

This Week's Top Articles

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Should you be a value or growth investor?

Ben Preston

The traditional distinction between 'value' and 'growth' investors is too simplistic. Classically, 'value' investors aim to generate returns from shares that offer a high yield from current earnings or dividends relative to their prevailing share price, whereas 'growth' investors buy shares with superior earnings growth potential. Since rapidly-growing companies are unlikely to be available at bargain prices, the two schools of thought are often considered to be at loggerheads.

Our approach is different. Investing isn't about putting stocks into boxes. It's about delivering superior long-term returns relative to the risks taken. When we make our assessment of a stock's future-return potential, we're primarily motivated by its intrinsic worth, an appraisal which includes due consideration for the value of future growth (if any). The critical question is whether we can buy a company's shares for much less than they are truly worth.

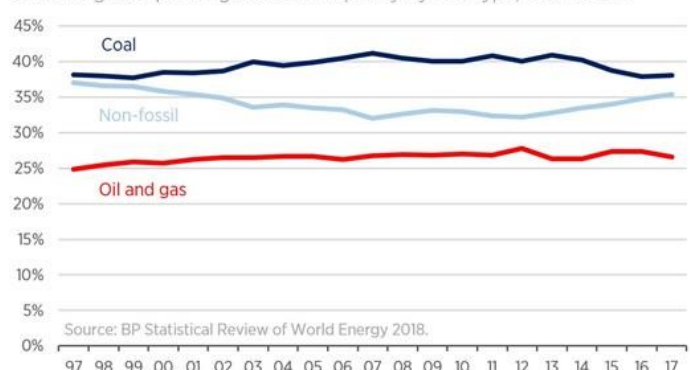
Unlikely bedfellows

Viewed through a value/growth lens, Facebook and Peabody Energy would make unlikely bedfellows. How much common ground can there be between the growth-rich business of mining for data and the growth-starved business of mining for coal? Perhaps more than first meets the eye. Dig deeper and it's evident that there is enormous economic demand for high-quality sources of both coal and data. Both are also targets of popular and regulatory backlash that threatens to restrict supply. And in both cases, we conclude that the prospects are brighter than implied by the current price.

Peabody Energy is the world's largest publicly-traded non-state-owned pure-play coal miner. Amid all the talk of a shift to cleaner fuel sources like gas and renewables, it's sobering to note that coal's share of electricity production was 38% last year – exactly where it was 20 years ago. As global demand for electricity has increased, coal has proved its worth as a cheap and reliable fuel.

Coal's share of power generation hasn't budged in 20 years

Share of global power generation capacity by fuel type, 1997 to 2017



Can we do without coal?

That's not to say coal is without its problems, and the environmental cost of burning coal is well known and beyond dispute. That said, the social cost of not burning coal is not to be ignored either. Consider China, the world's most populous nation, which accounts for more than 50% of global coal use. Its drastic 2016 directive to cut coal production as part of a project to restore 'blue skies' over Beijing proved to be so punitive for households and small businesses that it was relaxed just months later. So as tempting as it may be to say, "let's stop investing in coal", the reality is not that simple.

A better solution to the pollution problem needs to consider how coal is used, not just whether it is used. If coal isn't going away, at least those who rely on it can burn higher quality sources. That's where producers like Peabody stand to benefit. Its most valuable mines are located in Australia and have been blessed with higher energy-content coal than the Indonesian mines that currently account for most of Chinese thermal coal imports. By gradually switching from Indonesian to Australian coal, the Chinese can generate the same amount of electricity with less coal, thereby releasing fewer pollutants into the air. As a result, Australian mines are struggling to keep up with demand.

But you'd never know that from market sentiment. Among widespread condemnation of coal in general, such differences in quality are often overlooked. Indeed, so out-of-favour has coal become that even the most promising coal projects are finding it hard to obtain approval from regulators or financing from banks.

Peabody itself has learned its lessons the hard way. Flying high in the commodity bull market that peaked in 2011, Peabody took on too much debt and found it could not meet its obligations when the price of coal turned south, eventually filing for bankruptcy in April 2016. Investors tend to 'fight the last war' and are worried about a repeat. But while Peabody's operations haven't changed much since the last peak, its financial position is markedly different. Net debt has fallen from \$5.7 billion to zero, capital expenditure is down by almost 75%, and the company has plenty of loss carry-forwards to shield it from future tax. The result? Free cash flow has more than doubled from the last peak, while the company's enterprise value is down by over 70%. In terms of cash flow yield, Peabody is a true outlier.

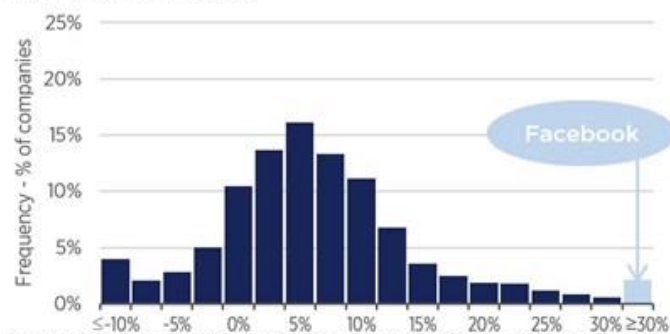
The risk, of course, is that Peabody's present could be much brighter than its future. We think that's unlikely, but it highlights one challenge of being a contrarian investor: if you are contrarian and wrong, it is generally for reasons that were obvious to everyone else. Lots of people hate coal, and if regulators go for broke and attempt to reduce coal use at any cost, they could hurt Peabody's fundamental prospects.

