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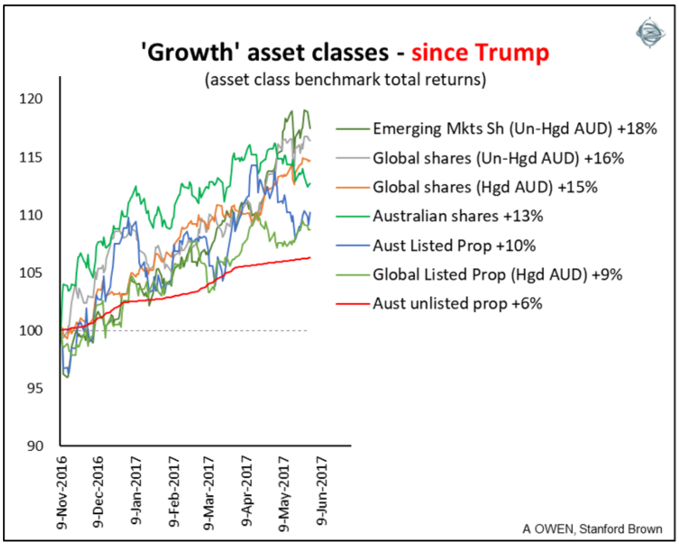
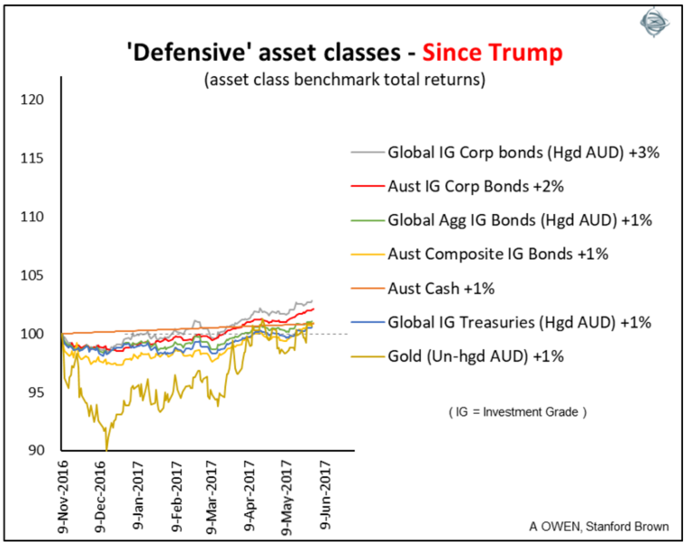
This Week's Top Articles

Six months of Trump, thanks, but what about impeachment?

Ashley Owen

It has been six months since Donald Trump won the US presidential election. Contrary to the talk of doom and gloom from the usual line-up of shrill 'experts' in the media, share prices have done well since the election. The chart below shows the total returns from the major asset classes since 9 November 2016.





Global shares have risen well virtually across the board. Returns in hedged and un-hedged Aussie dollars have both been good as the AUD has remained little changed against most currencies. Japanese shares have been the stand-out, up 20%, and European markets have also seen double-digit returns, led by Germany. We remained committed to global shares in portfolios throughout the lead-up to the election and since. We also increased weightings of Australian shares shortly after the election and the market here has done well.

The Trump victory became clear only after the US market had closed on Tuesday 8 November, US time, but the Australian market was already open on our Wednesday 9th, so local investors here had to think for themselves. With no lead from the US, local investors panicked and sold shares down 2% across the board. But as soon as the US market opened strongly on its Wednesday 9th US time, local Aussie investors said: “Oops – we should have bought, not sold!”, and then our market jumped 3% on Thursday 10th. The local Aussie stock market rose with the rest of the world until the local banks retreated a little in May 2017 as fears of a housing bust set in.

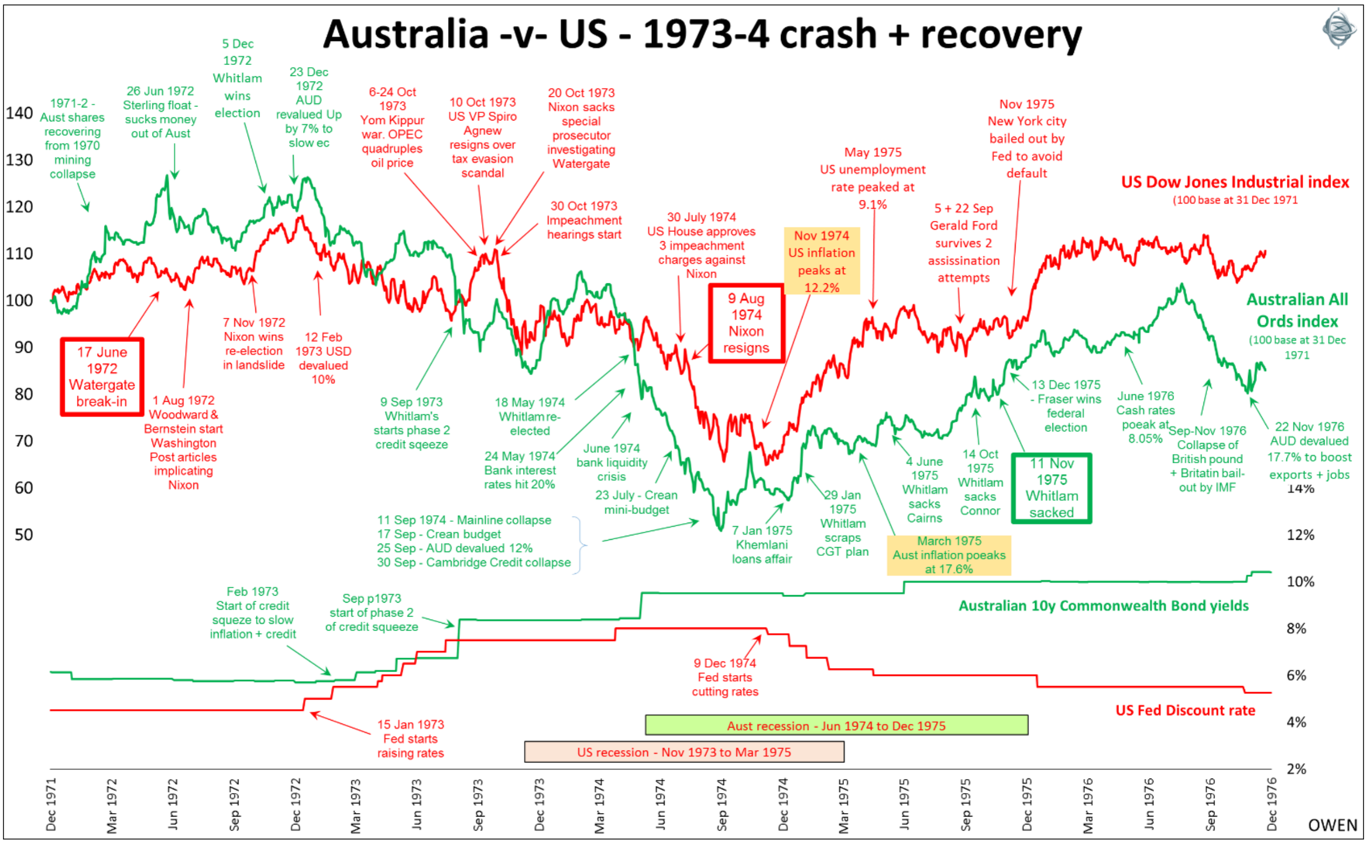
On the other hand, the ‘defensive’ asset classes have done relatively poorly, but still positive. Within the defensive allocations, our portfolios have been skewed toward corporate bonds and floating rates, which have done better than government bonds. The worst of the scaremongers in November were advocating selling everything and retreating to gold, but gold sold off sharply after the election. We hold no gold in portfolios.

