

Noel Whittaker's Top 5 Articles from 2017

- **Howard Marks on expert opinions as a coin toss** *Graham Hand*
- **Decide if 'fake crises' are worth the worry** *Don Stammer*
- **The 20 Commandments of Wealth for Retirees** *Noel Whittaker*
- **Why all the fuss about family trusts?** *Sam Wylie*
- **Philanthropy is growing, but what's the best way to give?** *Antonia Ruffell*
- **My four enduring lessons from the 1987 crash** *Ashley Owen*

At a time when we are overwhelmed with information, getting back to basics is crucial. This desire to focus on the fundamentals has guided the selection of my favourite five Cuffelinks articles from last year.

Whenever I give a seminar, many of the questions are from people who want to know where the stock market is going, where interest rates are going, where commodity prices are going and where they should invest next. My reply is always that if they focus on things they can control, they won't need to be unduly worried about things they can't.

This is why the article on **Howard Marks** is important. It goes right back to basic principles, explains the dangers of forecasting, and how many of them are wrong.

This leads naturally to the next article by **Don Stammer**. Just before the 2016 presidential elections, I received many emails and calls from people telling me proudly they had cashed in their portfolio "in case Trump got elected". And we know what a bad decision that turned out to be.

In my 20 Commandments of Wealth for Retirees (also available as a PDF by [free download from my website](#)) I point out that one of the worst enemies of the investor is the media – it only focuses on bad and pessimistic news.

The Labor attack on family trusts showed a deplorable lack of knowledge about how they work. It also had the potential to scare people away from what has long been one of the most attractive and effective entities for minimising tax legally, and protecting assets. Therefore, **Sam Wylie's** article was timely inasmuch as it explained in a simple way how trusts work and the benefits they could bring to investors.

As I have said many times, the main enemy of an investor is not the markets or taxation, it is simply ignorance. Having reached the ripe old age of 78, my focus has moved from acquiring assets for myself to spending my money in a way that enables me to leave a legacy. And all the research shows that giving money to worthy causes produces enormous personal happiness and satisfaction.

After I read the article by **Antonia Ruffell**, I phoned Chris Cuffe for advice on what my next step should be. This led me to a meeting with Antonia, and subsequently to starting my own endowment fund. I am delighted with the process.

We are now 30 years from the 1987 crash. For many of us old grey hairs it is still memorable, but most Australians who have reached investing age know nothing about it. **Ashley Owen** has been a friend of mine for many years, and is one of the most knowledgeable people about markets I have ever met. This article is an outstanding contribution to the pool of knowledge that any successful investor needs to have.

Noel Whittaker, Guest Editor for Cuffelinks

Howard Marks on expert opinions as a coin toss

by Graham Hand, January 25, 2017

Regular readers of Cuffelinks know we are fans of the straightforward and direct writing of Howard Marks. In September 2014, he personally gave Chris Cuffe permission to republish a [confidential presentation](#) he had given to institutional clients of Oaktree Capital.

Since then we have reported on a [conference](#) where he said there is no way to predict commodity prices, a more recent memo called '[Risk Revisited Again](#)', and then when he was a star attraction in the [Sohn Hearts & Minds Conference](#) in Sydney (see photo below).



His latest memo was therefore received with much enthusiasm, especially given the global uncertainty heightened by a totally unpredictable new US President. We need a calming influence in a sea of speculation. Marks's latest work is titled '*Expert Opinion*'. This article is a brief summary, and the [full paper](#) is here.

A poor year for polls and media

Marks goes to some length to describe the poor forecasting of opinion polls on both Brexit and the Presidential election. Even the legendary Nate Silver, who established his reputation when he correctly predicted all 50 states in the 2012 race, said Clinton was 71% likely to win, and many pundits were at 90%. The experts either misinterpreted the data or failed in their sampling.

Equally important, most experts forecast that a Trump win would be bad for markets, but then we experienced the strong 'Trump rally'. Marks gives this warning:

"First, no one really knows what events are going to transpire. And second, no one knows what the market's reaction to those events will be."

There are no 'facts' about the future, only opinions. We also have a media industry where 'news' is not original research or reporting, but a collection of personal opinions backed by little data, often with some contentious line of argument which is supposed to be the story. It's no coincidence that the Oxford Dictionary word of the year for 2016 was 'post-truth', defined as:

"relating to or denoting circumstances in which objective facts are less influential in shaping public opinion than appeals to emotion or personal belief."

