

This Week's Top Articles

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The spirit of the game applies to business, too

Vinay Kolhatkar

On Sunday morning, 25 March 2018, Australians were jolted into a serious awakening. Overnight, the captain of their favourite national sporting team had openly admitted to premeditated cheating. As multitudes condemned the action, it spoke to the *spirit of our nation*. Above all, we want to play fair. Better to lose than have winners who cheat. Even the Prime Minister became involved, well aware that a core Australian ethic was at stake. A few days later, captain Steve Smith received a one year ban from playing for Australia, and a two year ban from captaining the team. It was one of the most extraordinary and quickest falls from the sporting summit in Australian history.

The trophy of integrity

The Australian national (men's) cricket team has often been ranked world number 1, and is the current holder of the World Cup with trophies aplenty in their cabinet. But right now, it is being vilified globally, and even more so in its own country.

The videos of the incidents are hypnotic viewing. Particularly telling is a young man who hides a [piece of yellow tape](#) in his pants, and, like a magician, brings out a black handkerchief when asked by the umpires to reveal what's in his pockets.

When [Steve Smith appeared before the media](#) after the day's play, his psychological distress was visible (watch the 30 seconds from 1.04 to 1.34 in the *mea culpa*). The nation cringed. He is ranked the number 1 batsman in the world, he has just dominated an Ashes series, he was a national hero but his mental cabinet is dishevelled.

Much is at stake financially as well as morally. Fund manager Magellan is a naming rights sponsor of Cricket Australia. Smith is one of CBA's three 'cricket ambassadors', and is also sponsored by Sanitarium (makers of Weet-Bix). Other sponsors (of the team or the players) include Qantas, Nestle, LG (now withdrawn) and the Nine Network. Broadcast rights are soon up for renegotiation with free-to-air and Pay TV providers.

Fortunes can change overnight, but the fall that is crystallised by a loss of integrity is harder to bear, both externally and more crucially, internally.

It may feel good to have tombstones, Euromoney accolades and Morningstar awards in our closet, but the trophy of integrity lies *deep inside* our mental cabinet. No one can steal it. Not even a dastardly framing that succeeds in getting a person falsely incarcerated can deprive this treasure. That's the way the gods smile on those who imbibe the spirit of fair play when under no obligation by law or the rulebook. Many Australians treasure Adam Gilchrist's honesty in 'walking' despite being given not out at crucial moments. In real life, it can vary from acknowledging the driver who first spotted the empty car spot in a crowded carpark to not playing fast and loose with words in the high-stakes game of business.

The spirit of the game

Smith's actions, they said, were not only against the laws of the game, but also against the 'spirit of the game'. Is this a furore amongst cricket aficionados with no relevance to everyday life?

Think again. Cricket's spirit of the game ethic is supposed to put 'playing fair' above 'winning at all costs'. In 1981, then Australian captain Greg Chappell acted within the laws of the game, but outside the spirit of the game and soon, prime ministers on both sides of the Tasman got into discussions like there was a threat of war. Now the underarm incident is an endearing bit of trans-Tasman history.

No one remembers how many runs Greg Chappell scored that day. No one cares. But a show of character leaves a legacy, as many recall Chappell's teammate Rod Marsh openly dissenting on the field.

And that battle – playing fair versus winning at all costs – imbues every human endeavour, from politics and family to business and sports.

While the Royal Commission into financial services may seem like a political football, the cries for it to be set up arose because there was already a widespread perception that bankers and advisers do not play by the spirit of the game. The hearings demonstrate that brokers have been selling what's in their best interest as long as the fine print protects them, that bankers motivated by volume bonuses wrote inappropriate loans, that a man known to a bank as a gambling addict was given three credit cards and a large limit.

In investment banking, I have been both adviser and been advised, and, more than anything else, the one thing I detested was the fee structure in M&A transactions. It was typical to award, to the advisory firm, a fee being a percentage of the value of the transaction only if successful. In an auction situation, the advisory firm could win millions by encouraging the client into paying more to win the asset, but it won zero if the client bid no more than true value and lost to a higher bidder. The fee structure created an Olympian hurdle for integrity in the banker's mental cabinet to leap over.

When an airline leaves you stranded by departing four hours late, they are under no obligation to compensate you. But giving you a voucher for a \$10 free meal while you dawdle at the airport is probably in the spirit of the game, and for 200 passengers, that's \$2,000, peanuts for an airline company anxious to restore faith.

It's well-nigh impossible to cover every eventuality in a rule book or contract, but more than the 30 cameras around the field, the human eye has an innate ability to detect fair and foul play.

Above all, our mental cabinet

Amidst the cries for retribution, there are already voices concerned about Smith's mental health. Will he hold up for what's to follow?

We can easily spare ourselves that sort of mental trauma by not becoming agents of our own undoing, and encourage everyone in our business to do the same.

The balance sheets of our companies and of our own self have an asset called Reputation. That can be unfairly lost. But our mind space can, and should, have a well-guarded trophy called Integrity. Lose that, and life can become hellish.

Over 350 years ago, the immortal wisdom of a blind and impoverished John Milton, writing in *Paradise Lost*, spoke to that mind space:

*"The Mind is its own place, and in itself
Can make a Heaven of Hell, a Hell of Heaven."*

Vinay Kolhatkar is Assistant Editor at [Cuffelinks](http://Cuffelinks.com).

