

### This Week's Top Articles

- **It's not a shock that retirement is different** *Jeremy Cooper*
- **The ascent of Asia and what it means for Australia** *Phil Ruthven*
- **The Boyer lectures, Facebook and your social media rights** *Graham Hand*
- **Better portfolios: forecasting share and bond markets** *Wilbur Li*
- **Australian banks: reporting season wrap** *Greg Peel*
- **What's currently the worst asset class investment?** *David Bassanese*

### It's not a shock that retirement is different

Jeremy Cooper

This might come as a shock to some, but there is a serious question whether a defined contribution (DC) system like ours is fit for purpose in retirement. That was the fundamental conclusion that motivated the Financial System Inquiry (FSI) recommendation for Comprehensive Income Products for Retirement (CIPRs). The FSI realised that a 'pre-selected' combination of products would simplify decisions at retirement and, most importantly, deliver better outcomes for retirees. The FSI envisaged a regular and stable income stream, longevity risk management and flexibility (among other features). The FSI even suggested that the design should consider the possibility of cognitive impairment at older ages. In aggregate, the FSI pointed to a lot of things super is not doing for current day retirees.

#### 1. Fit for purpose question

This is an inconvenient truth, but even [Paul Keating conceded some years ago](#) that the super system was not designed for people who were going to live over the age of 80. The system he conceived was for the 55- to 75-year-olds. People are now typically living into their late 80s, more than nine years longer than they did in the 1990s. We need to enhance the model, which is what the MyRetirement reforms are asking us to do.

In the DC model, there is no structure to the drawdown phase. Flexibility is prioritised at the expense of risk management and income certainty and sustainability. This is the source of our current 'growing pains'. We are trying to bolt a more DB-like solution onto our DC system, while maintaining choice and flexibility.

We are also shifting from the world of merely supplementing the age pension to a world of substituting or supplementing it.

#### 2. Spending is different from saving

When a member of a super fund retires, the 'financial dynamics' of their long savings program are reversed. Instead of their employer making regular SG contributions on their behalf and their fund being a large scale 'wholesale' investor, the retired member becomes a 'retail' customer, but also a spender, rather than a saver. For the first time, there is a direct financial lifeline from the fund to the member. The fund becomes the source of the retired member's retirement pay cheque. This is a fundamentally different business from accumulating savings.

And yet, in Australia, we seem to have one way of thinking about, talking about, and measuring, the success of superannuation, and it has little to do with providing regular, spendable cash flows in retirement.

---

### 3. Retirement income products

This quickly leads to a discussion of retirement income products. Products are undoubtedly important because they ultimately deliver the outcomes retirees are looking for when it comes to their financial security in retirement.

But, products are downstream from some even more important considerations in getting the right financial outcomes for retirees:

#### a) Retirement income philosophy

A super fund needs a retirement income philosophy. You will not be surprised to hear that I don't think this amounts to 'being great investors'. The return of a member's money in the form of regular income and better managing their risks in retirement is not the same as the time-weighted returns achieved by the fund as whole.

Not all things can be addressed by asset allocation. Fund trustees should have a clear view of where they sit on the spectrum between entirely probability-based outcomes and a risk-free retirement: one backed entirely by the age pension and Commonwealth government bonds, for example. Once they have worked out this philosophy, they can work on the delivery.

Let's use an aircraft analogy that I must attribute to UK pensions academic and expert, Professor [David Blake](#). When an aircraft takes off, it has a very specific flight path to its destination and constantly risk manages its ability to reach it using navigational waypoints and myriad other technologies. The crew constantly check fuel and other variables. If you think about the MyRetirement reforms, they are aimed at more retirees having a smoother flight; consuming their retirement savings more evenly over the course of their retirement.

#### b) Trustee director duties

Most activities or outcomes that call for improvement in superannuation are connected to governance. It's extraordinary to think that the Superannuation Industry (Supervision) Act 1993 Cth (SIS Act) is silent when it comes to trustee director duties in favour of retired members.

The relevant part of the SIS Act which itemises trustee director duties (s52) is cast in an accumulation paradigm, referring to 'investment options' (among other things). It makes no mention of 'retirement income' or the issues to which the MyRetirement reforms are directed. The trustees should be required to consider things like the pooling of longevity risk, protection from market risk and inflation, the sustainability of the income and even how the income needs of retirees with cognitive decline could be met more effectively.

#### c) Supervision and accountability

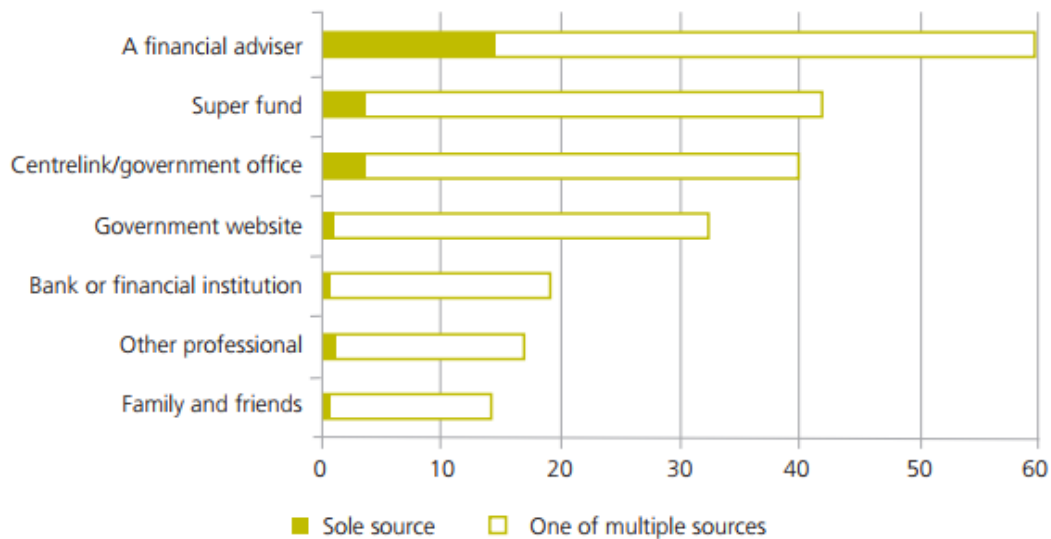
With such duties clearly spelt out in the SIS Act, APRA would then have a clear mandate and some signposts for building out a retirement income prudential standard. A close analogy would be the way APRA consulted with the industry in 2012/13 when it released a draft of, and then finalised, SPS 250 on insurance in super.

