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Weekly Review

WEALTH

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The steps likely to be taken by Donald Trump to revitalise the US economy will have major ramifications for the world.

BY ROBERT GOTTLIEBSEN • EUREKA REPORT • 16 NOVEMBER 2016

Stress testing Trump's policies

The world is in the process of changing many of the long-standing assumptions that have governed markets for the last few years.

Key Point

- ***Australia's challenge is to avoid the economic fallout if the US and China do come to blows. That will be difficult, if not possible.***

So today I'd like to stress test some of the new assumptions to determine whether they are likely to stand up, and what are the forces that will determine their fate.

The difficulty in such an exercise for Australia is that a large number of the new assumptions involve first the US and then China, and both countries now have governments that are much less predictable. And, of course, that especially applies to the US.

So I will start my first stress tests with Donald Trump's new America. The markets are assuming that Trump will spend vast sums on infrastructure; will slash US tax rates and that will bring back into the US more than $US2 trillion that are held by American companies overseas not wanting to pay high US taxes on their accumulated profits.

The market theory goes that the consequent boom will lift US inflation and, as a result, American interest rates will increase and that will spread around the world. These assumptions are totally different to the assumptions that world markets have been embracing for the last few years. Will they come to pass?

Trump's infrastructure quandary

There is no doubt that Trump is looking for a major lift in infrastructure spending, but sections of the Republican Party are very nervous about running up huge American deficits. The combination of big spending on infrastructure and cutting taxes is a recipe for large deficits. So there is going to be an internal Republican Party clash of wills. In particular Vice-President Mike Pence, who is a "Tea Party" supporter and has been advocating for deficit cuts for a long time.

The first sign of these cracks was when the Trump administration announced that the government would fund only 15 per cent of infrastructure spending and 85 per cent would be funded by the private sector. If that is what happens then the projected infrastructure boom will be far less than expected and will take a lot longer.

Government infrastructure can be built relatively quickly. Private infrastructure requires the negotiation of an income stream and evaluations, which is normally a much longer process. So we have two different streams of thought, and if it is to be private rather than government infrastructure the looming infrastructure boom will disappoint the market.

My guess is that Trump is smart enough to understand the difference between private and government infrastructure, and he will push for a much bigger slice to be government.

Trump's US money push

Trump, being Donald Trump, is going to do a series of deals with large American companies, which will see vast sums of

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money returned to America. But, to do that, he will need a much lower tax rate, which again runs into the deficit boost problem. He will drive at least some tax cuts through the Congress with the promise of American money coming back.

However, there is limited advantage in bringing the American money back home if there is only a limited increase in economic activity. The money will simply be plonked into banks and/or paid to shareholders. Trump needs to have the economy running so that the American companies bringing back their money will feel motivated to invest the funds in US expansion and therefore drive employment and prosperity.

The plan has the potential to be transformational, both for the US and to some extent the rest of the world, but I suspect that Trump will only get half-way. In other words, rather than it being $US2 trillion it will be less than $US1 trillion, because the tax cuts will be less than anticipated as will the level of infrastructure projects. But that could still transform the US.

But it will go part of the way, and this is a bold plan that affects the whole world. Accordingly, we will see major fluctuations in markets as people become bullish or bearish about the success of Trump's agenda.

Trump's oil injection plans

Another part of the Trump agenda is to lift American production of oil and gas, much to the annoyance of the environmental movement. Trump will do this by approving the pipeline from Canada and encouraging fracking and higher US oil production. Indeed, he wants to make the US an exporter of oil and gas.

Not surprisingly, this is depressing the oil price and it is causing great instability in OPEC. Last night oil recovered some of its recent losses, and we should not forget that if Trump does stimulate the US he would lift the demand for oil substantially.

Trump's European agenda

An important part of the Trump agenda is the deal he plans to do with Russian President Vladimir Putin. On the surface that plan will start with a joint plan for the Middle East, and Putin hopes that will be a springboard for higher oil prices. The discussions also will include Eastern Europe, and I suspect another deal will be done. Russia desperately needs a higher oil price, and it will be interesting to see if Putin raises this subject.

Under Trump, the US will be a much less reliable supporter of NATO than previous American administrations – particularly in Eastern Europe. This is a big change and will force the European Union to spend a lot more money on defence, which is what Trump wants.

Europe can no longer rely on the US, and if Europe needs greater defence spending it will need the help of the UK because Germany and France can't bear the full brunt of European defence spending. My guess is that the UK will only help if it gets favourable entry into Europe. The election of Donald Trump as President is a great asset for UK Prime Minister Theresa May.

Trump's impacts on Australia

On the interest rate front the bond market is becoming more important than central banks. Our bond rates are rising, which is hitting property trust and infrastructure values. The combination of higher interest rates (but not dramatic rises), inflation and the returning home of US money has got to be good for the US dollar and is likely to reduce the value of the Australian currency.

But, like Canada, our currency would have fallen a lot further if not for higher iron ore and coal prices. Will they last? Regular readers of *Eureka Report* will know that I think that big rises in the price of iron ore and oil will cause the Chinese to restart many of the mines they shut down when the price was much lower.