Is Facebook also an outlier?

The graphs below chart the percentage distribution of companies on a trailing 5-year average revenue growth and a trailing 12-month free cash flow yield.

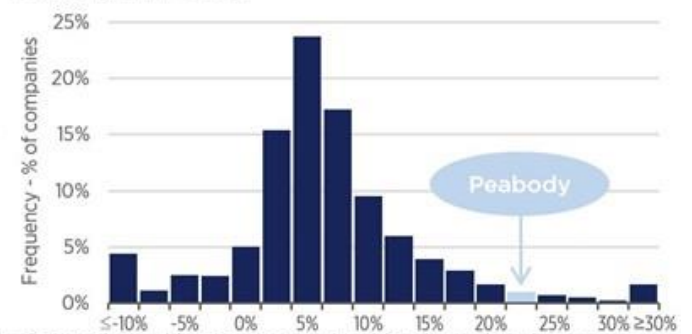
Trailing 5-year average revenue growth

Facebook is an outlier



Trailing free cash flow yield

Peabody is an outlier



Source: Datastream, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to data cleaning or changes in methodology. Distributions show the percent of stocks in the FTSE World Index (excluding financials) in each bracket. Each value on the x-axis represents the maximum value in the range. Orbis estimate of trailing 12-month free cash flow used for Peabody.

Priced at a multiple that is close to the market average, Facebook is an outlier in a different respect: its growth rate has been spectacular. It too has more than its share of haters, with the Cambridge Analytica fiasco putting personal data squarely in the regulators' spotlight. But, as with Peabody's coal, there has been no let-up in demand for Facebook's services along with its Instagram and WhatsApp properties. Users are still engaging with these platforms as much as they did before the scandal, while advertisers have shown no signs of deserting Facebook *en masse*.

The revenue that Facebook generates is primarily from advertising services. The company's ability to deliver more effective and relevant ads, and to therefore charge a premium for them, is unparalleled because of the amount of data it knows on its users. Regulation that seeks to discourage the sharing of this data with third parties would strengthen Facebook's competitive position, potentially allowing Facebook to capture revenue which previously had to be shared with partners. Meanwhile, the likely regulatory burden of having to identify and block inappropriate content is an exceptionally difficult task, one at which only the companies with the most sophisticated technology, like Facebook's, will stand a chance of succeeding.

Regulation as a barrier to entry

No doubt increased regulatory scrutiny is a fact of life for both Facebook and Peabody. However, while heavy-handed regulation is often viewed with trepidation by investors, again we take a different view. In our assessment, higher levels of regulation tend to act not as a barrier to corporate success, but as a barrier to competitive entry, and are often beneficial for incumbents' profitability in the long term.

We believe both Facebook and Peabody offer compelling returns for the long-term investor. Whether the returns are realised via growth or yield, or some combination of the two, is of little consequence: it's the total return potential that counts for us, and always has been.

It's true that we usually do a better job in market environments when shares with low expectations have outperformed those that everyone seems most excited about. But ask us if we are value or growth investors and our answer is: neither.

Ben Preston is Portfolio Manager at [Orbis Investments](#), a sponsor of Cuffelinks. This report constitutes general advice only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.

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Managing the pension Transfer Balance Cap

Graham Horrocks

The \$1.6 million pension Transfer Balance Cap (TBC) has become a major part of the financial plans of most people with high net worth. Gordon Mackenzie [discussed](#) the workings last year in Cuffelinks. The amounts that comprise the TBC, for each individual, are the accumulated total of:

- the balance in a pension account held as at 1 July 2017, and
- capital amounts that are transferred in to or out of a pension account after 1 July 2017.

Once the capital value of a pension has been counted, at 1 July 2017 or subsequently on transfer to or from a pension, no account is taken of the future account balance as a result of investment earnings (positive or negative) or pensions (ie income) paid. It only takes account of capital amounts as at 1 July 2017 and on each subsequent transfer to or from the pension account.

If investment income exceeds pensions paid, the account balance can increase beyond the \$1.6 million limit and there are no adverse consequences. Similarly, if investment income is negative or does not cover the pension payments made the account balance will reduce. This has been caused by investment returns and income (pension) payments and this does not open a gap for further transfers to a pension if the full \$1.6 million has previously been used.

Managing your TBC

So how can you manage your TBC to maximise the benefit of the tax-free status of the pension account?

There is a statutory minimum amount of pension that must be paid from a pension account. Taking this into account suggests that management of your TBC could include:

- Increasing the investment return of your pension account by investing it for the longer term using growth assets such as shares and property while investing more defensive assets such as cash and fixed interest outside the pension account either in accumulation accounts within superannuation or outside superannuation. You will need to be careful of any tax implications that might arise.
- Keeping the income (i.e. pension) paid from the pension account to the statutory minimum. If you need more income or lump sum amounts, these should, to the extent possible, be taken from moneys held outside superannuation or held within superannuation in accumulation accounts. This will maximise the pension account benefitting from its tax-free status.
- If you do need extra amounts, whether as income or lump sums, and these need to be taken from the pension account, do this as a commutation (or lump sum) rather than increased pension (income). If you are over 60, payments will be tax-free in either case. Income and lump sum (commutations) are treated differently under the means test for the Age Pension but this is unlikely to be an issue if you are concerned about the TBC. Lump sum (commutation) amounts come off your TBC account.

