

This Week's Top Articles

- **Labor policies and the impact on housing** *Noel Whittaker*
- **Vital signs: the right time to clamp down on negative gearing** *Richard Holden*
- **Get me out of Australia?** *Oscar Oberg*
- **Review: Howard Marks on the market cycle** *Jonathan Rochford*
- **Rethinking home equity and retirement funding** *Joshua Funder*
- **ESG by new means, to new ends** *Pablo Berrutti And Mark Nieuwoudt*
- **More ETF users are younger and female with ESG focus** *Ilan Israelstam*
- **Briefly, on the role of government bonds** *Warren Bird*

Labor policies and the impact on housing

Noel Whittaker

Recently, I was privileged to be a member of a roundtable conference in Canberra chaired by Treasurer Josh Frydenberg to discuss the implications of Labor's housing policy. The Treasurer said he had no specific agenda, and he had gathered together some of the most experienced property and finance people in the country to hear their candid views.

There were 12 guests at the meeting. They included executives from the Property Council, the Urban Development Institute of Australia (UDIA), Master Builders Australia, the Real Estate Institute of Australia, Adept Economics, Wizard Home Loans, property guru Margaret Lomas and Peter Koulizos, Chairperson of Property Investment Professionals of Australia.

The material in this article is based on the opinions from the people who were present. The implications of the major changes proposed by Labor will depend almost entirely on the reaction of the home buying and investor public.

It would be an entirely different matter if we were discussing Labor's franked dividend policies because I could say with almost perfect certainty that I can predict exactly what strategies will be put in place by those who will be affected by them.

Since that roundtable conference, I have been coming to terms with what the proposed changes may mean to Australia. To be frank, I'm scared.

Far-reaching changes to negative gearing and capital gains

Labor is proposing a massive change to existing arrangements. **First**, by restricting negative gearing to new properties only, and **second**, effectively increasing capital gains tax by reducing the present 50% discount to 25%. They have announced these policies will be grandfathered, so they will only apply to assets acquired after a certain date (yet to be announced). Here is the statement taken from [Labor's website](#).

Labor's Proposal

Labor will reform negative gearing and the capital gains tax discount to ensure that our tax system is fair, sustainable and targets jobs and growth.

Negative gearing

Labor will limit negative gearing to new housing from a yet-to-be-determined date after the next election. All investments made before this date will not be affected by this change and will be fully grandfathered.

This will mean that taxpayers will continue to be able to deduct net rental losses against their wage income, providing the losses come from newly constructed housing.

From a yet-to-be-determined date after the next election losses from new investments in shares and existing properties can still be used to offset investment income tax liabilities. These losses can also continue to be carried forward to offset the final capital gain on the investment.

Capital gains tax

Labor will halve the capital gains discount for all assets purchased after a yet-to-be-determined date after the next election. This will reduce the capital gains tax discount for assets that are held longer than 12 months from the current 50 per cent to 25 per cent.

All investments made before this date will not be affected by this change and will be fully grandfathered.

This policy change will also not affect investments made by superannuation funds. The CGT discount will not change for small business assets. This will ensure that no small businesses are worse off under these changes.

Labor will consult with industry, relevant stakeholders and State governments on further design and implementation details ahead of the start date for both these proposals.

Labor's reasons for the changes to negative gearing are that investors enjoying tax concessions are competing with first-home buyers and thus driving up prices, making it more difficult for young people to acquire their first home. Reducing the tax concessions available to investors should cause demand to drop, and property prices to stabilise or even fall.

But given the increasing disparity between the average home and average weekly earnings, a fall in property prices might not do much for aspiring homebuyers. If a \$500,000 property dropped 10% to \$450,000, the buyer would still need a deposit of at least \$45,000, plus the income to service a debt of around \$420,000 when mortgage insurance is taken into account. Making homes more affordable for first-home buyers is extremely difficult, and many of the initiatives taken in the past have been self-defeating, as they have pushed up the price of housing by creating more buyers.

When I was in the building business in 1975, the average suburban low-set brick home in Brisbane cost around \$30,000 and average earnings were about \$15,000 a year. Currently, a suburban house in Brisbane costs around \$500,000 which is about six times average earnings. So, housing affordability will continue to be an extremely difficult task and no party has a solution.

According to the Labor website:

"This policy will see a boost in new housing and will provide young families with the chance to find a home, and will take pressure off inner city housing markets that are predominantly made up of existing dwellings."

Whether or not this is true will depend on buyer behaviour. It may well be that millennials will prefer to rent in the inner city, rather than take on a large mortgage for a new home that's a long way from the action.

Not Keating Mark II

It's wrong to compare Labor's proposed changes to negative gearing with what Paul Keating introduced in July 1985 and repealed in September 1987. He increased the depreciation allowance to 4% for new construction and stipulated that losses on investment properties could not be written off against current taxable income, but would be quarantined to be offset against future income from the property when it became positively geared.

Under the current Labor proposals, as I understand them, losses cannot be offset against future taxable income, but will be added to the base cost to reduce capital gains tax on the property when it is eventually sold. Labor's proposals also apply only to new properties while Keating's applied to all properties.

Expect much debate on these policies in the next three months. Labor is using a 2016 report from the Grattan Institute to support its case. It concluded:

"Ultimately, people who invest in property take into account a host of factors, including rental returns, risk perception, familiarity with the asset class, and ability to obtain bank finance. Modest changes in tax treatment will not affect their decisions much."

In contrast, a report commissioned by Master Builders Australia, prepared by Cadence Economics, has forecast a decline in new home building of between 10,000 and 40,000 dwellings, and a loss of 7,500 to 32,000 full-time construction jobs. Master Builders tell me it's not the abolition of negative gearing *per se* that will cause a slump, but the combination of the new negative gearing and capital gains tax rules.

Back in 1985, when the Keating changes were in the news, I did several roadshows with a leading chartered accountant. We had conflicting views. My modelling demonstrated that the Keating proposals weren't really too tough and should not put anybody off acquiring investment property. The accountant's view was that perception, rather than facts, would resonate with the public and they would desert investment property in droves. His view proved to be correct.

When new becomes established

The distinction between new and established properties could have some serious consequences. Think about an investor couple who decide to buy a \$500,000 new investment property. They sign the contract and apply for finance. The bank's valuer does the valuation based on a forced sale of what would then have become an established property. Valuers tell me this could reduce the valuation down to \$450,000 and the application for finance may be rejected. If the buyer can't get finance, the contract will be cancelled, and there may be one less property available to be rented.

If the negative gearing rules are changed, it would make more sense to include all properties, as Keating did. After all, the majority of tax deductions that relate to investment property come from brand-new properties.

Political parties of all persuasions should understand some fundamental truths about the property market. There are many investors who are terrified of shares, and are wary of superannuation because of the continual rule changes. They use borrowing for residential property as their means of saving for retirement. This is a double win for Australia. It provides an ongoing supply of rental property, reducing pressure on rents, and enables hundreds of thousands of Australians to become self-funded retirees with no expectation of help from the government.

What does the future hold? It's anybody's guess, but we do know the election will be in May 2019, and the result may be a narrow win for Labor. If this happens, expect months of negotiating with the minority parties to pass these changes. This will create uncertainty, which may well mean that homebuyers will sit on their hands waiting to see what laws will be changed and how.