Of course, past returns provide no guarantees for the future, but it shows the value of keeping a cool head and sticking to a disciplined process. Markets have done well in the first six months under Trump but that does not mean this will continue. As always it pays to ignore the media noise and focus on the real drivers of markets over the long term.

Trump versus Nixon: impacts here

In recent weeks, many people have asked me about the possible impacts on markets of a Trump impeachment. Comparisons have been made to Nixon who resigned on 9 August 1974 to avoid being impeached over his involvement in, and cover-up of, the Watergate break-in on 17 March 1972 in the lead-up to the 1972 election.

The Nixon crisis in the US and the Whitlam crisis here both played out during the 1973-74 stock market crashes in the US and Australian markets. Here is a daily chart of the Australian All Ordinaries Index (green) and the Dow Jones Industrial Index of US shares (red) during 1972-75. I have re-based both to start at 100 at the start of 1972 to make the comparison easier. The chart also shows the main monetary policy indicators in both countries in that era – the yield on 10-year government bonds in Australia and the Fed’s discount rate in the US.



While the policy decisions of the Nixon and Whitlam administrations certainly influenced the direction of the crises, the tumultuous removals from office of Nixon in the US and Whitlam in Australia were not the main drivers of markets. The main issues were the battle against inflation (which peaked at 12.2% in the US and 17.6% in Australia), the trade-off with unemployment, and the severe credit squeezes in both countries. These factors triggered the deepest recessions and stock market sell-offs since the 1929 crash and the 1930s depression. Nixon and Whitlam contributed to the problems but the main causes of inflation in both countries lay in the sustained increases in government spending from the mid-1960s on social programmes and the Vietnam war, poor central bank responses to rising inflation and to the OPEC oil price hike, and worsening current account and currency imbalances.

Trump's continued haphazard announcements, and possible moves to impeach him, are likely to rattle markets from time to time, but that is not the main game. Far more important issues include fiscal policy (government spending and debt), monetary policy responses to rising inflation (interest rates), company profits and cash-flows.

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Seismic change and investing in barbells

Roger Montgomery

Change can be an investor's worst nightmare. Fast changing industries are often accompanied by equally dynamic competitive landscapes making the prospects for each player almost impossible to predict. Even more challenging, 70% of the gain in the S&P500 and 85% in the MSCI World index between 2012 and 2016 was due to P/E expansion. Investing requires navigating industries where an asymmetric barbell forms with a handful of massive winners at one end and virtually everyone else losing at the other.

Australian retail downgrades: permanent or temporary?

Investors in the Australian retail sector are perhaps the first to experience the effects of this 'barbelling' of outcomes locally and many are yet to fall into value traps. Many believe that which is in fact permanent and structural is merely cyclical or temporary.

The arrival of Amazon has put the fox in the henhouse. In a recent note to its clients, Citigroup wrote:

"Amazon has confirmed their plans to enter the Australian market. Analysis of US, UK and German retailer performance around Amazon Prime market entry and our survey of price differentials results in downgrades to our long term earnings forecasts for JB H-Fi by more than 40% and Harvey Norman by more than 30%, following the expected launch of Amazon Prime in FY19e. We downgrade JB Hi-Fi to Sell and cut our target price by 35%. We maintain our Sell rating on Harvey Norman and cut our target price by 33%." (My emphasis).

Another broker has performed a similar amputation to valuations for some of Australia's retailers:

"We expect that Harvey Norman is approaching peak-cycle sales and earnings growth as the tailwinds from a prolonged housing cycle begin to moderate. The company also faces substantial competitive headwinds as Amazon prepares to launch in the Australian market …"

And,

"Whilst near-term earnings are likely to surprise on the upside, we think that structural and competitive changes in the Australian electronics industry, particularly from Amazon, will put pressure on long-term earnings. Whilst we expect JB Hi-Fi could extract greater synergies from its purchase of The Good Guys, it is likely that EBIT margins will remain under pressure."

In the United States where fully 52% of households have an Amazon Prime account – that's more than the number of households that own a gun or have a landline – the retail landscape may have irretrievably altered.

Foot traffic to shopping malls there has fallen by more than 50% in the last six years, reversing the experience between 1970 and 2015, when the number of malls grew at double the rate of the population.

Not only retailing but major brands

Amazon is not only putting a knife into the traditional model of retailing, it is starting a war with brands themselves.

It is now argued that brands earn an undeserved premium in return for offering consumers a short cut to the due diligence that would be required to identify varying levels of quality. The supporters argue that Amazon, through the use of technology and millions of consumer reviews, will serve customers better by removing the brand premium that is just compensation for advertising, in store promotions and shelf space deals with retailers, none of which adds value to the consumer.

Investors who have seen global brands as some of the most powerful economic franchises are on notice.

It may also surprise that the fixed-price tags found on goods in stores today is historically a relatively recent phenomenon, created to remove the need for owners of the once-new department stores to train staff in the art of haggling. Amazon has dynamic pricing. Prices change by the minute and depend on your geographic location as well as your previous search behaviour. Check www.camelcamelcamel.com where Amazon product prices are tracked by the minute producing patterns like intraday stock charts. It is doing away with fixed price tags and permanently and simultaneously changing the price discovery power of consumers.

