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Call that disruption? Investors are forgetting

Roger Montgomery

I have been stunned for many years by Tesla's market capitalisation. At US$291.00 per share, Tesla is valued by the market at US$50 billion ($69 billion).

Manufacturing and quality control issues, longer delivery times, and the antics of the CEO aside (please stay away from Twitter, Elon), Tesla delivered only 126,740 vehicles in the year to 30 June 2018. That's a market capitalisation of US$394,500 per vehicle. To put that in perspective, Ford Motor Company sits on a market capitalisation of US$37 billion ($51 billion) and delivered 217,700 vehicles worldwide in the month of August alone. In 2017 Ford sold approximately 6.6 million vehicles worldwide. That equates to a market capitalisation per vehicle of US$5,600.

Over in Europe, Volkswagen AG trades on a market capitalisation of €68 billion (US$79 billion), which puts it on a market capitalisation per vehicle of $7,383 given it sold 10.7 million vehicles in 2017. Only the luxury brands such as Daimler and BMW trade on market caps of more than US$20,000 per vehicle sold and even then, they are more than 10 times cheaper than Tesla.

Market madness, or a transformative approach to market valuation

This table summarises the price investors are willing to pay, per vehicle sold, for each manufacturer. Market caps are converted to US dollars.

	Manufacturer	Market cap (US$)	Vehicles sold annually	Market cap per vehicle sold
1.	Tesla	$50 billion	127,000	$394,000
2.	Daimler (Mercedes-Benz)	$67.7 billion	2.3 million	$29,434
3.	BMW	$61.2 billion	2.5 million	$24,480
4.	Toyota	$197.6 billion	10.4 million	$19,000
5.	Volkswagen	$79 billion	10.7 million	$7,383
6.	Ford	$37 billion	6.6 million	$5,600
7.	GM	$48 billion	9.6 million	$5,000

Investors can buy GM for $5,000 per vehicle sold, or they can buy Tesla for nearly $400,000 per vehicle sold. The economics between Tesla and every other car manufacturer in the world, in the long run, might be slightly different but they cannot be sufficiently dissimilar to justify such a disparity.

Clearly, enthusiasm for the world-changing potential of EV technology has translated to an equally-transformative approach to stock market valuation. What investors are forgetting however is that Tesla will ultimately be a car company.

Since the horseless carriage was invented by Karl Benz, there have been more than 1,500 car manufacturers in the United States of which only one exists today – Ford – that makes a profit and was not bailed out by the US Government during the GFC. Changing a drive train from petrol to electric will not miraculously alter the economics of the business of making and delivering cars. Ultimately, if it survives, Tesla will be making cars, which is a highly labour- and capital-intensive fashion item where tastes for colours and styles change just as frequently as on the catwalk. Oh, and Ford plans to invest US$11 billion in electrification by 2022.

The same nutty logic is applied in Australia

While Tesla has not distracted me from the harsh realities of competitive business dynamics, it has distracted me from the fact the same insanely optimistic, if not just plain nutty, logic is being applied to high potential growth companies here in Australia. Let's not forget this is purely a function of cheap interest rates and inflation-free growth that simply won't last.

But more importantly, investors here in Australia are forgetting that the new businesses – even those that promise an exciting theme and a 'global' opportunity – aren't really new at all. Yes, in some cases they are signing up customers at a rapid rate, but ultimately, it is growth in profits not 'users' that counts. If they survive competition, they are more than likely to be a business with vastly similar economics to those they disrupt. There are no free lunches.

Take a look at the market capitalisations of some of Australia's listed businesses whose share prices have rallied on the back of hopes of global domination; A2 Milk, Afterpay Touch, Xero, Wisetech Global, Altium and Appen have an aggregate market capitalisation of $31 billion, combined revenue of less than $2 billion and combined net profits of just $240 million. Of that profit, A2M is responsible for $185 million and Xero and Afterpay Touch are losing money.

An equally-weighted portfolio of the above companies is trading on 129 times earnings. Yes, value investors tend to get a bit grumpy when the optimists are winning but it is not unexpected to see party revellers having a great time during the party. It's the morning after when heads hurt.

Afterpay builds in massive growth hopes

Afterpay Touch is a classic example of a company that has benefited from a hopeful approach to valuing growth. I cannot count how many times I have heard "if they can grab just X per cent of US retail sales, they'll be worth … X to the power of …". It's a good rule of thumb to zip up your wallet when a promoter includes in their slide deck the size of a market, and then asks you to consider what would happen if they 'only' take one per cent.

Afterpay is effectively providing a small and short-term (roughly 56 days) line of credit on an average transaction value of $150. When interest rates are zero and credit is cheap, consumers love borrowing money and consequently consumption surges. It's a combination that, in the absence of disruption, represents Goldilocks conditions for retailers and consumer finance companies.

The only problem of course is that when interest rates rise consumer finance companies are hit, not only by rising bad and doubtful debts but slowing consumer conditions too. Margins are squeezed between slumping revenues and rising costs. It wasn't so long ago that Afterpay was trading at less than $3.00, and today its shares are more than five times higher at $17.00.

Afterpay earns its money by charging consumers $10 if they miss a payment plus another $7 if they are more than a week late (the maximum cumulative penalty is $68), and by charging the retailer a few percent from each sale. Afterpay generates 75% of its revenue from retail merchant fees and about 25% from the customer via late fees, which jumped 364% in 2018.

As I mentioned earlier, many of these new age businesses and 'digital disrupters' aren't that new at all. Afterpay looks very similar to a factoring business, just as Tesla looks scarily like a car manufacturer.

When a business wants to receive cash flow, one of things it can do is sell its receivables at a discount. In a factoring arrangement, a business makes a sale and generates an account receivable. The 'factor' buys the right to collect on that invoice (the receivable) by agreeing to pay the seller the invoice's face value, less a fee. Sound familiar? It's exactly what these retail finance offerings are. A merchant is selling the goods today to a customer who hasn't yet paid, and is instead receiving a discounted payment from the finance provider – the 'factor', in this case Afterpay.