> **My guess is that Trump is smart enough to understand the difference between private and government infrastructure, and he will push for a much bigger slice to be government.**

And that restarting will tend to depress iron ore and coal. But there is a wild card. What if the US can't produce the steel and the other required raw materials for its infrastructure? China is the obvious supplier. If that happened it would transform the outlook for Australia's two largest exports, but I think it is a long shot.

Trump's China clash

The most dangerous problem for Australia is that the anti-Chinese rhetoric that Trump espoused during the election campaign will continue in his presidency. A big tariff will be placed on Chinese goods. If that happens, and we find ourselves too committed to the American camp, then China is quite capable of bringing the Australian economy to its knees. It can do that by not only cutting the exports of coal and iron ore but also turning off the tourism, education and apartment buying taps.

Step by step we have become far more dependent on China than we have realised. There is no doubt in my view that the single biggest risk Australia faces is if there is a breakdown in the US-China relations and we are punished.

I am not sure our government is sophisticated enough to understand all this, but we can only hope. In the very sensitive apartment market we are managing to get more than half of the Chinese buyers of off-the-plan apartments to settle when the apartments are completed.

If China really clamped down on that activity it would put great pressure on our banks, which have funded the building developers.

As I reviewed the above stress tests I concluded that while the Trump revolution is significant, the huge slump in bonds may be an overreaction. In particular, Australian property trusts and infrastructure investments have been hammered.

I am biased because I have investments in the area, including Transurban, but to me the widespread 20 per cent falls in the sector look like an overreaction.

The GOP will accept tax cuts but it's less clear how successful Trump will be pursuing protectionism and infrastructure spending.

BY CALLAM PICKERING • EUREKA REPORT • 16 NOVEMBER 2016

Prepare for a stumble on Trumponomics

An incoming Donald Trump administration has the potential to dramatically change the global economy and financial markets. The underlying problem is that there remains considerable uncertainty surrounding what he will or won't do. Not to mention what a Republican controlled Congress will allow him to do.

Key Point

- ***Trump's infrastructure program – and the resultant commodity spike – will likely prove to be short-lived***

Trump's economic policies are an unusual mix of Republican-style 'trickle-down economics', socialist protectionist policies and traditional Keynesian stimulus. Tax cuts will be immediately accepted by Republicans in the House of Representatives and the Senate, though there may be some disagreement on the size, but it's less clear how successful Trump will be pursuing protectionism and infrastructure spending.

Infrastructure spending will likely appeal to Democrats – many of whom pushed for stimulus throughout the initial stages of the global financial crisis – but it may fall on deaf ears among Trump's Republican peers. Protectionism will find pockets of support – particularly among those members from the states hardest hit by globalisation – but would be criticised extensively both within and outside the United States.

Much like 'Brexit' earlier this year, a Trump administration is an economic and financial shock that will take years to play out. The current market reactions provide as much noise as they do signal; bouncing around as investors try to position themselves for an event they cannot truly comprehend.

A lot of what we are seeing right now, whether it be in equities or the sell-off in bonds or the weakness in gold, reflect transitory market behaviour that could easily change next week, next month or next year. Only when Trump's platform becomes clear will we get a real sense of whether his administration can deliver on his economic policies.

Nevertheless, it is worth discussing the potential impact of Trump's economic plan. Understanding his economic platform, particularly with an eye to whether there will be obstruction within Congress, may provide some insight into how successful his economic plan might be.

Tax cuts

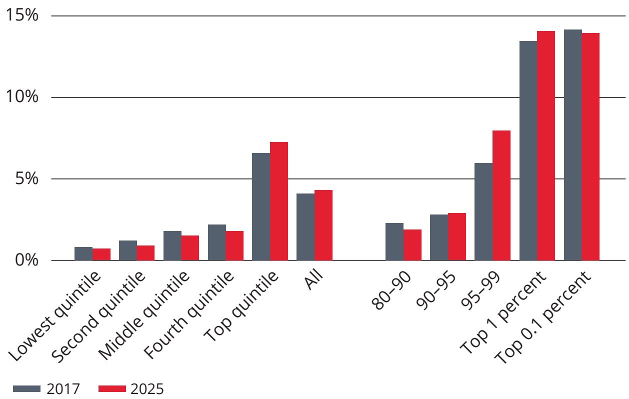
Let's start with the policy that is most likely to sail through Congress: the Trump tax plan. Trump plans to "collapse the current seven tax brackets to three brackets" of 12 per cent for married joint-filers earning less than $75,000 a year; 25 per cent for those earning more than $75,000 but less than $225,000 a year; and 33 per cent on those earning more than $225,000 a year.

Chart 1 considers the impact of these tax cuts on low, middle and high-income earners. The benefits of Trump's tax plan overwhelmingly accrue to people like Donald Trump. The benefits for lower-income earners are modest by comparison.

He also plans on reducing the business tax rate from 35 per cent to 15 per cent. This rate will be available to both small and large businesses.

Chart 1: Percent change in after-tax income under revised Trump plan

By expanded cash income percentile, 2017 and 2025



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1)

By historical standards, tax cuts of this magnitude are largely unprecedented. Trump's tax plan will cost $6.2 trillion over the next 10 years, around twice the size of the cuts proposed by Republicans in the House of Representatives, and after adjusting for the cost of interest and growth effects would increase national debt by around $US7.2 trillion over the next decade.

