



Weekly Review

WEALTH

3 NAB THROWS A LIFELINE

4 SMSF ASSETS TOP \$650 BILLION

6 THE RUSH TO JUNE 30 BEGINS

7 INVESTORS GAIN AMID RESIDENTIAL PAIN

– Issue –
24 Feb.
2017

The introduction of a 30-year Australian Government bond seems to have coincided with the peak in a global bond market rally that has been going on for just as long.

BY PHILIP BAYLEY • EUREKA REPORT • 24 FEBRUARY 2017

Ring the bell after a 30-year rally

Following the issue of the first 30-year bond by the Australian Government in October last year, **we asked** whether the action symbolised a coming of age for the Australian bond market or a ringing of the bell to signal the end of a 30-year global bond market rally.

Key Point

- **Markets are acknowledging that the direction of interest rates is upwards, to the detriment of owners of long-term bonds.**

It is likely that the issue did symbolise a coming of age for the domestic bond market, the significance of which should become more apparent as time goes by, but there is also mounting evidence that we were indeed hearing a bell being rung.

There were other momentous events at the time that pointed to the last hurrahs of a global bull market for bonds.

At the end of June last year there was \$US11.7 trillion of negative yielding sovereign debt on issue around the world, according to Fitch Ratings. But since then bond yields have been trending upwards and by the end of December, Fitch reported negative yielding sovereign debt had reduced to \$US9.1 trillion.

This is still a very large sum but a trend is becoming apparent.

In an environment of increasing negative yields on sovereign bonds Ireland and Belgium, in the first half of 2016, were able to sell 100-year bonds with coupons of just 2.35 per cent and

2.3 per cent per annum respectively. And in the same month that Australia issued its first 30-year bond, Italy was able to sell €5 billion of 50-year bonds with a coupon of 2.8 per cent per annum, against an order book of €18.5bn!

Both deals have since gone south.

The 30-year Australian Government bonds sold by AOFM had a face value of \$7.6bn and were sold at a yield of 3.27 per cent per annum. The bonds were trading in the secondary market at a yield of 3.79 per cent last week.

This means that investors who bought the bonds at issue are now nursing a 15 per cent capital loss. Ouch!

Investors in the Italian 50-year bonds have not fared any better and those that missed out on buying the bonds didn't have to wait long to realise that they were, in fact, the lucky ones. In less than a month after the sale, the bonds had lost 14 per cent of their capital value in the secondary market as investors began to fret about the outcome of the yet-to-be-held referendum on constitutional change.

Investors feared political upheaval if the referendum was unsuccessful. It was unsuccessful and Italy's then prime minister, Matteo Renzi, resigned, leaving a caretaker to run the government until elections can be called.

And in the meantime, the Italian Government has had to grapple with a growing non-performing loan problem among

Continued on page 2 ...

ARTICLES	PAGE	IMPORTANT INFO
NAB throws a lifeline	3	DISCLAIMER This publication is general in nature and does not take your personal situation into consideration. You should seek financial advice specific to your situation before making any financial decision. Past performance is not a reliable indicator of future performance. We encourage you to think of investing as a long-term pursuit.
SMSF assets top \$650 billion	4	COPYRIGHT © InvestSMART Publishing Pty Ltd 2017. Intelligent Investor and associated websites and publications are published by InvestSMART Publishing Pty Ltd ABN 12 108 915 233 (AFSL No. 282288).
The rush to June 30 begins	6	DISCLOSURE Staff own many of the securities mentioned within this publication.
Investors gain amid residential pain	7	
Potential in iron ore's dash to quality	10	
Starting early: Financial literacy lessons for children	12	
Tax with Max: More pension cap questions	14	
Diamonds might not be forever for Rio Tinto	16	

Continued from page 1 ...

Italy's largest banks that threatens to evolve into a systemic crisis.

The 50-year Italian bonds were trading at just 81.5c in the euro last week, and a week earlier had been trading at 79.25c.

Thirty years, and indeed 100 years, is a long period of time and anything can happen before bonds with such terms to maturity come due to be repaid. But it is very unlikely that anyone who bought the bonds at issue will be there to collect when they mature, the bonds will have to be sold at some point and a capital gain, or loss, will be realised.

