Cuffelinks
Connecting investors with ideas

Edition 191, 24 February 2017

This Week's Top Articles

Stop the tinkering and bring on the ideas

Dr Martin Fahy

[Editor's Note: In late 2016, Dr Martin Fahy became the CEO of the Association of Superannuation Funds of Australia (ASFA), the peak body representing institutional super funds. Despite the growth of SMSFs, institutions manage two-thirds of the assets in super funds.

Dr Fahy spoke at the Pritchitt Partners Annual Reception on 31 January 2017, on '2017 super outlook: what would good look like*?' His wide-ranging speech suggests ASFA will become more active in publicly advocating for big funds and their role in superannuation.*

He made many insightful comments which other leaders should consider in the policy debate. This version paraphrases his talk in the interest of brevity, and the headings are mine].

We need a market for ideas

There is a market for ideas where we have a large community of people who are selling ideas and a community of people who are buying ideas. At heart, I'm a markets person. If the market is to work, then we need purveyors of ideas and we need consuming critics. In a world where superficial thinking often masquerades as policy, we need an alert and engaged community of consumer critics and the media is an important part of that. For me, industry bodies and associations play an important part including as critics of public policy.

Superannuation is working in an aspirational society

I fundamentally believe superannuation is working. As a piece of public policy, it works because it provides dignity in retirement. Despite the claims of the Grattan Institute, Australians have aspirations beyond the age pension. Australians are in the business of lifting not leaning, and superannuation speaks to the culture of self-reliance which has defined this country. Superannuation supports fiscal sustainability and reducing the unfunded pension liability, it drives the financial system in infrastructure and nation building, it underpins the stability of the banking system with banking deposits, it's recognised worldwide and in terms of adequacy, it punches above its weight. If you sit like me with parents who are on an age pension in Ireland, where in 2010 and 2011, government spending contracted from 105 billion pounds to 76 billion pounds in a year, that's what austerity looks like and it really hurts people.

It's important for these reasons that we commit to the important and aspirational goal that we have for superannuation. I'd like to state clearly that an adequate and dignified retirement is not a wishy-washy, shapeless, vague idea. Constructs that underpin the western liberal democracy and the common law system such as the rule of law, the reasonable man, best endeavours, negligence, even indecency – all of these exhibit a level of constructive ambiguity that allows them to speak to context. Embracing constructive ambiguity is a key part of good public policy and the way we engage with each other. To insist on clarity is to oversimplify. On the ASFA standards, we should be prepared to push back when people say 'adequate' and 'dignified' are not terms that can be precise.

Public policy tinkering and freakonomics erodes confidence

In the market for ideas, it's easy to become complacent. The danger comes from two main sources: first is the tsunami of public policy tinkering that has characterised public policy thinking over the last five years. It causes uncertainties, it erodes public confidence in super and it erodes engagement. It drives up systems costs because we are constantly updating systems to take account of regulations. It also drives out the space and opportunity for real value-added innovation.

If you look at the development road maps across super funds in this country, there's an agenda which runs out for years and the burn rates run into millions of dollars every month, purely taking account of regulation changes. They impinge on the amount of capital that can be invested and they leave no space, time or appetite for genuine innovation.

The second thing that creates a danger for super in the midst of the skirmish about fees and costs or objectives or RG97 is that we are losing the battle for the hearts and minds of Australians. The compelling narrative that sits at the heart of super needs advocates and defenders. As an unqualified good, it needs to be defended from those people who would sell it out for short-term fiscal imperatives, political expediency, the Grattan-inspired chattering classes and dinner party freakonomics. It's worthy of defence and our best unafraid thinking.

Super must recognise the changing reality of work

The first vision I have for super is the need to embrace the changing reality of work, jobs and the organisation of effort in the economy. Self-employment and independent contracting may become the dominant vehicle for labour market transactions. Portfolios of careers could become part of the mainstream reality. The 'gig economy' is changing and super cannot be found wanting. Super must be personalised, on demand and ubiquitous.

Fintech is up to 15 years away from genuine disruption

The second need is to move beyond the superficial engagement which has defined fintech to date. We need to abandon the simplistic 'there's an app for that' sort of garbage can of solutions looking for problems and really start to engage with what are the difficult challenges in super.

Instead, we need to deal with the messiness of the superannuation value chain. We need to nurture a system where markets trump hierarchy, open architecture trumps regulatory standards, where a smart teenager in a college dorm might disrupt super, hopefully from within.

The market for ideas around fintech deserves some scrutiny. You know something's a fad by three characteristics: there's more written about it than is actually known; there are more people selling it than buying it; and the money is in the seminars.

The challenge for fintech is to deliver on the promise by getting into the plumbing and making a difference and there's a long way to go on this. I think for fintech to disrupt super, we're looking at a 10-15 year period. It needs a lot of capital to change it.

Own the reinvention of yourself

We need unafraid, hard thinking about the interrelationship not only between the traditional pillars of retirement (superannuation, age pension and the family home), but also with health care, age care, and what I call 'vitality' or 'transformation assets'. A large part of your success in post-retirement (putting aside money) is our ability to own the reinvention of ourselves that the shift in employment will mean as we get older.

We need someone to come forward with a higher purpose for our retirement. At the moment, we think about retirement as recreation, which means retirement is about consumption. It is essentially inwardly-focussed. In that setting, it is unfulfilling, it is very expensive, and it is economically-draining. Somewhere out there, and this is a challenge for baby boomers, we need some way of transforming our perception of retirement away from recreation and the associated consumptions and towards a higher purpose. That will sit uncomfortably with many people. It's not about working until you fall over but it is about a higher purpose.

The key players are the baby boomers

Much as we like to frown on their frivolous lives and what they've achieved, the reality is we're just jealous. They reinvented relationships and sexual intimacy in the 1960s, they gave us the protest movement, drugs, sex, rock and roll, Bob Dylan, and now we need them to reconceptualise retirement away from a five-year period of recreation leading to your demise, into a 25 to 35 year engagement which is about you recreating who you are.

