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How investment property returns depend on politics

John Daley, Brendan Coates and Trent Wiltshire

Australian housing has been a good investment with prices more than doubling in real terms over the past 20 years. Since 2012, house prices have risen 50% in Melbourne and 70% in Sydney. Our recent report, [Housing affordability: re-imagining the Australian dream](#), investigated the trends.

Prices went up the most in inner cities. People paid a premium for dwellings with good access to areas near the CBD where employment has grown fastest. And lower-priced dwellings [increased in value](#) more than higher-priced dwellings. Investors preferred lower-price property, below land tax thresholds. Shifts in migration rules skewed population growth towards younger households that typically buy cheaper housing.

The perfect storm created the price boom

Overall, prices went up because of a perfect storm of rising incomes, falling interest rates, rapid migration, tax and welfare settings that fed demand, and planning rules that restricted supply. And as with any asset, there's always the possibility that some of the current price is purely stemming from irrational exuberance.

The key question for investors is whether the good times will roll on for housing. Investors in residential housing are counting on continued strong capital growth. Most of them are negatively geared, and that only makes sense if housing values continue to soar.

Future prices depend on many factors. Recent history can tell us a lot about what matters.

Many of the drivers of rapid housing price growth may be slowing. Household incomes rose about 30% in the 10 years to 2013. Since then, real incomes have barely moved, as Australia ran into the headwinds that have afflicted many other developed countries. Housing prices also rose because interest rates fell, but nominal and real official interest rates are now at around their lowest in Australian history. If interest rates rise, one would expect housing prices to fall.

Housing prices also rose because tax and welfare settings boosted demand. In 1999, the Commonwealth switched to taxing half of *nominal* capital gains rather than all of the *real* capital gains. Given actual capital gains and inflation rates, this increased the after-tax returns on investments like housing with higher capital returns but lower annual income returns. The capital gains on homes have never been taxed. And there are big

welfare advantages to home ownership in retirement, because the means test for the age pension ignores all but the first \$200,000 of the value of a home.

Migration and population growth driving prices

These tax and welfare settings may not last. Australian government budgets are challenged. Not only is the population ageing, but a declining proportion of those over 65 is paying tax. Inevitably, policy makers are starting to focus on the tax and welfare settings that provide substantially greater benefits to older Australians. The ALP has already committed to changing capital gains tax and negative gearing rules. Changing the age pension means test to include more of the value of the home might be unpopular, but it is about the only policy change that boasts a unity ticket between think tanks from the right, left, and centre. If any of these policy changes are implemented, they are likely to weigh adversely on housing prices.

Demand for housing also rose when Australia's net migration rose substantially from about 2006. Population growth averaged 210,000 per year from 1990 to 2004, but 360,000 per year from 2005 to 2016. After dipping a little in 2014-15, net migration is now at record levels in Sydney and Melbourne. Governments can slow migration. It's not a first-best policy option, but the discussion is becoming louder. If governments do tap the brakes on migration, then house price growth is likely to be lower.

Population growth wouldn't have affected prices so much if supply of new housing had kept up. But while population growth jumped from about 2005, dwelling construction didn't rise much until 2013. [Reserve Bank analysis](#) suggests that much of the price rises reflected the 'zoning effect' – a premium paid for planning permission to build a dwelling on the land. Their work shows that the zoning effect explains around 40% of the price of a typical detached house in Sydney or Melbourne. In 2000, before demand for housing took off, the effect was only 20% of the value of a house in Sydney, and negligible in Melbourne in Brisbane.

The zoning effect reflects political reluctance to permit enough subdivisions relative to demand. Many voters support increased density, but only in the suburb next to theirs.

These patterns are already changing, with substantially more apartments completed in 2015-2018. Sydney allowed far more 5- to 9-storey developments along major transport corridors; Melbourne allowed more high-rise in the centre of the city, and Brisbane allowed more 10- to 20-storey buildings on the edge of the CBD. Although the strategies varied, in each city these materially added to supply. As a proportion of the population, the change was greatest in Brisbane, and apartment prices there have moderated over the past 18 months.

A key issue for future prices is whether state governments and local councils continue to permit increased levels of medium- and high-density development in our major cities. The issue is intensely political. A [backlash is brewing](#) in Sydney. Local residents usually oppose increased density because of the additional pressure it tends to impose on local resources from parks to parking. But the penny is starting to drop that the failure to permit more housing means that 'my children can't afford to buy a house'.

The political trends that will influence housing price trends

Housing affordability has become the second most important issue on voters' minds (after health). While other solutions (such as regional development and first-home buyer concessions) are politically popular, they won't in fact fix the problems. If governments want to allay voter worries about affordability, they will have to permit more building. The political paradox is that improving affordability for new home-ownership implies less capital growth for investors and homeowners.

The political pressures will be more intense because it is also increasingly obvious that housing is one of the biggest causes of the [widening wealth gap](#) between high- and low-income households, and between older and younger households. Age-based voting emerged as a force in the last United Kingdom election, and there are signs that political parties are positioning themselves in Australia to respond to the increasingly different social attitudes and economic interests of older and younger generations.

And our major cities are increasingly geographically divided between: the centre and middle, with higher incomes, levels of education, and female workforce participation; and outer suburbs with fewer advantages. This is a poor economic outcome – because employers ultimately have a smaller potential workforce than otherwise, and a bad social outcome – as rich and poor live increasingly segregated lives.

To some extent, the long-run returns to housing investment depend on macro-economic conditions, particularly incomes and interest rates. As such, they aren't so different from equity investments. But housing investments also depend a lot on policy decisions around migration, tax, and planning that will particularly affect the housing market. Housing depends, more than most investments, on the politics.

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The voting machine and the weighing machine

Tim Carleton

"In the short run the market is a voting machine but in the long run it is a weighing machine." – Benjamin Graham

The father of value investing, Benjamin Graham, said it so eloquently. In the short run many different things seem to matter. Investors focus on reports from journalists, brokers, market commentators, and anyone else trying to explain short-term gyrations in markets and prices. The *post hoc* causes of the dramatic recent market sell-off that we have read about include rising bond yields, inverse volatility, exchange traded notes, rising wages, the US Government deficit, computers running complex algorithms, profit taking after strong global markets ... the list goes on. In the short run, all of these factors seem to get a vote. The weighing machine of earnings and valuation can take a backseat as the market voting machine swings into action.