Through Amazon's virtual personal assistant Alexa, Amazon offers cheaper prices, incentivising consumers onto the echo smart speaker and removing the important visual aids brands use to differentiate themselves. Unsurprisingly, Amazon offers up those products that it makes the best margin on and takes some brands completely off its shelves. It's a strategy that suppliers to Coles and Woolies know only too well.

Retail collapses commonplace

For landlords of retail property and landlords of retail brands, the outlook has changed seismically. Witness for example the litany of recent retail collapses overseas this year, with dozens of major companies, thousands of stores and massive numbers of employees affected. Large retailers have filed for Chapter 11 bankruptcy and Sears is expected to do so after July 17, so as to not fall foul of the US bankruptcy code's two-year look-back period.

Fashion retailer Bebe Stores closed all 180 of its stores and may file for bankruptcy to get out of the store leases, selling only online, while 44-store luxury fashion chain Neiman Marcus/Bergdorf Goodman, owned by Ares Management and the Canada Pension Plan Investment Board, announced it will not pay interest on a $600 million 8.75% bond issue in cash, but 'in kind'.

The excess supply of retail space must kill growth in capital and rental yields for a long time and the shift from brands to homogeneity will decimate the margins for manufacturing, and down the track, innovation through research and development.

That aside, a barbell will also emerge in Australia as retailers cop it on the chin not only from Amazon's arrival but from the projected 23% decline in attached dwelling starts, including the 38% decline in attached dwelling starts in NSW alone.

Construction and retail industries are the two largest employers in Australia and that makes navigating the next cycle even more challenging.

Ask whether lofty valuations are justified

The key is to come back to valuations and ask if current market prices are offering future returns that are unappetising? Remembering the higher the price you pay, the lower your return, one must wonder at the lofty valuations at which all assets are being traded today, especially those that produce no income.

Witness for example the Basqiat painting that sold for US$110.5 million, a record for an American artist and a record for a painting created after 1980. Closer to home, Shannons auctioned the NSW number plate '29' with expectations of $450,000-$550,000. It sold for $745,000.

In equities, companies in the firing line need to be avoided for the time being, as well as the unicorns that earn no profit. Dangers in here at both ends of the barbell. While some commentators call "Loss the New black" and cite the market capitalisations of Uber, Snapchat, Wework and Amazon as evidence of a new world order, investors must remember the tech bust that followed talk of a previous 'new paradigm'.

For Australian investors, changes will be cyclical for some but structural and permanent for many more. The expected decline in the construction and retailing sectors will also produce opportunities. A likely fall in the Australian dollar will boost profits for companies that export such as CSL and Cochlear as well as those providing services to foreign customers locally such as IDP Education.

But most importantly investors need to be cautious and consider the incorporation of the asymmetric barbell metaphor into their framework.

Roger Montgomery is Chairman and Chief Investment Officer at [Montgomery Investment Management](). This article is for general information only and does not consider the circumstances of any individual.

The impact of the global migration of millionaires

Karl Siegling

A 2017 report by market research firm New World Wealth concluded that a record 82,000 millionaires moved to a new country in 2016, up 26% from 62,000 in 2015. The estimate is that approximately 100,000 millionaires will move country each year by 2018. A millionaire in this report is defined as those having at least US$1 million of assets less liabilities excluding the family home.

The number one destination is Australia with 11,000 millionaires moving here, followed by the USA with 10,000 millionaire immigrants and Canada with 8,000. United Arab Emirates and New Zealand fill spots four and five.

Interestingly the number one destination millionaires are leaving is France with 12,000 millionaires fleeing the country in 2016. The New World Wealth Report estimates that China ranks second.

What does millionaire migration mean?

There are estimated to be 13.6 million millionaires in the world. The 100,000 that are changing country is not a big percentage but it is worth thinking about what the net inflow of millionaires can do to a country, particularly one with a relatively small economy.

My analysis is based purely on scenarios I have put together with data that cannot be easily verify (see Table 1 below). I have assumed that most millionaires with net investable assets of US$1 million would live in a significantly above-average home, maybe worth US$2 to US$3 million. I have also assumed that millionaires who move to a new country, on average, have more than US$1 million of net investable assets, as 'wealthier' millionaires would have a higher propensity to move than the millionaires who barely 'scrape' onto the list. Some of these immigrants could have US$2 million, US$5 million or US10 million of net investable assets and would consequently want even bigger and better houses than those with 'only' US$1 million of net investable assets.

Year	Millionaire migration	Millionaire immigrants to Australia	$3M property purchases to satisfy millionaires	$5M property purchases to satisfy millionaires
2015	62,000	8,200	$24.6 billion	$41.0 billion
2016	84,000	11,000	$33.0 billion	$55.0 billion
2017*	94,000	12,200	$36.6 billion	$60.0 billion
2018*	104,000	13,500	$40.5 billion	$67.5 billion

**Cadence estimates*

Now let's assume that of the 11,000 immigrant millionaires that come to Australia, 60% go to Sydney, 30% go to Melbourne and the remainder go elsewhere. In Sydney as an example, 6,600 immigrant millionaires are arriving every year wanting to purchase a property worth say A$3-4 million. Those with significantly more net investable assets probably want to spend A$5-8 million on houses and those with greater amounts of assets want to spend A$10 million plus on a house. These millionaires are looking to spend a minimum of $26 billion per year on 6,600 high-end houses in Sydney. And according to New World Wealth, millionaires are looking to spend this much **every year** as each new batch arrives. The prediction is also that this number is rising dramatically.

The problem becomes obvious. Sydney does not have enough expensive houses to accommodate all these new millionaires, and it looks to be getting worse. Of course, the result is lots of little 'bubbles' all around the world in places where millionaire immigrants decide they are going to live.

What does all this millionaire migration say about a country's underlying economy? Clearly, the property sector and all ancillary services associated with property would be performing well. Of course, it does not necessarily follow that other parts of the economy benefit equally. You could even have extreme situations where those parts of the economy that benefit from millionaire inflow do well and other parts of the economy could go backwards.

Income inequality and the economy

Another way to think about millionaires is as the 1 percenters or the 0.1 percenters (see table below). In 1929, the top 1% of pre-tax income earners accounted for roughly 24% of all pre-tax earnings. This fell to 8.9% in 1976 but is once again at record levels of around 25%. The top 1% of earners in the world account for around a quarter to a third of all earnings and consumption in the world. This small 1% group and the even smaller 0.1% group have a disproportionate and large effect on the world economy. This small group of people also has a disproportionate effect on particular areas within our economy which may not translate to the greater economy.