Labor has promised that their capital gains tax increases will affect only assets acquired after a specific date in the future, which is yet to be announced. Once it is announced, expect a flurry of buying in both property and shares, as buyers jump in before the tax rules change.

If this happens, it is highly likely to be followed by a significant slump in activity after the change date, because many people who could buy would have bought.

But, it's a paradox. An asset bought before the change will be worth more than one bought after the change **for tax purposes**. However, if you buy or own a house, new or established, before the change it may well be worth less than it would be **after the change** because there'll be less people who want to buy it.

The housing market is already down

The big question now is whether such radical property changes should be contemplated at a time when the market is in a slump with strong indications that it may get worse.

The CoreLogic Monthly Property Report for February 2019 showed that Australian housing values continued to trend lower. Their Head of Research, Tim Lawless, said:

" ... the housing market downturn is now more widespread geographically and we aren't seeing any indicators pointing to the market bottoming out just yet."

Furthermore, according to the Australian Bureau of Statistics, Australia's construction sector has moved sharply into reverse. Private surveys run by groups such as the Australian Industry Group and the Housing Industry Association have reported home building activity to be at its lowest ebb in six years. The construction industry is one of the biggest employers in the country accounting for 989,400 full-time jobs during the three months to November 2018. If the residential market continues to slump, the loss of jobs could be catastrophic.

It's a great discussion to have with the family around the dinner table. The certainties are that Australia's population will keep growing, property will stay out of reach for many renters, and builders won't build to sell at a loss.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance, which can be found on his website noelwhittaker.com.au. This article is for general information purposes only and does not consider the circumstances of any investor.

Vital signs: why now is the right time to clamp down on negative gearing

Richard Holden

When I wrote a report for the McKell Institute about negative gearing, [Switching Gears](#), in 2015, Australia had a housing affordability crisis and negative gearing was costing the budget \$4 billion per year.

Three years on, Australia still has a housing affordability crisis, and negative gearing is costing the budget \$5.5 billion per year.

Back then, more than half of the money lent for housing (an unprecedented 55%) went to investors rather than people buying homes to live in. Only one in seven loans went to first home borrowers, down from one in five a few years earlier. Since then, the Australian Prudential Regulation Authority has leaned on the banks to wind back investment loans (they are down to a still-high 42%), and loans to first home buyers are back up to nearer one in five. It's not yet clear how the changes will stick.

But negative gearing is still costing the budget billions, and its worst effects are being contained only by threatening the banks and by the (possibly temporary) easing in house prices.

How to clamp down

My report put forward five different options, ranging from doing nothing to abolishing negative gearing forthwith.

My preferred option ([scenario 4](#)) would have outlawed negative gearing except for 'grandfathered' existing negatively-gearred properties, and for newly-constructed dwellings. Even where outlawed, people could continue to claim investment losses against investment income, just not against their salary. The exemption for newly-constructed dwellings would boost construction jobs and housing supply, helping affordability and economic growth.

It would also deliver a boost to the budget bottom line of more than \$30 billion over 10 years, and assist financial stability by cutting the proportion of the housing market from the hands of footloose investors.

Labor adopted a [version of it](#) in 2016. At that time, even the then Treasurer Scott Morrison wanted to target "excesses".

More than 120,000 people have three or more leveraged investment properties. Staggeringly, more than 20,000 have six or more. The Reserve Bank of Australia [thinks it puts the financial system at risk](#), noting that “investors with multiple properties have likely contributed to higher risk”.

The Treasury found the sort of changes Labor and I were proposing would have only a “[relatively modest](#)” effect on home prices, instead of the “[sledgehammer](#)” alleged by Morrison and the then Prime Minister, Malcolm Turnbull.

What negative gearing is

Negative gearing property involves two steps.

First, you invest in a property and get less income from it in rent than the cost of the investment (such as the interest on the loan and the cost of maintaining the property).

Second, you use that loss on the property to offset your income from unrelated streams such as wages or salary, thereby cutting your tax bill.

It’s this second part that is peculiar, and where Australia is out of step with most countries, including the United States, Canada and the UK. Other countries will allow you to use investment losses to offset investment profits, but not to offset income from wages and salaries. The tax deductions impose a big hit on the Federal Budget. The Treasury says that more than half of that \$5.5 billion impact goes to families [in the top 20% of the income distribution](#).

It hurts intending owner occupiers

Here’s how it locks genuine (residential) buyers out of the market. An investor who fronts up at a typical Saturday auction faces the prospect of the federal government paying roughly half his or her interest bill, given the top marginal tax rate and medicare levy. An owner occupier, in contrast, gets no help. Even if they have the same deposit saved and earn the same income as the investor, they can afford to borrow much less. Perhaps just half as much.

Owner occupiers get outbid. Sometimes, they end up renting from negatively gearing investors who elbowed residential buyers such as themselves out of the way.

Crimping it would level the playing field

My McKell plan levels the playing field right away. The day after the policy is enacted, owner occupiers and investors have the same firepower at auctions. Existing investors – those who already have negatively geared properties – would be able to keep those tax breaks until their loans were paid off. It would mean a smooth transition away from negative gearing, rather than an abrupt change. It would also respect the investment choices that had been made in good faith under existing policy settings.

It’s hard to find a credible economist – or even a non-credible one – who doesn’t think that negative gearing should be reformed. There has been a consistent call for reforms from leading voices like [Saul Eslake](#) and Chris Richardson. Even the then-sensible Malcolm Turnbull said in 2005 that Australia’s rules on negative gearing were “[very generous](#)” compared to those of other countries. He said it was a form of [tax avoidance](#). Quite so.

Of course, with another federal election coming up, Treasurer Josh Frydenberg has run [the same predictable scare campaign](#) about Labor’s negative-gearing policy as last time. This time he says:

“Labor’s policy will make sure people who own their home will see the value of their home be less and fall, and if they rent their home, their rent will go up.”

His claim is dubious at best. House prices have fallen 12% in Darwin in the past year, but risen 19% in Hobart, none of it due to negative gearing. Because negative gearing would still be available for new construction under Labor’s plan (and mine), it would add to the supply of new homes and push down rents. Also, as existing renters who want to purchase find they are able to, they will move from being renters to owners, cutting the demand for places to rent and also putting downward pressure on rents.

Now is the time

Negative gearing is a costly and peculiar provision of the Australian tax code, and one that creates both intergenerational inequality and financial instability. It was long overdue for reform in 2015, and the case has

strengthened since. The best time to crimp it is when the heat has already been taken out of housing prices and relatively few investors are rushing in anyway.

Opponents of reform need to explain why they would want to continue to spend \$5.5 billion per year encouraging yet another wave of negatively-g geared property speculation which would lock still more young people out of the dream when the market picks up.

Richard Holden is a Professor of Economics and PLuS Alliance Fellow at the [UNSW Business School](#), an alliance partner of Cuffelinks. This article is republished from [The Conversation](#) under a Creative Commons license.

Get me out of Australia?