Future changes

Even if you are satisfied that you have accommodated the TBC for now, this may change in future. You may need extra room within your TBC in the future if you ever have extra superannuation amounts which could arise from:

- Contributions made while you are under age 65.
- Contributions made if you are between 65 and 75 and return to work.
- A contribution made following the sale of your principal residence after 1 July 2018. Contributions of up to \$300,000 per person will be allowed if you are over age 65.
- A death benefit superannuation pension received on the death of a partner.

The superannuation rules become increasingly complex, but it's worth understanding the major rules to maximise the benefits of the tax-free status.

Graham Horrocks is an actuary specialising in financial planning and superannuation, and a former General Manager, Research & Quality Assurance, with Ord Minnett. Since 1999, he has been an independent financial adviser. This article is educational and does not consider the circumstances of any investor.

Four drivers of growth in managed accounts

Toby Potter

Since 2004, when ASIC promulgated the Managed Discretionary Accounts (MDA) Class Order, managed accounts were set to be the next big thing.

Over the past three or four years that promise has started to come to fruition. Approximately \$60 billion is now invested in various forms of separately managed accounts (SMAs) and MDAs. These two forms of managed accounts have developed in tandem and represent differing perspectives on the benefits which managed accounts offer, and who will be best placed to take advantage of those benefits.

What are SMAs and MDAs?

Think of managed accounts as 'Implemented Advice' – the service an investor client would receive from an adviser if they were the adviser's only client, and the adviser had the skills of an experienced investment manager across all asset classes.

SMAs generally have a legal structure of registered managed investment schemes. They have been developed by the platform industry as a way of assisting advice firms to deliver the promise of implemented advice. They offer the benefit that the platform takes charge of technology and operations, and often provides a menu of

investment managers, just like the traditional managed fund menu. But they suffer from the disadvantage that they are platform-specific and are fundamentally a financial product.

MDAs are set up under their own set of regulations. They are much more commonly provided directly by advisory firms. There are over 200 AFSLs with MDA Provider authorisations. But the issue is that the MDA Provider is responsible for providing or outsourcing all facets of the service from administration and operations to investment management.

Growth in managed accounts of both types has been running at around 40% per year. However, a number of commentators are questioning whether this can continue in a post-Royal-Commission world.

Four drivers of growth in SMAs and MDAs

Growth in SMAs and MDAs has been driven by several factors, including:

1. An attempt to achieve greater practice efficiency among advisers.
2. A desire by advisers to deliver better, more precise client outcomes.
3. Technology developments that have enabled the systematic, model-based management of many portfolios.
4. A strategic trend for advice businesses to move towards wealth management, with different pricing models.

If the last of these clashes with regulatory change, will the other three drivers be derailed?

All forms of managed accounts are subject to the existing FOFA regulations relating to conflicted remuneration, just like any other financial product. Indeed, as mentioned above, SMAs are generally registered managed investment schemes and are subject to identical restrictions to those which apply to unit trusts.

How might a tighter regulatory regime impact the key drivers of growth described above?

1. Practice efficiency

Whether an advice business (AFSL holder) obtains revenue from their managed account service or not, the efficiency gains are substantial. Advisers will seek improvement in their office efficiency, and, if anything, this drive will accelerate as advice firms look to control costs more firmly than in the past.

2. Better client outcomes

Managed account structures, particularly multi-asset class models, recognise that client outcomes will be improved in several ways:

- Efficient implementation of tactical changes.
- Client portfolios receive continuous review, rather than annual ad hoc review. This makes advice fees easier to validate.
- Use of listed investments that was previously seen as impractical by many advisers. Generally, this has meant a lower cost of investment.
- Establishment of central investment teams, with an increase in the level of experience and skill applied to portfolios.
- Other cost reductions, particularly in fund manager MERs and often platform costs. The benefit of this flows directly to the client.

Taken in aggregate, these factors lead to better client investment outcomes. None of these issues is likely to be reduced in their impact by regulatory change.

3. Technology advancements

One of the impediments to the adoption of managed accounts was the inability to implement them on major platforms. Every one of the large platforms is now well advanced in implementing this capability and a number of fintechs are offering implementation which makes it feasible to manage many portfolios concurrently. Again, no likely regulatory change will cause these developments to be withdrawn.

4. Charging for portfolio management services

The development of more rigorous portfolio management capability either with internal investment capability or through the use of external consultants or directly contracted investment managers, comes at a cost. Advice groups either absorb this cost or legitimately levy a portfolio management fee on clients to cover it.

For the groups who absorb it as a cost of achieving the benefits outlined above, any regulation change will likely be a matter of indifference. For groups that recover these costs, there are well established client consent processes they can apply.

So, without wishing to seem like a Pollyanna, we don't think there will be a material negative impact on the trend to migrate significant existing advised assets into managed account structures.

Toby Potter is Chair of [IMAP \(the Institute of Managed Account Professionals\)](#), an organisation whose mission is education, information and representation of managed account professionals.

10 tips for choosing a managed account

Damien Klassen

Managed accounts have grown rapidly in recent years, especially driven by 'independent' financial advisers who want to use one platform solution for the administrative efficiency of their office. Advisers are also moving away from the wraps of institutional providers as they seek to become more independent and remove perceived conflicts.