#### d) Seniors rely on financial advisers

National Seniors Australia (NSA) and Challenger recently released a [research report](#) on the behaviour and attitudes of senior Australians regarding their retirement finances. The report shows that six out of ten Australian seniors are turning to financial advisers for advice and information about retirement finances. This proportion is significantly higher than for superannuation member population overall, where only [one in five seek advice](#).

The most common sources of advice and financial information about retirement are: financial advisers (59%); super funds (42%); and, Centrelink and government offices (40%). Contrary to widespread belief, family and friends are not highly rated as a source of financial information at only 14%, as shown below.

## Who seniors turn to for financial information on retirement



### 4. Measuring success in the retirement phase

The predominant goal of super is to create a retirement pay cheque; a regular flow of income to live on in retirement. In practice, consumption or spending happens at a household level. This is another big challenge: we save up super individually because it's employment-based, but most of us spend it jointly in retirement. Sharing a roof is the most basic element of shared consumption of retirees. In the 2016 Census, 69% of people aged 60-64 were married or partnered and less than 20% were living alone. Where possible, all participants in the retirement income system need to be more accustomed to distinguishing between the solo retirement and the pooled retirement. They are very different experiences and need different treatment.

One of the problems facing the industry is determining measures of success, at the fund level, in providing income in retirement.

Measuring success in accumulation is relatively straightforward. It revolves around performance league tables. It is having a strategy with the highest net after-tax, risk adjusted returns over say a rolling 7 to 10-year period or longer. The trouble is that the sort of portfolios that are producing these returns are all built on ideas related to modern portfolio theory (MPT). The problem is that MPT doesn't work in retirement. It doesn't factor in the cash flows in retirement and effectively assumes an endless investment horizon. Most retirees will need to consume some or all of their savings along the way.

There are numerous other challenges in retirement: sequencing risk, inflation, longevity risk, drawdown rate and the bequest motive to name some. These factors all need to be managed to deliver a stream of retirement income for the retired member to live on. A higher accumulated balance alone will not guarantee success.

We therefore need new measures of success in retirement so that funds can better manage towards them. This needs a balanced scorecard approach, based around something like these key parameters:

- The probability of meeting the cash flows needed to support the retiree's desired spending. This would need:
  - a) An ex ante measure, an actuarially-based assessment of the payments that can likely be made; and
  - b) An ex post measure to look at payments made through a person's retirement
- An estimate of the expected estate balance (where zero is the optimal outcome for any unintended bequest)
- Member satisfaction with the level of liquidity (e.g. for unexpected spending needs) afforded by the plan
- The path and variability of income, and the impact on the member's peace of mind (e.g. loss aversion), and
- An overall retirement plan satisfaction score.

## 5. Call to action

The super industry is under pressure. Thought leaders are calling for radical changes, including even nationalisation. Pressure emanates from the Productivity Commission, digital disruptors and the community at large.

What is the solution? A focus on better meeting the needs of the customers. Who are those customers? Accumulators and employers might oil the wheels, but it is a fund’s retired members who look to a fund to provide regular income and to manage risks that they cannot manage on their own. We need to accept an inconvenient truth. Our wholly individualised DC system is not up to the task for the vast bulk of retirees who cannot afford to manage those risks themselves.

Jeremy Cooper is Chairman of Retirement Incomes at [Challenger](#). The full version of Jeremy’s FSC Retirement Income Products Conference keynote address can be accessed [here](#).

## The ascent of Asia and what it means for Australia

Phil Ruthven

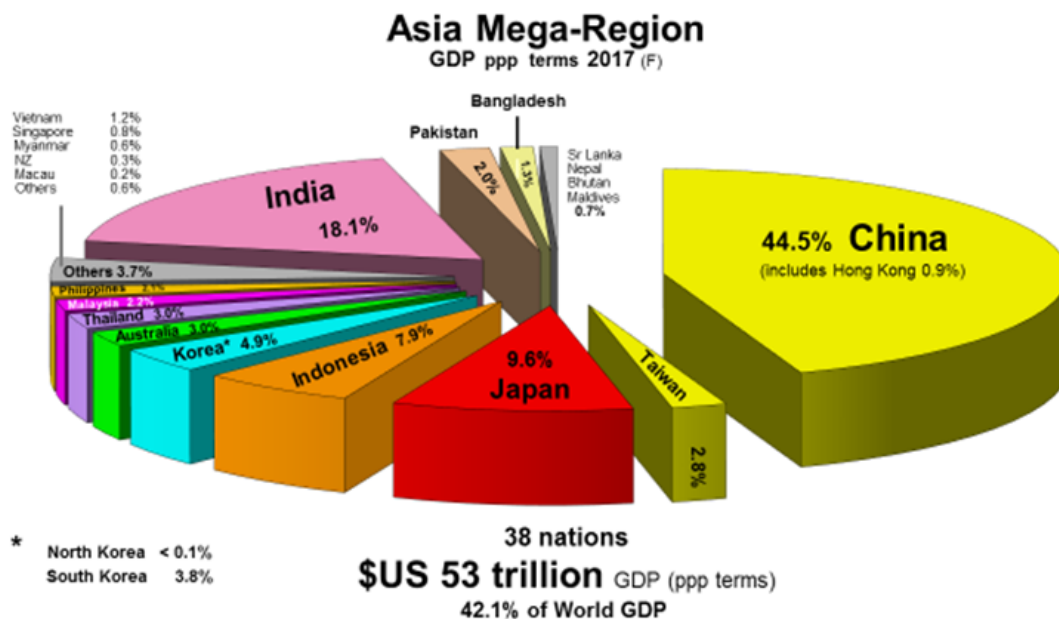
The proposed departure of the UK from the European Union could lead to other difficulties and defections. The US will be more insular under the Trump presidency. These trends point to an even greater need for Australia to consolidate its future in its own region of the Asia Pacific, and indeed in the wider arena of Asia.