Marks uses the example of the New York Post's Bettor's Guide, where 11 experts advise readers which teams to bet on. The overall results are distributed around the 50/50 level, suggesting it's little more than a coin toss.

Warren Buffett told Marks that for a piece of information to be worth pursuing, it must be both important and knowable. The CEO and President of Vanguard, Bill McNab, recently said:

"We've seen over and over again that the forecasters don't get it right. All the people who were wrong about Trump and Brexit are now putting forth all these things we should take as gospel in terms of what's going to happen. That makes no sense to me."

The influence of macro guesses

Last year, I presented a one-hour webinar for one of our sponsors. The subject was behavioural biases in our investing, using my own habits and SMSF as an example. At no stage did I portray myself as a stock picker or economist (although for my sins, I do have an economics degree). At the conclusion of the talk, clients sent in questions, and of course, they included: "Where do you think the Australian dollar will be at the end of the year?" and "Is the ASX good value at the moment?"

Like any 'expert', I gave reasons why either could go up or down and then a personal view, but the best answer is the one nobody likes to hear. It sounds unprofessional to say, "I don't know" but it should be a far more common response. I can know about the superannuation rules or the difference between an ETF and a managed fund, and these are useful facts, but what is my opinion on the future of the AUD worth?

It's refreshing to read Marks say the most common question he is asked is about when the Fed will raise interest rates, and his response is consistent: "**How would I know, and why do you care?**" Marks says nobody knows, even the closest Fed watchers, and probably not the Fed itself. Importantly for the effect on markets, events may already be priced in, and so even if a prediction is correct, it might have no value. Nobody predicted a price fall in oil of 75% between 2014 and 2016.

Not only does Marks not know what innings we are playing, he does not know how long the game will last. We are usually dealing with the unknowable:

"Developments in economies, interest rates, currencies and markets aren't the result of scientific processes. The involvement in them of people – with their emotions, foibles and biases – renders them highly unpredictable."

Some of Marks's favourite sayings on forecasting

We have two classes of forecasters: Those who don't know – and those who don't know they don't know. – John Kenneth Galbraith

No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future. – Ian Wilson (former GE executive)

Forecasts usually tell us more of the forecaster than of the future. – Warren Buffett

I never think of the future – it comes soon enough. – Albert Einstein

What does Marks rely and act on?

Given his legendary success as an investor, Marks must be acting on some guidance, instinct or insight. He makes his big gains acting on extremes in the market, especially capital markets, while not betting heavily in less distinct markets. He suggests investors ask whether markets are in 'an extended state' or not. That is, is there euphoria, depression, illiquidity, overly generous pricing, etc. These questions can be answered in a more predictable and helpful way.

He also espouses the importance 'second order thinking', as Roger Montgomery describes in the following article.

Graham Hand is Managing Editor of Cuffelinks and does not know whether Donald Trump will be good or bad for markets over the next 12 months. As a markets person, Graham cannot understand how a President that threatens tariffs and trade restrictions can be good for Australia and the global economy. We'll see.

Decide if 'fake crises' are worth the worry

by Don Stammer on July 27, 2017

'Fake news' has been dominating the media since the Trump Presidential win. Financial markets have a parallel concept we will call 'fake crises'.

A fake crisis is a major sell-off of one or more asset classes brought on by widely-held expectations of an impending disaster, but one that fails to eventuate or has been massively exaggerated.

Unnecessary losses from a fake crisis

A fake crisis can inflict heavy losses on an investor who dumps quality assets at depressed prices during the panic but provides the opportunity for an investor to acquire good assets cheaply.

An outstanding example of a fake crisis in investment markets – the *cause célèbre* – occurred in the early weeks of 2016. The dominant view then was China's economy was 'contracting' and would soon cause a global recession. Commodity prices, share markets and the Australian dollar plunged.

As things turned out, retail sales continued at almost double-digit growth, industrial production expanded strongly, and China boosted demand on a scale the doomsayers had not allowed for. Shares, commodities, confidence and the Australian dollar all rebounded.

Other fake crises in investment markets during recent years

Many examples of fake crises have unnecessarily worried investors, including:

- The initial (but very brief) collapse in share prices following Donald Trump's win in the US presidential election.
- The loss in market sentiment following the Brexit vote in June 2016.
- The 'taper tantrum' in 2013, when bond markets sold off aggressively on the expectation the Fed would mismanage the phasing out of its huge programme of bond purchases.
- The 'sovereign debt crises' in Europe in 2012 and 2013, which were exaggerated and were followed by record low bond yields.
- The widely held fears in the second half of 2011 that the US economy was sliding back into recession.

