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WEALTH

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As of January 1 next year the amount of assets people are allowed to have outside of their home while still receiving a full pension rises, but a higher taper rate means it cuts out fully at $816,000.

BY ROBERT GOTTLIEBSEN • EUREKA REPORT • 19 OCTOBER 2016

Pension pinch: The assets test challenge

I have just been looking at the detail of the new assets test for those who are part reliant on the government pension.

Key Point

- ***The asset-test measures will encourage people to organise their affairs so that they rely more on the pension and protect their asset base with the domestic home.***

The new changes are potentially horrific, and I am sure many *Eureka Report* readers will be affected. And if you are not affected personally you will certainly know people who are set to be hit, so we need to discuss at least the broad strategies that should be considered to adapt to the test.

And then I want to talk about why coal and iron ore are performing so well and canvass the possibility that the Australian economy may perform better than we expected, and that could include the firming of the inflation rate.

Assets test

But first, the assets test. Let's work on a couple that have a house, but the same principles apply to a single person and to those who don't have a house.

Right now a couple can have assets outside the family home of just over $1.17 million and still draw a part-pension. As their assets fall, so that pension increases. It has represented a comfortable lifestyle for a great many retired couples in Australia. And now that ends.

At the bottom end of the pension scale a couple can currently have a combined asset base of $296,500, excluding the home, and gain the full pension. As of January 1 next year the amount of assets they are allowed to have while still receiving a full pension rises to $375,000. But to fund that greater pension entitlement comes a savage attack at the other end.

Instead of being able to have some $1,178,000 in investments and other assets and still gain a part-pension, the pension cuts out when your assets – excluding the home – exceed $816,000. That is a huge reduction. And because the difference between full pension allowable assets of $375,000 and the cut-out level of $816,000 is only $441,000, there are bizarre consequences.

Let's take a couple with just over $816,000 in assets outside the home as at January 1, 2017. They will get no pension whatsoever. But if they reduce their assets to $375,000 they will get a full pension of some $34,382 per year. That equates to a theoretical tax-free 'return' of 7.8 per cent on the $441,000 asset reduction. And that 'return' rate of around 7.8 per cent is also applied to single people and those without a house – it's just that the amounts involved are different.

There is no way that a retired couple are going to earn 7.8 per cent on that $441,000 without taking considerable risks, so the government is basically telling them that they should begin to live on their capital and, as they do, that their income

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will be protected because they will get a greater pension. It won't be a smooth curve because adjustments are made over time.

But that is the principle. If a person is involved in this sort of game and wants to downsize their dwelling and get some cash, it may immediately slash their pension. So the harshest advice you will be given is to go off and have some cruises and let the government increase your pension.

The retired people I know that have between $375,000 and $816,000 don't really want to run down their hard won savings like that, and the gifting rules make it extremely dangerous to give the money to your children or grandchildren.

Because the pension rules are complex, you will need help. But my basic advice is that given the government is encouraging you to run your asset base down in ordinary living, so you should at least consider that as an option.

However the government also wants you to work, so there are rather generous allowances for work income. And so it might be possible for some retired couples to extend their working life to compensate for the pension loss – but it's not an easy process.

If you are approaching retirement you need to look at this new situation with great care, because it will involve different strategies. You may decide to work longer. You may decide well before you retire to help your children. You may decide to increase the size of your house, because that is a protected asset.

In the larger house, maybe your children can live with you if they can't afford their own home. These are some of the basic questions that this commentary can't answer, because each person is different. But they are some of the considerations that you will need to discuss with your spouse, your family and your advisors.

It is not a happy picture for people who based their retirement on the returns from $1.1m plus the pension. The measures were clearly designed by people who do not understand the retirement business.

It might save the government money in the short term, but in the long term it will encourage people to organise their affairs so that they rely more on the government pension and protect their asset base with the domestic home.

In some cases the pension can be maximised via a retirement village accommodation, but be very careful of this because it bristles with traps.

Coal and iron ore

To more pleasant subjects.

The rise in the price of coal is truly stunning. Australia's second-largest export has increased some 145 per cent since the mid-year and is still rising. The reason for the increase is that China has decided to reduce its high-cost coal production and, as a result, there has been a huge increase in demand for Australian and other coals. We are looking to open new mines.

To some extent the same thing has happened in iron ore, where the Chinese have also cut back production. My understanding is that the Chinese have been shocked by the increase in the price of coal and will look to restart some of their production again.

In the meantime, the Australian economy will get a considerable boost once current contracts are completed. Iron ore represents 15 per cent of our exports and coal around 11 per cent, and overall we have seen a considerable rise in other commodities as well.

> **As we all know, the interest rate differential between Australia and the US is just as important. The markets are telling us that the US interest rates are about to rise.**

That change in outlook for commodities will have a number of important effects on the Australian economy. First and foremost, it will boost Queensland and Western Australia. But second, it means that the Australian dollar will be underpinned, although, as we all know, the interest rate differential between Australia and the US is just as important. The markets are telling us that the US interest rates are about to rise; the Reserve Bank is looking to reduce rates in Australia, but there is now no certainty that it will.