In 2017, the shares of world GDP are forecast (by IBISWorld) to be: Asia Pacific (33%); Indian Sub-Continent (9%); North America (19%); Central and South America (6%); Western and Central Europe, mainly the EU (17%); Eastern Europe (4%); Middle East (7%); and Africa (5%). These are higher shares than contemplated for the two Asian regions just 18 months ago.

### Asia’s place in the world

Calendar 2016 was a landmark year. It was the first time the GDP of the East surpassed the GDP of the West, at least in purchasing power parity (PPP) terms, which is the most important measure of economic size. And in 2017, Asia, at over 42% of the world’s GDP, will exceed Europe and North America combined.

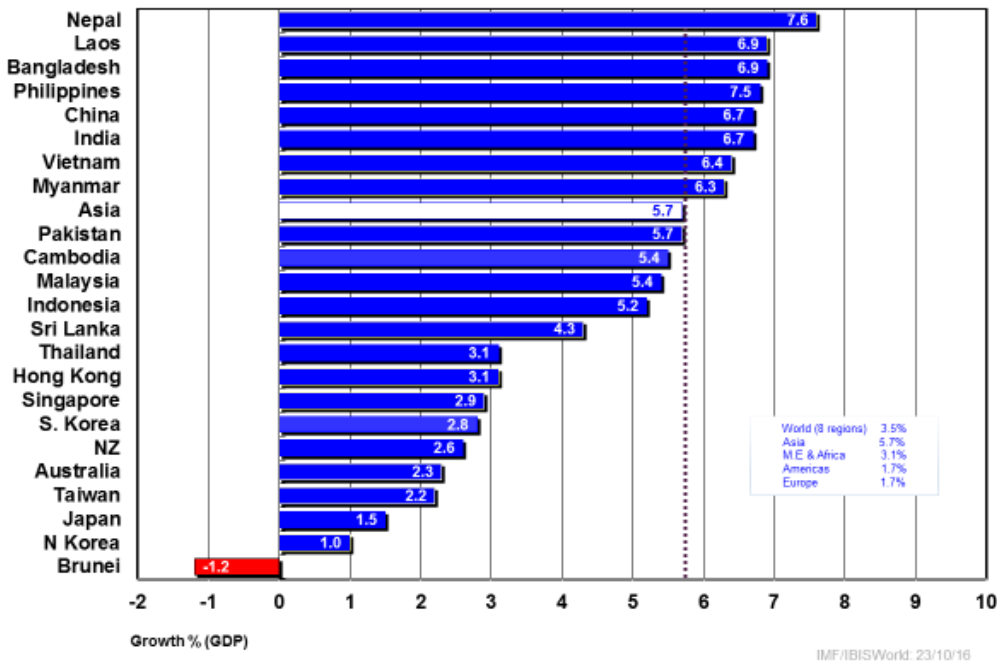
Asia’s economic composition in 2017 and its growth prospects, broken up by nations, are shown in the two following exhibits, the giants being China, India, and Japan.



IMF/IBISWorld 22/02/17

## Asia Growth 2017 (F)

Major Asia Pacific and Indian subcontinent nations (ppp ranking)



### Australia's place in the world and region

Australia is tiny, at 3% of the region's GDP, yet that still puts us as the 19<sup>th</sup> largest economy in the world of 230 nations and protectorates with 1% of its global GDP (in PPP terms). Tinier still is our population of 24.5 million at 0.33% of the world population of 7.4 billion.

The table below is an added reminder of our smallness among Asia's economic and populated giants, in everything except land mass.

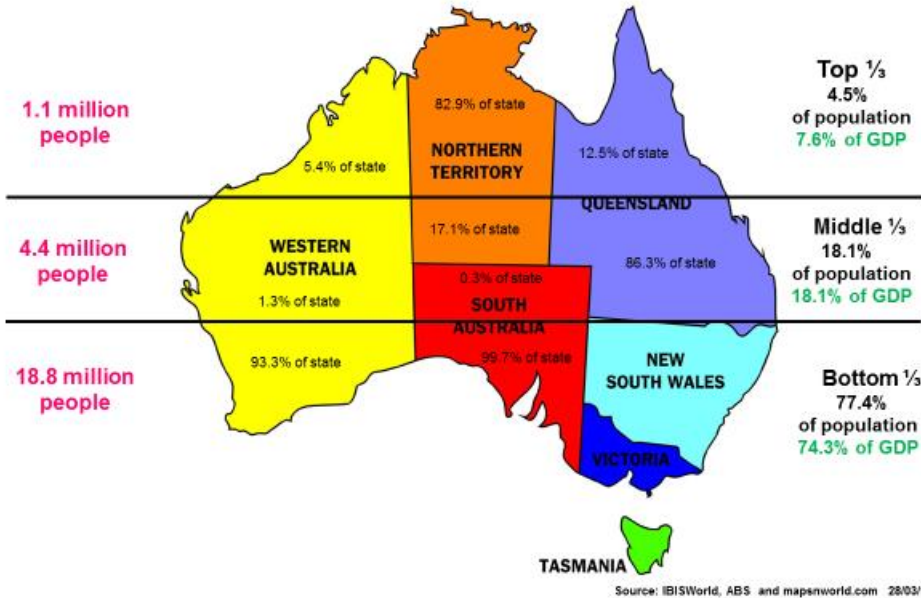
### Australia's Major Asian Neighbours 2017