In the short term, more capital losses appear assured for holders of the Australian and Italian government bonds in question. While the official cash rate in Australia may remain at 1.5 per cent per annum throughout this year, the US economy appears to be picking up steam and US Federal Reserve Chairman Janet Yellen last week signalled that the next increase in the Fed Funds rate may be just a month away.

As a capital importing nation, bond yields will inevitably rise in Australia as yields increase in the US.

As for investors in the Irish and Belgian 100-year bonds, they face the same prospects. Ireland and Belgium are price takers and not price makers, too. And then there are all of the uncertainties that are confronting the eurozone.

Brexit needs to be negotiated and elections are looming in France, Germany and the Netherlands, in which right wing nationalist, anti-euro parties may emerge victorious. Marine Le Pen, leader of the National Front in France, has already threatened to exit the euro and reintroduce the French franc.

And then, in 2018, a fourth bailout of Greece will be due and the prospect of 'Grexit' will re-emerge as Greek Prime Minister Alexis Tsipras is already threatening. This assumes, of course, that the European Union and the eurozone are still intact by then.

A moderating force on rising bond yields may be a surge in demand for German bunds and US government bonds.

Dr Philip Bayley is a former director of Standard & Poor's and now works as an independent consultant to debt capital market participants. He is associated with Australia Ratings.

NAB's new ASX-listed subordinated note issue could be a trigger point for the other big banks with maturing subordinated debt to launch new issues into the retail market.

BY PHILIP BAYLEY • EUREKA REPORT • 17 FEBRUARY 2017

NAB throws a lifeline

Just two days after providing its first quarter trading update to investors, and flagging the possibility of a new ASX-listed note issue at some time in the first half of this calendar year, NAB has announced an ASX-listed subordinated note issue.

Key Point

- ***Our relative value model suggests the notes would trade in the wholesale market at a spread of 219bps. Thus the return being offered can only be said to be fair.***

In doing so, NAB threw a lifeline to a section of the ASX-listed debt securities market that was looking likely to shrink to little more than a quarter of its current size before the end of this year.

NAB has \$1.17 billion of ASX-listed subordinated debt (NABHB) due to be redeemed on June 18. ANZ has \$1.5 billion of subordinated debt (ANZHA) due to be redeemed two days later, and Westpac has nearly \$1.7 billion of subordinated debt (WBCBA) falling due in August.

In addition, CBA subsidiary, Colonial Holding Company Limited, has \$1.0 billion of subordinated debt (CNGHA) due to be redeemed on March 31. For the last four weeks it has been expected that CBA would announce the redemption of the notes and a new issue of higher-risk hybrid notes.

But no announcement was made when the CBA advised the market of its interim results on Wednesday, and now an announcement seems unlikely. If the subordinated notes are to be redeemed that will be \$1.0 billion of securities that will leave the subordinated note sector of the listed debt securities market.

Until NAB made its surprise announcement, it had been expected that the other major banks would also redeem their subordinated notes on the due dates. Rolling over debt in the listed market is expensive given prospectus requirements and the banks have been raising subordinated debt in wholesale markets since 2013.

However, NAB has recognised the value of maintaining access to the retail investors that the ASX-listed debt securities market provides. Wholesale debt markets can close very quickly without warning, thus it is wise to have alternative markets available.

There is now a very good chance that ANZ and Westpac will follow NAB's example. CBA may even follow with a new subordinated debt issue at a later date.

NAB's issue details

As for the details of NAB's new NAB Subordinated Notes 2: the bank has raised \$800 million through the bookbuild conducted earlier this week for the Basel III compliant, Tier 2 capital. To qualify as Tier 2 capital the notes will pay cumulative coupons that must be deferred if the bank is not solvent before and after a coupon is due to be paid, and the notes will convert into ordinary equity in the bank if APRA declares the bank to be non-viable.

The size of the issue will be larger when the take-up from existing NAB security holders is known along with the size of the rollover by NABHB note holders. An issue size north of \$1 billion is expected.

The credit margin to be paid on the notes has been set at 220bps over the 90-day bank bill rate. And the notes will have a longer-than-usual 11.5 years term to maturity, and thus will be callable after 6.5 years.

