

### This Week's Top Articles

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### Let's get the numbers right on imputation

Graham Horrocks

*[Managing Editor's note: This is Part 1 in a series that Graham Horrocks has written due to "a miserable level of discussion and to relieve my frustration" relating to the Australian tax, dividend and superannuation system. Graham is an actuary and was my first financial adviser 30 years ago, when we spent most of the day talking about strategy and long-term structure, and nothing about picking fund managers or stocks.]*

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The Government proposal to lower the corporate tax rate in Australia has prompted a heated debate about the impact on shareholders. The widespread inaccuracy in reporting the consequences has prompted me to put together some figures and comments as background. For example, one prominent adviser/commentator recently wrote incorrectly that "at a 25% corporate tax rate, personal taxpayers would suffer because of their higher marginal tax rates and face additional tax bills on franked dividends."

#### **Income tax payable by an Australian investor receiving a franked dividend**

The Australian system of full dividend imputation should be front and centre in any debate on the rate of company tax in Australia. Dividend imputation was introduced after a long campaign by business to avoid the double taxation of company dividends. Australian shareholders only pay tax on dividends once, at their own tax rate, but the company tax rate and the amount paid by the company is irrelevant to Australian shareholders.

Calculations in the table below are based on a company tax rate of 30% and tax rates for Australian shareholders of 47% and 34.5% (including Medicare Levy) for individuals, 15% for superannuation funds in accumulation phase (super funds) and zero for superannuation funds in pension phase (pension funds).

## Shareholder tax rate and tax rate paid under dividend imputation

Shareholder	Individual	Individual	Super fund (accumulation)	Super fund (Pension)
Shareholder tax rate	47%	34.5%	15%	0%
Company profit	\$100	\$100	\$100	\$100
Company tax	(\$30)	(\$30)	(\$30)	(\$30)
Net profit after tax	\$70	\$70	\$70	\$70
Cash dividend (franked)	\$70	\$70	\$70	\$70
Franking credit	\$30	\$30	\$30	\$30
Taxable income to shareholder	\$100	\$100	\$100	\$100
Calculated tax	(\$47)	(\$34.50)	(\$15)	\$0
Less franking credit	\$30	\$30	\$30	\$30
Tax payable	(\$17)	(\$4.50)	\$15	\$30
Dividend after tax	\$53	\$65.50	\$85	\$100
Tax rate paid	47%	34.5%	15%	0%

The company tax rate is irrelevant because regardless of the level, tax is subtracted from profits and then added back for investors as a franking credit. These figures can be recalculated with a lower tax rate of 25% (or any other figure) and it will reduce the company tax payable, increase the after-tax profit, increase the cash dividend and reduce the franking credit. But, the dividend after-tax received by the shareholder on the various tax rates will be exactly the same: \$53 (47% tax rate), \$65.50 (34.5% tax rate), \$85 (15% tax rate) and \$100 (tax free).

### Company tax rate has no impact on the after-tax dividend

In each case, the total tax payable and hence the amount of the dividend after tax reflects the profit of the company before tax and the Australian shareholder's tax rate only. The company tax rate has no impact on the amount of after-tax dividend received by an Australian shareholder.

Some additional comments:

- The value of a company is the present value of the dividends which are expected to be earned in the future, after tax payable by the shareholder. Even when the company is sold, its value then will still be the present value of expected future after tax dividends. The amount of dividend received by an Australian shareholder after tax reflects the shareholder's tax rate and is independent of the company tax rate, so the value of a company to an Australian shareholder is also independent of the company tax rate.
- In many cases the after-tax position for an overseas shareholder is much the same as for an Australian shareholder. Tax rules in USA, UK, much of Europe and other countries, together with double taxation arrangements generally mean that any tax paid by the company in Australia is offset against tax payable overseas by the parent company. Thus, lower tax paid in Australia by a company will mean more tax paid overseas, i.e. a subsidy from Australian taxpayers to overseas countries – unless, of course, profits are passed through a tax haven on the way. Figures published recently suggest that the proposed reduction in the company tax rate in Australia for large companies would represent a huge subsidy from the Australian taxpayer to overseas countries, hardly in Australia's best interest.
- The proposed reduction in the company tax rate is expected to result in a significant cost to tax receipts received by the ATO. Some figures suggest that much of this cost comes from the subsidy from Australian taxpayers to overseas companies described above. Another component of the cost is likely to be retained (after-tax) profits within Australian companies where franking credits are retained rather than being distributed to shareholders. This is discussed in Part 2 next week.

*Graham Horrocks is an actuary specialising in financial planning and superannuation, and a former General Manager, Research & Quality Assurance, with Ord Minnett. Since 1999, he has been an independent financial adviser. The article was reviewed by Geoff Walker, former Chief Actuary at the State Bank of New South Wales and winner of the 1989 JASSA Prize for published research on the implications of the then relatively-new dividend imputation system.*

## US fiscal stimulus may prove reckless

Hamish Douglass

We are in uncharted waters. Prices for sovereign, corporate and high-yield bonds and equities are at, or near, record levels thanks to the ultra-low policy interest rates and the massive quantitative-easing programs of the G3 central banks (the US Federal Reserve, the European Central Bank and the Bank of Japan) over the past decade. But now two of those central banks are winding back. In response to the strengthening economic environment, the Federal Reserve is raising the cash rate and has commenced an automatic program to shrink its balance sheet while the European Central Bank has halved its asset-buying program.

### Potential for reckless and explosive consequences

While the major central banks would like to engineer a 'soft landing' with gradual increases in interest rates, there is a material risk that they could be forced to tighten monetary policy faster than expected. In our view, the US administration's tax cuts and recent budget measures have elevated the risks. The tax cuts and additional spending will make a fiscal injection into the US economy of nearly 2% of GDP per annum for the next two years. The timing of such a large fiscal stimulus at, or near, the top of an economic cycle when central banks are trying to exit the largest monetary expansion in modern history may prove to be reckless. The US unemployment rate at 4.1% is at a 17-year low and the US economy has added jobs over the past 88 months, which is the longest such consecutive stretch on record. While there appear to be powerful longer-term secular forces at work that are likely to result in low inflation over the longer term, there is a significant risk that the size and timing of the US fiscal stimulus could trigger a jump in US inflation, in particular from stronger wages growth, over the next year or two. This may be highly problematic for the Federal Reserve and complicate its efforts to engineer a gradual tightening with a soft landing. We cannot think of a similar combination of circumstances in modern history. **The cocktail could be explosive.** The best hope for investors is that either the US tax cuts and extra spending have limited effects on growth and inflation in coming years or the secular forces that have kept inflation low accelerate to offset any inflationary pressures from the fiscal stimulus.

