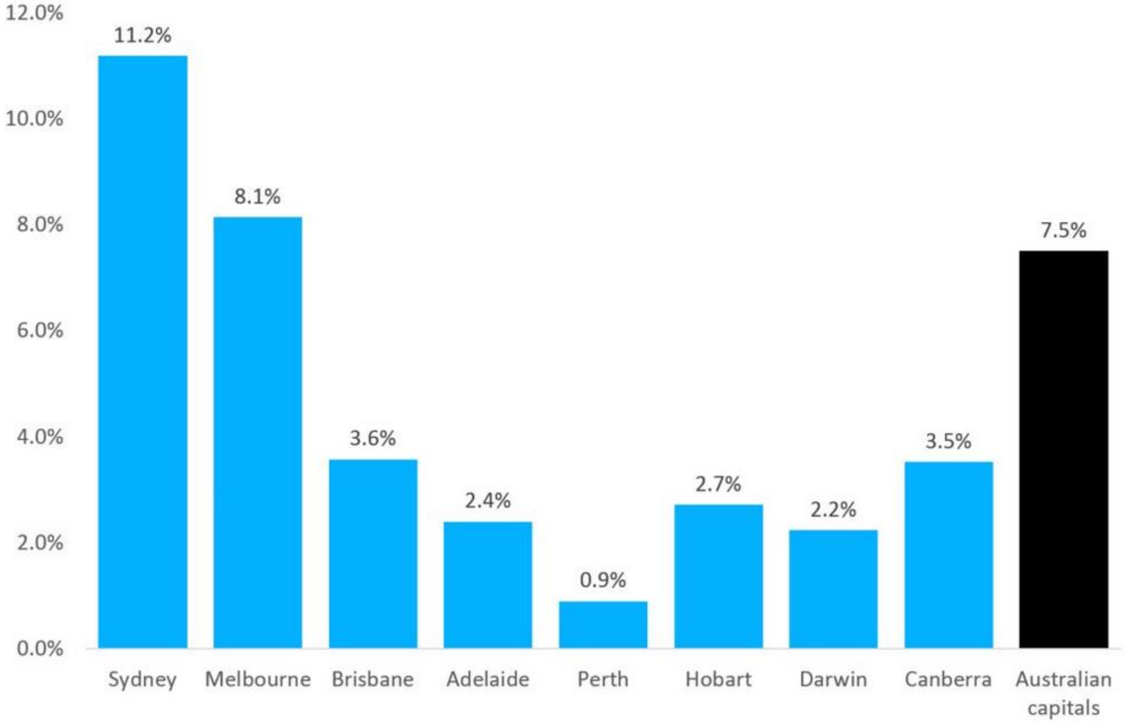
When Malcolm Turnbull addressed the National Press Club last week, I was really hoping he would announce a major policy addressing Australia's ongoing housing affordability woes. Sadly, little was offered. He laid the blame at the states and territories which simply confirmed that little will happen to this space.

Plan for a change in negative gearing rules

We can then expect political huffing and puffing until November 2019 when Australia must endure the next election. There is a strong possibility that we will see a changing of the guard, after which negative gearing laws will be amended, probably coinciding with a major property downturn. On that basis, the game plan for the next two and a half years is predictable. Property investors will go-hard simply because they want to get in before the negative gearing rules change.

There is little doubt that property prices will continue to rise in 2017 to the extent that we may see cumulative house prices reach 100% gains over five years in some areas. The latest statistics from CoreLogic to January 2017 showed Melbourne up 11.8% in the last year and Sydney continues to run amok at 16%. Since June 2012, the cumulative increase in house prices has been 70.5%, CoreLogic reported.

