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Weekly Review

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– Issue – 14 Oct. 2016

The flow of investment capital into ETFs is increasing, and there's also a pronounced shift into funds offering global share exposures.

BY TONY KAYE • EUREKA REPORT • 12 OCTOBER 2016

Exchange-Traded Funds become a global gateway

Australia's exchange-traded funds sector shows no signs of slowing. In fact, Australian investors can now access more international markets and investment thematics than ever before through close to 130 ASX-listed ETFs.

Key Point

- ***Investors should know what the fund is investing into, and where, and the investment philosophy behind the ETF. It's also important to be aware of fees, the amount of funds under management, and currency and tax risks.***

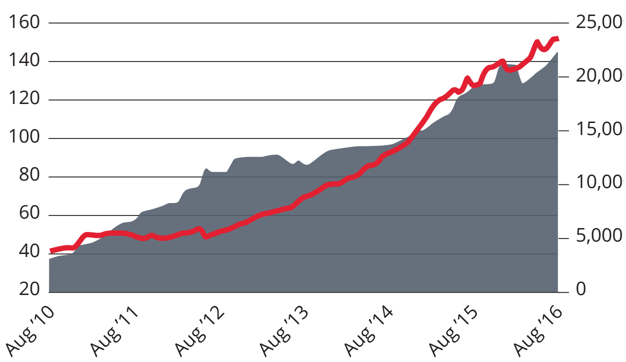
As well as ETF securities covering the broad Australian market and specific indices, investors have access to a veritable smorgasbord of products that offer direct exposures to stocks in different countries and regions, to defined market segments, to commodities such as gold, and even to asset classes such as fixed interest.

ETFs – also known as Exchange-Traded Products – act like index funds. The product holds a basket of shares that mirrors an index, sich as the ASX 200 or Nasdaq. An ETF is simply a version of an index fund where the product itself is listed and can be bought and sold on the stock exchange.

And the ETFs list continues to grow. Since the start of August four more securities products have joined the ASX boards, including three from the prolific ETFs issuer BetaShares. They include one, with the ASX code HACK, the first fund in Australia providing dedicated exposure to the fast-growing global cybersecurity sector. Shortly before, BetaShares launched a global healthcare ETF (ASX: DRUG), and another offering access to global agriculture companies ETF (ASX: FOOD).

In the United States, which is home to around 1700 ETFs managing $2 trillion of funds, there are ETFs for almost every investment theme. Take SLIM, for example, an ETF launched last month that is investing into healthcare companies that could benefit as they fight the global obesity epidemic.

Chart 1: ETP market growth



Source: ASX

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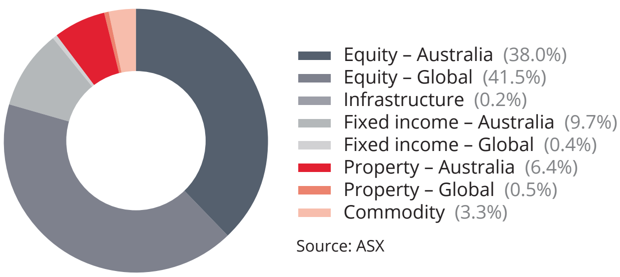
Fil Andronaco, a director of portfolio construction and consulting company InvestSense – which actively uses ETFs – believes there is still room for new products as our market matures.

"In the US you can buy an ETF that covers all of the industry sectors, different regions and market caps. There are others where you can buy into factor-based investment strategies such as momentum, value or growth," Andronaco says. "We're likely to see more of those products launching here too."

Picking the investment trends

"The way that we think about the opportunity for the ETFs industry is to look at how people are constructing their portfolios," says BetaShares managing director, Alex Vynokur, who notes that self-managed superannuation fund trustees often have very concentrated share portfolios. "The great opportunity that ETFs can bring to the table is the ability to have a diversified portfolio that meets their specific investment objectives."

Chart 2: Asset spread of ETPs, current period FUM (A$)



Source: ASX

Vynokur points out that "while it's difficult to get excited about the growth prospects in our market", ETFs are a gateway to the world. "It's very important to look outside our backyard and to think globally."

It seems that message isn't being lost on Australian investors, and the investment tide does appear to be turning as funds inflows into ASX-listed ETFs with global mandates continues to rise.

While there has been a rebalancing of investment capital across Australia's ETFs sector, research by InvestSMART shows that just over half of the roughly $24 billion of total funds under management (FUM) remains focused on domestic stocks, fixed interest, property and cash.

And of about $9 billion in funds directed into ETFs focused on international markets, sectors and investment strategies, about $7 billion is held within just four ETFs – two directed at stocks on the US market, one at European stocks, and the other at the S&P Global 100 index.

The balance of ETFs investment capital has been spread into niche products focused on specific industries, commodities and currencies, accounting for more than $4 billion overall.

But there's another obvious issue in the Australian market, and that's the fact that around half of the ETFs on the ASX manage less than $50 million in funds. Of these 60 or so ETFs, half have less than $10 million in FUM.

Size problems

In the ETFs world, size does matter. Those with billions of dollars of FUM, especially those investing into stocks in specific markets, have much greater capacity to construct a well-diversified portfolio. Smaller ETFs are limited and, in some cases, unable to offer investors a broad exposure to the indices or sectors they are purporting to cover.

Also, large ETFs from overseas with a local listing tend to be cheaper as they benefit from scale economies. However, depending on how you invest, you may have to fill out a foreign tax form. This often explains why ETFs with an entirely locally domiciled structure that invests in overseas assets will often be more expensive than an offshore ETF that appears to offer an identical exposure.

> **"Research by InvestSMART shows that just over half of the roughly $24 billion of total funds under management (FUM) remains focused on domestic stocks, fixed interest, property and cash.**

For the product owners, the financial viability of operating some of these smaller ETFs can be questionable too – and industry experts point to some ETFs having been quietly closed down when their numbers haven't stacked up.

Vanguard's head of ETF Capital Markets, Damien Sherman, says the breadth of the Australian ETFs product market is clear, and that the primary focus of issuers is to build funds under management.

"We definitely see a lot of room to grow in terms of FUM across the products," he says. "A lot of that will come greater institutional participation as they see the benefits."

What investors should know

For investors using ETFs, it is key to understand what a fund is investing into, and where, and the investment philosophy behind the ETF.

Most ASX-listed ETFs provide detail performance data as well as a breakdown of their top shareholdings, the general objectives of the fund and their FUM.