Ultimately, earnings matter

In the long run what is being weighed by the market are earnings, because ultimately earnings drive share prices. Earnings are what long term investors focus on. Short-term share price movements and gyrations in the broader market are hard to predict. Short-term movements in share prices are often random. They can be a function of an investor that decides one morning to buy or sell. They can be in response to someone leveraging or deleveraging their portfolio. They can move because of macroeconomic events. They can move on changes in investor sentiment. We are not aware of any person who has repeatedly and successfully predicted these short-term movements. We are, on the other hand, aware of many investors who have unsuccessfully tried to 'time' their investments.

Macquarie is an example of a high-quality business, with a strong return on capital, good cash generation, and a sensibly geared balance sheet. It has exposure to a number of financial sectors that are experiencing strong tailwinds. Its largest profit contributor is an asset management business centred around a global infrastructure portfolio.

However, its share price moves around wildly. During a recent market sell-off, Macquarie Group announced a near 10% upgrade to earnings, yet its share price fell over 8% in a matter of a few days. Did the *value* of Macquarie Group fall over 8% in this period? We suggest not. There will be many commentators espousing a *post hoc* view as to why Macquarie Group fell so significantly.

The simple fact is that more people wanted to sell the stock than buy the stock at a particular point in time so the price declined. What matters is what happens to earnings over time. And for very good reason. Ultimately the market will weigh the earnings of the company, which will be reflected in the share price. The evidence is clear in the fifteen-year chart below. Eventually the share price will follow the earnings of every listed company.

Macquarie Group Earnings and Share Price



Source: Bloomberg, Auscap

Stock price volatility that is not a response to volatility in company earnings is an opportunity for the patient investor who understands that it is the weighing machine not the voting machine. Focusing on the medium to long-term earnings profile of a company is the most sensible approach to long term investing.

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Investing complexity is a massive industry failing

Chris Cuffe

I hate paperwork. Although I originally trained as an accountant, and I'm happy to bury myself in spreadsheets and annual reports, I have too many other priorities to be bothered filling out lengthy application forms. Yet I want to invest with some fund managers who only offer their products through unlisted managed funds with application processes which have changed little in 20 years. These may include boutique Australian equity funds, international funds, unlisted private offers, property trusts and private equity deals which cannot be accessed another way. Investing in some of them feels like a visit to the dark ages, not much better than quills and scrolls.

Why has the wealth management industry made the application process so complicated and time-consuming and devoted relatively few resources to solving the regulatory requirements imposed on it? When I think of the thousands of hours and millions of dollars spent on self-interested lobbying against, say, the Future of Financial Advice (FOFA) proposals, to little avail, resources could have been much better spent addressing a major consumer need.

Industry groups, especially the main body representing the major retail funds, the Financial Services Council (FSC) have not developed solutions. Instead, a gap has been left in the market which products like ETFs and LICs have been rapidly filling through listed products.

What is the problem?

Let's say a property group acquires a large, iconic building and launches an attractive new property fund product following months of structuring and negotiation. They prepare marketing materials, webinars, presentations and advertisements. Investors are invited to onsite inspections. It's all very exciting. The property group sends its Business Development Managers far and wide meeting advisers and investors, and the launch date comes with much fanfare. The Product Disclosure Statement with the application form is sent to registered investors and other names on the mailing list, with brochures showing the steel and glass structure and its spectacular location.

Eagerly, the applicants read through the offer, and impressed by the long lease to national tenants, they reach the application form.

Sigh! Here comes the slog.

Section 1, Type of Investor, Individual must fill in sections 2 and 5. Trust or super fund, such as an SMSF, fill in sections 2, 4 and 5. Each different type of applicant fills in different sections. Is it the section for an Individual or an Individual Trustee? What if there are two trustees? OK, let's take a guess.

Identify both trustees, including Tax File Numbers (TFN). Then it says, "You must attach certified copies of documents to this application form." Is that all documents? Choose Option A, or Option B Category 1 PLUS Option B Category 2 as forms of identification.

Now, identify the corporate trustee. Who are the beneficial owners? Which TFN does it mean? Identify them as well. Then identify the SMSF itself, including a certified copy of an 80-page trust deed. What! Is that the entire document or the cover page, and is it every page that needs certifying? And do they need any deed amendments too or just the original deed? What's the name of the regulator, is it ASIC (for the trustee company) or the ATO (for the SMSF). And the TFN for the SMSF. That's disclosure of four TFNs. Now, here comes FATCA. Is this a Managed Investment Scheme? Adviser details, payment details, contact details ...

Still excited? I don't think so. I gave up a long time ago. Life is too short. Some fund managers with an online application process admit to a 90% drop out.

How did the industry allow it to come to this? The property company has spent hundreds of millions of dollars on a six-star building then laid out a one-star application process.

According to Investment Trends, 58% of Australian investors do not intend to use managed funds in the near future, and when asked why, the top two reasons are cost and the complex application process. Hard to believe the industry has tolerated this for so long.

Is anyone processing applications well?

A few companies have taken some of the hassle out of the application process, and automated as much as possible. However, I am reluctant to identify them because, in my experience, there is often a breakdown in a step along the electronic process. These more advanced systems tailor the questions for the type of entity and link customer details to a range of electronic or manual verification options. It is up to the fund manager to decide the level of verification required based on their interpretation of the law.

Many fund managers still require the delivery of certified copies into an office or by post, and they seem especially clunky with SMSFs, where the individual members, corporate trustee and trust have different identifications. Each application process seems to have a variation on requirements.

Of course, wraps and platforms go some way to addressing the problem, as one application gives access to potentially hundreds of fund managers. But these only work if the product required by the investor is listed on the platform, and it is usually not worth a one-off fund or a small boutique manager going through the platform approval process.

The ASX might argue that its mFund service addresses this problem by allowing order execution (but not real-time pricing) by clients already identified by their brokers. However, some fund managers will not fulfil mFund orders on global investments until a detailed FATCA report is completed, which somewhat defeats the purpose of eliminating paperwork.

What is the source of the problem?

There are technology companies marketing fund application solutions, claiming their entire process is automated and online. Some fund managers have designed their own online solutions. The limited adoption of these services goes to the heart of the problem. Just because a company has a lawyer willing to sign off on a process does not mean we have reached an industry-wide solution.