That means men becoming comfortable in jobs that involve caring, looking after elderly parents. It's a huge challenge and where it will come from and what it is, is a mystery.

GFC killed financial innovation

My final point is we have become gun-shy about financial innovation since the GFC. Securitisation, credit default swaps and the alchemy of financial engineering have acquired a bad name. To some extent, we don't want to engage with the science. We have to overcome these residual fears and embrace socially-useful financial innovation. The reality is such innovation gives us portfolio effects, it limits downside, it allows us to monetise things.

I see this innovation in retirement and CIPRs, particularly in the orderly monetisation of the family home to secure age care. Here, we need to address some of the conflicts of interest that children face, the lumpiness of the assets, the general market failure we have seen around reverse mortgages.

We also need innovation around insurance in super, member engagement (and the answer is not an app), and perhaps affordability. They would all benefit from product and technical innovation, process innovation.

Superannuation is a collection of paradoxes

The original idea of super was a collective group concept with pooling effects to give scale. The paradox is that we then want to personalise the offer. It is delivered through the employment channel but individuals want a tailored brand experience. We ask ourselves, if Apple were a superannuation fund, what would it look like?

The other challenge is super is fundamentally about delayed gratification but we need to build engagement in the here and now. I don't know how to build this engagement but I do know there are ideas out there that can do it. It's about a higher ideal and communities, not instant gratification.

Brands matter

I want to conclude on the falsehood that is dominating public policy with respect to super. The assumption is that superannuants are largely indifferent between two funds if they pay out the same amount. Fund A pays half a million dollars at age 65, Fund B does the same, they have the same risk, the same insurance products, and that's it.

All of the empirical evidence says I am not indifferent between them. The reality is (and self-managed super shows this) that people will pay a premium for control, to be associated with a brand, to be associated with a community, for ESG purposes, for ethical purposes. The myth that superannuants are indifferent between equal retirement amounts is doing enormous damage. It's given us an objective function that says it's about reducing fees and costs, and maximising net returns. Citizens in this country are not that stupid. They deserve public policy settings that take account of the multiple factors that they are trying to achieve. The things they want to do in terms of ESG and infrastructure are not about finance, they're about values and belief systems and contributions to communities they wish to identify with.

The aspiration I have is that we should embrace the complexity of the policy setting environment and its messiness.

Dr Martin Fahy is the Chief Executive Officer at the [Association of Superannuation Funds of Australia](#) (ASFA).

Super complex: the advice gift that keeps on giving

Graham Hand

"... we've got the chance in history. This is your great chance. This is the night you'll remember. This is the night that we are going to create national superannuation for everybody." Bill Kelty, Former ACTU Secretary

"… now I have got the system up and ready to rumble." Paul Keating, former Prime Minister

Paul Keating and Bill Kelty are rightly called the fathers of our world-acclaimed super system, but if they had attended the SMSF Association Annual Conference last week, they would have wondered who is looking after their child. This Conference of over 1,700 delegates is the leading event for SMSF experts from across Australia. As befits such an audience, the majority of the sessions were highly technical, but it was apparent that the supercharged complexity of the new rules was confounding most of those present.

The final summing up session concluded that the two most frequently heard words in the Conference were: 'It depends'.

Confusion, lack of time and brain freezes

Many SMSF advisers went into the Conference believing they understood the new rules, but came away realising there are many unknowns. One presenter said advisers who were not SMSF specialists were "hanging on by the skin of their teeth". An SMSF technical specialist told me she was compiling a list of questions she could not answer. Another said he had been in a meeting with the Australian Taxation Office (ATO), the Financial Planners Association and the SMSF Association, and the ATO officers were openly disagreeing in response to questions. A leading provider of software to accountants and advisers said his company has not been able to programme the changes and their software will be out-of-date.

Specialist workshops run by SMSF leaders Graeme Colley and Peter Burgess called '*Dancing with the experts – the SMSF strategy challenge*' did not complete their case studies due to adviser confusion about the new laws. Some speakers privately expressed surprise to discover a much lower level of adviser knowledge than expected.

Although the legislation on the new super rules was passed in November 2016, the consultation process on the finer details is currently underway. For example, the Law Companion Guide LCG 2017/D3 on *'Superannuation Reform: Transfer Balance Cap – Superannuation death benefits'* was only released last week with a response deadline of 10 March 2017. The rules will be operational three months later, giving negligible time for technical areas to analyse and inform advisers on the correct treatment, never mind explaining to clients and implementing prior to 30 June 2017. Many delegates shook their heads in disbelief when a speaker said they had 134 days to sort it all out.

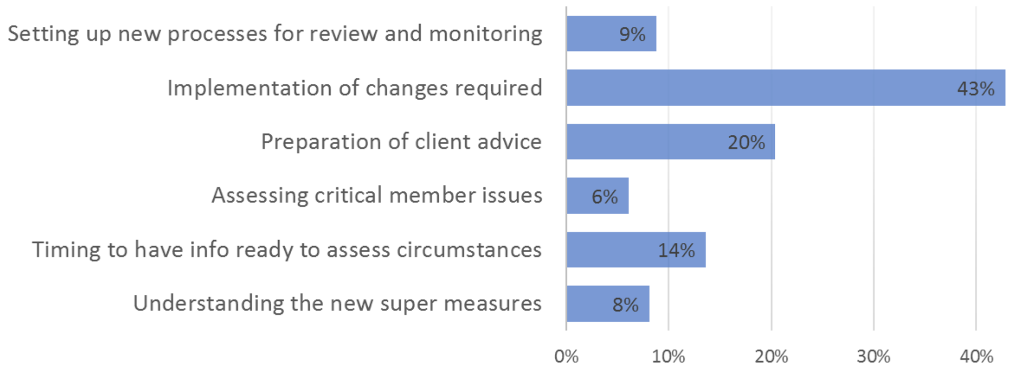
I sent Liam Shorte, NSW Chapter Chair of the SMSF Association and an SMSF Specialist Adviser, a draft of this article and he wrote back:

"This really sums up well the feeling that most advisers had coming away from the conference. The analysis of numerous strategies will play the biggest part of our advice with each client and investments will take a back seat. For many of us who had moved to focus on strategy it will be easier to have those conversations while others will struggle.