Sherman says that ETFs compete on a range of levels, from quality of coverage to management expense ratios (MERs). High MERs – the fees taken by the EFT managers – will often lead to what is known as "tracking error", where ETF prices will not exactly follow the price of the index or investments they are designed to track.

For investors, ETFs operating with significant tracking error will invariably trade below the net asset value of the stocks contained within the fund. An ETF trading above its NAV is effectively trading above its actual worth.

Another danger for investors to be aware of is that ETFs with small amounts of FUM can have liquidity issues, meaning buy and sell spreads can be wide and that it can be difficult to sell out quickly. This can be a significant risk.

Then there are other external factors to consider, such as the currency risk on unhedged ETFs with exposures to international markets and the potential impact of international tax laws on returns.

Yet, ETFs remain one of the most cost-effective ways for investors to diversify their portfolios into a broad basket of equities or other securities. And many have generated great returns over time.

Disclosure: InvestSMART currently has eight actively managed portfolios which are backed by ETFs. To find out more about our products, click here.

A supply shortage is driving record property demand in Australia, with demand for all

BY NERIDA CONISBEE • EUREKA REPORT • 13 OCTOBER 2016

How healthy is the Australian residential sector?

Another report released by a foreign bank, in this case UBS, last month outlined how risky the Sydney residential market was, which added to a long list of offshore observers puzzled by the strength of Australian housing.

Key Point

- ***NSW and Victoria remain Australia's most in-demand markets, with demand levels now at their highest ever recorded by REA Group. Tasmania and the ACT are also experiencing strong demand.***

Some clearly show a misunderstanding of the market, with the most common misconception being that the slowdown of the resources sector impacts Sydney and Melbourne as equally as Brisbane and Perth. Others, however, make very valid points.

Australian property is very unaffordable based on incomes compared to prices. Australian property is unprofitable based on rental yields. Yet demand continues and prices continue to rise. How healthy is this growth? And should we be worried?

What is driving the market?

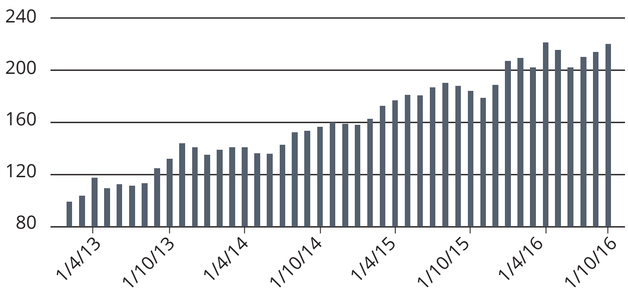
In pretty much every country, good economic growth means a strong residential sector. This is because people are employed, confident about their futures and their ability to pay loans. Markets like the US and Australia are seeing good economic growth and housing markets are strong. Contrast this to post Brexit Britain and southern European economies like Italy where economic growth is slow and consequently housing growth is weak.

Although this is generally the case, government policy can significantly change the performance of markets. The Chinese Government regularly introduces policies to calm speculation and overheating. In Vancouver, a city with previously no restrictions on foreign buyers, the introduction of a 15 per cent tax for this group in August led to a drop in properties on the market, although prices have continued to rise. In Australia, the Australian Prudential Regulatory Authority has put restrictions on banks as to how much they can lend to investors. Right now this is having minimal impact on house prices.

How strong is demand for housing?

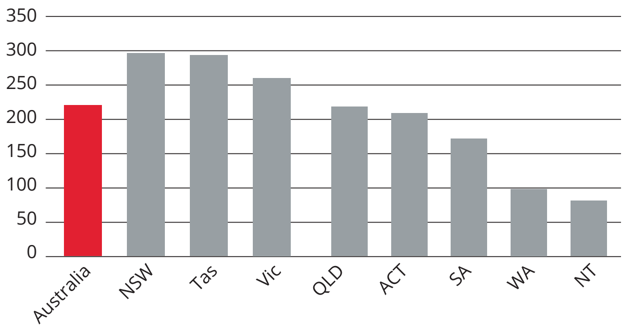
REA Group regularly tracks demand by comparing the number of visits to the number of listings. This week, we launched our inaugural **REA Group Property Demand Index**, which shows that demand for housing in Australia is high but has come off slightly from a peak in April 2016. Nevertheless, the index has risen by 17 per cent over the past 12 months.

Chart 1: REA Group Property Demand Index, all dwellings, 2013–2016



Source: REA Group

Chart 2: REA Group Property Demand Index, September 2016



Source: REA Group

Although the index has risen, there is a difference between how houses are performing relative to apartments. And despite there being significant development of new apartments and concerns about the oversupply of this form of housing, the difference is relatively small. Demand for apartments has risen by 10.7 per cent over the past 12 months compared to 17.6 per cent for houses.

> **“The REA Group Property Demand Index shows that demand for housing in Australia is high but has come off slightly from a peak in April 2016.**

Although demand levels are growing, some states are performing far better than others. Right now, the index is highest in NSW, Tasmania and Victoria, with all these states sitting higher than the Australian average. In NSW and Victoria, this is being driven by strong economic growth. For Tasmania, a strong drive to affordable locations which we are seeing nationally is likely to be a key. The poorest performing states are not surprisingly WA and NT, which have seen declining prices for some time.

Is there too much housing being developed?

Another theme common in the media is that Australia is seeing too much apartment development. In many ways this is contrary to the affordability argument that is also being set. It is difficult for a market to be in oversupply and to also have affordability issues. Without a doubt, there are pockets where there does seem to be too much development such as Melbourne CBD and Brisbane CBD apartments, and house and land developments in Perth. Overall, however, the amount of development taking place does seem about appropriate.

In the case of Sydney, there is still too little development taking place. Sydney is the second least affordable city in the world, based on incomes compared to price growth. The city does not do much better from a rental perspective, being 17 per cent more expensive on a weekly rental than the next most expensive city to rent, which is Canberra. Sydney has built 30 per cent less housing than Melbourne over the past decade. It has lost 160,000 people to other states over the same time period with affordability likely to be a key driver of this, particularly in recent years. If Sydney does not continue to develop more housing at a relatively high rate, it will be a major burden on economic growth as many people find it simply too expensive to live there.

Is there a bubble forming?

The UBS report stated that Sydney was at risk of a bubble because prices have surged over the past five years, and there was too much supply and a slowdown in interest from offshore, predominantly from Chinese buyers. Right now, affordability is an issue and we have seen a slowdown in interest from offshore. However, as our index shows, demand levels still remain elevated and we have issues with too little supply.