Baggy Green summit was bottom of GFC

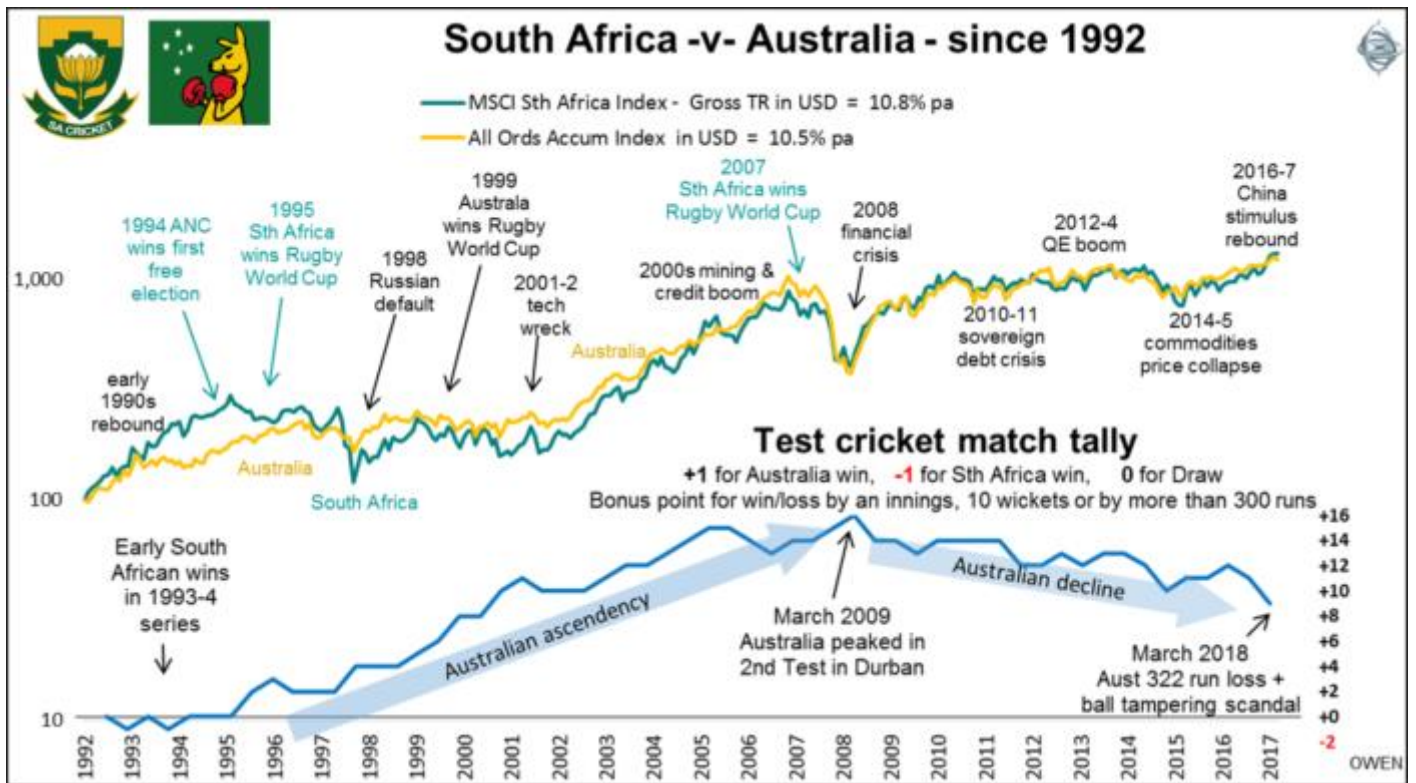
Ashley Owen

The only topic to capture more headlines in the past week than Trump’s trade wars has been the Australia – South Africa cricket test series – for all the wrong reasons. Even Trevor Chappell has said he is relieved that after 37 years he is no longer the most hated man in Australian sport. Let’s take a different angle by looking at the stock market performance of the two countries.

Dependence on commodities

Australia and South Africa are both commodities-based economies with stock markets dominated by mining explorers and producers. The chart shows total returns (including dividends reinvested) from the broad stock market index in each country, expressed in US dollars to show them in a common currency and starting from a common base from 1993 when South Africa re-joined the world following the end of Apartheid.

Both markets are highly cyclical and reliant on commodities prices and foreign ‘hot money’ capital flows driven by global sentiment. South African shares have done much better in local currency terms (averaging 15% pa in Rand versus 10% for the ASX in Aussie dollars) but returns in US dollar terms have been virtually the same and have followed the same path.



[Click to enlarge](#)

South Africa got off to a flying start as foreign money rushed into the newly minted ‘emerging market’ in the early 1990s, but then foreign capital fled in the 1997 Asian currency crisis and especially in the 1998 Russian default crisis. Both had a mild ‘dot com’ boom and tech wreck, but both had a huge 2003-07 China-led commodities boom and subsequent GFC bust. They fell together in the 2015 commodities price collapse and then rose together in the 2016-07 China-led rebound.

The chart reminds us that share prices are driven more by global cycles than local issues.

What about the cricket?

The lower section shows the test cricket match tally between the two countries since South Africa rejoined the sporting world in 1993. We have played a total of 97 matches in 26 series since 1902. Australia is winning the match tally with 52 match wins, and also the series tally with 16 series wins. Here we focus on the post-Apartheid era.

The blue line shows a running tally of test match wins and losses as +1 for an Australian win, -1 for a South African win, and a bonus +1 or -1 point for a win or loss by an innings, 10 wickets or by more than 300 runs. After a couple of early wins by South Africa in the Nelson Mandela-inspired post-Apartheid euphoria, Australia gained the ascendancy from the late 1990s to the late 2000s under Taylor, Waugh and Ponting. Australia peaked with a 175 run win in the Second Test at Durban in 2007 with two centuries by opener Phil Hughes (the youngest ever player to achieve this, at age 20, on his debut tour).

That match started on 6 March 2009, the same day the stock market reached its lowest point in the GFC. That day was the turnaround for shares rebounding out of the GFC but it was also the start of a long relative decline in Australian cricket. If the cricket scandal represents the all-time low for Australia, what omens does it offer for stock markets? The road out for Australian cricket surely starts now.

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.

Franking: never mind the logic, let's obfuscate

Geoff Walker

Last week's [Cuffelinks piece](#) by Warren Bird gave an excellent and logical refutation of the Labor Party proposal to eliminate refunds to taxpayers of unused franking credits.

However my belief is that this proposal will not be defeated by logic alone. Imagine a talkback shock jock demanding why a wealthy retiree earning \$70,000 in dividends each year can be given a free kick of \$30,000, no questions asked, when a poor old age pensioner has to survive on a maximum pension of less than \$20,000, and then only after surviving Centrelink grilling. The shock jock's listeners would enthusiastically and indignantly accept the statement at face value and would not be interested in reading lengthy, detailed explanations.

How a discussion goes off the logical path

That this battle will be fought on ideology grounds with other issues brought into play rather than logic was made clear on [ABC's 7.30 on Wednesday 21 March 2018](#) when the Grattan Institute's CEO, John Daley, was interviewed (starts at 24:20).

The interviewer, Leigh Sales, introduced the segment by saying that the Grattan Institute had been crunching the numbers, implying that viewers could expect to hear an objective assessment of the Labor proposal. And indeed, in the past, the Grattan Institute has done good work in relation to superannuation issues, for example its [2014 landmark report](#) on the impact of fees on retirement incomes.

The interview started well enough, and John Daley's responses to the first questions can be paraphrased thus:

Most of the money raised will come from people who have substantial assets other than their home.

Retirees often have low taxable incomes but high untaxable income because superannuation earnings are not taxed.

So far, perfectly reasonable. Then (at 27.50), Leigh Sales notes that individuals make long-term financial decisions on the basis that franking credits will continue to be refunded, and then the rules change after they are already in the retirement phase. John Daley responds:

"That's true but it's true for all of us. If I buy BHP shares and governments change the tax rates, I pay more tax. There it is. The idea that somehow, once you're retired, the government is not allowed to change any of the tax rates (when they can change them for the rest of the population) does seem a little odd."

You be the judge. For me, instead of responding to the question on the fairness of not refunding franking credits, John Daley defended any government's right to change tax rates as it sees fit. Of course governments can change tax rates, but tax rates were irrelevant to the question asked.

John Daley raised another issue and perhaps his partisanship on the franking debate. I previously held the Grattan Institute to be objective on issues.