Those hopes may well prevail, but the risks for investors over the next 12 months or so are asymmetrical to the downside. There is a meaningful probability that US inflation and wages growth will accelerate and the Federal Reserve will be forced to tighten monetary policy faster and by more than expected. On 27 February 2018 the Chairman of the Federal Reserve, Jerome Powell, responding to questions before Congress, suggested that they may need to tighten monetary policy more quickly when he said:

*"At the December meeting, the median participant called for three rate increases in 2018. Since then, what we've seen is incoming data that suggests a strengthening in the economy and continuing strength in the labour market. We've seen some data that in my case will add some confidence to my view that inflation is moving up to target. We've also seen continued strength around the globe. And we've seen fiscal policy become more stimulative."*

### Was it a 'canary in the coal mine'?

If the Federal Reserve is forced to act more swiftly and forcefully than expected, it is reasonable to assume that US longer-term bond yields could jump meaningfully (above 4% compared with about 2.90% for the US 10-year Treasury bond today), which could trigger the biggest slump on world share markets since the global financial crisis. In our view, a 20% to 30% global stock market correction is within the range of outcomes in these circumstances.

What happened on 2 February 2018 may prove to be the 'canary in the coal mine' warning for investors. On that day, the US Department of Labor disclosed that average hourly earnings for private sector workers rose 2.9% in January from a year ago. This was the fastest rate of wages growth since 2009. The news triggered a jump in longer-term US bond yields to four-year highs and nearly a 10% correction in the US stock market.

In light of the risks, we have increased the defensiveness of the Global Equity portfolio. Over the past three months, we have increased the cash weighting of the portfolio to about 13.5% today. The increased cash weighting should enhance the defensive characteristics of our portfolio and act as a partial hedge against a potential market correction and higher interest rates in general.

It may turn out that we are wrong or premature to be so cautious. But we have no desire to remain at the party, nor be the last to leave, when we judge that risks are elevated. Investors in this environment could well take some sage advice from Warren Buffett in Berkshire Hathaway's annual report for 2000:

*"The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behaviour akin to that of Cinderella at the ball ... but they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands."*

Hamish Douglass is Chief Executive Officer and Chief Investment Officer at [Magellan Asset Management](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

## Five ways to check attribution by active managers

Raewyn Williams

Investors who are paying fees for active management should understand whether they are receiving value for money.

The process of deploying capital in an active equity management programme is a familiar one for large superannuation funds. The fund chooses a diverse mix of managers and styles and provides each manager with a share of this capital to manage. The fund sets some boundaries around how far each manager can deviate from a simple set of 'benchmark' market exposures to chase market outperformance. These boundaries, measured by a concept known as 'tracking error', define what we might call an active risk budget.

### The active risk portion of a portfolio

The boundaries define a budget in the sense that they give the manager a limited amount of space to play in or set a level of allowable risks in the portfolio, to generate extra returns. While there are many, varied nuances to these arrangements, the manager's job is to use this active risk budget wisely, to maximise the manager's chances of delivering outperformance. Each month's performance report will include a handful of numbers which show the success (or otherwise) of the manager over short and long periods.

Simply put, if the manager's portfolio has delivered 8% and the market 6%, the manager has been successful. It is a sore point for some (perhaps unfairly) that if the manager has delivered minus 2% to the market's minus 4%, the manager has also been successful.

Long-term investors want to better understand not only what performance was delivered, but *how*. It is a better way of gaining confidence that the manager is 'true to label', that the performance is due to skill, not luck, and that the performance is replicable over a longer term. A useful way to answer these 'how' questions is by looking at the way managers use their active risk budgets.

We recently offered to help two large funds (independently) understand how their equity managers were using their active risk budgets. We compared a snapshot of each manager's portfolio holdings to a portfolio of benchmark (index) holdings and performed an attribution to identify the different sources of active risk. We explain below what sophisticated investors can do with these insights.

### Things to look for in active attribution

**First**, such an analysis can highlight *active* managers who are not using much of their active risk budget. Since funds pay active management fees on the entirety of the manager's portfolio, a discovery like this should spur spirited discussions between investor and manager. Reasonable explanations could be that the manager's style

is to adopt benchmark weights where the market looks overvalued across the board, or if the manager trades small positions at high volume, or if liquidity is an issue. But it could also unmask a genuine problem, like a lack of conviction or a manager banking outperformance in a prior period that they do not want to risk unwinding.

**Second**, an analysis of active risks can uncover managers which are similar in style. Many managers offer a tiered management fee schedule for large funds (i.e. lower fees for larger mandates), so there may be an opportunity to consolidate multiple manager mandates into a smaller number of genuinely diverse managers to reduce fees and complexity.

**Third**, managers who rely predominantly on sources of risk that are not idiosyncratic (that is, are defined by common, measurable attributes) are susceptible to being replaced (or to use an edgier term, disrupted) by lower-cost rules-based strategies. For example, if a manager's active risk comes primarily from tilting into stocks with value characteristics (or yield, growth, momentum, etc.), then an investor may prefer to find a factor manager who simply builds a portfolio to track a value index, much like a passive manager. Similarly, if active risk is mostly coming from size bets that differ from the market, the fund could look for a more equal-weighted strategy that can be implemented more cost effectively in a systematic, transparent way.

**Fourth**, an active risk attribution can highlight 'style drift', i.e. a manager who is not using the skills and approach the fund expects. If a fund investor is paying an active manager for a 'growth at a reasonable price' style, but their active risks are mostly coming from exposures relating to size, low volatility, stocks with common leverage characteristics etc., this flags an important issue.

**Fifth**, putting the active risk pieces together shows what the fund investor is really getting from a 'whole-of-portfolio' perspective. Sometimes when manager holdings offset each other, the noble aim of diversification may translate to a portfolio with hardly any overall active risk – more like a very expensive index portfolio! If the objective is to build a style-neutral portfolio, the fund might be surprised to find that multiple manager 'double-ups' lead to a significant overall bet in particular countries, sectors, or style risks. Alternatively, if the fund has an overall conviction in a certain area (for example, that large-cap markets are efficient, and so small caps yield active returns), a whole-of-portfolio view of active risks can show whether the sum of the portfolio's parts delivers the intended small-cap risk exposure.

Active risk insights empower long-term investors as they help explain what is driving a multi-manager active equity investment programme, allow manager assertions to be tested against the evidence, and enable funds to compare their portfolio objectives to the real-world portfolio of risks that has been created.