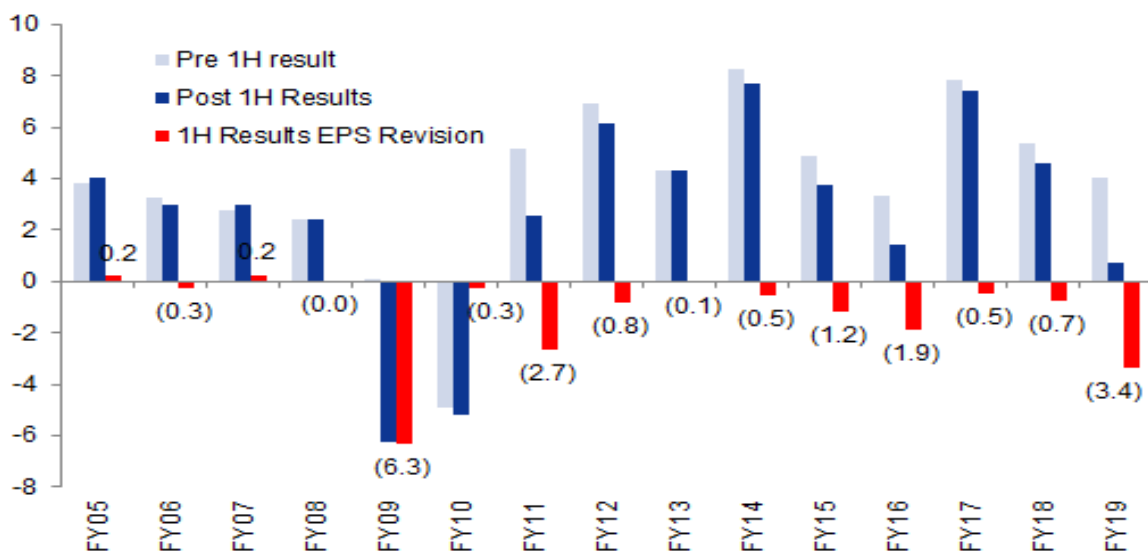
Oscar Oberg

Investors' desire for growth outside of the suffering Australian economy was a major theme to emerge in the February 2019 Reporting Season, particularly in the small-to-mid-cap segment of the market.

Since around September 2018, economic data in Australia has weakened, largely due to the flow-on effect of falling house prices on consumers. Key data points such as retail sales, business confidence and consumer sentiment have all weakened as a result. The downward trend in business confidence has continued with the February 2019 NAB Business Survey confirming that business conditions decreased to the lowest levels since 2013. As shown below, Consensus Earnings per Share growth forecasts were cut after the Reporting Season results by more than anytime since the GFC.

Exhibit 1 : ASX 200 Industrial EPS Growth was cut by 3.4%, the largest downgrade to full-year growth forecasts since the GFC.

Revision to full-year Consensus EPS Growth post 1H results announcements (pp)



Source: FactSet

Widespread impact of slowing

In addition to retail, the weakening economic data has impacted automotive, media and building materials contributing to the recent February reporting season being the weakest since the global financial crisis. According to Goldman Sachs' strategy team, housing-related cyclical companies have underperformed their industrial peers within the S&P/ASX200 by more than 80% over the last five years. Domestic cyclical companies such as Costa Group (ASX:CGC), Boral (ASX:BLD) and Bingo (ASX:BIN) disappointed expectations prior to the February reporting season, with these companies highlighting patchy demand over the December quarter.

With investors shying away from domestically-exposed cyclical companies, the divergence between value and growth companies has never been greater, with Goldman Sachs showing that the differential between value and growth is now at highs not seen since the 'tech bubble' in the early 2000s. According to Goldman Sachs, the bucket of 'high price-to-earnings' firms or growth companies are trading at a 70% premium to the market's valuation which is 21% above the long-term average.

On our estimates, sectors exposed to the domestic economy represent approximately 31% of the S&P/ASX Small Industrials Index. Given the uncertainty associated with these sectors at present, investors have been looking for growth companies offering greater certainty to earnings, which has driven up valuations as a result.

With consensus now assuming that the RBA may cut the cash rate in the second half of the year, expectations are for the Australian dollar to continue to decline. This expectation has driven companies with strong offshore franchises, to outperform strongly.

Which companies are still doing well?

Companies such as IPH Limited (ASX:IPH), Breville (ASX:BRG), Lovisa (ASX:LOV), Appen (ASX:APX) and Altium (ASX:ALU) reported solid results and have seen their valuations increase to all-time highs. Following the lead of the FAANG (Facebook (NASDAQ:FB), Amazon (NASDAQ:AMZN), Apple (NASDAQ:AAPL), Netflix (NASDAQ:NFLX), Google (NASDAQ:GOOGL)) stocks in the US, the Australian technology sector (what we call the WAAAX sector: Wisetech (ASX:WTC), Afterpay (ASX:APT), Altium (ASX:ALU), Appen (ASX:APX) and Xero (ASX:XRO)) has seen valuations increase to extraordinary levels with the average 12 months forward price to earnings multiple for these four companies a whopping 70x (excluding APT which is loss making) compared to the ASX Small Industrials Index which currently trades on 19x.

At Wilson Asset Management, we focus on undervalued growth companies in the market and like to invest in strong brands that have the potential to grow strongly in offshore markets. Two examples are Austal (ASX:ASB) and Infomedia (ASX:IFM).

ASB is a shipbuilding company with the vast majority of its earnings (92%) derived from its US business which has a contract to build Literal Combat Ships (LCS) for the US Navy until 2025. With the company currently outperforming its competitors, we see the opportunity for ASB to take market share and win large maintenance contracts on offer for the LCS fleet once it becomes operational over the next few years. The recent expansion of its low-cost Philippines shipyard has the ability to shift work away from Austal's high-cost Australian operations. ASB is well placed to grow earnings above expectations, with its growing support business providing a scope for a re-rating of Austal's valuation.

IFM is a technology company which does not have a 'sky high' valuation such as its WAAAX peers. The company is a leader in parts and services software to the automotive industry and has a strong exposure to Europe and the United States, representing 75% of its revenue. The recent first-half result is a breakthrough result for the company, with the previous 12 months of investment paving the way for the business to achieve double digit growth over the medium-term. The recent acquisition of Nidasu and other bolt-on acquisitions will further boost Infomedia's product suite going forward. IFM is trading on a price to earnings multiple of 32x which is less than half the valuation of other technology companies mentioned previously and is well placed to beat earnings expectations going forward.

Despite a number of domestic cyclical companies currently offering investors value, we believe the attraction to offshore growth companies will continue. This reflects a highly uncertain domestic environment in Australia, fuelled by falling house prices and exacerbated by the upcoming NSW and Federal elections and the fallout from the Royal Commission into Misconduct in Banking, Superannuation and Financial Services Industry.

Oscar Oberg is a Lead Portfolio Manager with [Wilson Asset Management](#). Listed investment companies managed by Wilson Asset Management were invested in ASB and IFM. This article is for general information purposes only and does not consider the circumstances of any investor.

Review: Howard Marks on the market cycle

Jonathan Rochford

Howard Marks has long been regarded as one of the great investment communicators; wise enough to understand how investment markets work and witty enough to explain it in an interesting way. His [ad-hoc memos](#) always receive broad coverage and are considered essential reading by many including Warren Buffett.

Marks' recently released book, 'Mastering the Market Cycle', combines new material with passages from some of his historical memos. The subtitle, 'Getting the odds on your side' explains the reason for the book. He regularly asks the question, "Where are we at in the market cycle"?