From an investor's perspective, the structural characteristics of the Subordinated Notes 2 do not make the notes an automatic replacement for the current subordinated notes. The current notes are old-style Basel II subordinated notes with coupons that must be paid, no convertibility into ordinary equity, and 10-year term to maturity, callable after five years.

Moreover, the current NABHB subordinated notes pay a coupon of 275bps over the 90-day bank bill rate. But the level of compensation required for risk etc. varies over time, so is the proposed credit margin for the new subordinated notes fair value?

Our relative value model suggests the notes would trade in the wholesale market at a spread of 219bps. Thus the return being offered can only be said to be fair.

The offer opened yesterday (Thursday, 16 February) and is available to all NAB security holders, sponsoring broker clients and institutional investors by invitation. There is no public offer.

Holders of the NABHB notes can elect to rollover all or part of their holding into the new notes, which will trade on the ASX under the ticker NABPE.

New APRA data shows strong capital inflows into self-managed super funds.

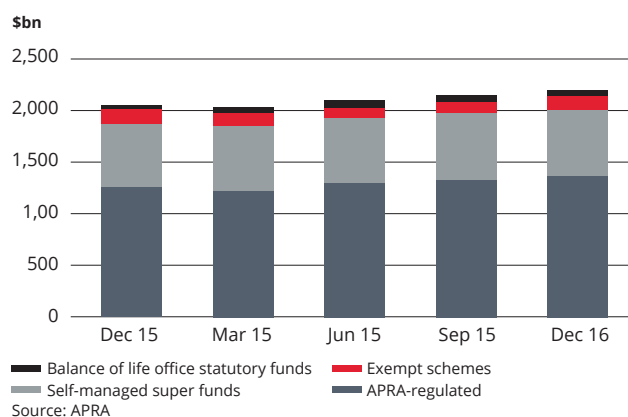
BY TONY KAYE • EUREKA REPORT • 21 FEBRUARY 2017

SMSF assets top \$650 billion

Self-managed super fund assets accelerated more than 8 per cent in 2016, breaking through \$650 billion for the first time, according to new data from the Australian Prudential Regulation Authority.

Total SMSF assets increased by more than \$50 billion in the 12 months to \$653.8 billion, which is equivalent to around a third of the \$2.2 trillion total pool of superannuation assets.

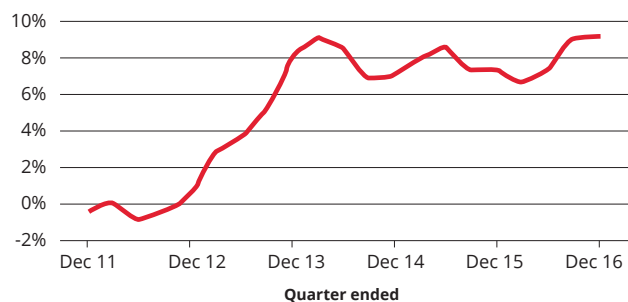
Chart 1: Assets of superannuation entities



APRA's data chiefly relates to superannuation assets held in larger regulated super funds, which it filters by limiting its key statistics to super funds with more than four members.

But there are also key lessons in there for SMSF trustees, particularly in terms of investment returns and asset allocation.

Chart 2: Five year average annualised rate of return



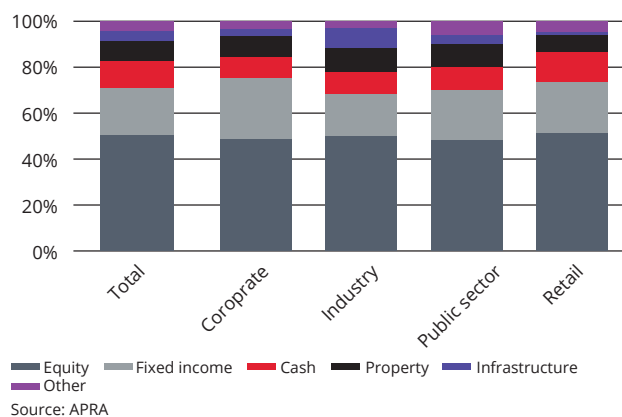
The latest data shows the annual industry-wide rate of return (ROR) for entities with more than four members for the year ending December 2016 was 6.8 per cent. The five-year average annualised ROR to December 2016 was 9.2 per cent.