Sydney is also continuing to achieve strong economic growth and remains aspirational as somewhere to live. The city may be losing people to interstate but remains the top destination for overseas migrants. It may be expensive, but it would take a strong economic shock, as big as Brexit, for a dramatic reduction in prices. In reality, what is likely to happen is that Sydney prices will continue to surge for some time longer but will then see a relatively flat market for an extended period of time.

In Melbourne, a city that has seen a lot of development, price growth has not been as aggressive over the past five years and overall it remains relatively affordable. In Brisbane and Adelaide, price growth has been relatively soft, while Perth has seen more of a slow deflate as opposed to a dramatic bubble popping decline in prices.

Conclusion

Australia does have issues with affordability and price growth is causing challenges in Sydney in particular. However overall, Australian residential does remain relatively safe compared to other countries around the world.

As a final note the OECD has stated that Australia is one of the most overpriced countries in the world. On the other end, it has stated that the most undervalued country is Japan. Japan is currently going through a major demographic shift.

Over the past five years, the country has shrunk by 1 million people and by the end of the century, Japan stands to lose 34 per cent of its population. This has obvious implications for housing demand with the forecast decline in population of almost 43 million people towards the end of the century leading to more than 14 million dwellings no longer being required.

While Australia may be expensive, we’re also forecast to require at least an additional 6 million homes over the same time period, meaning housing will still be in high demand.

Nerida Conisbee is Chief Economist of REA Group.

Funds that change portfolio assets based on market conditions and expectations.

BY DOUG TUREK • EUREKA REPORT • 12 OCTOBER 2016

Does Dynamic Asset Allocation stack up?

Dynamic asset allocation strategies and funds, interchangeably described as tactical asset allocation, offer great promise.

Key Point

- ***Just as there is debate between the merits of picking investments inside an asset class, so will there be debate about the merits of timing moving money between asset classes.***

Rather than manage an investment portfolio to a static, fixed, strategic asset allocation mix of assets, these strategies (herein noted as DAA) change the mix of portfolio assets based on changing investment market conditions and expectations about future returns.

The perfect DAA strategy is supposed to pull you out of equites before a market crash and put you back in at the market bottom, thereby offering more returns for less risk and volatility. After the launch of Australia's first multi-asset, dynamically allocated DAA exchange-traded fund (ETF), it is worth trying to answer if this strategy and funds built to employ it actually work?

DAA funds available to investors

DAA funds are difficult to characterise. My guess is there about 10 or so funds (Figure 1) available to retail Australian investors. More funds may say they are, but this might be an overzealous marketing department at work rather than just me miscounting. Closely related funds might be called objective-based funds targeting a certain outcome or retirement date objective, and multi-idea funds, which are closer to hedge funds, speculating on the prices of multiple assets, currencies and commodities.

The longest running DAA fund in Australia is the **Blackrock Global Allocation Fund** available to Australian investors since 2005, but started for US investors in 1995. By targeting a nearly fixed 60 per cent allocation to equities (mostly trading on the US share market) it might be fair to say it is partially practising DAA.

While Aberdeen's local **Multi-Asset Real Return Fund** has technically served Australian investors since 1994, until September 2012 it did so as a traditional boring fixed allocation, multi-asset growth fund. It was retooled and made sexy!

AMP's DAA fund operating since 2011 has recently become available as an ETF under the trading symbol **DMKT** making it the first multi-asset DAA fund and possibly the first multi-asset ETF.

Table 1: Sample of Australian multi-asset dynamic asset allocation (DAA) funds

FUND NAME	INCEPTION DATE
BLACKROCK GLOBAL ALLOCATION FUND	4 Jul 05
SCHRODER REAL RETURN CPI +5%	1 Jul 10
PERPETUAL DIV REAL RTN	1 Oct 10
AMP CAP DYNAMIC MARKETS CLASSA	28 Sep 11
UBS TACTICAL BETA GROWTH	14 May 12
ABERDEEN MULTI ASSET REAL RTN ('94)	1 Sep 12
UBS TATICAL BETA BALANCED	12 Oct 12
RUSSELL MULTI ASSET GROWTH STRATEGY PLUS	11 Dec 12
STATE STREET BUILDER FUND	31 Jan 14
PINEBRIDGE GLOBAL DAA	29 Jul 14

Asset re-allocation

In each of these three funds, over the last four-plus years, the percentage mix to various, mostly traditional, assets has changed a lot. With a traditional multi-asset (some might wrongly call a "balanced fund") the mix doesn't change much. It would only drift slightly before rebalancing, perhaps every six months, if it were a statically run fund. If actively managed, the equity/bond mix would stay within much tighter tolerances and sub-asset types wouldn't come and go.

In the last four years, Aberdeen's mix of equities ranged from a low of 22 per cent (in mid-2013) to a high of 42 per cent (late 2012). AMP's equity mix changed from a low of 30 per cent (early 2012) to a high of 65 per cent (early 2013). You can't accuse these two funds of inactivity, nor copying each other.

On the other hand, Blackrock's total equity allocation has largely held firm at 60 per cent. In fact, since 2000, or for 15 years, it hasn't really moved much – including through the GFC. Despite having a "go-anywhere, flexible investment approach" the fund investment approach seems to be only dynamically adjusting the composition of a nearly rigid 60 per cent mix of equities and 40 per cent mix of bonds/non-equities.

> **Surprisingly the academic and popular research hasn't written a lot about DAA or TAA funds. However it's fair to say many are sceptical about beating the market this way.**

In all three funds, cash has ranged from nearly nil to about 20 per cent.

Do they perform?

It is difficult to judge the performance of funds given the short track record of the locally designed funds (excluding the nearly 60 per cent fixed-equity Blackrock fund which has been around longer), differences in objectives and appropriate benchmarks.

But they have performed largely in line, or slightly behind, the returns from the median performing "Balanced" and "Growth" style fund ranked by researcher Morningstar and index funds from Vanguard. These hold roughly 50 and 70 per cent equities, which broadly bounds the equity mix (target or observed range) of some of these funds and would be expected to deliver the CPI +5 per cent target of others.

Before you jump (too early) on the band wagon that active managers don't perform, realise the impressive returns from the static index Vanguard funds result from their 50 per cent (Balanced fund) and 30 per cent (Growth fund) allocation to mostly sovereign bonds, which have recently rallied.