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## GPS Framework: A new way to think about SMSF retirement income

Melanie Dunn

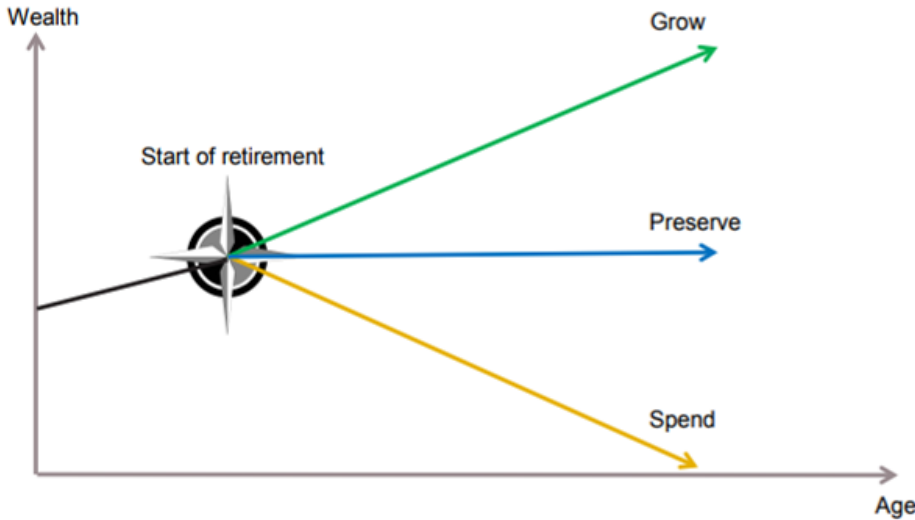
Australia's SMSF retirees should change their thinking about spending their savings to determine the best strategy for retirement, according to new research presented at the recent SMSF Association national conference. The 'GPS Framework' (Grow, Preserve, Spend) helps SMSF retirees set a direction for consumption of their retirement capital.

*Melanie Dunn, Accurium's SMSF Technical Services Manager speaking at the 2018 SMSF Association National Conference in Sydney.*



As people retire the key question changes from 'Have I saved enough?' to 'How much can I spend from these savings?' To answer this question, the retiree should consider whether their goal is to Grow, Preserve or Spend their savings over retirement.

**Chart 1: GPS Framework: setting a direction for retirement spending**



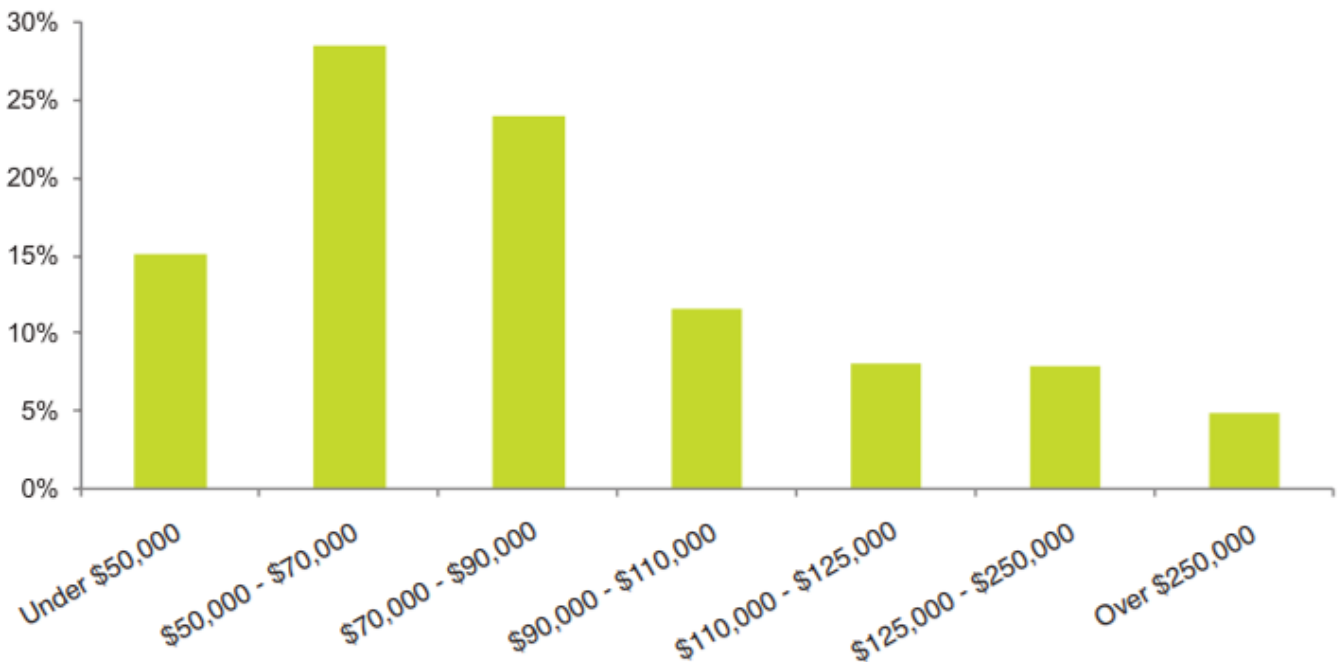
At one extreme are people with more than enough who will continue to grow their wealth during retirement. At the other extreme are those who don't have enough to last and will run out of money. In between are the options of trying to preserve the value of the initial wealth or taking a path that maximises consumption but leaves little or nothing for the next generation.

**Are SMSF retirees Growers, Preservers or Spenders?**

The Accurium report considers the proportion of SMSF households that fall into the different segments of the GPS Framework. This assessment requires an understanding of the household's desired spending level and amount of savings at retirement to support that lifestyle.

Accurium's retirement health **check** is a retirement planning tool that assesses the likelihood of retired households being able to meet their retirement spending goals. Analysis of nearly 800 SMSF households' detailed retirement plans over the year to June 2017 showed a range of desired annual spending levels.

