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Four key themes to emerge from Asia's pre-eminent investment conference

Chris Stott

I have recently returned from the 25th CLSA Investors' Forum in Hong Kong, one of the most comprehensive events of its kind in Asia. The investment conference was attended by over 1,800 investors, providing attendees access to over 700 senior executives from nearly 300 leading companies and industry experts around the world.

Four key themes stood out over the five-day Forum, following numerous insightful presentations and one-on-one conversations with industry leaders.

1. Driverless cars

Driverless cars will be here sooner than many expect, according to Mark Crawford, Chief Engineer for Autonomous Driving Systems at Great Wall Motor Company, the largest producer of driverless cars in China. The US is currently leading the way globally in driverless cars, with self-driving technology development company Waymo (formerly the Google self-driving car project) the main frontrunner. Many major automotive brands including GM, Ford and BMW are spending billions on driverless car capabilities, with the driverless car market expected to reach around US\$26 billion by 2024. Conversely, while Uber and Google have undergone trials of driverless cars, following a fatality, Uber has ceased testing. Domestically, driverless cars are not expected to become mainstream in Australia for at least 10 years.

Cost is currently a fundamental issue facing driverless cars, with premium pricing a significant barrier. The sensors surrounding driverless cars are the most expensive component in the manufacturing process. Until these costs are reduced and the total cost is on par with regular automotive vehicles, it will be difficult for them to become mainstream.

The shift towards driverless cars is backed by the universal desire to reduce the number of road fatalities, with 37,000 fatalities in the US every year and a staggering 300,000 in China, highlighting an immense and distressing problem. The US and Chinese governments are supportive of driverless cars due to their increased safety. The Great Wall Motor Company has created a partnership with Baidu to develop a driverless car, aiming to achieve mass production of self-driving automobiles by the end of 2020.

2. Artificial Intelligence

Many companies discussed the rise of Artificial Intelligence (AI) – what they are doing to capitalise on a trend that will accelerate over the next decade. By 2020, 27% of all Chinese homes will have smart home systems, allowing residents to monitor and manage power usage by configuring systems such as lighting, cooling and heating. Over half will have smart cars. It is clear China intends to be the global leader in AI and is investing significant amounts of capital in research and development. China is joined by the US and the United Kingdom as paving the way. Meanwhile Australia is lagging as few listed domestic companies are considering AI as playing a sizeable role in their future. Appen (ASX:APX) is one of the only companies that provides domestic investors exposure to this thematic.

3. US mid-term elections may provide catalyst for change

The upcoming November US mid-term elections were a popular topic of discussion, with a consensus view that the Democrats will emerge victorious, bringing forward the rising threat of President Trump's impeachment. Surrounding the mid-term elections is Special Counsel Robert Mueller's investigation into Russian meddling in the 2016 presidential election, with expectations that the report will be released after the mid-terms, perhaps early next calendar year.

While doubts have been raised about Trump's ability as US President, his presidency has been positive for the economy, with the S&P 500 Index up 37% since his election. His pro-economic policies are stimulating the US economy to grow at the fastest rate in over a decade, most notable of the policies being the drop in the corporate tax rate from 35% to 21%.

4. Chinese growth and implications for Australia

Compared to last year, the mood on the ground was bearish, with expectations of Chinese growth far less than previous years. There is no doubt Chinese growth is slowing, with 6.5% gross domestic product (GDP) growth this year and expectations around 2019 GDP growth at below 6.3%. The US and China trade war is having a significant short-term impact on China and this will manifest in fourth quarter numbers for the 2018 calendar year, announced early 2019. Chinese manufacturing is slowing as a result of tariffs, with many companies looking to relocate their operations out of China to countries such as Vietnam. This will affect the flow of goods, and to a lesser extent, the consumer.

This slowdown is no great surprise given the Chinese equity market is currently down 30% this calendar year. Overall the outlook for China is weaker than previous years and this will have negative flow on effects in Australia for the resources sector and companies that are exposed to Chinese growth.

Chris Stott is the Chief Investment Officer of [Wilson Asset Management](#). This article is for general information only and does not consider the specific circumstances of any individual.

The positive FX hedge returns have now gone

Christopher Joye

Not many investors realise that a decent chunk of their US equities and fixed-income performance over the last 20 years has come from the benefit of hedging, and had nothing to do with the assets' underlying returns.

According to CBA research, hedging your US shares or bonds into Aussie dollars increased your returns by 4% per annum over this period. That is to say, you were paid to hedge, rather than hedging imposing a cost. For lower yielding asset-classes like fixed income, this made a big difference to the realised outcomes.

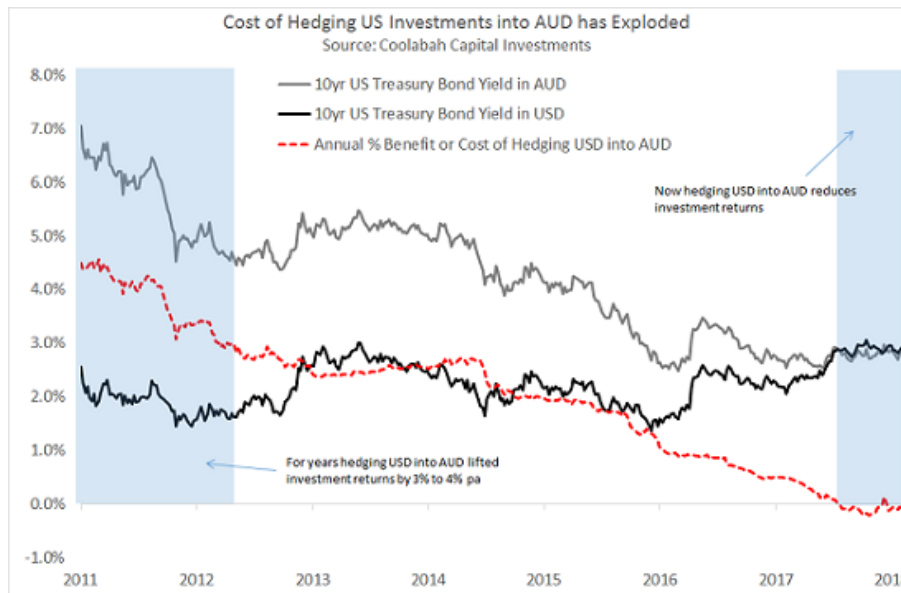
Between 1999 and 2018, US treasury bonds yielded only 3%, but by hedging into Aussie dollars, the yield increased to 7% while also reducing realised volatility significantly.