And because the factoring businesses extends its credit to the clients' customers, rather than the client, it's concerned about the credit risk of the customers, not the client. The client is laying off the risk of non-performance to the finance provider. Factoring is one of the oldest forms of finance available and the economics of factoring businesses aren't particularly attractive because factoring is not a particularly high-return business.

There is a basic relationship in investing that has always held true. High returns usually come from assuming higher risk. So how can investors in Afterpay generate high returns from what is effectively a low-return factoring business?

Some professional investors might argue that the returns from Afterpay's factoring business are in fact high and the risks very low because small individual amounts are being assumed and the terms are short at 56 days. But if that were true, how is Afterpay able to extract such high returns when extending credit to low risk customers?

If such great returns are available from extending credit to very low risk customers, others will join the party. And that is something both Afterpay and Tesla investors seem to have missed.

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

Being an obvious idiot is the worst part of value investing

Steve Johnson

Being a contrarian can be a lonely existence. It involves doing nothing for long periods of time. And then when you do something, you are usually going against conventional wisdom at the time. But loneliness is not the hardest part of the job. The hardest part is being an obvious idiot when you get things wrong.

All investors make mistakes. Most successful investors say the best you can expect is to get six or seven out of 10 right. That's been consistent with our experience over the past decade. The difference as a value investor is that you get things wrong in ways that are obvious, seemingly stupid and embarrassing.

Into the face of Jumbo concerns

Online lottery ticket reseller Jumbo Interactive (ASX:JIN) is a darling growth stock these days. But it wasn't always that way.

We first bought into the stock at around $2.50 a share. From there it fell more than 60% and we added significantly to the holding at less than $0.90 per share. As a value investing opportunity it was simple. Its market valuation was just $39 million. It had $17 million in cash, a pile of franking credits and an Australian business making $8 million of pre-tax profit a year.

But the issues with the business were well known in 2015. Jumbo was wasting money on international expansion gambles in Germany, the US and Mexico. It had one critical supplier, Tatts Group, that could terminate its distribution agreements and kill the business overnight. And, perhaps most worrying long term, Jumbo sold exactly the same product as Tatts for a 10% premium. Why did anyone even use it?

When the share price was getting hammered, everyone was focused on these flaws in the business model. Blind Freddy could see that this business didn't have a future.

Taking a contrarian view involved coming to terms with just how much money would be wasted, how profitable the Australian business could be and what the chances were of losing that big supplier.

Jumbo turned out well — the stock is up from $1 to $6.50. But imagine if Tatts had pulled the pin soon after we bought it. It would have been easy for our investors to turn around and say: "You guys should have seen that coming — everybody else did." Which, of course, is why the opportunity was there in the first place.

Wrong on Freedom and looking stupid

The Forager Australian Shares Fund owns funeral insurance company Freedom Insurance (ASX:FIG) in its current portfolio. Freedom's share price is down more than 60% over the past two weeks after being called before the Royal Commission into Financial Services and the release of an ASIC paper condemning its business model.

Forager made the investment knowing that Freedom's sales model was potentially flawed. Here's what I wrote in our research document in November 2017:

"The direct sales business model could come under threat. Regulators could require personal advice to sell life insurance products, for example. There's something ugly about phone sales of insurance product and I can imagine it getting a lot more scrutiny if it continues to grow. I would put the probability at low but meaningful and the impact very high."

A probability assessment of 'low' can be debated. The point is that we made the investment knowing full well that there was a chance of something very bad happening. We thought there was enough potential upside to compensate for that risk and that there was some downside protection in the company's existing customer base (the latter part of that thesis is about to be put to the test).

In Freedom's case, unlike Jumbo, that risk has become a reality. And when a risk that everyone was worried about comes to the fore, the nuance of chance and probability gets lost. It simply looks like we failed to understand something that was blatantly obvious to everyone else.

Making mistakes is something you get used to quickly in this business. Regularly looking like an idiot, though, is something I find much tougher. For me, that's the hardest part of being a value investor.

Steve Johnson is the Chief Investment Officer at Forager Funds Management, has a monthly column in the Australian Financial Review and regularly appears on Sky Business, the ABC and CNBC. To find out more about Forager Funds Management, please visit www.foragerfunds.com. Some of the comments below were posted on the Forager website.

SMSF investment trends show rising diversity

Marcus Evans

Frustrated by the underperformance of many Australian blue-chips, SMSF trustees have increasingly turned to a more diversified group of mid and small cap companies that have shown strong gains over the past 12 months. As shown below, in 2017/2018, small caps significantly outperformed stocks in the ASX50.

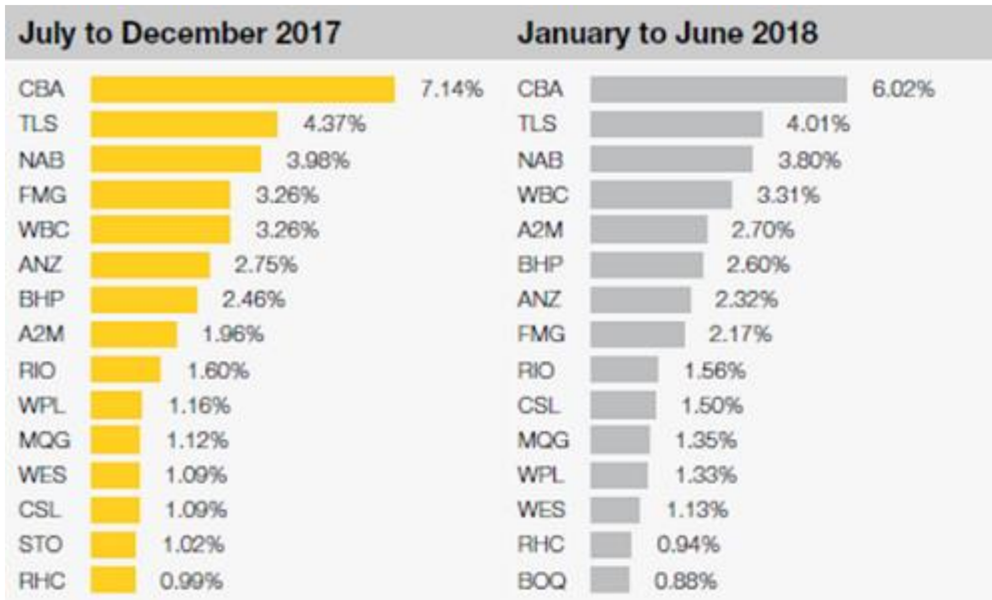
The trend away from the ASX20

ASX20 shares now account for just 33% of the total value of shares traded by SMSFs, down from 40% a year ago. However, SMSFs are still more likely than other investors to trade ASX20 shares. ASX20 stocks account for only 29% of trades by value undertaken by non-SMSF investors.