Fake crises generally follow the same pattern. Investors always have a lot of things to watch and to worry about. From time to time, concerns develop, sometimes without justification. A momentum builds up. Many investors come to uncritically accept data or comments that support the majority view while ignoring the countervailing facts. Maybe some hedge funds will 'short' assets or asset classes, expecting to buy them back during the crunch at lower prices. Research reports may be released full of gloom and doom to support the portfolio positions the hedge funds have taken up.

Managing reactions to a fake crisis

The best way I know of working out whether a crisis will create prolonged pain or be short-lived is for the investor (perhaps through his or her adviser) to create two lists on the outlook for the relevant market or markets. One list would show the worries. The other list would set out the positive or counter-balancing influences. The investor can then take an on-balance view appropriate to their risk tolerance.

This approach can be applied to any or all investment markets. Let us try it on the current outlook for the Chinese economy.

List of China negatives and positives

Negatives:

- The huge build-up in indebtedness by Chinese governments (at the national and regional levels) and by property developers.
- The potential for bad debts of banks to blow out.
- The excess capacity in heavy industry.
- The risk of a surge in capital outflow causing a run on the Renminbi.
- The slow pace of reform among state-owned enterprises.

Positives:

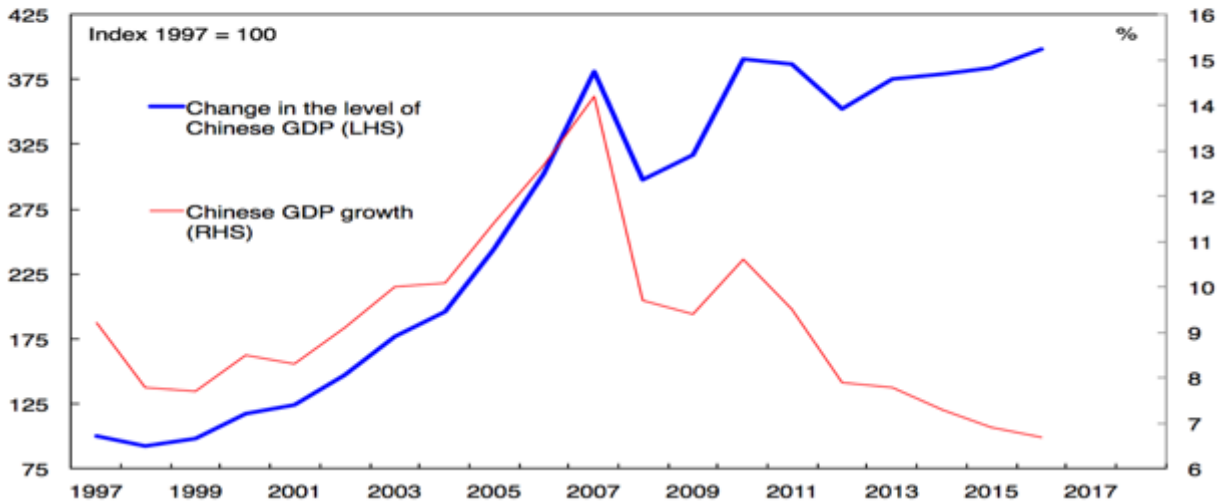
- China has a high level of saving.
- The increased debts are mostly owed domestically and not to lenders abroad.
- International reserves still stand at US\$3 trillion.
- For many years there will be a high level of building construction for the urbanisation program.
- To date, the move to a more market-determined exchange rate mechanism is working well.

Buy, sell, do nothing?

A reasonable on-balance assessment is that the pace of expansion in the Chinese economy will slow a little, both cyclically and in trend terms, in the next couple of years. The risks of recession are low but there will be recurring big swings in investors’ confidence in China’s economic conditions and prospects.

China’s growth has moderated from a rate of 14% in 2007 to 7% in 2016. But in absolute terms, the year-by-year expansion in the Chinese economy has remained impressively large, and that is what matters for both global growth and the Australian economy.

CHINA: ABSOLUTE CHANGE IN GDP IS IMPRESSIVE, DESPITE SLOWING % GROWTH IN GDP Source: Bloomberg



Fake crises can materially impact investor returns if it leads to panic selling, so a calmer and more systematic approach is called for to avoid overreacting to the noise.

Don Stammer has been investing for over 50 years, including long periods with Deutsche Bank and ING. He writes a fortnightly column on investments for The Australian and has advisory roles with Altius Asset Management and Stanford Brown Financial Advisers.