But simply because an adviser is 'independent' does not mean there is no conflict in the products they choose. Henderson Maxwell is the highest-profile example following the revelations of the Financial Services Royal Commission. As [The Australian Financial Review](#) reported:

"Mr Henderson was also skewered for putting a large proportion of his client book into managed discretionary accounts that included direct shares and charged high fees."

Henderson Maxwell is not unlike some other financial planning businesses in trying to bundle clients into a particular type of a managed account where the fees are large (2%ish) and often structured as personal advice fees rather than a product fee (which have some regulatory implications). The financial adviser runs the portfolio, often using direct shares.

Watch the total package

Some of these managed accounts are excellent, using investment managers who have the experience and the capacity to research stocks and run the portfolios for the planning group. Direct share ownership structures used by managed accounts can be tax advantageous over managed funds, and transparency is much improved. In the better cases, the total fees are closer to 1% than 2% and trading costs are cheap.

Other times, managed accounts are run by an adviser with a full book of clients to call and write plans for, accompanied by a newspaper and gut feel for research. The trading fees are high, maybe the adviser gets 'rebates' from the broker as a reward for having clients who pay a lot in brokerage. In some cases:

- platform costs are usually around 0.2%-0.5%
- investment management fees are around 0.3%-1.25% depending on the type of fund
- the adviser is often charging around 1%.

It adds up. If the adviser is also picking the stocks, then the adviser takes the investment management fees as well, probably doubling the revenue to the adviser. But the client has gone from having a full-time investment team running a portfolio to a part-timer planner who may not have the same experience in portfolio construction, risk mitigation or stock valuation as they do in financial planning.

There can be big differences on the investment side of managed accounts too. At one end is low fees, transparency and professional management. At the other end is high fees with little investment process but a

slick sales process. For the high fee options, you usually need to be 'sold', a seduction process that will appeal to the heart rather than the head.

If you have a managed account or are thinking of opening one, here are my tips:

1. Check the brokerage. It should be cheaper than you would pay with an online broker, and probably much cheaper. If it is more, then ask questions about how payments are made and whether your planner receives kickbacks from the broker. Check how much the typical brokerage is for your size of account. For some accounts, this can be the largest cost. Brokerage is often hidden. The better managers will be open with the costs, the worse ones will pretend brokerage costs do not exist.

2. Check the platform costs. You should not pay more than 0.5%.

3. Check who is actually managing your money. If you are paying for professional investment management, make sure that it is not being done by a salesperson in their spare time rather than by experienced, dedicated portfolio managers.

4. Check the investment process. There are a number of different investment strategies that work over time. The overwhelming majority of these have a process that is followed. When you see something like "XYZ planning is a style neutral investment manager looking to invest in investments that match its thematic view" what they are really saying is that they will buy whatever they want whenever they want and there is no real investment process. It may work out well. It often does not.

5. Check the investment constraints. There should be some. You want to know that they can't bundle too much of your money into one investment, and so there should be constraints like 'no more than x% in any one stock'. You want to know that there are also limits to asset classes. For example, you don't want to see Cash: 0-100% Australian Equities: 0-100% as the limits. These mean the investment managers can do whatever they want.

6. Check your internal manager costs. If your adviser is putting you into other managers' products, make sure you understand whether there are also other underlying costs. Say you are paying 1.25% for a managed account with adviser ABC which invests in a model portfolio run by a fund manager XYZ. In some cases, the 1.25% will include XYZ's management fees, in other cases, XYZ's fee will be an addition to the 1.25%.

7. Check performance fees and conditions. If you are paying performance fees, then you should have lower base fees. You should also have a highwater mark and a benchmark that actually reflects the return the portfolio should make.

8. Check investment performance. This should be of the model portfolio, assessed by a third party, probably the platform provider. Be wary of advisers who offer (as evidence of performance) individual accounts not assessed by a third party. These can be 'cherry picked' and may include assets that typical portfolios didn't own. Past performance should not be the only thing you look at, but it can be helpful.

9. Check risk metrics. Your investment manager should have some risk metrics, even though they don't tell the full story. However, if your manager isn't even watching ratios like volatility, relative return, tracking error or Sharpe ratios, then it is a sign that you have a part-timer running your money. High returns are good, but if your investment manager is using your money at the casino, then you want to know.

10. Check related parties. Who else gets paid? The worst ones are where low fees in one part of an operation are used as a bait for other divisions to make money. Accountancy fees, brokerage fees, platform fees, life insurance commissions, mortgage broking fees can all generate tens of thousands for financial organisations. Say you could have \$400,000 in an industry fund costing 0.8% (\$3,200 per year) or a managed account provider at 1.1% (\$4,400 per year). The tax benefits, transparency and customisation may more than pay for the 0.3% difference in fees. However, if you are also paying \$5,000 per year in accountancy costs on a new SMSF and another \$5,000 in life insurance commissions, then the equation might not look as good.

Damien Klassen is Head of Investments at [Nucleus Wealth](#). This article is general information and does not consider the circumstances of any individual.

Why more financial advisers are moving to 'independence'

Shannon Bernasconi

The flight to 'independence' from major institutions by financial advisers has been a developing theme over recent years and it is set to continue. The findings of the Financial Services Royal Commission increase the importance of demonstrating greater independence between products and advice, but the reasons for the move are as varied as the types of clients and communities advisers serve.