Nation	Land mass (million sq. kms)	Population (million)	Density (persons.sq. km)	GDP (\$US bn, ppp)
Australia	7.7	24	3	1.3
Indonesia	1.9	258	137	3.3
Philippines	0.3	103	337	0.9
Vietnam	0.3	95	95	0.7
Thailand	0.5	68	68	1.2
China	9.6	1373	143	23.1
S. Korea	0.1	51	507	2.0
Japan	0.4	127	870	5.1
India	3.3	1267	399	9.6

The next exhibit below shows the degree of our scarcity of population. Australia's top one-third, with a land mass of 2.6 million square kilometres, has a population of just over a million people. Our nearest neighbour, Indonesia, with less than three quarters of that land mass, has a population nearly 250 times greater!

## Australia's Three Geographic Zones

2016 (population in three equal land masses of 2.6 million sq. km)



In case we think of the top third of our continent as dry and largely uninhabitable, that part of our land mass has 60% of our annual water supply.

There are now seven Asian cities in the world that are of a similar or greater population size than our entire nation, with its extraordinary land mass. They are: Tokyo (38 million); Shanghai (34 million); Changquín (> 32 million); Jakarta (31 million); Karachi (25 million); Delhi (25 million); and Beijing (25 million). More will follow.

None of this should lead to xenophobia of the sort we have exhibited at various times in our history. We are already on our way to becoming a Eurasian society by the end of this century, having been European in the 20<sup>th</sup> century and British in the 18<sup>th</sup> century. We will be on our way to becoming an Asian society in the 22<sup>nd</sup> Century, albeit a rich and westernised Asian society.

We are expected to have a population of 70 million by the year 2100. Even at that stage, some Asian *cities* will be more populated than our entire *nation*. So, re-evaluating our place in Asia and our relevant population – given our land mass and resources – will be an ongoing, neighbourly and moral responsibility for many generations to come. We will need big and enlightened minds in such a significant and powerful part of the world where we live and work.

*Phil Ruthven is Founder of [IBISWorld](#) and is recognised as one of Australia's foremost business strategists and futurists.*

## The Boyer lectures, Facebook and your social media rights

Graham Hand

Two recent events give valuable insights into what is happening in technology with a focus on the risks and rewards of social media.

Each year since 1959, the ABC has produced a series called the Boyer Lectures. In 2017, Professor Genevieve Bell's series is called *Fast, Smart and Connected: What is it to be Human, and Australian, in a Digital World?* In particular, [Episode 4](#) asks how Australia should build its digital future and "a world that is not about our worst impulses but our best". Genevieve Bell pioneered futuristic research at Intel in Silicon Valley, and she focusses on the role of technology in our lives.

The second event is the recent release of simplified Terms and Conditions, based on those issued by social media giants, by the Children's Commissioner for England (the 'Commissioner', established under the Children's Act 2004).

Facebook has two billion users, but it's doubtful whether more than a tiny minority has read the [Terms and Conditions](#) everyone agrees to. The T&Cs connect to another 10 documents on specific policies, with thousands of words of legal undertakings. Users give away the right to privacy and the ownership of material shared online, while agreeing that Facebook can make money from the content without paying the user.

It's the same with all the social media giants. The Commissioner for England reports that in the UK, Instagram is used by 56% of 12- to 15-year-olds and an amazing 43% of 8- to 11-year-olds, and their T&Cs run to 17 pages and over 5,000 words. These children and their parents do not realise they are being tracked even when the app is not in use. They have given away their personal data including its commercialisation and even agreed that Instagram has the right to read direct messages. Snapchat can publicly display or sell any content put on Live Snapchat, including a person's face or voice.

### **Simplifying the rules for all to understand**

The Commissioner has issued simplified T&Cs and guides to give children, teachers and adults more power and information (aimed primarily at UK schools but available for all). She says of the social media giants, highlighting Facebook, YouTube, Snapchat, WhatsApp and Instagram:

*"Their terms and conditions are impenetrable, even to most adults. Children have absolutely no idea that they are giving away the right to privacy or the ownership of their data or the material they post online."*

In January 2017, the Commissioner published a year-long study called '[Growing Up Digital](#)' to help prepare children for their digital lives. She says the companies should be doing more to counter the negative social impact of cyber-bullying, grooming, control over content, the impact on mental health, the effect on body image, anxiety and depression.

In conjunction with Tes and legal firm Schillings, the Commissioner has produced [teaching packs](#) relevant to citizens around the world, including simplified T&Cs for five social media sites. The packs can be downloaded for free. Here is a short extract from the simplified version of Facebook's rights.

### **Facebook's rights**

- 1.** We use technology that can track information about you automatically as soon as you go onto Facebook.
- 2.** Facebook can collect information about you, including:
  - Everything you tell us when you set up your account
  - The pages you view, how long you spend and who you talk to
  - What device you're using, what browser and network, and your IP address
  - Details about what you post or 'like'
  - Anything anyone else shares about you or tags you in
  - What and who is in your address book, if it's synced to Facebook
  - Your card details, address and what you've bought, if you buy things on Facebook
  - Your battery and signal strength
  - Where you are
  - If you go onto another company's website or app
- 3.** We can use your name, profile pictures, information about what you 'like' and anything you post to make money and we don't have to pay you for that.
- 4.** Facebook owns other companies, including Instagram and WhatsApp who can share information about you with Facebook. If someone buys Facebook, the sale will include your information.

5. Facebook uses your information to suggest adverts, photos you should be tagged in, or places you should check in. We don't have to make it obvious whether something is an advert or not."

The Facebook terms and conditions have been edited for educational purposes and are not a replacement for the original version, which can be found at [bit.ly/TCsFacebook](http://bit.ly/TCsFacebook).