**Chart 2: Desired annual spending levels in retirement for SMSF trustees**

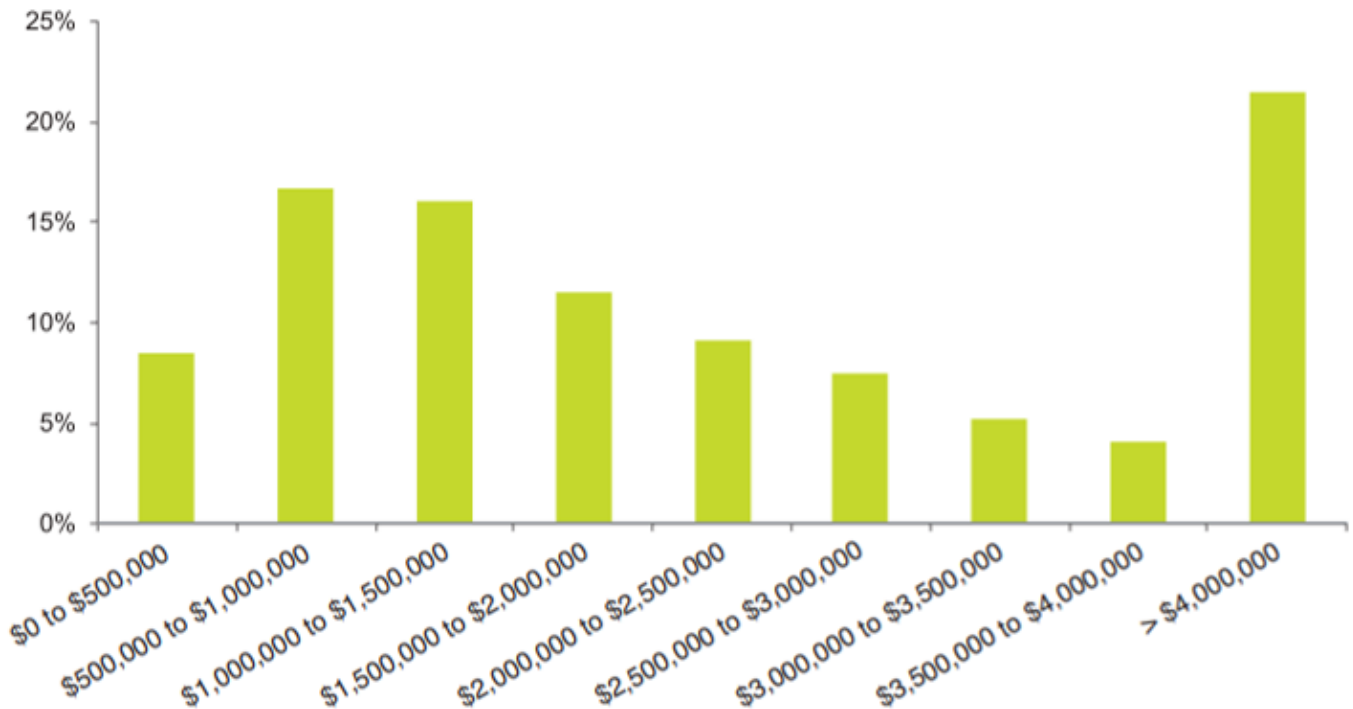


The ASFA Retirement Standard identifies approximately \$60,000 per annum as a sufficient budget to enjoy a comfortable standard of living in retirement for a couple. The median spending level in retirement for SMSF couples in the Accurium database was \$80,000.

While some households are spending at the ASFA standard or less, other SMSF households are looking forward to a more aspirational lifestyle in retirement. Accurium’s research showed 24% of SMSF couples aiming to spend over \$100,000 per annum.

Accurium’s research also suggests that, on average, an SMSF couple might have about 35% of their total retirement savings outside the SMSF. Using SMSF asset data from their actuarial certificate database of over 60,000 SMSFs from the 2015-16 tax-year, Accurium estimated the proportion of 65-year-old SMSF couples with different balances.

**Chart 3: Estimated distribution of total savings at retirement for SMSF couples**



SMSF retiree balances are typically larger than those of members of other superannuation funds. Accurium estimated the median balance at June 2016 for a two-member SMSF at retirement was around \$1,137,000. This is about four times the level of an average APRA-regulated household approaching retirement. The median couple with \$1,137,000 in their SMSF therefore might have total retirement savings of around \$1,750,000.

Our research shows that about 25% of SMSF retiree couples are Growers, who will increase savings in retirement, 28% are Preservers who will retain the majority of the value of their savings, and just over 20% are Spenders who will spend most of their savings across their retirement, based on a typical SMSF retirement spending goal of \$80,000 a year. The remaining 26% are at risk of running out of savings during retirement and might need to spend less so that their money lasts as long as they do.

However, it varies by annual expenditure. While 38% are Growers, 35% Preservers and 18% Spenders at \$60,000 a year spending (the ASFA ‘comfortable’ standard), this declines to 18%, 25% and 18% respectively at a more aspirational \$100,000 a year spending level because they are spending more of their retirement savings.

**Using the GPS Framework when setting retirement income strategies**

Accurium’s research concludes that in retirement, it is the level of spending rather than investment returns which is the primary determinant of retirement outcomes. SMSF households can utilise the GPS Framework to assess whether their retirement spending is aligned with their goal to Grow, Preserve or Spend retirement savings.

“Many SMSF retirees adopt similar financial strategies when it comes to spending but this report highlights that retirees should think differently”, says Accurium’s General Manager, Doug McBirnie. “The amount they can spend and the appropriate retirement strategy depends on where they sit in the GPS Framework. The financial risks faced are different in each segment and the GPS Framework can provide a guide for retirees when it comes to setting their retirement income strategy.”

The report suggests that a simple bucket approach to generating retirement income might be appropriate for the limited risks faced by Growers. However, a more detailed cashflow strategy might be needed for Preservers who are more exposed to market timing risks, while Spenders need to focus more on managing the risk of outliving their savings and should consider the benefits of an income layering approach to ensure they have enough to continue to meet their needs.

The full GPS Framework is linked [here](#).

*Melanie Dunn is SMSF Technical Services Manager at [Accurium](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.*

## What the surveys of SMSF investments reveal

Vinay Kolhatkar

The Australian Taxation Office (ATO) releases annual data on SMSFs, with the [latest for 2015/2016](#) issued a few weeks ago. It is not up-to-date because of the time it takes trustees to lodge returns, and it includes estimates as many SMSFs are late in lodging. Notwithstanding the data shortcomings, the ATO issued an interesting graphic this year, including sections on assets, contributions and benefits, and member characteristics.

It was good to see, for example, that we finally have more corporate trustees than individual trustees, given the benefits of the former. It’s also notable that benefits paid were larger than contributions, and more SMSFs are moving into pension phase. [See ATO graphic, next page]

Given the delays and estimates in the ATO data, SMSF administrators produce more up-to-date reports from their funds. SuperConcepts, for example, undertakes a quarterly analysis of its SMSF client investments. The results show a shifting of investor behaviour in response to regulations, market moves and expectations.

### Portfolio shifts to equities

The changes applying to superannuation from 1 July 2017 were the most significant since 2007. From 1 July 2017, members can only benefit from tax-free pension accounts for a total value of up to \$1.6 million. New reduced contribution caps also began to apply to member balances.