> **Much like 'Brexit' earlier this year, a Trump administration is an economic and financial shock that will take years to play out.**

These tax cuts will lift corporate profitability, supporting equity prices, but the personal tax cuts will offer only a modest boost to growth. While lower-income earners spend most of the tax cuts they receive, higher-income earners tend to spend very little of it. These personal tax cuts may boost asset prices but are less likely to boost retail spending and the real economy.

Even the notorious small-government advocates within the Republican Party may be reluctant to agree to tax cuts of this magnitude, particularly given that Trump is also advocating greater spending on infrastructure. Some compromise will likely be met that requires cost cutting in other areas of the budget such as education, health or welfare.

This offers a nice segue into Trump's infrastructure program.

Infrastructure

"We are going to fix our inner cities and rebuild our highways, bridges, tunnels, airports, schools, hospitals," Trump said on election night. "We're going to rebuild our infrastructure, which will become, by the way, second to none, and we will put millions of our people to work as we rebuild it."

It's a nice sentiment and one that appeals to Democrats and economists alike. For generations the US has under-invested in infrastructure, creating significant shortfalls that have undermined productivity and growth. With interest rates near historical lows it makes sense to invest in America's future.

According to the American Society of Civil Engineers, it will cost in excess of $US3.3 trillion to merely maintain existing infrastructure over the next decade. Based on current projections, the US will fall $US1.4 trillion short of meeting those repair costs. This doesn't even include the need to invest in new infrastructure to meet the needs of a growing population and changing technology.

Trump has committed to a $US1 trillion investment in infrastructure over the next decade. There is, however, some uncertainty surrounding these estimates.

His policy documents indicate that this policy will be revenue neutral, which suggests that the federal government will basically act as guarantor as part of a public-private partnership, allowing private companies to borrow at a cheaper rate but not officially use the public balance sheet. Alternatively the scheme will operate via tax credits, with the federal government effectively subsidising private infrastructure.

Public-private partnerships can be a useful way of financing infrastructure but historically they haven't proved popular in the US. According to the Congressional Budget Office, in the past quarter-century there have been 36 privately funded road projects, with just 14 completed. Three went bankrupt and one required a public bailout.

Public infrastructure may prove less appealing to the private sector, even at low interest rates, than president Trump expects. Not to mention that other forms of public infrastructure, outside of roads, can be more difficult to monetise.

Public infrastructure is often necessary for a well-functioning society and economy but does not always make financial sense for a corporation. State and federal governments are often better placed to absorb the risks associated with public infrastructure and there can be real dangers in relying on private corporations to fill the infrastructure gap.

Any attempt by the federal government to take on more debt to finance infrastructure will also be met with resistance by a Republican-controlled Congress.

"Conservatives do not view infrastructure spending as an economic stimulus and congressional Republicans rightly rejected that approach in 2009," said Dan Holler, spokesman for the influential conservative lobby-group Heritage Action for America.

Now, there is little empirical support for that position; an economy can barely function without public infrastructure and infrastructure investment has long been associated with productivity growth, which remains the only source of long-term sustainable growth. Nevertheless, it points to the opposition that any infrastructure plan may receive in Congress.

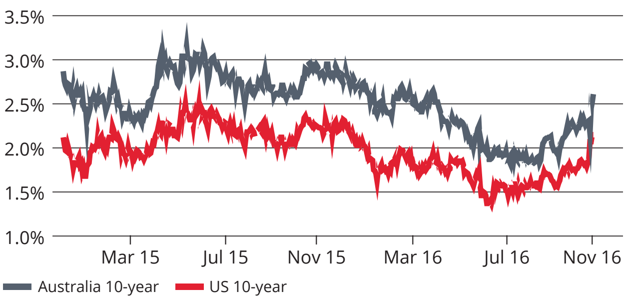
At this stage, I expect that Trump's infrastructure boom will fall well short of expectations.

> **Politics will ensure that Trump's tax policies and infrastructure program are not as stimulatory as they appear at first glance.**

Interest rates

Markets are currently pricing in significant stimulus arising from Trump's election win. Ten-year treasury yields in the US have increased by 32 basis points since Tuesday, which indicates that the market expects the Federal Reserve to hike rates more quickly than they did pre-election. Ten-year government bonds in Australia have increased as well.

Chart 2: 10-year government bond yields



Source: RBA; Federal Reseve of St Louis; via CP Economics

Federal government debt will increase significantly under a Trump presidency, that much is clear, which may put upward pressure on interest rates and justifies at least some of the recent selling across the US bond market. The federal budget has deteriorated under the past three Republic presidents and I don't expect Trump to be any exception.

Default isn't a serious consideration for the US, so the main risk with rising government debt is that it crowds out more productive private investment. Finding the right balance between stimulating the US economy and overburdening it with debt is difficult.

Australia will benefit from a stronger US dollar, which has already pushed the Australian dollar down around 2 per cent since the election. The infrastructure plan has also pushed key commodity prices higher, though if I am correct regarding Trump's infrastructure program then that will prove to be short-lived. The market is also pricing in a reduced probability of further rate cuts by the Reserve Bank of Australia.