Within the offices of each fund manager, lawyers design application processes to comply with their own interpretation of laws and regulations. Many remain apprehensive that a totally online application process fulfils legal requirements relating to Know Your Customer (KYC), Anti Money Laundering (AML) and even privacy requirements. There is little comfort in a software company telling the marketing person (who wants simple applications to maximise fund flows) that their process complies with all relevant laws when there is an in-house lawyer with a different opinion. That's just lawyers at 10 paces. The in-house lawyer's job is to protect the fund manager, not the software provider.

The ongoing dispute between AUSTRAC and the Commonwealth Bank has increased caution. No fund manager wants to be the next target for accepting money from a client without sufficient identification. Imagine the lines of enquiry when a regulator is told the fund manager accepted an electronic facsimile of a signature which anyone could have signed.

"Does anybody know or has anyone even met the customer?"

"Have you seen a copy of the SMSF Trust Deed to know the trustee even exists?"

"Did you obtain a certified hard copy of the identification form of everyone involved?"

A lawyer confirmed to me there is no legal requirement for a 'wet signature', but there remains "apprehension that electronic identification is sufficient, leaving the reporting entity to decide whether to accept the risk". He said it's an "evidential thing".

What is the solution?

The industry will not accept a 'solution' from a software provider who hopes its process will become widely adopted by all participants. I'm not saying these companies cannot find clients, but overall, it will not become the industry standard required.

I believe there are two roads forward to solve this inefficiency dogging the industry.

First, a company or body that carries government support and the confidence of the industry should develop an industry standard. Ideally, an applicant would be approved once, given a code or PIN, and this would be accepted by all fund managers. Such a body might be under the auspices of the FSC or the Australian Securities Exchange or even Australia Post, with the support of ASIC and the ATO. An industry group would interpret the law and gain agreement across the industry.

Second, it should work off the APIR standard which has been used for identifying and coding data for unlisted products since 1993. The Superannuation Product Identification Number (SPIN) is an APIR code and with a fund's ABN, is accredited by the ATO for Superstream.

Make it easier to invest

With fintech, regtech, roboadvice, AI, machine learning, blockchain and a thousand other technologies flying into the funds management industry from all directions, it's inconceivable that applicants should fill in 12 pages every time they invest with another fund manager. The industry must work to a common solution for the sake of everyone's efficiency.

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Turbulence creates opportunities for bonds and hybrids

Christopher Joye

Most investors have polarised portfolios bifurcated between cash deposits and equities. Few appreciate that these two very different securities span a rich corporate capital structure that allows for a much more continuous distribution of risk and return experiences.

One powerful illustration of this point is the recent financial market turbulence, which has unearthed some fascinating opportunities across the cash deposits, senior bonds, subordinated bonds and hybrids issued by the major banks.

Let's deal with each in turn. The hybrid market has been hammered by a number of technical, or non-fundamental, shocks since late January 2018. First, Westpac and then CBA both announced large hybrid deals (WBCPH and CBAPG respectively).

Over \$3.1 billion of new hybrid supply

It is quite unusual to have two major bank hybrids launched at effectively the same time, and we explicitly warned CBA about following Westpac so closely. In total, the two major banks have flooded the ASX with over \$3.1 billion of new hybrid supply over February and March.

When Westpac officially launched WBCPH in early February we wrote that fair value for this security with no 'new issue concession' was a spread of 3.43% above the 3-month bank bill swap rate (BBSW) based on the spreads offered by similar major bank hybrids at the time.

We would normally expect a minimum of 0.2% (or 20 basis points) in extra spread as a new issue concession, or a total trading margin of about 3.6% above BBSW. Rightly or wrongly, Westpac chose to issue almost \$1.7 billion of hybrids at an incredibly tight spread of just 3.2% above BBSW, or 0.23% less than the fair value margin assuming no new issue concession.

Today WBCPH is unsurprisingly trading poorly, bid at \$96.90 on 26 March, which translates into a 3% plus capital loss for the original investors in the issue.

New hybrid margins too skinny

CBA offered a 3.4% margin above BBSW for its new CBAPG security, which was the secondary market fair value on the same day that Westpac launched. The problem is that the effect of bringing \$3 billion plus of new hybrid supply to market blew-out this fair value margin to 3.5% on 2 March before one accounts for any new issue concession (ie, 3.7% including one).

With Westpac and CBA both paying brokers and advisers sales commissions of 0.75% on the new deals to push them, we have seen enormous churn, or selling, of older existing hybrids paying superior spreads (or returns) to the new securities.

This temporary dislocation has been amplified by Bill Shorten's sudden announcement in mid-March that Labor would ban cash rebates on franking credits (notably not franking credits themselves). While the policy does not affect more than 92% of all taxpayers, and Labor has subsequently diluted it down materially by expressly excluding all pensioners and part-pensioners (over 300,000 retirees), including pensioners in self-managed super funds, the knee-jerk reaction on the day of the news was savage with hybrid prices falling over 0.4%.