As pointed out in my recent article, ***The inherent risks of index investing***, these funds now own bonds yielding about 2 per cent locked in for nearly a decade – and soon a small proportion of Australia's first 30-year bond launched on Tuesday. I think active and very active (DAA) funds are doing you a favour minimising those holdings, which should show up in the future as better returns. They and I could be wrong, of course.

That aside, it's not immediately apparent from comparing DAA fund returns that they did that much better than returns from actively managed but more traditional, mostly static strategic asset allocation funds, as evidenced by the Morningstar benchmark returns.

In fact, over a longer nearly six years, the four operating funds from Aberdeen, Schroder, Perpetual and Blackrock returned 6.1, 6.2, 7.3 and 8.1 per cent annually (respectively), of which only two of four are between the 6.6 to 7.1 per cent for the median performing Balanced and Growth fund, respectively (and far short of 8.4 and 9.3 per cent for Vanguard).

Based on rolling annual returns of funds compared over the last 3.5 years, there have been quite significant variation in relative returns over time.

For instance, Aberdeen underperformed for the first five months, later finishing as top performer in the last 12 months – that's great for new investors in the fund in the last three years. AMP was a top performer until lagging in the last 6 months (just when launching their ETF perhaps). Schroder is highlighted because perhaps you can see it offered the most stable returns (along with Perpetual) – its annual volatility of returns is about half of others. The most volatile was UBS. Vanguard Growth started with the biggest annual return and hid in the top of the pack for most of the return – doing not much!

There is some luck in picking a DAA fund, depending on when they are hot or not. This is not surprising. Even with a small sample, funds adopt quite different asset allocations.

Some will be right, some will be wrong, and it's hard to be right all the time. DAA is hard to do!

Overseas experience

Surprisingly the academic and popular research hasn't written a lot about DAA or TAA funds. However it's fair to say many are sceptical about beating the market this way.

In the US, researchers at Morningstar weren't convinced when they studied this sector in late **2010**.

In the first study researcher Jeffrey Ptak found of the 62 funds studied that were at least three years old, only 13 notched up superior returns to a 60/40 equity/bond benchmark index fund. Of the 30 funds studied that were one to three years old, only nine beat the benchmark. Rather than just beat a buy and hold approach, it was hoped that at least DAA funds could offer some portfolio insurance – that is fall less in a downturn, like in the GFC. Sadly, they found 42 of 62 suffered maximum drawdowns worse than the benchmark fund.

Ptak summarised: "We found scant evidence that rapid-fire trading enhanced results-- portfolio turnover averaged more than 200 per cent among the tactical funds we analysed, most of which didn't distinguish themselves. High fees didn't help, either .... These results reinforce our belief that tactical

> **Perhaps DAA does add some value, but the modest and inconsistent amounts are eaten up in higher fees and expenses.**

allocation is no panacea: A long-term, fundamentals-based approach is important to success".

In the follow up study Morningstar noted: "In extending our study of tactical mutual funds through Dec. 31, 2011, we found that tactical funds generally struggled to deliver competitive risk-adjusted returns when compared with a traditional balanced fund. With a few exceptions, they gained less, were more volatile, or were subject to just as much downside risk as a 60 per cent/40 per cent mix of US stocks and bonds".

Other anecdotes offer, when practising DAA, that you can be out of an asset class years before it corrects and back in too early after the initial fall. This was true of the GFC for some investors and might be again for those betting on sovereign bond prices collapsing.

Fees and expenses impact

Perhaps DAA does add some value, but the modest and inconsistent amounts are eaten up in higher fees and expenses. Management fees, where performance fees aren't charged, average about 1 per cent. Base fees, where performance fees exist, are less: 0.2 and 0.5 per cent for Blackrock and AMP's funds, for instance, but you'll also have to give up 12.5 per cent of absolute, or 15 per cent relative above CPI+4.5 per cent, returns respectively. Given high turnover, this fund or strategy would only be appropriate for nil or lightly taxed investors, those probably investing in super.

Just as there is an unresolved debate between the merits of actively picking and avoiding investments inside an asset class, so will there be debate about the merits of timing the buying and selling of different asset classes (DAA). While I want to say DAA can work, and may at times be necessary, my investigation here is far from supportive.

If you "go to cash" worried about high share market or bond price-earnings ratios, I guess you are technically practising your own version of dynamic asset allocation. However, I think for some this is a risk management exercise - intending to avoid loss.

If you are confident you can forecast future returns and dynamically allocate between assets, then good luck to you.

With the rise of so many specialist ETFs you never have had so many tools available to implement your vision. Just take care!

*Dr Douglas Turek is principal advisor with family wealth advisory and money management firm **Professional Wealth**.*

Please note financial products referred to here are for educational purposes and do not constitute an investment recommendation. Do your own research or contact a licensed financial advisor before investing.

While Wall Street has viewed a Donald Trump victory as a potential threat, an imminent rise in US interest rates has far greater consequences for global markets including ours.

BY CALLAM PICKERING • EUREKA REPORT • 11 OCTOBER 2016

The US threats for Australian investors

Two key risk events in the United States gained clarity over the weekend.

Starting with the presidential election, the campaign of Republican nominee Donald Trump has reached the point of no return just a month away from the general election in November. Meanwhile, a favourable set of labour market data pushed the Federal Reserve ever closer to raising interest rates for the first time this year.

Key Point

- ***When US rates are lifted expect a negative reaction on the share market as stocks adjust, a fall in the Australian dollar and commodity prices.***

A Donald Trump presidency has been viewed as a major risk event throughout much of this year. Markets like stability and certainty and Trump is the antithesis to everything market participants want in a political leader. Even Trump's promise to cut tax rates on companies and high-income earners hasn't been enough to convince Wall Street.

The past fortnight has been a disaster for the Trump campaign. On September 24, FiveThirtyEight – the online website run by polling guru Nate Silver - gave Trump a 45 per cent chance of winning the election. As of right now, that number sits at just 16.2 per cent.

Based on those odds, Clinton is expected to win 49.2 per cent of the vote compared with 43.0 per cent for Trump and 6.4 per cent for Gary Johnson, the candidate for the Libertarian Party.

That Trump is behind in these polls isn't exactly news. According to FiveThirtyEight, Trump has been in front during this campaign on just one occasion (July 30). But the dramatic shift, so late in proceedings, means that investors now face a more certain and more favourable risk environment.