The SuperConcepts SMSF Investment Patterns Survey covers about 2,670 funds. The assets of the funds surveyed represented approximately \$3.2 billion as at 31 December 2017.

In anticipation of the superannuation changes, cash levels for the June 2017 quarter showed a significant increase, from 18.0% at the end of March to 19.8% at the end of June. This cash was invested during the September and December quarters, mainly into Australian and international equities markets.

Year on year, end December 2017 versus end December 2016, investment in Australian shares (36.0% to 36.9%) and international shares (13.1% to 14.2%) increased at the expense of cash levels (18.4% to 17.3%) and investment in property (19.6% to 19.0%).

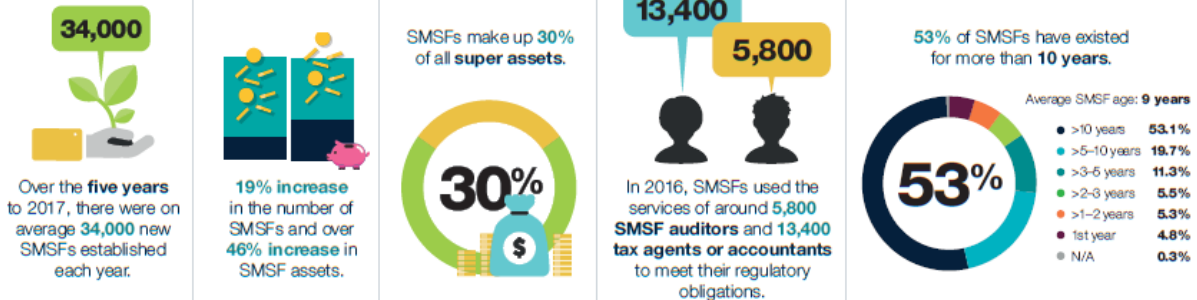
Exposure to international equities increased from 13.9% to 14.2% even from the September quarter to the December quarter. SuperConcepts suggests that:

*“When looking at performance in the different sectors and currency movements, the theoretical allocation should have declined to 13.5% if trustees had left their allocation unchanged for the quarter.”*

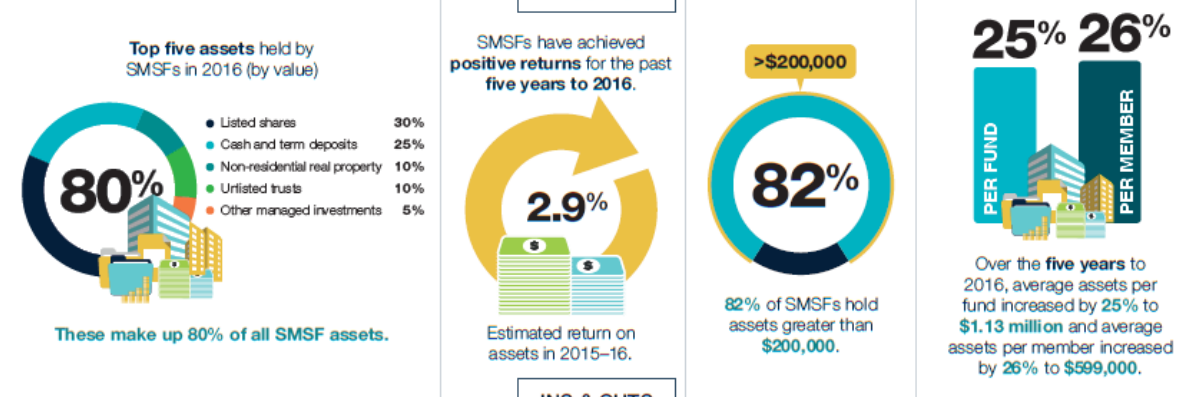
# Self-managed super funds

## annual statistics overview

### SMSF OVERVIEW



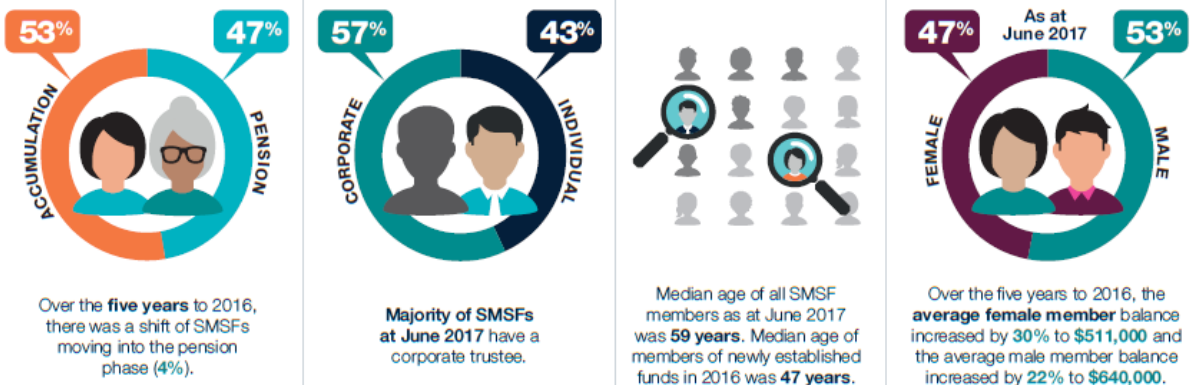
### ASSETS



### INS & OUTS



### LET'S TALK ABOUT SMSFs AND THEIR MEMBERS



The inescapable inference is an *active* decision by trustees to direct new funds into the international equity market. The allocation to managed funds in the international equity sector also increased, although this is likely to be higher than for SMSFs generally as SuperConcepts is part of AMP and investment patterns are influenced by the decisions of financial advisers. The report concludes that

*"... pooled structures are the preferred method of investing in overseas markets due to the complications still present in investing overseas directly."*

### **Largest holdings**

The 10 largest investments represented 14.2% of the total SMSF assets held, out of 7,850 investments in the SMSFs covered in the survey. Two of the top 10 are pooled structures used for accessing international equities which have solidified their positions at number 4 and 6 on the list.

The most commonly held investments (by investment size) as at 31 December 2017 were:

1. Commonwealth Bank
2. Westpac Banking Corporation
3. National Australia Bank
4. Magellan Global Fund
5. BHP Billiton Limited
6. Platinum International Fund
7. ANZ Limited
8. Telstra Corporation
9. CSL
10. Wesfarmers

There's little change in this compared with the top 10 holdings as at 31 December 2016. Magellan and Platinum have moved up from the 6<sup>th</sup> and 8<sup>th</sup> position respectively to 4<sup>th</sup> and 6<sup>th</sup>, possibly reflecting a preference for international equities.