Not just a product off a shelf

What are independent advisers looking for when partnering with technology and service providers? When I asked this question of our clients, the advisers, a strong theme in the responses was that they want to build trusted relationships and partnerships as opposed to buying a product off a shelf or a 'user licence'. They want open architecture and an Approved Product List (APL) that does not restrict them from delivering what is in the best interest of their clients. They want compliance with a delivery mechanism that is flexible, allowing their own culture and brand in communications. Ultimately, they also need easy to use services and platforms that allow them to spend more time with clients without being bogged down in administration and compliance tasks.

Jayne Graving of Arch Financial Planning summarised the drive for independence as:

"I would say the benefits of being independent and what we value are the ability to partner with best of breed and like-minded firms with resources including research, technology providers, platforms etc. We have complete flexibility and are not locked into any system, methodology or product. Every layer of the advice process is independent of the others, and everyone retains the integrity of their service delivery. There are no impeding constraints like limited APL's or conflicts, just teams of professionals working together by choice to achieve the best outcomes."

What about the client perspective?

Some of the themes in the adviser feedback on what their clients are looking for, and hence what the adviser needs to deliver, include:

- Transparency and confidence in the safety of the assets
- Access to appropriate investment options at reasonable cost
- Cost effective and demonstrative value of advice
- Honesty and integrity in the way that services are priced, and fees are levied, with no hidden charges (such as in the form of no interest on cash)
- Online portal for viewing portfolios and ease in communication paths for updates from the adviser.

Not only are these advisers looking for great services and products for themselves, the outcomes and the experience for their clients was paramount.

Features of the platform that assist the advice process

Advisers say they are looking for a provider to deliver these outcomes for their clients:

- Remove the layers of fees built up over the years of institutional management
- A cost-effective solution to assist with best interest duties
- Support and automation of compliance through audit trails, controls, alerts and monitoring, as well as accuracy through reconciliations
- Flexible and reliable reporting systems that can integrate into financial planning software
- Open architecture giving the ability to choose from a landscape of financial products and services based on what is best suited to achieving the clients' goals: *"We don't want to be beholden to one major, vertically-integrated financial company."*
- Next-generation thinking: *"Gone is the old 'hidden fee', 'shelf space' and 'lock in' approach."*

- Branding by the adviser to keep the marketing and messaging consistent and assist in a retention of culture
- Technologically advanced so that it reduces administrative staff time, lowering cost, reducing human error and increasing the efficiency of managing models. *"Time spent on back office and administration is time that could be better spent working with our clients."*
- Scalability to grow the business
- A single solution that can be tailored for different types of clients, including retail, wholesale, families, individuals and not-for-profits

The efficiency of model portfolios and managed accounts

Operational efficiency and best interest responsibilities are also assisted by the use of model portfolios and managed accounts.

Firstly, advisers can easily change a model portfolio and it flows through to all clients' portfolios with that model, and a bulk rebalance can occur smoothly and quickly.

Secondly, a good investment committee or investment manager can make a decision and make the change within a day, allowing them to be responsive to market conditions in best interest of clients' returns and outcomes. Intraday 'trading' is no longer dependent on a stockbroker's ability but execution is transferred into advice through segregated accounts with their own Holder Identification Numbers (HIN).

Liza Janakievski, CEO of Giles Wade, expresses what many advisers view as the emerging approach to the relationship between the technology (platform provider) and the adviser:

"As a firm with bespoke family group clients, we want to ensure that our future requirements for client tailoring are heard and not just put on a 'wish list'."

Even though technology plays a bigger role in the life of advisers and their clients, it does so in subtle ways. Interactions with technology are becoming more seamless within the advice process and systems are becoming easier to use. The goal at WealthO2 is to deliver elegant and intuitive software solutions for advisers that are efficient and compliant. Advisers want to spend more time with clients and develop relationships and let the software implement the adviser's best interest advice in a scalable and efficient manner.

Now is the opportunity for advisers to cleanse the public perception of poor behaviour raised in the Royal Commission and deliver better outcomes that are clear of conflict and give the best results for both the client and the business alike.

Shannon Bernasconi is Managing Director of [WealthO2](#), a wealth management software solution provider for financial advisers. This article does not consider the financial circumstances of any individual.

Will sovereign defaults spark the next GFC?

Vinay Kolhatkar

"Countries don't go bankrupt." Walter Wriston, former head of Citibank

"There is a myth that floated around the banking community not many years ago that governments do not go bankrupt. I cannot imagine who dreamed that one up." Gordon Tullock, Economist

Sovereign restructures have been witnessed for Russia, Argentina, Greece, Iraq, Uruguay, and many others, with [investors taking 'haircuts'](#), some ranging from 50% (Russia) to nearly 90% (Iraq). Expensive haircuts those, but for what is purportedly a defensive asset class, investors flock back again with renewed vigour: "This time, it will be different." So said Argentina, who, by some estimates, has defaulted eight times on its sovereign debt. In 2017, jaws dropped as Argentina issued US\$2.75 billion of bonds at 7.9% (in US\$) on a 100-year maturity, and then, with inflation running at 40% per annum and the peso falling, sought IMF assistance in May 2018.

Perhaps some money managers are so hungry for *yield today*, that they underplay the risk of *haircuts tomorrow*.