The 20 Commandments of Wealth for Retirees

by Noel Whittaker on January 9, 2018

1. Ignore the prophets of doom – they are always with us and usually wrong.
2. Make sure your children have adequate insurance. It's much more affordable than your funding their misfortune.
3. Understand compounding, and appreciate that the rate of return your portfolio can achieve will be a major factor in how long your money will last.
4. Understand the basics that never change, and take advice on the things that do.
5. Take advice before the deed is done – not afterwards. It's hard to rewrite history.
6. Always judge an investment on its merits – any tax benefits should be regarded as the cream on the cake.
7. If a person contacts you by phone with an offer of an investment, or even to help you pay your mortgage back faster, hang up.
8. Don't have all your eggs in the one basket – diversify across the major asset classes and certainly have some international exposure.
9. Involve your partner, if you have one, in all your financial decisions. This will make it easier if one of you passes away or becomes incapacitated.
10. Don't panic when the share market has a bad day – volatility is the price you pay for the unique benefits of shares.
11. Make sure your wills are up-to-date and include a testamentary trust if that is appropriate.
12. Give Enduring Powers of Attorney and an Advance Health Directive to trusted people. And make sure they have copies and can locate the originals when needed.
13. One of the most expensive evenings you can go to is a "free" investment seminar.
14. Be extremely wary of going guarantor for any of your children – especially if they are in business.
15. Don't spend unnecessarily just to maximise your Centrelink benefits. Further cuts to benefits are possible.
16. Investigate if you should have a Binding Death Nomination in your super fund. Keep in mind that what is appropriate in one situation may not be appropriate in another.
17. Each year assess whether it is to your benefit to stay in super. In some cases you may be better off to withdraw the balance and invest outside the superannuation environment.
18. Don't follow the herd and back last year's winner – that's a recipe for disaster.
19. If you decide to take on a reverse mortgage involve family members in the process and have them pay the interest if possible. This will stop the debt increasing.
20. Finally – keep in mind that your potential worst enemies can be the media who focus on the negative, and well-meaning acquaintances who may give you information that may be half right.

Noel Whittaker is one of Australia's foremost authorities on personal finance and a best-selling author of many books including Making Money Made Simple. See www.noelwhittaker.com.au. A colour PDF version of this article is on his website.

Why all the fuss about family trusts?

by Sam Wylie on August 3, 2017

Affluent Australians usually hold their investments in some combination of superannuation, family trusts and direct ownership of negatively geared property. Over the last year, changes in superannuation rules and more challenging property market conditions have shifted the relative benefits of these arrangements. Family trusts have become comparatively more attractive. Investors should consider whether their 'structuring' and tax planning is still optimal.

The reduction in the income tax rate for small corporations, from 30% to 25%, will make the accumulation of wealth through family trusts more tax effective compared with super and negative gearing.

In the example below, a couple with children can accumulate wealth in their family trust at an effective tax rate of only 13.5% on their investment income. However, when the income tax on small corporations falls from 30% to 25%, as it is legislated to do, the same family trust's strategy will accumulate wealth at an effective tax rate of only 11.3%.

A family trust with a corporate beneficiary

Mei Li and Jack Houston are a professional couple with high incomes, with three young children aged two, four and six years. They recently sold an apartment that they bought a few years ago, and the couple decides to use the \$200,000 net proceeds from the sale to establish a family trust.

The Houston Family Trust will have two purposes. The first and main purpose is to accumulate family wealth in a low tax environment. The second is asset protection (from law suits, creditors in bankruptcy, and some family situations).

After the Trust is 'settled' (brought into existence) the couple makes a gift of the \$200,000 to the Trust (or they might instead have loaned the money to the Trust). The \$200,000 is then invested in high-income assets, such as high-yielding shares or commercial property. The couple resolves to make further gifts of \$20,000 at the beginning of each successive year from their after-tax income.

Six beneficiaries of the Trust are named in the Trust deed: Mei Li, Jack, each of their three children and a corporation (the corporate beneficiary).

Accumulation phase

Assume the pre-tax return on the Trust assets is 6.5% per year after adjusting for inflation, received entirely as income with no capital gain to simplify the example.

At the end of each year, the annual income from the Trust's assets must be distributed to the beneficiaries of the Trust. It will not be distributed to Mei Li or Jack because they already pay income tax at the highest rate. And, it cannot be distributed to the children (without incurring top rate income tax) until the children turn 18 years. So, in the first 12 years of the Trust's existence (until their eldest child turns 18), all of the income is distributed to the corporate beneficiary (CB), sometimes called a 'bucket company'.