My view is that the markets have oversold bonds to some extent. Politics will ensure that Trump's tax policies and infrastructure program are not as stimulatory as they appear at first glance. Trump's protectionist positions on globalisation could prove to be damaging to both US and global growth but unfortunately Trump's positions are not clear enough to make a sound assessment.

As I said earlier a Trump administration, like the 'Brexit' before it, is an economic and financial shock that will play out over a number of years.

We will see volatility, and markets will react and over-react to everything that Trump says. Only when his policies begin to move through Congress can we get a genuine sense of whether they will stimulate US demand, fuel inflation and push interest rates higher. Only then will investors be able to determine the signal from the noise.

Never before has the country seen so much residential development in the inner city and there exists a reactionary fear of the unknown.

BY NERIDA CONISBEE • EUREKA REPORT • 15 NOVEMBER 2016

Should you buy a CBD apartment?

CBD apartments have received some bad press of late, with risks of oversupply the primary concern shared by most analysts. However, a quick snapshot of median unit price growth in Australian CBDs provides further cause for alarm. While prices for houses and suburban apartments continue to rise across Australia, in our CBDs apartment prices have dropped – in some cases considerably – over the past 12 months.

Key Point

- ***In the current climate caution is advised when looking to buy, however there are still a number of opportunities which could be considered.***

To say that all apartments located in Australian CBDs have the same investment metrics ignores the diversity of demand and market conditions. Not all apartments are of equal risk and despite the numbers, there are even some that may be worth considering.

Table 1: Australian CBD apartments, median price growth

	MEDIAN PRICE JUL 16 ($)	12-MTH GROWTH (%)	3-YEAR GROWTH (%)
MELBOURNE	435,000	–8.4	–8.4
SYDNEY	720,000	–9.1	15.2
BRISBANE	490,000	–1.8	6.1
ADELAIDE	415,000	–5.8	–1.7
PERTH	432,500	–6	–15.2
HOBART	452,000	–6.8	7.6

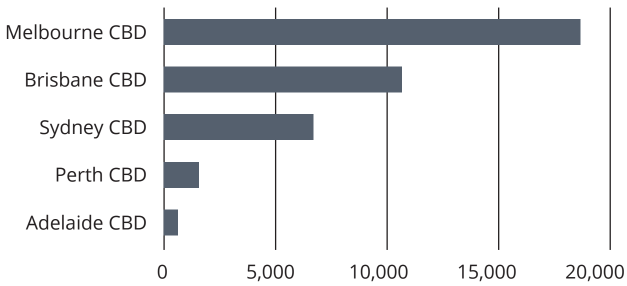
What are the main concerns?

The unprecedented numbers of new apartments in our CBDs is the main area of concern. Never before has the country seen so much residential development in the inner city and there exists a reactionary fear of the unknown.

The sheer amount of development is eye watering. In Melbourne alone, there are over 18,000 apartments under construction and scheduled for completion within the next 18 months. Historically, Melbourne CBD has added 1500 apartments every 18 months for over a decade, so we're currently seeing numbers which are more than 10-fold on past trends.

In Brisbane, construction has started on over 10,000 apartments but, unlike Melbourne, Brisbane has a relatively low number of inner city apartments. A bigger challenge may well prove to be lifestyle related. People are simply less used to apartment living than their eastern seaboard counterparts in Sydney and Melbourne.

Chart 1: Apartments under construction by CBD (Nov 16)



Source: Corelogic

Dropping prices and the large pipeline of new developments are alarming enough, however we need to recognise that there are further challenges facing the CBD apartment market. There are three main risks that should be considered:

1. Default risk

The number of apartments which are being given lower valuations on completion than what purchasers initially paid for them is rising in some cities. While this is clearly not an ideal scenario, it is not a problem for many buyers. However, those who are marginal in terms of receiving bank lending may struggle if the apartment drops in value prior to settlement. We're not currently seeing many defaults, but if prices continue to drop across all CBDs it is possible that this will increase.

2. Occupational risk

CBD apartments are selling, so there is still a market for buyers, however the question is now who'll be living in these apartments. Such high levels of development will put pressure on rents and this is already happening in Brisbane and Perth

> **“Never before has the country seen so much residential development in the inner city and there exists a reactionary fear of the unknown.**

CBDs. While declines in rents are not great for investors, a large increase in the vacancy rate is even worse; no tenant equals zero rent, and therefore no return on investment.

Table 2: Australian CBD apartments, median rent growth

	MEDIAN RENT JUL 16 ($)	12-MTH GROWTH (%)
MELBOURNE	470	4.4
SYDNEY	700	2.6
BRISBANE	580	–3.3
ADELAIDE	430	2.4
PERTH	450	–10
HOBART	460	2.2

3. Secondary market risk

Many CBD apartments are being purchased by offshore buyers, although the exact percentages are unknown. In Australia, offshore buyers are restricted to buying only new dwellings. Given the demand for CBD apartments appears to be higher with overseas buyers, there will potentially be a shortage of local buyers once these apartments are re-sold in years to come.

Are all apartments equal?

In the current climate caution is advised when looking to buy, however there are still a number of opportunities which could be considered:

1. Sydney CBD

Apartment prices in Sydney CBD are currently declining, however the longer-term outlook for this market is more positive than the rest of Australian CBDs. There’s been far less development in wider Sydney and in the Sydney CBD over the long term. In addition, Sydney CBD has a far less aggressive pipeline and the stock being developed in Sydney is different to other markets, with far fewer student apartments and more high-end development. Sydney CBD is also seeing very strong white collar growth and strong demand from people wanting to live in, or close, to the CBD.