Tailwind becomes a headwind

Now the big deal is that this tailwind, which reflected the fact that the RBA's cash rate was historically situated well above the Fed's cash rate, has reversed as the Fed has embarked on its hiking cycle.

The chart below shows precisely how this dynamic has changed since 2011. The lower black line is the annualised yield on a US treasury bond while the upper grey line shows the same asset hedged back into

Aussie dollars. Observe that in 2011, a US treasury yielding 2.5% morphed into a nearly 7% yield for hedged Aussie investors. The red dotted line represents the benefit or cost from hedging at any point in time.



Whereas in 2011 local investors picked-up a return uplift of as much as 4.5% hedging US assets into Aussie dollars, that advantage has fallen away over time to the point now where the red dotted line is slightly negative. In 2018, a 2.94% yielding US treasury paid only 2.86% in Aussie dollars.

Understand the cost or benefit of a hedge

This comes back to the principle known as 'covered interest parity'. If you own a US asset and want to hedge it back into Aussie dollars, the cost will normally reflect the interest rate differential between the two countries for the relevant maturity. For example, if the RBA's cash rate is above the Fed's, you should receive additional returns and vice versa.

In practice this relationship can be distorted if there is excess demand or supply for either currency, which can generate a cross-currency 'basis' under which you receive or pay more for the hedge than covered interest parity would otherwise imply.

The Reserve Bank of Australia has been capitalising on this dynamic for years, hedging billions of dollars worth of Japanese government bonds into local currency. While the Japanese bonds have carried a negative yield, hedged into Aussie dollars they deliver a handsome return above many other government bonds because of both the local interest rate differentials and the attractive cross-currency basis the RBA has earned.

It becomes important to recognise this when undertaking long-term performance analysis. I recently saw a presentation for a new, predominantly US high-yield fund that contained historical yields and returns hedged into Aussie dollars over the last five years. The annual yield enhancement from hedging US dollars into our currency over this period was about 1.4%, which is no longer present.

With this benefit the US high yield product outperformed Aussie high yield by 1.3% in total return terms, albeit that US high yield had much higher volatility (4.7% versus 2.8%). But this might not be true going forward as the Fed's cash rate has risen above the RBA's equivalent.

Something that appears superficially attractive might be a hedging mirage that has subsequently evaporated. This is, of course, a generalised statement and one should evaluate every investment on its merits on a case-by-case basis and ideally seek the counsel of trusted advisers.

And it is not just about outright returns. Many asset classes, including US high yield, can play a valuable role in portfolios if they are less than perfectly correlated with your existing assets and therefore furnish diversification gains.

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

Investing in global disruption, four years on

Alex Pollak and Anshu Sharma

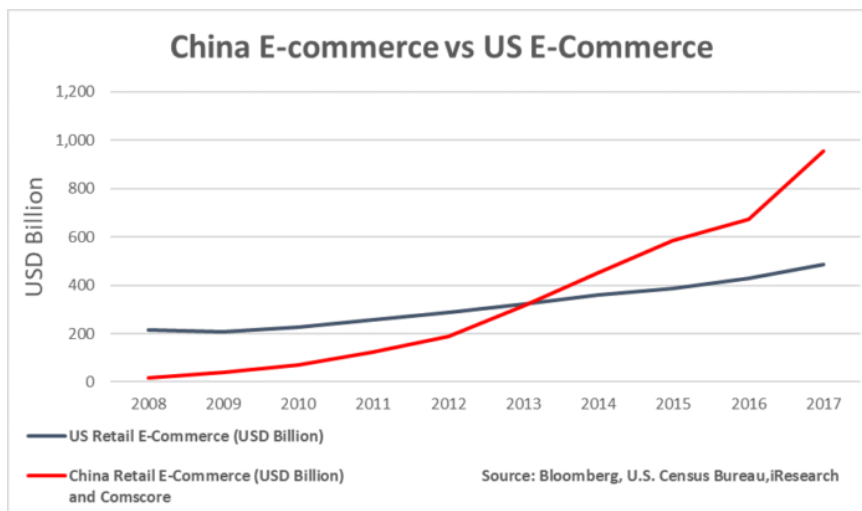
When Loftus Peak first began taking investor funds four years ago, there was a perception that smartphones and Google searches meant the world was hooked up and the big disruption money had already been made in the sharemarket, so further pickings would be slim.

But that is not the way it went. Facebook closed above US\$38 a share on its first day of listing in 2013, halved thereafter, and then went up 10 times to more than US\$200 on the back of the company's successful shift to mobile (after a panic that the company could not make the leap from the desktop).

Markets struggle with long horizons

Markets react to visibility and can struggle to ascribe value beyond a two-year horizon. The sheer size of some of the disruptive themes might help understand the dilemma markets face in correctly valuing the affected companies; that is, all companies.

There are secular trends that will not reach their addressable market size in a single quarter but will keep expanding faster than GDP for years to come. For example, one of the strangest valuation anomalies was Alibaba, which investors thought was fully valued based on its hold on the Chinese e-commerce market. That market is already bigger than the US, is growing faster and has several years before it hits maturity, as the chart below shows. The stock has doubled since listing.



These big trends – such as energy as a technology (not a fuel), networks, connected devices (sometimes called the internet of things) and mega-data – will play out over decades. Single-period valuation methodologies such as price-to-earnings are too inexact, but it is a statistical certainty that 10-year forecasts will be wrong, too.