But fixed interest investors only need worry about banana republics not paying them back, right? Think again. We are entering uncharted investment waters, a world in which great republics may repudiate their sovereign debt, setting off a chain of catastrophic corrections. And the greatest republic is the United States.

Will the USS Titanic hit the iceberg in 2028, or before?

When the US Congressional Budget Office (CBO) released its 10-year budget and economic outlook in April 2018, it reported that:

"The budget deficit will near one trillion dollars next year, after which permanent trillion-dollar deficits will emerge and continue indefinitely." The national debt, CBO said, *"... is rising unsustainably."*

However, [several economists](#) have long argued that the CBO vastly understates the problem. Boston University Economics Professor Laurence Kotlikoff contends that CBO's debt estimates do not take into account the full financial obligations the government is committed to honor, especially for future payments of Social Security, Medicare and interest on the debt. That 'fiscal gap', according to Kotlikoff, a net present value (NPV) of future obligations (written into current law) less expected revenues is well over US\$200 trillion. In 2017, US GDP was US\$19.4 trillion.

The International Monetary Fund (IMF) also has a more pessimistic opinion. The IMF's view is that by 2023, the US debt-to-GDP ratio could be on par with Italy's, both well above 100%.

Audits of sovereigns

We justly require an independent financial audit of corporations. Sovereigns should be subject to a similar discipline, with auditors chosen by a lower house majority and affirmed by the upper house (in democracies).

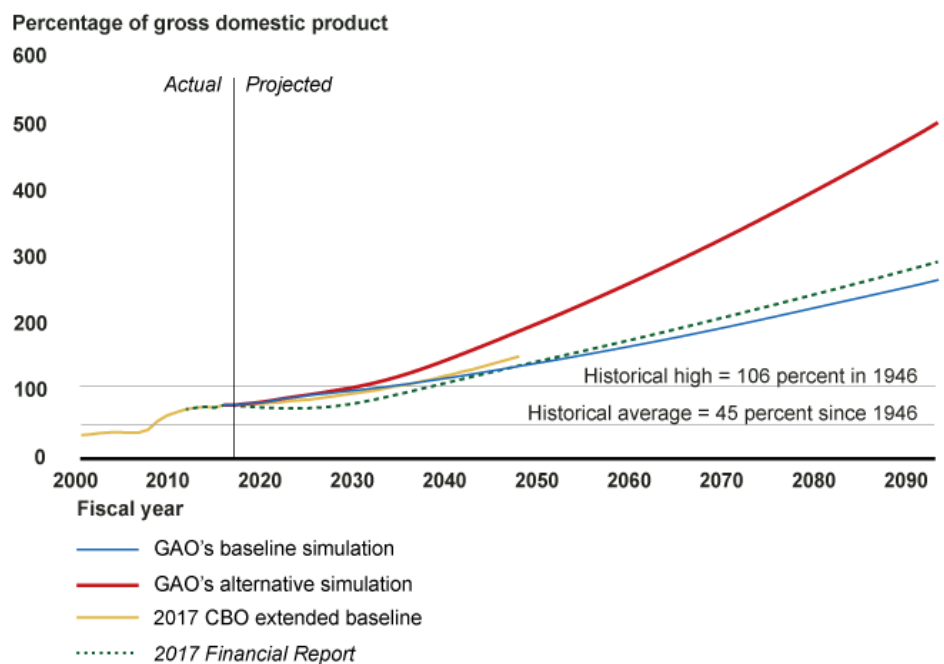
The [vast majority](#) of sovereigns are incessantly running budget deficits. The power to tax is constrained by the 'Laffer Curve' realities: Taxation revenue falls when tax rates become too high due to evasion, reduced incentive to work and economic deterioration.

If auditors applied the same tests as they do to corporations, many sovereigns may not pass the test of solvency.

Indeed, the Bureau of the Fiscal Service (BFS), a US government agency, says that as at 30 September 2017, the US Government's liabilities exceeded its assets [by US\\$20 trillion](#). This is a 'as at a date' calculation, not an NPV of a future cash flow stream.

The US Government Accountability Office (GAO), an independent, nonpartisan agency that works for Congress, adds: "... policymakers will need to consider policy changes to the entire range of federal activities, both revenue and spending (entitlement programs, other mandatory spending, and discretionary spending)".

The chart (right) compares the GAO, CBO and BFS projections on the ratio of US Government debt (limited to that held by the public) to GDP:



Sources: GAO, Congressional Budget Office, and 2017 Financial Report. | GAO-18-299SP

Note: Only GAO's simulations include the effects of legislation enacted after September 30, 2017. At the time of this report, CBO has not yet released its 2018 long-term outlook report, which includes its 30-year extended baseline projection.

The US is not alone ... the rumblings in Europe and Asia

Trading Economics produces a Debt/GDP ratio table by country. Here are the 10 worst:

Government Debt to GDP, %					
Country	Last		Previous	Highest	Lowest
Japan	253	Dec-17	250	253	51
Greece	179	Dec-17	181	181	23
Lebanon	148	Dec-16	142	183	131
Italy	132	Dec-17	132	132	91
Portugal	126	Dec-17	130	131	50
Cape Verde	125	Dec-17	130	130	57
Congo	118	Dec-17	115	204	22
Singapore	111	Dec-17	112	112	67
Bhutan	109	Dec-17	119	119	37
United States	105	Dec-17	106	119	32

Unsurprisingly, the worst offenders are trading at or close to their highest ever ratios.

