

### This Week's Top Articles

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### Blockchain founder on this new asset class

Scott Stornetta

Seventeen years before there was Bitcoin, my colleague Stuart Haber and I developed the basic elements of the blockchain, as described in the [Journal of Cryptology, January 1991](#). Namely, using cryptography, we found a way to create an immutable, shared ledger. Its integrity was based, not on some trusted third party, but on the democratisation of trust across all participants in the ledger. This is the blockchain: an immutable record, witnessed and vouchsafed by all mankind.

And so while I find little to quibble with in recent blockchain-related Cuffelinks articles by [Joe Davis](#) of Vanguard and [Carlos Gill](#) of Microequities, I can nevertheless bring an historical perspective to the subject.

#### A new asset class?

For superannuation managers, perhaps the most pertinent question to ask is this: Is the blockchain space a new asset class? If so, what portion of a portfolio should be allocated to it? Or is it simply an internet version of the Dutch tulip craze, an emotional bubble to be avoided at all costs?

Some would say that of course blockchain is a new asset class. After all, the combined market capitalisation of all cryptocurrencies is in excess of a quarter of a *trillion* dollars. Cryptocurrencies and their related derivatives are traded on several exchanges, tracked breathlessly by well-established companies, and analyzed by hundreds of analysts.

But all of those trappings of credibility also accompanied the collateralised debt obligations of subprime mortgages, broken into tranches rated as high as AAA by our unerring guardians of the galaxy, Fitch, S&P and Moody's. And we all know how well that turned out.

To answer the question, let's begin by observing how diverse the blockchain economy has become. Five years ago, blockchain and Bitcoin were all but synonymous. However, since then there has been what Scott Rosenberg called a Cambrian-Era explosion of use cases.

The largest criticism of Bitcoin is the enormous energy consumption and instability that mining and proof of work create. But let's not confuse the particular volatile mix of incentives Satoshi created with the full range of possibilities that the Haber-Stornetta paradigm allows for.

### **There is more than one blockchain**

There are blockchains that completely disavow proof of work as an incentive mechanism. Or Ethereum, whose *raison d'être* is smart contracts, which aim to make many business transactions, currently requiring tedious paperwork and accountant and attorney fees, frictionless. Then there is the class of asset-backed stable cryptocurrencies (of which Australia's own Havven is a leading example), whose prime directive is to eliminate the volatility so often associated with Bitcoin. There are also utility tokens, which don't aim to be currencies at all, but simply measure prepaid deposits into a system for which work can be claimed. And Australia's own ASX, which is transitioning from CHES to a blockchain-based solution, simply on the merits of settling transactions more inexpensively, quickly and reliably than its predecessor – hardly the stuff of a speculative bubble.

One way to examine how meaningful blockchain might be in the future is to consider its effects in the present. The emergence of Initial Coin Offerings (ICOs) has already begun to disrupt the venture capital industry. This is a particularly poignant example as the VC industry traditionally views itself as the ones in charge of disrupting other industries. What's good for the goose . . .

### **Where will blockchain take us?**

Will blockchain disintermediate the banks? Commoditise attorneys and accountants? Threaten fiat currencies? Some think this last idea is particularly preposterous. Perhaps. But fiat currencies have only really undergirded the world's financial system since the abandonment of the gold standard. Not much more than a century. This is something about which another eminent Australian, Shann Turnbull, [has written quite incisively](#) (That's the third Australian reference to blockchain in this article. Is there a pattern here?)

So to finally answer the original question.

Yes. Blockchain is, in fact, an emerging asset class. Certainly with its own set of risks, but in the midst of all the hoopla, it is finding footholds of genuine value creation. And with value creation will come appreciation in price. Hence, those who invest responsibly can expect above average risk-adjusted returns. The trouble, as always, is how to invest wisely in the blockchain space. But that is a Cuffelinks column for another day.

*W. Scott Stornetta, Ph.D. is, along with his colleague, Stuart Haber, widely credited with the foundational work for the [blockchain](#). He will be speaking at the University of Sydney as part of the [Blockchain World Tour](#) event on 1 May 2018. This is the first article written for the Australian market by Dr Stornetta.*

## **Short selling is harder than you think**

### **Hugh Dive**

Short selling has been a hot topic after a noted US-based short seller released [a negative report](#) about listed fund manager Blue Sky Alternative Investments (ASX:BLA). This caused Blue Sky's share price to fall 50%, wiping \$440 million from its market cap. Short sellers are frequently derided as vultures, rumour mongers or even 'unAustralian'. However, in practice, shorting stocks is a difficult, stressful and lonely way to make money in a market which is predominately skewed towards good news and wearers of rose-tinted glasses.

This article does not look at the merits of Blue Sky as an investment, but rather at the mechanics and issues around short selling equities. Much of the recent coverage on short selling reveals that many of those who hold strident opinions on short selling have only a limited understanding of how it actually works.