What has become clear is that such longer-term thinking when combined with other key metrics provides 'less wrong' valuation parameters compared with concentrating the investment horizon to one or two years, which can lead to a game of valuation catch-up. For example, there are serious problems in the world of central processor unit (CPU) chips. You shouldn't be reading this here first, but Gordon Moore's law that the number of transistors on a chip doubles every 18 months, is now breaking down.

It isn't the CPU that will make computers go faster, it is graphics processor units and the like. They will not just double the speed, their advent into the data centre will mean an over 10-fold hike. Moore's law drove disruption, but it is not fit for purpose from here. It will be different architectures that make processing speeds faster, thus increasing the pace of change.

Intel itself has acknowledged this, stating in 2015 that the pace of advancement has slowed. Brian Krzanich, the former CEO of Intel, announced: "Our cadence today is closer to two and a half years than two."

Greg Yeric, chip designer at rival ARM, says:

"As Moore's law slows down, we are being forced to make tough choices between the three key metrics of power, performance and cost. Not all end-users will be best served by one particular answer."

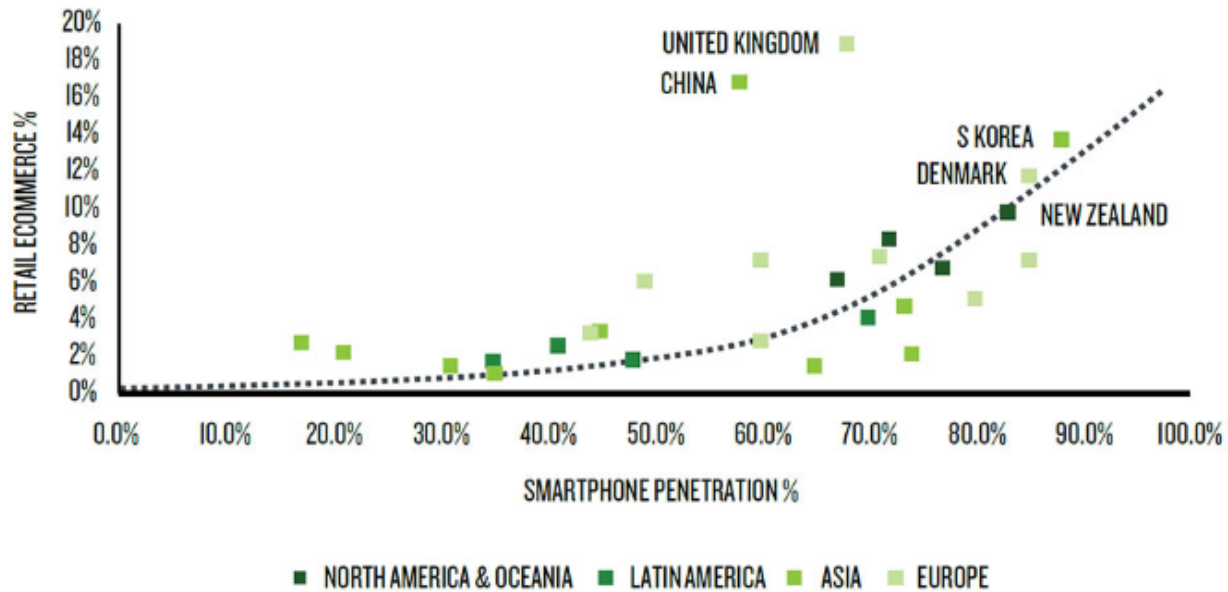
This thematic will not play out in one year. It has already taken half a decade and is only halfway through.

Investing in global megatrends

There is an interesting line between being a disruption investor relative to that of a technology investor, meaning that it is more important to understand Moore’s law, not because it leads to smaller chips but because of what new business models arise as a consequence.

The chart below shows the growth of smartphones, a direct result of Moore’s law, but also their relationship to retail ecommerce (as a proportion of all retail), a disruptive business that was not necessarily foreseeable.

The relationship between retail e-commerce and smartphone penetration



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It’s not only about increasing processing speeds

It is the same with 5G. The technology itself may not be investable, but the changed business models that arise from it may be. For example, all the fancy processor power rolled out in the past 50 years could not even cope with a YouTube cat video until broadband speeds – meaning money in fibre and cell towers – caught up on a national and international scale. If self-driving cars become ubiquitous, it will be because there is 5G processing power, with the attendant massive real time data-transfer rates, to help steer them safely.

Meanwhile, Amazon has built a web services company that is at least as valuable as its US retail business and is now close to having an unassailable lead in voice, with the stock up five times in four years.

Voice is the next battleground in search, and both Google and Apple are behind Amazon in its execution here. We think about how this will impact business models on a multi-year horizon. And it isn’t because of the machine learning tools that drive voice, but the business implications of having an Alexa device in your home organising your shopping.

And so it is with Netflix. The company is not just an entertainment service, its model threatens to upend networks and pay-TV as we know them, globally. The fact that there are no real barriers to entry other than capital, for Hollywood film studios to create competitors to Netflix, has not stopped them from completely missing the point about the company and its role as a cable-TV killer.

Disney and Comcast were beating each other over the head to double down on old media by trying to buy 21st Century Fox for more than US\$60 billion – a bid in which Disney won, at a cost of US\$71.3 billion – presumably on the principle that scale will solve bad per unit economics, but it won’t.

What they should be spending that money on is great content, which is what’s really keeping Netflix’s share price moving. AT&T sort of gets it with the acquisition of Time Warner but is going to wind up so leveraged it will not have the additional resources to bring the fight to Netflix, content-wise.

There are other developments across sectors as diverse as energy, finance, robotics and transport. Four years after we started in this company, we believe there is still return to be had from the sharemarket, provided we continue to focus on the important trends and keep an eye on valuation. This remains our daily focus.

Alex Pollak is Chief Executive, CIO and Founder of, and Anshu Sharma is Portfolio Manager at, [Loftus Peak](#). This article is general information and does not consider the circumstances of any individual.