It's not about knowing the future

From the outset, Marks is explicit that no one can know the future, particularly regarding market timing. Those who are given credit for calling the top of one cycle almost never repeat that feat again. However, investors should plan and invest with the market position in mind. Whilst the probabilities are never certain, they are often slanted towards above- or below- average future returns. The pendulum of market cycles often swings well past the mid-point, creating opportunities for patient investors to buy assets cheaply and sell them richly.

Marks is pragmatic in his advice. Even if an institutional investor could perfectly predict the peak or trough, it would be impossible to trade everything near that level given the relative illiquidity in markets for large portfolios. Marks notes how his firm, Oaktree Capital, was raising capital in 2007 and 2008, then started buying heavily in late 2008, all ahead of the market's nadir in March 2009. If Oaktree had waited, it simply would not have been able to deploy its capital in meaningful size before the bargains were grabbed by others.

Structure of the book

Marks explains the characteristics of market cycles and the frequency with which they occur. Readers are then taken through chapters on the economic cycle and its impacts on the cycle of company profits, followed by investment psychology and attitudes to risk as the market cycle evolves. The book flows onto an analysis of the credit cycle, distressed debt cycle and property cycle, with the three interlinked as the boom and bust of credit cycles creates the other two. Marks finishes off with chapters on coping and positioning for market cycles, and a reminder that human behaviour isn't always rational.

Marks' book has the potential to either engage readers or frustrate them, over two types of repetition: reusing slabs of his memos, and repeating points from previous chapters before progressing. I was fine with this method but I've spoken to others who found it annoying.

The final chapter is a 22-page summary, a quick review which might be helpful for a professional before an asset allocation meeting.

Key risk lessons in market timing and asset allocation

Three key components of investment returns are market timing, asset allocation and security selection. Marks focusses on the first two.

Evaluating what the crowd is doing is partly art and partly science. The art is judging whether investors are seeing risk everywhere or ignoring risk everywhere, an ability enhanced by experience but never really definable. It often comes back to the anecdotes of stock tips from amateurs and people investing with expectations of rapid gains. The science aspect is more definable, for example P/E ratios for stocks and credit spreads on debt instruments. Marks notes that perceived risk dictates future long-term returns, in that when everyone is fearful long-term returns are likely to be above average and when optimism abounds, below-average returns lie ahead.

The impact of credit on economic and market cycles in chapters nine to eleven are compulsory reading. Marks sums up the impact of bad lending with: "look around the next time there's a crisis; you'll probably find a lender". Excessive risk taking in lending inflates asset prices, particularly in sectors like property and infrastructure that use large amounts of leverage. The widespread withdrawal of credit, as lenders switch from being risk embracing to risk averse, leads to bankruptcies and fire sales of assets.

Market timing and asset allocation are highly interlinked. Market timing is not as simple as increasing cash and reducing risk assets or vice versa, it is nuanced across and within asset classes. For instance, a late cycle view on credit points to owing higher-rated securities and having lower credit duration across a portfolio. But it also

has implications for bank equity, with the likelihood that credit losses will increase from their current low levels, reducing future bank profits.

An Oaktree crisis story

For portfolio managers, Marks inclusion of an Oaktree crisis story on pages 129-134 is a standout. He details how Oaktree had started managing geared funds of leveraged (sub-investment grade) loans in the years before the crisis. As loan prices declined and margin calls were imminent, Marks had to visit clients and plead with them to add more equity to their position in one fund. He could not convince all investors to add to their positions but saved the fund by adding either his own or Oaktree's capital and reaping a great return as a result. Marks uses the story as an illustration of an investor's irrational risk avoidance, but there are far deeper lessons for portfolio managers which he leaves out.

First, Oaktree should never have been in a situation where it was facing margin calls on its funds. When leverage is used, it should be locked in for a long enough period for the underlying assets to materially paydown the debt from normal cashflows. Strategies that include borrowing short to lend long (e.g. structured investment vehicles in 2007/2008) or giving lenders control via mark to market triggers (e.g. LTCM in 1998), have a long history of blowing portfolio managers out of their positions.

Second, using leverage creates the wrong conversation at the wrong time. Margin calls always occur at the most inconvenient time and will almost always be seen by clients as mismanagement on the part of the portfolio manager. Rather than pleading for more equity for a precariously placed fund, Oaktree should have been pointing to the good management on its existing funds and asking for additional capital for a new distressed debt fund.

Going beyond the book

Howard Marks sticks to high level commentary and strategy in his writing and interviews. This is understandable given his role as Chairman and face of Oaktree, which would involve far more time on marketing and client engagement than 'on the tools' investment analysis. However, I like to give more detail on what I'm doing with the capital I'm entrusted with.

I'm in hearty agreement with Marks that we are late in the cycle but simply cannot know how long it will be before there is a meaningful downturn. Sell-offs in late 2015 and late 2018 turned out to be blips rather than busts. Holding cash and hoping that the next major downturn will arrive soon is both unprofitable and unnecessary for credit investors.

I'm finding plenty of opportunities to invest in low risk, short duration securities. What I'm typically giving up is immediate liquidity, instead getting liquidity from a portfolio of securities that predominantly matures or amortises over the next 6-24 months. It's a case of fishing in a different pond, rather than fighting with the crowd who are seeking higher returns from subordinated securities, by extending duration and by giving up covenants.

This delivers on almost all of what clients are looking for. They have below average risk, they receive good returns (often equivalent to the long-term average returns of listed equities) and they will have cash available when asset prices fall and the bargains are there. The portfolios have also been surprisingly stable month to month, experiencing little of the losses seen through the sell-off late last year.

One final point on the value of market timing. Using basic estimates of long-term returns, inflation and asset prices through the cycle, 15 years of alpha can be made in 5 years from buying crossover (BBB/BB) credit securities towards the bottom of the credit cycle. This demonstrates the optionality from having near-term maturities in a credit portfolio during buoyant times. There may be underperformance of 1-2% per year for two to three years before a downturn occurs, but this can be recouped many times over through buying bargain securities in the downturn.

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Rethinking home equity and retirement funding

Joshua Funder

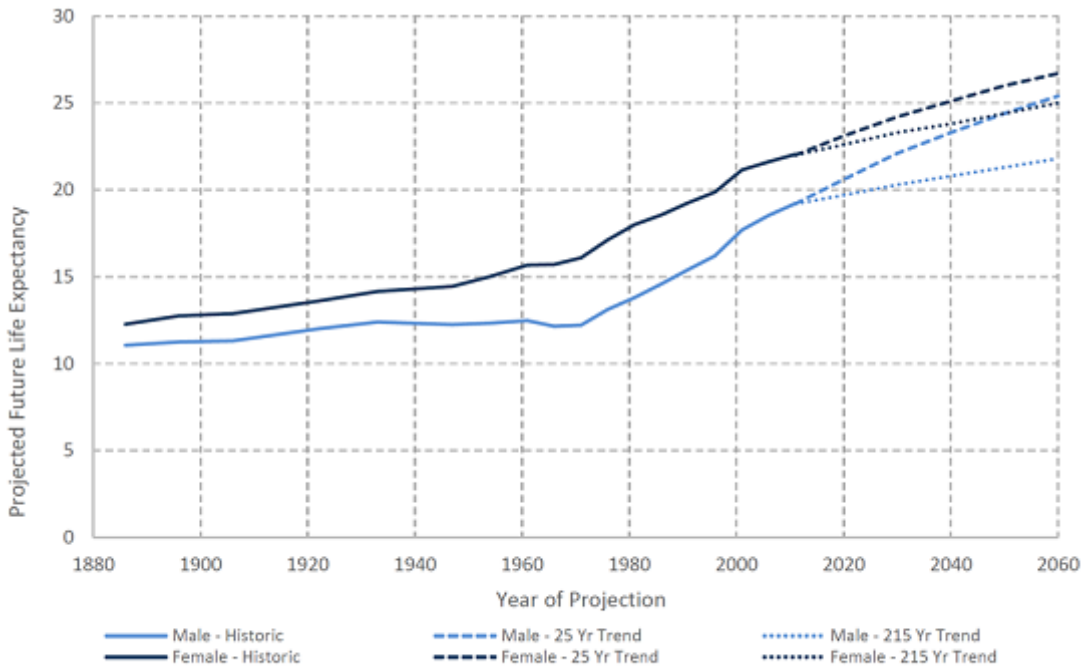
Australians are experiencing a major societal transformation as the baby boomers, around 5.5 million people born between 1946 and 1964, are reaching retirement. While they are living longer than ever, it presents a conundrum – many of this cohort simply don't have sufficient superannuation to fund a comfortable retirement for their projected lifespan.