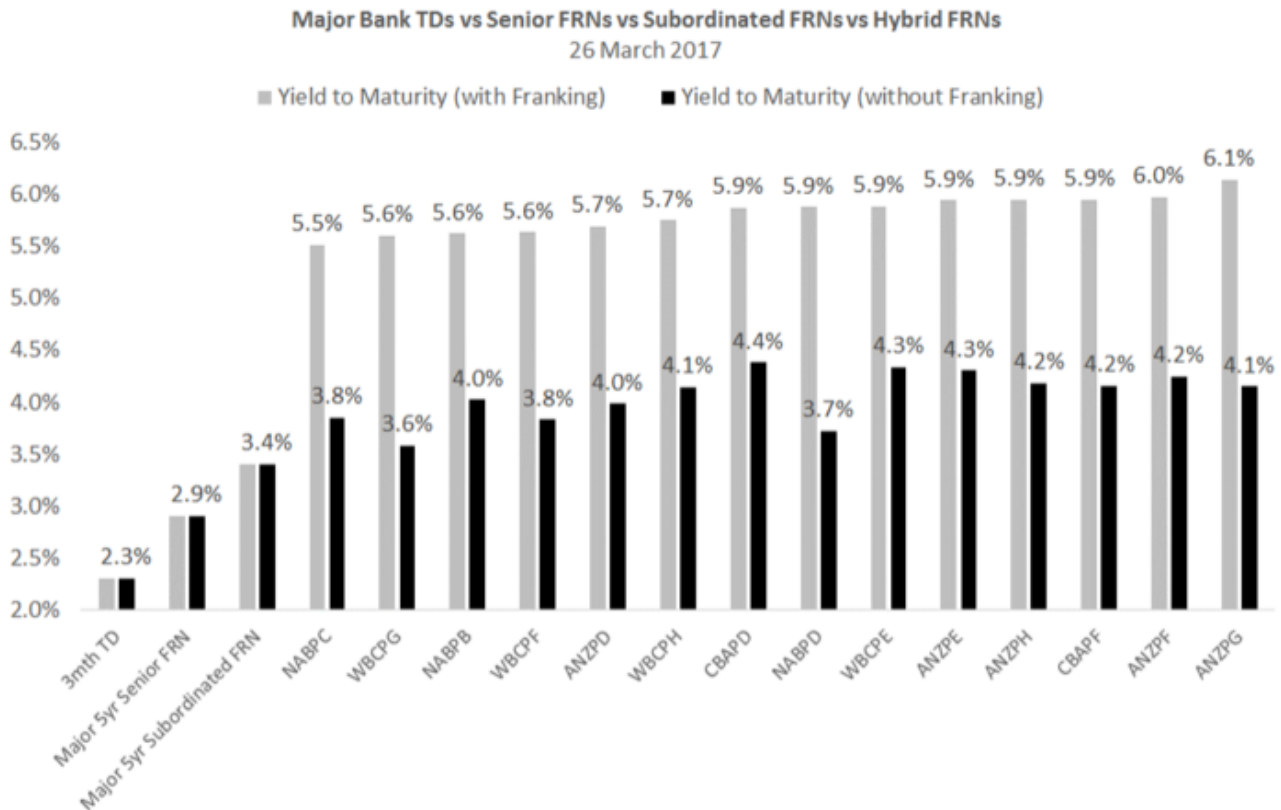
The reality is that both parties have confirmed their support for the franking system, which is a win for investors, and anyone who happens to not be able to fully use franking credits will be selling to buyers who can price them in.

Hybrid cash yields over 4%

Even excluding all franking credits, major bank hybrids like CBAPD are paying a very attractive, 2.38% cash spread above 3-month BBSW, which means it is offering an all-in cash return of 4.38% for a BB+ rated security that has much better liquidity than other Australian sub-investment grade bonds.

With franking, CBAPD's spread above BBSW jumps to 3.87%, which represents a total yield to maturity of 5.87% (see the first chart). Put differently, cash returns on hybrids today are significantly above anything else that investors can switch into with comparable risk. For the 9.5 out of 10 people that can still use franking

credits if Labor wins the election, and the pensioners that can still get cash rebates, the fully franked yields are in the order of 5.5% to 6.1% per annum.