### **Step one: Find a company with bad characteristics and a catalyst**

In traditional long only investing, the goal is to own good quality companies with honest management teams, clean balance sheets and solid future prospects. By contrast, the desirable characteristics of a short sell include companies with low or negative growth, high and increasing debt levels, a weak business model, overvaluation by a market, and possessing a shaky management team. However, a critical factor is the requirement for a catalyst: overvaluation or high debt in itself is rarely enough. In Blue Sky's case, it was the negative report

from Glaucus. As very few investors have the luxury of lobbing a damning report from the sidelines and outside the regulation of ASIC and the ASX, we would normally look for events such as a potentially bad acquisition (preferably off-shore), heavy directors selling, or corporate turnover at management level.

### **Step two: Find the stock to borrow**

Short sellers will then borrow stock from a stockbroker and sell it. They are essentially betting that the price of the target company will decline before they have to replace the borrowed shares by buying the stock back. This is often the step that is ignored in the financial press when talking about shorting a company's stock, as it is wrongly assumed that investors can easily borrow stock to reflect their negative view on a company.

When borrowing shares to short sell, an investor has to look closely at both the rate per annum that they are required to pay to borrow the stock, and where the owner is located geographically. The rate reflects supply and demand, and for most stocks is currently 0.5% per annum. For stocks where the shorting demand may be higher than the supply (such as Fortescue) the rate may be 15% or higher. In the case of small capitalisation or tightly held companies such as Blackmores, the short seller may be unable to borrow stock and thus cannot short sell. Obviously a high cost to borrow stock to sell short imposes a return hurdle on the would be short-seller.

In the case of Blue Sky, when we looked a week ago there was no stock available to be borrowed and the current short-sold position only represents 2.6 million shares, or 3.3% of the register and over the course of this week this has been reduced by 1 million shares as short sellers have closed their positions, buying back Blue Sky stock.

In a small and tightly held company such as Blue Sky, most holders would not lend out their stock for short selling as to do so they would be providing short sellers with the ammunition to bet against their long position. For example, BigUN – which was suspended from the ASX in February 2018 due to accounting irregularities – only had 500,000 shares lent out to short sellers, which is a mere 0.3% of the register. In the lead up to BigUN's suspension as its share price was falling, the demand to short this stock would have been intense, but there would have been no stock available to be borrowed.

### **Step three: Watch for dividends and corporate actions**

The short seller is required both to return the shares to the owner when requested, and also to pass on any dividends paid. We also strongly prefer to borrow stock from foreign owners such as large index funds like Vanguard or State Street, as if you borrow stock from a domestic owner and a dividend is paid, short sellers are required to compensate the original owner for both the dividend and any associated franking credits.

### **What happens if the stock goes up?**

If the short stock rises sharply, the lender will be required to give their broker additional collateral, or the broker will require the short seller to close out the short sale transaction before the planned timeframe. A series of urgent requests to wire cash to your margin account to cover a short-sold stock that is rising sharply will test the mettle of even the most hardened short seller. In contrast, a long only position in a falling company can mentally be filed in one's bottom drawer until it eventually comes good (or goes into administration).

This gives rise to the skewed payoff ratio from short selling, where the maximum gain is known (the stock falls to zero), but the maximum loss is theoretically infinite. Also, when a short position goes bad because the stock price rises, it becomes a larger part of the portfolio, and from a portfolio risk management perspective, there may be additional pressure to trim the position, which contributes to the short squeeze (defined below).

### **The market can remain wrong longer than you can remain solvent**

It would be wrong to view that short selling risky stocks is a smooth path to outperformance. Keynes, the father of modern macroeconomics, once famously said that "markets can remain irrational longer than you can remain solvent". This quote particularly resonated with me after an unprofitable short selling of Fortescue prior to the GFC due to concerns about the overvaluation and debt situation of the company.

This trade was put on at \$50 per share late 2007 and then was closed out at \$70 four months later as the price continued to rise with no signs of slowing momentum. It was very painful to lose 29% in a short stretch of time; however, Fortescue peaked at \$120 in June 2008 before falling back to \$20 in December 2008. Whilst our investment thesis was ultimately correct, we were unable to handle the pain of a steeply rising stock and the associated unrealised losses and increasing margin calls.

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## What's a short squeeze?

A 'short squeeze' occurs when a heavily-short stock rises sharply, forcing sellers to close out their position by buying back stock, thus causing further upward price momentum. Often when the market appears to overreact to a small piece of positive news, this is a short squeeze and it is similar to too many people trying to fit through a door.

For example, if JB-Hi Fi (currently 17% of the register has been 'borrowed' by short sellers anticipating that the price will go down) or Domino's Pizza (18% short) were to receive a takeover bid, the price would escalate sharply as short sellers look to cover their positions. A nightmare scenario would be a contested bidding war if you are short. In December 2017 we saw a short squeeze in Westfield when a bid from Unibail-Rodamco came through. However, unlike Dominos or JB Hi-Fi, the percentage of the property trust's outstanding shares that we sold short was not a large amount, though we did see a spike in the share price that reflected the short sellers buying back stock to exit their positions.

## Short selling is not easy and does not deserve its poor reputation

While short selling is often criticised and retains a negative connotation in a securities industry that is inherently biased towards optimism, it serves a valid role in financial markets. Short sellers provide an alternative view and can aid both liquidity and price discovery. In coming years, especially with [MiFID II](#) (new European regulations on stockbrokers) reducing the incentives for the investment banks to put out sell side research, shorting will provide an alternative view. At the moment, it's no surprise that 80% of calls are buy or hold!