The SMSF Investment Patterns Survey as at 31 December 2015 had similar rankings except Telstra was in 3<sup>rd</sup> position and it is now in 8<sup>th</sup> position. In part the rankings in general may reflect share price rather than a change in holdings. Another clue to Telstra's fall may be contained in the investment patterns of pension funds versus accumulation funds, as we explore below. Pension SMSFs (funds with at least one member in pension phase) make up half of the 600,000+ SMSFs. These funds are generally expected to be more conservative and are stereotyped as chasing yield.

### **Pension vs accumulation SMSFs**

Class Limited also issues an SMSF Benchmark Report, and in the December 2017 quarter, it answers the question of whether pension SMSFs match their stereotypes.

The Benchmark Report states that:

*"The average age of a pension SMSF member is 70 years, compared to 52 for accumulation SMSF members. And with nearly twenty more years to accumulate wealth, SMSFs with at least one member in pension phase have an average balance that is over 151% higher than accumulation SMSFs – \$1,939,985 compared to \$772,947. In fact, pension SMSFs make up half of all funds, but they hold 71% of total net assets."*

In March 2016, when Class published its first Benchmark Report, over 55% of SMSFs held Telstra. By December 2017, Telstra was still the most *widely-held* ASX stock, but it had reduced to being held by 50% of SMSFs. Class wonders whether some of that shift was due to Telstra's August 2017 announcement to reduce dividend payouts.

What the Benchmark Report also reveals is that pension SMSFs:

- Are three times as likely to invest in defensive debt securities compared with accumulation SMSFs, and
- Despite holding slightly more cash than accumulation SMSFs, they allocate a 43% greater proportion to domestic equities compared to accumulation SMSFs.

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Accumulation SMSFs, on the other hand:

- Allocate nearly three times as much to residential property, and
- And are 12 times more likely than pension SMSFs to borrow money to invest in residential property.

When pension SMSFs do invest in property, the preference is commercial property. Class suggests that "Perhaps this is another example of the pension fund's need for income as commercial properties deliver a more reliable and higher rental yield."

### **Regulations affect contributions**

Since 1 July 2017, members with a balance in excess of \$1.6 million as at 30 June of the prior financial year are no longer able to make non-concessional contributions to super. The average non-concessional contribution in the December 2017 quarter was \$1,852 compared to \$2,050 for the September 2017 quarter and \$26,900 for the June 2017 quarter.

The average benefit payment was \$12,218, down from \$25,342 for the September quarter and a sizeable outlier of \$50,313 for the June quarter.

The June quarter increase resulted from members adjusting their pension balances to the new \$1.6 million Transfer Balance Cap. Members are able to hold their remaining balance in accumulation phase where earnings are taxed at 15% compared to 0% for pension balances.

Lump sum withdrawals were not affected. The split between lump sum withdrawals versus pension payments for the quarter was 12% versus 88%, which is similar compared to prior quarters.

Looking ahead to the next quarter, SuperConcepts says:

*"It will be interesting to see whether we see a spike in lump sum benefit payments as trustees implement lump sum withdrawal strategies to help stay under the \$1.6 million pension transfer balance cap."*

### **Tax and regulatory versus economic drivers**

For now, domestic tax and regulatory drivers seem to explain the changes in investment patterns, as well as a growing preference for international equities.

However, the global economy is in the midst of an unprecedented era. The phenomenally low-interest rate cycle may finally turn, with serious implications even if doesn't turn. The aggregate size of the balance sheets of the G4 central banks (the Fed, BOJ, BOE, and ECB) is around US\$16 trillion, and the holdings are more diversified than only Treasury bonds, with only the US Fed indicating a path to asset reduction. The financial markets have never sat across an overhang of this size. Even with the Fed, the jury is still out on whether asset sale plans can be effected without a severe disruption.

Such global winds will affect Australia.

*Vinay Kolhatkar is an Assistant Editor at [Cuffelinks](http://Cuffelinks). This article is in the nature of general information and does not consider the circumstances of any investor.*

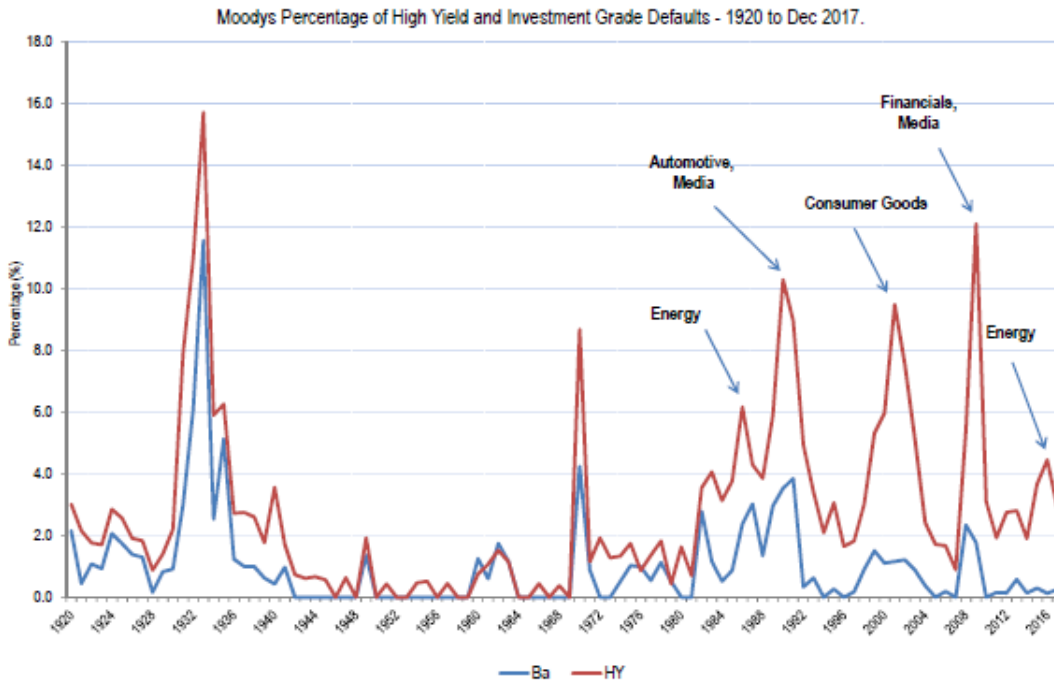
## **Defaults low but no room for complacency**

### **Campbell Dawson**

February is 'Groundhog Month' for credit market nerds. Moody's publishes its annual default study each February and for seven out of ten years, not much happens. This year was one of those, which is good because it means it's been a boring year. Nothing that was investment grade at the start of 2017 defaulted during the year and only around 3% of sub-investment grade issuers defaulted. Overall default rates were just over 1%, which is around median levels.