ASX hybrid supply to shrink

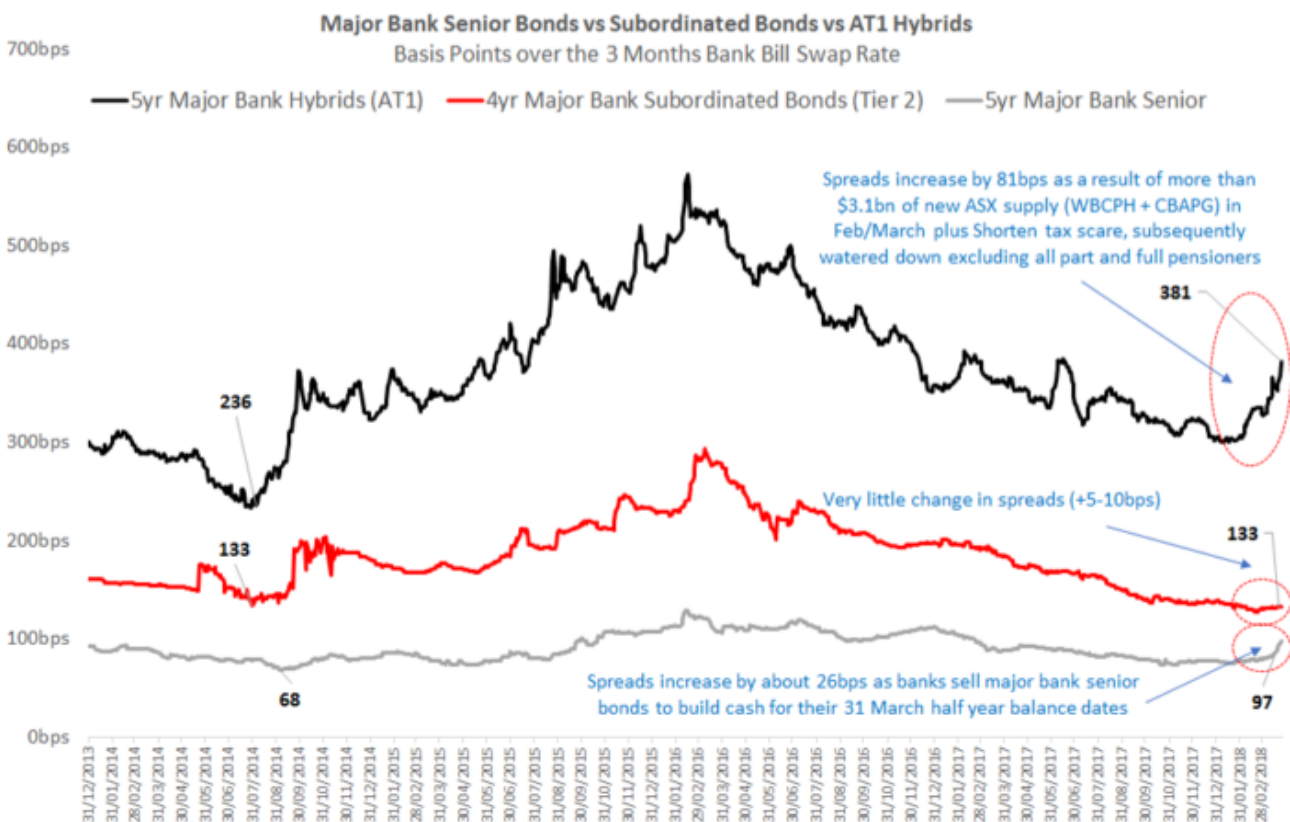
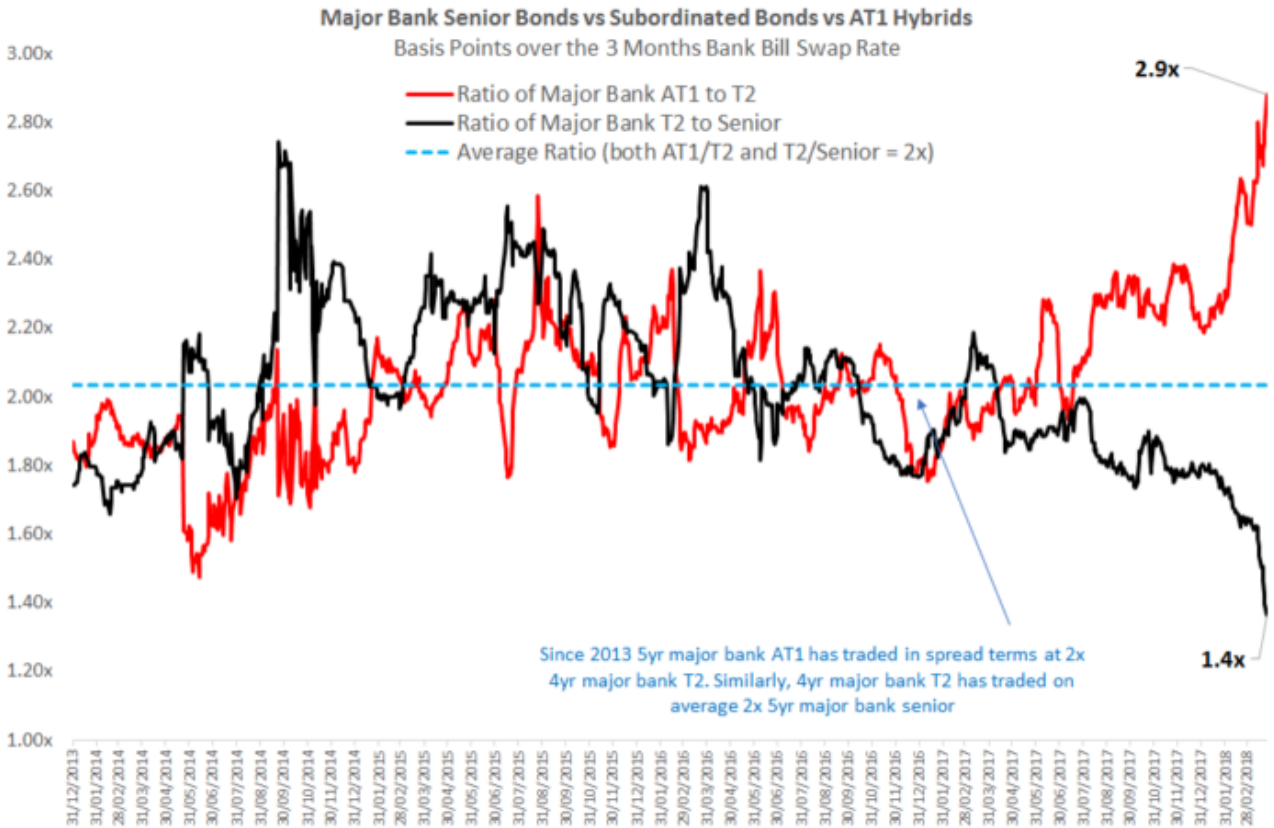
We believe that the stock of ASX hybrids will shrink over time as the major banks shift some of their issuance to the deeper US dollar market, as ANZ, Westpac and Macquarie have recently done. And we think that there will likely be unlisted issues of major bank hybrids to institutional investors in the Aussie dollar over-the-counter market in the years ahead, which will collectively combine to create a shortage of ASX supply.

Whereas 5-year major bank hybrids were paying spreads of about 3.0% above BBSW in January, this has now blown-out to 3.81% as at 26 March. This is about 1.45% (or 145 basis points) above the mid 2014 'tights' of circa 2.36% above BBSW even though the major banks have massively increased their common equity tier 1 (CET1) capital ratios from around 8% in mid-2014 to circa 10.5% today. This increase in CET1 capital directly reduces the risk of the hybrids being automatically converted into bank shares, which occurs when the CET1 ratio falls to 5.125%.

Hybrids much more attractive than subordinated bonds

The unusually attractive trading opportunity associated with major bank hybrids is highlighted by the second chart, which examines the historical ratio of 5-year major bank hybrids over 4-year major bank Tier 2 subordinated bonds (we use the 4-year maturity because there are more securities to sample from). It also compares 4-year subordinated bonds to 5-year major bank senior bonds.

Since 2012 both ratios have tended to oscillate around a 2-times-multiple until late 2017 when subordinated bond spreads compressed further than hybrids and major bank senior bonds. But the real break has been seen in 2018 where the ratio of major bank hybrid to subordinated bond spreads has exploded to its highest level ever of 2.9 times. At the same time, the ratio of subordinated to senior bond spreads has also fallen to its lowest level ever at 1.4 times.



As there are no credit events affecting major bank paper – as borne out by the strength of the riskier subordinated bond securities and only marginal increases in the major banks’ 5-year credit default swap spreads – it is likely that hybrids and senior bonds have been impacted by one-off ‘technical events’ that should normalise over time.

Major bank senior debt spread changes

Normally among the safest and lowest risk assets other than cash, the major banks' AA-rated senior-ranking floating-rate notes (FRNs) have gapped some 26 basis points wider in spread terms since January 2018. Specifically, the bid for 5-year major bank senior FRNs has jumped from 0.74% over the 3-month BBSW to around 1.0% over, which has in turn reduced the clean price of these bonds by almost 1%.