Over the December 2016 quarter, total assets in the larger funds increased by 2.7 per cent (or \$39.7 billion) to \$1.5 trillion.

Broken down, APRA's data shows that asset allocations in equities are almost equally split between Australian and international stocks.

As at the end of the December 2016 quarter, 50.2 per cent of the \$1.5 trillion investments were invested in equities; with 23.4 per cent in Australian listed equities, 22.2 per cent in international listed equities and 4.5 per cent in unlisted equities.

Chart 3: Asset allocation (as of Dec 2016)



Fixed income and cash investments accounted for 32.5 per cent of investments; 20.4 per cent in fixed income and 12.1 per cent in cash.

Property and infrastructure accounted for 13.4 per cent of investments and 3.8 per cent were invested in other assets, including hedge funds and commodities.

“Overall super fund returns fell by 0.1 per cent in January, according to separate data from superannuation research and ratings firm Chant West.

Meanwhile, after a strong finish to 2016, overall super fund returns fell by 0.1 per cent in January, according to separate data from superannuation research and ratings firm Chant West, with Australian shares slipping 0.8 per cent and international shares down 2.4 per cent in unhedged terms.

Watch our exclusive interview with Chant West director, Warren Chant, where he talks about the latest investment returns and trends.

“The flat result in January doesn’t come as a great surprise after the unexpectedly strong showing in 2016,” Chant said.

“The median growth fund return of 7.5 per cent for 2016 was nearly 6 per cent above inflation. That’s well above the typical long-term objective of inflation plus 3.5 per cent and much better than what most asset managers expected, given that we’re in a lower return, lower growth environment and most asset sectors are fully or close to fully valued.”

Contribution levels from SMSF trustees soared in the December quarter, while pension benefits also increased.

BY BRUCE BRAMMALL • EUREKA REPORT • 21 FEBRUARY 2017

The rush to June 30 begins

Self-managed super fund members are gearing up for a last hurrah on higher contributions limits.

Contribution levels soared in the December quarter as legislation was passed and uncertainty subsided. Contributions jumped 181 per cent to \$8550 per fund, according to data released this week.

Key Point

- ***Members have one last chance to get in \$35,000 in concessional contributions if they are over 50 and \$30,000 for the under-50s. From July 1, all members will be restricted to a maximum CC limit of \$25,000.***

It followed a heavy drop in the September quarter – the worst quarter for contributions in years. Not surprising, given the complete lack of confidence in what would, or wouldn't, get through of the Turnbull Government's super revamp.

Contributions countdown

Expectations are that there will be a big lift in contributions over the four months to the end of this financial year, as people look to use, for the last time, higher concessional and non-concessional limits ahead of July 1.

Members have one last chance to get in \$35,000 in CCs if they are over 50 and \$30,000 for the under-50s. From July 1, all members will be restricted to a maximum CC limit of \$25,000.

For many, making the maximum contribution will be a no-brainer. For others, it will be worth making the sacrifice this financial year knowing that the option won't be open next financial year.

And NCC limits will also drop. They are \$180,000, or \$540,000 under the three-year pull-forward rule for this financial year, dropping to \$100,000 and \$300,000 next. But further, members will not be able to make NCCs once they have hit a total super balance of \$1.6 million.

Pension benefits also increased during the final quarter of calendar 2016. This was potentially for two reasons. The first was trying to reduce balances ahead of the new age pension eligibility requirements that came into force in January. The second was potentially for recontribution strategies. These strategies will be less effective, or harder to use, come July 1.

Also to this end, member payments changed considerably

during the quarter. The percentage of income to lump sum payments changed from 89.2/10.8 per cent to 81.9/18.1 per cent.

Low-cost audit 'concerns'

The Australian Tax Office has also completed an interesting survey. When the ATO does surveys, they are generally for a specific reason. And they often come with lessons.

And this one is no exception.

The ATO surveyed SMSF auditors. But not all of them. Specifically, the 'cheap' end of town. Cheap was defined as an audit conducted for \$400 or less.

And those charging that amount showed some serious concerns, according to ATO commissioner Chris Jordan.