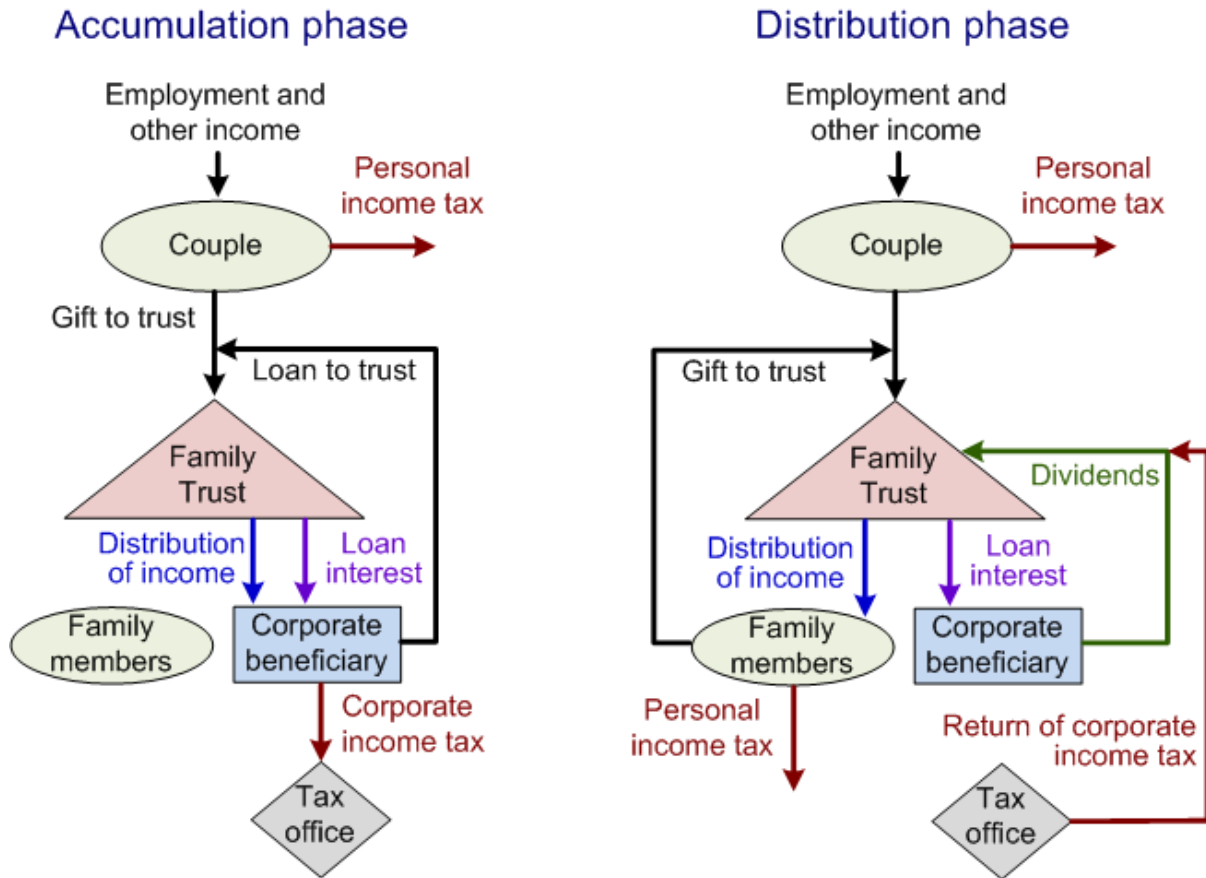
The left-hand side of the diagram below shows the role of the corporate beneficiary in accumulating distributions from the Trust until the children are ready to receive distributions. Each year the CB receives the Trust income and pays corporate tax on that income. The payment of corporate tax creates credits for corporate tax paid (or franking credits).

At the end of the first year, there is $\$200,000 \times 0.065 = \$13,000$ of Trust income, which is distributed to the CB. The CB then pays $\$13,000 \times 0.30 = \$3,900$ of corporate income tax. The remaining \$9,100 is loaned to the Trust. The CB then has assets of \$9,100 (the loan) and \$3,900 of franking credits.

At the end of the second year, the CB will again receive all the income generated by the assets of the Trust, but this time in two parts. First, as interest on the loan, and then the remainder as a simple distribution of income. The CB will again pay corporate income tax at the 30% rate and again loan its after tax income to the Trust.

