Cuffelinks
Connecting investors with ideas

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Three reasons the bull keeps running

Graham Hand

Within a few days, I attended presentations from two global equity managers offering divergent perspectives. Both are realistically open to all possibilities and know about the market's current optimism, but where Hexavest saw a bubble, Insight Investment Management justified the valuations. Both these fund managers do not market to retail investors and their views are normally restricted to institutional and wholesale investors.

It's highly relevant that both managers are top-down, starting at macro conditions rather than bottom-up stock pickers. They forecast growth, currencies, financial conditions and prices before looking at which companies to invest in.

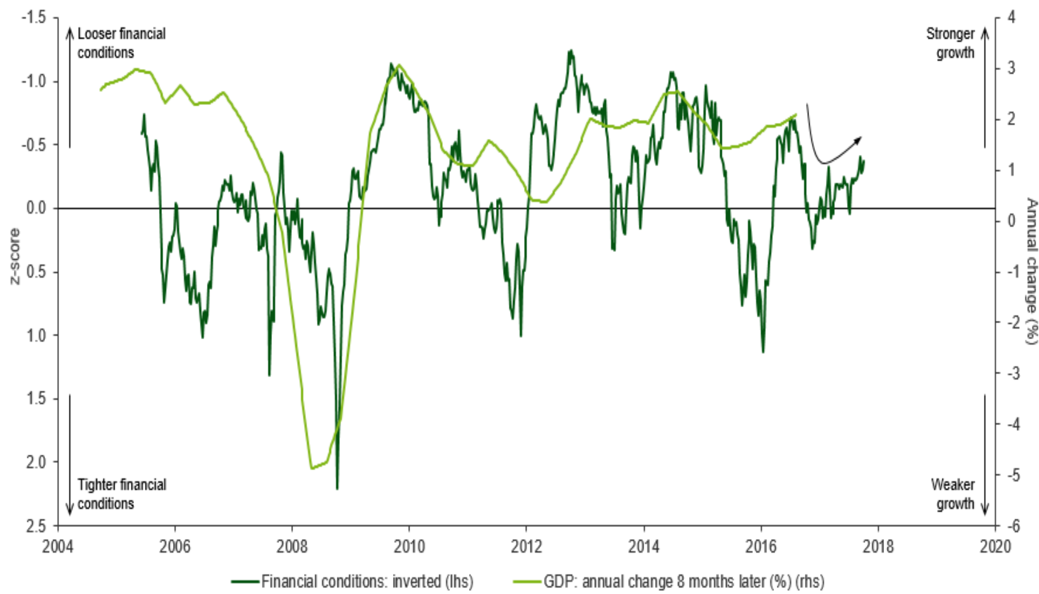
In its active asset allocation process, Insight makes frequent adjustments based on expected returns and risk. Its current listed equity allocation (excluding infrastructure) at around 40% is the highest for a couple of years, and cash holdings are at the bottom end of the range since 2009. However, most risk is carried in 'total return strategies' which are less prone to overall market directional influences and derive returns from relative value or absolute returns. Insight believes:

"Our pro-cyclical portfolio stance – based on the idea that a synchronised global recovery would continue – looks well supported. Purchasing managers' indices (PMIs) from around the globe are at high levels and moving higher."

1. Better financial conditions and growth

Insight quotes many indices which show an improvement in global growth and lead indicators, with improving global growth since the start of 2017 after slowing into 2016.

Global: financial conditions and GDP



Source: Bloomberg, Thomson Reuters and Insight Investment as at 5 October 2017. Note: global series are GDP weighted composites using numbers from the US, euro area, UK, Japan and Australia.

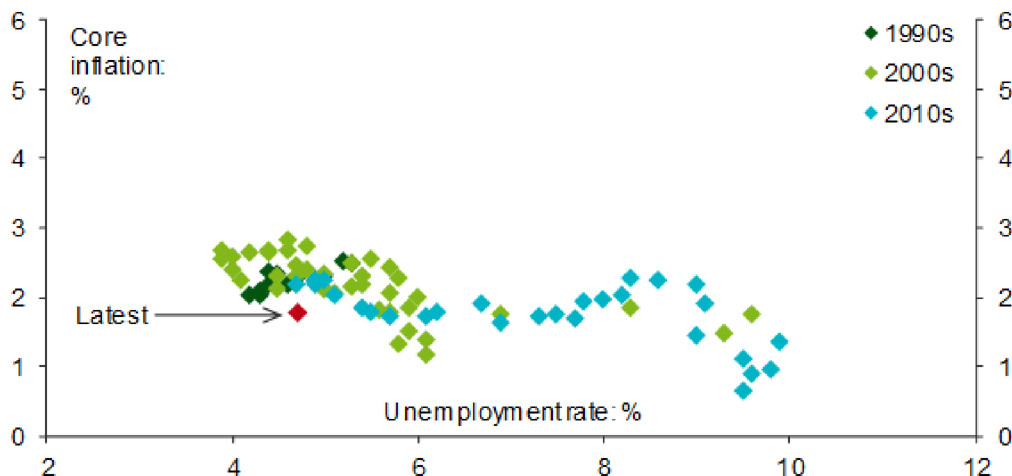
For example, the Institute of Supply Management (ISM) manufacturing index monitors employment, production, new orders and supplier activity based on over 300 major firms. The ISM Index has been rising since early 2016, and in the last few months has had a healthy uptick. Insight reported in early October:

"In the US, economic data continued to be strong. The ISM manufacturing index reached 60.8 in September, the highest since 2004. US service sector growth also reached its highest in 12 years in September. The US trade deficit dropped to an 11-month low and factory orders rebounded in August. Markets are expecting a non-farm payrolls figure around 90,000 today. The House of Representatives approved a $4.1trn budget, with markets optimistic that this could be a step towards tax reform."