"No great surprise, we have found cases of concern where they've failed to conduct any sort of adequate audit that complies with any of the standards," Mr Jordan said.

"They have no written audit plan or representation letters from trustees, all the things you would expect to be done, and we have taken action there," he said.

Around 9 per cent of SMSFs are being audited by low-cost auditors, the ATO said.

If you're one of them ... you need to question why you are using a low-cost auditor, particularly if it is likely to bring you unwanted attention from the ATO.

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 advisor/s, as some of the strategies used in these columns are extremely complex and require high-level technical compliance.

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](#).

Housing affordability is a hot-button issue, but proposed policy responses won't weigh on investors.

BY CALLAM PICKERING • EUREKA REPORT • 22 FEBRUARY 2017

Investors gain amid residential pain

Residential property is not only a key component in the portfolios of thousands of Australians, representing over half of household wealth, but it's also a key mechanism through which monetary policy affects the broader economy.

Key Point

- ***Investors should be unperturbed – even encouraged – by proposed responses to Australia's housing affordability woes. But they might want to consider other dynamics in the residential property space, such as debt levels and credit streams.***

Individual investors mainly concern themselves with the profit and loss on their investment properties, the yield they can earn and whether they will take advantage of negative gearing. The Reserve Bank of Australia, by comparison, has a much broader interest in the health of Australia's \$6.2 trillion property sector.

We know that Australian households are among the most indebted in the world. We also know that Australian house prices are expensive by global standards. But is this cause for concern?

Newly minted RBA assistant governor Luci Ellis gave an interesting and far reaching **speech** on 'Housing and Inequality' last week in Melbourne. Housing affordability, a key part of any discussion on inequality, has been a key political issue in recent years and Ellis offers some insight into both prices and debt.

When it comes to analysis on the housing market it is quite common for analysts to refer to 'median' or 'average' outcomes, but those are often uninteresting or misleading. The systemic risks associated with housing never come from the median or average household. Similarly, housing affordability is not often a concern for the median or average household.

Ellis focuses on the distribution behind property prices, ownership and debt. If knowledge is power, then an understanding of the forces behind the property market is an important tool for the savvy property investor.

From the outset it should be made clear that Ellis' speech refers mainly to home ownership rather than investors, per se. However, since the family home represents the biggest and

most important investment for most households I think the analysis warrants some consideration even if Ellis doesn't address investment housing directly.

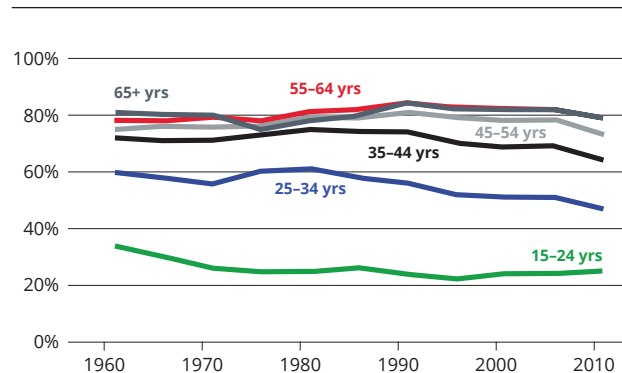
It may also have some relevance since many readers may be thinking about helping their children buy their first home or investment property.

A policy vacuum

Home ownership rates have fallen for most age groups over the past three decades. The decline has been most pronounced among those between the ages of 25 and 44 years of age. This is the group for whom housing affordability has the most relevance; they are the group that is likely to have just entered or is planning on entering the housing market.

Available data suggest that home ownership rates have fallen further since the 2010 Census. Chart 2 based on data from the Household, Income and Labour Dynamics in Australia (HILDA) Survey, indicates that ownership among 25–34 year-olds has fallen below 40 per cent, while ownership among 35–44 year-olds has dropped to below 60 per cent.

Chart 1: Home ownership and age*
Share of households in each group



* Based on a special request tabulation of Census data
Source: ABS; Yates (2011) via rba.gov.au

Ellis isn't particularly concerned about this development, noting that "many people wait to settle down before they buy a home". Certainly the Federal Government doesn't appear too concerned despite the occasional lip-service.