2. Unique apartments

Unique, older style apartments in CBDs can offer good opportunities, even in Melbourne with its enormous pipeline. For example, consider a low rise apartment block in one of Melbourne’s laneways, or converted factory space. Another example could be a higher end development in a CBD populated primarily with apartments aimed at students. As is the case with real estate more generally, uniqueness is often sought after.

3. CBD markets in three to five years

A challenge for CBD markets right now is that there is still a large pipeline of new development, which will continue to put negative pressure on prices. Eventually the pipeline will clear and there will be growth in values, the challenge is picking the bottom of the market, and it’s different for each city. My view is that Brisbane and Melbourne will take longest to resume capital growth in CBD apartments, while Sydney will pick up sooner.

4. Owner-occupiers

If you are looking to buy as an owner-occupier, CBD markets can offer benefits like close proximity to retail, workplaces and public transport. If you do want to live in a CBD, then there are certainly some good value apartments available. And, provided you are looking at a longer-term investment, you should be able to ride through the cycle.

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There are concerns over the partial segregation/transfer of assets in self-managed super funds, off-the-plan property, and Labor's policy backflips.

BY BRUCE BRAMMALL • EUREKA REPORT • 17 NOVEMBER 2016

Pension cap creates a property dilemma

For self-managed super fund property investors, super's "new" rules and surrounding framework are a long way from being clear.

Key Point

- ***How property is treated within a fund when its value exceeds the $1.6 million pension cap remains unclear. And beware of unconditional lending clauses on property purchases inside super.***

Draft legislation has been out for comment for a few weeks, and SMSF experts are falling over themselves to point out fresh dangers and risks that will come with the new rules.

And, speaking of which, the rules that seemed almost certain a month or so ago are, again, back up in the air, with Labor switching and arguing for even tougher new contribution limits. But I'll come back to this.

Property warning I: Partial segregation/transfer of assets

The new concern for SMSF property investors from the draft legislation comes for those who are likely to bust the $1.6 million transfer balance cap.

Some senior SMSF lawyers believe there is a big gap between what the new legislation says and what the Australian Tax Office has traditionally allowed.

The ATO has, traditionally, not accepted partial segregation of assets. That is, you can't put a portion of an asset into pension, leaving a portion out in the accumulation fund.

The issue is probably best explained with an example such as the following:

A SMSF has assets of $2m, which include a property worth $800,000. The "other" $1.2m of assets might automatically go into the pension, leaving $400,000 of the cap left. Common sense would suggest that you would then be allowed to transfer 50 per cent of the property, or $400,000, into the pension fund.

At some later stage, if the $800,000 property was sold for, say, $1.2m, then half of the gain would be taxed in accumulation and half (not) taxed in pension.

Surely, this makes complete sense. And to many experts, it does. However, the ATO has traditionally not believed in the partial segregation/transfer of assets. The draft legislation, according to Dan Butler, one of the best SMSF lawyers in the business, seems to suggest that it will be allowed. But the ATO is the regulator and is, inevitably, left to determine rulings. So clarification, at some stage, will be required.

Property warning II: Off-the-plan purchases

Further warnings are also circulating about SMSFs buying off-the-plan property, with unconditional finance clauses.

There is an increased volume of high-rise development properties hitting the market. And finance disaster stories are becoming a daily occurrence for SMSF investors.

Banks traditionally won't offer unconditional financing on properties being built by developers, until very near completion. They will wait until approximately three months out from completion to make their financing offers to purchasers.

However, with the flood of properties coming on the market, and pressure coming on those high-rise developments, banks are backing away, or simply changing their finance requirements.

Don't sign anything regarding a geared property purchase in your SMSF with finance clauses that are unconditional. Banks are prone to changing their minds on lending – for example, if they no longer like the suburb, or a particular development; or they won't lend on the same loan-to-valuation ratio; or feel over-exposed to a given area.

The ramifications for SMSFs are potentially huge. You could lose your deposit and be sued by the developer for losses and costs, if you are unable to settle on the property on the agreed date.

> **Some senior SMSF lawyers believe there is a big gap between what the new legislation says and what the Australian Tax Office has traditionally allowed.**

What's Labor up to?

When it comes to superannuation, Labor has become "super limbo champion".

Labor is literally bending over backwards to have almost every super bar lowered. If there is a superannuation race to the bottom, there is no question as to who is leading.

Despite having very vague commitments to attacking super prior to the election, it has now found some courage and appears to want to beat the already crippled super to death.

Take this, for example. Labor now no longer supports the reduction in the non-concessional contributions limit from $180,000 to $100,000.

It now wants to see the limit for NCCs dropped to $75,000.

Prior to the election, it supported reducing the "high earners" tax rate of 30 per cent on super contributions kicking in at $250,000 a year. The Coalition matched that at the Budget.

Labor is now demanding that be dropped to $200,000. That is, anyone earning more than $200,000 a year, should pay 30 per cent contributions tax on what is put into super for them.