Investors should not look at situations like Blue Sky, BigUn or Slater and Gordon and view that it is an easy way to make money, nor that it is unfairly ganging up on a company. Even experienced and adept short sellers such as Glaucus make expensive mistakes. For example, its shorts on Japanese trading house Itochu would have cost the fund manager substantially, with Itochu's share price up +43% since Glaucus released a report in mid-2016. The same could still happen with Blue Sky.

*Hugh Dive CFA is Chief Investment Officer at [Atlas Funds Management](#). Neither the Atlas High Income Property Fund nor the Maxim Atlas Core Australian Equity Portfolio employ shorting as an investment strategy. However, the author has previously managed a long-short fund. This article does not consider the circumstances of any individual.*

## End-of-cycle and riding an ageing bull

### Miles Staude

My first boss and mentor always knew when it was going to rain. He would stand up from his desk, stretch an aching leg, and declare that a thunderstorm was coming. He could "feel it in his bones." Today the received wisdom in the market, especially from investors with a little grey hair and barometric bones, is that we are in the final stages of the bull market, one that has now become the second longest in history. At some point in the not-too-distance future, the "correction is coming".

### What a bull market it has been

From its lows in 2009, through to the end of March 2018, the MSCI All Country World Equity Index (MSCI ACWI) has risen by 227% in US dollar terms, equivalent to an annual rate of return of 13.9%. The biggest driver of gains for global share markets has been the returns delivered from the US, with the S&P 500 index increasing by 311%, or 16.8% annualised. In turn, the biggest driver of US market returns has been the gains in the technology sector. The NASDAQ, an index dominated by US technology stocks, has increased by 552%, equivalent to an annualised rate of return of 22.9% over the last nine years. These gains have happened against a backdrop of near-zero interest rates in almost all the world's developed market economies (Australia and Canada two notable exceptions). The opportunity cost for an investor who has stayed in cash over this period has been extreme.

Such equity market returns are not sustainable over the long run. It is a brave investor who assumes equity market investments will deliver double-digit returns over a full investment cycle. Over the past 30 years, the annualised returns of the S&P500 and the MSCI ACWI have been just 5.4% and 5.2% respectively. It's

understandable why investors who have lived through a few market cycles have a gnawing sense of unease about how easy it has been to make money in recent years.

The challenge investors face today is how to approach markets when history suggests we are closer to the end than the beginning of the current cycle. On most conventional measures, equity markets look expensive, the current P/E of the S&P 500 at 21.4 is comfortably above its long-term average. Corporate debt levels have increased considerably. High price to earnings valuations are justified when interest rates and inflation expectations are low as discount rates are lower. High debt levels are sustainable when borrowing costs are near all-time lows. Both positions however, rely on interest rates remaining low to support the status quo. However, financial imbalances have built-up in the decade since the financial crisis, and most economists and central bankers do not believe such low interest rates are sustainable in the long term.

### **Forecasting: the art of saying what will happen, and then explaining why it didn't**

Consensus, even if it's true, doesn't give us much to work with. Forecasts are easy. Being in the 'final stages' of the current bull market could mean markets are three months or three years from their pending highs. In December 1996, amid a market rally similarly driven by technology stocks, Alan Greenspan, then Chairman of the US Fed, famously opined that markets had become [irrationally exuberant](#). Few people would have disputed Mr Greenspan's assertion that markets were expensive at the time, however markets continued to rally for a further four years, rising 116% in the process. Secondly, history suggests that the final stages of a bull market often generate the greatest period of returns as caution gives way to euphoria. Exiting now may lead to missing the great returns that are still to come.

Finally, as was the case in 1996, we are currently living through a period of immense technological change, one that most traditional investors (myself included) do not fully understand. Companies like Google, Amazon, Uber, and Tesla have radically changed well-established businesses landscapes in just a few short years.

Here's a remarkable and recent example: Researchers working at the artificial intelligence (AI) unit, DeepMind, created a game-playing AI program called AlphaZero. In the space of just four hours, AlphaZero taught itself to play chess and then went on to decisively beat Stockfish, widely regarded as one of the world's strongest chess engines. These sorts of advancements tell us that serious changes are underway to both the jobs market and the business landscape, changes that will both create and destroy considerable value from an investment point of view.

### **Checklist for the end of the cycle**

The two most important things investors control are their investment horizon and their risk tolerance, and both these parameters should be set by individual circumstances, not the market cycle. Putting that aside, below is my checklist for investors trying to navigate the final stages of a bull market.

- **Be disciplined and rebalance.** We all have winners and losers, and after a 9-year market run it would be unsurprising to find individual investments within a portfolio that have done remarkably well. The path of least resistance is often to let these positions continue to run. Be sure to ask yourself if you would put them on again at their current size today.
- **Adjust for volatility.** The final years of a bull market are often the most volatile, but as risks increase so do the potential returns. An increase in volatility acts like a form of leverage, and your actual investment exposure to the market in dollar terms can increase without a reduction in the amount of money you have invested.
- **Forget timing.** One of the great fallacies of investing is the idea that it is possible to time markets with any real precision. Far more important is to match what you want from your investment portfolio to your investment horizon. If you were 25 when 2008 struck, what happened to the shares in your super fund will be distant noise when you come to retire. If you were 65, it was a different story.
- **Technology.** Tech stocks are the defining characteristic of this cycle. Disruptive technology clearly creates problems for many established business models, but in aggregate, it should be positive for equities over the long run. New technologies are dramatically increasing the productivity of existing capital and putting more money back into the hands of consumers to save or spend. The pace of this technological change is unlikely to correspond neatly to any historical expectations we have about how long a bull market should last.