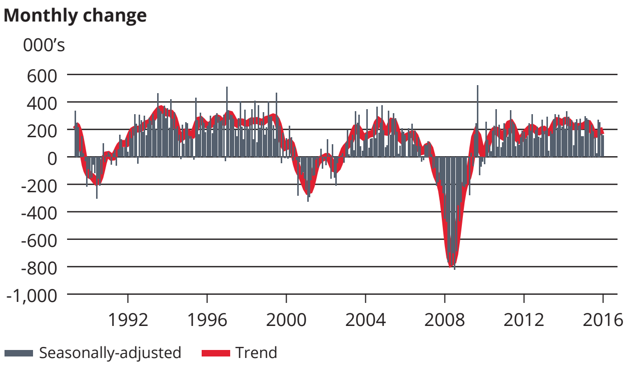
A Clinton presidency is widely viewed as a continuation of the Barack Obama administration. Their policies are similar and the Clinton campaign is expected to make a smooth transition into office. Clinton represents a continuation of policies that have, for the most part, proven successful.

The US economic backdrop

Nevertheless, the anti-establishment sentiment that gave rise to Donald Trump won't go away. The rise of hard-right nationalism hasn't occurred in a vacuum: it is the product of eight years of economic and financial failure which built upon the foundations of earlier anti-globalisation sentiment.

It reflects the failure of monetary policy that have enhanced the market valuation of banks and other assets but have done little to support jobs and put food on the table. It reflects trade policies that have exacerbated inequality and subjugated a generation of lower-income and less-educated Americans.

Chart 1: US Non-farm payrolls



Source: Bureau of Labor Statistics; via CP Economics

Political clarity has also removed one source of uncertainty for the Federal Reserve. The bank also received good news in the form of another favourable read on the US labour market.

> **A Clinton victory will be viewed as a positive market event but a rate hike will be priced in negatively. I'd expect the latter to more than offset the impact of the former.**

Non-farm payrolls rose by 156,000 jobs in September and the broader monthly trend suggests that the US economy is adding around 190,000 jobs a month. The result missed market expectations, though not materially, and it was a result that I'd categorise as being 'good enough' even if it wasn't spectacular.

Rates set to rise

Market participants are now pricing in a more than 50 per cent chance that the Federal Reserve increases interest rates before the end of this year. The most likely scenario is a December rate hike, although a lot can change between now and December 13–14.

At various times over the past two years the Federal Reserve has been the central bank that cried wolf; promising that a rate hike was just around the corner but always pushing that decision out a few months into the future.

The argument in favour of a rate hike is relatively simple. Good monetary policy is forward-looking because it often takes 12 to 18 months to see the full impact of a change in interest rates. As a result, the Federal Reserve must make a decision about how it sees inflation and labour market conditions developing over that period and set monetary policy in accordance with that forecast.

'Hawks' within the bank are arguing that, without a rate hike, inflation will push above the Fed's annual inflation target of 2 per cent. They are concerned that the Fed will get behind the curve and be forced to chase inflation in a dangerous game of catch-up.

There is very little risk that the latter happens given low inflation is now a global phenomenon. There is no sound reason why inflation would surge to such an extent that it becomes difficult for the Fed to rein in.

The Fed's poor record

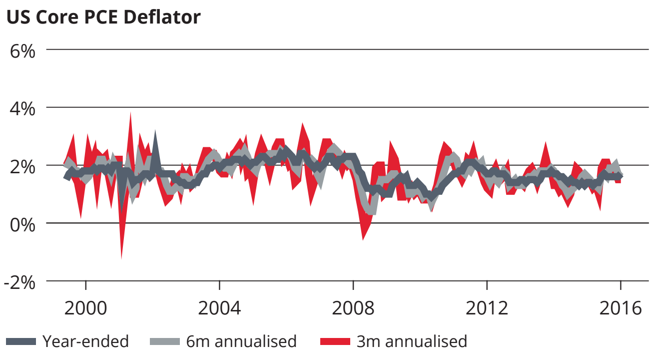
But the argument that policy needs to be 'forward-looking' holds weight. The main issue is that the Federal Reserve is terrible at forecasting the US economy and inflation. Forward-looking policy is sound if your forecasts are sound and dangerous when they aren't.

The Fed's record on inflation targeting is also suspect. It has met its 2 per cent annual target in just four months since the beginning of the global financial crisis. The core PCE deflator – the Fed's preferred measure of inflation – has increased by 1.7 per cent over the past year and hasn't touched 2 per cent since April 2012.

More importantly, it appears as though inflationary pressures have actually eased over the past three-to-six months as shown in the graph below. A pre-emptive strike on inflation runs a significant risk of undermining the Fed's credibility.

A final complicating factor is lacklustre economic growth across the US. Real GDP has increased by just 1.2 per cent over the past 12 months and is expected to remain at around that level when the September quarter national accounts are released at the end of the month. The US economy rose at around twice this pace from 2013 until 2015.

Chart 2: US core PCE deflator



Source: Bureau of Economic Analysis; via CP Economics

It would take an exceptionally brave or foolish central bank to raise rates into a combination of softer inflation and lacklustre growth. Nevertheless, we stand on the verge of such a decision and we must consider the implications.

> **“The good news from Australia’s perspective is that higher interest rates in the US narrows the spread between US and Australian interest rates and will put downward pressure on the Australian dollar.**

Positives and negatives

A Clinton victory will be viewed as a positive market event but a rate hike will be priced in negatively. I’d expect the latter to more than offset the impact of the former.

Global financial markets are more highly correlated than they were prior to the GFC and I’d expect some of this negativity to spill over into Europe, Asia and Australia. Loose monetary policy has been driving equity valuations since the crisis, and even a modest step towards policy normalisation will lead to some adjustment across the equity space. Fixed income products, such as government bonds, will also respond directly.

The good news from Australia’s perspective is that higher interest rates in the US narrows the spread between US and Australian interest rates and will put downward pressure on the Australian dollar. This will benefit the non-mining sector, which has made some gains in recent years but continues to struggle under the weight of an elevated currency.

A stronger US dollar will, however, hit commodity markets and put downward pressure on the likes of iron ore and coal. Separating the effect of a stronger US dollar from other demand and supply factors will be difficult and I anticipate heightened volatility for many commodity prices over the next six months.