Since the conference I had to stop reading for a few days as I literally felt a brain freeze and I have had to break each issue down in to talking points. Now I am making my accounting partners aware of the detailed discussions we will need have with clients in a meeting where the accountants had previously just done a simple overview of the financials and collected signatures.

If there ever was a time for Financial Planners, Accountants and Lawyers to work as a team for SMSF clients, then this is it."

In Aaron Dunn's (CEO of The SMSF Academy) session titled, '*Capitalising on the super reform opportunities*', he challenged advisers to adapt and engage in the face of the reforms, recognising the opportunity presented to build a stronger business. He polled the audience with the question, *"What do you feel is the greatest challenge with the super reforms?"* The responses showed the critical issues advisers face in the next few months (not years!).



Demonstrating the complexity, Aaron has prepared a detailed checklist on the new rules which runs to 11 pages, and to quote Liam, "I am using it in every client meeting and you cannot ignore any part of it."

The example of transitional CGT relief

Consider one slide from one presentation, by Justine Marquet, Senior Technical Manager at AIA, titled, '*SMSF pension opportunities, contingencies and some unfortunate realities*' on the subject of transitional CGT relief (if you don't know what that is, this was not the conference for you):

Checklist

- Determine whether SMSF needs/can access transitional CGT relief
- Will CGT relief produce the best tax result?
- If using CGT relief under segregated fund rules, decide which assets to apply relief to
- Members with multiple super income streams, consider which to reduce
- If need to reduce amount in excess of TBC then commute out or roll back to accumulation?
- Review estate planning options after commuting/rolling back. Reversionary? Age of children?
- Check insurances and allocation of premium cost
- Remember option to rollover death benefit

That's one slide in a 26-slide presentation in an hour. This is obviously not a criticism of Justine, but an illustration of the level of complexity the system now delivers.

Again on this one issue, Darren Wynen, a Senior Tax Trainer at TaxBanter, presented a paper called '*Latest CGT issues for SMSFs*', and it ran for 13 pages of text, detailed examples and technical points. All for a transitional arrangement which ends in a few months. To quote Wynen,

"The relief allows complying superannuation funds to choose to apply the relief to reset the cost base on assets that are reallocated or re-proportioned from the retirement phase before 1 July 2017."

Could it be the rules will not be finalised before the transition period ends?

Is this only a problem for the super-wealthy?

The Transfer Balance Cap is set at $1.6 million, which is a large amount. However, it will effect a spouse who inherits super from a partner, so arguably couples with $1.6 million between them need to know the options. With approximately two people per SMSF, it is instructive to consider the cap in terms of SMSF balances, not only per member.

In case this is considered a trivial issue relevant to a few large SMSFs, consider the statistics:

Number of SMSFs (June 2016): 577,236

Number of SMSF members: 1,087,741

Average assets per SMSF: $1.1 million

Average assets per member: $0.6 million

SMSFs by asset size: >$1 million-$2 million, 18.8% of total or 108,000 funds
>$2 million-$5 million, 11.4% of total or 66,000 funds
>$5 million, 2.8% of total or 16,000 funds

That's almost 200,000 SMSFs with balances over $1 million (recognising that many funds have two members). This does not include people in public super funds or those in defined benefit schemes. This complexity is not only an issue for a few super-wealthy.

ATO expecting errors from trustees and their advisers

The Commissioner of Taxation, Chris Jordan, told the Conference that the ATO would work with people who make an honest mistake. An adviser later told me this was wishful thinking, and recounted his experience with a client pulled over hot coals by the ATO after an insurance payment had created a small excess contribution, resulting in a heavy fine.

Also from the ATO, James O'Halloran, Deputy Commissioner, Superannuation, presented on '*Navigating the new measures: How the ATO is responding."* He said the ATO is preparing tools, checklists and guidance notes, and they expect errors and non-compliance. He added,

"Come and talk to us when you think you've made a mistake. We do want early engagement. We may have discretion or conversely it may not be a mistake … We think there has been some misunderstanding around CGT relief and also how to apply for it. We want to help promote consistency and also draw together a greater common understanding of how to get things right in the first instance."

Response from Government included a quote from Cuffelinks

The Minister with responsibility for superannuation, Kelly O'Dwyer, spoke on the final day. She quoted from an article written by Paul Keating in Cuffelinks. She acknowledged the somewhat strained relationship with the super industry when she said, "Not everyone is happy with all aspects of this legislation." However, she had obviously not attended the sessions designed to use the system for tax minimisation, estate planning and wealth accumulation, when she said:

"The new measures support the key objective of superannuation, which is to provide income in retirement to substitute or supplement the age pension. Superannuation is not a vehicle for tax minimisation, unlimited wealth accumulation or estate-planning purposes."

Really? How many people with over $1 million in their SMSF reference the age pension as an objective?

A system few people understand

Since the Superannuation Guarantee was introduced in 1992 to address Australia's retirement income needs, it has become progressively more complex. Through preservation ages, salary sacrifices, preserved, restricted non-preserved and unrestricted non-preserved, non-concessional and concessional contributions, reversionary pensions, surcharge taxes, co-contributions, segregation, sole purpose tests … and on it goes, we have a structure that most people disengage from, despite it increasingly representing the second-largest part of their total assets.

The most recent changes are widely considered to be the most significant and complex in at least a decade, adding to the minefield of jargon and confusion. SMSF specialists, financial advisers and accountants have never been busier, with one presenter calling the new rules, "the gift that keeps on giving". And at the time of writing, only about 128 days to work it all out.

I doubt all this expensive advice work is what Paul Keating meant when he said the super system was up and "*ready to rumble*". Let's leave the final words to Minister O'Dwyer:

"And it does mean the system must be the best it can possibly be."

Graham Hand is Managing Editor of Cuffelinks. He attended the SMSF Association Annual Conference as a guest of the Association. The quotations at the start come from a new book, 'Keating's and Kelty's Super Legacy: The Birth and Relentless Threats to the Australian System of Superannuation' by Mary Easson.