*Miles Staude is Portfolio Manager at the [Global Value Fund](#) (ASX:GVF), which he manages from London. This article is for general information purposes only, as it does not take into account anyone's individual financial situation.*

## Are two SMSFs worth the bother?

Gemma Dale

Following the introduction of the \$1.6 million transfer balance cap, many clients have asked whether it may be desirable to start a second SMSF to quarantine different benefit types and maximise their overall superannuation benefits. The Australian Taxation Office (ATO) has [advised that it may not look kindly upon such arrangements](#). However, the ATO must treat each case on its merits.

Why consider such an arrangement? Most strategies centre on the principle of separating accumulation and pension benefits in order to maintain or grow the tax-free (pension) component in a separate fund. This makes sense if particular assets are expected to grow at a higher rate or generate more income than others. However, the ATO has the discretion to argue that Part IVA of the Income Tax Assessment Act (ITAA) applies in circumstances where a taxpayer has structured their affairs with the sole or primary purpose of avoiding tax, therefore there should be a greater objective at stake.

### Administration costs and CGT

The total amount you can transfer to an income stream is capped at \$1.6 million, although this amount can grow or decline in value without being assessed against the cap again (unless you make substitutions). Many retirees are keen to quarantine their high-yielding assets in this tax-free pension phase, and leave lower earning assets in the accumulation phase where income is taxed at 15%.

If you have an SMSF, generally earnings on your pension and accumulation accounts are assessed proportionately for tax purposes, which means you can't allocate your higher-earning assets to the pension account and the lower-earning assets to your accumulation account. If you have two separate funds, different assets (and therefore their earnings) are segregated (for example, property in one fund and equities in another). However, you will have to pay two sets of administration costs, which could exceed the amount saved in tax payable on the different earnings.

If your fund is already fully or partly in pension phase, and you wish to set up another fund, not only would additional establishment and administration fees apply, but the sale or transfer of any assets from the existing fund to the new fund could create a capital gains tax (CGT) event. Capital gains in pension phase are generally tax-free, so this would be mostly relevant for accumulation interests. Stamp duty may be payable depending on the asset and the jurisdiction in which the transfer occurred.

### Public offer funds

Many investors have a public offer fund in addition to their SMSF. This may be due to their employment arrangements, longstanding defined benefit schemes, or to retain insurance policies. While many individuals will roll these benefits into their SMSF at retirement, there may be incentives to retain these arrangements with a public offer fund, which will effectively quarantine the assets within this account. Others may consider establishing a new SMSF. While CGT and stamp duty issues are relevant only to the extent that they would apply in the public offer fund, the same considerations regarding purpose apply (i.e. the purpose is not the avoidance or minimisation of tax).

It should be noted that those SMSFs where **no member** has a balance greater than \$1.6 million including in both accumulation and pension accounts can still use the segregated method if they wish, which would allow the allocation of different assets and their earnings to occur. In this scenario, holding all assets in pension phase is the most tax-effective option, although there may be other reasons for individuals to retain accumulation accounts. Additionally, public offer funds such as wrap accounts may not be subject to these accounting requirements and therefore segregation opportunities may be available.

If you wish to pursue a strategy of having two SMSFs, consider your objectives and the purpose for doing so in light of the ATO's position. Some individuals may wish to have one fund with a spouse and another with children from a previous marriage or for the purpose of holding real property with business associates, others may wish to hold their assets in different funds for other reasons.

Whatever the objective, it is critical to seek advice given the ATO's concern about the strategy, and the general costs and complexity of adding additional structures to your financial affairs.

*Gemma Dale is Director, SMSF & Investor Behaviour at [nabtrade](#), a sponsor of Cuffelinks. Any advice and information contained in this article has been prepared without taking into account your objectives, financial situation or needs.*

## Why an SMSF pension is tax-free and receives a refund

Jon Kalkman

Much is made of retirees who pay no tax but also receive a tax refund. This view demonstrates a fundamental confusion about how the super system works. Any income generated by an asset belongs to the owner of the asset who is responsible for the tax on that income. In the case of retirees with a SMSF, the owner of the fully franked shares is the SMSF, not the retiree. The retiree is the trustee of the fund with a fiduciary duty to all members of the fund, some of whom may not be retired. As a separate taxpayer, the SMSF has a tax file number and completes a tax return after the fund has been audited.

If the SMSF is an accumulation fund, it pays tax at the rate of 15% on income and concessional contributions. At present, some of the imputation credits help to pay that tax. Any excess imputation credits are presently returned as cash to the fund and this adds to the income produced. It is typically reinvested to grow the fund for future retirement needs. The same applies to retail and industry super funds. No money is withdrawn because super cannot be accessed before retirement.