Meanwhile, here is [Forbes magazine on the top offender, Japan](#), December 2017:

"By 2041, assuming tax revenue remains constant and there won't be any economic shocks, Japan's interest repayments will exceed tax income. Note that we also assume [the] interest rate to stay at 1.1%, because if this figure increases then the government will default more quickly."

And here's the IMF (January 2018) on China:

"International experience suggests that China's current credit trajectory is dangerous with increasing risks of a disruptive adjustment and/or a marked growth slowdown ... A disorderly correction from such an expansion could have far-reaching implications on financial stability and growth."

In Italy, all the main [political parties are promising](#) sweeping tax cuts, higher public pensions and a boost in welfare provisions. With a straight face, the politicians also say they will cut the national debt at the same time, in a Don Corleone "we will make them an offer they can't refuse" style. Voters agree, but not Roberto Perotti, an economics professor at Milan's Bocconi University, who cried out: "They are just trying to trick us, they are throwing out random numbers that make no sense."

Kicking the can down the road

Raising taxes or cutting welfare is the surest recipe for removal from office.

Borrowing from the next generation, as long as capital markets allow, is one way to kick the can down the road. The nation's banks must hold sovereign bonds as liquid, 'low-risk' assets by regulation. The central bank reduces interest rates because the Keynesians think that's stimulatory. Yet they have been near-zero in many advanced economies, after non-stop diminution for 30 years.

Saving rates plummet, but the yearly interest bill is low, courtesy of low rates, and principal repayments and ongoing deficits are met by ever-more borrowing. When the markets do not buy enough, the central bank itself starts buying – sovereign bonds at first, then mortgage assets, corporate bonds, equities – whatever is required to keep the markets afloat.

A debt feast of that nature does not end until markets force it to or when even interest payments cannot be met. By this point, the austerity required is so high that it's politically unmanageable.

Repudiation is the better course of action. It does not destroy the currency or the economy, but hurts those who bought the bonds in the first place. However, besieged countries may choose a bit of everything: a little austerity, high inflation, and an offer of an expensive haircut.

When everyone is both the rescuer and the rescued

Relentless Quantitative Easing has created some US\$13 trillion of assets across the US Federal Reserve (the Fed), the European Central Bank (ECB) and the Bank of Japan (BoJ), plus several trillion more with other major central banks. As equity underwriters to an IPO who are stuck with a lot of stock know, a large overhang that stands at 'ready to offload' creates a price ceiling. The US central bank balance sheet is now 23% of GDP, [a level nowhere near seen since just post WWII](#), while BoJ's assets are over 50% of GDP.

Between them, the Fed, the Bank of England (BoE), ECB, BoJ and other central banks have bought not only their own sovereign bonds and financed their government's deficit, but also other sovereign bonds, mortgage securities, asset-backed securities, corporate bonds, and even outright listed corporate equity.

European banks hold other European sovereign risk to a significant degree. They intertwine and entangle their fortunes. In Europe, we may see no one on the pier, hauling the drowning out. A more likely scenario is a circle of sovereigns (and their central banks) holding hands, each assuring the one on their left, "No worries, I've got you, mate," as market currents push them all out to sea.

Can investors insure against Black Swan events?

Downside correlations among asset classes can be much higher than upside correlations, upsetting diversification metrics. Even worse, in Black Swan events, asset classes could be as together as Jack and Jill tumbling down the hill. We know that from the GFC. Global fixed interest manager PIMCO opines that activist central banks make for [stronger correlations](#) across asset classes. Old correlations do not hold as paradigms shift.

Some insurance portfolios include customised strategies and inverse exchange-traded funds (ETFs), which profit when markets go down. Some investors may prefer physical gold, gold ETFs, or long volatility trades (positions which profit from higher market swings). Such insurance involves ongoing opportunity costs and risks.

A comparison of the risks, costs, and strategies of such investment insurance policies is beyond the scope of this paper.

The year 2029 will mark the centennial anniversary of the Great Depression. It's not just a bad omen, the fundamentals point to a severe correction sometime over the next decade, but the lack of certainty over timing makes the events hard to insure against.

Vinay Kolhatkar is Assistant Editor at Cuffelinks. This article was written for educational purposes and to stimulate debate and is not intended to be financial advice. Analyses from professional investment managers which address the insurance issue are welcome.

How a carer inherited an estate

Donal Griffin

Do you or your parents have a cleaner or a carer? Don't get us wrong, we think that properly-paid cleaners are a good thing and properly-paid carers deserve their place in heaven.

However, just as these people can be underpaid, sometimes they arguably get much more than a family might think appropriate.

A recent case of a carer inheriting an estate

In Carr v Homersham, Ms Cynthia Carr (the Carer) said that she commenced cleaning for a Mrs Beryl Hordern (the deceased) in the eastern suburbs of Sydney. The deceased suffered from Alzheimer's disease for more than 10 years before her death in 2014. A friendship developed between the two women and they met frequently on a social basis. Ms Carr also performed many chores for the deceased.

When the deceased died, she left 100% of her estate to the Carer. We make no suggestion that the Carer acted with a view to benefitting from the estate of her client.

The deceased executed a will kit in 2001 leaving everything to Ann Richardson, her niece. She subsequently made a new will in 2004 under the belief that her niece complained about having to care for the deceased's late sister, who passed away when the deceased's niece was in her twenties. The niece was left out of the estate and so she challenged the 2004 will.