The top three most-traded stocks by value remain Commonwealth Bank (CBA), Telstra (TLS) and National Australia Bank (NAB), although they now account for a smaller proportion of trades overall. The key changes were CSL (CSL) into the top 10, while A2 Milk

(A2M) moved up from eighth to fifth. On the flip side, Woodside (WPL) fell out of the top 10, and Fortescue Metals (FMG) fell from fourth to eighth.

Top 15 shares traded by SMSFs (by value, as a proportion of total trades)



Some of the biggest increases in traded values included Mirvac (MGR), with trading by value up 937%, Wisetech Global (WTC), up 161%, AMP, up 154%, and Afterpay Touch (APT), up 126%.

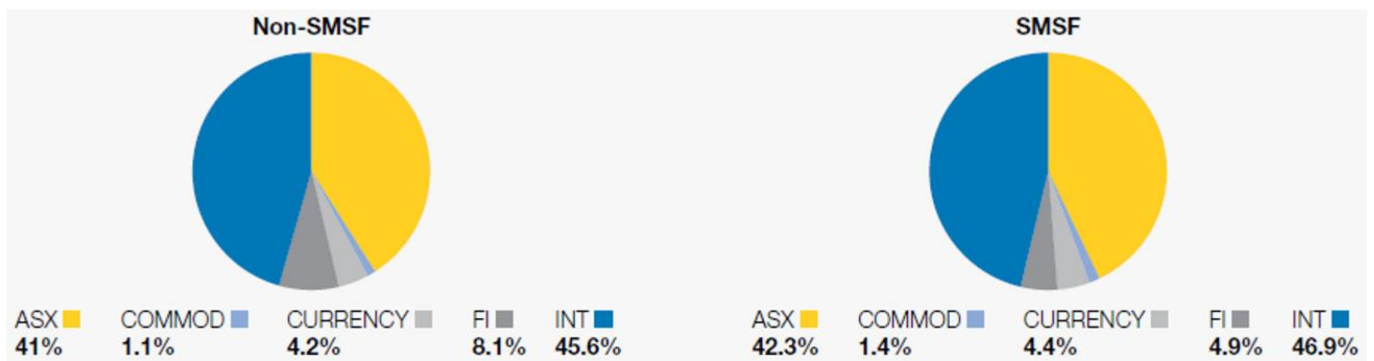
There was a clear overlap with seven of the top 10 performing stocks in the ASX200 over the 12 months to 30 June 2018 appearing in the top 50 stocks traded by SMSFs, as the winners attracted the buyers. Many of these are in the ASX MidCap 50, comprising the companies in positions 51–100 of the ASX200, and the technology sector.

Traditional blue-chips continue to have a strong attraction and we have seen SMSFs taking advantage of share price weakness to buy into companies like AMP, Ramsay Health Care and Telstra, in a blue-chip bargain hunt that reflects an underlying belief in the long-term prospects for these ASX stalwarts.

Offshore diversification

SMSFs increasingly use ETFs to diversify offshore. Over the last six months, we've seen this trend intensify, with internationally-focused funds now comprising nearly 47% of all ETF trades, up from 44%. As a result, Australian share ETFs now account for only 42% of ETF trades, down from 43%.

ETF trades by value and category



While the top four ETFs have remained unchanged over the last six months, an analysis of the top 12 ETFs traded by value shows SMSFs increasing their exposure to currency and property, as well as international equities. The strength of this shift suggests it is being driven by a desire for greater diversification, rather than simply the relative performance of different markets.

The Top 10 ETFs by trade value 1 January to 30 June 2018

	EFT	CODE	CATEGORY
1	SPDR ASX200	STW	ASX
2	VANGUARD AUST SHARES	VAS	ASX
3	ISHARES S&P 500	IVV	INT
4	VANGUARD HIGH YIELD	VHY	ASX
5	VANGUARD INTER SHARES	VGS	INT
6	BETASHARES NASDAQ 100	NDQ	INT
7	BETASHARES US DOLLAR	USD	CURR
8	VANGUARD US TOTAL MKT	VTS	INT
9	VANGUARD ALL WORLD EX US	VEU	INT
10	ISHARES ASX200	IOZ	ASX

The Top 10 LICs/LITs by trade value 1 January to 30 June 2018

LIC	CODE	CATEGORY
WAM CAPITAL	WAM	ASX
AUST FOUNDATION INV CO	AFI	ASX
ARGO INVESTMENTS	ARG	ASX
MAGELLAN GLOBAL TRUST	MGG	INT
MCP MASTER INCOME	MXT	FI
WAM LEADERS	WLE	ASX
MILTON CORPORATION	MLT	ASX
DJERRIWARRH	DJW	ASX
AUSTRALIAN LEADERS	ALF	ASX
BKI INVESTMENTS	BKI	ASX

Like ETFs, SMSFs are increasingly using Listed Investment Companies (LICs) and Listed Investment Trusts (LITs) to gain exposure to new asset markets, particularly offshore. During the last six months, the value of international LIC and LIT trades by SMSFs has risen from 23% to 26% of total LIC and LIT trades.