2. Inflation and unemployment under control

The US remains the most important economy for economic growth, and despite record low interest rates and low unemployment, core inflation does not seem to be rising. Wages growth remains subdued. The economic theory behind the so-called Phillips Curve, that low unemployment would lead to high inflation and wages growth and vice versa, is not occurring.

Phillips Curve is flat in the US



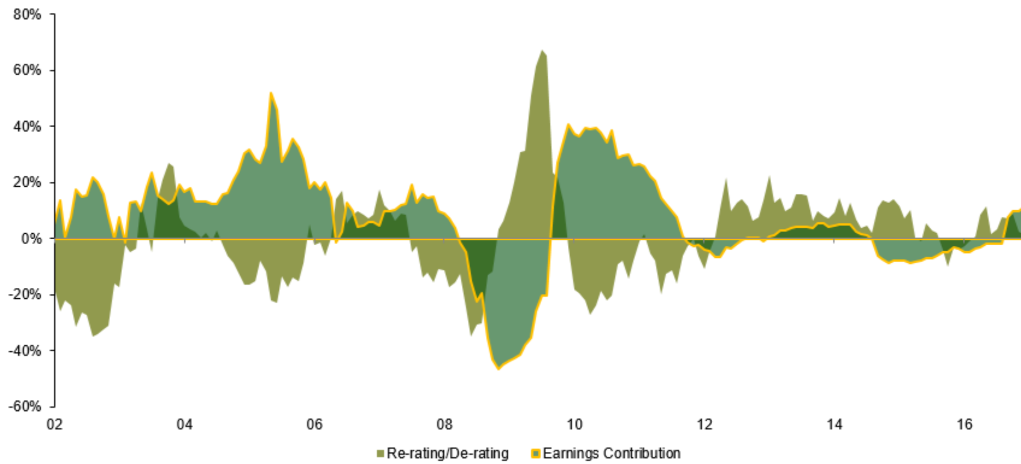
In Germany, engine room of the European Union, unemployment is at its lowest for decades but there is also little sign of inflation.

3. Improving corporate profitability

A rise in share prices might be driven by a re-rating, or earnings expansion, where investors are willing to pay higher prices for the same earnings. For example, low interest rates reduce the attractiveness of alternative assets such as bonds and encourage buying of equities if earnings do not expand. The other driver is increasing earnings contributions, and after flat conditions through 2015, there was an improvement in 2016 and into 2017, as shown below. Says Insight:

"After more than two years of contraction, global corporate earnings growth turned positive at the start of this year and the 15.8% year-on-year rise in August 2017 marked the highest reading since 2001."

Global: earnings growth and multiple expansion



Source: Data for MSCI World Index. Bloomberg and Insight Investment as at 31 August 2017.

Conclusions

This combination of improving growth, low unemployment and corporate earnings growth leads Insight Investment Management to believe there is reason for optimism about the near-term performance of equities. The portfolio managers have shown a willingness to rapidly change portfolios from month to month so asset allocation can respond to conditions, but at the moment, they are solving the equity conundrum with confidence in the market.

Graham Hand is Managing Editor of Cuffelinks. Insight Investment Management has AUD930 billion in assets under management with AUD33 billion for wholesale Australian clients (although its funds are found on many local wraps). It is part of the BNY Mellon group. This material is not investment advice and it does not consider the circumstances of any investor. It is based on material considered to be reliable but no assurances are given.

Bull or Bear? After reading this article as well as Graham's other piece *Five warnings about the most hated bull market in history*, we invite you to voice your opinion in this short survey.

Five warnings about the most hated bull market in history

Graham Hand

Differences of opinion make a market, but there is a stark contrast of views among leading equity fund managers at the moment. While the bulls point to better global growth and shares looking far better than bonds on a relative value basis, the bears argue the market's low volatility is an unwarranted complacency at a time of high valuations. In Sydney this week, global equity manager Hexavest was clearly among the bears, concluding:

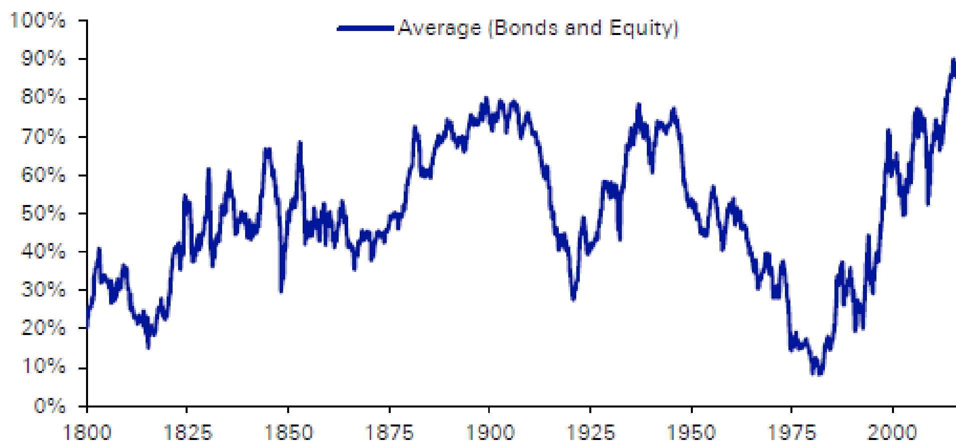
"Calm and stability lead to imprudent behaviour. When volatility drops, many investors let their guard down and increase their exposure to risky assets, often confusing risk with volatility … the return of volatility has the potential to do a lot of damage."