If the SMSF is paying a pension, the tax rate is presently zero. This also helps to increase the income produced by the fund. This is also true of retail and industry super funds. Since 2007, withdrawals from the fund (both pensions and lump sums) have been tax-free.

### Implications for withdrawals

There is no limit on the maximum withdrawal from a super fund. It is possible for a retiree to withdraw their whole super balance at any time. In fact, many people with small super balances do just that as soon as they retire. It may pay off their mortgage or have other uses without interfering with their claim for the age pension.

Retirees, whose assets exceed the assets test and are therefore ineligible for the age pension, will want their super fund to sustain them for as long as possible. The more they take, the quicker the fund is depleted. When their super fund is depleted, most retirees have no choice but to claim the age pension. As most people regard the age pension as only a basic standard of living, most self-funded retirees would want to delay that date as long as possible.

The other problem is that once money is removed from the tax-advantaged area of super, the contribution rules make it difficult to put it back in. Therefore, in order to sustain the super fund for as long as possible, most retirees take no more than the minimum they need or the mandatory minimum required. For the pension fund, the secret to long life is a higher investment return and a lower drawdown rate. In the pension phase, the government assists by reducing the tax rate on investment earnings to zero. The purpose of any super pension fund is to fulfil its assigned task of delaying the member's claim on the government age pension, possibly indefinitely.

Some countries choose to collect no taxes on contributions or earnings in the accumulation phase but then tax retirement benefits at normal rates. When universal super was established in 1992, the Australian government was not prepared to wait 30 years before it collected tax so it chose instead to tax contributions and investment earnings in accumulation but made the retirement phase tax-free. Either way the aim was to make it possible for the fund to provide retirement benefits for as long as possible.

### Minimum pension

The catch, of course, is the minimum pension which at age 55 is 4%, rising to 14% of a member's super balance from age 95. These mandatory withdrawals force retirees to progressively sell assets for cash to satisfy the pension requirement thus depleting their super balance over time. This ensures that money is removed

from super and exposed to normal tax. It also reduces the balance of tax-advantaged super, if any, remaining at death that is passed on to dependents.

Australian shares provide an excellent income in retirement. The much-publicised volatility of share prices only requires management if shares are traded. If shares are not traded, an SMSF's income depends on dividends. The income does not rely on the sale of units with volatile market prices, as is the case in an industry super fund providing a pension.

Removal of the cash refund for excess imputation credits will reduce dividend income to an SMSF by up to 30%. Lower investment returns in the super pension fund means that more assets will need to be sold to meet pension requirements, and that hastens the fund depletion. This policy will cut the lifespan of an SMSF pension fund by many years, depending on its shareholdings.

This makes no difference to the tax-free nature of the withdrawal a retiree takes out the fund.

### **Periods of low investment returns**

The evidence from the GFC is clear. This period of low investment returns had a devastating effect on many super pension funds. The government response to the GFC was to halve the minimum pension requirements. That was useful for those who could afford to live on a smaller pension, but for many who had to maintain their lifestyle, selling all those assets at depressed prices slashed years off the life of their fund. Those lost assets can never be regained because a pension fund cannot accept more contributions.

It is disingenuous and misleading to suggest that some retirees pay no tax but still get a tax refund. The cash refund for imputation credits is received by the fund, not the member. The tax status of the fund is independent of the member's tax-free cash withdrawals, which are governed by the member's age and their income needs.

We are facing a tsunami of baby boomers reaching retirement along with their increased life expectancy. We could face a situation where people in their 90s, as well as their children, claim the age pension at the same time! It is short-sighted and financially reprehensible to guarantee that more self-funded retirees will become dependent on the age pension much sooner than they otherwise would. Policy makers need to understand this.

*Jon Kalkman is a former Director and Vice President of the Australian Investors Association. This article does not consider the circumstances of any investor.*

## **\$1 million v \$500,000 and accepting a pension**

Graham Hand

The article on why [\\$1 million is always superior to \\$500,000](#) despite the potential loss of franking credits and age pension attracted many worthy comments. A reader, John Hyslop, asked about self-funding a retirement and staying off the age pension. John asked:

*"This is a powerful analysis with great supporting graphics. Could you please run some numbers on two other couples?"*

*Let's use the same basic assumptions as in your article but with a different mindset. The couples have always been self-reliant. They realise that they have been fortunate to save well, with generous taxpayer help in tax concessions, and essentially tax-free retirement. They are concerned that coming generations are being asked to fund a great lifestyle.*

*They aim to refrain from being on the age pension for as long as possible can. They realise that they can live a good life on \$50k p.a. They will avoid major house extensions or 'unnecessary' spending simply to qualify for the age pension. Although being forced to make annual withdrawals from their SMSF, they could build up another investment reserve fund outside super using any surpluses.*

*Could you re-run the numbers to assess when they 'have to' go on the pension and with the possibility of being able to leave some inheritance for the kids? I believe the system is unsustainable and is likely to produce inter-generational conflict."*

Hi John

Under age pension rules, a couple can have a home of unlimited value and receive a full age pension if their other assets are worth less than \$380,500. The pension cuts out when assets exceed \$837,000.