While the top four most-traded funds by value have remained the same over the last six months, the MCP Master Income Trust has moved into fifth place, with trades increasing 60% by value. This trust is a fixed income LIC, and its newfound prominence is further evidence of a growing tendency by SMSFs to use listed investment vehicles for greater diversification.

Overall, recent trading data confirms that the new, internationally focused LICs and LITs have carved out a significant niche, despite the considerable head start enjoyed by long-established domestic LICs.

Direct investment into international shares

As international trading becomes easier, adding Apple or Facebook to an SMSF portfolio has become increasingly attractive.

Top 15 International stocks by Trading Value (AUD)			Top 15 International stocks by Holdings (AUD)		
	INTERNATIONAL	STOCK CODE		INTERNATIONAL	STOCK CODE
1	AMAZON	AMZN	1	APPLE	AAPL
2	APPLE	AAPL	2	BERSHIRE HATHAWAY B	BRK B
3	FACEBOOK	FB	3	AMAZON	AMZN
4	TESLA	TSLA	4	FACEBOOK	FB
5	BERSHIRE HATHAWAY B	BRK B	5	ALPHABET	GOOGL
6	ALPHABET CLASS A	GOOGL	6	ALPHABET	GOOG
7	MICROSOFT	MSFT	7	MICROSOFT	MSFT
8	ALI BABA	BABA	8	TESLA	TSLA
9	NETFLIX	NFLX	9	ALI BABA	BABA
10	JD.COM	JD	10	BANK AMERICA	BAC
11	NVIDIA	NVDA	11	NVIDIA	NVDA
12	ALPHABET CLASS C	GOOG	12	VISA	V
13	DIREXION DAILY 3X CHINA50 BULL	YINN	13	WELLS FARGO	WFC
14	BOEING	BA	14	NETFLIX	NFLX
15	BANK AMERICA	BAC	15	EXXON MOBIL	XOM

Over the last six months, the value of direct international shares traded by SMSFs has grown by 30%, building on a 27% rise in the prior period, a growth rate significantly higher than that of non-SMSF investors. International share portfolios have become increasingly diversified, with the average number of international stocks held by SMSFs rising from 5.7 to 6.4, compared to just 3.4 among other investors.

Looking at the top 15 stocks held by SMSFs (refer Top 15 table above) reveals a list of well-known names and strong share price performers, especially the FAANG stocks – Facebook, Amazon, Apple, Netflix and Google (or Alphabet). They also include trusted names such as Berkshire Hathaway and Microsoft, with a strong overall US focus.

However, Chinese-based stocks, particularly technology stocks Ali Baba and JD.com are also represented, and over the last six months, some of the largest increases in trading value have been Chinese-based bank stocks, as shown in the trading values table. This interest in international diversification among SMSF investors extends beyond individual companies to ETFs available only on overseas exchanges. As a result, the value of offshore ETF holdings has increased 49% over the last six months, albeit from a low base.

1	BANK OF CHINA	BACHF
2	AGRICULTURAL BANK OF CHINA	ACGBF
3	DIREXION DAILY 3X CHINA50 BULL	YINN
4	PROSHARES ULTRA SHORT DOW30	SDOW
5	PROSHARES ULTRA SHORT S&P500	SPXU
6	CHINA MOBILE	CHL
7	NETFLIX	NFLX
8	PROSHARES SHORT 3X NASDAQ	SQQQ
9	BEIGENE	BGNE
10	INTEL	INTC
11	MICRON TECHNOLOGY	MU
12	FACEBOOK	FB
13	JOHNSON & JOHNSON	JNJ
14	VAN ECK JR GOLDMINERS ETF	GDXJ
15	BOEING	BA

Increasing SMSF diversity and sophistication

Looking back at the last six months, SMSF investors are increasingly diverse and sophisticated in their investment choices. While their portfolios are still heavily weighted towards larger domestic stocks, SMSFs are looking beyond the ASX20, as well as taking advantage of market dips to buy into blue-chip shares at a bargain price.

Marcus Evans is the Head of SMSF Customers for Commonwealth Bank. This article is based on a report, the CommSec SMSF Trading Trends Report, an exploration of the online trading behaviour of SMSF investors, released every six months, prepared by Commonwealth Securities Limited (CommSec). This article is general information and it is not intended to replace professional advice.

Zero tax rate on pensions is right and fair

Warren Bird

In my article and subsequent comments about Labor's proposed removal of franking credits for shareholders on a zero tax rate, I've not addressed whether the system should change to make the targeted retirees pay tax. I've said merely that if that's the goal, then it should be addressed directly through a change in their tax rate, not through the back door of the imputation system change.

However, much of the discussion about this policy is focussed only on the alleged wealth of these retired folk with their multi-million dollar SMSFs and six figure pension payments. If that's all that is said about them, then it's an easy 'social justice' argument to say that they're benefitting from a rort and should be made to pay more tax.

I don't believe this thinking is correct. Everyone should understand how such retirees reached the current situation and what is actually fair in terms of their taxation.

How are large SMSF balances accumulated?

Let's look at BB (for Baby Boomer) who has $1.6 million in their super fund. We need to understand clearly where that money came from and what tax BB has already paid on it.

The **first** source is the contributions under the Superannuation Guarantee paid by BB's employers. This was taxed at 15% when it was invested. At the very least when this is withdrawn, whatever tax rate BB is on should be reduced by that 15% or BB will be double taxed.

The **second** source was non-concessional contributions, paid by BB out of after-tax salary. This money has already been taxed at BB's full tax rate. There should be no more tax on this withdrawal or BB will have been double taxed.

The **third** source is income that's been earned on the investments in the fund, which will of course largely be compounded earnings. This has also been taxed at 15%, so whatever BB's current marginal rate is, these withdrawals should be taxed at least 15% less.

OK, the $1.6 million from accumulation mode now goes into a pension account and is split into those three components. For simplicity, let's say that 25% comes from non-concessional contributions, 15% from concessional and the rest from accumulated earnings. When BB makes a withdrawal from this fund as a pension payment in retirement, the tax already paid needs to be recognised in any tax obligation.