Compound annual change in dwelling values, 5 years to January 2017



Source: CoreLogic

Other potential policy responses

Two announcements I was expecting were on immigration and reducing the off-the-plan ratios to overseas buyers. CBA Senior Economist Michael Workman said,

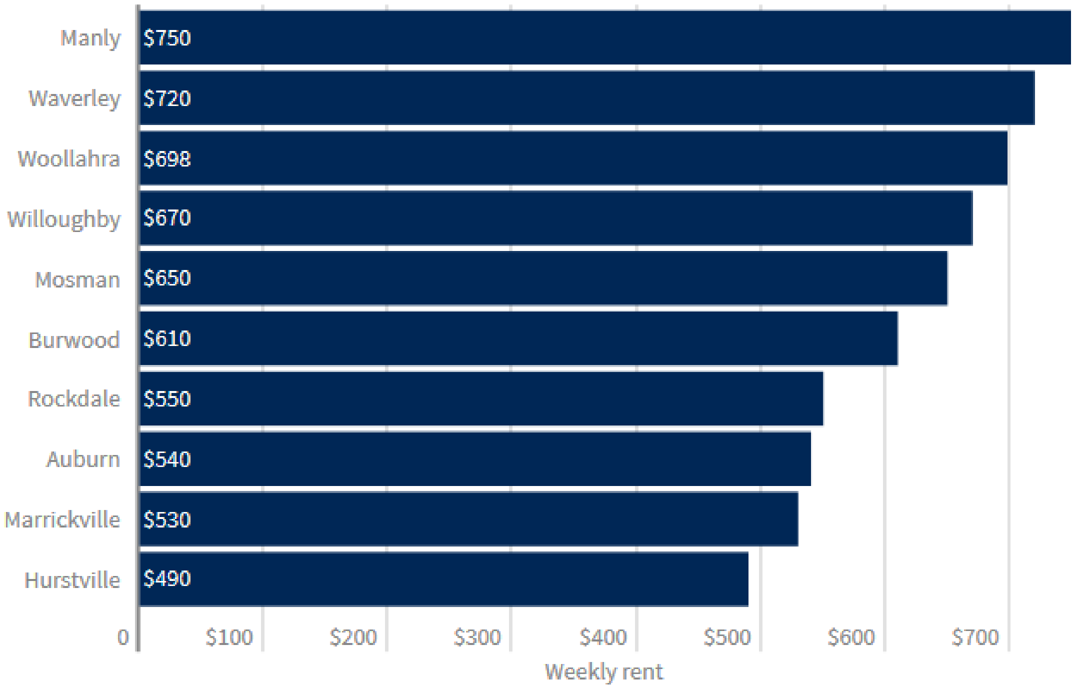
"Housing affordability is set to worsen without federal action. The Federal Government controls some of the significant demand factors for housing markets, namely population growth via migration and the spectrum of tax and foreign investment policies that significantly inflate demand for existing and new housing. Housing affordability can be improved, via stabilising growth in house prices and rents, by gradual reforms to both supply and demand issues."

In the present property environment, there is no need for off-the-plan sales to foreign buyers to remain at 100% and this ratio is controlled by the Federal Government.

Despite the construction of thousands of new apartments, we are not seeing an easing of rents as was expected. Data analysis from the NSW Rental Bond Board identified more tenants than ever. No surprises that the most expensive five suburbs are Manly, Waverley, Woollahra, Willoughby and Mosman. We can therefore expect to see these areas hot-spotting with investors to achieve the best rental returns as well as capital appreciation. Investors will keep driving these markets simply because the Federal Government has tinkered with superannuation, and property markets are out-performing the share market.