And so it goes as 12 summers and 12 winters come and go. The children's cartwheels on the backyard lawn turn to car wheels in the driveway, and now the eldest child reaches 18 years, and the Family Trust is now ready to move from accumulation to the distribution phase.

The cash flows in the accumulation and distribution phases



Distribution phase

After 11 years the totals are as follows:

- Gifts to the Trust have amounted to \$420,000
- CB has stored \$185,000 from accumulated income
- Tax paid of about \$80,000.

At the end of the 12th year of the Trust’s life, distributions to the CB cease and distributions to the children begin. Each child receives a distribution of \$37,000 at the end of each year for six years after they turn 18. The children’s after-tax income is then gifted back to the Trust. The distribution phase goes on for 10 years, with distributions peaking at \$111,000 in the two years that all three children are receiving distributions.

The cash that is distributed to the children has three sources:

1. Annual income from the Trust’s assets, which is now distributed to the children instead of the CB.
2. Value accumulated in the CB.
3. Return of the corporate tax paid by the CB.

The diagram above shows on the right-hand side the cash flows in the distribution phase.

During the 10-year distribution phase, all the distributions to the CB that were made during the 12 years of the accumulation phase are returned to the Trust and distributed to the children. The value stored in the CB is paid to the Trust as a series of annual dividends (the Trust owns the shares in the CB). The Trust then passes the dividends, with franking credits attached, to the children who use the franking credits to reclaim the corporate tax that was paid. So, all the money that was ever sent to the CB, including the part that was then sent to the ATO as tax, is returned through the Trust to the children, who then pay personal income tax on that amount.

The Trust's 'effective' tax rate

At the end of the distribution phase the Trust has existed for 22 years. The accumulated value in the Trust is \$1.38 million of which \$620,000 is the gifts from the couple and \$760,000 is the investment returns after tax. The Trust is now reset in the sense that the balance in the CB is zero and the tax credits are zero.

The couple can do whatever they wish with the \$1.38 million, including taking it out of the Trust and paying it into their superannuation (at \$100,000 each per year); gifting it to the children to launch them in the property market; leaving it in the Trust and start accumulating again through the CB; or spending it.

The Family Trust provides some real tax benefits. The \$620,000 of gifts compounded into the final value of \$1.38 million at an annual rate of 5.62%, which is the after-tax return on the assets. The before-tax return is 6.50% and the after-tax return is 5.62%. Therefore, the effective tax rate of this strategy is 13.5%, which is less than the 15% income tax rate in superannuation during the accumulation phase.

The effective tax rate is so low because the income is stored in the CB until it can be retrieved and cycled through the children's income. When the children receive distributions of \$37,000 they only pay \$3,867 in income tax, which is an average tax rate of 10.5%.

But if the children pay all the tax (the CB's tax is all retrieved), then why isn't the effective tax rate of the strategy 10.5% instead of 13.5%? All the taxes paid by the CB are retrieved from the ATO and distributed to the children, but while the ATO has the CB's tax the ATO is effectively receiving a zero-interest loan from the Trust. The ATO does not receive a loan in a legal sense, but that is how we should think of it economically. The taxes go to the ATO but are only returned after a period of time, and that raises the effective tax rate of the strategy.

Effect of corporate tax falling from 30% to 25%

The effect of the tax on small corporations (< \$10 million in income) slowly falling from 30% to 25% will lead to the Trust having \$1.41 million in assets after 22 years and the effective tax rate falls to 11.3%.

The effective Trust tax rate is lower when the corporate tax rate falls, even though all corporate tax is returned because the corporate tax rate determines the size of the zero-interest loan to the ATO. If the corporate tax rate is 30% then the ATO has collected about \$79,000 of corporate tax during the accumulation phase (the size of the zero-interest loan). If the tax rate is only 25% then the accumulated tax is \$67,000.

If there were no delay in the return of tax paid, through franking credits, then it would not matter to the couple whether the corporate tax rate was 30% or 25%. But once there is a delay in return then the tax becomes a zero-interest loan to the ATO, until it is returned. If that loan goes on forever, then the effective tax rate equals the corporate tax rate of 30%.

A CB meets the ATO's requirement that a corporation is carrying on a business to qualify for the lower tax rate on small businesses, as according to ATO's website, even if the company's activities are relatively passive, and its activities consist of receiving rents or returns on its investments and distributing them to shareholders.