And, more recently, it has voiced opposition to the five-year 'catch up' provisions, which would allow people to use up to five previous years' concessional contribution limits in one year.

As I said when the Coalition first announced its original super recommendations in the May Budget, the package went way further than any Labor, or even Greens, initiative would have gone had they been in government. It was change on a scale no-one had predicted.

The non-governing major parties couldn't believe they had been undercut. But some feel Labor is putting up a token front for some political mileage … and will pass the Coalition's pretty tough new measures when called to vote.

*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 Tax Office has its eye on SMSF trustees still holding collectables in their fund who have not yet adhered to rule changes that came into effect in July.

BY JOHN CONROY • EUREKA REPORT • 18 NOVEMBER 2016

SMSF collectors still on ATO notice

The word from the Australian Tax Office is that it will work with you if you have not yet got your collectables act into gear.

Key Point

- ***If you have collectables within your SMSF, they must be stored at a third-party location and have a separate insurance policy.***

But make no mistake, if you hold collectable assets within your self-managed super fund and have somehow missed the ATO's repeated warnings since 2011, time is rapidly running out because you must have your house in order by the time you lodged your next audited annual accounts. In fact, the clock actually hit midnight on June 30.

That being said, it seems most SMSF trustees have got things right. Four-and-a-half months after the ATO tightened its rules governing the ownership of collectables in SMSFs, industry experts say that compliance among trustees largely appears to be in check and any flow-through effects to collectables markets – such as the art market – seem contained.

Much of that can be put down to the five-year gap between the rule announcement, made in 2011, and this year's July 1 implementation. But SMSF trustees still with collectables are being urged to have that asset class in order well ahead of March's annual accounts deadline, or they risk facing stiff financial penalties.

Under its guidelines the ATO will fine any SMSF 10 penalty points, equal to $1800, for every breach by an SMSF.

Still a sizeable collectables cache

While collectables as a portion of total Australian SMSF holdings has fallen 67 per cent, to just 0.06 per cent, of all holdings across those five years to June 30, there was still $375 million in collectables in SMSFs at the cut-off date. It's highly likely that figure has dropped, but that a large number of super funds are still exposed to collectable assets including coins, artworks, cars and bullion.

The ATO this week said it was willing to "work with them (SMSF accountholders) to rectify any issues".

"SMSFs who are concerned that they may have investments in collectables that do not comply with the new rules are encouraged to approach the ATO through our SMSF early engagement and voluntary disclosure service," a spokeswoman told *Eureka Report*.

The rules were designed to close off the loophole that allowed the purchase of collectable assets through funds for personal enjoyment and use – namely protecting the integrity of superannuation's sole purpose test.

Understanding the rules

The rule changes tighten the conditions around having collectables stored with "related parties" - they can only store, but not display, collectables in premises owned by a related party, and only provided it is not their private residence. Trustees must also keep a record of the reasons for deciding where to store assets.

However, this change is tempered – especially for large funds – by SMSF in-house assets rules, which allow up to 5 per cent of a fund's total assets to be leased to a related party.

On the insurance front, collectables must not be be insured under their household policies but rather a policy in the name of the fund (collectively or individually), and within seven days of purchase.

The availability and cost of insurance must also be considered by trustees as part of the decision to invest in collectables and personal use assets.

The changes have made the asset class more restrictive and costly for SMSF accountholders.

While industry figures say there has not been any noticeable panic on the front since June 30 among the owners of those $375m in SMSF collectables, there could be situations where people have been caught out. For example, sellers transferring collectables out of SMSFs who hadn't met a condition of release and then found the collectables market had dropped, and thus decided to hold onto the assets. One potential workaround in this scenario is for SMSF trustees to buy their own collectables back should they have the cash on hand.

> **The rules were designed to close off the loophole that allowed the purchase of collectable assets through funds for personal enjoyment and use.**

Art market not impacted

Collectables market figures say the rule changes has had a negligible effect on prices, with Sotheby's auction house's Australian chief executive Gary Singer saying the deadline passed unnoticed, as had the five-year transition.

"In terms of the Australian art, we haven't seen any change in that, we've had very strong sales in August. We're not getting called into appraise works for sales because super rules are changing – as much as we'd love to," Mr Singer said.

"And that's the same with jewellery, where we are also the market leader."

Mr Singer said the indigenous art market – in which reports said half of all sales in 2010 were linked to SMSFs – was struggling, but weakness there was being driven by export-restriction rules from government, not SMSF activity.

"That's still a very tough market," he said.

Sydney based art collector and art investor Durva Gandhi doused worries from some in the SMSF industry that the new insurance requirements would be prohibitive, at least on the art front.

"I think it is easy to insure Australian art in Australia. International art is a little harder, but I think it wouldn't even be such a big deal for a global insurance company to find counterparts in other parts of the world to get valuations done – but yes, more difficult than Australian art," she said.

The Tax Office will publish fresh figures on collectables holdings later this month.

Options for protecting familial assets for a child that is married or part of a couple.

BY CAROL TAWFIK • EUREKA REPORT • 14 NOVEMBER 2016

Protecting your children's inheritance from divorce

I recently wrote a piece exploring some alternate ways in which one might consider financial assistance to family members (see ***Four financial gifts for the family***).