How might a hypothetical interview unfold?

A line of questioning might have continued along the following track, the responses to which are purely my own invention in trying to play the devil's advocate (I'm not suggesting John Daley would head in this direction, but illustrating how difficult it is to have a logical discussion on this subject):

Question: But the ALP isn't proposing any change in tax rates, is it? Its proposal is all about refunds. If two SMSFs each have income of \$100,000 a year, with the first's income being entirely real estate rents while the other's income comprises share dividends and refunded franking credits, what's fair about one being unscathed while the other loses \$30,000?

Answer: Quite straightforward – the income of the share dividend SMSF includes a \$30,000 concession refunded from Australian taxpayers.

Question: But is it fair to call the refund a concession? And how does a franking credit refund differ from an employee receiving a PAYG refund after putting a tax return in at the end of the year? There's no ALP proposal to abolish PAYG refunds for ordinary taxpayers.

Answer: Again straightforward – the refunds that PAYG taxpayers receive is their own money that has been collected during the year, not a concession financed from taxpayers.

Question: But isn't that also the case with franking credits, which are sourced not from taxpayers in general but from the tax that has been collected from the specific companies that shareholders are invested in?

Answer: And that's the critical difference – that the tax has been collected from the companies, not from the shareholders. So it is not the shareholders' money in the first place.

Question: Are you saying a company's money belongs to other than its shareholders'? In fact, the word 'company' is simply the collective noun for shareholders, just as in a company of soldiers.

Answer: Er ... I'm sorry, but I have another pressing commitment that I must leave for now.

Question: Well, just before you go, is it equitable that the SMSF pensioner we talked about earlier could simply roll over the SMSF's share assets into a pooled superannuation fund, perhaps an industry fund, and continue to collect the franking credits refund, on account of the pooled fund having ample taxable income to absorb his franking credits.

Answer: As I said, I must rush. Goodbye.

Geoff Walker is a 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.

The Grattan Institute's position on Labor's policy is [here in The Conversation](#).

Tax-free super drives the politics of envy

Jon Kalkman

The Labor Party has announced a policy that will deny the cash refund of excess imputation credits, and Bill Shorten said that people who do not pay tax should not get a tax refund. The subtext issue here, the one that working taxpayers (especially Gen Y) complain about, is that many retirees receive their superannuation benefits tax-free.

This debate will not progress further until the anger and envy is confronted. Even if we could educate the population on the merits of imputation credits (and that is unlikely) retirees would still be guilty in the public mind of not paying enough tax.

The real issue is the zero tax paid on pension income

Since 2007, super withdrawals (pensions and lumps sums) have been tax-exempt to retired members over the age of 60 (subject to caps introduced in July 2017). This was done because little tax was collected from this source and it coincided with a much more generous assets test for the age pension.

Many see the changes in 2007 as overly generous. Its lasting legacy is that it has led to the inter-generational politics of envy where the older (retired) generation pay little or no tax and the younger (working) generation pays progressively more tax as they earn more.

To working taxpayers, it seems incomprehensible and terribly unfair. Those who are old enough will remember:

- Before 2007, people paid tax on their superannuation pension at their marginal rate. Because this was money derived from super, they were also entitled to a tax rebate of 15% which was compensation for the 15% tax they paid on their contributions during their working life. Most important, this tax only applied to the proportion of the pension which was derived from the concessional (pre-tax) contributions in the fund. The after-tax proportion of a pension was tax-free as it was seen as the return of the contributor's own money. That system still applies to people who draw a pension from their super before the age of 60.
- People whose contributions are limited to (pre-tax) employer contributions and salary sacrifice soon discover they never accumulate a large super balance from which to draw a pension. People only achieve large super balances at retirement by making large after-tax contributions. Before 2007, when taken as a pension, the larger that portion, the less tax was collected. Since 2007, it is all tax-free after 60 anyway.
- The combination of the higher tax-free threshold for retirees and the tax-exempt portion of pensions meant that few people paid much tax on their super pensions before 2007. This meant that Costello could appear to be generous but the actual cost to government revenue was quite small. It meant considerable political gain with little economic cost.
- There was no limit on after-tax contributions before 2007. That explains why some SMSFs have more than \$10 million. Of course, the facility to make large after-tax contributions was limited after 2007 and since 2016 was only \$100,000 per year. It is now impossible to make non-concessional contributions when super exceeds \$1.6 million per person.

At present, about 50% of the population over the age of 65 depends on the age pension (which is \$23,500 for a single person and \$35,500 for a couple) for all their income needs. Another 25% or so receive a part pension because their assets and incomes are below the upper limits of the incomes and assets tests. Given the way these tests work, it is almost impossible for a couple on a part pension to earn more than \$50,000. The AFSA standard for a comfortable retirement as a couple is \$60,000.

Only 25% of the senior population is self-funded and that proportion declines with age as retirement savings, including super, are depleted. Of course, there is no way of knowing from Centrelink data if a self-funded retiree has failed to qualify for a part-pension by only a small amount or if they have \$100 million at their disposal. But because there is no data this is often treated as a homogenous group, so they are all considered multi-millionaires.

Retired people have always paid little tax

No age pensioner pays tax on their pension and most part-pensioners do not pay any tax because of the Senior Australian Pensioners Tax Offset (SAPTO). Many self-funded retirees paid little tax on their pensions before 2007 and access tax-exempt pensions from their super funds now.

No government since 2007 has tried to undo the concession that allows tax-exempt withdrawals from super after age 60, to the chagrin of many workers and commentators and so the politics of envy continues. The \$1.6 million cap on super in pension phase went some way to limiting the benefits.

In response to that confusion and envy, the blunt instrument proposed by Labor will cause much collateral damage. For all taxpayers on low marginal tax rates (especially retirees), the tax paid on dividends from Australian shares will be higher than other sources of income. As this increased tax will lower their income, this will distort investment decisions.

While the tax-exempt payments from super remain unaffected, this policy harshly affects the fund that pays a super pension, especially an SMSF where many self-funded retirees hold their retirement savings. Depending on the asset allocation to Australian shares it would mean a reduction in the fund's income of up to 30%. A lower investment return due to a tax increase means super balances will be depleted sooner. A reduced capacity to pay retirement benefits to their members will place greater pressure on the age pension which is already under strain. It is difficult to see how this is good policy.

There has been insufficient consideration of the signals and incentives this policy sends, or the likely behaviour changes it will usher in.

Update as Labor announces a policy variation

In response to the public outcry, [Labor has announced](#) that pensioners and part-pensioners will be exempt from this policy. This extends the cynical approach of maximising political gain without too much cost to government revenue. To receive a full pension, a home-owner couple must have assets below \$380,500. For a part pension, the limit is \$837,000. It is unlikely that these non-home assets would all be invested in fully franked Australian shares. But if this were the case, for the couple on the full pension, the dividend (earning 5%) would be \$19,025, the imputation credit refund is around \$8,000 plus they would also receive the full pension, giving them an income of \$62,600.