This would hit Australia’s terms of trade and lead to weaker growth in national income, which will spill over into wage growth and inflation. The dollar would adjust downwards (above and beyond that caused by the narrowing of interest rate spreads) to contain the fallout of lower commodity prices, which will support the non-mining sector and help to facilitate our economic transition towards stronger growth across the non-mining sector.

As a result, tighter monetary policy in the US is both a blessing and a curse for Australian markets. It helps us get to where we need to be – a stronger non-mining sector – but it does create some short-term headaches and undermines some of the recent strength across commodity markets.

Insurance inside super from next year will require a re-evaluation. Lower contribution limits have tilted the field.

BY BRUCE BRAMMALL • EUREKA REPORT • 13 OCTOBER 2016

Superannuation changes set off insurance alarms

Life insurance inside superannuation has been a relatively simple equation for most Australians, until now.

Key Point

- ***Depending on your concessional contributions, it may make sense to move your insurance premiums into your personal name. But that can be a minefield.***

Current higher contributions limits and the advantages of tax deductibility had meant that, for the majority, it made sense to have at least life and total and permanent disability (TPD) cover inside a super fund.

But now, a swathe of Australians – most of whom will run self-managed super funds – will need to reconsider taking their family protection outside of super.

Why? Because, if you have considerable insurance requirements and are maxing out your now-lower concessional contributions, you might chew up too much of the money you can get into super by paying insurance premiums.

Moving outside of super

To maximise your super, it might make far more sense to pay for insurances outside of superannuation.

Instead of getting a 15 per cent tax deduction for the premiums inside super, perhaps take the insurance coverage (or move your existing insurance covers) outside of super.

This won't be the best option for everyone. But the number who should consider doing so will rise exponentially following on from the nearly 30 per cent drop in the maximum contributions level, which apply to everyone from July 1, 2017.

From then, everyone will have the same $25,000 maximum super contributions limit for concessional contributions. This is a reduction from the current limits of $35,000 for the over-50s, and $30,000 for the under-50s.

But what if you assessed your needs for insurance, and the cost to get that cover is $5000? The cost of the cover is now eating into the reduced amount you can get into super. At $5000 of premiums, 20 per cent of your $25,000 of CCs are now being chewed up by insurance coverage.

The cost of $2 million worth of straight life cover for a 55-year-old male, non-smoking, white collar worker, is approximately $7000 a year. For $2m worth of life and TPD insurance, it's nearly $15,000 a year.

And those numbers are a far bigger percentage of $25,000 than they were of $30,000 or $35,000.

As for income protection? A 55-year-old white collar worker trying to insure 75 per cent of a $120,000 annual income would have a minimum premium of around $3000 for a base-level (indemnity policy, 90-day waiting period, to age 65) policy.

***Note**: In my opinion, income protection is almost always better done outside of super. The quality of the policies are better, as they don't have to conform with super legislation. And it is a tax deduction at your marginal tax rate, of up to 49 per cent, rather than 15 per cent inside super.*

My point is this, that anyone who has the cash flow that will allow them to maximise their concessional super contributions to $25,000 a year, who has insurances inside super, should put some thought into moving that insurance outside of super and into their personal names.

It's not a straight one-size, fits-all suggestion. It will depend on your personal circumstances. But for a tax deduction of 15 per cent of the premium on your policy it will, in many instances, make sense to take the policy outside of super.

The drawback is that, for life and TPD insurances, there are no tax deductions for the premiums when taken in your personal names (it might qualify as a business expense, if the cover is taken there, but speak to your accountant or adviser).

How do you take a policy outside of super?

If you make the assessment that you need, or should, transfer or reorganise your insurances to being owned outside of super, there are two main ways of doing this.

> **Anyone who has the cash flow that will allow them to maximise their concessional super contributions to $25,000 a year, who has insurances inside super, should put some thought into moving that insurance outside.**

The first way is to simply take out new insurances outside of your SMSF (or, if you have your insurances inside an APRA-regulated fund, it is the same principle).

This can be a good opportunity to re-examine the level of cover that you have and decide whether you need less (or more) than you currently have, and re-apply for that insurance in your personal names.

If you are considering doing this, make sure that you apply for, and receive, insurance on terms that are acceptable to you **before** you cancel your existing insurance policies.

One advantage to doing this includes being able to change supplier (if your existing insurer has become expensive, or their insurance terms are less competitive). The main downside is that if your health has deteriorated since taking out the policy, you might not be able to get it on the same favourable terms.

(I'm assuming for a second that most people's heath gets worse with age. If your health has actually improved, which can happen, then you might get more favourable terms while redoing your insurance this way also.)

Transferring policy ownership

If your health has deteriorated, or the cost of your policy would increase by taking out a new policy, then you might also wish to examine transferring your existing policy (inside your SMSF or APRA-regulated fund) from being owned by the super fund trustee to your own name.

This usually means requesting from the trustee of your existing fund for a transfer of ownership. If this is a SMSF, you would think that his would be a reasonably simple request, but there are complications. If it is coming from an APRA-regulated fund, there are complications also. And, in most cases, it actually will not be allowed by the insurer.

I wish I could summarise them here. I can't. You will need to speak to your individual insurer and ask what their requirements are for the transferral of policy ownership. Expect a "no" in many cases.

Then you need to effect the transfer itself. This can, of itself, set off a blizzard of paperwork. I've done this a few times for clients. Some insurers offer a bit of paperwork. But it's relatively straightforward. Others make the above option – of reapplying for new insurance – look like the better and easier option by a long shot.

Technically difficult - get advice

Sometimes it is easy. Sometimes, it requires patience that you have not needed to draw on before. And sometimes the paperwork will not just be astounding, but could actually take you to an early grave.

If you don't know what you're doing, get advice. Pay a financial adviser to organise it for you.

If your health has deteriorated since you last took out insurance, a financial adviser will know where your best shots at keeping equivalent insurance will lie. You can do this yourself, but generally insurance is a very specialised field, and professionals will pay for themselves.

This is a topic too big to cover in just one article. I will return to this area in later columns.

Bruce Brammall is a licensed financial advisor, a mortgage broker and an expert on self-managed super funds. He is a regular contributor to Eureka Report. To contact Bruce, please ***click here****.*

The information contained in this column should be treated as general advice only. It has not taken anyone's specific circumstances into account. If you are considering a strategy such as those mentioned here, you are strongly advised to consult your adviser/s, as some of the strategies used in these columns are extremely complex and require high-level technical compliance.

Recent trends in nickel, gas and graphite stand to impact these three mining companies.