And remember, we have a situation where rural commodities, oil, as well as many other products have increased in price in the last six months, and that is going to creep into inflation.

I think that the extremely low levels of inflation Australia is experiencing will change, and that means that inflation-protected assets will come back into favour. When inflation is very low no-one thinks about that particular attribute of a security.

Higher capital levels have already led to a lower returns on equity for the major banks than investors have become accustomed to.

BY CALLAM PICKERING • EUREKA REPORT • 19 OCTOBER 2016

Big banks face lower return risks

If you are an Australian investor focused on equities then it's almost certain that you have some exposure to Australia's banking sector. The major banks account for a quarter of the market capitalisation on the ASX200 (the financial sector more broadly accounts for around 34 per cent).

Key Point

- ***Many analysts expect that ROE will remain at its existing level over the next couple of years. I'm more pessimistic.***

A key issue for financial stability is the capitalisation of Australian banks. A bank's capital represents its capacity to absorb unexpected losses; for a given level of financial risk, the higher a bank's capital the lower their risk of becoming insolvent.

The global financial crisis revealed that many banks had failed to hold sufficient capital given the risks they were taking. The regulatory debate since then, driven by the Basel Committee on Banking Supervision, has focused on addressing that by forcing banks to not only hold more capital against their assets but also to hold higher quality and more liquid capital.

According to the Reserve Bank of Australia, "the ongoing implementation of these measures has contributed to a material rise in bank capital globally and a reduction in return on equity (ROE)". In other words, higher capital requirements place downward pressure on profitability and eventually dividend payouts.

Australia's Financial System Inquiry, released in 2014, focused on two key reforms to bank capital requirements.

The first was that domestic capital standards must be set so that Australian banks are "unquestionably strong" to ensure that the banking system remains resilient and continues to operate in the event of an adverse financial or economic shock.

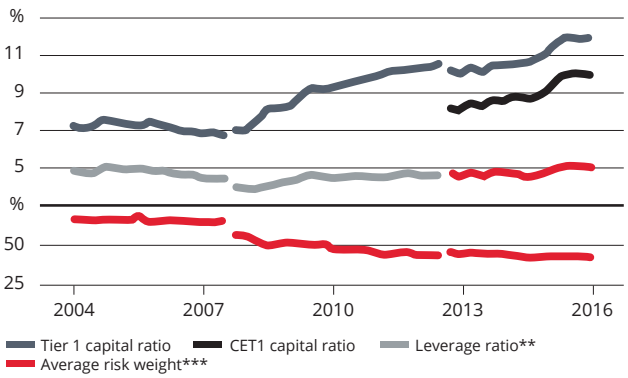
The second recommendation was that the average risk-weight applied to mortgages by the major banks would converge with the average risk-weight used by other banks. Under the existing regulations, the major banks were allowed to set their own risk-weights to mortgages, an opportunity not afforded to smaller banks and other financial institutions.

This provided the major banks with a significant competitive edge that allowed them to take on more debt and issue mortgages at a lower interest rate than their smaller competition. In practice, the major banks leveraged up to the point where they were holding just a few cents in capital against every dollar of mortgage assets.

It's worth explaining how these risk-weights work because they are far from intuitive. Assume that we have a bank with $100 billion in mortgage assets and they are required to hold risk-weighted capital worth 10 per cent of that value. Now, assume that the bank places a risk-weight on mortgages of 25 per cent.

How much physical capital does that bank hold against their mortgage assets? The answer isn't $10bn ($100bn times 10 per cent) but actually $2.5bn ($100bn times the capital ratio times the risk-weight on mortgages).

Chart 1: Major banks' capital ratios* (consolidated global operations)



* Break in March 2008 due to introduction of Basel II; break in March 2013 due to introduction of Basel III
** Estimated prior to September 2015 as Tier 1 capital as a per cent of assets
*** Risk-weighted assets as a per cent of assets
Source: APRA, RBA

The Australian Prudential Regulation Authority (APRA) implemented higher risk-weights on Australian mortgages on July 1 this year. According to the RBA, "the increase in risk-weights is expected to have a large effect on their CET1 ratios, reducing them by an estimated 0.7 to 1.1 percentage points, all else equal". CET1 or Common Equity Tier 1 refers to the highest quality capital that a bank can hold and a decline in that ratio means that a bank isn't as well capitalised as it once was.

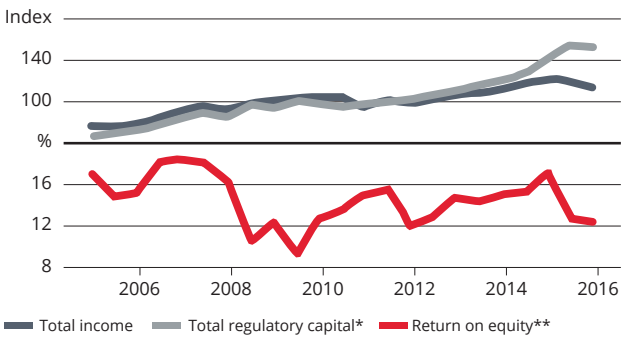
In response to these developments, the major banks have raised more capital and increased their capital ratios. The major banks' Tier 1 capital ratio was around 12 per cent in the June quarter 2015, which is around 50 per cent higher

> **Many analysts expect that return on equity (ROE) will remain at its existing level over the next couple of years. I'm more pessimistic.**

than its level at the onset of the GFC.