For the home-owner couple with \$837,000, the dividend would be \$41,850, the imputation credit refund would be less than \$18,000 giving them a total income of almost \$60,000, but those assets would reduce the age pension to zero. Note that more assets deliver a lower income. Refunded imputation credits are really the refund of tax already paid, but politicians seem to believe that any money handed back by the ATO is a tax concession. Even seen in that light, the cost to government revenue here is \$18,000, but this couple saves the taxpayer the cost of the age pension which is now \$35,500 for a couple.

SMSFs in pension mode pay zero tax on income or capital gain so they are clearly the target on the policy (although SMSFs with at least one pensioner member as at 28 March 2018 will also be exempt). To see how this policy plays out, take a SMSF in pension mode with two 'non-pensioner' members, and the fund's balance is \$1.4 million earning 5% from fully franked Australian shares. This couple have saved hard to be self-funded retirees, but the fund balance is well short of the \$1.6 million per member currently allowed. The fund's income from dividends is \$70,000 and the imputation credit refund is \$30,000. Since 2000, excess tax credits have been refunded in cash and this couple's income from their SMSF is \$100,000, and that is a comfortable retirement by any definition. The cost to government revenue is \$30,000 but this couple has also saved the taxpayer the cost of the age pension of \$35,500. Under this policy the members of the SMSF are ineligible for the age pension because their assets exceed the limit, but the income they draw from the fund has been cut by 30% from \$100,000 to \$70,000.

The couple with \$1.4 million in their SMSF now has an income of \$70,000. This compares with the couple on the full age pension, having saved \$380,000 who has an after-tax income of \$62,000. Similarly, the couple on the part-age pension has saved \$837,000 and has an after-tax income of less than \$60,000. It does not seem such a great return for all that sacrifice to save to become self-funded retirees! The question many members of SMSFs will be asking is: "Why would anyone bother?"

Jon Kalkman is a former Director and Vice President of the Australian Investors Association.

Overcoming loss aversion in retirement income

Aaron Minney

Many retirees are hampered by their own loss aversion in the challenge to generate cash flows to spend in retirement. Some behavioural tools can help to overcome this loss aversion while still leaving a larger estate for the next generation.

The difference between loss aversion and risk aversion

It is standard practice for financial advisers to determine a client's risk profile by measuring risk aversion and linking it to an appropriate asset allocation. Loss aversion is a related issue that was first highlighted in Kahneman & Tversky's 1979 paper on behavioural issues in finance.

The premise of loss aversion is that people dislike losses more than they like gains. The interesting fact is that loss aversion trumps risk aversion. Research has shown that people who are normally risk averse will become risk seeking to avoid a certain or likely loss.

The following example is adopted from Kahneman's 2011 book, 'Thinking Fast and Slow' and highlights the strength of the loss aversion.

Participants are given \$1,000 which they are allowed to keep and not required to wager. They are then asked to choose between the following 'bets':

1A	1B
50% chance to win another \$1,000	Get another \$500 for sure

The majority in this case prefer the certainty provided by choice 1B, reflecting risk averse preferences.

The alternative comparison then describes a loss.

Participants are given \$2,000 and asked to choose between the following bets. This time they are wagering part of their gift:

2A	2B
50% chance to lose \$1,000	Lose \$500 for sure

Now the majority prefer to take the gamble, 2A, in the hope of avoiding any loss, even though the net outcome under both scenarios is exactly the same. The choice is between:

A	B
50% chance of +\$1,000 & 50% chance of +\$2,000	+\$1,500 for sure

The difference in behaviour reflects how people think and manage their money.

Endowments, life savings and avoiding capital reductions

There is a related issue for retirement planning around the so-called 'endowment effect'. It is evident in the example above as participants immediately view the \$1,000/\$2,000 as their own (and not a separate 'win' or gift) and make subsequent decisions on that basis. Building up a lifetime of savings has a similar, and probably more powerful, effect. Retirees often view their retirement savings as capital that should be preserved.

In reality, these savings are just deferred wages and 'interest' that should be spent down to support the retiree's desired lifestyle in retirement. However, there is an endowment effect so that once the balance is highlighted as 'capital', many retirees react negatively to any reduction in the capital. They regard it as a loss, which they would prefer to avoid, rather than being part of the lifecycle plan of building up and running down savings.

The annuitisation puzzle and loss of capital

Most retirees expect to spend down some (or all) of their savings through retirement. A report by National Seniors Australia in 2017 noted that only 3% of retirees expect to preserve all their savings for the next generation, while living solely off the income generated. Nearly half would prefer to preserve some capital, but the clear majority of Australians expect that they will use up some capital to enjoy the lifestyle that they desire in retirement.

The perceived loss of capital is sometimes stated as a reason for retirees preferring return-seeking investments over annuities. Academics dating back to Yaari (1965) have demonstrated that the lifetime annuity is the most efficient way to turn some capital into a stream of lifetime income. However, because of loss aversion, many clients will see the possibility of their premature death as a potential loss of capital. This can be a barrier to using an annuity for retirement income. The challenge is to overcome this fear by adding some flexibility features to the lifetime annuity to remove the prospect of a loss of capital.

A flexible approach to a lifetime annuity

With many people seeking the peace of mind that is provided by a guaranteed lifetime income stream, there is a benefit in overcoming a retiree's loss aversion to lock into an annuity or other guaranteed income stream. The key to helping them is to provide additional flexibility by:

- Using only part of their accumulated savings to guarantee a layer of income
- Providing capital access and a death benefit, particularly in the early years of retirement.

The first element of this is central to a 'layering' strategy and a similar concept has been adopted in the Government's Comprehensive Income Product for Retirement (CIPR) framework. Some of the retiree's savings are used to generate guaranteed income, and some of the savings are used to provide flexibility.

The second element has been a part of the rejuvenation of the lifetime annuity market in Australia. By including a death benefit with the annuity, retirees are no longer worried about losing capital if they die early. Indeed, the estate of those unfortunate few who only spend a few years in retirement can have 100% of their capital returned. Just like any consumer product that offers a 100% money back guarantee, the return of capital to the estate (which could just be a dependant spouse) is a relief to those loss averse retirees who are also risk averse and value a guaranteed lifetime income stream.

Aaron Minney is Head of Retirement Income Research at [Challenger Limited](#), a sponsor of Cuffelinks via its subsidiary, Accurium. This article is for general educational purposes and does not consider the specific circumstances of any individual.

ETFs firmly established in the mainstream

Ilan Israelstam

The seventh annual BetaShares/Investment Trends ETF Report provides a unique snapshot of the key statistics and drivers in the Australian Exchange Traded Fund (ETF) industry, from the perspective of self-directed investors, SMSFs and financial planners.

This year's findings signpost a continued rapid growth story, as Australian ETFs shift further into the mainstream market.