Home is where the care is

Rachel Lane

Last year over 1.3 million Australians received aged care. Around 295,000 received residential aged care while over 1 million people received aged care in their own home.

Over the coming year, the number of Home Care Packages is expected to grow by almost 30,000, from around 72,000 to around 100,000.

Significant changes to Home Care Packages will take effect from the end of February 2017, giving consumers greater access to care and greater choice about who delivers that care to them.

Home Care Packages: eligibility and cost

Home Care Packages assist people who wish to continue living in their own home and community, whether it's the family home, an apartment, a caravan park, a retirement community, a granny flat or other living arrangement.

Eligibility for a Home Care Package is based on an assessment of the person's care needs. This assessment is performed by an Aged Care Assessment Team (ACAT) and normally takes place in the home where the care will be delivered to gain an understanding of any environmental factors. Referrals to the ACAT are often made by a medical professional, however people can make the request for an assessment themselves or on behalf of a loved one.

There are four levels of Home Care Packages:

- Home Care Level 1 – to support people with basic care needs.
- Home Care Level 2 – to support people with low level care needs.
- Home Care Level 3 – to support people with intermediate care needs.
- Home Care Level 4 – to support people with high care needs.

Home Care Packages are delivered on a consumer-directed care (CDC) basis, which gives the consumer the ability to choose the type of care and services they wish to receive and who provides those services.

The funding is based on a daily rate and paid directly to the care provider. Currently Level 1 funding is $22.04/day, Level 2 $40.09/day, Level 3 $88.14/day and Level 4 $133.99/day. Additional subsidies are payable for people who are returned servicemen or women, have dementia or require assistance with oxygen or feeding apparatus.

Currently the ownership of a Home Care Package is with the care provider. It is their role to assess applications for the packages they have available and then co-ordinate the delivery of the services. This system has led to accusations of providers charging excessive administration fees (in some cases more than 50% of the value of the package) or discriminating against people who couldn't afford or didn't want to purchase private services in addition to the package. It has also meant that people who move to another location need to relinquish their package and apply again in their new area.

Arrangements change from 27 February 2017

From 27 February 2017, funding for a Home Care Package will be allocated to the package recipient. The care recipient will be able to choose their preferred home care provider and can move providers at any time - the package will be transportable nationally. Providers will be able to charge an exit fee to consumers, which will need to be disclosed on the government's My Aged Care website and in the Home Care Agreement.

The government's My Aged Care will be responsible for prioritising and assigning packages. The level of the package assigned will be specified (1, 2, 3 or 4) and may be lower than the package that the consumer is eligible for based on their care needs. Any Home Care Packages that are held by providers but not in use as at 26 February 2017 will be reclaimed and form part of the national inventory.

Once the Package has been assigned, the consumer will have 56 days in which to find a home care provider and sign a Home Care agreement. An extension of up to 28 days is possible where the consumer is finding it difficult to identify a provider.

The means-testing arrangements for Home Care Packages remain unchanged. People who are full pensioners (or with the equivalent income) can be charged the Basic Daily Fee, which is currently $9.97 per day. Those with higher levels of income are levied an income-tested care fee in addition to the Basic Daily Fee. The income tested care fee is assessed by Centrelink based on their income test. The fee is calculated at 50c per dollar of income above the annual thresholds of:

$25,792 single

$20,025 couple (each)

$25,324 couple separated by illness (each)

The fee is capped at $5,208/year for part-pensioners and $10,416/year for self-funded retirees and cannot exceed the value of the package. There is also a lifetime cap of $62,499 which extends across home care and residential aged care.

Consider the example of Shirley

For example, Shirley is a part pensioner who is happy living at home. Shirley has been assessed as eligible to receive a level 2 package which provides $40.09 per day of funding. In addition to her home, Shirley has $250,000 in a combination of bank accounts and shares.

Shirley's Home Care Package cost would be calculated as:

Income is: $7,387/year from investments (deemed) + $19,929/year pension entitlement (less supplements) = assessable income $27,316/year

Less the income threshold $25,792/year = $1,524 income above the threshold

At 50c/dollar Shirley's income-tested care fee would be $2.09/day.

The cost to Shirley of receiving the Home Care Package is $9.97 basic daily fee + $2.09 income-tested care fee = $12.06/day or $4,402/year.

While the total value of the package is $50.06/day, or $18,272/year.

Watch the advice complexities

From an advice perspective, these means-testing arrangements are straight forward. The complexities come from the various legal and financial considerations involved with the client's living arrangements, such as granny flats, retirement villages and land lease communities, which are part of their care solution.

The latest edition of '*Aged Care, Who Cares?*' which I have co-authored with Noel Whittaker, helps people to understand all the options in accommodation (including granny flats, retirement communities and aged care facilities), the care services available, the legal tips and traps to be aware of and some strategies for making it more affordable.

With the overwhelming majority of people choosing to receive care at home, the million-dollar question is 'Where is home?'

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

Unwelcome consequences of new US trade policies

Vimal Gor

January 2017 may well set the tone for the rest of the year, one of disruption to the economic and political order and a resetting of the way the US does business. The end to US hegemony is here and it is being driven internally as President Trump and his team focus solely on the needs of America and step back from self-imposing itself as both role-model and policeman for the globe.

For the first time since 2007, global macro markets will react differently to economics and politics in a way that may seem counter-intuitive. There is a further risk that past correlations between asset classes will weaken because the baton has been passed from central bankers to politicians, whose reaction functions are difficult to ascertain and change constantly with the political wind. While markets originally feared this switch, they are now embracing it wholeheartedly as the prospect of a move away from the regulatory hell of the last few years to more overt capitalism holds much allure.