According to the RBA, "the major banks' CET1 ratio is well above the standard regulatory requirement, and a buffer is expected to be maintained even after taking into account the effect of higher mortgage risk weights in the second half of the year."

Chart 2: Australian banks' profitability



* 2011/12 fiscal year average = 100
** Includes an adjustment for losses associated with NAB's divestment of Clydesdale

Source: APRA, banks' financial disclosures, RBA

According to the RBA, "much of the increase [in the capital ratio] was due to a reduction in average risk weights as the composition of banks' portfolios shifted towards mortgage lending (which tends to attract a lower risk weight than lending to businesses)". By shunning risky business lending in favour of issuing greater mortgages, the banking sector has managed to boost its profitability and ROE.

More recently, the increase in "the major banks' capital ratio has largely been due to an increase in capital; the major banks have raised around $20bn of new equity and an additional $7bn from retained earnings since the start of 2015".

On a risk-weighted basis, Australia's major banks are relatively well-capitalised by international standards. According to an APRA report released in December 2015, the major banks' CET1 capital ratio had moved into the top quartile of international banks following the decision to raise capital during the second half of 2015.

Of course this assessment is based on the historical risk assessment of the housing and business sectors. A change in that risk assessment, particularly heightened risk across the property sector, would lead to a significant downgrade to the CET1 capital ratio. Our banks are well capitalised on a risk-weighted basis but perform quite poorly on an unweighted basis.

This discussion on risk-weights is essential to understanding recent developments in the major banks' ROE. Higher capital levels have already led to a lower ROE for the major banks than investors have become accustomed to.

Many analysts expect that ROE will remain at its existing level over the next couple of years. I'm more pessimistic, based on my expectation that we will see a broad-based reduction in the level of mortgage approvals combined with an ongoing shift towards higher capital. If this occurs then ROE will fall towards levels not seen since the global financial crisis.

It's worth remembering, however, that the ROE available from our major banks continues to be high by international standards. The sheer size of their mortgage lending has ensured that the returns from investing in the Australian banking system exceed the average returns found overseas.

The major banks' have responded to the reduction in ROE by increasing the spread between their products and the cash rate. According to the RBA, "most lenders increased their standard variable housing rates by 15-20 basis points in the second half of 2015 after the announcement of higher risk weights on Australian mortgages".

Some banks have also looked to reduce their focus on divisions that have historically achieved lower returns. NAB divested its UK Clydesdale subsidiary earlier this year and ANZ announced that it would narrow its focus in the Asian region. The major banks' wealth management arms have also come under increased internal scrutiny.

Investors will need to determine whether they are willing to tolerate a lower ROE. A lower ROE isn't without its benefits since it also coincides with lower risk and volatility and that may be appealing to some investors.

Perhaps the greatest risk is that investor pressure to maintain an elevated ROE and dividend payout encourages the major banks to take on additional risk or shift the composition of their books further towards mortgages at the expense of small and large businesses.

Many of the commodity price rises around the world are being driven by government. Some are not. Investment traps abound.

BY TIM TREADGOLD • EUREKA REPORT • 18 OCTOBER 2016

The long commodities grind

Coking coal's 120 per cent rise in less than six months has done more than anything to reignite interest in commodities as an investment class. But it is no reason to rush back to mining and oil stocks because this is not a boom, it's the start of a long upward grind.

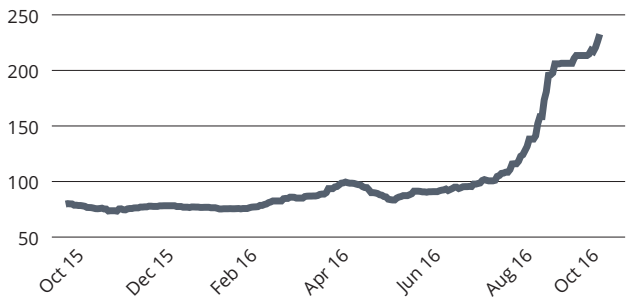
Key Point

- ***For most investors the commodity sector should be seen as a long game, especially as supply-demand fundamentals take a detour.***

That means there is plenty of time to be selective, and to be careful, focusing on low-cost producers and commodities benefiting more from demand and less from price spikes, which at this stage of the recovery can be the result of government market interference.

Coking coal, the material used to make steel, could prove to be a perfect example of the trap created by government policy with today's $US200 a tonne potentially reverting quickly to $US90, the price investment bank Citi is forecasting by the middle of next year.

Chart 1: Coking coal spot price ($US per tonne), past 12 months



Source: Bloomberg, Eureka Report

Chinese Government policy lies at the heart of the coking coal price surge, with miners ordered earlier this year to limit the number of production days to 276 annually as a means of boosting local coal prices and limiting environmental pollution. It worked too well.

Prices for all types of coal rose including thermal, which is used to generate electricity, but with coking coal doing best because China has limited supplies of that category, forcing steel mills to rush back to overseas suppliers, especially Australia.