However, over the last few decades, the overall default and high yield default rates have been boosted by a higher proportion of lower-rated issuers who default more often. The chart below shows this with default rates

of 'Ba' and 'high yield' since 1920. We have also shown the industries which were over-represented during default spikes.



**Watch for the once-a-decade jump in defaults**

Since the 1970s, there's been a once-a-decade spike in defaults for investment grade and the upper end of the high yield market. Defaults in those sectors invariably coincide with recessions. For the lower end of the high yield market, there are always defaults, and they become chunky in recessions. Interestingly, there are always industry clusters of defaults. Energy is the most cyclical of industries and the large majority of defaults over the last three years have been due to energy (particularly shale energy) when the oil price fell. However, other sectors which have been disproportionately represented in high-yield defaults include media, construction and finance (during recessions).

Two of our forward indicators are indicating another sleepy year. Moody's uses a model to predict high yield defaults and it is forecasting that default rates will fall to 1.7% in 2018. If that occurs, it will be the second lowest default rate since 1981. The chart below shows the Kamakura Troubled Company Index, which has been an excellent predictor of the default rates 12 months ahead. It forecast the GFC default avalanche over a year before it happened, and also it picked the peak of defaults in 2009 about 12 months before.

Currently, conditions are in the best 28% of observations since 1990 and it is predicting subdued default activity over the next 12 months.



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## So where are we?

The standard position for an investment grade credit investor is to remain invested, because the margin over risk-free rates is sufficient to compensate for the default risk. If an investor bought every 5-year 'BBB' bond at the start of every year, they would have outperformed the risk-free government bond for that 5-year period in every year but one since the 1950s.

The default cost on that cohort of bonds has (almost always) been less than the additional yield investors receive on 'BBB' bonds over the risk-free government bond rate. It's more cyclical lower down the credit spectrum, but over the long run there is always a gain. However, for anyone who can correctly forecast a recession or near recession, selling can be extremely profitable.

Notwithstanding the positive non-recession forecast, there are some issues, including:

- The non-default cycle is now very long-lived and over the post 1970s pain-free average (but still well below the 1940 to 1970 experience)
- There has been an overall increase in leverage and other negative debt metrics over the past few years, and valuations are expensive
- There's no recession in sight and if that continues, we'll see little stress on investment grade or high non-investment grade debt
- We can't see any obvious industry bubbles and the two largest debt widow-makers (energy and commercial real estate) seem within normal valuation parameters.

However, take a look at the first chart, and see those spikes in defaults every decade or so. High yield defaults around 10% and investment grade around 2% to 4% are not uncommon.

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## Guns, banks, innocence and a Trump warning

### Graham Hand

When Donald Trump floated his crazy idea about arming teachers with guns in schools, it jogged my memory.

In 1976, I was a university bursar with the Commonwealth Bank, and we were required to spend our first vacation in a branch. I worked three months in Engadine branch, and there was a hand gun in an open cupboard next to my desk. Just sitting there innocently on the shelf, next to the stapler and tin money boxes.

I sent out a note to some former colleagues from that era, asking if anyone could confirm branches had guns lying around and if so, what were we supposed to do with them.

What came back was often hilarious, but also deeply troubling. I reproduce here with minor editing, removing any identifiers.

### **Story 1: Union rules, carry the gun in a fabric bag and don't touch it**

When I left school in 1978, I worked in Stock and Share Department, which was on the corner of George and Market in the city. There was a trading bank on the ground floor and we were on the 8th floor. On paydays, the staff clerk collected all the withdrawal slips from the staff. You were asked to fill out a slip saying how much of your pay you wanted to take in cash. This was so that staff were not continually traipsing down to the branch and clogging up the queues.

She (the staff clerk) took them down to the branch, collected all the cash (which could be quite a lot – Stock and Share must have had about 100 employees) and brought it back up to distribute it.

Bank policy was that she had to be accompanied down the fire stair (using the lift was considered a security risk) by a male staff member carrying a gun. One day, I was asked to fill this role.

Union policy, on the other hand, was that they did not want their members exposed to attack from criminals. They therefore did not want their members to be seen carrying the gun, nor did they want their members to risk their lives for the bank's money. So – this was apparently the compromise solution – I was given the gun, but it was in a fabric bag, and I was told that under no circumstances was I to take the gun out of the bag or attempt to defend the staff clerk or the money in the event we were robbed.

So I climbed up and down the 8 flights of fire stairs carrying (very carefully as I had never touched a gun before) this fabric bag with a gun in it that I was under no circumstances to use, to provide 'protection' to our staff clerk. I am sure this made her feel much safer!

### **Story 2: Women could not handle the gun**

In 1964 -1965 I was working at Sydney University branch. Every morning at precisely the same time a colleague and I would walk precisely the same route across the University from the Parramatta Road side to City Road. Beyond retrospective disbelief at the lack of variety in our approach (obviously would be thieves were of a nicer class of people in those days), my colleague and I each carried a gun in a holster. A bit like the Cobb and Co gold delivery without the horses

The introduction of female tellers started the end of guns in branches. When our female colleagues were finally allowed to handle cash, they were not allowed to have access to a gun. Many young male tellers were very comfortable to also give up the 'privilege', especially as new security features like the exploding bank notes filled with indelible ink and then the rising screens started to make their introduction.

### **Story 3: Half a million in a tin box, gun in pocket**

CBA Townsville branch doubled up as the Reserve Bank's dispenser of new notes for the banking system in the region in the 1960s and 1970s. At Christmas time there could be as much as \$50 million in notes in the branch vault.

One of the jobs was to destroy old notes and send new notes to different towns. I can vividly remember walking a tin box with \$500k in it to the Post Office, signing it in for sending by train to Cairns and wandering back to the branch with my trusty bank pistol in my pocket!

I am pretty sure the PO people were unaware the box contained cash. I was told if I were accosted, to hand the cash over without resistance. But if you were confident about not hitting any bystanders, you might think about giving the villains a hurry up!

### **Story 4: Gun taken home then dropped and it discharged**

What great stories ... and I confirm them.

In Victoria as a 16-year-old teller, I was given a pistol and six bullets to take home on the train and then report first thing the next morning at the Reserve Bank pistol range in the city. I brought back my target sheet with 2 holes in the bullseye and I still have that treasured item!

Oh ... the gun but no bullets were returned to the branch in case you were wondering!