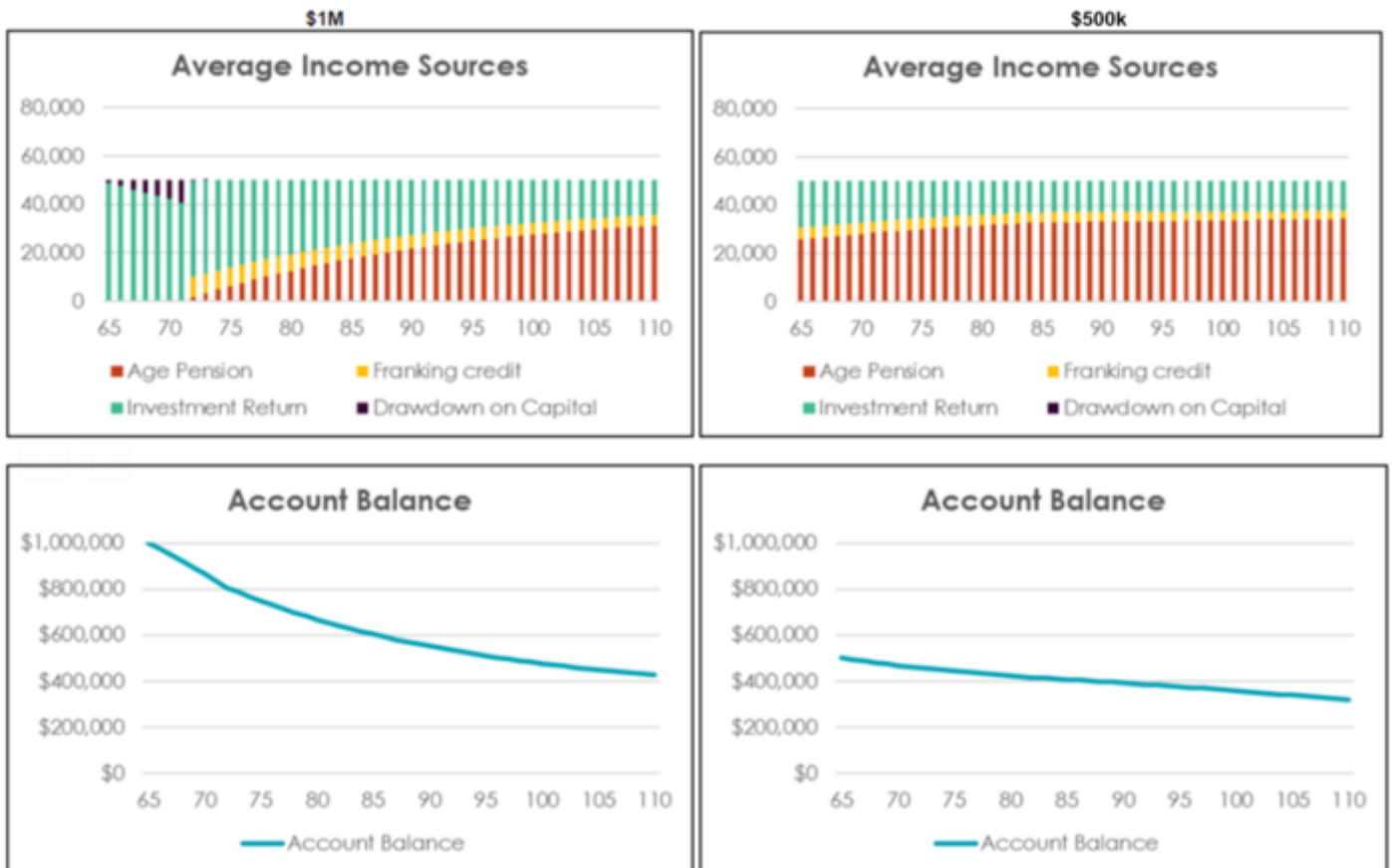
The couple with \$500,000 will be eligible for a part-pension from the start which will make up half their annual income. The couple with \$1,000,000 will start to receive a part-pension when they reach age 72 after drawing down some of their capital. Using the minimum drawdown rule would not impact the period until they become eligible for age pension because from age 65 to 75, the minimum drawdown rate is 5%, the same as the investment return.

The charts below show:

- Both couples will go on the age pension, unless they feel strongly that they should not be a 'burden' on the budget. This is typical of most retirees as even with compulsory superannuation since 1992, it is expected that 70% of Australians of eligibility age will still be drawing a part-pension by 2055 (see 2015 Intergenerational Report).
- When the Smiths become eligible for the age pension, they also receive their franking refunds (assuming not in an SMSF), and no longer need to drawdown capital to spend \$50,000 a year.
- Due to the more modest lifestyle, neither couple runs out of other capital, so there will always be something in reserve for unexpected costs or a bequest.

It's especially interesting to contrast the consequences of living on \$50,000 versus \$80,000 (in the previous article), with both couples trading off greater financial security for a lesser lifestyle, assuming money delivers lifestyle benefits.

**Smiths (\$1 million) versus Joneses (\$500,000) based on \$50,000 annual expenditure**



Graham Hand is Managing Editor of Cuffelinks. My thanks to quantitative analyst Estelle Liu for assisting with the calculations.