It's getting hot in here

Brett Gillespie

Tariff wars, emerging markets in crisis, and the US economy overheating ... where does one start when trying to work out what it all means?

Well, as always I like to start with history. Have we seen this before? Pretty much. We have many historical examples to ponder, and so many possibilities, but for me the 1960s and the 1990s come to mind.

Let's start with tariffs. Is it simply brinkmanship, where Trump's true desire at the end of the day is to force the Chinese to lower tariffs? Or is it something more pernicious, perhaps a multi-decade turning point in globalisation?

If brinkmanship, how will it end? The market assumes rather gently, with the US stock market generally happy to look through the shenanigans and assume a positive end result. Perhaps that will be the case, but key to securing large concessions through brinkmanship is not only threatening large repercussions, as Trump is currently doing, but convincing your combatant that you are deadly serious about following through. More often than not, deadly serious means actually following through.

Kennedy knew this. For a perspective on successful brinkmanship, one can't go past 13 days in October, 1962 – the Cuban missile crisis. In August 1962, the Soviet Union snuck nuclear missiles into Cuba (in response to the US placing nuclear missiles in Turkey three months earlier) and assembled launch pads before the US noticed. Despite some suspicions, the US did not realise that a nuclear arsenal had been deployed until 14 October when aerial reconnaissance confirmed launch pads and missiles ready to go in Cuba.



Kennedy threatened to invade if they were not removed. The Soviet Union protested. The missiles in Cuba were purely for Cuba's defence, and any invasion by the US of Cuba would trigger a war with the Soviet Union. Kennedy publicly moved to DEFCON 2 and said that the United States will:

"... regard any nuclear missile launched from Cuba against any nation in the Western Hemisphere as an attack by the Soviet Union on the United States, requiring a full retaliatory response against the Soviet Union."

After some rather tense exchanges, they took his threat seriously, and agreed to remove the missiles. Pretty heavy brinkmanship when the consequences of escalation were so high for both parties. See the [timeline here](#).

Of course, we are not talking about the same consequences here. But we are talking about the same game, namely the game of brinkmanship. To get big concessions, big threats need to be made convincingly. Which as we are seeing, needs some follow through. Sometimes the outcomes aren't as intended. Beyond brinkmanship, there are a few other examples that come to mind.

Perhaps inflation breaking out, like in the late 1960s when the Fed allowed unemployment to breach new lows? Or can the US economy handle stronger growth, like the productivity surge Greenspan embraced in 1996-97 to forestall rate hikes? Or does none of this matter, because we are about to repeat an EM crisis like 1997-98? Perhaps there is no historical analogue? After all, we don't have a historical analogue of 10 years of zero to negative interest rates in the major economies of the world, combined with 18 trillion dollars of bond purchases by their central banks! (But we do have analogues of low interest rates generating financial bubbles) Do you have a conviction? If you are highly convicted, perhaps you should heed Alexander Pope's famous phrase, "A little knowledge is a dangerous thing"! Nonetheless, I think one can have conviction in how scenarios might play out. So let's start with the scenarios.

The scenarios

1. Tariff escalation. If Trump imposes a tariff of 25% on US\$200 billion of US imports from China, and particularly if he follows it up with another US\$267 billion of tariffs, that is all that will matter for markets in the next 6 months. With the latter, one can't escape both a significant growth and inflation impact in coming months. EM equities will fall a further 10-15%, and US equities will likely fall 5-10%. The USD would soar 5-10%, at which point the Fed stops hiking.

2. Tariff de-escalation. If the US agrees a resolution with China, the focus turns back to the current status of the US economy. It is too strong. Initially equities rally, the USD likely falls as emerging market equities outperform, and bond yields rise markedly. At some point in the next 6-12 months the market realises the Fed needs to take a restrictive policy to slow the economy and quell inflation, and a recession gets priced in.

3. A bubble bursts. What bubble? As I wrote in June, after 10 years of zero interest rates and low bond yields, money has poured into any bonds that give a little extra yield. We have seen the wobbles already.

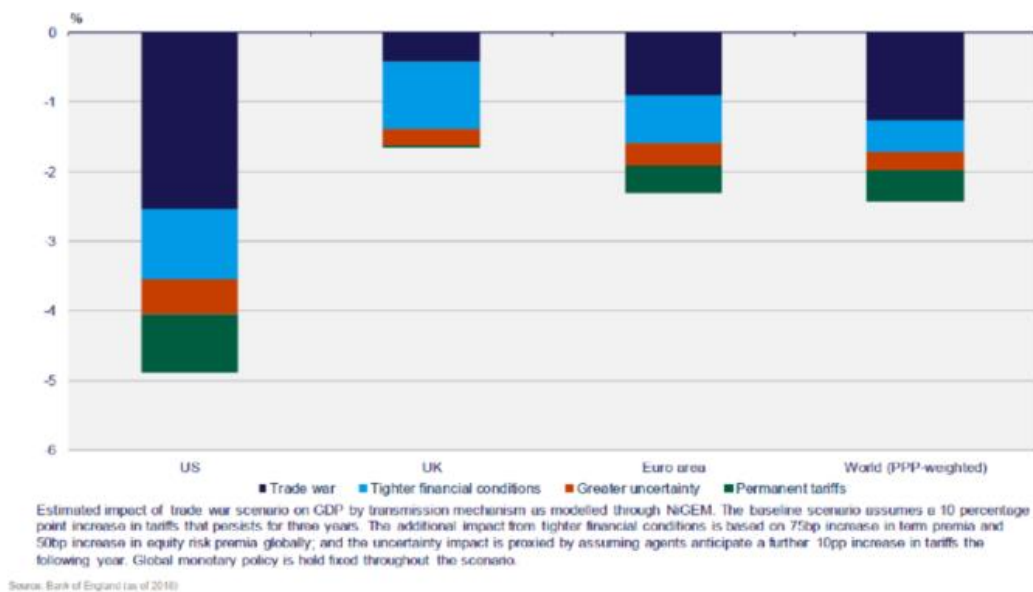
At the moment, with the unresolved tariff war, it is impossible to be emphatic. But the time is nigh when it will pay to be very decisive indeed. And conversely, a disaster, potentially, if you are not.