BYTIM TREADGOLD • EUREKA REPORT • 12 OCTOBER 2016

Minefield: Going to ground

As with every edition of Minefield, this article is not providing investment advice. For all of Eureka Report's stock recommendations, click here and then click on each of the three tabs: ASX Large Caps, ASX Mid Caps, and ASX Small Caps.

Commodity prices are one way of gauging the likely future direction of resource stocks, while another is to see what's happening at ground level. Two recent deals involving "ground" are indications that the mining trend is up.

The first deal was a move by lithium project developer Pilbara Mines to buy an exploration project that abuts its Pilgangoora project in WA's Pilbara, a move which is all about acquiring access to additional land and to lock out a potential rival.

Independence Group has just done something similar by launching a takeover bid for Windward Resources, which controls land close to its almost complete Nova nickel and copper mine in the south of WA.

The deals are for different commodities, but there is a common driver: land access at a time when values are reasonable and the future for mineral prices looks better than at any time in the past few years.

Of the two deals the one that seems to offer the greatest potential is that by Independence, a company which has the appeal of a diversified asset base. This is an important consideration for investors interested in the mining sector but uncertain where to start.

Independence Group (IGO)

Once seen as a pure nickel play thanks to its roots in the Kambalda nickel belt of WA, Independence has blossomed into a true diversified resource stock, adding copper, zinc, cobalt, silver and gold to its portfolio.

The combination, which is dominated by nickel and gold, is a useful hedge, with gold doing well in uncertain times while nickel and copper benefit from rising industrial production.

Like all mining stocks Independence was sold down sharply during the latest commodity slump, with its shares falling to a five-year low of $1.98 in mid-January before staging a solid recovery thanks to its gold assets that include a 30 per cent stake in the rich Tropicana mine in WA. After hitting the bottom Independence shares have risen to around $3.89.

While gold has worked for Independence it has more recently been the turn of nickel to generate interest, with the 100 per cent-owned Nova mine due to start production in the next few weeks. It will join the smaller but high-grade Long mine as a source of the company's nickel.

In the background are the other assets which round out the company's production profile, including the wholly-owned Jaguar copper and zinc mine, and an extensive exploration division that is focused on the Fraser Range, host of the Tropicana and Nova ore-bodies.

There is another reason for keeping an eye on Independence and that's because of the role played by one man, Mark Creasy.

While not on the board of the company, Creasy is the power behind the throne thanks to his 17 per cent stake in the stock and his unparalleled record as a prospector able to discover ore-bodies and then create value out of the discovery. This started with the Bronzewing, which he sold for $115 million in 1991, and has since been followed by his pioneering role in the Fraser Range, which has become Australia's hottest exploration address.

The latest deal by Independence, its 19c-a-share offer for Windward, is all about pulling another Creasy creation under its corporate wing thanks to Windward having the third-biggest land position in the Fraser Range with tenements that are close to the Nova nickel mine.

Like Creasy himself, Independence is a company with fingers in many pies. That means it is well positioned to rise with a commodity-price recovery, or to ride out a storm if tough times return.

Karoon Gas (KAR)

Once a high flyer with a share price approaching $7 in 2013, Karoon crashed with the rest of the oil sector when Saudi Arabia opened the flood gates to try and kill the US shale-oil industry, only to discover that the oil-price slump almost killed its own economy.

Whether oil is in the early stages of a sustainable revival is a hot debating topic in the commodity sector today, though it seems that the management team at Karoon reckons that is precisely what's happening and why a potential "company-making" deal has been initiated in Brazil.

> **The latest deal by Independence, its 19c-a-share offer for Windward, is all about pulling another Mark Creasy creation under its corporate wing.**

While it already has assets in Brazil, the proposal being considered by Karoon is the acquisition of existing oilfields operated by the scandal-wracked national oil company of that country, Petrobras.

No price has been put on the possible acquisition of a 100 per cent interest in the producing Bauna oilfield and a 50 per cent stake in the Tartaruga Verde development project. Both are located in the offshore Santos Basin close to Karoon's existing Echidna and Kangaroo projects.

Petrobas put the two assets on the market 12 months ago, with Karoon last week winning the right to negotiate a price during what is expected to be an exclusive six-week opportunity to agree on a price.

Reports so far indicate that the Brazilian fields will cost more than $US1 billion. According to Deutsche Bank, the well-regarded oil industry consultancy Wood Mackenzie values the assets at $US1.6 billion. But that value assumes an oil price of $US74 a barrel, well above its latest $US52/bbl.

With around $480 million of cash in the bank, largely as a result of selling a gasfield off the WA coast just before the oil price tumbled, Karoon will need a helping hand to secure the Brazilian assets. That could come from its shareholders, banks or a joint venture partner – with Woodside Petroleum suggested as a possibility.

On the market, Karoon shares have been moving higher, in line with the oil price. After hitting a low of $1.14 in January the stock is currently around a six-month high of $1.62, which values it at $400 million, or $US300 million – less than a third of what it might have to pay for the new Brazilian assets.

Deutsche Bank likes the proposed deal and reckons Karoon has a 12-month price target of $2.30, while Macquarie Bank reckons $2.90 is the target – views that are very much oil-price dependent.

Syrah Resources (SYR)

Once a darling of speculative traders with an interest in graphite, one of the emerging winners from a future world filled with electric cars powered by long-life batteries, Syrah has hit a rocky patch that is not yet fully understood by outsiders.

The key asset of the company is the Balama project in the East African country of Mozambique, centre of the global rush to develop new sources of graphite to break a Chinese stranglehold on the material.

As a project Balama is world class, though there is some concern over Syrah's plans to produce 350,000 tonnes of graphite a year. That target represents close to one-third of current global consumption of a carbon-rich material which is effectively ultra-high-grade coal.

Syrah is not alone in what has become a stampede to snatch a slice of the graphite market, which will undoubtedly grow as demand for electric-storage batteries grows. The critical question is whether too much graphite could hit the market too soon, crushing the price and profitability of all producers.

Concern about over-production has been evident for some time in the graphite industry and Syrah has not been immune, with its share price retreating sharply since it hit an all-time high of $6.72 in June. It reached $4.34 earlier this month, when a management change shook the stock.

With no prior notice the chief executive of Syrah, Tolga Kumova, announced last Wednesday his immediate resignation, but with plans to remain a consultant to the company.

Kumova's exit sent a shockwave through Syrah, with the share price plunging to $3.32, a price which represented a 50 per cent fall in three months. It has since recovered to around $3.75, a level which values the company at $975 million.