## Rising bank funding costs driven by liquidity not credit

Tamar Hamlyn

The bank bill rate – Overnight Index Swap (OIS) spread is a keenly watched risk measure in fixed income markets that has experienced a significant widening in recent months, both in Australia and in overseas markets (where LIBOR is the equivalent rate to the Aussie bank bill rate).

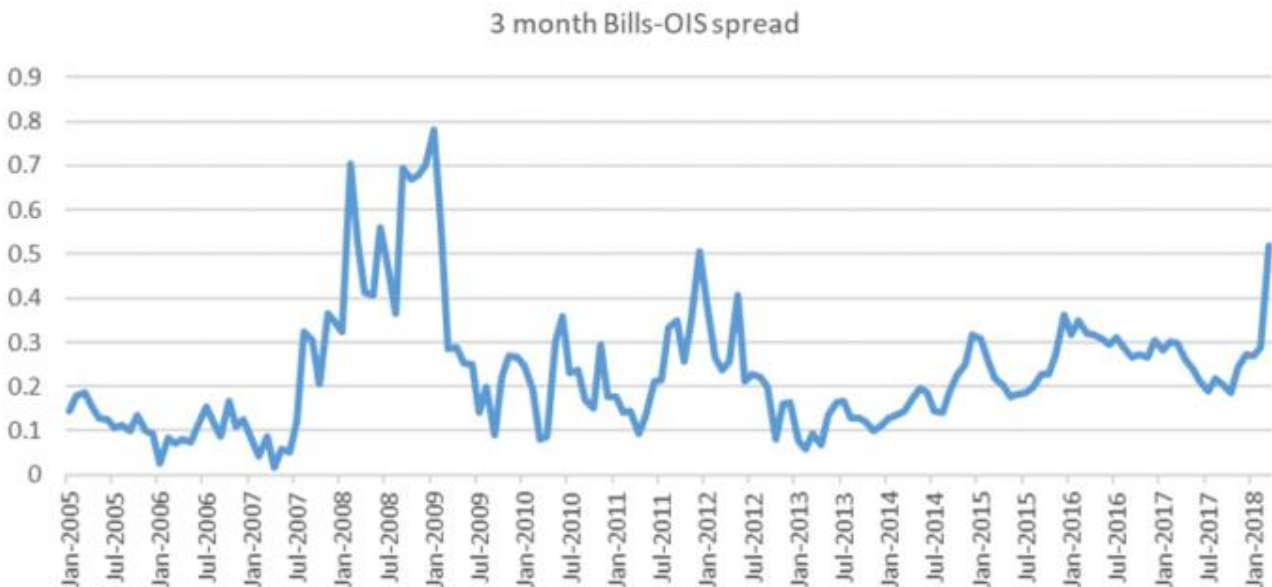
The OIS is an interest rate swap whose floating leg is tied to an overnight rate. The OIS market is used in fixed income markets to both hedge exposure to, and speculate on, changes to the overnight RBA cash rate in the future. When market commentators quote statistics like “the market estimates the chance of the RBA raising rates next month is xx%,” they are quoting the pricing of the OIS market.

The bank bill market and LIBOR rates, on the other hand, represent the cost to banks of raising money in the bank bill market for terms generally between three months and one year. As such, the OIS market represents expectations of the *short-term risk-free rate*, whilst the bank bill rate includes margins for bank credit and liquidity risk.

### What is happening here?

In recent weeks, short-term money market rates such as USD LIBOR and AUD bank bill rates have increased sharply and have risen relative to measures of the cash rate. Some market commentators have highlighted this as a risk to market stability.

However, we view the current environment as relating more to an environment of tightening global liquidity and increasing government bond supply. This is having knock-on effects on domestic liquidity.



Source: Bloomberg, Ardea

### Causes of widening in LIBOR-OIS

Some of the more commonly cited influences pushing LIBOR rates higher include the potential for USD repatriation flows following recent tax changes, and the significant increase in issuance of US Treasury Bills seen in recent months. However, some other factors have also been at work too.

One additional influence is the potential reallocation of US dollar reserves by China. Given recent tariffs and resulting trade tensions, the desire of the Chinese authorities to diversify their holdings is likely to be high. Reduced demand for US Treasuries from China, and perhaps net reductions, would be consistent with a worsening short-term cash flow position for the US Treasury.

On tighter bank regulation, while much of the heavier burden reflects actions taken by global regulators some time ago, these constraints limit a bank’s ability to hold large inventories of government bonds and corporate bonds. This makes it harder to finance the purchase of government bonds, which in turn has resulted in repo

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rates widening substantially in recent weeks. Repo rates are a secured funding rate, as the repo rate is the rate earned on lending cash when accepting government bonds as collateral.

This has fed directly into upwards pressure on LIBOR and bank bill rates, as unsecured and secured funding rates in the money market are closely linked.

We would thus add repo rates and perhaps reserve reallocations as additional influences in pushing LIBOR rates wider relative to OIS.

### **This time, it's not about credit quality**

It's notable that two of the major factors in wider LIBOR-OIS rates relate specifically to government bonds, and not corporate bonds or banking sector concerns. For this reason, we would describe the current widening as having different underlying fundamental causes from that seen during the GFC.