Among the charts Hexavest used to support its argument, the following were highlights.

1. Everything is expensive

Hexavest quotes Deutsche Bank research which shows the expensiveness of financial assets as a risk factor. In the graph below, Deutsche aggregates 15 developed market bond and equity valuations, and with equities in the 90th percentile of historical distributions since 1800, and bonds the most expensive ever (that is, yields the lowest), the risks are obviously asymmetrical.

Figure 57: Aggregated 15 DM country average bond (nominal yields) and equity percentile valuations (100% = most expensive; 0% = cheapest)



Source: Deutsche Bank, Global Financial Data, Bloomberg Finance LP

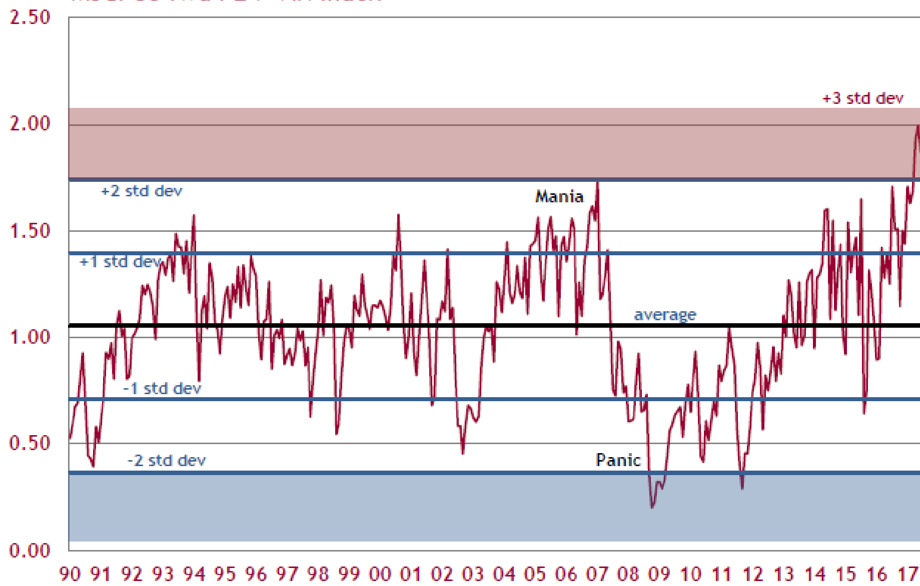
2. Low volatility and high P/E ratios

Hexavest believes many current valuation and sentiment indicators are consistent with a bubble, a term most market experts do not use lightly. Many investors believe the US market is overvalued but continue to buy due to the lack of alternatives, some calling this "the most hated bull market in history". The low volatility in equity prices lulls investors into a sense of security, and they allocate more of their risk budget to shares. The fear is that when volatility rises, these same buyers will rapidly become sellers.

The following chart divides forward P/E ratios (a measure of the market valuation) by the VIX index (a measure of market expectations of near-term volatility). This measure demonstrates the mix of high values and risk complacency. Any ratio which is at an all-time high and over three standard deviations away from its mean since 1990 is a warning that the markets face a correction at some time. The problem facing all investors is knowing when to leave the dance party. The year before the market crash of 1987, the Dow Jones added 37%.

Hexavest says:

"It is generally recognised that valuation is not a good leading indicator of short-term equity market returns. In our view, it is a different story when valuations reach extreme levels. In the past, when valuations were stretched to this degree, we generally saw negative returns in the ensuing 12 months."



Sources: Hexavest, Datastream

3. Share markets trading without material corrections

Equity markets are calm despite elevated levels. Not only is the VIX at historical lows, but in the last 12 months, the number of trading days with a 1% or more loss is also at historical lows. The S&P 500 index has not had a drawdown more than 3% since November 2016, a run of over 240 days which is the longest since 1928. Historically, such calm periods usually end without warning.

Sources: Hexavest, Datastream

4. Asset allocators making record equity investments

Professional fund managers who run multi-asset portfolios can allocate across bonds, equities, property or whatever, depending on their perception of risk and return. Those who manage so-called 'risk-parity' portfolios focus on the allocation of risk, measured by volatility, rather than the dollar size of positions. With bonds offering low returns and equity risk perceived as low, funds have placed a record amount into equities. These allocators have the ability to buy and sell quickly when they are exposed to risk increases, especially when their risk budgets are fixed and they are forced sellers.

US households also have high equity allocations, and while their holdings of equities is not at the pre-'tech wreck' levels of 2000 (about 42%), they are currently over 35% which is above the pre-GFC level of 34% and the long-term average of below 25%.

Source: Morgan Stanley Research

5. Optimism among all types of investors

Across many types of investor populations (including individuals, institutions, hedge funds, mutual funds, etc), the attraction of a rising stock market is too strong to resist, and cash holdings are at record low levels. Institutions usually have an average cash holding of 5% and it is currently about 2%.

Source: ICI, BofA, Rydex, Federal Reserve, SENTIMENTRADER

Conclusions

Hexavest acknowledges economic growth has maintained a decent pace, but contrary to the gathering market optimism, they believe risks tilt to the downside. Investors should watch for markets anticipating an economic slowdown, or a decline in risk appetite, as a sign of a potential end to the equity market rally.