The millionaire immigrant and the 1 percenters are creating bubbles around the world, especially in property in cities like Sydney, Vancouver, Auckland, Hong Kong and London. When we see such large demand and supply imbalances, we should consider the underlying factors creating these distortions. In small economies, these distortions are not necessarily a sign of the strong performance of the underlying economy.

Year	Top 1% of income earners as a % of all income
1929	24%
1976	8.9%
2017*	25%

**Cadence estimates*

Rather than conclude with a note of caution, our immediate problem is that we need to come up with a solution to satisfy this year's and next year's millionaire immigrant requirements!

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Managing downside risks in retirement with alternative assets

Bev Durston

Managing assets in retirement presents a significantly different challenge from the accumulation of wealth phase. Retirees generally have less capacity for risk together with a reduced ability to rebuild wealth once they've started depleting assets by drawing off income and selling assets for living expenses.

Unfortunately, there aren't many retirees who've built the necessary wealth to live solely on investment income. Assuming a 4% yield on an Australian equity portfolio – which for retirees can be further buoyed by a generous dividend imputation credit system – nearly $700,000 is required to be invested to maintain a modest level of income (defined by ASFA as $34,687 per annum for a couple).

This figure is far above current average super fund member balances and yet still does not allow for the necessary growth required to maintain purchasing power. For a comfortable level of income in retirement (defined by ASFA as $59,808 per annum for a couple), the balance needed is $1.2 million, which is only a dream for many.

Disadvantages of the decumulation phase

In accumulation, monies are regularly invested via employee and employer contributions and investors can harness the power of 'dollar cost averaging'. In a volatile world, if the market falls, the investor 'averages down' and buys more assets when prices are low, thereby enhancing overall returns. But, these advantages are reversed in the decumulation stage of retirement. On average, monies are removed when prices are low but cannot be replaced as fresh contributions are no longer applied. For markets that remain broadly static, the impact of a regular withdrawal pattern can lead to a 50% worse overall return than one without cash inflows.

The clear message is that both the sequencing of returns and the withdrawal pattern matter significantly in retirement. To partly mitigate this disadvantage, retirement balances are generally invested in growth assets for as long as possible while income requirements are met separately from a pool of more liquid, low return assets.

Managing downside risk in volatile times for retirement is best approached by combining two inherent advantages of investing:

- the investment 'free lunch' effect of diversification
- a long-term investing approach utilising alternative assets.

This approach manages downside risk by opportunistically diversifying monies away from listed assets (listed equities, REITs and listed bonds) into alternative assets and strategies. If carefully managed, this switch can preserve capital, reduce volatility, and still provide reasonable returns.

Diversification is the 'free lunch' of investing

The extraordinary power of diversification is demonstrated by a simple two stock investment portfolio example: an umbrella manufacturer and a sunscreen manufacturer. Both do well in entirely different weather environments and have low correlation with each other, moving differently in price according to weather conditions.

Assume both expect to return 7% per annum, have identical risks (defined by standard deviation) of 12% per annum, and zero correlation. From an investment perspective, you can choose to own either:

- **Either stock in isolation**
  Here you'll expect an annual return of 7% and volatility of 12%. The risk adjusted return is 0.58 units of return for each unit of risk (i.e. 7/12).
- **A 50/50 portfolio of both stocks**
  Here you'll also expect an annual return of 7%, but due to the zero correlation, you'll get the benefit of diversification on the portfolio risk.

Surprisingly, the risk of a 50/50 portfolio is lower than either company singularly. The portfolio risk for the equally-weighted blend is 8.5% and the risk-adjusted return rises to 0.82 (i.e. 7/8.5), that's 0.82 units of return for each unit of risk. This is a more than 40% improvement in the risk-adjusted return of the portfolio.

The benefit of diversification is the proverbial 'free lunch' of investing – you either have the same return for less risk or match the risk number and have a higher return. Magic indeed! Providing the correlation between these two investments is less than 1.0, then combining them in your portfolio will provide a better risk-adjusted return and make your portfolio more efficient (on a risk-adjusted return basis).

When investing for retirement, taking maximum advantage of this diversification benefit will move the investing odds in your favour. Since retirement involves a long time horizon, you can adopt a long-term view and consider investing a portion of the portfolio in alternative assets, defined as anything that is not listed equities, bonds or REITS.

A diverse range of alternative investments can enhance returns and reduce risk

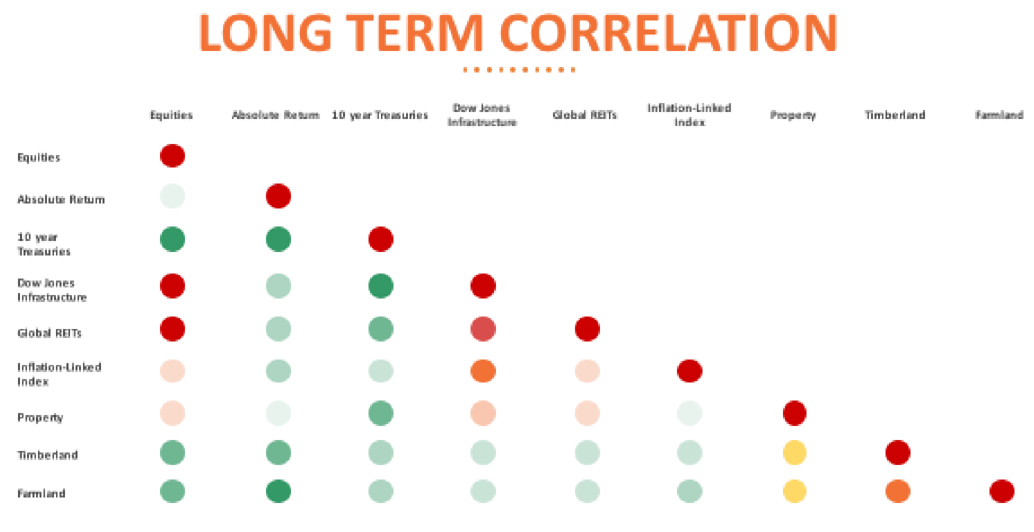
There are plenty of alternative asset classes to explore as shown below, from direct lending and macro to reinsurance and infrastructure.