### What can be done?

Facebook acknowledges that its users also have rights, and these are also outlined in the teaching packs. Probably most important is this interpretation:

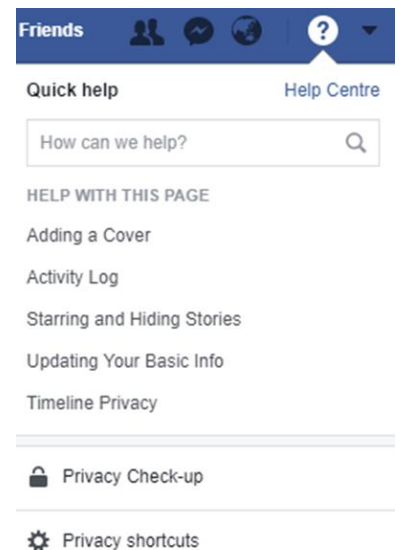
*"Some companies will share information about you with us and we will share information about you with them. We won't share your name or email address, but we can share your age, location, gender and interests with advertisers all over the world, or people doing research. You have the right to tell us not to and we won't."*

Therefore, users have the right to control and limit some of the details that Facebook may share.

I'm not an expert on Facebook, but in the top right of the home page, the Help Center is under the question mark, and it contains the tabs to set the privacy settings, including an advertising and preferences tool. It's worth exploring your preferences.

It's doubtful whether many people would freely give away their rights to privacy and ownership of their image and voice, and allow personal details to be shared with advertisers without making it obvious they are being marketed to. People should consider what rights they are prepared to relinquish, especially when protecting vulnerable young people who do not know what is happening.

*Graham Hand is Managing Editor of Cuffelinks. The material for this article is sourced primarily from the website of [Children's Commissioner for England](http://Children's Commissioner for England), and this should be checked for more details and context to confirm the accuracy of this interpretation.*



## Better portfolios: forecasting share and bond markets

Wilbur Li

In the age of the 24-hour news cycle, many are devoting considerable effort into predicting the next market move. However, history has shown that trying to 'time the market' is extremely challenging even for the most astute of investors. Given this, how then should we think about investing and constructing portfolios?

A report by Research Affiliates titled '[Pricing Stocks and Bonds](#)' introduces a simple framework which sheds light on how we can forecast expected returns and construct an optimal portfolio. Instead of focussing on the short term, Research Affiliates argues there is greater value in forecasting long-run returns which can be predicted with greater reliability. Admittedly, even forecasts of long-term returns are unlikely to turn out accurate. But precision in forecasting is not necessary for constructing optimal portfolios.

We can illustrate this via a simple framework which has outperformed a standard 60/40 portfolio (60% equity, 40% bonds).

### Simplest return expectations

In our quest to estimate future returns, a crystal ball is not needed to foretell the future. Instead, we attempt to quantify the returns we would obtain if everything unfolds as we expect (which admittedly rarely happens). Hence, we account for returns from unexpected events through the idea of an 'Unexpected Shock'. In short:

$$\text{Future Return} = \text{Expected Return} + \text{Unexpected Shock}$$



To establish our framework, we begin by examining a scenario where everything plays out as we expect. Imagine we are investing in a security with zero chance of default, does not pay dividends and we hold it until maturity. An example of this is a three-month certificate of deposit. In this case, the future return of the investment and the expected return today is known with certainty to be the purchase yield of the investment. We can simply look up its yield and know exactly what our future return will be. We can consider the same problem in a different way by asking ourselves the four questions below:

**Valuation Considerations**

Assumptions	Question to Consider
Fixed Cash Flows	Are the cash flows paid by the instrument constant over time?
Reinvestment Rate	Will we be able to invest all future cash flows from the asset at the initial purchase yield?
Ensured Payback	Are we assured of receiving our principal at maturity?
Holding Period	Can we, or will we, be able to hold the instrument to its maturity?²

If the answer to all of the questions above is 'yes', then we know with absolute certainty that the future return of the investment is equal to its yield today. Of course, most of the time we do not have such certainty about future cash flows, either due to default (fixed income) or due to cash flows that are not contractual (e.g. equity dividends). As we attempt to price a wider variety of investments, we begin to answer more negatives to these four questions. Consequently, the expected return moves away from the purchase yield and returns becomes more difficult to estimate. To overcome this, we adopt a framework based on long-term expectations.

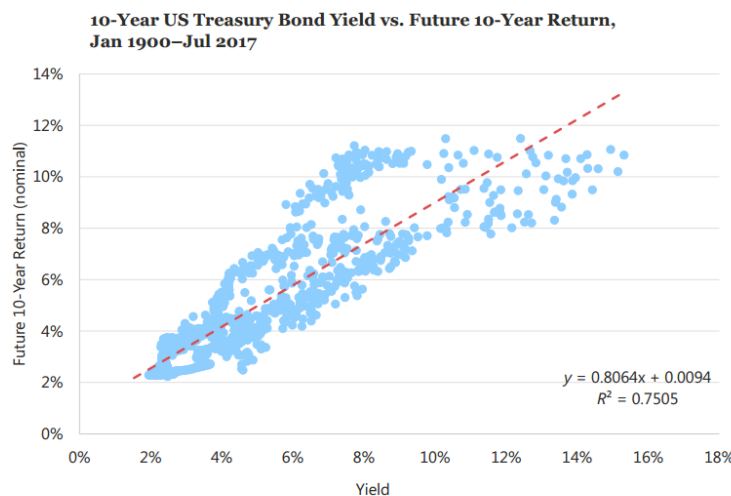
**Begin with a focus on the long term**

To minimise the impact of idiosyncratic shocks in asset returns, we focus our attention on long-term returns as they tend to be more predictable. One study found the volatility of 1-year returns to be 19.2%, while the volatility of 10-year returns was only 4.7%. However, unless we accept the historical average of returns as our future expected returns, a tighter distribution of returns is of no great use. Instead, we document below how we forecast expected returns.