What happens next is critical because the government policy which created the coal revival has been reversed. Chinese coal production is recovering and prices should fall. Citi is tipping coking coal to be back to $US118 in six months, and then down to $US91 by June – back to where they started.

What about oil?

Oil is perhaps an even better example of government intervention in a market, not that anyone should need reminding of that, especially if they lived through the oil embargoes of the 1970s, which drove oil through the ceiling – followed by a crash through the floor.

This time around it is the Government of Saudi Arabia which has killed the oil price by flooding the market as part of a war with the US oil-from-shale industry, with everyone in the industry suffering, including Saudi Arabia itself.

The latest government-driven attempt to manipulate the oil market is a proposed production cut which might lift the price, if it happens. But it would be a wise investor to watch and wait as all previous attempts to control output have failed, because too many governments with big oil industries cheat and the market remains flooded.

Metals mess

Nickel is another metal being buffeted by government policy flips. Last year it was the Indonesian Government which helped the nickel price by banning the export of unprocessed nickel ore. The Philippines followed this year.

But today, Indonesia is easing its ban and nickel, having reached a 12-month high of $US4.85 a pound last month is struggling at $US4.65/lb.

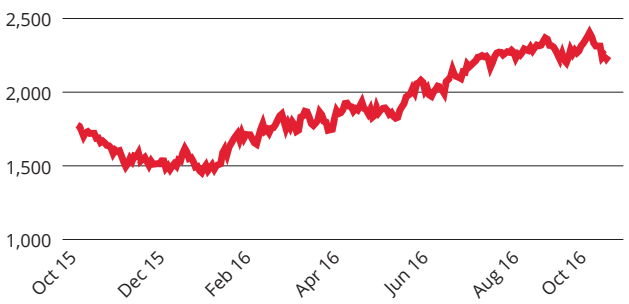
> **Through this fog of government market manipulation and oversupply there is a case study of what a genuine demand recovery looks like – zinc.**

Gold, a commodity and currency seemingly immune from government interference, is perhaps the most exposed to policy changes with its recent weakness traced directly to the US Government's interest-rate settings, and even to the outcome of next month's US presidential election.

A win for Donald Trump would do wonders for the gold price whereas his opponent, Hillary Clinton, is likely to persevere with existing policy settings, and the US central bank, the Federal Reserve, is more likely to raise rates with the certainties that come with Clinton.

The best way of looking at commodities is as an investment class which was driven into a burst of gross over-investment during China's peak construction boom, with commodity overproduction from the over-investment now being absorbed, slowly.

Chart 2: Zinc coal spot price ($US per tonne), past 12 months



Source: Bloomberg, Eureka Report

Copper, a bellwether metal which is seen by some economists as a proxy for global industrial production (IP), is not in good health thanks to overproduction, which is depressing the price. There are few signs of an imminent recovery despite global IP ticking over at a growth rate of around 2 per cent annually.

The main copper culprit is Chile, the South American country which produces close to 30 per cent of the world's copper, with a government heavily dependent on tax and royalty revenue from copper to meet its budget requirements. This means it is encouraging production, which will sit on the price.

Over the past 12 months copper has been the second-worst performing metal, falling from $US2.35/lb to $US2.10 – beaten only by uranium which has fallen from $US36/lb to $US22.75.

Through this fog of government market manipulation and oversupply there is a case study of what a genuine demand recovery looks like – zinc.

Since hitting a five-year price low of US66c/lb late last year zinc has risen by 55 per cent to $US1.02, seemingly on its way back to its five-year high of $US1.10 – and perhaps on to a fresh high of more than $US1.20.

The rise of zinc can be directly linked to a fall in stockpiles of surplus metal predominantly used to galvanise steel, and while tricky to forecast because of "hidden" stockpiles in the yards of steel mills, zinc's recovery has been remarkably predictable.

Falling supplies from mines which are in decline or, in some cases, have been closed when the ore ran out, was obvious as far back as three years ago, with the low price discouraging exploration and investment in mine development.

Night follows day in the commodities market, and it certainly has in zinc with the predictable mine closures, such as Century in Queensland, happening on cue and stockpiles declining as predicted, to reach a point where genuine demand is starting to drive the market rather than supply changes.

For at least the next year zinc should be one of the commodity world's top performers, outgunned only by red-hot speculative metals such as lithium and graphite which look terrific today, but just wait until supply gushes over demand and the price corrects, perhaps quite sharply.

Investment strategy

Hot-house commodities, and those subject to government manipulation, are fun for speculators who have planned their exit and target price. They know when (and how) to get out before they even get in.

> **The first 10 months of 2016 have been good for commodities, with most prices up but with the increase made to look good because they're off a low base.**

For most investors the commodity sector should be seen as a long game, especially in the aftermath of the massive boost to supply triggered by Chinese demand, which led to the false forecast of "stronger for longer" that has now morphed into "lower for longer".

Iron ore, once a favorite of speculators, has returned to its roots as a commodity with classic long-run fundamentals as a supply surge from new mines is gradually absorbed by steel mills, a process that could take up to 15 years.