Hexavest was founded in 2004 and is a Montreal-based equity manager that targets institutional clients rather than retail. This material is not investment advice and it does not consider the circumstances of any investor. It is based on material considered to be reliable but no assurances are given.

Bull or Bear? *After reading this article as well as Graham's other piece Three reasons the bull keeps running, we invite you to voice your opinion in this short survey.*

7 lessons from my Dad, in and out of aged care

Alex Denham

It's been a difficult year for my 82-year-old widowed Dad. He had a strong heart, perfect blood pressure, complete mental capacity but a troublesome skeletal frame. In February this year, he collapsed out of bed and was unable to walk, even a little bit. He'd been wobbly for a while, then on a frame, then finally his legs just couldn't support him anymore.

The surgeon gave the prognosis: endure two *major* neck and back surgeries, followed by a year of hard work and physio, or end up in a wheelchair in a nursing home. Not much of a choice. He chose the surgeries, and a long and horrific few months followed.

By June it was clear that the hospital and rehab environment was not doing him good. He was despondent and his progress plateaued. Although still in a wheelchair, it was time to find alternative accommodation where he could be looked after and continue with the rehabilitation.

My sisters and I weren't in a position to take him in, nor did he want to live with us. He wanted to stay in Sydney near his friends and support network. An aged care facility (read: nursing home) was the only option available (we thought). Fortunately, he had the means to take his pick.

We found one that we thought would be ideal: Sydney harbour views, award-winning dining, luxury and style. Dad would love the company of others and a bit of nurturing that he hadn't had since Mum died a couple of years ago. They even have an in-house physio programme.

We did the negotiations, he was discharged from the hospital and he moved in. No doubt, it was a better environment for him than the rehab hospital, but for poor Dad, it was not a positive step. They *did* look after him well, I emphasise that, but a nursing home is a nursing home, no matter how fancy it is. It is not filled with 65-year-olds discussing world issues. He felt he was the youngest there by years, and found no one on his intellectual level. He was lonely, sad and frustrated.

That, and the monthly bills, were enough to light a fire in his belly to work hard on his physio to get out of there. Eventually he moved from the wheelchair to a walking frame, and now after a 119 day stay, he's headed home.

I've worked as a technical specialist and adviser in aged care matters for many years, and have written countless articles on the fees, charges, effect on age pension, and strategies. However, I now have a further - much more personal - insight into this process to share.

Lessons learnt from personal experiences in an aged care facility

1. No matter how pleasant the facilities, or how many awards it has won, it's still a nursing home. In many (but not all) cases, the residents are there out of need, not desire. The food is never going to be as good as home-cooked. They are running a business and working within budgetary restraints. Scotch fillet made to order and fresh fruit are a thing of the past unless the resident goes out for it, or a family member brings it in.

2. Speaking of meals, dinner is at 5:30, then it's back to the room by 6:30. Makes for a long, boring night for a person who has full mental capacity and wants someone to chat to. In summer daylight savings, they are having dinner at what is close to afternoon tea time.

3. Read everything in the Resident Agreement, read it closely and understand it. If you don't understand it, get someone to read it who does. I do understand most of these things better than the average person, and was still taken by surprise by some of the charges that popped up on the monthly statement.

4. Residential aged care can be breathtakingly expensive, and every little extra thing is charged. It's that feeling when you've spent a week at an expensive resort, charging everything to your room, then it's time to look at the bill. Only it goes on, month after month. The temptation is not to look at the statements, but please do. We found Dad had been overcharged a whopping 25 days due to an error in accounts.

5. Even for a high means person, it is worth completing the awful Combined Assets and Income Assessment form (SA457) from the Department of Human Services. We didn't for Dad, but in hindsight I wish we did, as I think we'd have had a clearer picture of where he stood.

6. The Means Tested Care fee is based on the actual daily cost of care as determined by the Government based on the ACAT assessment. However, it is subject to an annual cap of $26,566.54 or $72.78 per day. As Dad was assessed for a high level of care, the facility charged this daily capped amount on the assumption that he would be staying for the full year. However, when he gave notice that he was leaving 119 days later, we got a nice little surprise … his actual daily cost of care was $214. His Means Tested Care fee was back-dated to the day of entry, and he was hit with an extra $12,600, which kept him just below the $26,566 for the 3½ month stay. My training and experience failed to see that one coming, even though I probably should have. It's a trap for when a person exits the Residential Aged Care system.

7. Dad's mobility has improved, but still has a way to go. The reason he can go home is because there are some excellent home care service providers that provide home help, personal care, companionship, transport, and specialist care (24-hour, dementia, palliative or respite). They can also manage the overall care and tap into nursing services, specialist doctors, GPs, equipment suppliers etc. If you live in an area where these services exist, it is possible to stay at home and miss the whole residential aged care step altogether. BUT, and it's a big BUT, if you need to rely on a 'Home Care Package' to help fund it, there's a long wait. Following the ACAT assessment, you're put on the waiting list. No one really knows (or reveals) how long the waiting list is but it's months if not a year or two. Dad will have to pay for his home care services privately until the package comes through (which is also subject to a means test). You can get more information about home care here.

Summary

I've learnt that although aged care in Australia has vastly improved over the last few years, it's still not a happy time for some. It's expensive, impersonal and can be downright depressing, although to be fair there are many positive stories as well. Many years ago, my Grandpa - deep in dementia - loved it. He got his three square meals a day and familiar faces caring for him.