Let's say BB immediately withdraws $100,000 upon retirement. The most tax that should be levied on that amount should be:

- Zero on the $25,000 that is the proportionate withdrawal of the fully taxed non-concessional contributions
- BB's marginal tax rate minus 15% on the $15,000 from concessional contributions
- BB's marginal tax rate minus 15% on the remaining $60,000 of accumulated earnings.

If BB is in, say, the 32.5% marginal bracket from other earnings when this withdrawal is made, then this means a tax rate of 17.5% would apply to $75,000, which is **13.125%** of the $100,000 amount.

The tax incentives have a social purpose

The money was invested into super because of the promise of a tax-effective long-term saving vehicle to fund retirement rather than drawing an age pension from the public purse. During the 1980s in particular, we faced projections of an ageing population that would become a burden on the budget because of age pension requirements. We also had a current account deficit that was portrayed as a domestic savings deficiency (e.g. in Vince Fitzgerald's report on National Saving).

This social contract is not the result of a conspiracy against Gen Ys or other younger people in 2018! It is based upon sound economic and fiscal policy thinking. More retirees will fund their own lives rather than Gen Y's taxes having to be even higher to pay more old age pensions.

The flat tax rate of 15% on earnings within a super fund is one way the social contract is expressed in policy, as it's lower than the marginal rate for many investors. The system also provides for a lower than normal marginal tax rate on withdrawals in retirement. This means that the tax rate when those accumulated funds are drawn should be discounted by more than the 15% tax already paid.

Thus, for BB, the tax on this $100,000 withdrawal from their fund should be less than 13.125% to honour the social contract that led them to defer spending their income earlier in life. The current regime levies zero tax on withdrawals for those over 60 in retirement. It's a tax discount that for BB is approximately 13%, but would be a bit more or a bit less depending on the exact mix of the source of the funds.

The message to those who think this is unfair on subsequent generations is simple: it's not a rort but a perfectly fair arrangement for those who've saved the way they've been urged to by the government. Tax has already been paid and to demand that full tax be paid again now is not only unwarranted, but would be punitive.

Limits placed on the amount in superannuation

We've also had policies to limit super, such as reasonable benefit limits and contribution caps. The superannuation system allows ordinary folk to accumulate a reasonable amount to fund their retirement, but not give the wealthy a tax haven. Peter Costello opened the window too much 10 years ago, but that's been closed now with the $1.6 million cap – a perfectly reasonable policy change, albeit disappointing for those who had counted on the previous level of generosity.

Furthermore, those who earn more than $250,000 per annum (until recently this threshold was $300,000) pay 30% on their contributions, not just 15%. If our friend BB was in this camp, then the calculation above of how to tax a $100,000 withdrawal from their fund means 2.5% on $15,000 plus 17.5% on $60,000, which is **10.875%** of the $100,000 amount. The tax discount in the current tax-free regime is thus only a discount of about 10%.

Of course, nothing is ever that simple. The $1.6 million that BB has built up in a pension account will now earn income that is tax free in the fund. Therefore, an ongoing stream of cash flow to BB out of the fund will include

components from that income. Even then it may also include a component that is withdrawing from the accumulated $1.6 million that should be taxed at no more than 17.5%.

Tax treatment on income in pension account

Let's say that BB is between 60 and 65 and draws a pension of 4% a year, or $64,000 from the $1.6 million. How should we think about this payment? The answer depends on what the fund's income earnings have been.

If the fund earned more than 4% in income, then all of the $64,000 should be treated as being paid out of investment earnings that have not yet been taxed. At the moment the rule is that this is tax-free to BB. If the ordinary personal income tax scale was applied to this amount, however, then BB would be sitting in the 32.5% marginal tax bracket and pay $12,347 in tax. This is 19.3% of the income. Some untaxed earnings would remain in the fund.

If the fund earned less than 4% in income, however, then a portion of BB's $64,000 payment is drawing down capital and the calculations above should apply to that portion, which would result in an overall tax rate of less than 19.3%.

Fairness, therefore, calls for no more tax to be levied on retirement incomes than these sorts of amounts, which will of course vary from person to person. My own view is that, it's simpler and honours the long-standing social contract with BB to just stick with the tax-free arrangement we have at present on this relatively modest amount. Average weekly earnings at the moment are running at around $88,000 per annum, so a pension account income of $64,000 does not make BB a wealthy person!

People who have money in super over and above the $1.6 million that can be put into a pension account face, rightly, a higher tax obligation when they withdraw from that excess amount. Again, recognition should be given to the tax already paid on the money that they have invested in super, but calls for full marginal taxation of withdrawals from super funds are wide of the mark.

The reality is that when people draw an 'income' from their super, it's not the same as earning more dividends or interest or rent that hasn't had tax paid on it yet. Much of it – especially later in life when the required withdrawal rate is well above interest and dividend earnings rates – is simply withdrawing from a pool of contributed capital and investment earnings that has already been taxed at an appropriate rate. The boundaries already in place, such as the $1.6 million cap on the size of that pool, are adequate to restrain any 'rorting'.

Final comment

I'm not a tax expert. I've checked everything in this article with the ATO website, but no doubt there are nuances I've missed.

However, I hope that the framework I've outlined can serve the interests of an informed discussion about appropriate tax policy towards self-funded retirees rather than the class and inter-generational warfare arguments that have been too prevalent. What we want is a fair tax system and decent retirement income policy. We have a better chance of getting those outcomes if we base our discussions on facts and not emotion.

Warren Bird is Executive Director of Uniting Financial Services, a division of the Uniting Church (NSW & ACT). He has 30 years' experience in fixed income investing. He also serves as an Independent Member of the GESB Investment Committee. These are Warren's personal views and don't necessarily reflect those of any organisation for which he works.

What does the shape of the yield curve tell us?