A rejection of trade ideals

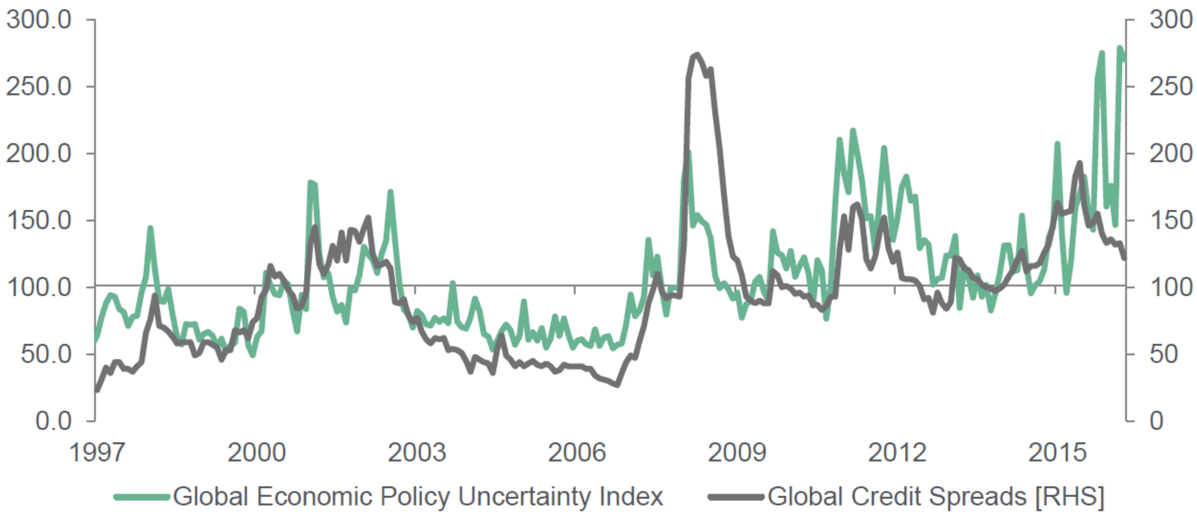
This article looks at why voters and markets are rewarding a rejection of the liberal ideals that purport open and frictionless trade as the only way forward. They are demanding a move away from the old guard that defends a political structure (e.g. Europe) that does little to benefit the people as a whole. This acts as a wealth creating and protection mechanism for the privileged few who have amassed the most wealth over the last 30 years. The populist voice has been heard and it is positive for economics and markets and therefore we expect this to run much further and much faster.

That said, while we believe the key beneficiary of these changes will be the US, the rest of the developed world should be pulled along in its slipstream. We have concerns though on two fronts: firstly, that the Fed is likely to raise rates aggressively as fiscal stimulus risks overheating a capacity-constrained US economy and this is likely to sow the seeds of the next recession. Secondly, while we believe that US dollar strength will be mild against the majors we fear that the emerging market economies and currencies (Asian especially) will suffer materially.

Market performance this year post the two main wildcards, i.e. Brexit and Trump, suggests that the market instead of fearing the unknown of first time politicians on populist tickets has been quick to embrace the change. The Trump election had the air of the divorcee's mantra 'anything but this' and a change was sought no matter the size of the risk and the potential costs. Sometimes it just becomes an emotional rather than a rational decision.

This muted reaction to political swings away from the center and towards too far-right and far-left (which are the same thing these days) was highlighted by the response to the Italian referendum. After a short hiccup it was back to normal programming which was trading for risk-on. A lot of people have been pointing towards the gulf between political uncertainty indices and risk markets (whether they be equities or credit), suggesting that risk markets are incorrectly ignoring political risk. We think there is a chance that both are right and while uncertainty is high, this delivers a change which is ultimately good for risk assets hence their strong performance.

Chart 1: Markets are starting to look at political risk another way

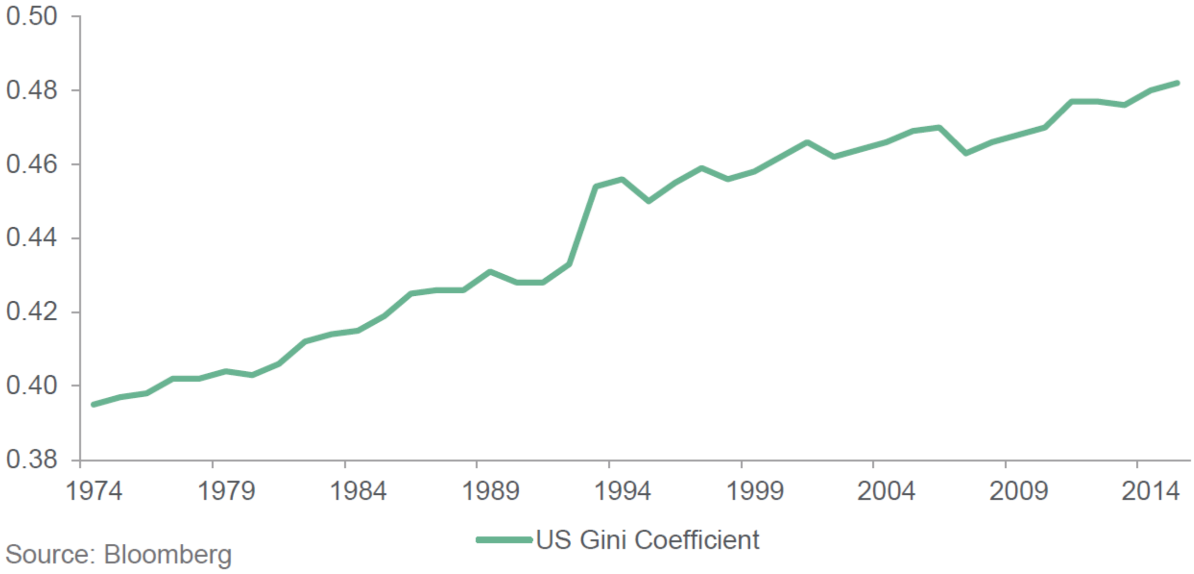


Source: Bloomberg

Theresa May’s announcement of the roadmap for Brexit was one of the highlights of January. It represented another point at which markets have clearly changed their view on what is ‘bad’ and what is ‘good’. There are several other examples of this switch in market psychology that have occurred over the last few months. The increase in Marie Le Pen’s chance of winning the next French election have increased, but have hardly elicited any market response, apart from a widening in French OAT v German bund spreads. Greece has even fallen off the radar again despite some ridiculous ‘can kicking’.