Key findings of the report

The insights collected from this round of research are based on responses from approximately 6,000 investors and 500 advisers:

- The number of ETF investors in Australia grew 18% in the 12 months to September 2017, reaching 314,000
- SMSF trustees, the early adopters of ETFs, comprise 33% of ETF investors. Since 2010, the number of SMSF investors using ETFs has grown 288%

- While SMSF usage of ETFs remains strong, there is increasing adoption by self-directed non-SMSF investors
- Diversification, cost-effectiveness and access to overseas markets are the top drivers of investing in ETFs
- Approximately 60% of Australian financial planners recommend ETFs or intend to do so within the next 12 months.

SMSFs, the ‘early adopters’ remain key supporters

The number of Australian investors using ETFs has grown to a record 314,000, up 18%, from 265,000 in the previous year.

The number of investors holding ETFs through an SMSF increased (by 5,000 compared to the year before) to 105,000, meaning that approximately 1 in 6 SMSFs are now investing in ETFs. That said, in aggregate, SMSF ETF investors as a percentage of the total market declined from 38% in 2016 to 33% in 2017. This proportional decline is due to an increase in the number of self-directed investors who are utilising ETFs outside of SMSFs (+44,000).

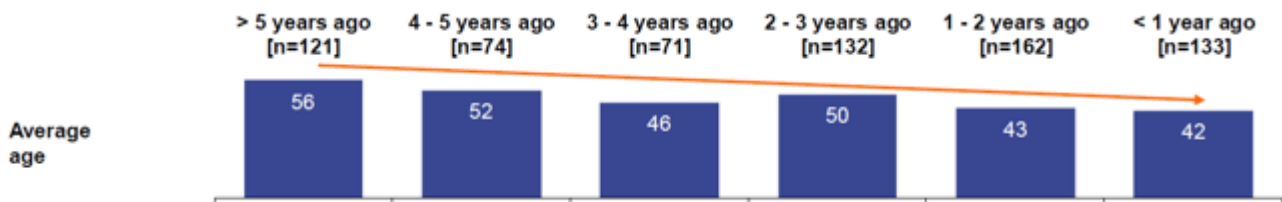
SMSFs who use ETFs typically cite a wider range of reasons for using them, especially access to overseas markets and liquidity. Diversification remains the primary driving factor, with 72% of investors citing this as a reason for using ETFs.

Other investor categories are growing fast as younger investors enter the market

While ETF investors are on average 49 years old, including a quarter who are retired, the average age of those who started investing in ETFs in the last 12 months is now 42, significantly younger than an average age of 56 among those who started investing in ETFs more than five years ago.

This is a prominent statistic showing how mainstream the ETF industry in Australia is becoming, as well as how important the younger or millennial investor will be to the industry in future.

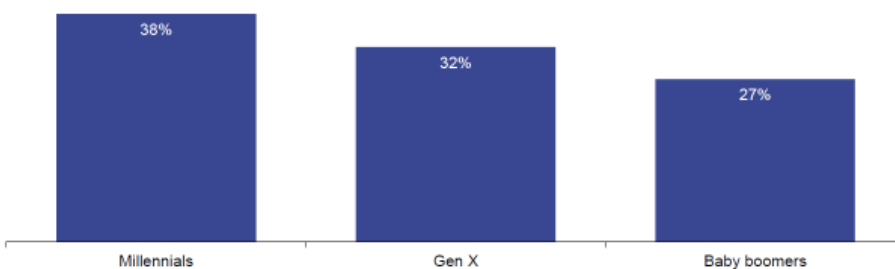
Profile of current ETF investors – by when investors first started investing in ETFs



Source: BetaShares/Investment Trends ETF Report, 2017

Among the online share investor population, the appetite for ETFs is greater among the younger cohort. About 38% of millennials say they use or intend to use ETFs in the coming year, versus 32% for Gen X investors and 27% for baby boomers.

Proportion of online investors who currently use or intend to use ETFs in the coming year



Source: Investment Trends 2017 Australian Online Broking Report

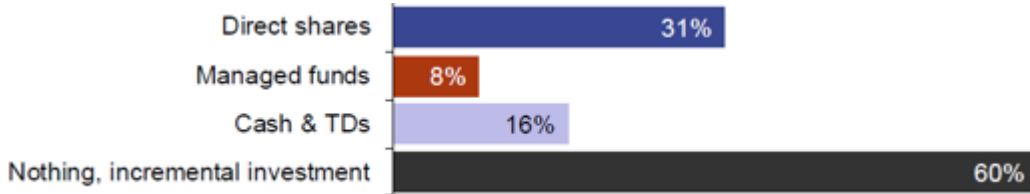
Strong appetite for continued use of ETFs

Repeat investment into ETFs is high, with 56% of investors indicating they would consider re-investing in ETFs in the next 12 months.

ETFs also play a more prominent role in the investment portfolio as investors gain experience using these products. Investors who invested in ETFs under two years ago have an average of 7% of total assets allocated to ETFs, whereas investors who stayed using ETFs for more than four years have around 13% allocated.

The majority of investments into ETFs represents new money into the industry, with 60% of ETF investors buying the products with incremental investment monies, rather than decreasing their allocation to direct shares or managed funds.

What investments did current ETF investors reduce usage in order to invest in ETFs?



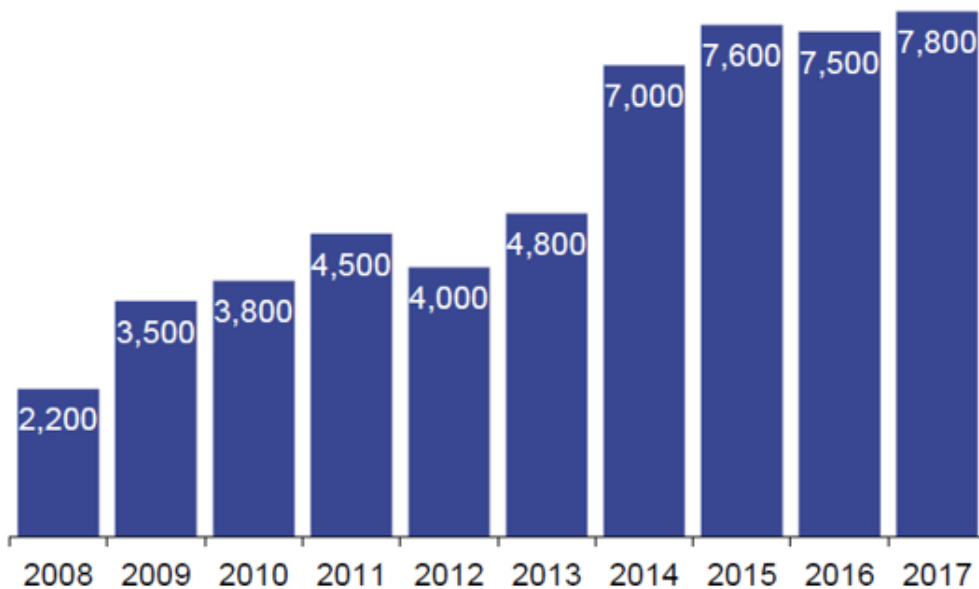
Source: BetaShares/Investment Trends ETF Report, 2017

Financial planners can leverage client interest in ETFs

Financial planners are now adopting ETFs in a meaningful way, with approximately 60% of Australian financial planners currently recommending ETFs or intending to do so within the next 12 months.