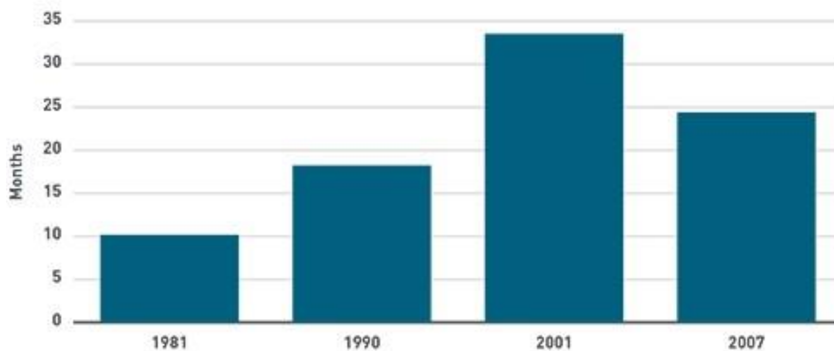
Erik Weisman

The financial press is awash with stories highlighting the correlation between yield curve inversions, in which yields on long-term US government securities fall below the yields on short-term government debt, and recessions. So as an investor, once the curve inverts you'd probably want to underweight equities and overweight Treasuries, right? After all, since 1929 in the US, the S&P 500 Index has declined an average of 33% during recessionary pullbacks, and interest rates usually fall during recessions.

If it were only that simple

Over the past 60 years, while the curve has inverted in advance of every recession, recording only one false positive, the subsequent onset of recession has sometimes taken years to unfold. For instance, the US economy didn't fall into recession until about two and a half years after US 10-year Treasury note yields first fell below 2-year note yields in mid-1998. And during that stretch, which included the dot-com bubble, the S&P 500 advanced more than 40%. Clearly, knowing a recession is coming and timing its arrival are two very different things.

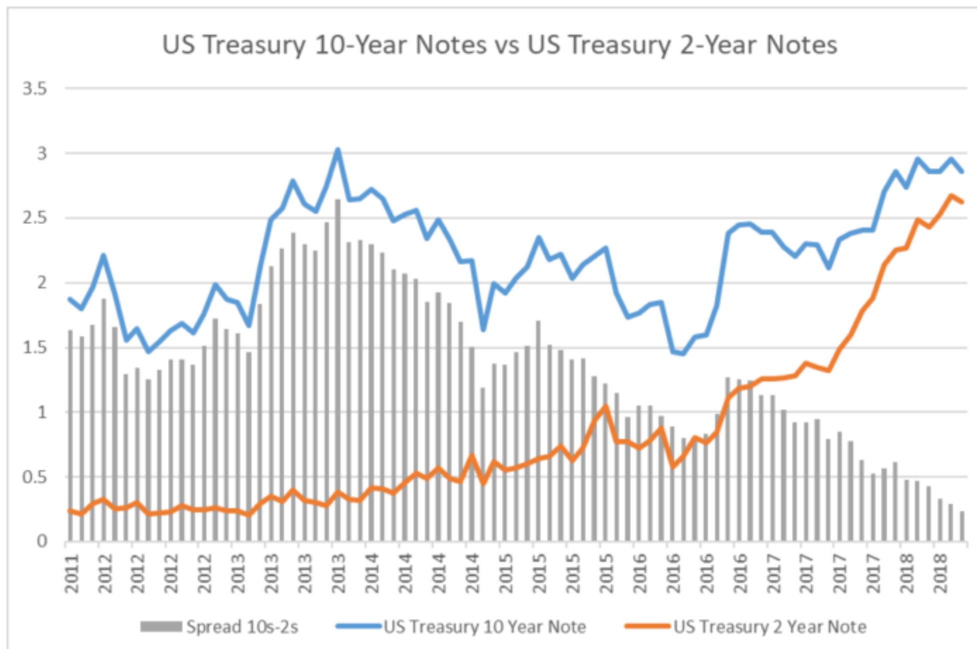
Getting the timing wrong can be ruinous, and complicating the equation is the fact that, historically, the curve can invert, uninvert and reinvert again several times preceding recession. For instance, ahead of the 1990 recession, the 2s/10s Treasury curve inverted off and on for over a year. Which of the many inversion signals should investors have focused on? It's tough to say.



Source: Bloomberg LP. Federal Reserve Bank of St. Louis. Inversion defined as a negative value for the US 10 year yield minus the US 2 year yield. Recession start dates used are from the NBER as of 17 July, 2018.

Not your father's yield curve

Typically, yields on longer-dated bonds, such as 10-year US Treasury notes, are greater than on shorter maturity bills and notes since investors demand to be compensated for locking their money up for longer. But these days, the spread between short-term and longer-term Treasuries is quite narrow. And if the yield curve continues to flatten at its current rate, it won't be too many more months before the 10-year Treasury note yield falls below the yield on the two-year note. But given years of extraordinary central bank intervention in global bond markets, does today's yield curve send the same signal as it did in earlier business cycles? We're not sure it does.



Source: Bloomberg as of 31 August 2018. Click to enlarge

What causes curves to flatten and sometimes invert? Usually, tighter monetary policy from the US Federal Reserve, since the effects of Fed tightening are much stronger on the short end of the yield curve than on the long end. And flattening of the curve and inversions tend to happen at the end of cycles as the Fed tightens. And cycles, by definition, end in recessions. But it's a leap of logic to suggest that curve inversions cause recessions. In our view, while there is a correlation there isn't necessarily causation.

And even if there has been causation in the past, we'd be mindful of Goodhart's law: When a measure becomes a target, it ceases to be a good measure. In other words, when market participants — including the Fed — become laser-focused on something like the shape of the yield curve, it may no longer be a useful metric.

What's different this time?

This business cycle is unique when compared with other post-World War II cycles. For starters, our present cycle has been influenced by the Fed's use of quantitative easing, which resulted in a ballooning of its balance sheet. Many would reason that this build-up, from roughly 5% of GDP prior to the GFC crisis to a peak of nearly 25% of GDP in 2014, has changed the traditional dynamic when it comes to curve inversion. The Fed's massive asset purchases appear to have reduced term premium, the excess yield that investors demand to commit to holding a long-term bond instead of a series of shorter-term bonds. Fed economists estimate that long-term rates may be 0.75%–1.00% lower today than would otherwise be the case absent the larger-than-normal balance sheet. Some contend that accounting for the amount of quantitative easing and its dampening impact on term premium, the curve would have to invert by 50 to 100 basis points before it would provide the same signal of a subsequent recession as in the past.