With infrastructure costs (which essentially means mines, railways and ports) being absolutely critical in all bulk commodities the winners in iron ore will be the producers with the lowest cost per tonne, and that means having the highest quality ore and the best railways and ports.

The first 10 months of 2016 have been good for commodities, with most prices up but with the increase made to look good because they're off a low base.

The next 10 months will be a time of settling down after the initial euphoria of the first signs of a price recovery.

It is the start of a long, slow, upward grind, which will produce winners – just don't expect too many 100 per cent price spikes, and if you get one see it as a sell sign rather than a buy.

You may now begin to reminisce about superannuation's "good ol' days" – because the glory/generosity days are dead.

BY BRUCE BRAMMALL • EUREKA REPORT • 19 OCTOBER 2016

Super: It's time to move on

I hate to be the crusher of dreams, the strangler of wishful thinking. But I think it's about time to snuff out some truly false hope.

Key Point

- ***The government wants you to change your habits. Instead of shovelling in money as you approach retirement, it wants you to start making the sacrifice earlier.***

Today, I think I need to do that. To help some SMSF trustees to move on.

Superannuation as we have known it – with high contribution allowances and uncapped pension accounts – is dead. Stone, motherless, dead.

There is no pulse. Superannuation will not, somehow, receive a "Packer Whacker" and return to its previous glory/generosity.

You may, officially, begin to reminisce about superannuation's "good ol' days", the sorts of stories that start with sentences such as "back in my day", and "when I was young".

Goneski. It's not coming back. And, I'm sorry, but the likelihood of Mack-truck sized loopholes in the new legislation are akin to your chances of flipping 15 consecutive heads at a two-up school.

I say this because some truly starry-eyed hope is still being held.

Such as one reader who is hoping that the transfer to pension cap of $1.6 million will be based on purchase prices. So, if you bought $1.6m of BHP shares in the 70s, that are worth, say, $10m or $20m now, you would be still under the cap?

It won't be. The transfer to pension cap will, I have no doubt, be based on the market value of your assets on June 30, 2017.

Or that the government will allow couples to "average" their super balances, to go under the $1.6m limit each. That is, if one has $2.5m in super and the other has $500,000, then they can average it out, because they have a total of less than $3.2m ($1.6m each).

Nope. Balances will be for individuals. And individuals will be able to have no more than $1.6m as a tax-free pension fund. Unless you can use the existing rules, or have used them in the past (see my column on **couples' super strategies**), then bad luck.

The false hopes are coming from a misunderstanding. And that is that the government will come to the realisation that what they have done is, somehow, "unfair".

You need to understand that this is not really coming from "the government". It's not being driven by Malcolm Turnbull, or Scott Morrison. This is being driven by the Department of Treasury.

Superannuation has become big business. Probably bigger than Paul Keating thought it would become when he did the deal to make it compulsory in the early 90s.

In order to give it a solid start, the ability to get money into super was deliberately left very loose. It got tightened by Peter Costello in 2007, then further tightened by Kevin Rudd, then Julia Gillard. And now, most recently, by Scott Morrison.

All restrictions have, however, been driven by Treasury and their concern about this ever-growing Mt Everest of tax-free investments.

Treasury has been arguing this for some time. It is fine that a pile of the nation's money was sitting in tax-advantage states. But not that it had become a way for individuals to create monstrous tax-free investment trusts.

I've been trying to build one. And been cut off at the knees, in my relative youth of mid 40s.

Any time that there is change, there will be winners and losers, at least in a relative sense. The government (or Treasury, really), now apparently backed by the Opposition, is saying a few things.

- That $1.6m is a generous amount to have tax-free in a pension fund, on which no tax will be paid, ever.
- That if you have any more than that, you can leave it in super and pay a maximum of 15 per cent tax. Which is better than up to 49 per cent if you pull it out of super.
- In order to build your balance you can put in $25,000 as concessional contributions a year, or $100,000 a year as non-concessional contributions.

At its crux, it's that simple. And with the support of most in politics now, it's unlikely to change much before implementation.

> **Anyone hoping that we are going to see the new rules, or any major part of the new rules, abandoned, needs to wake up.**

It's not going to stop people, or the superannuation industry, trying or lobbying though. The SMSF Association joined forces with actuaries Rice Warner to produce a report that says that the over-50s should have higher CC limits, because few start making major contributions until they are in their mid-50s.

"The research confirms what the (SMSF) Association has long been telling policy makers: that there is a sharp difference between compulsory and voluntary contributions to superannuation – the former increase gradually over time while the latter jump dramatically in the years leading to retirement," said the association's chief executive, Andrea Slattery.

"This research graphically shows why people aged 50 and over need to have a more generous contribution cap than the $25,000 that will apply from 1 July 2017."

But Slattery knows that she's avoiding the real point. The government wants you to change your habits. Instead of shovelling in money as you approach retirement – which is as much about saving tax as it is putting away for retirement – it wants you to start making the sacrifice earlier, even if that is at the expense of paying off the mortgage faster.

Saving for retirement is something that should happen throughout your working life. Not just at the end bit, to get bigger tax deductions.