Source: Edgehaven Pty Ltd

These require expert navigation but there is a broad opportunity set to produce diversifying returns, taking an opportunistic approach and finding attractive alternatives that complement existing exposures. Diversification into alternatives is certainly not a 'fill the buckets' task, nor should it be a simple bolt-on to an existing portfolio. Instead, it's more akin to searching for excellent quality standalone investments in areas which are not easily accessible via listed markets.

Long term correlations between asset classes

This diagram below highlights diversification benefits of three alternative asset classes – timber, farmland and absolute return – with listed asset classes including equities, global REITs and listed infrastructure. The traffic light scheme shows the effects of diversification with green being good, red bad, etc. The 'farmland' row is nearly all green, demonstrating the asset's good, long-term diversification effect. It's also noteworthy that direct property is not shown here to be a particularly good diversifier on this measure, nor is Dow Jones infrastructure (representing listed infrastructure), which many use as an infrastructure proxy.



Source: Bloomberg, Datastream, Standard Life Investments and Edgehaven (Q1 2016)

The challenge lies in accessing these alternatives in smaller parcels. Institutional investors and super funds have relatively easy access but they generally don't make these available to their investors except within large, diversified portfolios. Individuals and SMSF trustees struggle to invest the minimum amounts required for each investment, typically $5-10 million.

The good news is there are possible solutions available. Super funds can create choice options containing broad alternative asset exposures, albeit the investment would need to be locked up for a minimum investment period. This may be a novel concept right now. But given equities are a long-term investment (minimum seven years) we should not confuse the daily pricing of asset classes with the minimum exposure time required for successful investing.

Future retirement investing will include more alternatives

Long-term investment principles and locking up monies via minimum investment periods will allow retirees to reap the diversification 'free lunch'. Opportunistic alternative asset investing also prevents 'silo' asset class thinking and the 'fill the bucket' style of investing which dominates accumulation schemes. Plus, it allows investors to take advantage of the longer-term horizon of retirement investing and harvest illiquid premia in assets that can be selectively chosen for explicit downside protection.

The market is changing and some more liquid forms of alternatives are now available to smaller sized investors, often in listed form, although many are not best suited to a liquid version. For these, investors should expect to invest via a lock up structure which matches the investment to the illiquidity of many of these asset types.

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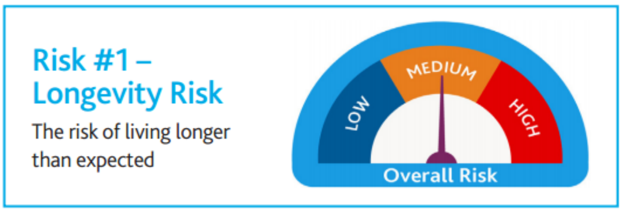
The big three risks in retirement

Josh Hall

The transition to retirement can be challenging, as retirees adjust to major changes in their lifestyle and finances. Entering retirement means the end of employer-sponsored pay cheques and a reliance on personal financial capital, plus any age pension entitlement, to maintain a desired lifestyle. In economic terms, the *human capital* has expired and the *financial capital* must take up the heavy lifting. This can be quite a mental and emotional hurdle for many retirees to overcome.

To make sure retirees' financial capital (superannuation and other wealth) is able to meet their needs, it is important to understand the major investment risks facing those in retirement: *Longevity*, *Sequencing* and *Inflation* risks.



Living longer than expected may not seem like a bad thing and, all else being equal, it's not. Longevity risk is the risk of outliving your capital rather than living too long, per se.

We have a reasonably good understanding of life expectancies. According to [ABS Life Tables](), for the average 65-year-old man, it is around 84.5 (or, looked at another way, another 19 years after retiring) and 87.3 for woman (or another 22 years). However, these are average figures and therefore around 50% of people will live longer, for another 6 or 7 years. An easy way to adjust for this, and therefore provide a reasonable chance of not outliving savings, is to plan for financial capital to last an extra five to 10 years longer than initial life expectancy.

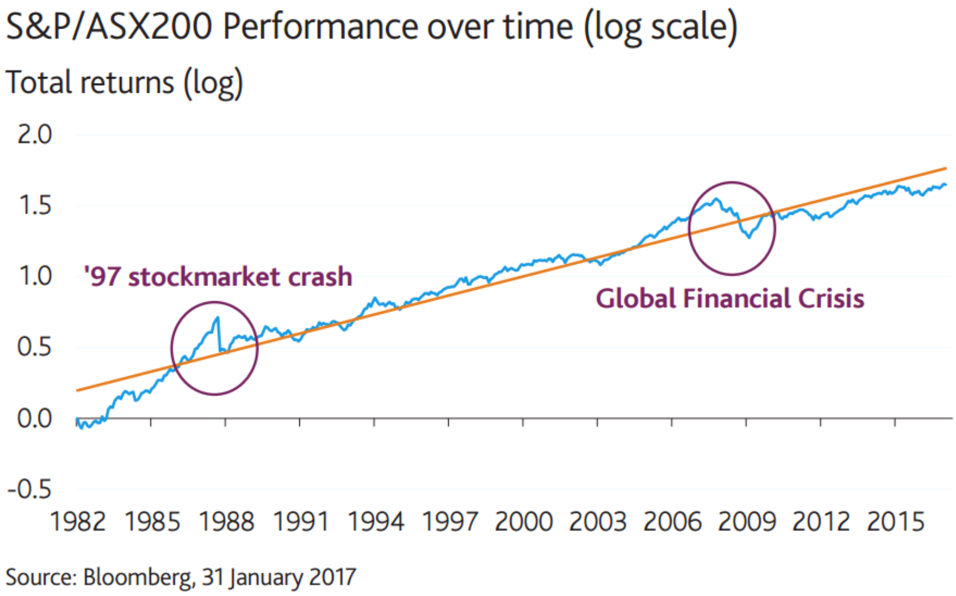
Life expectancies are increasing over time as health standards improve. A cure for cancer, for example, or any similar advancement in medical research, will have the potential to increase our life expectancies substantially in a short period. While this would be a welcome development, it would also make longevity risk a bigger investment risk for retirees.

The age pension offers protection against longevity risk by providing for our base minimal income requirements, although emphasis should be placed on *minimal* (with no certainty of future levels). Other financial products offer hedges against longevity risk, such as lifetime annuities, but these tend to have relatively high implicit costs associated with providing a lifetime guarantee and offer relatively low returns. Investors should therefore consider these options cautiously, in our view.