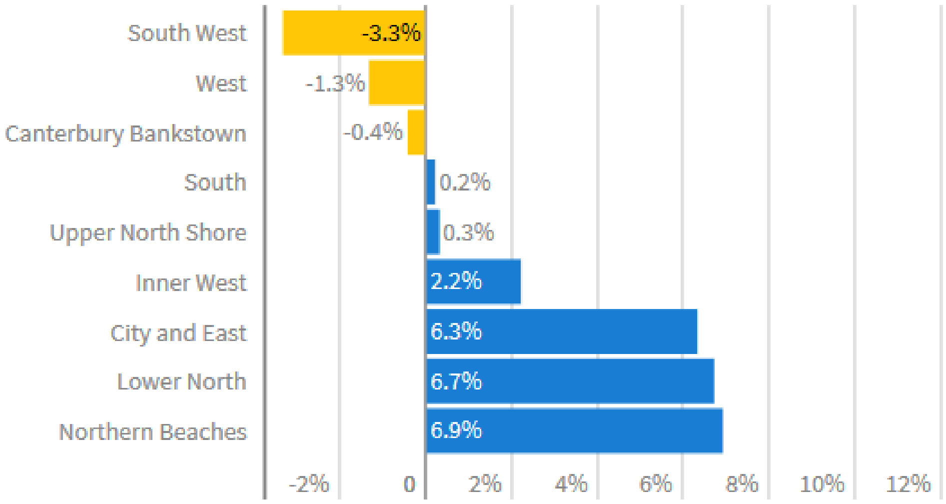
Of course, we all know that this will change over time although the momentum is much stronger with our respective governments doing absolutely nothing aside from weekly lip service.

Top ten weekly rents for a median 2-bedroom flat



Source: Housing NSW, tenants.org.au/tu/rent-tracker

Sydney's apartments: How prices fared over last 6 months



Source: Domain Group House Price Report, December 2016 data

AUSTRAC and ATO asking direct questions

Much has been written about money laundering within the Australian property markets. The appointed watchdog, the Australian Transaction Reports and Analysis Centre (AUSTRAC), is investigating more than $3 billion in suspicious transfers from Chinese property investors last year. This was further backed-up late last year when the major Australian lenders ceased lending to foreign buyers. I was surprised to read last week that foreign investors are again rising but this time, they are paying cash to settle the full amount of the purchase.

Many will ask the obvious questions as to where all these monies are originating, based on recent announcements that the Chinese Government had shut down money transfers from China.

Well, allow me to lay your concerns to rest. The smartest thing Joe Hockey did when he was Treasurer was to hand all data collection on every property transfer in Australia to the Australian Taxation Office (ATO). Some months later, after reviewing the data, an excited ATO announced they were expanding their forensic property investigations back to 1985.

Just last week, I received a telephone call from an ATO investigator requesting purchaser contact information for a property we sold late last year. Nothing was said to justify the request. I simply provided the relevant information.

What this clearly tells us, is that every property transaction is scrutineered by the ATO and it should not be possible to beat the system.

With so many discussions on housing affordability, this development should please all those closely following real estate movements. As each property settles, the data is then sent to the ATO for recording and investigation.

Everybody buying Australian real estate should know that each transaction is noted and investigated. And yes, they have the resources.

Robert Simeon is a Director of Richardson and Wrench in Sydney's Mosman and Neutral Bay and has been selling residential real estate in Sydney since 1985. He has been writing the real estate blog Virtual Realty News since 2000.