I think my Dad has learnt that he wants to be at home, he wants his independence, and he wants to stay connected with the world. Before all this, and since Mum died, he was feeling lonely and isolated at home, but this time around he will revel in being back in his own space. He's already in touch with friends and filling up his diary with social outings. More power to him.

This experience was a revelation to me as a long-term adviser in the aged care field. Even a person in a comfortable financial position who has the means to enter a facility with many extra services over and above the government-subsidised standards faces unexpected and disappointing experiences. In future when discussing aged care matters with my clients, I will urge them to investigate home care options as well as residential ones. It's horses for courses, and it's heartening to know that there are increasing options available for our ageing population.

Alex Denham is a Senior Adviser with Dartnall Advisers. Prior to becoming an adviser, she spent 20 years in senior technical roles with several financial services companies. This article is general information and does not consider the circumstances of any individual and is based on a current understanding of the rules.

What we look for on company site visits

Robert Miller

Research procedures combine both qualitative and quantitative processes and the company site visit is particularly important as part of the qualitative assessment. A picture can tell a thousand words and a site visit can be much more effective than watching a company presentation.

A company site visit can reveal much more

Here are a few of the things we look for during a company site visit:

1. Describe the business in one sentence

We adopt the old adage that if we can't explain an investment in a sentence then it is not for us. Site visits should be a valuable way to understand a company's operations and gauge the current business environment.

It's crucial when speaking with our investors to explain exactly what we are investing in, particularly given our investee companies tend to be lesser known by the broader community. If we spend a day with a company and walk away without a clear understanding of their operations, it is generally thrown in the 'too hard basket'.

I recall an investor day where we discovered the company had built up numerous divisions across competing product offerings. What had started out as a simple business was now a complex conglomerate. Following a number of ad hoc acquisitions, they had created a completely different culture. It became a confused message from the company with too many people talking about different areas of operations. Since our visit, this particular company is looking to restructure and has been discredited by the market.

2. Look for activity

Looking for the 'pulse' of an operation is essential regardless of whether we are visiting an office, a factory or construction site. We focus more on what we see as the business grinds away rather than what we are told. Are all the sales staff busy? Are there a lot of empty seats? Is the machinery working? Are the shelves full? Are there a lot of trucks driving in and out? These could be key factors underpinning the company earnings 12 months down the track.

We have counted the number of times an activity occurred to do the rough maths on whether the company is delivering on its market outlook. More obvious signs are delays resulting in the slowing of the sales process, for example, visiting a logistics company headquarters where there is a complete lack of activity or empty trucks being deployed.

At a recent agricultural site visit, we could see that a company's operations were working efficiently. Commodity throughput was strong, the team members were working well together and a steady stream of semi-trailers were moving in and out. The site visit played a part in forming our investment thesis and we became shareholders.

3. Understanding company morale

Typically, site visits are conducted by company CEOs to show investors their operations. Something you will not get a feel for in a boardroom meeting is how employees behave towards the CEO. It can be more of an art than a science, but it is always a great sign when the CEO knows everybody's name and shows and receives respect to and from other staff members. Body language can be a telling factor. If we notice anything which makes us question the ability of a CEO to generate a successful culture, we will reconsider our investment decision.

We place a strong emphasis on management quality. During a visit to an interstate company site, it was obvious the CEO did not have the respect of his colleagues. We flew home, reassessed our investment and sold out. On the flip side, we visited a retirement living home where the CEO knew the residents and was happy to talk to Mrs Jones or Mr Smith about what they were having for lunch and how their grandkids were going. This company has grown its share price by more than five times over the past five years.

4. Detecting a gravy train

In listed companies, management's key role is to act in the best interest of shareholders so it is crucial management act responsibly with the capital entrusted to them. It is easy to disguise spending in the income statement reported to the market. We look out for things like the types of cars in the carpark or we sneak a peek at the CEOs office. Excessive spending will influence our view of the company.

An example was an unprofitable local micro-cap which had an extravagantly-sized office and boardroom filled with expensive furniture when the company came close to bankruptcy shortly after our site visit.

Site visits are an essential aspect of our investment process which endeavours to find quality companies to be held for the long term.

Robert Miller is a Portfolio Manager at NAOS Asset Management. NAOS Asset Management is a boutique funds management business providing exposure to emerging and small-mid cap industrial companies. *This content has been prepared without taking account of the objectives, financial situation or needs of any individual.*

'Utility function' research wins Retirement Innovation Award

David Bell and Estelle Liu

Retirement outcomes is a hugely complex and challenging area for the superannuation industry.

From a financial perspective, the retirement problem is an integrated dynamic consumption and investment problem. There are many sources of uncertainty, especially investment returns and mortality outcomes.

The superannuation industry is unclear what it is trying to achieve for retirees. Many super funds remain lump sum focused.

Setting retirement preferences

Yet academic researchers have had a framework for addressing retirement outcome problems for nearly 50 years. They use something called a utility function, which in simple terms is establishing a set of retirement preferences and reflecting these in a formula. With clear objectives reflected into a metric, we can then design products and services which increase the expected utility of member's outcomes.

Eliciting someone's preferences is part of financial advice. It is also a hard thing to do well.

The challenge is different for super funds who may have members default into retirement solutions. It is necessary for trustees to assume a sensible, paternal, set of preferences for default members.