Planners who currently recommend ETFs typically invest 17% of new client money in them, and are expressing an intention to increase this allocation over time – with this number set to increase to 20% by 2020.

Number of financial planners using ETFs in Australia



BetaShares/Investment Trends ETF Report, 2017

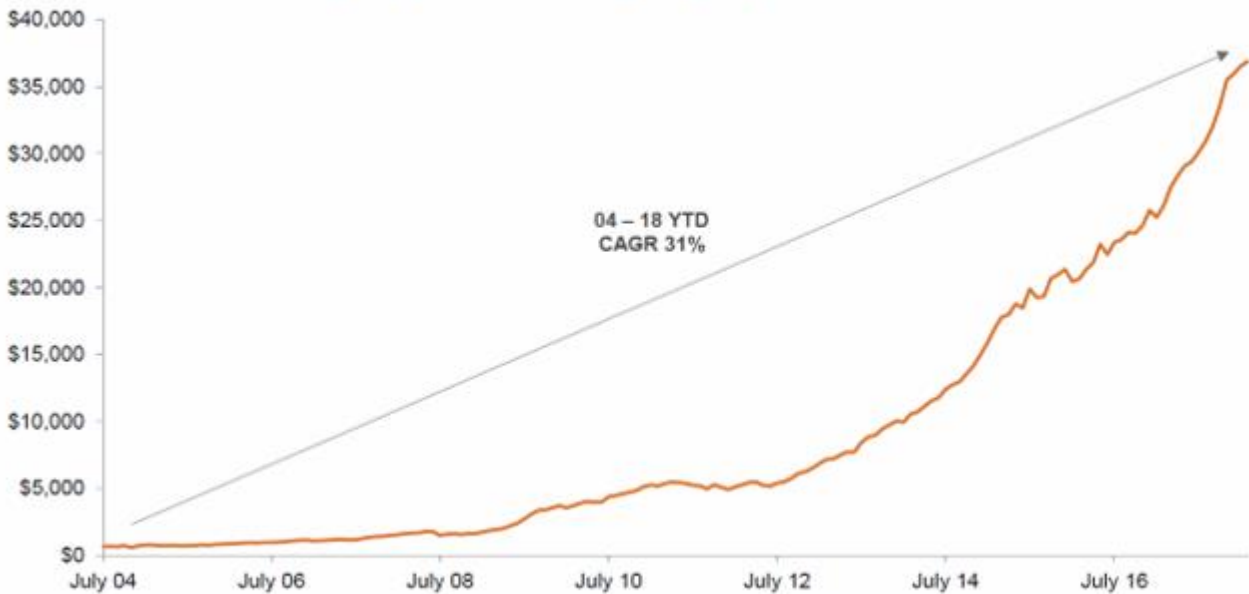
The key motivations for planners recommending ETFs remains similar to those of end investors; low cost, diversification, liquidity, access to specific overseas markets, and access to specific types of investments/asset classes.

While financial planner ETF usage is high, there remains a significant opportunity for financial planners to get more involved in the ETF market, with only 25% of investors saying a financial planner was involved in their most recent decision to invest in ETFs.

Outlook for the sector

The Report projects a record 381,000 Australians will be invested in ETFs by September 2018.

Australian ETP Market Cap: July 2004 – February 2018 (A\$m)



CAGR: Compound Annual Growth Rate
Source: ASX, BetaShares

In line with the growth we are seeing, we project the industry will grow from the current \$36.9 billion (as at 28 February 2018), and reach \$40- \$45 billion in funds under management, with approximately 250 exchange-traded products, by the end of 2018.

Ilan Israelstam is Head of Strategy at BetaShares, a sponsor of Cuffelinks. A summary copy of the Report can be accessed [here](#). This article is general information and does not address the needs of any individual.

Unwinding is warning of late stages of boom

Roger Montgomery

In October 2018 in Cuffelinks, I wrote an article entitled '[Fear of missing out trumping fear of loss](#)' in which I highlighted the overwhelming demand for Argentina's 100 year bond issue, despite the country's litany of defaults, military coups, and bouts of hyperinflation over the last 90 years. The demand for Argentina's bond issue was the tip of an iceberg representing investors' insatiable appetite for returns above cash.

'Fear of missing out' driving markets

From post-80s American art, to low-digit number plates, stamps, coins, wine, and collectible motor vehicles, 2017 saw auction records smashed just as the appetite for Bitcoin, KodakCoin, and any company that added Blockchain or Nodechain to their name, fuelled a fear of missing out that usurped the fear of loss.

Then [last month](#) I wrote; "I do not know with any useful accuracy when the US market will turn down more meaningfully than it did last week ...", and I listed many problems facing markets.

The recent enthusiasm for higher return and higher risk alternatives, which always defines the late stages of a boom, has begun unwinding. And the unwinding will have serious implications for equities, especially those companies whose earnings multiples can only be supported by an uninterrupted period of high growth rarely achieved in the business world.

One useful signpost, following a period of unbridled optimism, that an unwinding has begun, is investors in credit markets pulling back, even while equity investors continue to party.

First, let's look at equities

In late January and early February, volatility spiked but investor bullishness and complacency were largely unwavering, especially when it came to tech stocks – enthusiasm for which was reflected in new March highs in the Nasdaq.

One of the most crowded trades has been US technology stocks. Today the Nasdaq 100 is dominated by a few names as investors have piled into index funds that care little about future prospects or value. Apple (NASDAQ: AAPL) alone accounts for 12% of the Nasdaq 100 index. Alphabet (NASDAQ: GOOGL) at 9.4%, Microsoft (NASDAQ: MSFT) at 8.2%, Amazon (NASDAQ: AMZN) at 6.9% and Facebook (NASDAQ: FB) at 5.5% are the next four largest companies. A significant part of the gain in both the Nasdaq 100 and the S&P 500 indices over the last year can be attributed to an extremely narrow band of tech stocks.

Immovable bullish sentiment toward a narrow band of similar companies is reminiscent of the heavily-crowded positioning that has marked important market tops of the past.

In the week ending 23 March 2018, investors poured \$3.3 billion into the PowerShares QQQ Trust Series 1, the biggest exchange-traded fund tracking the Nasdaq 100 index. It was a cash injection into technology shares not seen since the peak of the tech bubble. J.P. Morgan also reported the biggest weekly inflow ever into equity ETFs in the week ending 16 March of US\$34 billion.