Am I being too alarmist? Or even too simple? Let me give you some facts, after which you can decide.

How bad can a tariff war be?

Well I could start with the Bank of England's prognosis:

A trade war would deliver a meaningful blow to the global economy



Wow, 5% off US growth ...

However, note there are some pretty dire assumptions in there. Firstly, they assume every country imposes a 10% tariff. The impact of that is shown in the dark blue (about half the overall impact). The rest of the impact comes predominantly from higher bond yields, lower equity markets, and greater uncertainty. There is no assumption of stimulus, either from rate cuts or fiscal policy (which has just had a windfall from the tariff 'tax').

So it is fair to say that the impact would be much less than this. But how much? Well the first point is we don't know what the final tariffs are yet. But if Trump proceeds with tariffs on all Chinese imports (about \$500 billion), as he is threatening, reasonable estimates would see a growth impact of 1-2% for each economy. And that will hurt.

Of course, many assume this is nothing more than brinkmanship. A game of chicken. As John Cirace argues, to win the game of chicken, the individual must "create the impression that nobody is crazier or badder than me". [Law, Economics and Game Theory. John Cirace, page 120]. Ipso facto, Trump will win!

Or crash ... I'm not sure he realises crashing is a possibility. So he just might not see it coming. What does a crash look like? US stocks down 10%. That would get his attention, though not necessarily a reaction.

Will it happen? Well, by the time you are reading this, the answer might be clear. But I strongly believe as I write, one cannot hold a view on the evolution of the confrontation with conviction. We pay many consultants who are experts on Chinese and US politics. The more you know, you realise the less you can be sure.

Brett Gillespie is Head of Global Macro at [Ellerston Capital](#) and has worked in the financial services industry for over 28 years. This article is for general purposes and has been prepared without taking account your objectives, financial situation or needs.

Trustees beware: what is 'cash' and why it matters

Jonathan Rochford

Do you know what's in the so-called 'cash' allocation in your super fund, that is, the part that is supposed to be unambiguously liquid and protecting capital?

[APRA's letter to superannuation funds](#) in June this year laid bare a concealed and often-ignored risk taken by some fund managers. Funds that are meant to be invested in low risk, highly-liquid securities are being invested in medium and high-risk securities with limited liquidity. Here's the key paragraph from the APRA letter:

"Assets that APRA has observed forming part of cash options' underlying investments include asset-backed and mortgage-backed securities, commercial bonds and hybrid debt instruments, credit-default swaps, loans and other credit instruments. These assets do not typically exhibit the characteristics necessary to be considered as cash or cash equivalent. There were also exposures noted to cash enhanced vehicles without sufficient policy guidance as to the permitted holdings of these vehicles."

There are many different definitions of what constitutes a cash security. Terms like 'cash', 'enhanced cash' and 'investment grade' do have precise meanings to those who are working with the underlying securities on a day-to-day basis. However, these definitions can be blurred in sales pitches and as strategies work their way through an investment approval process. There are serious pitfalls in the wrong cash investments, and the 10-year anniversary of the failure of Lehman Brothers is a reminder of the tumult for cash funds that followed.

Cash funds

Cash funds hold the operational cash of a portfolio and funds can be called upon at any time. Publicly-offered cash funds typically offer same day or next day liquidity. To match the potential liquidity requirements, cash funds must only invest in short term securities (12 months maturity or less), which also have the ability to be sold or redeemed quickly without substantial bid/offer spreads. Cash funds are likely to have a mixture of at-call accounts, bank bills, commercial paper and similar securities. Government, corporate and securitisation bonds that are highly liquid and have a firm maturity within 12 months may be considered for a small portion of the total portfolio. As term deposits now have restrictions on early redemptions, this limits their use in cash funds to a minimal portion.

Securities must also be extremely capital stable. In the balance between risk and return, cash funds must choose low risk securities that have almost no possibility of defaulting or suffering any meaningful mark-to-market loss. This limits investments to securities with short-term credit ratings of A1+ and A1, and securities with long-term credit ratings of AAA, AA and A.

Enhanced cash funds

Enhanced cash funds hold capital that is expected to be invested in other asset classes in the medium term. This could be shares, property, infrastructure, private equity or other investments subject to capital calls. As these asset classes involve material mark-to-market volatility, it is reasonable to invest in a fund that takes a small amount of capital risk whilst awaiting redeployment elsewhere. Enhanced cash funds may also be used as a long term allocation for conservative investors who are uncomfortable with the risks of investment grade funds and other asset classes.

As the expected time horizon for enhanced cash funds is longer than cash funds, it is reasonable for an enhanced cash fund to invest in some securities that have maturities beyond twelve months. Ideally this is limited to three years, but there are examples of funds that cap at five years or (wrongly) have no maturity limit and include perpetual securities in their portfolios. The same credit rating restrictions should apply as for cash funds, though some managers will push into BBB-rated securities, which carry an increased but still low risk of defaulting and suffering capital loss.

Investment-grade funds

These funds differ from cash and enhanced cash in that the capital is a core and long-term allocation within the portfolio. The fund manager is therefore able to invest with a three- to five-year outlook and a reduced focus on short-term liquidity. To be true to label, credit ratings must be a minimum of BBB-. In some cases, managers will be allowed to invest in securities that do not have a public credit rating but where the debt has all of the underlying characteristics necessary for an investment grade rating. Hybrid and preference share instruments are not appropriate securities for an investment grade fund or any type of cash fund due to their inclusion of equity features.

Sub-investment grade buckets are an increasingly common inclusion, often with a limit of 5-10% of the portfolio. Including sub-investment grade securities in an investment grade fund is likely to substantially increase the potential for capital losses and mark to market volatility. They are also inconsistent with their label, something regulators are likely to take a dim view of even if they are clearly disclosed. Managers focussed predominantly on investment grade securities may not have the credit skills and market knowledge to deliver good outcomes from sub-investment grade securities.