The old thinking is that less free trade will mean an increased cost of goods as they will not be created as efficiently as before, resulting in lower consumption and therefore less economic activity. This is tough to argue against, as a result it will decrease global aggregate demand growth even below where we are now. This is a disaster, right? Perhaps not, as with most things the quality of aggregate demand may mean more than the quantity of it, especially when wealth and income inequality is as disparate as it is currently.

Chart 2: Wealth inequality is the most damaging macro trend



Source: Bloomberg

The benefit of free trade and globalisation is actually one of the few things the majority of economists agreed upon as the power of comparative advantage was appealing theoretically and was able to be viewed empirically. It makes sense to smelt aluminium in countries where electricity is cheap, freeing up resources elsewhere to be used more efficiently. It takes the idea of job specialisation in a local economy (we don’t all grow our own food because there are farmers that can do it better and cheaper) on the global level. This almost unanimous appreciation of globalisation has meant that Trump’s protectionist stance has been presented as more proof that Trump’s policies are just populist, taking advantage of an angry middle America who just do not know any better.

When globalisation might not work

But what happens if globalisation only works in the rare case where everyone is an honest and open participant in the game? Consider two countries trading with each other. Similar to most ‘game theory’ problems in finance, the best outcome occurs when there is cooperation between the countries. Both eliminate tariffs, allow freely floating currencies, protect no industries and enforce the same quality of life for their citizens. This way the best industries in each country will thrive there and everyone will have a better quality of life. But if one country has far more advantages than the other (whether it be through resources, education etc.), a trade imbalance will open up and the currencies will adjust to eliminate it. The movement in the currency makes the workers of the poorer country cheaper to the richer, encouraging some industries to move production across which evens everything out again. This is great, if it happens. Trade between Australia and New Zealand can mostly be categorized this way, so it can work.

The problem arises however when ‘cheating’ becomes prevalent it can destroy the whole idea of globalisation being mutually beneficial. Cheating can mean protecting industries in other ways apart from tariffs, such as cheaper financing, subsidies, less rights for labour etc. If one country can successfully do this, it will end up owning a large piece of the other country as the former will need to fund the other’s trade deficit for years to allow them to buy stuff.

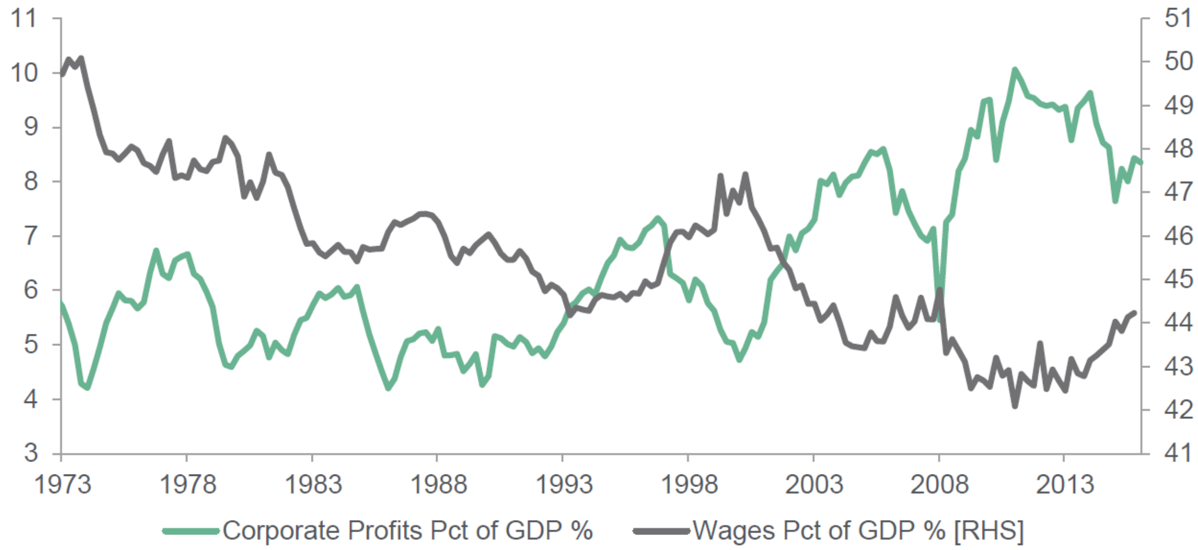
In the relationship between the US and China, this is exactly what happened. The trillions of dollars in Chinese reserves (held largely in US Treasuries) accumulated over the first decade of this century is proof that the currency wasn't being allowed to correct for huge trade imbalances that were opening between the two countries. Economists were saying during this time it was proof of the comparative advantage China had, especially in manufacturing. Labour was definitely cheaper, but was it more to do with the fact that the lack of any labour protection laws gave Chinese labour an unfair advantage or the lack of any environmental regulations in China? While these factors may be considered a comparative advantage (the environment can be considered a resource that can be squandered like oil or iron ore), stepping backwards on labour rights or environmental protection would result in a lower quality of life which may be even worse than losing good paying, manufacturing jobs.

The question you may ask is why would the US subject itself to being cheated like this for such a long time? If China is the winner, surely the US was the loser. People knew they were losing jobs, and they knew they were losing them overseas, mostly to China. But the crucial point was not everyone in the US was a loser and this was key to why the last election went the way it did.

The beneficiaries of China being a cheap producer was the US corporate who could expand their margins while lowering prices by taking advantage of the cheap offshoring that China offered. Corporate profits as a share of GDP skyrocketed, while wages as a share of GDP kept falling. According to the 2011 US Census, roughly the top 15% of all households own 70% of the equities owned by all households. Wealth accumulated for the top two quintiles, as shown in Chart 4, with everyone below that getting poorer, even though the GFC punished financial assets the hardest.