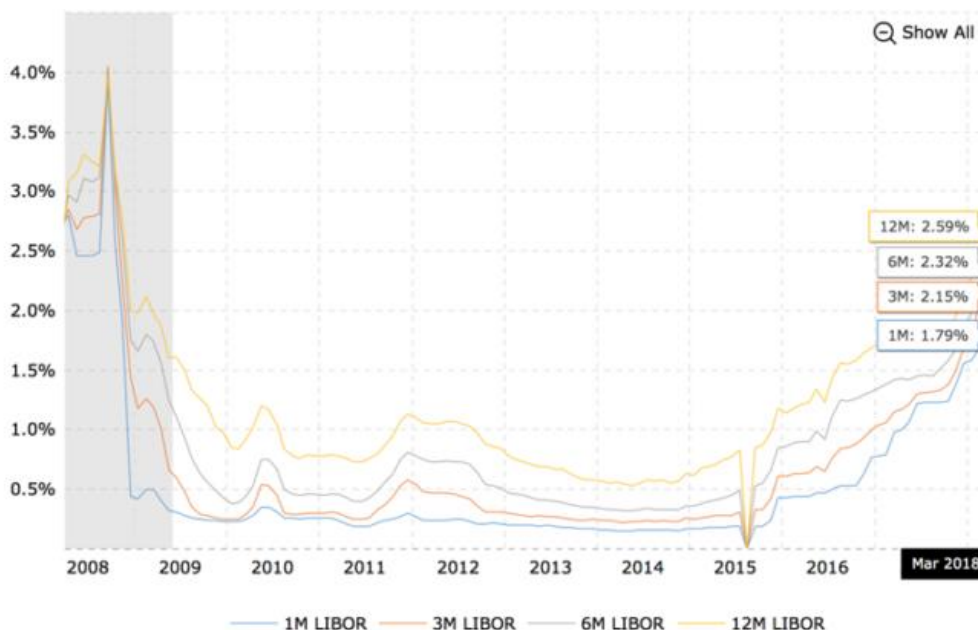
Now to credit markets

Meanwhile, US corporate bonds are sending investors a warning. Investment grade bond spreads now sit near their widest level in six months and yields have risen to their highest level in six years. Corporate bond investors are pushing yields higher, signalling the greater risk associated with investing, while their equity counterparts continue to accept a high P/E and prices that imply ultra-long-term growth rates that few businesses have ever achieved.

Elsewhere, current forecasts for US federal government borrowing needs, expected to exceed 100% of GDP by 2028, are brushed aside. By contrast, we have been reminded of the 1980s, when federal publicly-held debt hitting nearly 40% triggered fears of an apocalypse. According to some analysts the demographics were more favourable in the 1980s, and tailwinds existed in the form of productivity growth, financial-sector deregulation, and benign inflation. Today, these could now be headwinds and yet complacency over rising debt and deficits persists.

We agree with analysts who suggest the jump in the TIPS (Treasury Inflation-Protected Securities) market and in Libor spreads to levels last seen in the GFC should be setting off alarm bells because it is a sign that monetary policy has tightened considerably.

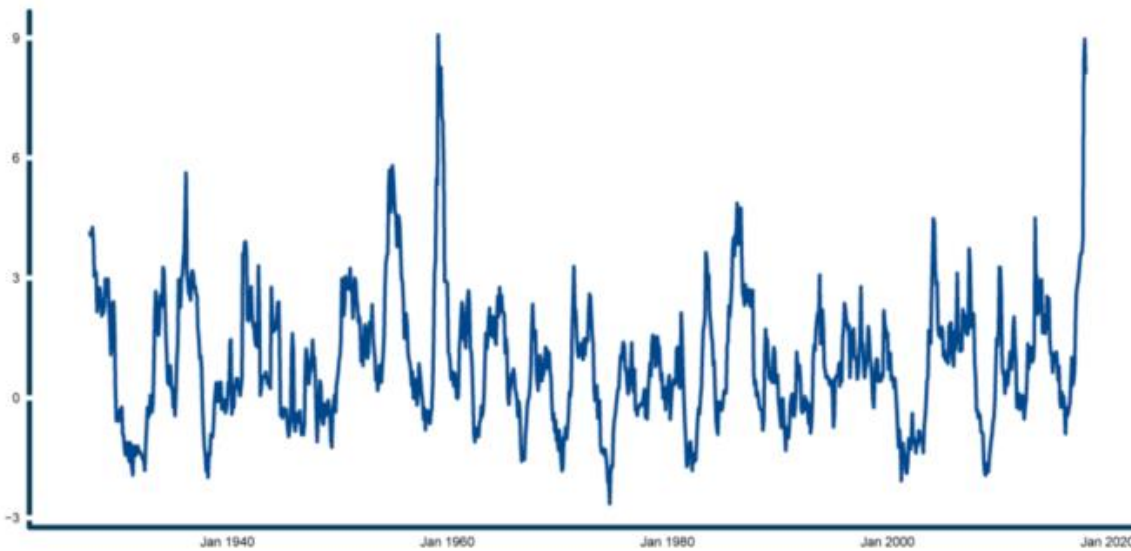
LIBOR rates since 2008



Quantitative Easing has been inflationary for property and financial assets including equities, bonds and bond proxies. Quantitative Tapering will at least generate heightened volatility in the same markets. And as volatility increases, cost-of-capital assumptions increase, opportunity costs rise, price-earnings multiples contract and credit stress or merely fears of credit stress become more frequent.

The 12-month annualised Sharpe Ratio for the S&P 500 reveals that the combination of very high returns and very low volatility in recent times is an anomaly last observed in the 1950s. The combination of higher volatility and lower returns is likely to return.

12-month annualised S&P 500 Sharpe Ratio to Dec.31, 2017

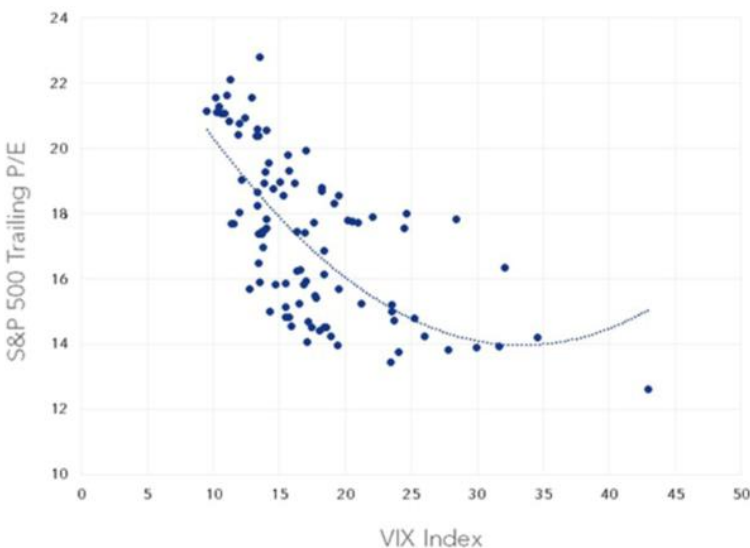


Source: Gestaltu, ReSolve Asset Management

The figure below shows that when volatility (risk) as measured by the VIX index, picks up, P/Es (price to earnings multiples) contract. Investors are simply less willing to make optimistic assumptions about a company’s prospects, and therefore less willing to pay higher multiples, when a fear of loss replaces the fear of missing out.