The Court at first instance found: "I am not satisfied that [the Carer] has satisfied the onus of proof that the 2004 will is the will of a free and capable testator so found in favour of the 2001 will kit which left her entire estate to her niece." The niece won Round 1.

The Carer appealed to the Court of Appeal, where three judges reviewed the evidence. A geriatrician from St Vincent's Hospital had concerns about the deceased's capacity but the Court seemed unsure whether he saw her in her then-normal state. He said that she had a whisky during the consultation and that she said she had already had a drink before he arrived! We note the irony of the geriatrician's name being 'Dr Beveridge'!

While there was evidence of advanced dementia and difficulty remembering names, the number of the property in which she lived and managing money, the evidence of the two lawyers who witnessed the will was persuasive of her capacity at the time she executed it.

The testator's solicitor, Mr Noel Bracks, gave evidence that he had questioned her about being sure that she wished to leave everything to Ms Carr. She said she was sure, describing Ms Carr as "my only real friend." Mr Bracks pressed, noting that she had a niece overseas. The testator responded:

"Yes, and a nephew, but I don't want to leave anything to them. I have a will leaving it to Ann [the niece] but she has disgraced herself with comments about my sister (her mother) and the nephew doesn't deserve anything."

The other evidence came from Ms Carr, who was present when the solicitors came to the testator's apartment to witness her execution of the 2004 will. Her affidavit stated:

"I said 'What about Ann [sic], I thought she was to get everything.' She said 'No, Ann has paid no attention to me since I spoke to her about the way she had spoken about her mother ruining her life When did she last visit me or even inquire as to my well-being? No, you deserve everything. You have been a very good friend to me and anyway Ann has got plenty, she doesn't need this.'"

The 2004 will stood. Round 2 (the final round as at the date of this article) to the Carer. The Court even found that the deceased was mistaken in her belief that her niece had spoken ill of the deceased's sister. Crucially, however, there was no evidence that the deceased was irrationally holding on to this belief.

Judicial comments

MacFarlan JA in the Court of Appeal stated:

"The authorities to which I turn below in my view establish that a false belief, even one that is material to the making of the will in question, is not of itself sufficient for this purpose. More is required: the nature of the deceased's false belief and the circumstances in which it was adopted and adhered to must point to a lack of capacity of the deceased "to comprehend and appreciate the claims to which he [or she] ought to give effect" (Banks v Goodfellow)."

"It is only if there are repeated attempts to correct the view and they are rebuffed that it may get to the point of irrationality and ordinarily evidence will be required that there has been an attempt to reason the deceased out of the belief, such that the deceased's adherence to it suggests that the deceased has a mental disorder or deficiency precluding the deceased from comprehending and appreciating 'the claims to which he [or she] ought to give effect' (Banks v Goodfellow). He found the trial judge erred in thinking the talking out of the understanding was immaterial."

"To adopt the language of Gleeson CJ in Re Estate of Griffith, whilst the deceased's approach may have been 'harsh' and 'unreasonable', it would not have reflected a 'morbid aberration' which [so affected the deceased's judgment of Ms Richardson] as to warrant the conclusion that she lacked the capacity to make a valid will".

Basten JA stated:

"There was, in effect, an absence of persuasive evidence linking the antipathy for her niece with unsoundness of mind. A court must be vigilant against drawing such a link on the basis of its view that the judgment exercised by the testator, founded upon a false recollection of the reason for her antipathy, was quite

unreasonable. Accepting that it raised a relevant doubt, a careful analysis of the whole of the evidence showed that there was no proper evidential basis to conclude that an irrationally based antipathy towards her adult niece warranted a finding of testamentary incapacity. The doubt should be rejected as insubstantial."

The decisive factor

If the deceased could have been reasoned out of the mistaken view, it would not have been regarded as incapacity. If there had been a statutory declaration by the deceased explaining her thought process, the case could have been decided differently.

We will never know if the deceased was deliberately compromising the assessment of the geriatrician by drinking. You could not make this stuff up.

In all seriousness, the case demonstrates the care that the Court takes to establish the facts and to honour the real testamentary wishes of a person. Unfortunately for the parties, the dirty laundry is closely examined and washed publicly. Without evidence, it is hard to win.

As the experienced consultant psychiatrist said in this case, "[misunderstanding of the family dynamics is] common enough in families". What family is immune from that?

Postscript

If you like this type of drama, there is more to come when the Supreme Court of NSW delivers its decision in the case of the author of *The Thorn Birds*, Colleen McCullough. Senior Counsel for the winner in the Carer case, David Murr SC, also appeared in the *Thorn Birds* case, acting for the author's husband.

To set the scene for that decision, we quote from [Traveller magazine](#) which published a puff piece on Ms McCullough's house on Norfolk Island, without knowing the drama that was to follow after her death:

"From the outside, Australian novelist Colleen McCullough's home on Norfolk Island is prim and picket-fence perfect, a long tree-lined driveway leading to a white two-storey colonial house in a leafy garden. Inside, it's a different story ...".

Isn't it the same in many houses?

Donal Griffin is a Principal of [Legacy Law](#), a legal firm specialising in protecting family assets. The firm is not licensed to give financial advice. This article does not consider any individual circumstances and Cuffelinks does not know the merits or otherwise of the case.

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