Australians are living longer

The life expectancy of Australians in retirement has almost doubled in the last 150 years due to better lifestyles and medical breakthroughs. Since the introduction of compulsory superannuation in 1992, Australians at retirement have gained an extra decade of longevity.

Figure 1 shows the range of expected increases in longevity after retirement for Australian men and women based on current assumptions. It is estimated that retirees aged 65 now will live *on average* until 84 for men and 87 for women.

Figure 1: Historic and future life expectancy for Australian men and women aged 65



Source: Source: Australian Government Actuary 2010-12 Life Tables; HHC analysis

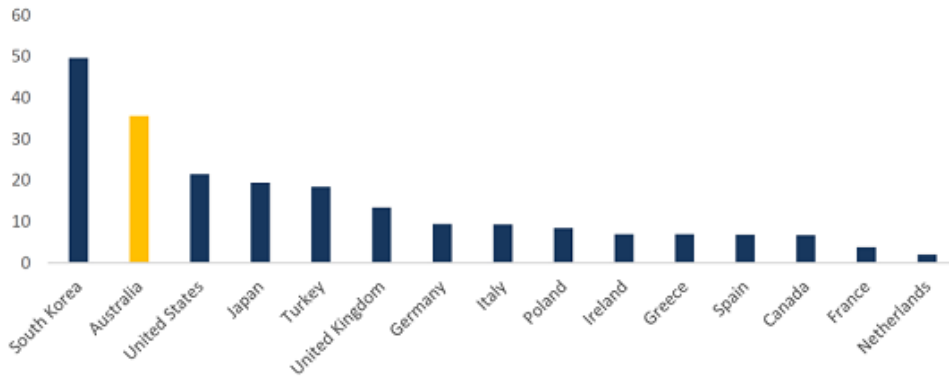
The blessing of longevity is a new and extended phase of life which will endure well past 90 years-of-age for many people. The downside is that individuals should plan for 25-30 years of retirement.

Retirees are not always prepared

According to the Credit Suisse Research Institute Global Wealth Report 2018, Australians have the highest median wealth per adult. Despite this, retired Australians experience high levels of relative poverty, as shown in Figure 2. When compulsory superannuation was introduced in 1992, many baby boomers were more than halfway through their working life, and they missed out on the benefits of compounding returns over time. As a result, the median household superannuation balance for retiring Australians currently sits around \$200,000, estimated to support a 'comfortable' retirement income for just 10-15 years.

Most baby boomers were busy paying off their mortgages, with approximately 80% of retirees owning their own home. For most home-owning Australians, the majority of their wealth is tied up in their home equity. In total, there is over \$900 billion in untapped home equity owned by Australian retirees, according to the Productivity Commission.

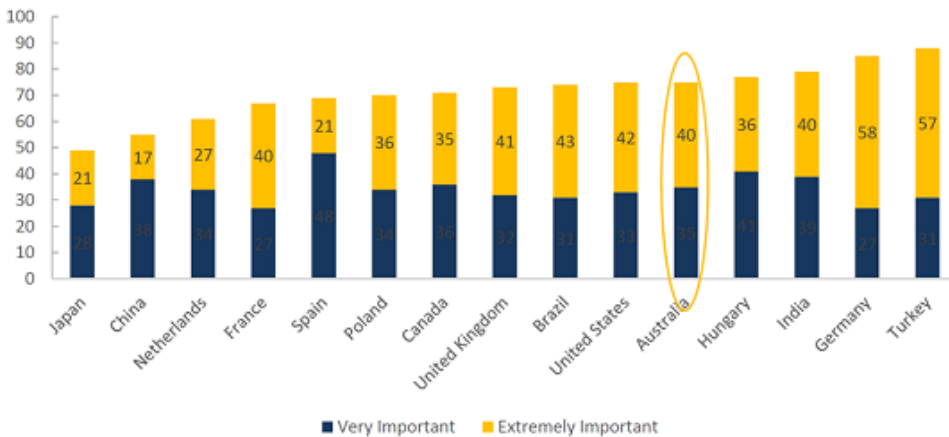
Figure 2: Percentage of those aged 65+ living in poverty



Source: OECD 2018

Long, healthy lives enable Australians to spend a greater part of their retirement living independently. Most retirees prefer to stay in their own home as they age, as illustrated by Figure 3, and this untapped savings pool is a valuable resource that could be utilised to provide improved retirement funding.

Figure 3: Importance of remaining home in retirement



Source: Aegon Retirement Readiness Survey 2018

How can investors access home equity?

There are four main approaches used by retirees to access home equity, as shown in Figure 4. Each of these approaches has downsides in terms of cost of access, security of tenure in the home or the ability to fund a long-term retirement income.

Figure 4: Approaches to access home equity

	<p>Banks</p>		
<p>Downsize</p>	<p>Line of credit/ Offset</p>	<p>Home Reversion</p>	<p>Traditional Reverse Mortgage</p>
<ul style="list-style-type: none"> Sell home and purchase lower value property High transaction costs Limited supply of suitable local housing stock Irreversible 	<ul style="list-style-type: none"> Draw on home equity when required May not suit retired – mortgage default terms Loan repayments deplete available retirement income 	<ul style="list-style-type: none"> Sell home now, receive part proceeds less value of "rent" Opaque pricing of home Opaque cost of finance Limited availability 	<ul style="list-style-type: none"> Loan secured by home Interest capitalized and paid when home is sold Subject to adverse selection/misalignment Mostly short-term consumption of equity, depleting retirement assets

Source: Household Capital

The reverse mortgage experience

A. Overseas

Canada and the United Kingdom have a similar demographic composition to Australia with an ageing workforce and a large baby boomer cohort entering retirement. Residential property values have skyrocketed in these markets and many individuals approaching retirement are asset rich, cash poor, with home equity significantly outweighing the value of retirement savings.

There has been significant growth in reverse mortgages used to fund long-term retirement income streams in these markets, with both Canada and UK experiencing 30% growth, year on year since 2013.