Mine Super has a dedicated retirement outcome modelling team that has focused on this area for a few years. Our Board endorsed us to create a utility function which we can then use to better assess the products and services that we provide to our members.

Rather than do this on our own, and create the risk of being too different from the rest of the industry, we collaborated, creating a working group of 14 researchers from industry and academia (see panel members here). Over 18 months we developed a metric which we call the 'Member's Default Utility Function version 1', or 'MDUF v1' for short (with a name like this you can deduce I don't have a marketing bone in my body!). We use 'v1' because every two or three years we would like to update MDUF to account for new research into retiree preferences.

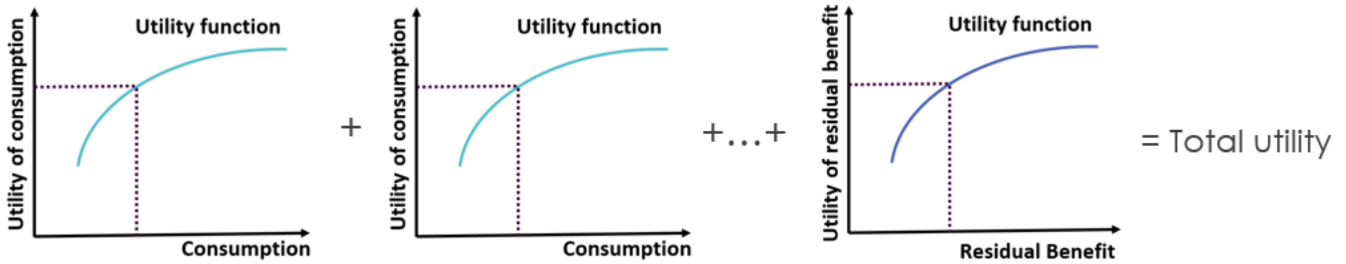
Converting preferences to 'utility'

What preferences are included in MDUF v1? Hopefully as you read through these you are nodding your head in agreement:

1. Members prefer higher (rather than lower) income in retirement
2. Members would prefer a smooth rather than a volatile income stream
3. It would be undesirable for a member to outlive their retirement savings (or the income stream it generates)
4. Members are economically risk averse: this means that the size of the joy experienced from a higher level of consumption is less than the size of the pain experienced by an equivalently sized reduction in consumption
5. Members place some value on the residual benefit at death.

We then produced a formula and associated parameter values which establish the trade-off between the different preferences. You can see that some pull against each other. We think there is an important 'straw man' role for MDUF v1 – funds or advice groups who believe they have greater insight into the preferences of their members or clients can create their own version (we provide a 'how to' document to help).

Multiple preferences make for a complex formula but importantly we can easily reflect the MDUF v1 into a diagram.



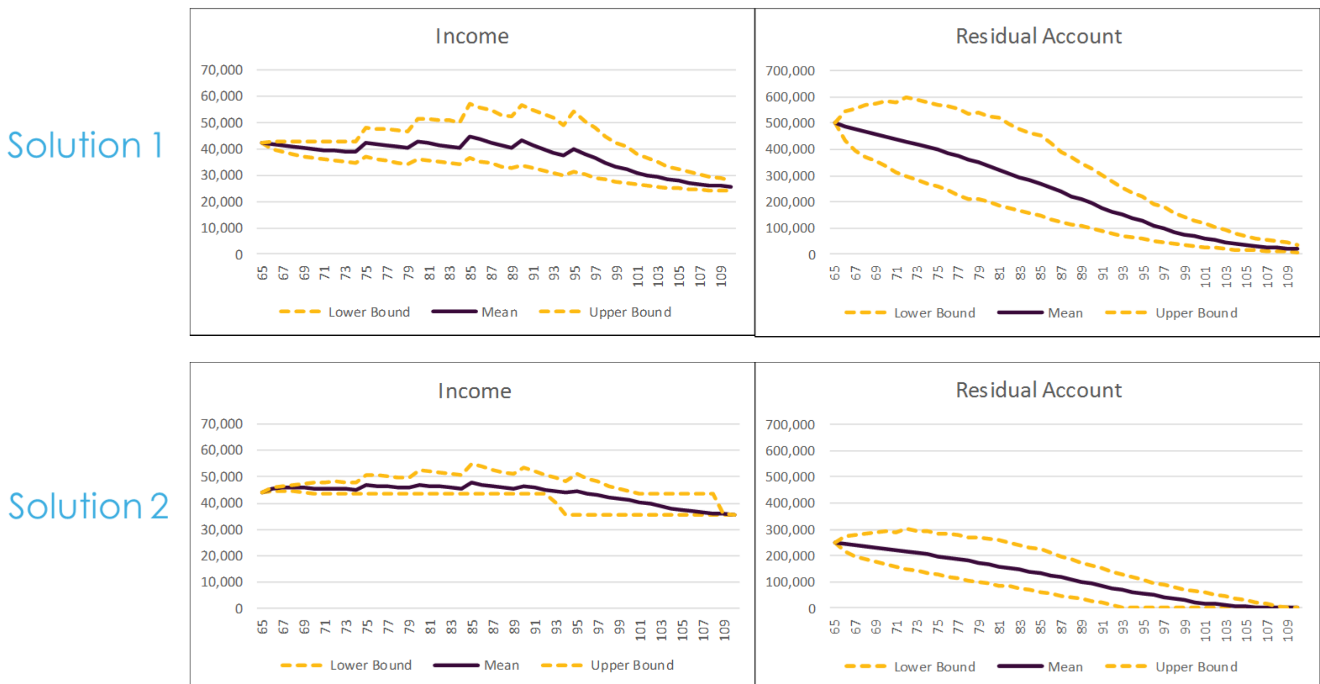
MDUF is not just a formula, it implies a framework for thinking about retirement outcomes. Looking at the diagram above, we can see the following:

- Retirement is a collection of periods of retirement income and a final payment (residual benefit)
- A utility function simply converts the income (or consumption) into a measure of the experience of that consumption. Our utility function is a curve which 'bends over', incorporating risk aversion. That is, higher outcomes are valued but lower outcomes are penalised more harshly
- We sum the utility of each individual payment to get a total utility score. This would represent the total utility of one possible outcome for a retirement solution. But there are many possible outcomes. So, it would be appropriate to simulate many possible scenarios accounting for different investment and mortality outcomes, calculate the associated utility, and then calculate the expected utility of a retirement solution.

This all sounds complex, but retirement is a complex challenge. You ignore the complexity at a cost to your members, or clients.

A solution for a specific person

MDUF is a quick and ready way to compare the pay-off profiles of different retirement solutions. Consider the following two profiles:



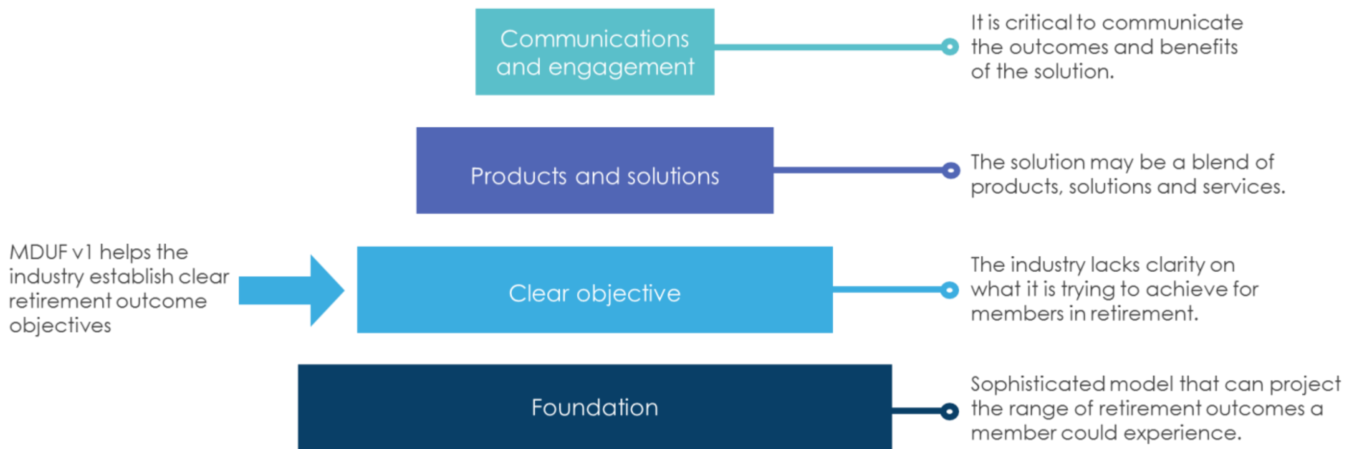
In the example, the modelled scenario is of a single man, home owner, with $500,000 at retirement. Solution 1 is simply an account based pension, investing 50% in equities and 50% in cash, following the minimum drawdown rules (our modelling incorporates age pension payments). Solution 2 involves 50% annuitisation and a 50% allocation to the account based pension.

The first column considers the income stream while the second column models the residual benefit if someone were to die at a particular age. The purple lines are expected outcomes while the yellow lines are 90% confidence intervals, providing some insight into the range of possible outcomes.

Which solution is better?

What a difficult question! There is no clear winner and one is forced to make trade-offs between level of income, volatility of income and the residual benefit profile. MDUF v1 does all the heavy lifting. In this case, Solution 2 achieves a higher (better) MDUF score.

The MDUF project attempts to help the industry step forward. The message is that you need a clear objective of what you are trying to achieve in retirement and represent this as a metric (or scoreboard), before you can effectively design good retirement solutions.



There is an unlimited number of possible applications of MDUF by many different industry participants, be it super funds, financial advisors, asset managers, insurance groups, policymakers, retirees or ratings groups.

We would like to thank all members of the Working Group for their contributions, and also AIST and ASFA for being supportive custodians.

We encourage you to think about this work, and consider what important aspects you can pull out of it. Don't make the mistake of rushing to solution mode yet. Think what problem you want to solve, what is your objective, and how can you quantify what you are trying to achieve. This is where MDUF v1 may be a useful straw man for you.

David Bell is Chief Investment Officer at Mine Super. Estelle Liu is a Quantitative Analyst in Mine's Investment team, focused on retirement outcome modelling. MDUF v1 has been made freely available to all in the industry via the websites of MDUF's custodians, AIST and ASFA. You will find papers (from the introductory through to the highly complex), presentations, models and FAQ's.

David Bell is a Co-Founder of Cuffelinks and he won the BTIM Retirement Innovation Award from SuperRatings for this research.

Are there opportunities for an active manager in an efficient market?

Tim Carleton

We view the Australian stockmarket as highly efficient. There are a large number of domestic research analysts, brokers, fund managers and investment professionals poring over the listed securities. In such an environment it is difficult, if not impossible, to regularly be smarter than the other informed market participants.