**1. Forecasting bond returns**

Calculating an asset's expected return is dependent on assumptions of certainty, size of cash flows, reinvestment rate, and holding horizon. Relaxing the hold-to-maturity and constant reinvestment rate assumption, we find that a strong relationship exists between the yield of a bond today and the yield of a similar bond issued a year ago. As a result, we can use our knowledge of bond yields today to predict future bond returns even if we do not hold the bond until maturity.

Historically, a strong positive relationship exists between the starting yield of a 10-year US Treasury and the 10-year future return of an annually rebalanced bond.



Ensured Payback (Low Risk of Default)	Fixed Rate	Constant Reinvestment	Hold to Maturity
Yes	Yes	No	No (Annual Rebalance)

## 2. Forecasting stock returns

Forecasting stock returns is similar to forecasting bond returns, however we will need to relax all four initial assumptions. This is because dividend payments are not fixed, equity holders can be wiped out by default, reinvestment rates change, and stocks do not have a maturity date. By relaxing these assumptions, dividend yield alone does not do a good job of predicting future returns. Instead, we find that returns can be explained by three additional factors: inflation, growth in dividends and changes in valuation levels. The impact of these factors on returns can be seen below:

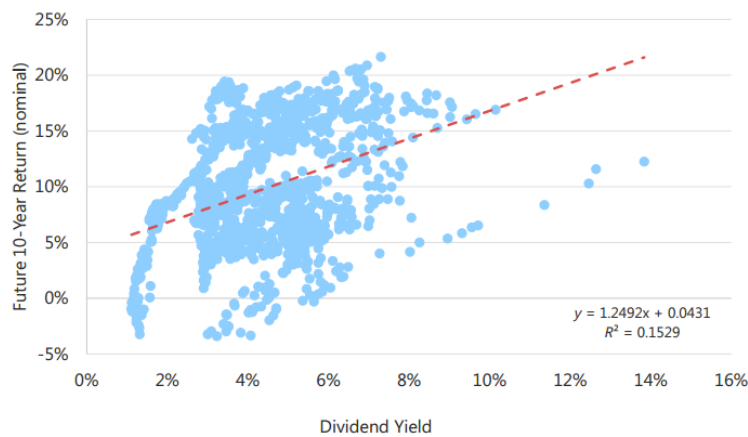
### US Equity Historical Return Decomposition

Period	Dividend Yield	Dividend Growth (Real/Inflation)	Dividend/Price Multiple Expansion
Full (Jan 1871–Jul 2017)	4.5%	1.5%/2.1%	0.8%
Post War (Jan 1946–Jul 2017)	3.4%	2.3%/3.7%	0.9%

Research Affiliates finds the model does a fairly good job of predicting stock returns, however they concede they have often missed the mark. Forecasting returns is not an exact science.

With equities, as compared to bonds, we observe a much noisier relationship between the purchase yield and future return.

**US Equity Dividend Yield versus Future 10-Year Return, Jan 1871–Jul 2017**



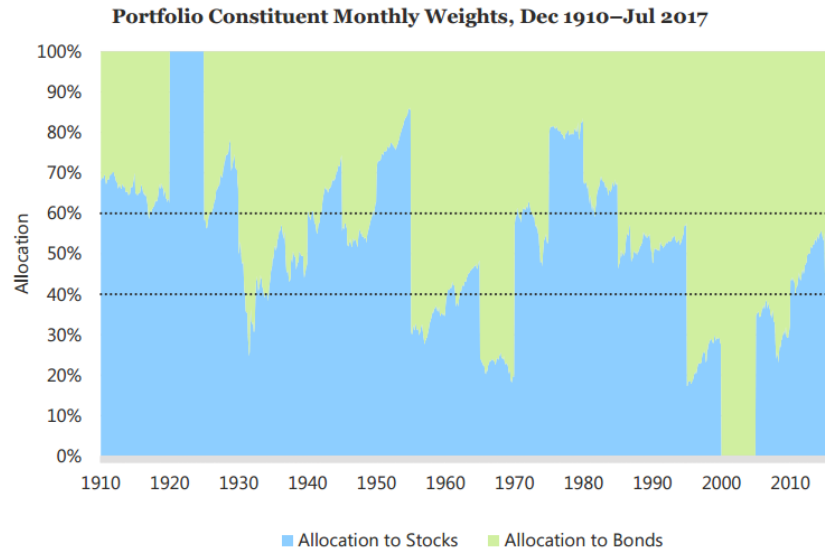
Ensured Payback	Fixed Rate	Constant Reinvestment	Hold to Maturity
No	No	No	No (10-Year Hold)

### Building a portfolio using expected returns

Using the expected returns generated, they proceed to construct a portfolio.

They allocate between stocks and bonds by comparing current expected return for each asset against its historical expectations. By doing this, they can form a 'confidence score' for stocks and bonds and allocate across these assets accordingly. For instance, if stocks have a high expected return versus its historical expected return, the model shows more confidence in the 'cheapness' of stocks and assigns a greater weight to stocks.

Over the majority of our data sample, our two-asset portfolio of stocks and bonds has held a healthy mix of both asset classes.



Using the strategy proposed, they find that it consistently outperforms a 60/40 portfolio across different rebalancing intervals, delivering superior returns with less volatility.

#### Portfolio Statistics vs. Benchmarks

	Average Return (annual) <sup>7,8</sup>	Volatility <sup>9</sup>	Return/Volatility	Average Stock Weight	Average Bond Weight
Our Portfolio	9.3%	11.3%	82.0%	54%	46%
60/40 Monthly Rebalance	8.5%	11.7%	72.8%	60%	40%
60/40 5-Year Rebalance	8.8%	11.9%	73.7%	62%	58%
60/40 Pure Buy and Hold	10.6%	16.9%	63.1%	88%	12%

#### What this means

First, the framework does not imply we can predict short-term market moves. Instead, it focusses on long-term relationships that are more reliable.