The SMSF sector by the numbers

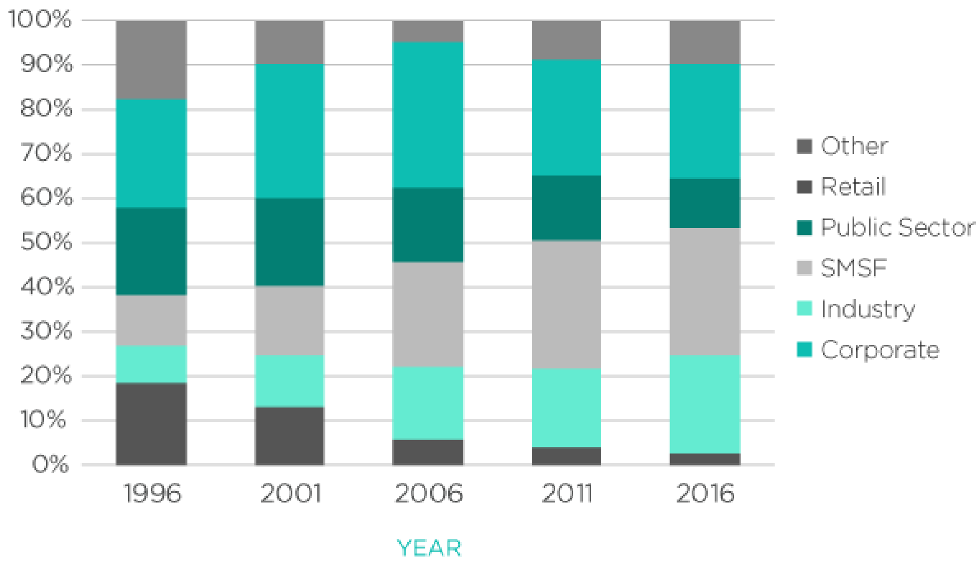
Philip La Greca

The best available data on the SMSF sector as a whole comes from the latest ATO statistics. The report released in December 2016 is based on 2014/15 SMSF tax returns, with the time lag due to the tax return process.

Largest sector but slower growth

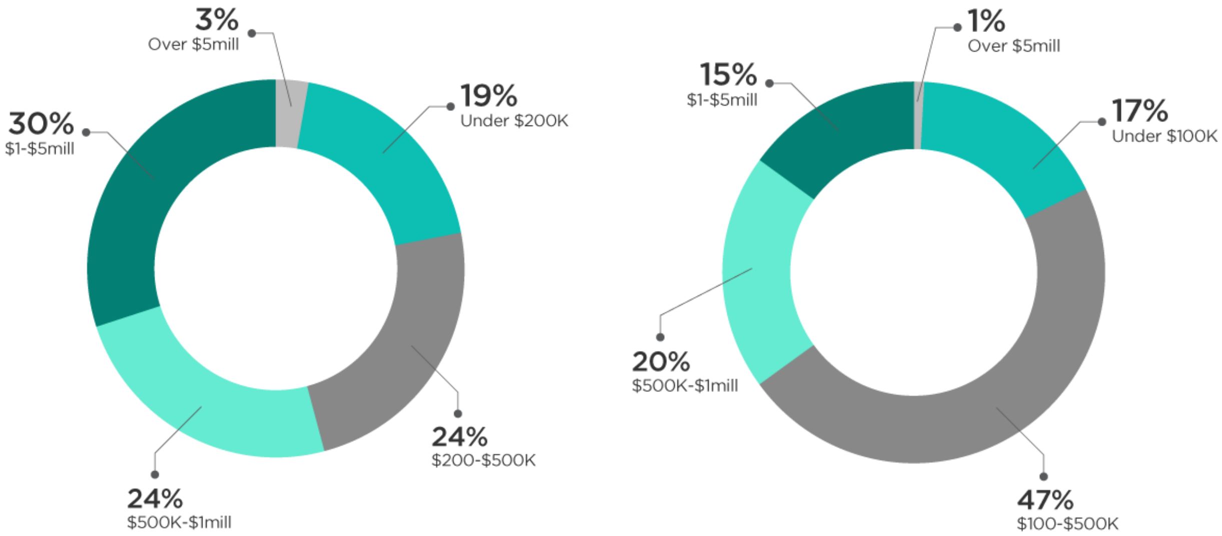
SMSFs remained the largest sector of the Australian superannuation industry, with 29% of the $2.1 trillion total super assets as at 30 June 2015. However, in the past five years, SMSFs are no longer the fastest-growing sector due to increased growth of institutional funds. During this period, total super assets grew by 59%, while SMSF assets grew by 55%, and non-SMSF funds by more than 59%. The SMSF net cash flow, based on contributions and rollovers minus benefit payments, has fallen from $16 billion in 2011 to $7.8 billion in 2015.

Superannuation assets by industry sector, as at 30 June 2015 (Source: ATO)



Larger SMSF balances rising quickly

The average balance per SMSF was about $1.1 million as at 30 June 2015. Referring to the left chart below, the number of SMSFs with more than $1 million of assets grew from 27.5% in 2011 to 33.0% in 2015, with 3% over $5 million. Conversely, the number of SMSFs under $200,000 fell from 24.7% in 2011 to 19.1% in 2015.