B. Australia

Traditional bank reverse mortgages were generally unaligned with the long-term housing and funding needs of Australian retirees, and therefore failed to provide genuine retirement funding adequacy and certainty. These products failed to meet the widespread needs of Australian retirees, including:

1. Adverse selection – seen as a form of ‘last resort’ financing for many older Australians, historical access of home equity was often for inappropriate purposes for potentially distressed borrowers. These circumstances provide a recipe for dissatisfaction for the product and the provider.
2. Misaligned distribution – while financial advice was often recommended, access to home equity in Australia was never directly linked to long-term retirement planning or financial advice. It left many borrowers cash poor and asset depleted throughout the remainder of their lives.
3. Short-term consumption of equity – according to a recent ASIC review of reverse mortgage lending, the application process historically focused primarily on the borrower’s short-term objectives, with limited attention paid to future needs.
4. Lack of intergenerational transfers – traditional reverse mortgages failed to provide a structured mechanism to satisfy the long-term retirement income needs of a borrower and enable the responsible transfer of home equity to subsequent generations at a time they incur major lifetime expenses.

By the end of 2018, CBA, Westpac and Macquarie, the three big-bank providers of traditional reverse mortgages, had all withdrawn from the Australian market. Reasons for the withdrawal include: the Royal Commission, proposed APRA capital risk weighting changes, an inability to scale the traditional reverse mortgage product, and perceived reputational risks. Since the withdrawal of the major banks, Australian retirees have been left without widespread access to their home equity as a means to fund retirement.

The future of home equity

The next generation of home equity lending must identify a range of responsible retirement funding needs, and overcome the shortcomings of traditional reverse mortgages. Two guiding principles should govern this approach.

First, long-term retirement funding needs are responsibly met by the transfer of illiquid home equity into appreciating, diversified assets in a more liquid form. The improved accessibility can meet those funding needs over time.

Second, funding availability is constrained to prevent spending for short-term consumption or deployment into depreciating assets.

By restructuring responsible access to home equity, retirees can receive multiple benefits:

1. Access to savings – where the majority of lifetime savings are in the home.
2. More reliable retirement income – for some retirees, income is volatile relative to the performance of superannuation and home equity can smooth income and capital supply.
3. Asset diversification – as superannuation is depleted, retirees’ assets become increasingly concentrated in a single residential property, and a transfer to superannuation can diversify assets.
4. Long-term financial advice – higher super balances during retirement create benefits that come from holistic management of household savings.

5. Sequencing risk management – responsible, long-term access to home equity adds a second, independent, largely uncorrelated source of income should super assets decline periodically, especially where age pensions are inadequate.
6. Imputed rent annuity – non-recourse borrowing provides certainty of occupancy of the home, increasing the annuity value of long-term imputed rent and enhancing real retirement incomes.

Traditionally, Australia's retirement income policy has been framed as having three pillars: superannuation, non-superannuation savings and the age pension. It is time to include the fourth, and largest, pillar of retirement funding: home equity. By drawing on multiple sources of income, Australian retirees can achieve funding adequacy throughout the full course of 25-plus years of retirement. To do this, however, retirees must be able to responsibly and cost-effectively access home equity savings to generate retirement income.

Joshua Funder is Chief Executive Officer of [Household Capital](#). This article is general information and does not consider the circumstances of any investor.

ESG by new means, to new ends

Pablo Berrutti And Mark Nieuwoudt

As shareholders question ESG (Environmental, Social and Governance) practices more than ever, we spoke to some institutional clients about how they are thinking about ESG when managing their funds. From reducing emissions to corporate culture and ESG risk assessments, the conversation highlighted the industry's approach is not uniform but we are all grappling with the same issues.

Carbon production dominated client discussions

Depending on how you measure carbon, especially emissions versus intensity, a portfolio can yield different results. When it comes to portfolio construction there are two schools of thought: exclusion and inclusion.

On the one hand, excluding carbon producing companies in a smart beta portfolio lowers the environmental impact of the overall portfolio but may create an unintended sector bias. Allocating more funds to low carbon sectors can result in unintended tracking errors.

On the other hand, an actively-managed portfolio might invest in carbon-producing companies that have sensible action plans in place. Once these companies have achieved an emissions reduction, or steered their operations towards a more sustainable future, they generate long-term value and good returns for their investors.

As fund managers, we have a clear responsibility to avoid the worst impacts of poor ESG management to minimise the risk of losing client capital. As seen in the starkly different approaches to carbon emissions, there is not necessarily a single or correct way of mitigating ESG risks.

Credit risk analysis should focus on ESG as well as default risk

Identifying ESG risks requires a constant scrutiny of past and present decisions. Our analysis shows a strong relationship between our ESG analysis and our internal credit ratings. In 2018, 40% of our internal credit ratings were lower than those of credit rating agencies S&P and Moody's*, with 60% of these being rated high or very high ESG risk. This highlights a potential underweighting of ESG issues by the market.

However, 30% of our internal credit ratings were higher than S&P and Moody's ratings in 2018*, which again is partly a result of companies taking steps to address ESG risk and implement safeguards. ESG in fixed income has mostly been focused on the risk of default, however a company's ESG practices can also give investors greater confidence in the quality of management and the business, positively shifting the risk versus return ratio.

We believe our strong ESG processes have contributed to our global credit income strategy having an average BBB security rating but delivering below AA default outcomes.

Research should scrutinise each issuer on a case-by-case basis against a range of ESG metrics. The risks are different in every sector. Warning signs range from safety lapses, regulatory fines and environmental breaches.

In the electronics industry, investors should look for any signs of exploitation in a factory's supply chain, while the biggest area of scrutiny for banking is lending policies.

If it appears a company is managing any of these visible risks poorly, then we don't have confidence in other risks being well managed. This [interactive case study map](#) includes over 100 examples from across our business.

One recent example was our raising Woolworth's ESG risk assessment from low risk to moderate risk. While Woolworths has commendably exceeded its target to reduce carbon emissions and has partnered with Replast to address plastic waste, we hold concerns over the risks associated with allegations of underpaying employees found by the Fair Work Ombudsman. We anticipate that ongoing legal action from the Retail and Fast Food Workers Union, which is seeking damages of over \$1 billion in back pay, could trigger a structural change.

Ethical sourcing of products such as palm oil and seafood also remains a concern, but due to investor pressure and the Modern Slavery Act, policies are being adopted by Woolworths to improve the social supply chain standard. We believe governance could be enhanced by aligning compensation with ESG factors.

Corporate culture often needs addressing to support successful ESG practices. ESG is more than making a statement about carbon reduction or unveiling a new social policy. ESG should be at the heart of everything that a company does and its corporate culture should serve as an incubator for lasting change.

These examples show that regardless of whether it is a smart beta strategy investing in thousands of companies or through bottom-up company analysis in a credit fund, ESG factors can be a powerful investment consideration that can deliver sustainable long-term returns and better social and environmental outcomes.

** Source: CFSGAM, Investment Opinion Network as at 31 Dec 2018. Moody's and S&P annual default studies, based on number of issuer defaults. Averaged cumulative defaults since 1983.*

Pablo Berrutti is Head of Responsible Investment, Asia Pacific and Mark Nieuwoudt is a Business Development Strategist at [Colonial First State Global Asset Management](#), a sponsor of Cuffelinks. This article is for general information purposes only and does not consider the circumstances of any individual.