Key Point

- ***A testamentary trust can be both a powerful tax planning and asset protection tool.***

With increased cost of living pressures and, for many, an almost impenetrable home property market, it remains natural that parents may simply wish to offer lump sum gifts to alleviate life's financial strains on their children where it is in their capacity to do so. If not during their lifetime, this may instead manifest through their estate with the transfer of assets through a will.

Where a child is single, this can be a relatively straightforward notion, however where that child is married or part of a couple, considering options which offer protection over the familial assets may be appropriate.

While the divorce rate has somewhat stabilised over recent years, McCrindle's 2015 **analysis of ABS data** illustrates that around one-in-three marriages will end in divorce. Most will likely attest to good relationships with their sons or daughters-in-law, but underlying that will undoubtedly be a natural preference to keep family assets within the bloodline in the event of their child's relationship breakdown.

Where a financial advance is made to a child as a gift, that can later become part of the child's divisible assets in the event of a property settlement. This means that monies gifted in good faith can inadvertently end up in the hands of an ex-partner, unless appropriate mechanisms are put in place.

Of the divorce data, the average length of marriages was 12 years, highlighting that while it might be hard to imagine divorce when times are good, things can unfortunately change as time – maybe many years – goes by. Further to this, laws introduced in 2009 allow that de-facto couples can in the event of their separation seek property division through the court in the same way that applies to married couples. The definition of a de-facto couple, while it must be assessed on its individual circumstances, will broadly mean those living in a genuine domestic relationship of at least two years.

Loan vs gift

Rather than providing a straight financial gift, a loan arrangement between parent and their child may instead be considered, particularly where the amount is relatively significant. This ultimately allows mum and dad to be treated in much the same way as any other creditor and, in the event of a relationship breakdown, the monies are payable back to them without those funds forming part of the child's divisible asset pool.

A loan agreement can therefore be a straightforward and effective way of protecting assets in the event of a marital split. It is important to note however that – if it becomes necessary – the arrangement must be able to be validly demonstrated to be a loan, and so certain criteria should be met at the outset including but not limited to having the agreement in writing, duly signed by all parties. It is possible that the loan amount not have a fixed repayment date or interest payable, but it will be important to consider making all the conditions in the agreement at the time of the advancement, and to put the right documentation in place then and not afterwards. In order to ensure the effectiveness of the arrangement, advice should ideally be sought from a solicitor who would also draw up the formal written agreement covering the key criteria.

Understandably a parent might struggle with the discussion around why funds might be advanced in this way rather than as a clean gift. In my experience however, once the rationale around protection is stepped through, any potential offense is usually dissolved.

As always, speaking to an adviser about what it means for one's own circumstances and what is viable should remain at the forefront of consideration. A parent's natural desire to support their children is one thing, but ensuring that their own position and retirement plan can sustain it should first be assessed.

Testamentary trusts

A testamentary trust can be both a powerful tax planning and asset protection tool, and I will separately expand on their broader benefits in a follow up piece. When it comes

> **A parent's natural desire to support their children is one thing, but ensuring that their own position and retirement plan can sustain it should first be assessed.**

to passing assets to beneficiaries after death, they can offer protection against the financial implications of relationship breakdown long after a will-maker's passing.

A testamentary trust, sometimes called a will trust, is be established through the will at the time of death and will essentially house the inheritances on behalf of the beneficiary rather than those monies falling directly into their hand. An inheritance that is held within a properly established and controlled testamentary trust is less likely to be the subject of a Family Court proceeding and therefore become a divisible asset of the child's in the event of a relationship or marital split.

While there is typically not an obligation on the beneficiary to maintain the testamentary trust, they would elect to retain the structure in order to have the continued ability to protect their inherited assets into the future (together with other benefits). The inclusion of testamentary trusts in one's will simply creates that option for the beneficiaries, so engaging them in the discussion and at the planning stage is a positive. Although there is a cost of establishing testamentary trust wills, it typically is not viewed as prohibitive in light of the possible long-term benefit.

As always, seeking specialist advice is paramount. And while wholeheartedly hoping that loved ones will not be faced with the stress associated with a relationship breakdown, both in an emotional and financial sense, it does not preclude taking reasonable precautionary steps when making financial gifts – either through one's estate or during their lifetime.

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As with every edition of Minefield, this article is not providing investment advice. For all of Eureka Report's stock recommendations, click here.

BY TIM TREADGOLD • EUREKA REPORT • 17 NOVEMBER 2016

Minefield: Three mining turnarounds

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.*

Gold nosedived after last week's election of Donald Trump as the next US president, but whether it will stay down for long given the uncertainty associated with the changes he is planning for the global economy is an interesting question.

Key Point

- ***For investors seeking a safe haven against rapid commodity and currency moves gold retains its status as a unique asset class.***

Equally interesting is the burst of enthusiasm for industrial metals such as copper and iron ore because of the potential for US policies under Trump to start a trade war with China.

Anyone expecting a surge of copper use in the US needs to consider the fact that China is far more important, consuming around 45 per cent of the world's copper compared to 10 per cent by the US, which means a Chinese copper cutback in a trade war would overwhelm any US pick-up.

It is, however, early days in life under Trump, who doesn't get the keys to the White House until January 20. But the first reaction on commodity markets is a pointer to the volatility likely over the four years of his presidency, and the potential for a Trump-triggered crisis.