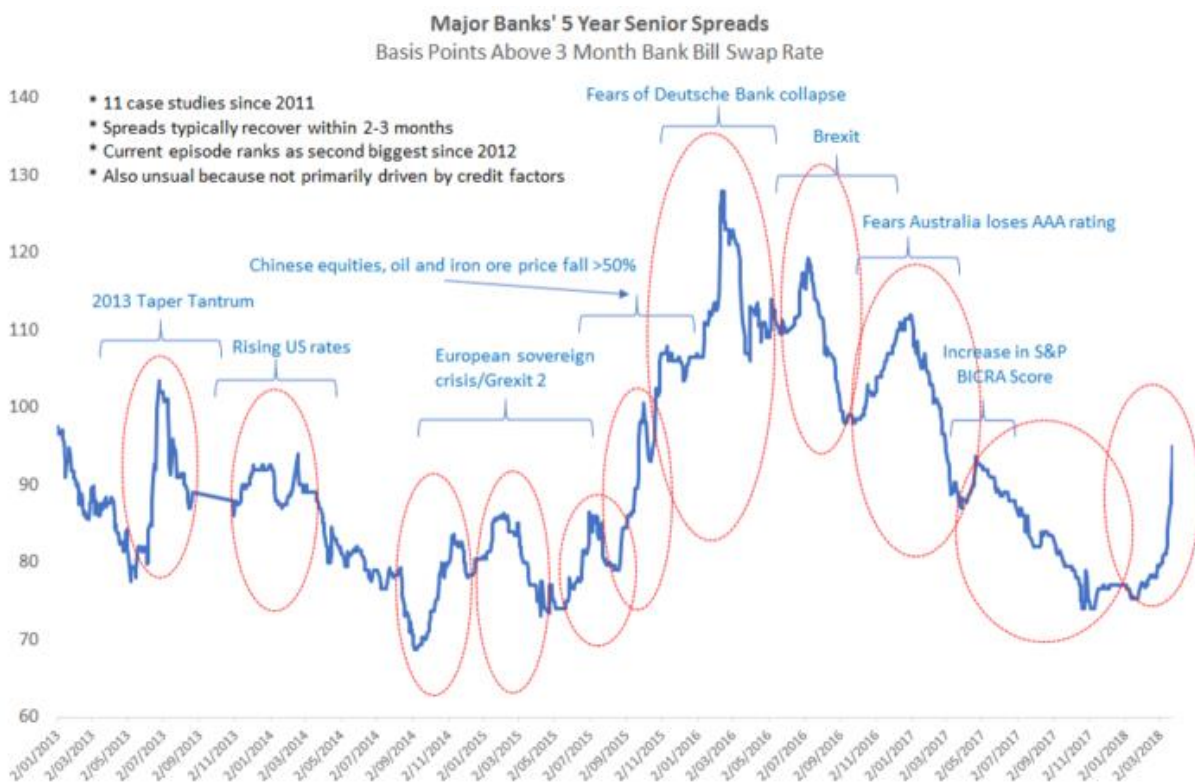
After a massive increase in major bank senior spreads over late 2015 and early 2016, which was subsequently reversed, this is the biggest spread widening in major bank senior bonds since 2012. However, it does not appear to be driven primarily by credit-related concerns as was the case in 2015 and 2016. The major banks' subordinated bonds are behaving like they are safer than senior debt. In 2015/2016, the blow-out in major bank subordinated bond spreads was 1.5 times to 2 times more than the increase in senior spreads.

Banks selling to boost LCRs

So what is going on? We understand US companies have been pulling their cash deposits out of Australia and sending the money back to the US following recent tax changes made by President Trump to encourage the repatriation of capital. This has left Aussie banks with lower than normal amounts of cash on their balance sheets.

Market participants report that over the last month or two these banks have been selling their holdings of major bank senior bonds, which are among the most liquid assets (ie, easy to both sell and buy-back), to improve their cash ratios coming into their half-year ends. Specifically, they want to boost their 'liquidity coverage ratios' (LCRs).

At the same time, important buyers in the market in the form of Japanese banks, life insurance companies and asset managers have temporarily disappeared because all Japanese institutions have their full financial year balance dates on 31 March. Market participants suggest that these Japanese investors ordinarily withdraw from the market in the final month of their financial year, returning again in April.



Cash rates spike

The jump in 5-year major bank senior spreads has been significantly amplified by a very large increase in the 3-month BBSW from 25 basis points above the RBA's 1.5% cash rate (or 1.75% in total) to 50 basis points above cash, or 2% today. This has likewise been driven by non-fundamental factors.

Specifically, an increase in short-term US government debt issuance has pushed all short-term money market interest rates higher. This has been accentuated by changes in US regulations in 2016 that encouraged US money market funds to shift their capital from short-term bank paper to government bonds, which has created a scarcity of short-term funding.

It would, however, be unusual for BBSW to remain at 50 basis points above the RBA cash rate, and these spikes have always normalised historically. Until BBSW mean-reverts, investors in major bank senior FRNs can potentially get an extra 51 basis points of return (26 basis points from major bank senior spreads and the 25 basis points via BBSW).

A final influence on these interest rates has been the general widening in credit spreads globally, although this has not been driven by any empirical deterioration in credit fundamentals. The move wider in spreads has been mostly explained by technical factors in the northern hemisphere.

Christopher Joye is a portfolio manager with [Coolabah Capital Investments](#), which invests in fixed income securities including those discussed by this column. This article does not address the individual circumstances of any investor.

Reports of the death of economic cycles are greatly exaggerated

Don Stammer

Following the global financial crisis, many investors came to expect a new normal of slow economic growth, negligible inflation and sustained low interest rates. Cyclical swings in the economy, inflation, and bond yields largely disappeared from investment discussions.

Since the second half of 2017, this new orthodoxy has been challenged by quickening growth in the global economy and by inflation reappearing in the US, causing bond yields to quickly move higher. Share markets turned choppy and, for a while, extremely gloomy.

This isn't the first time widespread predictions of the taming of the cycle in the economy and investment markets had taken hold – and proven to be wrong.

Why do economies and investment markets have cycles?

Cycles occur because we are affected by the optimism or pessimism of others, because governments and central banks often change their policy settings 'too much' and 'too late', and because of the big swings in credit.

No two cycles are ever the same. Cycles aren't rhythmic. Previous cycles have been affected by globalisation, the IT revolution, China's modernisation and the float of the Australian dollar, but less than is generally realised at the time.

Let's look back on two earlier episodes from the last 70 years when many investors believed the cycle was tamed permanently. In my view, we're at another point in time when cycles will reassert themselves.

Example 1: The 1950s and 1960s were the heydays of the so-called 'Keynesian revolution'. Confidence abounded that the business cycle could, and would, be contained by economic management. Governments would ease their budget settings when economic activity was slack and tighten when economic activity was buoyant.

For a while, it seemed to work well. Unfortunately, governments were too keen to use stimulative policies and too reluctant to introduce policies of restraint. Public debt grew to be uncomfortably high and expectations formed that governments would set their economic policies to maintain full employment even as rates of increase in wages and prices moved significantly higher. An inflationary psychology built up and morphed into stagflation. By the 1970s, cycles in the economy and investment markets became very wide.