How does an individual stock picker outperform over long periods of time? Why would such a market present outstanding individual risk-adjusted opportunities for investors? It is a good question to ask if you are invested with an active manager. It has been a key question for researchers for a long time. Professor Eugene Fama's

Efficient Market Hypothesis (EMH) proposed that it is impossible to beat the performance of a liquid stockmarket over time because prices constantly incorporate and reflect all relevant information.

Opportunities come from one main source

If we find a stock that we think is compellingly cheap, one of the first questions we ask is why we are getting the opportunity. What circumstances have led to the mispricing? What are people reacting to in order for the stock price to have deviated so far from our perception of fair value? The absence of a logical answer might infer a problem with the analysis, rather than an opportunity for an attractive purchase. The collective market is almost always more informed than the individual investor, assuming the investor is an outsider to the company under consideration.

We think we find opportunities for one predominant reason. Market participants have cognitive biases that lead to emotional rather than rational responses to new or changing circumstances. We are no different. We feel the same emotional responses. Our role is to invest as rationally as possible. We focus attention on the facts and try to remove the influence of the emotional response from our thinking.

Good investments typically come in one of three forms. The **first** is at the stock level. A company has a temporary setback or earnings revision and the market extrapolates the problem across the entire business. We focus on the medium-term outlook and ask whether we can make sensible, modest forecasts about earnings over the following few years. If earnings are delivered as expected, would this make buying at the current stock price attractive? A favourable answer means there's a time horizon arbitrage in a company we would like to own for a long time.

Secondly, sometimes a whole sector might screen as attractively priced because the market is focused on a threat that appears overblown. An example is shown in the chart below.

In May 2014, the Federal Government proposed a restrictive and somewhat unpopular budget to assist in repairing the budget deficit. Over the following six months, the market sold retail stocks that many assumed would be significantly impacted by any cut to disposable income. The likely numerical impact of any budget measures on consumer discretionary spend was, on our analysis, likely to be small and transitory in nature. It gave an attractive entry point into a number of high quality retailers that we had been watching for some time.

Thirdly, there may be a market-wide reaction to a particular event, such as the surprise election of Donald Trump or UK's Brexit vote. Participants in the domestic market reacted to Brexit by selling financial stocks in the weeks that followed. We believed the risks to corporate earnings were relatively low. Similarly, it was unclear why the election of President Trump would negatively impact the earnings of Australian companies, yet at one point in the afternoon of the election the domestic stockmarket was down nearly 4% (as highlighted below). Many individual stocks were down considerably, having already fallen on the uncertainty heading into the election.

Need to be patient for these opportunities

Outstanding opportunities do not come along frequently, and certainly not predictably. In the intervening periods, investors should be as patient as possible, remaining focused on their existing portfolio and ready to respond rationally. There may be an opportunity to invest sensibly in familiar companies with quality attributes.

We agree with the notion that the market is most often efficient, but that the difference between 'often' and 'always' is like night and day. Opportunities for the value investor occur when the majority of market participants are distracted from the immediate opportunity by an issue where the impact is either exaggerated or transitory. This is when we become most interested and plan to take full advantage for the long-term.

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How pension accounts can exceed $1.6 million

Gordon Mackenzie

One of the joys of being an academic, after 25 years in corporate life (besides not having to speak in that risk averse formal legal way), is you have the time to check the tax rules and then get one of those lightbulb moments.

A Cuffelinks reader asked whether an SMSF member who has already maxed out their $1.6 million Transfer Balance Cap (TBCap) can have additional earnings added to the fund account supporting their pension?

The answer is yes.

And here is the light bulb moment: there is no connection between the actual value of a member's account when paying a pension and their TBCap. The Explanatory Memorandum specifically says that.

The Transfer Balance Account (TBAccount), the value of which is measured against the TBCap, is calculated, briefly, as the 1 July 2017 value for existing pensions or the value at commencement of subsequently-commenced pensions. Of course, there are credits and debits to that which can take the TBAccount over the TBCap but, briefly, they are credits for deemed earnings on commencing TBAccount excesses and debits for commutations, plus some more obscure events giving rise to debits.

That is, the TBAccount value for these purposes is frozen at commencement so that additional earnings added to the members' account in the fund, and consequent additional pension because of the minimum 1 July account balance that must be paid, are ignored for this calculation.

What that means in practice is that, say, you have a fund roaring along at a 10% pa earnings rate which will then have an increased pension of that amount, the TBAccount will stay at the amount it was when the pension commenced.

In fact, that is the design of the system. The fund doesn't have to annually check the TBAccount for a member, it is only done at commencement or when one of those specific credits or debits occurs.

If the TBAccount exceeds the TBCap at commencement, or otherwise, then there is a mechanism that is intended to reclaim the exemption from tax that the fund receives on the income from the excess. This is achieved by the rules deeming an earning rate on that excess TBAccount, which earnings are taxable to the member, but the fund will still continue to get the exemption from tax.

So, again, earnings allocations, and indeed losses, to the members' account in an SMSF are ignored for the purposes of comparing their TBAccount with their TBCap.

Finally, I'm not so sure that the delight you get from these ahha! moments in academe actually makes up for the pay differential, but that is another discussion (sigh).

Gordon Mackenzie is a Senior Lecturer in taxation and superannuation law at the Australian School of Business, University of New South Wales. This article summarises the major points as understood by the author, it does not consider the needs of any individual and does not consider all aspects of the legislation.

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