Dr. Sam Wylie is a Principal Fellow of the Melbourne Business School and a Director of [Windlestone Education](#). Sam consults and teaches finance programmes for corporate and government clients. Please seek professional advice on structuring and tax planning from a qualified accountant or financial planner. This article is general information and does not consider the circumstances of any individual.

Philanthropy is growing, but what's the best way to give?

by Antonia Ruffell on May 25, 2017

With 30 June approaching, charities are ramping up their fundraising campaigns, reminding people that they can make tax deductible donations before the end of the financial year. The challenge for donors is finding the most effective way to give.

Private and public ancillary funds are rapidly increasing in popularity, and enable an individual or family to put aside a chunk of money in a trust to support charities over the long term. It's good news for charities. The most

recent ATO tax statistics (for the 2014-15 year) show total deductible giving by Australian taxpayers increased by 18% in 2014-15 to just over \$3 billion. About 75% of this increase came from the most wealthy Australians (those with total incomes over \$500,000). Those with incomes over \$1 million donated the equivalent of 3.4% of their taxable income in 2015, up from 2% the previous year. An increase in donations to ancillary funds was a significant part of the uplift.

How ancillary funds work

Private ancillary funds (PAFs) were introduced in Australia in 2002. A PAF is a type of charitable trust that allows an individual or family to put aside a chunk of money for charitable purposes in perpetuity. The individual donates capital into it and gets an immediate tax deduction for the donation. The capital is then invested long-term, and a minimum of 5% of the value of the PAF assets must be distributed as grants to charities each year. To be eligible, a charity must have Deductible Gift Recipient Item 1 status, and there are over 20,000 charities to choose from.

By their nature, PAFs are a vehicle for the wealthy – most people donate upwards of \$500,000 to kick one off. However, there is an alternative, usually for smaller amounts.

A public ancillary fund (PuAF) has the same tax advantages as a PAF but is a communal structure. Unlike a PAF, there is no requirement to establish a new trust or trustee company, so a named sub-fund can be established immediately. It can be set up in a few days before 30 June, and there's no set-up cost to do this. For example, a sub-fund in the Australian Philanthropic Services Foundation can be established with \$50,000. A minimum of 4% of the PuAF assets must be given away each year, slightly lower than with a PAF, and the same range of charities can be supported.

A sub-fund in a PuAF can be a great way to grow your philanthropic pot. Portability is allowed which means, for example, that someone could set up a sub-fund in a public ancillary fund, grow the balance over a few years, and then transfer the funds to their own PAF later.

Leading to more structured giving

This proliferation of charities can make deciding where to give an overwhelming task. It takes time to think through the projects worth supporting and the desired impact, especially if you're involving others, such as family members, in the decision. In my role, I often hear people say that before they set up a sub-fund or PAF, they gave reactively, responding to fundraising appeals, phone calls and events. Over time, as they gave away more, they felt they were being increasingly ineffective.

Establishing a philanthropic structure provides a solution. Rather than having to make a quick decision, a PAF or sub-fund allows an immediate tax deduction while the choice of charity can be made at a later stage when there is more time for research. The founder can spend time articulating what they are passionate about and the types of causes they want to support. Some people like to fund those areas that are overlooked by government, or to support slightly riskier, pilot projects that seek to find new ways to respond to some of society's most entrenched and difficult issues. Others like to support those long-standing charities that they know and trust. There is no right or wrong answer, but taking the time to consider where you want to donate leads to greater satisfaction that your charitable dollar is making a difference.

A philanthropic structure can also be an important investment in the future. Multi-year funding commitments are easier as the PAF or sub-fund founder knows the money is already set aside, and the charity has the benefit of knowing they have a revenue stream for the next few years. Involving younger family members can help to increase childrens' social awareness, inspire future generations, and ensure the founder's philanthropic legacy continues.

In the next 10 to 20 years, baby boomers will be retiring, selling family businesses or passing away, setting in motion an enormous transfer of wealth to the next generation. People often think of donating after they've had a particularly good year, retirement payment or inheritance. Ancillary funds are likely to continue to grow as people ponder what to do with philanthropic plans and charities will reap the benefits over the long-term.

Antonia Ruffell is CEO of Australian Philanthropic Services (APS), a not-for-profit organisation that sets up and administers private ancillary funds, offers a public ancillary fund, and provides grant-making advice. Chris Cuffe is the pro bono Founder and Chairman of APS.

from the state banks as well (the 1980s lending binge destroyed the State bank of every State except Qld which no longer had one).