And it is a sacrifice. Making the decision to not take salary/income in your 30s and 40s (when you could use that money to pay down the mortgage or school fees) and put it into superannuation instead, is a long-term sacrifice. If you're doing that at age 40, you are kissing goodbye to that money for 20-25 years at a minimum.

But, if you want to build your tax-free super pot to $1.6m for retirement, then that is what the government wants you to do. It is the behaviour that it is encouraging.

Some changes to the currently agreed/proposed rules, are possible, even likely. But anyone hoping that we are going to see the new rules, or any major part of the new rules, abandoned, needs to wake up.

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.

A 'debt recycling' strategy will convert non-deductible mortgage debt into tax-deductible debt over time and potentially enable borrowings to be repaid more quickly.

BY SCOTT FRANCIS • EUREKA REPORT • 17 OCTOBER 2016

Recycling mortgage debt into 'good debt'

An obvious financial planning strategy that benefits from record low interest rates is to pay off your mortgage more quickly.

Key Point

- ***There are three types of debt, and 'debt recycling' allows you to transform mortgage debt into tax deductible 'good debt' - albeit at a risk.***

With low interest rates should come lower mortgage repayments, leaving more money in the household budget to make additional repayments.

The math of making extra mortgage repayments is, most often, compelling. When mortgage rates are 7.5 per cent, a fairly 'average' level of mortgage rates by historical Australian standards, every extra dollar that you invest in your mortgage saves you interest at the rate of 7.5 per cent for the remainder of the loan. That is your 'return' – 7.5 per cent risk free and tax free. A comparatively attractive return.

With mortgage rates now as low as 3.75 per cent, half that rate, perhaps extra mortgage repayments look less attractive. Even though extra mortgage repayments provide a risk free, tax free return of 3.75 per cent, it certainly seems less exciting than earning a 7.5 per cent return in a higher interest rate environment. That said, making extra mortgage repayments continues to be a sound and simple personal finance strategy.

The arguments for extra mortgage repayments

There remains a series of powerful arguments for making extra mortgage repayments regardless of the low interest rate environment. Firstly, for most people a key financial goal is to own their house outright. Extra mortgage repayments are the fastest way to that destination. Secondly, once the mortgage is paid off that is a significant expense that doesn't have to be worried about, and strategies like salary sacrificing to superannuation and investing regularly in an investment portfolio can be adopted. Thirdly, debt is risk. Repaying the mortgage provides a greater ability to cope with circumstances like the loss or reduction of household income.

For those comfortable with the strategy of extra mortgage repayments, record low interest rates help. Lower monthly mortgage repayments should leave more of the household budget for extra repayments.

That said, for people comfortable with holding a level of debt and looking for a more aggressive strategy, the idea of 'debt recycling' is a strategy worth considering in a time of low interest rates.

'Debt recycling' as a strategy

Debt recycling works on the fact that there are different classifications of debt. There is 'terrible debt', which would be the debt that sees 10 per cent-plus interest paid on credit cards and high interest financial products, and which people should always get rid of as a first priority.

Then there is mortgage debt used to buy a residence, which is often characterised as necessary but undesirable, having a comparatively low interest rate but no tax advantages. Then there is 'good debt', which is the debt that is used for investment purposes. This is characterised as 'good debt' because it is tax deductible, and you are using the funds to (hopefully) invest in assets that will grow in value over long periods of time.

Before going any further it is worth stressing that all investment debt increases the risk in a financial situation – we should not be too persuaded by the idea of 'good debt'. When we borrow money, we are increasing our exposure to both increases in market values, and falls. Those people who borrowed money to invest just before the market fell during the Global Financial Crisis may never find themselves getting ahead on their strategy. As we stand now, it is nearly 10 years later and they are still well behind – an example of the risk of borrowing when asset prices then fall sharply.

> **You will reduce your mortgage debt, and replace it with tax deductible investment debt, while not increasing the total debt beyond a limit that you are comfortable with.**

Those words of caution in mind, there may be people looking for a more aggressive personal finance strategy than just making extra mortgage repayments. This brings us to debt recycling.

The basics of debt recycling are that you make extra repayments to your mortgage, while then borrowing to invest in growth assets. Let's say that you have a $200,000 mortgage on your property, and you have decided that you are comfortable with this level of debt in your personal finance situation. You make extra mortgage repayments and you reduce your mortgage to $190,000. At this point in time you set up a second loan, borrow $10,000 and invest in growth assets, for example shares.

The benefit of the second loan is that it is tax deductible, and you now have an extra asset, being the $10,000 share portfolio. Because you want to keep the proportion of tax deductible debt as high as possible, you would choose to keep the investment loan as an 'interest only' loan.

You then continue to make repayments to your $190,000 mortgage – perhaps at a slightly quicker pace as you also have some income from the $10,000 share portfolio to help you (admittedly it won't be much at this stage, however it will grow over the course of the strategy). Once the mortgage gets down to $180,000 you might then choose to increase your interest-only investment loan to $20,000 and invest a further $10,000 into your share portfolio.