The reaction seems to mainly relate to liquidity becoming increasingly scarce, and money market rates being priced higher accordingly. This is quite different from the GFC episode, where the blowout in LIBOR rates was directly attributable to a lack of willingness by banks to take overnight exposure against each other.

If credit concerns were rising, we would expect government bonds to be in high demand, and repo rates (i.e. secured rates) to decline amid a flight to quality. This isn't happening, and in fact we are seeing the opposite with repo rates rising by more than LIBOR rates.

Other evidence that this is not a banking sector crisis is that bank share prices have generally been fine from a top down global macro perspective, setting aside the domestic factors such as the banking sector inquiry and slowing house prices.

Credit Default Swaps (CDS) haven't moved much either. A CDS provides direct insurance against a default, so if credit were a concern we would see these rates rising rapidly.

The regulatory reforms and protections put in place since the GFC have generally required banks globally to hold much more capital than previously. This places banks on a much stronger footing, but counting against this is the reduced ability to access government bailouts, due to strong reluctance from governments to repeat the bailouts of the GFC.

### **Broader market impacts of higher funding costs**

If the heightened LIBOR-OIS spreads remain persistent, they will create a higher cost of funding for domestic banks. An increase in funding costs will ultimately be passed through to end borrowers. This will affect both households and corporates, in the form of higher mortgage and borrowing rates. If the increase in bill rates were maintained for long enough, this could effectively act in a similar manner to a regular rate hike from the RBA.

Overall, we view the increase in LIBOR-OIS spreads as a result of tightening liquidity globally arising from greater banking sector regulation, and withdrawal of earlier stimulus by the major central banks.

The wake-up call for markets is creating welcome opportunities for price discovery after a period of extremely low volatility. This allows greater scope for active management strategies to deliver additional value through understanding the market dynamics and second-order impacts of situations like this.

*Tamar Hamlyn is a Principal of [Ardea Investment Management](#). The information in this article is general and is not intended to constitute advice or a securities recommendation. It does not take into account the investment objectives, financial situation and particular needs of any individual.*

## **Third Link Growth Fund's 10th anniversary**

Chris Cuffe

It's a personal thrill that Third Link Growth Fund has just passed its 10th anniversary. The Fund opened for investment on 10 April 2008, in hindsight a difficult time to launch with the global financial crisis around the corner.

With the passing of these 10 years, it's a good time to pause, reflect and celebrate the achievements of the Fund. These include:

- The Fund has grown to \$163 million at the end of March 2018, a significant achievement given there has been no sales force selling the product. It relies on word-of-mouth, the innovative charitable angle whereby all fees are donated to charity (a structure since copied successfully as well), a good performance track record and some favourable press.
- Over the 10 years since inception, the Fund has achieved a compound annual return of 9.6% after fees. During this same time period the bank bill rate has yielded 3.4% per annum.
- From February 2012, the Fund altered its objective from a multi-sector growth fund (invested in a combination of Australian shares, international shares, property and fixed interest) to one that invested only in Australian shares. Since that time, the Fund has achieved a compound annual return of 13.6% after fees compared with the S&P/ASX300 Accumulation Index increasing by 9.8% per annum. The Fund outperformed this benchmark by 3.8% per annum.
- Zenith Investment Partners, an independent research group, currently has a 'Recommended' rating on the Fund. Furthermore, the Australian financial data provider, FE, and Money Management have recently launched the FE Crown Fund ratings in Australia (a quantitative measure of performance, consistency and volatility) and Third Link Growth Fund has received the maximum score of 5 crowns. The Fund sits within the top 10% of its peer group.
- Since inception, over **\$7,500,000** has been donated to charities (all listed on the Fund's web site, and which include Australian Indigenous Mentoring Experience (AIME), National Centre for Childhood Grief, The Song Room, batyr, Foundation for Rural and Regional Renewal, Dismantle, SHINE for Kids, BackTrack, Mirabel Foundation, Raise Foundation and Children's Ground) from the fees received in managing the Fund. Donations are now running at around \$175,000 every month!

Of course, none of this could have been achieved without the extraordinary generosity of the underlying investment managers and service providers who all provide their services on a pro bono basis. The investment managers include Aberdeen Asset Management, Bennelong Australian Equity Partners, Colonial First State Global Asset Management, Cooper Investors, Greencape Capital, Harness Asset Management, JBWere Wealth Management, L1 Capital, Lazard Asset Management Pacific Co, Lennox Capital Partners, Montgomery Investment Management, Ophir Asset Management, Paradise Investment Management, and Pengana Capital. And the service providers include Bennelong Funds Management (Responsible Entity), RBC Investor Services Trust (custodian and administrator), Minter Ellison (legal work), Deloitte (auditors of the Fund), Ernst & Young (auditors of the Manager), KPMG (tax advisers to the Fund) and Nexia Australia (tax advisers to the Manager).

Thank you to those who have supported the Third Link Growth Fund and helping make the concept a reality. The Fund closed to new investors in September 2017.

*Chris Cuffe is the Founder and Portfolio Manager of [Third Link Growth Fund](#).*

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