That said, each business cycle since the 1980s has displayed unique characteristics with regard to term premium, so we're not convinced a term-premium-based argument concerning curve inversion is particularly useful in timing the onset of recessions.

Another unique feature of this cycle is that nominal rates are much lower than in prior cycles, so a yield curve inversion may provide a different signal than it did in the past. Some would argue that it's more difficult to invert the curve when yields on the front end (two years and shorter) — despite rising over the past few years — are still historically low. To illustrate, Japan's economy, with its super-low interest rates, hasn't experienced curve inversions ahead of recessions since 1991, though it has fallen into recession seven times since that year.

An additional oddity of our present cycle is that not all sections of the yield curve are behaving similarly. Indeed, the short-end of the curve — from federal funds out to two years — steepened while the more closely-watched 2-years/10-years curve has flattened. We'd be more worried about recession if both curves were inverted. The fed funds/2-years curve is particularly important to the banking system as that part of the curve is where banks make much of their money. Should it invert to the point where banks are paying out more on short-term deposits rates than they are taking in on 2-year loans, the flow of bank credit would likely dry up, constraining economic growth.

Watch the macro

So if investors can't reflexively rely on the slope of the yield curve to help guide asset allocation, what should they watch? In our view, they should keep a close eye on macroeconomic data. High-frequency data such as purchasing managers' indices, non-farm payrolls and initial jobless claims, taken together, can help guide decision making more holistically than relying too heavily on a single indicator. These sorts of macro indicators would be good signals to gauge whether the Fed is expected to become overly tight, pushing front-end rates too high, and ultimately resulting in a recession.

Erik Weisman is Chief Economist and Portfolio Manager at [MFS Investment Management](), a sponsor of Cuffelinks. The views expressed are those of the speaker and are subject to change at any time. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice from the Advisor.

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GFC and personal reflections, 10 years on

Brett Lewthwaite

Last weekend marked 10 years since the fall of Lehman and their role in the start of the GFC, and it is a good time to reflect on that incredible time in financial markets.

The importance of liquidity

About 15 years ago, when I joined Macquarie Fixed Income, one of my first tasks was to work with Head of Research, Dean Stewart, on a piece called the '*Importance of Liquidity in Fixed Income*'. I didn't know it at the time but that research would influence and shape our investment beliefs, philosophy and processes. It became the bedrock of our approach to markets and portfolio positioning during the most extreme financial market conditions, and is just as important today as it was back then.

The 2003 research paper was well received by clients and consultants, but it didn't gain a following (or receive 'likes' or 'retweets' as it might today). It was five years before anyone would come to appreciate (or be reminded of) the true value and importance of liquidity.

Collateralised Debt Obligations: a lesson in the value of research

Linked to this time was the emergence and then proliferation of Collateralised Debt Obligations, or CDOs. Consistent with our belief that we must truly understand the risks involved before we invest in new markets or instruments, we investigated CDOs and again released a research paper to little fanfare. Okay, so it was complicated … even for fixed income.

The research concluded that CDOs were not liquid, not really AAA-rated and not at all diversified. The research suggested to perhaps buy one, though not many, due to cross-holding exposure, and only if the price truly rewarded for the risks involved, including liquidity risk. None of the CDOs met the requirements so we did not invest.

We then watched with interest as CDOs exploded in popularity from 2003 to 2007, evolving as:

- Plain vanilla CDOs. These were mainly packages of loans to many companies.
- 'Synthetic' CDOs. Synthetic means they were made up of derivatives, not loans to real companies, and we wondered in amazement why anyone would buy a security that had no economic purpose.
- Subprime CDOs. Poor-quality loans, some even nicknamed NINJA loans (No Income, No Job or Assets).
- CDO-squared. CDOs of other CDOs, with more wonderment and questions about their economic purpose.
- Tranche CDO-Squared. CDOs of tranches of other CDOs, where banks and hedge funds began offloading their risk or shorting the market.
- Leveraged-Super-Senior CDOs. I don't even remember what they did.

While we didn't invest, we did the work on what we saw, with fascinated interest. The final straw was when financial institutions, some where we had little or no relationship, appeared *very, very*keen to sell us the new format CDOs.

And so, it began to unravel. The flow of credit which had been gushing in all its structured, derivative, opaque and levered forms, had stopped, and with it, its influence on economic growth. And all that leverage upon leverage on opaque collateral undermined trust in what were once supposedly safe AAA-rated assets. In markets as it is in life, trust is everything. The rest is history.

A lesson in hindsight: research, research, research

To this day we are often asked why we didn't get caught up. The answer starts with the research and liquidity in particular. We did the work and stayed true to our findings.

Writing in hindsight is a wonderful thing. We don't wish to claim anything close to foresight. And we don't mean to suggest we didn't feel every bump or learn painful lessons along the way. Indeed, things got far worse than any worst-case scenario we ever imagined. We did however, start from a solid place that was founded on sound research and principles.

Liquidity and the current market environment

We all know that tighter regulations have altered liquidity conditions vastly from 10 years ago. Even though there are now many new investment vehicles that purport seamless and plentiful liquidity (even when the underlying holdings are not very liquid), the reality is these claims are untested by any liquidity event of significance. And with the proliferation of exchange traded funds (ETFs) and passive funds, amid a market environment of unthinkable central banks' support, we like to say, "Everyone thinks they are a macro trader now". All market professionals think they have that special edge to exit just before the herd rushes for the same exits.

And so, now like so many times in the past, perceptions of the value and importance of liquidity has diminished, and its existence, or tendency to quickly shift to lack thereof, is once again under-appreciated. Investors are giving up liquidity in the belief they don't need it. We know that this will change one day, even if we cannot predict when.