The challenges ahead for Syrah are to find a new chief executive, finish building Balama, deliver finished product to its customers, and to push ahead with value-adding projects it has proposed such as the production of spherical graphite. It must do all that ahead of its competitors in what looks likely to become a crowded market.

Deutsche Bank likes the Syrah story, telling clients on Monday that it was a buy with a 12-month price target of $7.30. Morgan Stanley sees things differently, telling clients that the exit of Kumova "raises questions", leading to an underweight recommendation and price target of $3.75.

**Stocks worth a closer look are highlighted in green; ones requiring great care in amber; and those to avoid in red.*

The sale of a business has added complications for those in pension mode, including potentially to senior's benefits.

BY MAX NEWNHAM • EUREKA REPORT • 11 OCTOBER 2016

Ask Max: Pension benefits and business sales

***Question**: I am 66 years old and thinking of opening a new and separate allocated pension account in parallel to my existing pension account to prevent the loss of my Commonwealth Seniors Health Card, which would otherwise be caused by stopping my 2014 pension to add extra savings and re-starting it.*

Could I perhaps commence a new SMSF to receive proceeds from the sale of a business without affecting my CSHC or my existing commercial pension provider account?

Also, under the most recent policy announcements, can accumulated payments from the sale of a 34-year-old business, to be received on a progressive work-out basis, be contributed as non-concessional contributions into the separate pension account up to $1.395m, so long as the $1.6m cap is observed and applied to both pension accounts combined?

Answer: You are correct about what the effect will be on your CSHC if you stopped your existing account-based pension to make extra contributions. Up until December 31, 2014 the income test for the CSHC was based on a person's adjusted taxable income that included:

- taxable income;
- foreign income;
- net investment losses;
- reportable fringe benefits;
- reportable superannuation contributions;

From January 1, 2015 the income test was changed to include deemed income earned on account-based pensions started after December 31, 2014. If you ceased your current account-based pension this would result in the new account-based pension having deemed income added to your other income.

The deeming rates that currently apply are as follows:

SINGLE	1.75% up to $49,200	3.25% on over $49,200
COUPLES	1.75% up to $81,600	3.25% on over $81,600

The income test that applies to the CSHC is as follows:

CATEGORY	ADJUSTED TAXABLE INCOME ($)
COUPLES	84,472
SINGLES	52,796
COUPLES COMBINED, COUPLE SEPARATED BY ILLNESS OR RESPITE CARE	105,592

Assess the best option

Your plan of not ceasing your current account-based pension but making contributions to a new account-based pension will help you preserve your entitlement to the CSHC. By maintaining your existing account-based pension this will result in it not being counted under the deeming rules.

The new accumulation account could either be with an industry fund or a commercial fund, or it could also be with an SMSF that you set up. To work out what is your best option you need to assess what the costs of each of the three different funds would be.

This involves not only taking into account the administration costs for each of the three different types of funds but also the investment costs. You need to do this because some commercial funds advertise a low administration fee but then load their investment fees, which results in a much higher cost.

As to whether you will keep your CSHC will depend on what your taxable income is, the other additions, plus the deemed earnings on the new superannuation accounts. If your only income was from your account-based pensions you could have approximately $1.64 million in super that is counted, or $2.64 million if you have a partner, and still retain the CSHC.

Contributing business proceeds

The proceeds you will be receiving from the sale of your business may not be able to be contributed to a super fund. If your business qualified as a small business entity, in other words it had an annual turnover of less than $2 million, you could make contributions to a super fund under the small business capital gains tax concessions.

These contributions can only be the capital gain component of the proceeds you are receiving, and any non-assessable receipts would have to be made as a non-concessional contribution. This would mean, as you are over 65, you would need to pass the work test, and the amount that you could contribute would be limited by the non-concessional contribution limits.

If the changes to superannuation are passed by federal Parliament this would mean you could make a contribution

> **“ If your business qualified as a small business entity you could make contributions to a super fund under the small business capital gains tax concessions.**

of non-capital gains proceeds of $180,000 for the 2017 year, and then $100,000 for each year after. But, again, to make these contributions you would need to pass the work test.

If your business does not qualify as a small business entity you may still be able to make small business CGT concession contributions. This would depend on you passing the $6 million net asset value test.

The assets included in this test are the net value of all of your capital gains tax assets with the following assets excluded:

- assets used solely for personal use and enjoyment,
- your own home,
- superannuation or an approved deposit fund,
- rights to an asset of a superannuation fund or an approved deposit fund,
- life insurance policies.

Possible CGT exemptions

There are two capital gains tax exemptions that could apply to the capital gain on the sale of your business. They are the retirement exemption and the 15-year exemption. Under the retirement exemption there is a $500,000 lifetime maximum, while the 15-year exemption has a current lifetime limit of $1.395 million.

Both of the small business CGT exemptions only apply to active assets. Active assets include those used in your business and the value of any goodwill that you receive. To qualify for the 15-year exemption:

- the business assets must have been owned continuously for a period of at least 15 years,
- if the assets were owned for less than 15 years they must have been used in the business for at least half of the period of ownership,
- if the business was owned through a company or trust you must have been a significant individual for at least 15 years that the entity owned the business, and
- you must be retiring or permanently incapacitated.

To qualify as a significant individual in a company you must have owned at least 20 per cent of the company. If your business was owned through a trust you must receive at least 20 per cent of the income and capital distributions by the trust in the year that the capital gain is made.

Once you have established that you are eligible for the CGT small business exemptions you should use the 15-year exemption due to its higher limit. To calculate how much that exemption will be you must first establish what capital gain will be made on the active assets being sold, reduce that gain by any current or carried forward capital losses, then reduce this net capital gain by the 50 per cent general CGT discount.

The total of the 15-year CGT exemption can be contributed to your superannuation fund up to the lifetime limit. As you will be receiving the proceeds from the sale of your business in instalments the super contributions for the CGT 15-year exemption component of each instalment can be made without having to pass the work test.

If the new $1.6 million limit on pension accounts becomes legislation you will still be able to contribute the 15-year CGT exemption contributions, but they will need to be retained in an accumulation account in your name.

The good news is that the change to the non-concessional contribution limits do not apply to the small business CGT 15-year or retirement exemptions. Before taking any action you should seek professional advice.

Got a question for the Tax with Max column? Email: askmax@eurekareport.com.au eureka report