As well as additional yield gained from taking greater credit risk, investment grade funds can also take advantage of the illiquidity premium. In the Australian context, investing in low risk securities that are highly illiquid is the primary pathway to achieving substantial outperformance of an investment grade index. Some investment grade funds limit maturities to five or seven years but many do not have a stated maturity limit.

Lessons from the GFC

The GFC shook cash funds in two major ways.

First, some cash funds had lost their focus on capital preservation and should have sold out of (or never bought into originally) Lehman Brothers securities long before the default as rumours of its demise increased. For the sake of a few extra basis points of yield these funds ended up losing millions.

Second, the fund had a mismatch between the liquidity of the investments and the liquidity offered to investors. This problem has been likened to a fire in a theatre where patrons are hurt rushing for the exits and not from the fire itself. Open-ended enhanced cash and investment-grade funds are particularly vulnerable to this risk. Once mark-to-market losses occur, redemptions are inevitable. If outflows are faster than the pace at which underlying investments can be sold or mature, or if the buy/sell spread isn't a fair estimate of the cost of trading, investors that stay will suffer losses that should have been attributed to those who left early.

Know what you and your manager are holding as cash

APRA's letter to superannuation funds was a timely reminder of the role of cash funds. Cash, enhanced cash and investment grade funds each serve a different purpose within a superannuation fund or individual investor's overall portfolio. Capital allocators and investors should ensure that their cash funds are fit for purpose. Take caution with open-ended funds that are investing in securities that could become illiquid when the next downturn occurs .

Jonathan Rochford, CFA, is Portfolio Manager for [Narrow Road Capital](#). This article is for educational purposes only and is in no way meant to be a substitute for professional and tailored financial advice.

Garry Weaven on 5 areas of super investment

Graham Hand

[Introduction: Garry Weaven chairs IFM Investors, a fund manager owned by 27 industry superannuation funds with over \$100 billion in assets under management. This article reports on his presentation at the 2018 Australian Institute of Superannuation Trustees' Super Investment Conference in Cairns on 5 September 2018].

Garry Weaven started with a slide showing superannuation assets will grow from the current \$2.6 trillion to \$6 trillion in 2030, a more than doubling in size, while GDP would increase from \$1.3 trillion to \$1.9 trillion. It demonstrated super's growing role in the Australian economy. Said Weaven:

"The business community and governments of any persuasion would be totally mad looking at those numbers not to pursue greater collaboration with super funds."

He then identified five areas of potential growth for superannuation investment: corporate debt; infrastructure; residential property/affordable/social housing; agriculture; and growing new industries

Edited transcript of Weaven's future focus on these five areas

"Generally speaking, the **corporate debt** field has been left to the big banks and their large credit assessment teams but the changing regulatory environment is restricting bank balance sheets from fully servicing that sector. They will focus more on lower risk or higher profit businesses. This will expand opportunities for our sector to step in, possibly in partnership with the banks. Something like \$95 billion per annum is lent to non-financial corporations from the banking sector each year. It's potentially very big business that can be addressed by us.

Second on **infrastructure**, almost everyone agrees we could spend hundreds of millions over the next decade if we could get the correct frameworks in place. I've been arguing there is a better way, a partnership approach between governments and the superannuation sector where a bargain will occur in a very transparent way about the target rate of return on particular projects with risks allocated between the parties. There would be a ceiling above which the taxpayers would share in any outperformance. The manager should not make windfall profits. The deal once negotiated would be offered to every registered superannuation fund in Australia.

Third on residential **property**, the first investment ever made by IFM Investors' predecessor was to assist people into affordable housing. In the thousands of seminars since, housing and affordability has got worse. It's time something was done.

Fourth, some of you will have noticed rural politicians squawking about **agriculture**, lamenting the fact that superannuation funds were not investing more. The reason is very simple: the returns are very poor and the volatility is substantial due to commodity prices and drought. The reason large offshore investors are able to come in here and invest in a significant way is because they can participate in the margins of the downstream processing or distributions of the agricultural output in the destination markets – China or Canada or wherever it is. If the government wants to do something useful in the area, it should be using its trade and foreign affairs diplomacy to broker deals where the super sector could partner with some of those organisations so the returns would be more attractive.

The fifth thing is **industry** policy generally. A really bold view would include governments collaborating with the super industry in the development of proactive industry policy."

Weaven called for a new era of cooperation between industry funds and the Coalition:

"Over 35 years of history in the industry fund movement, we've hardly had a year go by where there hasn't been some attack in one form or another from the Coalition, in either government or opposition. There could be an emergence of an opportunity for all of that conflict and opposition to finally turn to collaboration, at least to some degree, between the business community, the super sector and governments – both state and federal."

Graham Hand is Managing Editor of Cuffelinks. Garry Weaven is Chair of [IFM Investors](#). As ACTU Assistant Secretary in the 1980s, he played a seminal role in the development of the industry superannuation fund movement.

The reality of three phases of retirement

Assyat David

Planning for how you would like your retirement years to play out can be an exciting proposition. Amid those holidays and time spent with family, however, it is important to also consider the 'frailty years'. They are the later years of retirement where you might experience physical and cognitive decline. A plan is needed if you want to maintain independence for as long as possible.

The reality is that we are all likely to experience some cognitive decline or lose some of our physical ability as we age. This is a natural process but does not mean we will all develop dementia or lose the ability to live independently.

But at some point, we may need to ask for help with our normal activities of daily living. This might be help we access in our own home, or we might need to move into residential care for a higher level of support.