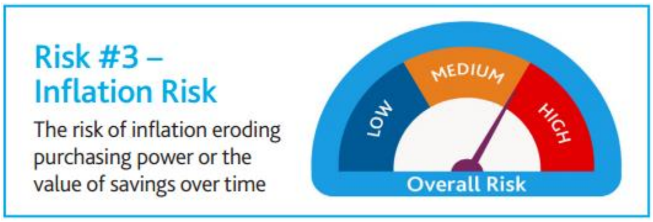
Sequencing risk is the risk of an adverse market event, such as a GFC, occurring at a time when the dollar value of an investor's portfolio is largest. For retirees, this is usually during the early stage of retirement. A 20% fall in portfolio value would hurt more in dollar terms at this time than it would early in their working lives or much later, when their account balances are generally much smaller. It is also harder to recover from an adverse market event (or sequencing risk event) in retirement because the investor is drawing down on capital at this time, meaning there is a smaller capital base from which to recover after such a loss.

When considering its impact, we tend to overstate the impact of a sequencing risk due to our inherent behavioural biases. We have a tendency to measure our losses against the previous peak of our portfolio wealth, typically at the top of an economic or share market cycle where valuations of assets are at their highest and often overvalued.

The example in the following chart shows the accumulated value of the S&P/ASX200 Accumulation Index over time (in log scale), including the average return (straight line). Prior to both the 1987 share market fall and the GFC, where equity markets fell by approximately 50% each time, returns had been well above the average in the preceding period. In the case of 1987, the share market had roughly doubled in value in the preceding 12 months before falling by half, or in other words, returning to where it started. The same occurred during the GFC, although the rise and fall happened over longer timeframes.



To manage sequencing risk, the portfolio should be properly diversified and match the retiree's risk tolerance. Investors should realise, at least retrospectively, that account balances at the top of a bull market are probably too high and losses from previous peaks will probably be overstated.



Inflation is possibly the most underestimated of the three risks.

The impact of inflation in any given year, say 2-3%, compared to the impact of a 50% sequencing risk event, seems small. However, if inflation occurs year in, year out, its compounding impact over a long-term retirement can be substantial. Inflation of 2-3% per year over 20 to 30 years can reduce purchasing power by 50% or more. While this roughly equates to the impact of a 50% sequencing risk event, the two differ in their probability. The risk of inflation causing a 50% reduction in purchasing power in retirement is highly likely over a 20-plus year period, whereas a 50% sequencing risk event like 1987 or the GFC might occur only once on average during that time. What's more, a retiree would need to be at or near the point of retirement to feel the full force of the sequencing risk event.

The lesson therefore is to be aware of and manage the incremental, yet compounding and therefore significant, impact of inflation on investment portfolios in retirement.

This can be achieved by:

- Ensuring sufficient growth asset exposure in the portfolio. Overweight exposure to nominal return assets such as cash and term deposits can mean that your retirement income is not inflation hedged.
- Aligning your investment objective to outperforming inflation, such as using a 'CPI+' approach as a benchmark or objective makes more sense for the average retiree compared with managing against more traditional market benchmarks.

Moving into retirement can be a challenging time, with financial stability a real concern. Retirees need an understanding of the major investment risks and have appropriate strategies in place to manage them in order to enjoy a more financially-secure retirement.

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Irrational exuberance: is history repeating?

Miles Staude

In December 1996, the two words, irrational exuberance, spoken by Alan Greenspan, then Chairman of the US Federal Reserve, became forever burned into financial market psyche. US equity markets had risen by 126% over the five preceding years, stretching equity market valuations in the process. As Robert Shiller, an economics professor at Yale University describes, Mr Greenspan was delivering a speech titled "The Challenge of Central Banking in a Democratic Society". Fourteen pages into that speech he posed the rhetorical question, "But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions", adding later that "we as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy". His speech was being televised live and immediately after he made this famous statement, the Japanese stock market fell, closing 3% lower, followed by a 4% fall in London and a 2% fall at the open of US market trading.

At what point are markets seriously expensive?

The question he had posed encapsulated the underlying fear of investors who had witnessed a nine-year long bull market run. In the grip of the new dot-com world, had investors gotten carried away and lost sight of valuations? With the S&P 500 trading on a historical Price to Earnings (P/E) ratio of 21 times, were markets being irrationally exuberant?

While his question captured the zeitgeist of the time, equity markets quickly shrugged off Mr Greenspan's ruminations. The US stock market rallied strongly for four more years, rising another 116% before it reached its dot-com boom peak in late 2000, after which it fell by 47% over the following two years. While the correction did ultimately validate Mr Greenspan's musings, it also highlighted the folly of trying to pick market tops and bottoms. An investor who had bought the S&P 500 on the day of Mr Greenspan's speech would still have been 13% up at the bottom of the market crash in 2002.

Twenty years on from Mr Greenspan's famous warning about asset price bubbles, a similar fear hangs over equity market investors today. As equity markets around the world are near all-time highs, valuations once again look elevated, leading many commentators to question the sustainability of current prices. A commonly-cited metric used to uphold the overvaluation argument is the Cyclically Adjusted Price to Earnings Ratio (CAPE), otherwise known as the Shiller P/E. The premise of CAPE is that valuing a firm based on one year of earnings is a poor predictor of future returns. Instead the CAPE draws on the work of value investors such as Benjamin Graham and David Dodd who argued for smoothing a firm's earnings over five to ten years when assessing its intrinsic value.

CAPE uses ten years of inflation-adjusted S&P 500 earnings as its denominator when calculating a P/E ratio for the market. Mr Shiller and his index rose to fame after the publication of his '*Irrational Exuberance'* book which argued that the stock market had become a bubble. Demonstrating a serendipity of market timing that had eluded Greenspan, Shiller's book was published in March 2000, just months before the start of the market crash. The Shiller P/E as a powerful tool has stayed with investors since, and he won the Nobel Prize in 2013.