Over time there should be a number of benefits from this strategy:

- You will reduce your mortgage debt, and replace it with tax deductible investment debt, while not increasing the total debt beyond a limit that you are comfortable with ($200,000 in the example above).
- You will build a portfolio of investment assets.
- You will increase your total income as the investment assets provide an additional source of income, allowing you to increasingly pay your debt off faster (keeping in mind that your level of debt doesn't change from where it started with the strategy, so you are not increasing your debt levels or mortgage repayments).
- You are effectively investing regularly into investment assets over time. This means that if markets fall, you have the ability to buy more assets at lower prices.

Final word

Debt recycling is not a new strategy. It might be one that is of interest to the more aggressive investor comfortable with a level of debt in their financial situation, looking to build an investment portfolio over time. It is not without risks, and these should be carefully thought through when considering the strategy.

Even sophisticated investors are falling victim to well-presented investment scams that specifically target the successful and play on areas of current interest.

BY CAROL TAWFIK • EUREKA REPORT • 19 OCTOBER 2016

Investment scammers: Spotting the red flags

It's the investment opportunity we all dream of, to earn money seven days a week, even while we sleep, using an online financial platform that automatically trades securities known as binary options that are linked to different asset classes.

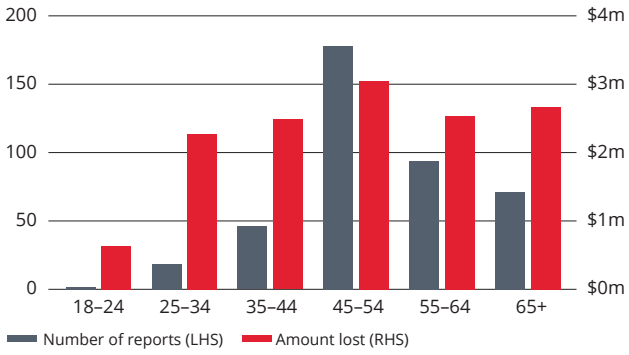
Key Point

- ***There are key warning signs to help you spot scammers, or at least prompt you to proceed with extreme caution.***

In an investment environment where record low interest rates and volatile markets are a fact of life, it's little wonder that even sophisticated investors are being enticed into products offering huge percentage returns.

Within minutes of entering your phone and email details, a salesman will be in contact to get you started on the pathway to riches.

Chart 1: Age group of victims



Source: Scamwatch.gov.au

But these schemes are scams, and the Australian Competition and Consumer Commission estimates that so far this year Australians have lost $3 million to the binary options scammers.

"Although they may be a legitimate financial product with many licensed firms trading in them, binary options are speculative, high risk products that are almost impossible to predict, even for professionals. There are groups of scammers who use binary options to steal your money," says the ACCC on its **Scamwatch** website.

Spotting the red flags can be difficult in the moment however, particularly when the balance of the scenario is quite convincing and plays upon an investor's desires.

Scamwatch reports that in 2015 there was just under $24 million reported as lost in connection with investment related scams, with 2016 on track for similar results. Those figures are almost twice that 2014.

And it's the 45–54 age category that is hit the hardest. Interestingly, and despite the global proliferation of the internet and ability for scam artists to more easily cast a broader net, in Australia telephone remains the dominant method of delivery when it comes to funds reported as lost. This, in addition to promises of higher rates of return in a low interest rate environment, likely goes some way to explaining the also high portion of reports among Australians of retirement age overall.

The big property spruik

Another area which has its fair share of spruikers is property, with Australia's ongoing love affair with bricks and mortar making investors particularly vulnerable. Questionable arrangements sometimes delivered through slick investment seminars have proven to come in various shapes and sizes.

Self-managed super funds' ability to gear into property has opened the door to a host of operators in recent years looking to capitalise on the interest. As such the area continues to draw the Australian Securities and Investment Commission's attention, with one-stop shops doing it all from establishing the SMSF to arranging the property investment and then the loan.

Although it can be an appropriate investment in some circumstances, investors should be wary to ensure that any investment in property – particularly inside superannuation – is in their best interests, aligns with their overall strategy and suits their circumstances.

> **Anyone can fall victim to a questionable scheme as many are exceptionally well presented, specifically target the successful and play on areas of current interest.**

Furthermore, the complexities that surround SMSFs and property investment mean that some may not only enter into mispriced or inappropriate investments for their circumstances but potentially unknowingly breach SMSF rules.

It is therefore important to ask questions, be aware of any conflicts and deal with a licensed advisor who is legally obliged to act in their clients' best interest and who is not remunerated in any way other than by you.

Spotting the fakes

Out of the blue phone calls offering something which sounds too good to be true more than likely will be just that. ASIC's **MoneySmart** cites fake companies with 'not to be missed' investment offers and claims of high returns and low risk as often characteristic.

They may relate to anything from share investments, foreign currency or options trading, betting software, domestic or international real estate, credit – and the list goes on. However, these might not always be easy to spot as it may seem as crafty scammers, often from overseas, continually evolve their methods.