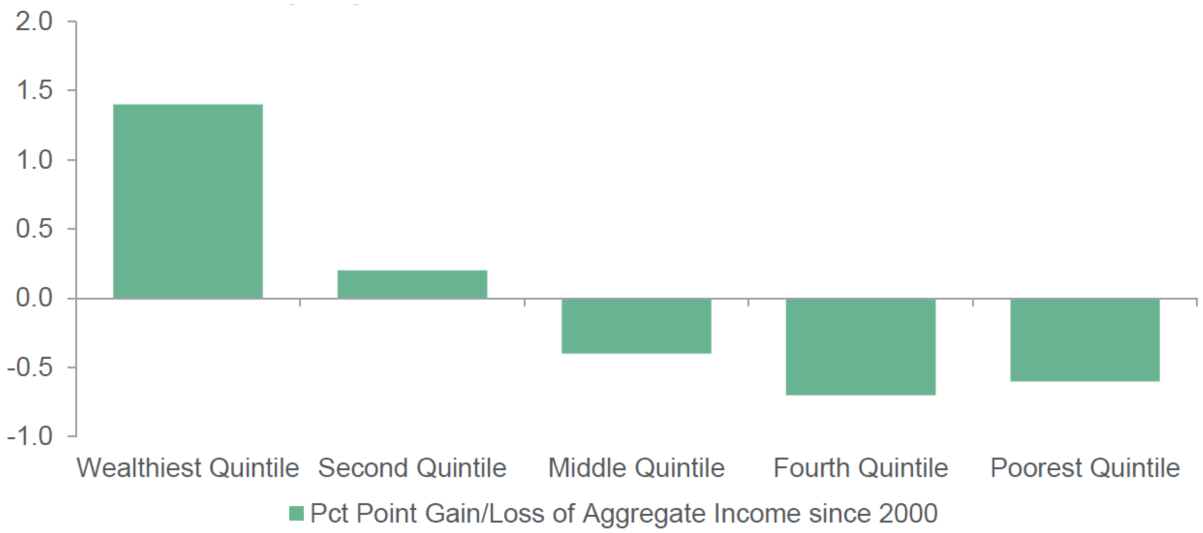
The fall in the value of housing through the GFC hit the poorest disproportionately of course, but the credit that caused the housing boom in the first place is also rooted in issues with trade. Additionally, these more powerful corporates started to 'own' the government through lobbying, ensuring their continued success.

Chart 3: …and the effects can be seen everywhere



Source: Bloomberg

Chart 4: Income disparity has worsened since China entered the WTO



Source: Bloomberg

The theory of globalisation has made a lot of people rich beyond what could ever be imagined in the post-war period. The fact that eight men are now wealthier than half of the world's population highlights the absurdity of this phenomenon.

Unwelcome consequences of a trade war

There are other policies that anger the Trump haters. One particular topic is the environment, which Trump appears not to care about one bit, enraging those who put it at the top of their global issues. We mentioned before that labour rights and the environment were two very big factors giving China the advantage. The EPA has been extremely aggressive in forcing through environmental regulations in recent history, increasing the cost of compliance for industry and widening this gap. While this is admirable, it makes the job of re-shoring all that much harder, and Trump knows it. Slowing down the increase in cost of compliance will put the US in with a fighting chance. He also knows that moving further away from fossil fuels will reduce competitiveness against countries that have no qualm in abusing them. In the end a trade war could be one of the best outcomes for the environment.

However, whilst a trade war may drive up growth and inflation in the US while reducing wealth inequality, the effect globally will be nowhere near as positive. This will slow Chinese and EM growth, reduce commodity consumption and be deflationary for the rest of the world. If it works you can count on more countries doing it, worsening the effect.

The investment story is a very US-centric one now which is concentrating on the positives there, but ignoring the serious effects elsewhere. The global story will surely eventually drive bond yields lower once again, albeit from higher levels, and this is even before considering the difficulties and tail-risk in Europe. Right now, the global market is still feeding from the Chinese credit growth, plus the belief that Trump policies will drive not just US growth higher, but global growth. While Trump may end up delivering a better outcome for middle America, the rest of the world will suffer. Trade has already been slowing before the protectionist policies have even begun and it is not difficult to foresee the reversal of 20 years of global 'free' trade.

Vimal Gor is Head of Income & Fixed Interest at [BT Investment Management](). This is an edited version, the full copy is linked [here](). The article is general information and does not consider the circumstances of any individual.

'Episodic' market volatility ahead for 2017

'Episodic' market volatility ahead for 2017

Simon Ho

Episodic bouts of equity market volatility in 2017 could presage a market crisis in 2018, and much hinges on the macro response of global economies in what will be a very interesting year.

The US is the wildcard in the global market outlook for the year, but market volatility in 2017 will likely be irregular rather than prolonged. However, the levels of asset price distortion in the market are expected to rectify during the year and this could be the forerunner of a sharp downturn and increased average volatility in 2018.

Recent volatility levels

Despite market commentators talking about high levels of volatility in the past year, it actually was not a very volatile year when the movements in the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) are considered.

The VIX Index, also called the Fear Index, measures expected volatility on the S&P500 Index over the next 30 days. If investors expect that the market will move sharply (either up or down), the VIX will give a high reading.

The 20-year average of the VIX registers at just shy of 20, although it has moved as low as 10 and as high as 85. Although the VIX had the occasional rally in the past year it started from a very low base. There were a few volatility spikes during the year but no ongoing activity.

With 20 considered to be the baseline for volatility, the VIX was actually below this baseline 83% of the time in 2016, as shown below. In fact, the past three years have been incredibly non-volatile from an historical point of view.

Volatility Index (VIX) in last 12 months

Source: Yahoo! Finance

This may surprise investors who read headlines on market gyrations and assume markets have been volatile. But many of those movements are just little blips on the chart. When you are living it, those blips feel large, but historically they're not.

In fact, the years since the Greek crisis, from 2012 onwards, occupy some of the calmest periods in the VIX's history since 1990.

Drivers in 2017 and the overvaluation of assets

We expect this trend will continue into 2017, but there will be some key drivers of episodic market volatility to watch out for.