Back in 2008 amid the chaos of markets, we were juggling newborns and infants (an uncanny number of daughters). Looking around now, we are 10 years older and wiser. Our children are entering their teenage years. And while now we can look back with some fondness on that chaotic time, we know that as in life, the challenges may have changed their form, but the same debt-related structural issues remain and seem destined to at least rhyme, if indeed they don't repeat.

The principles of how to navigate them haven't changed, and the next 10 years will require similar resolve to do the work necessary to understand the risks.

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August 2018 reporting season: the final verdict

Rudi Filapek-Vandyck

The August 2018 reporting season always provides investors with fresh insights as input for portfolio adjustments and strategy re-alignment. Last month was no exception (definitely not!), but before we get to the nitty gritty of how corporate Australia is faring, let's zoom in on the statistical data first.

Guidance and expectations

As the bulk of broker reviews and responses are in the public domain, 307 companies in the FNArena universe have reported with 145 (47%) broadly in line with guidance and expectations, leaving 87 (28%) doing better and 75 (24%) disappointing. The overall context for Australian companies is business has become tougher since February 2018 when 37% of companies did better than expectations and 25% disappointed, although there is a noticeable switch to in-line reporting (i.e. results as expected).

In a check against data gathered from all prior seasons since August 2013, only 28% of companies outperformed market expectations, underpinning the suggestion that it is not easy out there in the real economy.

The 24% 'misses' metric in August 2018 sits right in the middle of historic comparables, on par with August and February 2016, but also better than each of the reporting seasons since. So with less misses and less upside surprises, does this make for a middle-of-the-road reporting season, unspectacular but decent?

Probably yes. Earnings estimates have fallen, as they do most seasons, but Australian companies ex-resources are still expected to continue growing at circa 7%, on average, which is not bad compared with years past. Banks continue to be laggards, while resource companies reap the benefits from expansion restraint and higher-for-longer product prices.

Valuations not cheap but some warranted by growth

Valuations, in general, remain far from cheap, but they have been around present levels for a while now. The average Price-Earnings (PE) ratio for the S&P/ASX200 is around 15.7x, but many companies with robust growth under the bonnet are trading on much higher multiples, and have been for a number of years now.

When we take this into consideration, the number of spectacular misses and subsequent capital punishments have arguably remained relatively benign, and August 2018 was not an exception in this department. Yet evidence suggests there is more at work behind historically high PE multiples for selected growth stocks than simply investor exuberance or momentum traders' delight, as some value investors would like us to believe.

Stockbroking analysts issued 83 recommendation downgrades through the month (only counting those in relationship to financial results) and 45 upgrades. Back in February, the balance was in favour of more upgrades (88 versus 53) but that is rather the exception. What stands out is the circa 3.46% average increase for consensus price targets through the month.

History shows February is usually the season when price targets jump more but not in 2018. February saw an average increase of 4.3%. Combined with August's 3.46% makes for the highest annual increase since FNArena started keeping records in August 2013.

Most of the increases in February and August this year can be attributed to the high growth, high PE stocks that have kept on performing this year. Think CSL (ASX:CSL) and REA Group (ASX:REA), but also Afterpay Touch (ASX:APT) and WiseTech Global (ASX:WTC).

In terms of share market performance, the S&P/ASX200 Accumulation Index (including paid out dividends) performance to end August rose 7.23%. Again, considering most equity markets outside the US are barely in positive territory or deep into the negative, this does not look like a bad achievement.

One has to acknowledge though, the Australian share market remains one key beneficiary from funds flowing out of emerging markets and this, more than local corporate results, has underpinned share market momentum thus far.

Financial results versus consensus price targets

In my view, the best way to judge how companies are performing is through measuring the impact of their financial report on analysts views and forecasts. And the best measurement of such impact is via consensus price targets. Looking at the share market or an investment portfolio from this angle can trigger fresh insights.

The price target for Commbank (ASX:CBA), for example, has increased to $73.94 from $73.63 prior to its FY18 release. Given the share price at the time of the release was actually higher, it shouldn't surprise us that CBA shares have since been sliding lower (they paid out one final dividend too). The table below shows the FY19 expectations for the major banks, showing healthy dividends (before franking) for the near future.

	FY19 EPS	EPS Growth on FY18	Forecast FY19 PE	FY19 Dividend	FY19 Div Yield
ANZ	233.1c	+2.2%	12.2	163.7c	5.8%
CBA	548.2c	+2.6%	12.9	432.8c	6.1%
NAB	231.1c	+6.9%	12.1	190.9c	6.8%
Westpac	238.5c	-0.1%	11.7	190.2c	6.8%

Source: FNArena

Put in a broader sector perspective, at least the target is no longer falling, even though it might be too early to make robust predictions about the worst of sector challenges now being behind us. It equally serves as evidence that the golden years for Australian banks, when each reporting season would add several percentages on top of existing targets, will not resume anytime soon.

On the other hand, price targets for first mover lay-by facilitator Afterpay Touch (ASX:APT) jumped by an average of nearly 69% to $22.33 post the release of FY18 financials and the announced expansion into the UK. This is also where the stock settled at first, before investors taking profits pushed it lower.

And if we really want to know how bad the latest profit warning by iSentia (ASX:ISD) actually was, let's consider the price target has fallen to 44c from $1.01, and that's not taking into account this is a stock that has traded as high as $4.85 since it IPO-ed in June 2014, with valuations and price targets sliding ever lower as more bad news and disappointments have accumulated.

G8 Education's (ASX:GEM) price target has now sunk to $2.36 from $3.03 (-22%). Telstra's (ASX:TLS) average target, in contrast to the strong rally in the share price, has now fallen a further 6.5% to $2.95. And if anyone wonders how disappointing the market update by Origin Energy (ASX:ORG) really was, its price target has since lost more than 6.5% to $9.54.

Rudi Filapek-Vandyck is an Editor at the FNArena newsletter, see www.fnarena.com. This article has been prepared for educational purposes and is not meant to be a substitute for tailored financial advice.

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