Here are some of the key warning signs that should prompt you to proceed with extreme caution:

- Any cold or unsolicited phone calls – treat with high suspicion.
- Claims that you can earn additional income with very little effort or expertise.
- Claims that the offer is 'limited', provides discounts for early birds or that there is a sense of urgency that a decision needs to be made quickly, if not on the spot.
- Upfront incentives.
- Claims of little to no risk.
- The absence of an Australian Financial Services Licence. Any Australian provider must carry a licence, so it's important to ask questions here. A company based outside of Australia will deliberately be outside the Australian regulator's jurisdiction.

While consumer awareness is on the rise, it is important to recognise that anyone can fall victim to a questionable scheme as many are exceptionally well presented, specifically target the successful and play on areas of current interest.

Deception or misrepresentation can be highly unsettling, with or without financial loss. Recognising that our very nature makes us vulnerable, exercising caution can make all the difference in a successful retirement outcome from a disaster.

If in doubt over an offer's legitimacy or appropriateness for your circumstances, it is critical to undertake research and ensure you have the opportunity to step back and seek independent advice.

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The Australian government has issued $7.6 billion of 30-year bonds, at a yield of 3.27 per cent per annum.

BY PHILIP BAYLEY • EUREKA REPORT • 13 OCTOBER 2016

A 30-year bond, as the bell tolls

For the first time, the Australian government has issued a 30-year bond. Many would argue that this is a coming of age for the domestic bond market.

Key Point

- ***Global bond yields have been rising and markets are acknowledging that the direction of interest rates is upwards.***

For a long time, the government bond yield curve did not extend much beyond 10 years. And indeed, if the then Federal Treasurer, Peter Costello, had got his way, we would have had no government bond yield curve at all, from the early part of this century onwards.

The government was net debt free and Costello was keen to use surplus cash holdings to repay all outstanding government debt. However, the local financial market was in uproar at the proposal.

Without any risk-free assets, how would the market function?

Firstly, there is the problem of how to price riskier debt obligations, when there is not a risk-free benchmark to use. And, secondly, what high-quality bonds could be used for repo transactions with the Reserve Bank?

A then (and possibly still) nascent corporate bond market would have been stillborn.

Fortunately, Costello was persuaded from taking the puritanical high road, and instead used the surplus cash to establish the Future Fund, which has been a great success. And for the government bond market, the decision has seen it go from strength to strength, aided of course, by a simultaneous ballooning in government debt since the GFC.

It is in the post-GFC years that most of a lengthening in the government bond yield curve has taken place. Bonds with terms to maturity of 15 years, 20 years and 25 years, have been progressively introduced, along with other maturities in between.

Now we have a 30-year bond, which brings us into line with other large and developed economies around the world.

For governments, such long-term debt instruments facilitate long-term planning for economic development and ease the task of debt management on a year-to-year basis. For the economy as a whole, it has much the same benefits: development of long-term infrastructure is easier to price and to finance, and long-term liabilities such as life insurance and annuities can be more effectively hedged.

Innovation in new long-term debt products will inevitably follow. Imagine having a 30-year, fixed rate mortgage?

Of course, if we lived in some other countries, it wouldn't be necessary to imagine. But fixing interest rates for 30 years can be an advantage or disadvantage depending on where we are in the interest rate cycle and whether you are a borrower or a lender.

This brings us to the ringing of the bell. Ringing of the bell is a mythical event that occurs when a bull market reaches its peak and it is time to stop buying and start selling.

In this case, does the introduction of a 30-year Australian government bond (coincidentally) coincide with the peak in a global bond market rally that has been going on for just as long?

Interest rates peaked in the late 80s and for the most part have been in decline since then. The declining trend accelerated after the tech wreck in the early part of this century and with the introduction of the Greenspan put.

This was followed by quantitative easing brought on by the GFC and the eurozone crises, and more recently, the move into negative interest rates by the European Central Bank, the Bank of Japan and others, as quantitative easing has failed to stimulate economic growth.

But even as this move is aimed at currency depreciation to stimulate export growth, it has failed, as investment will not take place if positive returns cannot be generated. There is a growing realisation that negative interest rates do not work and only succeed in destroying the profitability of banks and insurance companies.

Global bond markets are starting to acknowledge the likelihood that interest rates have gone as low as they will go and that the longer-term direction is now upwards. The bell may well have been rung: yields globally have been rising for the last month or so.

> **Global bond markets are starting to acknowledge the likelihood that interest rates have gone as low as they will go and that the longer-term direction is now upwards.**

But to underline the excesses of the peaking of the long global bond bull market, at the end of June this year there was $US11.7 trillion of negative yielding sovereign debt on issue around the world, according to Fitch Ratings. It was in this environment that Ireland and Belgium were able to sell 100-year bonds at yields of just 2.35 per cent and 2.3 per cent per annum, respectively, according to a recent report from ANZ.

Moreover, Italy, which may not be too far away from Greece, both geographically and economically, was able to sell €500 billion of 50-year bonds at a yield of 2.8 per cent per annum, against an order book of €18.5 billion!

The bell may well have rung and for the Australian government selling $7.6 billion of 30-year bonds now, at a yield of 3.27 per cent per annum may be the cheapest long-term funding it will see for a very long time.

But the buyers of the bonds may prefer to remain in blissful ignorance, rather than consider where just 10-year Australian government bond yields were 30 years ago, in the late 1980s.