Second, the proposed multi-question framework provides a useful approach for forecasting the future returns of any asset class. It is not limited to just stocks and bonds.

Finally, even if the long-term return expectations are not accurate, we can continue to construct portfolios which add value over a 'set and forget' portfolio.

*Wilbur Li recently completed his Bachelor of Commerce (Honours in Finance) at the University of Melbourne and is a Portfolio Manager with [Sharewell](#). He has worked at Unisuper (global equities) and PwC (debt and fixed income). This article is general information and does not consider the circumstances of any investor.*

## Australian banks: reporting season wrap

Greg Peel

On face value, the major Australian banks' recent earnings results were weak and below expectation. ANZ Bank (ANZ), National Bank (NAB) and Westpac (WBC) have all now posted second half FY17 results and Commonwealth Bank (CBA) a first quarter FY18 update.

Over the period, all the banks suffered a drag from the government's bank levy and from fines and regulatory compliance costs emanating from their various indiscretions. But the biggest drag on earnings was market income.

Market income refers to profits made by the banks' proprietary financial market trading and broking activities. For these divisions to be profitable, market volatility is required to provide for both trading range opportunities and client interest. What did we see over the period in question? A stock market stuck in the same range for months, with the VIX volatility measure at an historical low, and the RBA's cash rate unchanged, leading to little volatility in interest rates.

### **Solid underlying result**

Ignoring market income, analysts saw a pretty good underlying result from the majors over the period. Revenue growth was solid, reflecting mortgage repricing. Asset quality continued to improve, implying yet another earnings boost from lower bad & doubtful debts (BDD).

Underlying net interest margins improved, despite the drag from the levy and regulatory costs. Aside from the banks all increasing rates on investor mortgages and interest-only mortgages, on the other side of the equation, wholesale funding costs fell. Competition among the banks on deposit rates eased.

As Deutsche Bank puts it, *"There was little to suggest [in this result season] a material deterioration in credit quality is imminent, with no new problem areas"*.

We have also now eased off on fears over bank capital positions, which so dominated the past couple of years as APRA waited interminably for new Basel IV international guidelines that never came, before spending another lifetime finally deciding what the earlier throwaway line of 'unquestionably strong' actually meant in real numbers. It meant 10.5%.

Analysts agreed that achieving a tier one capital ratio of 10.5% by the 2020 deadline would be a stroll in the park for the majors. As at this result season, ANZ and Westpac are already over the line, with ANZ in particular benefitting from asset divestments. NAB is dragging the chain at 10.1% but should catch up ahead of time. CBA was looking comfortably on track in the middle, but we're yet to find the extent of fines.

The bottom line is that bank investors no longer have to fear possible capital raisings or dividend slashes in order for the banks to meet stricter capital requirements.

### **All looks rosy in bank land ... or does it?**

What can investors look forward to?

Things are looking a little rosier on the bank market income side as we move into FY18 (further into FY18 for CBA). The local stock market has at least broken out of its trading range. But FY18 will see bank earnings handicapped by a full year of the government's bank levy and as noted, there remains an unresolved issue of fines.

On the positive side, mortgage repricing benefits will continue to flow through. But APRA's crackdown on interest-only loans, and subsequent hikes to banks' variable interest-only rates, has prompted a flood of property investors switching to standard principal & interest loans at lower rates.

The banks should continue to enjoy an earnings boost for another six months or so. However, the flipside is additional APRA restrictions regarding the ratio of risk-weighted assets held in bank portfolios, which in short means the banks have to cut the number of riskier loans on their books (investor, interest-only) as a ratio of all loans. Repricing those mortgages goes some way to achieving such a reduction, as existing investors switch to P&I and potential new investors are put off, but this also ultimately implies lower loan book growth.

Analysts agree that the impact of tighter APRA restrictions is an ongoing story rather than a one-off event. The benefits of repricing will continue to provide a tailwind. Eventually, the number of investors still looking to get into the property market will ease, offsetting those repricing benefits. There will be a point at which any further repricing will lead to a fall-off in demand to the extent that bank earnings reduce, not rise. And that's in isolation, before we begin to even talk about signs the Australian housing boom is now cooling.

Morgan Stanley, for one, suggests bank margins are currently in a sweet spot that won't last as far as the second half of FY18. Morgan Stanley is not alone. Of the various brokers' result season report headlines, "Has

retail banking seen its best days?" asks Citi. "Environment challenging," suggests Deutsche Bank. "Tapped out on revenue growth," says Credit Suisse.

It has nevertheless been a while now that bank analysts have warned of subdued earnings growth ahead. The question is as to whether or not such a view is reflected in bank share prices.

**Banks trading at discount to other industrials**

One of the enduring bull arguments for the banks, notes Goldman Sachs, is that bank PEs are trading at a -30% discount to non-bank industrial PEs compared to a 17-year average of -15%. But as Goldman notes, the banks are expected to deliver less earnings growth and return on equity compared to non-bank industrials than has been the case on average since 2000.

Thus, suggest the analysts, unless one believes the risk inherent in the Australian banking system is materially less today than has been the case since 2000, the banks appear to be trading at relative fair value.

Which brings us to relative valuations between the banks themselves.

Bank	FNArena Major Bank Data				FY18 Forecasts				FY19 Forecasts			
	B/H/S Ratio	Previous Close \$	Average Target \$	% Upside to Target	% EPS Growth	% DPS Growth	% Payout Ratio	% Div Yield	% EPS Growth	% DPS Growth	% Payout Ratio	% Div Yield
NAB	4/2/2	30.13	32.06	6.41	0.5	0.0	86.3	6.6	4.8	-2.3	80.5	6.4
WBC	3/5/0	32.11	33.70	4.95	2.5	0.5	77.5	5.9	2.0	2.2	77.7	6.0
ANZ	2/6/0	29.20	30.50	4.45	6.3	0.4	68.6	5.5	3.1	1.6	67.6	5.6
CBA	0/7/1	80.82	78.72	-2.60	0.4	2.1	75.5	5.4	-0.8	1.5	77.2	5.5

NAB’s result was the least well-received by the market, not because it was any worse on an underlying basis than peers but because the bank announced a costly increase in investment. A month ago, the market had priced NAB to within 1% of the FNArena database consensus target price for the bank, but as the above table shows, the gap has now blown out to over 6%.