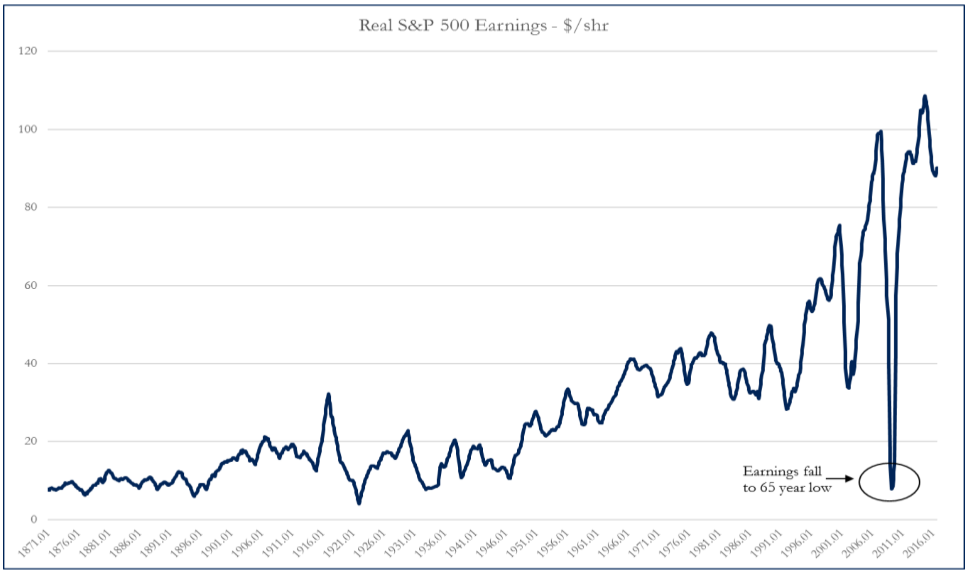
The Shiller P/E of the S&P 500 today trades at about 29.2, well above its long-run average of 16.7. It was 10 years ago this month, May 2007, when the CAPE reached its peak in the last market cycle, at 27.6. The S&P 500 then suffered one its worst corrections in history. In a similar vein, if we ignore the five-year period of the dot-com boom, the last time the US equity market traded at Shiller P/E ratio of over 29 was just before the market crash of 1929.

One valuation tool tells only part of the story

When presented like this, current market valuations using the Shiller P/E provide cause for concern, especially since the bull market in US equities is now eight years old, making it the second longest bull market on record. The problem with using market valuation tools like the Shiller P/E however, is that it is not possible to condense all relevant market factors into one single measure.

Take the notion that we should average company earnings over several years to establish a reliable basis for pricing future earnings potential. In practice, a simple average of a randomly chosen number of years is open to large distortions. In the case of the current Shiller P/E ratio, the 10-year trailing average earnings includes the 2008/09 financial crisis. As the chart below shows, real S&P 500 earnings per share fell by 90% during this period, to a level not seen since the depression of the 1930s.

Real S&P500 Earnings in $/share



Source: Robert Shiller

This earnings crash was a short-lived affair. Within three years, market earnings had largely recovered to their pre-crisis levels. If we were to thus calculate the Shiller P/E using a trailing five-year average, instead of a 10-year average, the resulting market multiple falls to 24.3, which is below the 20-year average of 24.6. Future signalling problems must cope with the 2008/09 earnings period falling out of sample.

Lastly, while many pundits like to compare the Shiller P/E ratio to its long-run average of 16.7, most fail to explain that the data Robert Shiller provides stretches back to 1871, and current interest rates are well below long-term measures. US benchmark interest rates as provided by Mr Shiller back to 1871 average 4.6%, twice the current benchmark rate of 2.3%, which is what the market uses to price assets from today. Low interest rate environments inflate asset prices while high interest rate environments depress them. The Shiller P/E ratio reached its post WWII low of 6.6 in 1982, when US benchmark interest rates were 14%. That current market P/E multiples, Shiller or otherwise, look inflated against their long-term averages mainly tells us that current interest rates are low relative to history.

I have no special insight into whether we might be nearing a point of irrational exuberance, but a selective focus on simple valuation metrics is inherently flawed. While identifying asset price bubbles is easy in hindsight, one hard rule is that they are impossible to identify in advance. It is doubtful the current hand-wringing on the high Shiller P/E provides us with any real information on where markets go to from here.

Miles Staude is Portfolio Manager at the Global Value Fund (ASX:GVF), which he manages from London. This article is the opinion of the writer and does not consider the circumstances of any individual.

Commutation of death benefit streams before 1 July 2017

Peter Burgess

In response to uncertainty about the commutation options available to self-managed superannuation fund (SMSF) members who are in receipt of a death benefit pension, the ATO has released guidelines which set out a practical administrative approach.

[Editor's note: a commutation is an exchange or a conversion. In a superannuation context, it usually means converting an income stream to a lump sum or another income stream].

Background

On the death of a superannuation fund member, the trustee(s) of the fund are required to pay out the deceased member's superannuation benefit as soon as practicable.

For dependants of the deceased, a superannuation death benefit can be paid out:

- As a lump sum
- As death benefit income streams that are retained in the superannuation system, or
- A combination of the two.

Based on previously issued ATO public guidance materials, industry participants have inferred that on the expiration of the 'death benefit period', the spouse of a deceased member is able to commute a death benefit income stream and retain this amount as their own accumulation interest in the fund, or in another fund, without the need to immediately cash-out that benefit.

The 'death benefit period' is the latest of:

- 6 months after the death of the deceased person, and
- 3 months after the grant of probate of the deceased member's will or letters of administration of the deceased member's estate.

The ATO's view is that the commutation of the pension by a spouse does not change the trustee's requirement to pay out the deceased member's superannuation interest as soon as practicable.

If the death benefit income stream is commuted, the trustee must immediately pay out the deceased member's death benefit as a lump sum or as a new death benefit income stream. The requirement to pay out the benefit is not satisfied if the spouse retains this amount in the accumulation phase of the fund, or is rolled over and retained in the accumulation phase of another fund.

ATO compliance approach

Recognising the practical difficulties that many funds will face in identifying and paying out superannuation death benefits, the ATO will not apply compliance resources to review whether a SMSF has complied with the cashing rules provided that:

- The member of the SMSF was the spouse of the deceased on the deceased's date of death; and
- The commutation and roll-over of the death benefit income stream is made before 1 July 2017; and
- The superannuation lump sum paid from the commutation is a member benefit for income tax purposes because it is being paid after the expiration of the death benefit period.

Relevance to the $1.6 million transfer balance cap

The ability to retain these amounts in a superannuation fund is particularly relevant to individuals who may have superannuation income stream balances in excess of $1.6 million and who are required to commute the excess amount on or before 30 June 2017 to comply with the $1.6 million transfer balance cap. Rather than needing to withdraw any excess income stream amounts that relate to a death benefit income stream (which is outside the death benefit period), these amounts can be retained in the fund.

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Is the illiquidity premium in property outdated?

Adam Murchie

As non-classically trained investment operatives, we have found the basic question 'Why?' has served us well. In the past 10 to 15 years, watching market performance, we have constantly questioned why unlisted assets are expected to provide a return premium over their listed peers.