Policy uncertainty is a big driver of volatility, and with the election of President Trump, world markets have plenty of that. The second driver, closely related, will be the movement in the US dollar. The third will be oil and commodity prices, which are intermittently linked to the movement in the dollar. The fourth will be interest rates and the speed in which the US Federal Reserve (the Fed) undertakes interest rate hikes.

Economic growth is starting to happen in countries where it hasn't occurred in recent times. We are already seeing green shoots of inflation - even in Europe - in the most recent data. We are certainly expecting inflation in the US, and President Trump pump-priming the economy will also impact inflation.

The Fed is considered by many to be behind the curve in this regard, and its reaction may be to raise rates higher and faster than the market anticipates. This will have a negative flow on effect because of the overvaluation of many assets globally. Many housing markets around the world are overvalued, along with equity markets, as well as the asset classes that have been pumped up for the past five years.

If rates surprise on the upside – and President Trump's policies feed into that – a market downturn is inevitable for 2018.

A depressed US market is bad news for global economies. Stocks globally are priced at fairly high levels, and a rapid rise in rates could see a lot of that come undone. If the $US continues to rally, that is also not good for emerging markets, because their debt is denominated in dollars and so in local currency terms their obligations increase.

Opportunities for investors

This expected volatility, whether episodic or prolonged, creates opportunities for investors.

Investors should consider using options over the VIX to prepare for these bouts of volatility ahead of a potential market downturn in 2018.

Although most investors see volatility as simply a measure of risk, it is also an asset class in and of itself. An investment in volatility can be accessed through VIX options, which have been one of the fastest growing option markets in recent years. Volatility is usually negatively correlated to equity markets, so that when equity markets fall, volatility tends to rise, and vice versa. Investing in options on the VIX Index allows investors to access this negative correlation to the S&P500 which cannot be as reliably harnessed in other asset classes.

Although the VIX is a measure of the US, and not the Australian, equity market it is still a useful diversification tool for domestic holdings. Australian and US markets are highly correlated, and particularly so in periods where markets are falling. VIX options now rank up with the world's most liquid, and have been known to trade over 1 million option contracts per day.

Generally speaking, people want to own equities because over the long run they do well. Allocating a portion of the portfolio to a volatility strategy can help to mitigate or circumvent the losses that come when the markets go down.

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When a company is a money pit

Peter Bull and Nimalan Govender

"Assets collect risks around them in one form or another. Inventory is one risk, and accounts receivable is another risk." – Michael Dell, founder and CEO of Dell Technologies.

All businesses face the ongoing challenge of generating cash flows in excess of their borrowings. If a business is unable to pay its debts owed, it is no longer a 'going concern' and will face reorganisation or liquidation. Nevertheless, profitability is not necessarily a prerequisite for a business's ongoing survival. A business can keep losing money if investors keep pumping cash back in, often in the vain pursuit of growth opportunities that, for some reason, cannot be funded through existing profitable operations.

Watch for the death spiral

Some businesses may even have the duty to continue unprofitable operations if they need to keep servicing their debt, to the detriment of equity holders. This is the unhappy scenario where excess debt begets excess production and forced sales through reduced prices. Lower prices require higher production volumes to meet the same existing debt burden, and the death spiral continues.

Forced asset selling or 'deleveraging' is a variation on the same theme, as is the current predicament of cash-strapped energy producers. While the law of supply and demand suggests that they limit supply to drive up prices, the need for immediate cash flows defies this and ultimately lowers the return on their assets, perhaps changing the nature of the assets in the process.

"We started the company by building to the customer's order. And, interestingly enough, we didn't do it because we saw some massive paradigm in the future. Basically, we just didn't have any capital to mass-produce." – Michael Dell

Different types of capital and liquidity

Asset values and their power to generate profits are joined at the hip. Some would say that net profits provide the best way to value the assets of a business, since assets are only worth the cash flows they can generate. This is a useful concept, but it overlooks the overall convertibility of the assets, or how they fare in a liquidation scenario. The more capital intensive a business is, the less valuable its capital actually is, all things equal. If invested assets strain to generate profits as a going concern, they will likely strain to achieve satisfactory prices in liquidation. Similarly, the very fact that assets may be relatively liquid would likely prevent their 'forced liquidation' in the first place and accordingly, this should be considered when performing valuation analysis.

This points to a duality between the profitability and liquidity of assets as they pertain to the risks of the equity holder. Both imply an ease of converting assets into cash and, in this sense, may act as substitutes for each other in the reduction of equity risk. Equity investors, as a rule, forego the safety of cash to make their investments. To the extent they can get it back, they might have their cake and eat it too.

Recognising this duality can uncover more investment opportunities with a greater skew to positive outcomes. The good ones may be less exciting or glamourous unless you happen to like specialty chemicals or Pachinko balls. They often combine a modest upside with a very limited downside and can be fantastic investment opportunities since, while the equity risk is reduced, the participation in business or economic value-add is preserved.

Some investors bemoan 'lazy balance sheets' with excess cash and lower return on assets on paper, but they shouldn't overlook the downside protection that this liquidity inherently provides. 'Optimising' balance sheets by leveraging up to juice equity returns comes with its own risks. Only to the extent that operational and business risks can be eliminated can leverage be safely applied, and history is littered with investors who have gotten this balance wrong, with nothing left to show for it.

"When leverage works, it magnifies your gains. Your spouse thinks you're clever, and your neighbors get envious," explained Warren Buffett in his 2010 Shareholder Letter. *"But leverage is addictive. Once having profited from its wonders, very few people retreat to more conservative practices. And as we all learned in third grade — and some relearned in 2008 — any series of positive numbers, however impressive the numbers may be, evaporates when multiplied by a single zero. History tells us that leverage all too often produces zeroes, even when it is employed by very smart people."*

Equity investors assume fundamental risks (e.g. the level of borrowings) and should be aware of the relative severity in their investments. If and when prevailing market prices permit them to capture most of the upside they expect from their equity investments, while severely limiting their downside, investing first principles should be the guide. Almost by definition, these opportunities are unlikely to be headline-grabbing growth stories that lead to exciting narratives and visions of the future.

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