CBA’s earnings update received the most positive market response, despite the bank having to shift money aside to cover (hopefully) whatever the regulator may apply in fines. This remains a point of uncertainty for CBA.

ANZ’s earnings growth is expected to lag peers in FY18 but the bank’s program of simplification and subsequent divestments will put the bank in a strong capital position. Westpac will, continue to do what Westpac does.

The government recently slapped the levy on the banks to head off increasing calls for a bank Royal Commission. The Opposition has made it clear that were it to win government, a Royal Commission would sit atop the to-do list. A Royal Commission is all the banks need right now.

*Greg Peel is Senior Writer at FNArena. Investors can trial their service two weeks for free at [www.fnarena.com](http://www.fnarena.com). This article is general information and does not consider the circumstances of any investor.*

**What’s currently the worst asset class investment?**

David Bassanese

Investing success is not just about picking the right asset class or securities, but also avoiding the poor investments. In the current global economic environment, out of the world’s major asset classes, global fixed rate bonds appear to have the lowest likely return over the next year or so.

**Global bond yields are incredibly low**

The rally in risk markets since the GFC has benefited from a major tailwind. Central bankers have delivered extraordinary monetary stimulus, despite the recovery in global economic growth and employment. They have remained resolutely accommodating to lift still unusually low rates of inflation.

As seen in the chart below, this has led to a decline in global bond yields – as represented by the prevailing yield on the Bloomberg Barclays Global Aggregate Bond Index – through the post-crisis global equity rally. The yield is now only around 1.6% p.a. This reflects very low bond yields around the world, with the yield on US, German and Japanese 10-year government bonds presently around 2.3%, 0.4% and 0% respectively. These bonds are an important component of most diversified investment portfolios around the world.



Source: Bloomberg. 'Yield-to-worst' for Bloomberg Barclays Global Aggregate Bond Index. Shaded areas represent periods of significant equity market decline. Past performance is not an indicator of future performance.

Given this bond index is comprised of fixed rate bonds (both government and corporate), the low yield means that even if interest rates don't change further, the best annual return available from this Index is around 1.6% p.a. That's not much compensation for the rate of inflation or for the volatility in capital returns on fixed rate bonds as interest rates fluctuate over time.

What's more, depending on the period over which this Index is held and the speed of the change in market interest rates, returns may be even lower should, as seems likely, global bond yields eventually return to more normal levels.

### Global bond values at risk of higher rates

As many investors know, the capital value or 'price' of fixed rate bonds moves inversely with movements in the level of interest rates. This sensitivity is greater, moreover, the longer the duration of the bonds in question. In the case of the Bloomberg Barclays Global Aggregate Bond Index, the average term-to-maturity of the bonds it contains is relatively long at around seven years. A 1% general rise in interest rates is estimated to produce a 7% decline in capital values.

Indeed, the ongoing decline in bond yields since the bottom of global equity markets in early 2009 has delivered investors, up until end-September 2017, a handy 7% p.a. return as measured by the global benchmark bond index. But while global central banks have been a boon to bond holders over recent years, the reverse is likely to be case over the next few years. Already the US Federal Reserve has started lifting official interest rates and will begin net reductions in its substantial bond holdings this month. The European Central Bank is also inching toward policy tightening, and is likely to announce in the next month or so a reduction in its bond buying programme for 2018.

By way of example, should the yield on the benchmark global bond index rise from say 1.6% p.a. to 2.6% p.a. over a given year, the implied total return from the Index (ignoring hedging costs) would be negative 5.4% (1.6% income return less 7% loss in capital value). Even if such a rise in yields were to take place over two years, it would still imply negative annual returns over this period of around 2% p.a.

In short, when and if global bond yields start to rise, investors in the global bonds benchmark index should expect negative returns for a time. At the very least, given the ongoing recovery in global economic growth and corporate earnings, global bonds may well underperform other major asset classes such as local bonds, global and local equities and even many commodities over the next year or so.

Accordingly, at least in terms of major asset classes, in my view, longer-term fixed rate global bonds are currently potentially one of world's worst investments.

### **Rising rates favour floating over fixed rate bonds**

Given that local bond yields also tend to closely track global rates, rising bond yields would not be great news for the Australian fixed rate benchmark bond index, even if the Reserve Bank initially resists following other central banks in tightening policy. While the local Bloomberg AusBond Composite Bond Index might outperform the global benchmark, returns would still likely be low, and even potentially negative for a time. Indeed, in the year to end-September already, this Index produced a negative 0.7% return due to a rise in its average yield from 2% to 2.6%.

In this environment, Australian floating rate bonds should deliver a potentially better risk-return outcome than funds which aim to track the AusBond Composite. The floating rate exposure not only benefits from higher interest payments, they should not suffer the potential capital losses of fixed rate bonds if bond yields rise.

*David Bassanese is Chief Economist at [BetaShares](#), which offers exchange traded products listed on the ASX. BetaShares is a sponsor of Cuffelinks. This article contains general information only and does not consider the investment circumstances of any individual. Floating Rate Bond ETFs are now available on the ASX, with BetaShares' [OPON](#) being the largest.*

#### Disclaimer

*This Newsletter is based on generally available information and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider obtaining financial, tax or accounting advice on whether this information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.*

*For complete details of this Disclaimer, see <http://cuffelinks.com.au/terms-and-conditions>. All readers of this Newsletter are subject to these Terms and Conditions.*