Classical investment theory defines the illiquidity premium as compensation for the loss of control (or liquidity) to exit an investment position at a desired point in time. This is sound logic if markets always trade upon fundamentals. Once behavioural forces come into play, this theory seems to deviate.

Locked funds versus loss of capital

Our research for this article left us thinking that the mortal sin of investing is having investors lose control of their equity in locked funds. While we appreciate the sensitivity of the loss of control, surely losing capital is worse. The distinction between these two will become clearer in a moment.

Historically, unlisted property has provided a return premium of between 100 and 300 basis points (1% to 3%) over listed property as recompense for poor or no liquidity. Property is a good asset class by which to assess the illiquidity premium concept as the listed and unlisted property markets in Australia are deep and generally well researched.

The figure below illustrates the returns from listed property and unlisted (core) property since 2004. This data captures the pre- and post-GFC markets, so represents the impact of the cycle.

Pre-fee cumulative returns, unlisted (core) and listed property (% pa, Jun 2004 = 100)

Source: MSCI

Listed market can suffer from liquidity

Pre-GFC, the listed market was trading at a premium to its unlisted counterpart, clearly at odds with the illiquidity premium, but the listed market was savaged during the GFC.

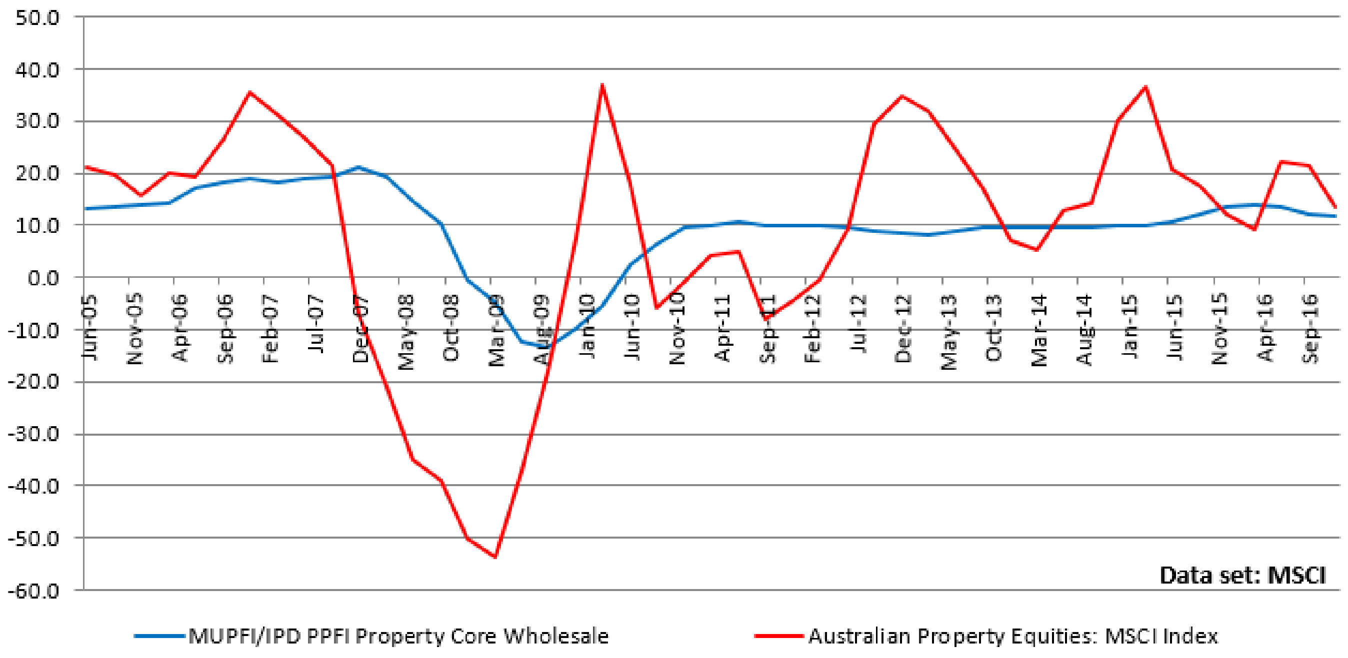
Herein lies the disconnect: in boom markets, the liquid market appears to trade at a premium to its unlisted counterpart, and then in a market correction, the liquidity sees prices savaged. Peak to trough, listed property lost ~70% of its value whereas unlisted property only declined ~20%.

There is an argument that liquid investors should obtain a premium for the price volatility of their investment. The listed market also took almost 10 years to regain its pre-GFC values whereas the unlisted space took just three years.

Consider our earlier point that losing capital should be the mortal sin of investment, not losing control of the equity. There were a number of unlisted funds that were frozen or locked during the GFC, which saw many investors lose the ability to manage their equity. While this is a less than optimal outcome, freezing these funds may have been the best preservation strategy for the equity at that time. Certainly, these charts indicate that being in an unlisted fund saw ~50% of the equity value preserved in the unlisted sector versus its listed peer. We consider that a reasonable outcome even when factoring in the loss of equity control.

The figure below illustrates year on year returns of listed and unlisted property markets. The listed market shows massive price volatility and ventures into loss territory three times, as opposed to the unlisted sector which has far more stable returns and ventures into loss territory only once.

Pre-Fee rolling annual returns, unlisted (core) and listed property (% pa)



Source: MSCI

If the return expectation for a particular investment is a function of the risk the investor takes on, there is an argument that listed property should provide a return premium to compensate investors for the market risk during irrational periods (both bull and bear markets).

Reconsider the illiquidity premium

We are not pushing one position over the other. Rather we contemplate whether traditional thinking about the illiquidity premium may need to be reconsidered. Periods of exuberance or correction tend to see liquid markets surpassing the fundamental level of the underlying assets, both on the upside and downside.

On this basis, investors need to be clear as to why they are selecting one investment structure over another. Structural differences tied into the same asset class can provide divergent performance and therefore investors need to be clear about their objectives when taking a particular investment position.

Clearly, there are arguments for and against the illiquidity premium. Listed and unlisted markets both have an important role to play in investment portfolios, but the nature of each is shifting. Relying purely on classical investment theory when making asset allocations can be dangerous. As always, drill down into the data and see if the reality matches the theory.

Adam Murchie is a Director of Forza Capital Pty Ltd which provides property investments to high net worths, private clients and family offices. This article is general in nature only and does not constitute specific investment advice.