Volatility as measured by the VIX Index versus P/E ratios for S&P 500

VIX vs. S&P 500 P/E
2010 to present



Source: Bloomberg, ETF Daily News

There are of course many arguments that suggest portfolios should be fully invested. We agree that in the long run, being fully invested is preferred. But it is also true that the higher the price you pay the lower your return, and holding long-term just means locking in a low return on a long-duration asset.

Prices today are factoring in all of the bullish arguments with little room for setbacks, hiccups, or speed bumps. In the bond market, some investors are already leaving. Those who are patient will be well rewarded for making additional investments only when there is blood in the streets.

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

Higher funding costs loom for lower quality assets

Charlie Jamieson

The volatility genie is out now and is unlikely to go back in the bottle as late cycle fiscal expansion in the US, combined with higher global funding rates will have markets on their toes going forward.

The liquidation of the short volatility fund XIV (Velocity Shares Daily Inverse VIX) in February 2018 could be the Bear Stearns peek behind the curtain before a larger Lehman crescendo. The now-liquidated XIV product did exactly what it was designed to do, making a small amount of money each day for being short volatility until in one single day everything was lost. Any ETF owners of risky assets (particularly credit ETFs) should be wriggling in their chairs right now, for the XIV was totally a victim of its own success. The volatility community knew full well the thresholds required to trigger a XIV liquidation, and surely helped itself to a grand feast pushing volatility higher and higher until the XIV fund was forced to enter the market and cover risk at high prices, thereby guaranteeing its own death spiral.

Credit ETFs have systemic weakness too

We have long argued that higher funding costs will be a huge problem for lower quality assets in a highly leveraged world, as higher funding costs not only create an income shock in the near term, but also lift refinancing hurdles over time.

As funding costs are rising and liquidity is being withdrawn (illustrated with LIBOR rates rising), investors need to think through liquidity sources, their individual liquidity needs going forward as the tide goes out, as well as the asymmetry of some current portfolio holdings.

Certain parts of the credit market (particularly 'perceived' high returning liquid credit and high yield) often re-price in an asymmetrical manner. We need look no further than a well-known highly leveraged US infrastructure fund that recently lost around 40% of its value in one day after provisioning for higher funding and debt obligation costs.

Warren Buffet's famous quote, "You never know who's swimming naked until the tide goes out", is a perfect illustration for the current leveraged environment. In adding large US fiscal deficits to a late cycle environment, plus the addition or continuation of higher funding pressure via US rate hikes, the tide is most certainly going out right now for certain parts of the credit spectrum (i.e. lower parts of the capital stack). Often at the end of a cycle, we get a systemic shock: a company or group of companies that fail unexpectedly from sailing too close to the wind.

The danger for credit ETFs comes from the massive credit liquidity gap that now exists between credit debt outstanding (which in the US has roughly doubled since the GFC) and primary dealer inventories which have shrunk more than sixfold. To put that in context, the credit liquidity gap is now twelve times the size it was going into the GFC, when credit products froze and were gated for long periods, on one twelfth of the liquidity mismatch. The rise of credit ETFs gives the market a host of products that they can collectively target in adverse circumstances, forcing them to rebalance into weakness without any circuit breakers seen in equity markets.

Good news velocity turned negative as higher rates are biting

We retain our view that the US Federal Reserve will likely hike interest rates three times in 2018 (this alone will keep pressure on low quality risk assets via funding costs), however, the extrapolation by some pundits of the late 2017 environment is short sighted. We need to consider the 'flow' of markets rather than just focusing on the 'stock'.

Global economic data has been nothing short of great over the later part of 2017 and early 2018. However, the velocity of that data has now turned negative and the sell-off in US bond markets is having an impact. Some isolated recent global data to indicate this include: US durable goods orders -3.6%, US factory orders -1.4%, Germany factory orders -3.9%, and very weak global retail sales. London house prices dropping at the fastest pace since 2009 (Wandsworth/Fulham lost 15%), and US mortgage applications -6.6%. Data has been decaying quickly with a large geographical reach.

Quantitative tightening needs a bond buyer

Calendar 2018 is shaping to be a pivotal year. Political policy is changing, monetary policy is being normalised and asset markets will be asked to stand alone with less central bank intervention. Higher volatility is almost certainly here to stay, making investors demand more in return for the higher volatility risk they must endure.

There is widespread market concern about the withdrawal of global central bank balance sheet accumulation, known as Quantitative Tightening (QT). This term was first used in early 2016 when the Chinese central bank was selling \$100 billion dollars of US Treasuries a month to stem capital outflow from China. Many then wrongly assumed yields would rise sharply given the world's biggest bond buyer had become a net seller. In fact, yields fell and bonds rallied through this period as a 'flight to quality' bid emerged from the private system as other risk asset markets decayed.

Fast forward to 2018 and QT is again topical, as central banks have telegraphed a decline in balance sheet growth. However, that isn't the full story for the bond market, because the existing 'stock' of previous Quantitative Easing (QE) actually creates new 'flow'. When bonds on central bank balance sheets mature, their proceeds have to be reinvested just to keep the 'stock' of balance sheet from shrinking. In other words, even in QE the 'stock' itself generates 'flow'. And as the stock gets bigger, so do the reinvestment flows: in 2018 total QE reinvestment flows will be some US\$990 billion, vs US\$600 billion in 2016 and 2017. Those reinvestment flows already outstrip balance sheet expansion, with global central bank balance sheet expansion slowing down, reinvestment flows have already become larger than 'new' QE flows.

AUD bond rates below US Treasuries

Our expectation is that the RBA remains firmly on hold in 2018 whilst the US Federal Reserve continues to lift interest rates. We expect this interest rate decoupling to continue and as a result pressure to build on the AUD currency over the year.

The huge fiscal expansion in the US (despite being in the 10th year of recovery) has forced US bond yields higher due to vastly increased US bond supply. This has taken Australian interest rates below that of the US across all key maturity points on term structure curves for the first time since the year 2000. The continued decoupling of US and Australian interest rates reflects the vastly differing economic outlooks and budgetary positions between the two nations. Interestingly the last time these yield differentials were negative, the AUD was around 0.50 cents to a USD, rather than today's 0.78 cents.

Charlie Jamieson is Executive Director and CIO of [Jamieson Coote Bonds](#). This article is general information and does not consider the circumstances of any investor.

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