That cloudy outlook should create a climate for higher gold prices, especially in Europe as Trump resets relations with Russia and the revolution which started with the Brexit vote in June stirs a nationalist reaction that might accelerate, leading to the break-up of the European Union.

For investors seeking a safe haven against rapid commodity and currency moves gold retains its status as a unique asset class, which is why this latest edition of the *Minefield* column starts with a gold stock that is emerging as a future star of the Australian mining sector.

Gold Road (GOR)

Overlooked in its early years because it was exploring in virgin country 400km north-east of WA's gold capital, Kalgoorlie, Gold Road can expect closer international investor interest after last week striking a project development deal with one of the world's biggest goldminers.

In a move which significantly de-risks the remote Gruyere discovery, Gold Road has teamed up with South Africa's Gold Fields Ltd. This should see the relatively small Australian company make the shift from explorer to producer without suffering the usual project funding problems of most new miners.

The downside is that the deal, which injects $350 million into Gold Road, involves the sale of a 50 per cent stake in Gruyere and a number of other nearby discoveries.

Cash-in-hand at a tricky time for all commodity producers is as good as gold. There's additional upside in the form of Gold Fields, with its decades of mining experience, taking control of the development and operational phase of Gruyere.

While Gold Fields undertakes the engineering and logistics challenges of building a mine in some of Australia's least hospitable country, Gold Road is free to continue exploring its vast tenement holding covering 5000 sq km of highly-prospective ground.

By outsourcing the project development risk, while also securing its share of project construction costs, Gold Road effectively becomes a self-funded explorer with control of a region known as the Yamarna Belt, a structure which geologists regard as a look-alike to similar gold-rich structures in WA that host big gold deposits, such as those found close to Kalgoorlie.

Gold Road was not immune from last week's sudden fall in the gold price, though the damage was limited to a 9c (12.5 per cent) share-price fall from 72c to 61c. Since that drop the stock has clawed its way back to 63.2c, a price which values the company at $550m.

Macquarie is one of only a handful of big name stockbroking firms to research Gold Road and has been enthusiastic since a team of its analysts (with me along for the ride) made the trek to site several years ago with the company's chief executive, Ian Murray.

The broker's enthusiasm has not dimmed over time, with Macquarie last week putting a 12-month price target of $1

> **If the iron ore price stays higher (and that's not guaranteed), and if Atlas can continue to hold down costs and retire debt, it should continue its trip back from the brink of failure that seemed likely last year.**

on Gold Road in a report which described the Gruyere deal with Gold Fields as a "straight forward transaction for a no-nonsense asset".

Atlas Iron (AGO)

If you paid $4.40 a share for a stake in Atlas Iron five years ago you might not be celebrating the fact that this week the stock traded as high as 2.6c, which is understandable as the value of your investment has plunged by an eye-watering 99.4 per cent.

But, if you snapped up a fistful of Atlas shares earlier this year when they were bumping along the bottom at around 1c it would be a different matter.

Because it dropped so far from mid-2011, when the price of iron ore crashed, Atlas barely registers on any investment radar screens today.

That might change if the recent increase in the iron ore price can be sustained and Atlas can continue to retire debt and manage a bloated share register the result of creditors swapping debt for equity in a complex process to save the business.

The net result is that Atlas today is largely working for creditors-turned-shareholders, and doing quite a good job with debt repayments reducing the $257 million of eight months ago to net debt today of less than $90 million.

Atlas has further to go before its revival can be considered complete but it is operating profitably thanks to a massive cost cutting exercise. Last financial year it produced more than 14 million tonnes of iron ore on a skinny profit margin of around $3 per tonne.

This year, the margin should be much higher thanks to the iron or price rising to more than $US70/t, which implies a price in Australian dollars of more than A$90/t.

Some speculators see Atlas as a recovery story, lifting the stock from 1c late last month to its recent high of 2.6c on Monday before it slipped back on Wednesday.

If the iron ore price stays higher (and that's not guaranteed), and if Atlas can continue to hold down costs and retire debt, it should continue its trip back from the brink of failure that seemed likely last year.

Pilbara Minerals (PLS)

Four months ago Pilbara was in the red-light category of Minefield thanks to its exposure to lithium and doubts about demand for the electricity-storing metal being swamped by a wall of supply.

Back then, Pilbara was trading at 67c, having retreated from 87c in mid-May. The stock is now priced at a more realistic 56c, with the decline over the past six months enough to earn it a switch to amber, a signal that it is worth watching.

Two developments have earned Pilbara a fresh look.

The first is completion of a positive feasibility study into its proposed $214m Pilgangoora lithium processing project in WA's Pilbara region.

The second is more interesting, a deal to ship unprocessed lithium ore directly to a customer in China, creating a fast route to cash flow while the processing plant is built.

As mentioned before, quick cash at a time when resource-project banking is in the doldrums is a smart move and similar to what Sandfire Resources did in generating early cash from direct shipping copper ore from its Doolgunna project ahead of construction of the main processing plant.

First deliveries under Pilbara's direct lithium-ore shipping plan are expected to be made by July with the Chinese customer, Shandong Ruifu, making a $US10m pre-payment to secure the deal.

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