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More ETF users are younger and female with ESG focus

Ilan Israelstam

The 10th annual BetaShares/Investment Trends ETF Report provides a snapshot of the key statistics and drivers in the Australian Exchange Traded Fund (ETF) industry, from the perspective of self-directed investors, SMSFs and financial advisers. The latest report shows a record numbers of investors have entered the Australian ETF market, with some changing characteristics.

Key findings of the report

The insights collected from this round of research are based on responses from around 8,000 investors and 800 advisers:

- The number of ETF investors in Australia grew by 22% in the 12 months to October 2018, reaching a record high of 385,000.
- The number of investors holding ETFs through an SMSF rose to 120,000 from 105,000 the previous year, an increase of 14%. Diversification and access to overseas markets are the main drivers for this market.
- Growth in non-SMSF investors was even stronger, with an increase of more than 24% from 213,000 investors in 2017 to 265,000 in 2018.
- With increasing mainstream take-up of ETFs, the average age of ETF investors has fallen. 29% of ETF investors are millennials, up from 19% in 2013.

- The use of ETFs by financial advisers continues to grow, with more than half of all advisers (53%) now recommending ETFs (up from 45% in 2017).







SMSF usage remains strong, and non-SMSF take-up is growing even faster

SMSF ETF investors as a percentage of the total ETF market declined from 33% in 2017 to 31% in 2018, reflecting a surge in the number of self-directed investors who are utilising ETFs outside of SMSFs (up by 52,000 from 2017).

Diversification remains the primary driving factor for SMSFs, with 77% of SMSF investors citing this as a reason for using ETFs, followed by access to overseas markets (65%) and low cost (53%).

The average ETF investor is getting younger

The average age of an ETF investor is 46 years old, down from 51 years old in 2013. About 29% of ETF investors are millennials, compared with 19% five years ago. This trend towards younger investors will be a big part of the ETF growth story in the future.

Profile of current ETF investors:	2013	2018
 Average age	51 years old	46 years old
 % who are female	11%	19%
 % who are Millennials	19%	29%
 % who are retired	29%	18%
 % who invest in ETFs through an SMSF	45%	31%
 % who intend to re-invest in ETFs in the next year	68%	57%

Source: BetaShares/Investment Trends ETF Report, 2019

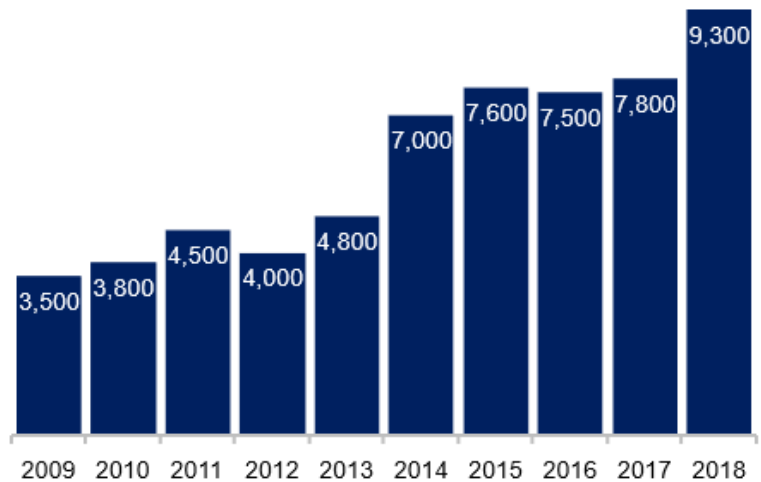
Use of ETFs by financial advisers continues to rise

Financial advisers are adopting ETFs in increasing numbers, with more than half of all advisers (53%) now recommend ETFs, and a further 16% intending to use ETFs within the next year.

51% of financial advisers agreed that the use of ETFs has been of financial benefit to their clients, while 45% said that using ETFs had enabled them to service more clients. However, there is scope for more growth through advice as only 21% of investors say a financial adviser was involved in their most recent decision to invest in ETFs.

We believe that the Royal Commission could have a positive impact on the ETF industry, with financial advisers likely to favour lower cost, transparent products.

Number of financial advisers using ETFs in Australia

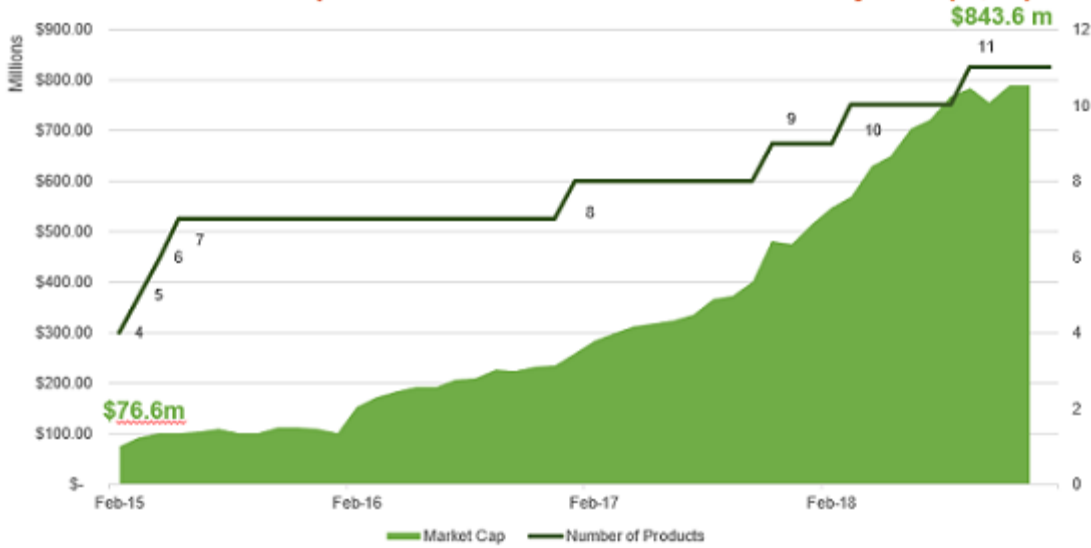


Source: BetaShares/Investment Trends ETF Report, 2019

Increased interest in responsible investing

The latest study found an increased focus on responsible investing by ETF investors. The market cap of ESG-oriented ETFs grew by a factor of 10 over the last four years, from \$77 million in 2015 to \$844 million in 2018. One in three ETF investors has already applied the concept of ESG in their investing over the last 12 months, while 25% of financial advisers have expressed interest in more education on socially responsible investing. Our two 'Sustainability Leaders' ETFs, ASX codes ETHI and FAIR, received over \$250 million of inflows over the course of 2018.