At the top of the market the raiders were still cheap with low 'price/earnings' ratios: Elders was on 13, Bell Group on 15, IEL on 19, Bell Resources on 12, Adsteam on 11, Hooker on 15, Bond Corp and Ariane on just 9, and FAI on 7! Bargains! PE ratios were meaningless. The problem was in the quality of the reported 'earnings'.

Are we in a 1987-style market bubble now? No.

Lessons from 1987 have stayed with me

The experience of 1987 affected me personally and it is at the core of my investment philosophy. 1987 serves as a reminder to ignore finance theory and focus on what happens in the real world. Finance theory likes nice neat lines, it assumes markets are always stable and static, that buyers and sellers are perfectly rational, and that returns are 'random' and 'normally distributed'. It dismisses major events like the 1987 crash as random anomalies, simply ignoring them as irrelevant outliers and placing little importance on them.

I believe in the exact opposite – that the extreme outliers are actually the cornerstones of our experiences, they define our lives, and can create or destroy wealth – much more so than so-called 'normal' markets.

I was lucky enough to be on right side of both the 1987 boom and the crash. I had started out in the early 1980s as a lender with Citibank and Midland Bank (now HSBC). I learned about booms and busts first-hand by cleaning up the aftermath of bad lending in the late 1970s building boom which collapsed in the early 1980s recession. (Yes, you can lose money in housing – big time – just wait for a recession! Remember them?).

By 1986 I was running a bank financial control operation. Markets were booming again and I was young and single with no debt so I left the safety net of a salary, moved to Sydney, teamed up with three other characters and we set up a boutique investment bank. We were a motley bunch and I was the youngest, a bank financial controller with a couple of law degrees and a speciality in spreadsheets (remember *Lotus 1-2-3*, the forerunner of *Excel*?). This picture of me is from a 1987 prospectus.



My four fundamental rules

Rule 1: Recognise when you are in a bubble or a bust. Easy enough from a distance but it's harder when you are actually in it at the time.

Rule 2: Never buy in a bubble – sell instead. Likewise: never panic sell in a bust – buy instead.

Rule 3: If you're in a bubble and have nothing to sell, build something and sell it, assuming you have the skills and background to do it quickly. In 1986-87, we built and listed four companies – two gold refineries, a finance company, and a 'cash box' (a cash box is the ultimate bubble stock – there's nothing in it except cash but in a bubble people bid up the price anyway).

Rule 4: Never use debt (very unfashionable in the debt-fuelled 1980s. Debt was like big shoulder pads and skinny ties – everyone had them!)

In 1986-87, there were signs of a bubble everywhere – 'hot stock' shows on TV, talk back radio, magazines, newspapers (there were no blogs or social media or internet back then and not even mobile phones). There was even a tax-driven reason to lure investors into the market as franking credits were introduced in July 1987. Stock brokers ran seminars in the suburbs convincing people to gear up and buy shares to get access to the hot new toy called franking credits! The same thing happened in the 2007 boom when hundreds of seminars in the suburbs encouraged people to gear up into superannuation to take advantage of the '\$1 million contribution window'. Thousands of people borrowed money at the top of both of the booms, threw it into the market, and promptly lost most of it in the crashes that followed immediately after.

Don't lose control of your own destiny

The other half of Rule 2 is that in a bust, buy when everybody else is panic selling. If you have no debt (Rule 4) you can survive even the worst crash and retain control. It is sad to see people sold up by margin lenders in busts. When you borrow money, you give control to the lender, and they will sell you up at the worst time.

The All Ordinaries index collapsed by 50% from 2,306 on 21 September 1987 to 1,151 on 11 November 1987 but that masks the fact that hundreds of stocks were left completely without buyers. The true market had probably collapsed 70% or more if there were any buyers to set market prices. We picked over the ashes and bought one of the Elders group companies for \$1 (not \$1 per share, \$1 for the lot, with no debt). It had 35 subsidiaries and we spent the next couple of years sorting through the ruins

1987 was a great learning experience for me. I do have regrets. There were a few things we developed that went nowhere, but if you have no debt the downside is limited. Also, I was probably too careful and should have taken more risk at the time. You can always make more money if you borrow – but I’m too cautious and not that greedy.

The lessons and the same four rules have applied in every cycle since. And because all markets are driven by human fear and greed, hard-wired into human nature, the same four rules will probably apply to all cycles in future as well.

Ashley Owen is Chief Investment Officer at advisory firm [Stanford Brown](#) and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.

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