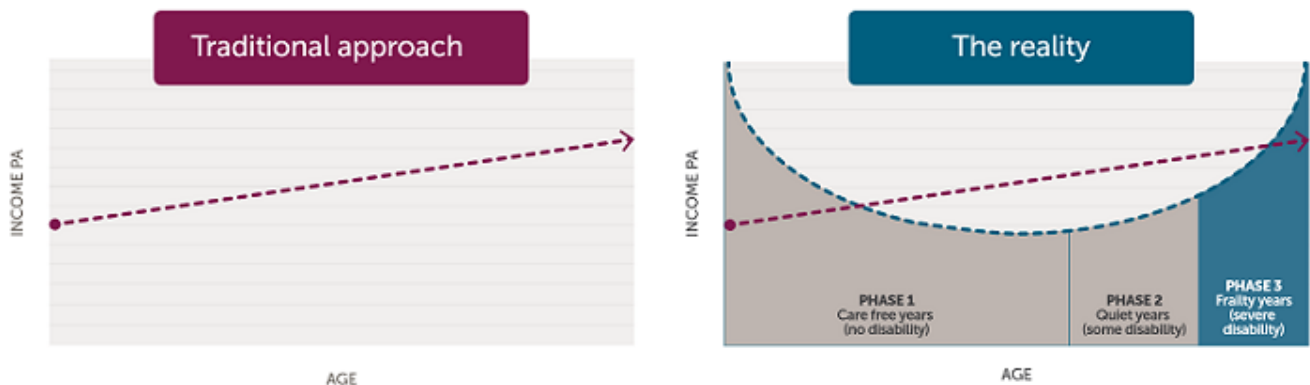
Funding the increasing costs of care allows greater independence and control, which is key to a happier retirement. Take control while you still have capacity to make these choices yourself.

Rethinking retirement planning

We need to rethink our approach to retirement planning to consider the increasing cost and complexity of aged care.

Recognising and accounting for retirement income needs can reduce the risk of retiring with insufficient savings. This should include the means to deal with the increased cost of care in the later stages of retirement which can influence when we are 'retirement ready'.

Historically, the approach to retirement planning has been to decide what income you need and then calculate how much you need to save to generate this income. Most people assume a flat (or declining) level of income which grows with inflation. However, if you consider the cost of care, the pattern is more likely to follow an upwards curve as shown in the graph below.



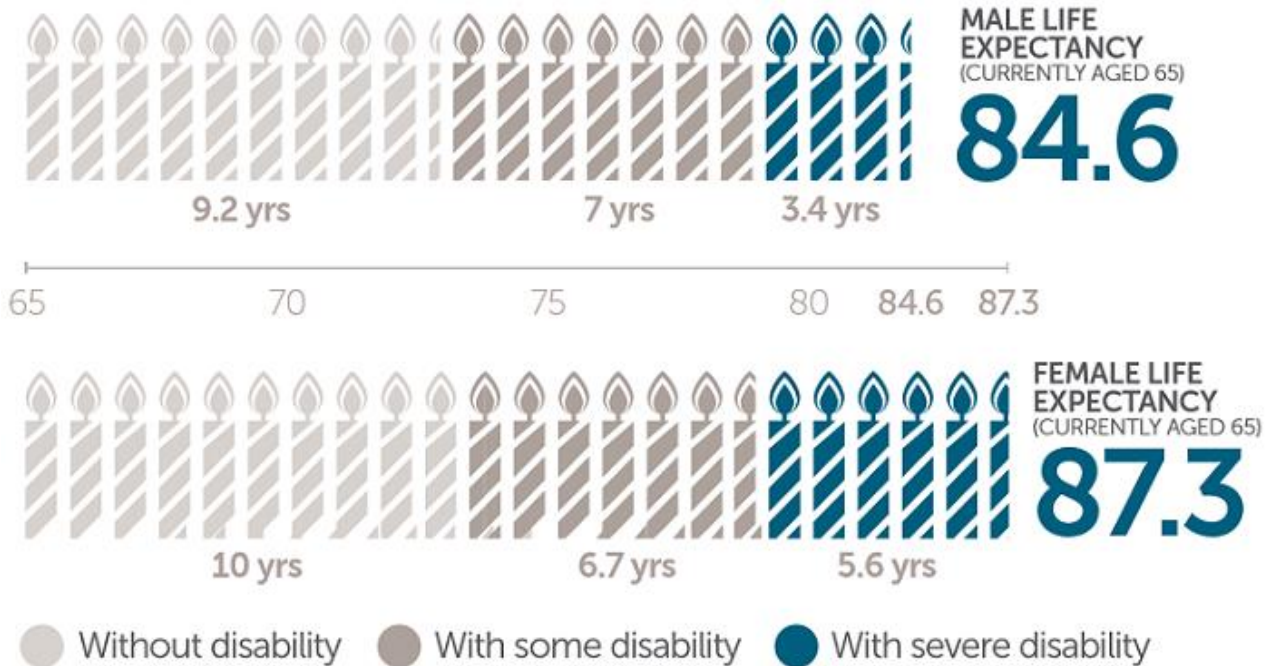
The three phases of retirement

There are three phases of retirement linked to a retiree's health, including years:

- without disability
- with some disability
- with severe disability.

Retirement planning and projections need to consider the income requirements for each of these phases, including the frailty years when expenditure patterns change.

An average 65-year-old retiree will have a health pattern as shown in the diagram below.



Source: Australian Institute of Health and Welfare – selected health expectations by age 65, by sex, 2015.

Spending patterns in retirement are likely to vary over the three phases.

Phase 1 is the initial period of retirement with 'care-free' years to focus on travel, spending time with family and friends and basically loving life! Health and wellbeing during this time are good, and the income needs of this phase of retirement are generally well accounted for in the planning process.

Phase 2 includes the 'quiet' years when health starts to decline. As we experience some disability, the level of activity and therefore spending declines.

Phase 3 is when we experience severe disability, and can be described as the 'frailty' years. This can account for 17%-25% of retirement years where help may be needed with daily living activities, and more is likely to be spent on dealing with aged care needs.

Preference for ageing in place

Older Australians strongly prefer to age in place (in their homes) rather than move into residential care. The costs of aged care have been accelerating at a rate higher than inflation. The opportunities for home care (in terms of home adaptations) are also increasing, adding pressure to retiree household budgets.