The guns at the many suburban branches where I worked were indeed kept in tellers' drawers during open hours but stored in the vault at night. I vividly recall one of my colleagues dropping a pistol inside the vault and it discharging! I dodged a bullet you might say! True story.

### **Story 4: 17 years of age and given the duty of 'escort officer' with a gun**

Shortly after starting work at 96 William Street, Adelaide (17 years of age) was assigned to the duty of 'escort officer' being required to walk with the carrier of cash and negotiables to the Reserve Bank some 600 metres away. I pointed out that I had never used a gun and was reassured that it probably wouldn't be needed as it hadn't been previously.

I can recall the pistol being kept in a cupboard which allowed easy access to anyone during the day. However, it was locked at night. I can vividly recall one thing. On one very hot day the cash carrier and I stopped for a milkshake on our return trip. While perched on a high stool the pistol eased itself out of my pocket and proceeded to bounce across the tiled floor of the shop in which, fortunately, we were the only customers. I can't remember how long I held the 'escort officer' position but I was very happy to be replaced.

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**Story 5: Gun discharges, bullet hits roof, audit finds bullet missing**

Serving at Coolangatta during holiday times with the CBA as the local cash issuing/collecting (same day/same time each week) certainly made us stand out but we still strolled 150 metres down the road with rather suspicious boxes full of cash (at least the holes were punched in the notes but who knew that).

A lot of comfort was taken by having the pretty much useless .38 deep in our pocket with the extra 'security' of another suspicious looking officer walking 15 metres behind with another weapon that Wyatt Earp wouldn't have been able to draw in a week. The boxes were very causally treated by the PO staff, left lying on a counter out the back beside the open back door!

At Mt Isa, we had an occasional service centre at the Mines Barracks in a tin shed. Unfortunately, one of the officers on duty on one occasion accidentally dropped the weapon which discharged and put a hole through the shed roof. The noise was deafening and so was the manager's investigation at the audit that found one bullet missing that was not otherwise reported.

Shooting range was always fun especially when the old bullets had to be replaced so we were able to shoot more than the regulated 5 or 10 shots. At least it confirmed that with the .38 being a very heavy 'can't shoot straight' weapon, we were never going to be a real threat to anyone in a time of 'anger' and couldn't hit the side of a barn with a handful of wheat.

**Story 6: Gun taken home to shoot some chooks**

Joined Redfern branch 1968. Had a pistol which was locked away in my teller tin and put in the safe at night. Trained to shoot in Martin Place (boy, did a pistol kick on first use). Another teller took his gun home one night and shot some of his neighbour's chooks. Needless to say he got dismissed and the Branch Accountant was in deep s— for not seeing the gun away at night.

**Story 7: Take cab, deliver foreign notes, don't forget the gun**

To add a bit more colour, on attachment to Overseas Department Sydney in the early 60's, I had to take a parcel of foreign currency to the Central Parcel Office at Central Railway by cab and was given a revolver to take with me. No training or any idea how to use it. On alighting from the cab at Central, it fell from my pocket onto the floor of the cab, to the consternation of the driver.

**Story 8: Bank gun used for suicide was not unusual**

Late 1950's, aged say 16, I collected registered mail from the Sydney GPO via the tunnel under Pitt St (over the Tank Stream). My collection and delivery of the mail was supported by three hand guns – I believe a .22, a .32 and I think a .45.

One delivery each day was to George & Market Sts branch and I always selected the bigger gun and holster so it was more obvious to pedestrians under my unbuttoned suit coat???

Playing with one of the guns in a room off Overseas Department (ground floor, Martin & Pitt Sts branch), I half-cocked the gun and jammed a bullet. I spent many, many very anxious minutes clearing the weapon, avoiding it going off to the consternation of staff, customers and me!

A good friend took his life with the bank's gun at an inner west branch. I believe this was not that unusual. The training and practice firing range in the Elizabeth St and Martin Place branch had a full-time instructor. I never received any weapons training.

**Story 9: Waving the gun around, how many shots left?**

My favourite memory of guns in the CBA was in 1957 at Maitland NSW. The entire branch staff were at the local rifle range for 'pistol practice' under the watchful eye of the manager. One by one we stepped forward onto the mat and were handed the pistol. It was already loaded and all we had to do was release the safety catch, point at the target and fire six shots.

The remainder of the staff were located immediately behind the 'shooter' in an extended line. And of course, offering their learned advice. The manager's final instruction was to face forward until all shots had been fired.

Things went great until the office junior stepped forward and took control of the pistol. She looked so professional and almost hit the target with her 4<sup>th</sup> shot. Then, alas, she turned around, faced everyone and said, "How many shots have I got left?" No one answered as everyone had gone to ground.

There was no more pistol practice that day or in the following year.

### **Story 10: Rebuilding the gun, and more suicide**

I can confirm all the gun stories. I was a teller in 1958 aged 18 when tellers were supposed to be at least 21 years of age. In my second branch posting, I was on the counter as the only teller at a small branch with no training except observation. And of course, I was given control of the gun, which was a Browning .32. The gun was kept in a leather holster under the counter in the teller's box and locked away in cash tin overnight.

Like others, we later had some gun training at the range in Martin Place. There were strict instructions and processes for cleaning the gun which I would do between customers whenever the work book said it was due. The most important instruction said never to twist the gun barrel.

Anyway this day I did twist the barrel, I think on purpose, and the gun exploded into a bunch of spare parts with a couple of large pieces and many small pieces and springs. I thought this was the end of my banking career so I tried to put it back together with no luck. I put the large gun pieces together and they looked like the gun enough so that the Manager when he checked my cash tin to go away overnight could see the gun. All the small pieces were in a tobacco tin in my teller's drawer. Every time I got a chance when the Manager was not looking, I tried to put the gun back together.

This went on for a couple of months but no luck with the reassembly. I kept at it and one day it all clicked back together, and I had no leftover parts. Soon after we went to Martin Place for our regular shoot and of course I had to take the gun but there was no way I was going to shoot with it. I went to the man in charge and softly asked him if he would give my gun a careful check over. He turned to my workmates and some from other branch people and very loudly said, "HERE IS ANOTHER ONE WHO TWISTED THE BARREL."

One tragic matter ... I was at Petersham branch when the cleaner came in early one morning to find the manager had used the office gun to suicide in his office. That would have been in late 1950s or early 1960s.

### **Concluding ...**

Yes, they were simpler and more innocent times, and no doubt procedures would be tighter now. But it has been [estimated](#) that with about 3.4 million teachers in the US, if only 20% had guns, that would be another 700,000 in circulation.

More guns, more accidents, more killings, more suicides. Not so innocent then.

*Graham Hand is Managing Editor of Cuffelinks.*

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