Example 2: As a result, the ‘fine tuning’ of economies was downgraded and increased emphasis was put on ‘policy rules’, such as allowing central banks greater independence to pursue low inflation. For a while, these changes, too, seemed to work well. From the early 1980s to the early years of this century, the economic cycle in the US and many other countries was mild.

A report from the US central bank records this episode:

"Reducing inflation and establishing basic price stability laid the foundation for the great moderation. But in looking for deeper reasons, economists have generally proposed three reasons: changes in the structure of the economy, good luck, and good policy."

Alas, these good times came to generate excessive optimism – and borrowing – and brought on the sub-prime debt crisis and the GFC. Within six years, the new moderation was replaced in North America and Europe by the ‘great recession’; the cycle was back.

The last decade

Following the GFC, many investors and strategists believed governments and central banks could no longer raise rates of economic growth above stalling speed. Low inflation and low interest rates were here to stay and the business cycle was dead again.

A minority view, perhaps strongly influenced by the writings of Carmen Reinhart and Kenneth Rogoff on eight centuries of financial folly, was that severe financial crises were always followed by a lengthy slump in confidence, low growth, and little inflation, but these periods are a drawn-out phase within the economic cycle, not a permanent structural change.

Inflation is the dominant influence on interest rates. The massive decline in bond yields over the past 40 years took place in three phases, each of them following a decline in inflation.

In the 1970s and early 1980s, most countries had experienced very high inflation. In response, central banks lifted cash rates to record levels (20% in the US and 17.5% in Australia). Inflation was brought to heel, though at the cost of deep recessions and big cyclical increases in unemployment. Inflation was further restrained in the 1990s by globalisation (including the availability of competitively-priced manufacturers from China) and by the IT revolution (which gave consumers an unprecedented ability to shop around).

Has inflation died, or just been in hibernation?

The GFC fuelled fears of world-wide depression and deflation. As things turned out, there wasn't a depression, but inflation just about disappeared (to be replaced by fears of deflation). Since the second half of 2016, some influences – including intense competition from Chinese manufacturers – that had caused rock-bottom inflation around the world started to loosen their grip.



Recently, however, a significant number of investors have become concerned inflation is on the way back, initially in the US and later in other countries. They focus on: the narrowing in output gaps in most economies; the spurt (and synchronisation) in world growth since late 2016; the substantial easing legislated for US fiscal policy; the rebound in energy prices; the quickening in wage increases in the US and views that wages have troughed in other countries; and political populism including the unfortunate move by the US to impose tariffs on imports of steel and aluminium.

Implications for investors

It's a good time to be focusing on the return of the cycle in inflation and bond yields. For a year or so, the impact could well be reasonably mild, but later may be disruptive. The implications are:

- Investors need to allow for heightened volatility as markets adjust (and at times over-adjust) to the return of inflation.
- Bond investors might favour variable-rate securities, short-dated bonds, positive return bond funds and inflation-linked bonds.
- Traditionally, average returns from shares are boosted when inflation lifts from negligible to mild rates but should inflation quicken from moderate to high rates, it's generally bad news for share markets.
- Real bond yields, not nominal yields, matter for share market valuations. Were bond yields to rise to, say, 4%, the negative impact on shares would likely be more marked if inflation was 1% than if inflation was running at 3%.
- Share investors also need to consider the cause of the spike in bond yields: Is it stronger economic growth, or are central banks moving too quickly to tighten their monetary settings?
- As interest rates rise, shares seen as 'bond proxies' will likely underperform, particularly shares in capital intensive businesses with heavy debts, that's because their costs increase when assets are replaced.
- Higher interest rates also tend to dampen or weaken the property market and make property more uneven and selective.

Don Stammer has been involved with investments since the early 1960s. Now semi-retired, he is an adviser to Altius Asset Management and Stanford Brown Financial Advisers. The views expressed in this article are his alone.

What is happening with LIC dividends?

Peter Rae

For investors in managed investments, it is important to focus on the total returns achieved. We use two measures of performance for listed managed investments (or listed investment companies, LICs). They are the 'share price return', which reflects movements in the share or unit price of the LIC, plus dividends, and the 'NTA return' which measures movements in the NTA after tax but before tax on unrealised gains. We generally refer to this as 'pre-tax NTA plus dividends'. We prefer this measure as we believe it gives a better indication of the underlying portfolio performance after allowing for cash taxes paid, expenses, and manager fees. These returns can be directly influenced by the manager, whereas managers have limited control over the share price movement.

However, we do recognise that many investors in LICs are looking for attractive, stable and steadily growing, dividends or distributions. In this case, it is important to focus on the profits generated by LICs, as dividends can only be paid out of profits and profit reserves. In this report, we look at how the LIC sector fared in the latest reporting season. We also review the LICs under our coverage that offer the highest dividend yields and assess the sustainability of those dividends.

During the recent reporting season, 21 of the 29 LICs we cover that reported results for the six months to 31 December 2017 increased their profits over the prior comparable period. This reflected growth in income from their underlying portfolios, including higher dividend income and capital appreciation.

LIC dividends remain attractive

The solid profit reporting season was positive for dividends, with no LICs reducing dividends. Of those paying dividends for the half, 16 increased dividends, albeit some were very modest increases, and 10 held dividends steady. Four of the five largest LICs increased dividends with AFI the only one to hold its dividend steady. The sector continues to offer attractive yields with the five largest LICs offering an average yield of 4%, broadly in line with the S&P/ASX All Ordinaries yield of 4.1%. Dividends from the top five are fully franked, whereas the average franking of the All Ordinaries is lower.