We might need increasing levels of support over the last 10-12 years of our life, with many people experiencing high levels of care dependency in the last 4-5 years. This may require income to cover:

- home care costs
- home adaptations to make the home suitable, such as widening doorways for wheelchairs and ramps.

Aged care costs can be difficult to predict and can vary from \$100 – \$5,000 a week (\$5,200 p.a. – \$260,000 p.a.) depending on care needs and family circumstances. Access to government subsidies helps to drastically reduce the cost payable by the user, but having adequate savings expands the options available and the ability to control the level and type of care received.

Did you know: ASFA Retirement Standard

Modest retirement for a single 85-year-old only allows \$31.04 per week for care and cleaning. This is less than half the basic daily fee for a home package and that's before extras!

Fragility is the third pillar of retirement risks

When planning for retirement and calculating the required level of savings, we usually consider two key retirement risks – longevity and sequencing risk. Longevity risk means savings may run out earlier than anticipated.

There is a third pillar of retirement risk – frailty risk – which if ignored, could also cause savings to run out earlier than anticipated, exacerbating the longevity risk. We need to manage the greater spending in the third phase, and in particular, care costs could be significant. Planning for frailty years should consider independence and control and the ability to stay in your home as long as possible, including:

- How you expect to fund aged care costs – recognising that legislation has been shifting towards a greater user-pays basis
- The role of your home in meeting aged care costs – including your willingness to access the equity in your home as against a preference to maintain the equity in your home as an inheritance for your family
- Ability to rely on family and friends to provide care and financial support
- If you choose to move to residential care, what options you have for funding the accommodation deposit and ongoing costs

It is important that you discuss these issues with your financial planner to ensure that you plan for a secure and comfortable retirement throughout all phases of your retirement – including the frailty years.

Assyat David is a Director of [Aged Care Steps](#).

Heed my problems borrowing in my SMSF

Mark Ellem

SMSFs have enjoyed the ability to borrow to buy property since 2007. However, with the recent crackdown on lending criteria, many options for finance have disappeared from the market.

An SMSF can borrow to acquire an asset provided it complies with the requirements of section 67A of the Superannuation Industry (Supervision) Act 1993 (SISA). This arrangement is commonly referred to as a limited recourse borrowing arrangement (LRBA), where the rights of the lender in the event of default are limited to the asset held under the LRBA. This is not the case for most other loans, which generally have no such recourse limitation, for example, business loans, home loans, investment loans and personal loans. Consequently, the application process is generally more onerous, takes longer and will have less favourable terms, for example a higher interest rate than a similar loan without any recourse limitations.

In considering an LRBA, the source of finance is as crucial as ensuring the LRBA complies with the relevant rules. Even where the LRBA satisfies all the legislative hurdles, failure to secure finance can prove costly for the SMSF.

Obtaining a loan is harder

Starting a few years ago and gathering pace recently, we have seen many lenders either withdraw completely from this space or tighten the lending criteria. I have personally experienced this change with my own SMSF attempting to obtain finance to buy a recently-completed townhouse, just one hour north of the Brisbane CBD. I approached many lenders and went through many arduous application processes, only to come up against a 'no' each time. One of the issues is the requirement for the lender to obtain their own valuation of the property. The difference in valuation on the same property was considerable, ranging from purchase price to \$90,000 below. Generally, a value more than 10% below purchase price will see the loan application fail.

Another hindrance has been loan-to-value ratios (the amount a financier will lend as a proportion of the property's value), which I've seen drop as low as 50%. Be prepared to kick in extra cash from the SMSF, as the days of 80% LVRs are long gone.

Even where you meet all the relevant criteria, you can still come up short with a lender's 'minimum loan amount' condition. I had the experience with one lender where I seemingly met all the requirements, the

maximum amount that their lending model said my SMSF could borrow was acceptable, yet the amount was below their minimum loan amount of \$250,000.

If you hit a brick wall, then what?

So, if your SMSF has entered into an LRBA, signed a contract, but can't obtain the finance, what are the options?

First, make sure when the purchase contract is signed that it contains the relevant 'subject to finance at purchaser's choice' clause and obtain legal advice on this before executing the contract. This may give you the option to withdraw from the contract. It's also best to seek legal advice if you believe the fund cannot settle due to being unable to obtain finance.

Second, consider a related party loan. Do you have the ability to borrow against non-super assets and on-lend to your SMSF? Of course, you will have to either comply with the related party lender safe harbour rules, or have evidence that the loan is on commercial terms. This second option may be difficult given many finance institutions may not be willing to lend to your SMSF.

Third, are you able to make a contribution to the fund to assist with the settlement? Be careful though, if you end up with sufficient monies to settle without the need for finance, but the purchase has been done via an LRBA.

Under an LRBA, the SMSF invests in a related trust (a bare trust), and therefore, prima facie, an asset funded by an LRBA is an in-house asset (IHA). However, the regulator has effectively exempted an LRBA from being considered an IHA, provided the LRBA is used for its intended purpose. If not, and there is no actual money borrowed as part of the LRBA, the exemption does not apply and the LRBA is treated as an IHA.

Consequently, where the SMSF can settle on the purchase of a property without the need for finance, but the contract has been entered into under an LRBA, consideration should be given to having a small related party loan. This related party loan could be repaid soon after settlement, however, as the LRBA included a loan amount, the legislative instrument IHA exemption would apply. There would also be the option of rescinding the original contract and executing a new contract in the name of the SMSF's trustee. However, this requires extreme care and depends on the state jurisdiction. Consultation with a lawyer would be advised to ensure no adverse stamp duty outcomes.

Satisfy all the rules

When it comes to LRBAs, whilst it is important to ensure all the requirements under the law are satisfied, in my experience it's equally important to focus on where the funding will come from. And with more lenders withdrawing from this space, this may be easier said than done.

Mark Ellem is Executive Manager, SMSF Technical Services at [SuperConcepts](#), a sponsor of Cuffelinks and a leading provider of innovative SMSF services, training, and administration. This article is general information only and does not consider the circumstances of any individual.

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