Market Cap for ESG-Orientated ETFs: 2015- January 2019 (A\$ m)



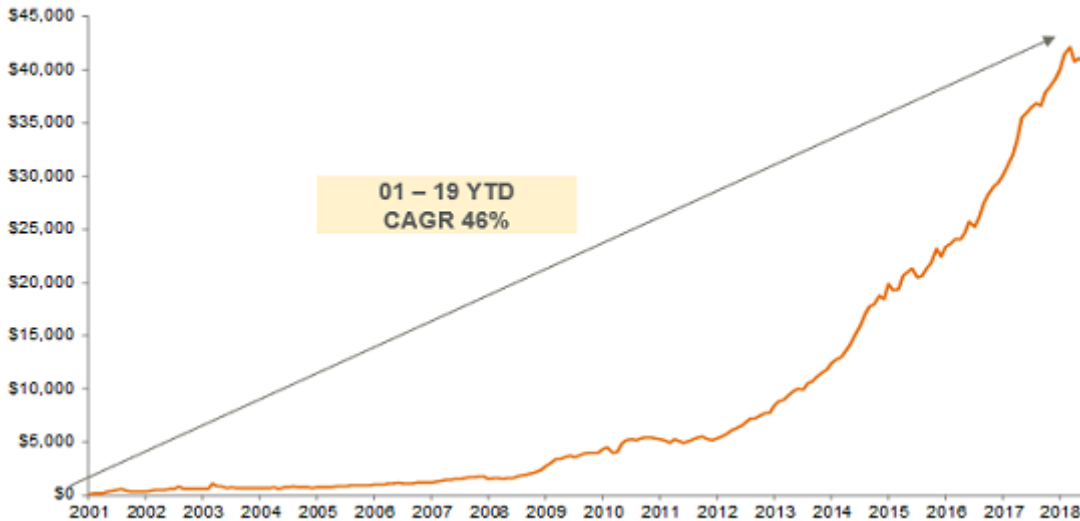
Source: ASX, BetaShares. As at 31 January 2019. Inflow data as at 31 December 2018.

Source: BetaShares/Investment Trends ETF Report, 2019

Outlook for the sector

The Report projects a record 437,000 Australians will be invested in ETFs by September 2019, and we project the Australian ETF industry could end 2019 with \$50 to \$55 billion in funds under management.

Australian ETP Market Cap: July 2001 – February 2019 (A\$m)

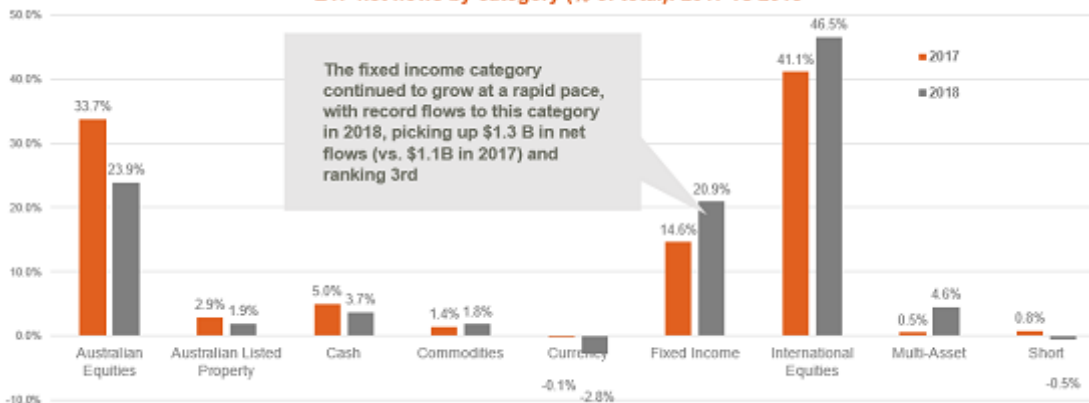


CAGR: Compound Annual Growth Rate. Source: ASX, BetaShares

More than half of all ETF investors rate their understanding of ETFs as average or lower, suggesting efforts to improve investor knowledge may prove rewarding and increase both new and existing investors’ participation.

Two other major trends are worth noting. First, we are seeing an increased adoption of ETF model portfolios, where advisers or ETF providers pre-mix a selection of ETFs in an asset allocation model. Furthermore, while Australian equities remain important, they have been overtaken by global equity ETFs, and a big growth in non-equity ETFs, especially fixed income.

ETF net flows by category (% of total): 2017 vs 2018



Source: BetaShares, Bloomberg

Ilan Israelstam is Head of Strategy at [BetaShares](#), a sponsor of Cuffelinks. A summary copy of the Report can be accessed [here](#). This article is for general information purposes only and does not address the needs of any individual.

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Briefly, on the role of government bonds

Warren Bird

The recent [article by Paul Chin](#) advocated a role for government bonds in a diversified portfolio at *all* times.

I'm more in the 'against' camp than the 'for' camp. I disagree that government bonds should *always* play a role in a diversified portfolio. It's too long a bow to draw for one of the lowest-yielding asset classes. In [another article on government bonds](#), Jonathan Rochford makes a good point that the cost of gaining this diversification is too great if it has to be obtained by owning an asset class that delivers a low return over time.

The role of government bonds in some portfolios

I advocate holding government bonds if there's a particular requirement for the security and liquidity and a specific investment need. For example:

- Insurance companies need funds maturing at various dates in the future, with absolute certainty about the value of the asset that matures
- Banks need high quality liquid assets to meet unexpected levels of withdrawals and as part of managing their capital adequacy
- Central banks hold foreign exchange reserves on behalf of their government
- Super funds that have a reasonable allocation to illiquid assets could hold government bonds to help them to meet redemptions quickly and easily

The sweeping arguments about government bonds don't specify properly what segment of the market is being analysed. For example, the return quoted in Paul's article of 5.1% contrasted with the experience of some investors who achieved only 2% from the asset class in 2018.

It's easy to guess how the return difference came about. These are the possibilities:

- The return quoted in the article was from an 'all maturities' index. Investors in a fund that focuses on shorter term, lower duration bonds received a smaller return. For example, a fund limited to securities with maturity not longer than 10 years returned around 1% less than the 'all maturities' market. Shorter maturities were returned lesser. Further, deduct an active management fee and you could easily be as low as 2% for your return last year.

- Another possibility is that some investors were in an actively-managed 'all maturities' fund in which the manager expected yields to rise during 2018 and so had positioned the fund in shorter term bonds. Such a strategy would miss a chunk of the capital gains on offer.

Owning 'government bonds' doesn't, in itself, deliver the degree of diversification benefits claimed in Paul's essay. The portfolio needed a reasonable holding of longer-term bonds that enjoyed some capital gains. Short-term government bonds really only give downside protection. Of course, in a year in which domestic shares delivered a negative return, even +2% provided some 'diversification'. But a corporate bond portfolio also did that with better returns over the medium to long term.

A couple of other comments on Paul's article

Paul's chart showed returns from global government bonds in 2018 of +13.7%. One comment correctly pointed out that this would have been from unhedged global bonds, therefore most of the return came from currency gains rather than from bonds as such. Currency is also a diversifier and may well be the better diversifier for Australian investors to rely on, than our own government bonds.

Another comment said Paul's argument only works when inflation is falling, claiming that this is why bond returns have been strong for 'the past 30 years'. I'll simply point out here that falling inflation led to lower bond yields which have reduced bond returns, not bolstered them. Lower yields deliver capital gains only in the short term, but ultimately bonds are all about income. The last 30-year period started with high yields and high returns, but that was because of high inflation in the 1970s, not because of falling inflation in the 1990s and since.

In any case, you don't need to create stories about the macroenvironment to predict that Australian government bond returns will be low over the next several years at least. We know it from their yields. The 5- to 10-year Commonwealth bonds are now paying investors only around 2%. So, over the next 5-10 years, that will be their average annual return. If yields do rise, then those returns will gradually increase as well.

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.

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