Top 10 Yielding LICs*

LIC	ASX	Div	Franking	Reserves
Name	Code	Yield**	%	Cover (x)
Contango Income Generator	CIE	6.8	50	1.3
WAM Capital	WAM	6.1	100	1.4
Cadence Capital	CDM	6.0	100	2.0
Pengana International Equities	PIA	6.0	100	6.0
WAM Research	WAX	5.9	100	3.8
Djerriwarrh Investments	DJW	5.8	100	1.7
Mirrabooka Investments	MIR	5.2	100	2.6
Westoz Investment Company	WIC	5.2	100	5.8
WAM Active	WAA	4.9	100	1.8
Perpetual Investment Company	PIC	4.8	100	3.1

*LICs covered by IIR

**Based on dividends for last 12 months over 28 February share price

Source: IIR/Company Accounts

In the table above, we have shown the 10 highest yielding LICs in our coverage universe. We have based our calculations on the last 12 months dividends payments. We have included special dividends only if we believe they are paid regularly. In order to be able to pay dividends, LICs need to generate profits. However, it is possible for LICs to pay out more than they generate in profits in a given year by dipping into retained profit or dividend reserves from prior years. LICs can smooth dividend payments to their shareholders by retaining profits rather than simply paying out 100% of earnings each year.

The table above shows our estimates (based on published accounts at 31 December 2017) of the number of years each LIC could retain its current dividend payments without generating any additional profits. We think this is a good indicator of dividend sustainability when markets turn down. Coverage of one means that a LIC could maintain its current dividend payout for one year without generating any profit in the current year. The five largest LICs (not shown in the table above) all have coverage of at least two years, except BKI which has coverage of one year. This means they are well-placed to maintain dividends at current levels unless the markets experience a sharp and prolonged downturn.

Pengana has the highest dividend cover

Pengana International Equities (ASX:PIA) maintains the highest dividend reserves coverage level at six years, which should continue to support its high payout levels. However, we note that given it invests in global shares, maintenance of franking at 100% will depend on its ability to continue to generate sufficient realised profits (on which it pays Australian tax) from its portfolio.

Resources recovery boosts Westoz profit reserves

Westoz Investment Company (ASX:WIC) has significantly increased its dividend coverage over the past six months given strong returns from its portfolio which has benefited from exposure to the rebound in resources. Coverage has increased from 3.3 years to 5.8 years meaning it is well placed to maintain its current dividend of six cents per share. However investors should remain mindful of the fact that, with the portfolio exposed to the West Australian resources driven economy, returns and earnings can be volatile. The board is targeting a dividend of six cents per share for FY2018.

WAM Research maintains strong cover and WAM Active increases cover

WAM Research (ASX:WAX) continues to maintain strong dividend reserve cover at 3.8 years and Perpetual Investment Company (ASX:PIC) has built up strong coverage in its short period since listing. Cadence Capital (ASX:CDM) has managed to increase its reserve cover from one to two years over the past six months.

We note that WAM Active (ASX:WAA), which was forced to significantly cut its dividends in 2015 after becoming too aggressive with its payouts, has rebuilt its dividend cover to a slightly more comfortable level of 1.8 years. This should be able to support its current approach of steadily and progressively increasing its dividend in the absence of weaker market conditions.

Highest yielding LICs have lowest reserve cover

It is worth noting that the two highest yielding LICs, Contango Income Generator (ASX:CIE) and WAM Capital (ASX:WAM) also have the lowest coverage. Provided markets continue to perform reasonably well, we do not see an immediate threat to the dividends from these LICs. However, in a material and sustained downturn, when it is more difficult to generate portfolio gains, dividends would most likely come under pressure.

Continue to focus on total return

We encourage investors to focus on LIC total portfolio returns, not just dividends, and before investing in individual LICs, ensure they meet their individual portfolio needs.

Peter Rae is Supervisory Analyst at [Independent Investment Research](#). This article is general information and does not consider the circumstances of any individual.

Labor's new franking policy is unfair to LICs

Howard Badger

The Labor Party needs to articulate how it will treat shareholders in Listed Investment Companies (LICs) fairly under their proposal to deny refunds for excess franking credits.

The current system of taxation of dividends ensures that Australian resident shareholders are taxed at their applicable rate of income tax on dividends received from companies, rather than a minimum of the company tax rate. Denying refunds for excess franking credits will require complex changes to legislation to maintain the existing policy of allowing shareholders in LICs to effectively receive the CGT discount on capital gains earned by the LIC.

When a LIC earns a capital gain it pays income tax on the capital gain at the corporate tax rate, typically 30%. When it pays the capital gain to the shareholder as a LIC dividend, the shareholder is taxed on the dividend and franking credit in the usual way, but also receives a tax deduction that represents the CGT discount the shareholder would receive if they derived the gain directly or received it from a trust.

Below is the analysis showing the calculations for an investor (super fund or High Net Wealth Individual) investing in a LIC or either directly in shares or via a trust.

Calculation of tax payable on a \$10,000 capital gain by:

- Super fund in accumulation phase invested in an LIC (Super-LIC)
- Super fund in accumulation phase invested in a trust or direct shares (Super-Trust)
- High net worth individual (HNWI-Trust)

	Super-LIC	Super-Trust	HNWI-Trust
Underlying capital gain	10,000	10,000	10,000
Company tax	- 3,000		
After tax profit	7,000	10,000	10,000
Dividend/trust distribution	7,000	10,000	10,000
Franking credit	3,000	-	-
CGT discount	-	- 3,333	- 5,000
Assessable income	10,000	6,667	5,000
LIC deduction	- 3,333	-	-
Taxable income	6,667	6,667	5,000
Tax rate	15%	15%	47%
Tax payable	1,000	1,000	2,350
Franking credit	1,000	-	-
Tax paid	-	1,000	2,350

Calculation of total tax payable

Tax paid by LIC	3,000	-	-
Tax paid by investor	-	1,000	2,350
Total tax imposed on investor	3,000	1,000	2,350

Currently, they receive a refund of the excess tax paid by the LIC above their tax rate after the tax deduction for the CGT discount. Denying the refund of excess franking credits results in the shareholder paying 30% tax on the dividend. This is a 27% higher rate of tax on a capital gain than is paid by someone on the top marginal rate of tax. This means a super fund will pay at least three times that rate of tax on a capital gain distributed by a LIC when compared to a capital gain it earns itself or via a trust and 27% more tax than an individual on the highest rate of tax.

(That is, a HNWI pays \$2,350 on a \$10,000 capital gain. A super fund in accumulation phase pays \$3,000 on a capital gain earned by a LIC. The difference is \$650 divided by the tax paid by the HNWI of \$2,350 gives 27% more tax payable by the super fund).

Given that a large percentage of investors in LICs are super funds and that many investors in LICs are not wealthy, this is an inequitable result that will need to be addressed.

Howard Badger is a Partner in Tax Consulting at [Pitcher Partners](#). This article is general information that does not consider the circumstances of any individual.

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