SMSF member balances and ages

The average member balance was $589,636 compared with the average non-SMSF member balance of $46,000. The largest group of members (47.5% of the total) have balances between $100,000 and $500,000. Almost 17% of members have balances below $100,000 while 15.9% of members have individual balances in excess of $1 million (see chart above right).

About 38% of SMSF members also had entitlements in other superannuation funds, presumably to maintain insurance.

About 71% of SMSF members were over 50 years of age. This contrasts with non-SMSFs where 71% of members are under age 50. However, there are signs of increasing SMSF uptake among a younger age band. The 2015 year shows members below age 35 representing slightly over 10% of the newly established funds, compared with 5.7% for the whole SMSF member population.

Contribution levels

In the five-year period to 30 June 2015, contributions to the SMSF sector averaged $26.6 billion a year (member contributions $20.0 billion, employer contributions $6.6 billion). Member contributions to SMSFs increased by 54% over this period, while employer contributions decreased by 0.5%. In comparison, both member and employer contributions to all super funds increased by approximately 48% and 24% respectively. This discrepancy is driven by age differences between members of SMSFs and other super funds, with non-SMSFs having fewer retired members and thus receiving more compulsory employer contributions.

	2011	2012	2013	2014	2015
Contributions ($b)	23.8	26.6	23.5	25.9	32.8
Rollovers ($b)	11.4	12.2	12.2	10.2	10.0

Form of benefits heavily skewed to pensions

94% of all SMSF benefit payments now are pension payments, a significant increase from 74% in 2011. The proportion of benefits relating to transition-to-retirement pensions is 19% for SMSFs compared to 12% for superannuation overall.

Despite the higher average age demographics of SMSFs, only 48% were paying pensions to at least one member, while 52% of SMSFs reported they were solely in the accumulation phase.

Philip La Greca is Executive Manager of SMSF Technical and Strategic Solutions at SuperConcepts, a leading provider of SMSF services. SuperConcepts is a sponsor of Cuffelinks.

Update on LIC developments

Leisa Bell

January's update from Independent Investment Research (IIR) includes the reasoning behind recent suspensions of ratings for Hunter Hall and Contango MicroCap, three new funds entering the market, changes afoot for Century Australia plus the regular pricing and performance update.

IIR has suspended its rating for Hunter Hall Global Value (HHV) following the surprise resignation of its CIO. Although there is confidence in the remaining management team, any further loss of key personnel will have a negative impact. The two takeover offers that are in place add another level of uncertainty. HHV's largest shareholder, Wilson Asset Management has also weighed in, recommending an equal-access share buy-back which has met with resistance.

The suspension of Contango MicroCap's (CTN's) rating was prompted by the unusual move to appoint an additional portfolio manager and rebrand away from the Contango name. IIR's concerns lay with "the potential for differences in style and process to the existing manager".

Three new ASX listings are detailed:

- URB Investments Limited (URB) – is an urban renewal-themed investment company, which will invest in a range of assets, including property and infrastructure, focussing on urban renewal and regeneration.
- The Switzer Dividend Growth Fund (SWTZ) – will be targeting consistent dividend and long-term capital growth by investing in high-yield Australian blue chips.
- Fat Prophets Contrarian Fund – will consist of 15-25 international stocks, selected based on mispricings, plus a small element of short-term trading.

Century Australia (CYA) has recommended Wilson Asset Management's restructure proposal, subject to an independent expert review. Shareholders are expected to vote on the proposal in early-March.

In the pricing and performance update, large cap focused LICs saw improved performance over the last quarter, but remained below index returns over the last 12 months. The current reporting season is also highlighting a trend for lower dividends. Small cap focused LIC's performed strongly in the first half of 2016, but weakened in the second. This underperformance is expected to continue over the coming months. International focused LICs performed well on the back of a Trump-led US market rally, despite lower returns from emerging markets.

Access the full paper plus other LIC updates and reviews on our web page, Listed Investment Companies updates.

Leisa Bell is Assistant Editor at Cuffelinks.