Federal MP Michael Sukkar, charged with finding solutions to housing affordability issues, recently said that young people needed to get a "highly paid job". It echoes comments made by former treasurer Joe Hockey. Unfortunately, that is an

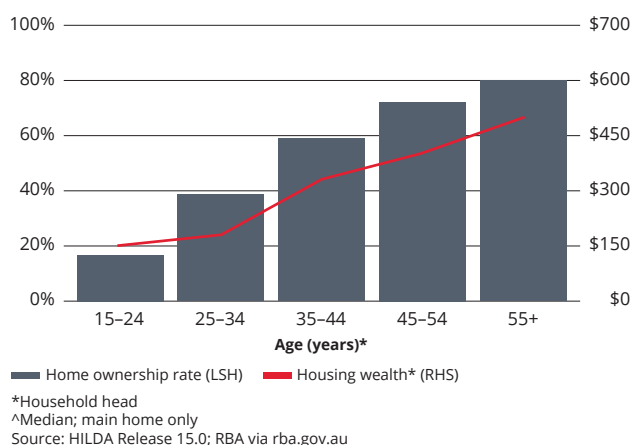
“The data on deposits suggests that the average loan-to-valuation ratio for first home buyers has actually declined somewhat in recent years.

oversimplification and an unhelpful one in an environment where full-time employment is falling and wage growth is at its lowest level in a quarter century. Australian wages are some of the highest in the world and that has done little to reduce ownership rates among younger people.

Details are scarce, but some MPs are urging the Federal Government to pursue ‘affordability’ measures that could actually prove lucrative for existing owners and property investors.

The proposal to allow young Australians to access their superannuation to fund a deposit is straight out of the first-home buyers’ handbook. It will push prices higher across the board and encourage younger Australians to take on more debt. It wouldn’t help housing affordability, since it would create artificial demand, but it would be beneficial for existing home owners and investors.

Chart 2: Home ownership and housing wealth, by age group, 2015 sample



Meanwhile, the MPs propose allowing retirees to downsize their existing home without affecting the assets test for the purpose of receiving the aged pension. For asset-rich retirees this would prove lucrative.

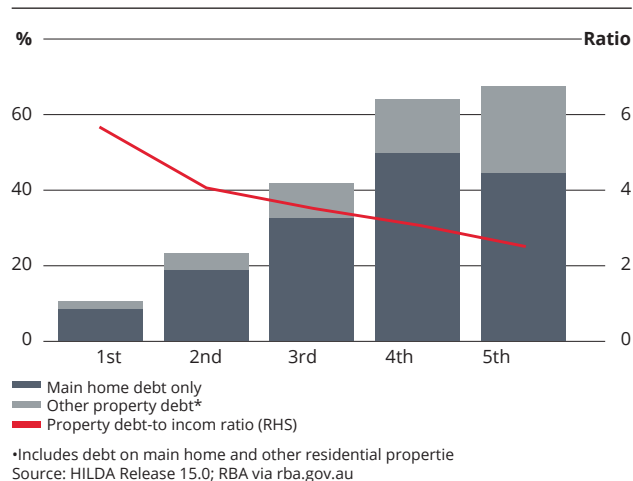
Debt-to-income considerations

Returning to Ellis there is, however, good news for those concerned about the level of household debt. Household debt is undeniably high, but it is generally held by higher income earners. High house prices, by crowding out first home buyers, have ensured that those in the housing market

are often well placed to manage their mortgages.

Chart 3 also shows that the highest income earners tend to be those that also hold ‘other’ (or investor) property debt. These loans are frequently ‘interest-only’ and are considered riskier than standard loans – though lucrative for investors – so it is comforting that those taking on these loans are well placed to manage such risk.

Chart 3: Households with property debt (mean, 2014 sample)



Nevertheless, property debt-to-income tends to be higher for lower income households. They may not hold as much debt but there is greater risk of default associated with that risk.

Deposit blues

“Much of the commentary around the difficulty of achieving home ownership centres on the task of accumulating the deposit,” said Ellis.

This isn’t exactly true. The biggest issue with housing affordability is raising a deposit, but the commentary largely focuses on whether it is difficult or not to pay interest. Even the RBA, via its regular charts and updates, focuses on interest payments rather than deposits.

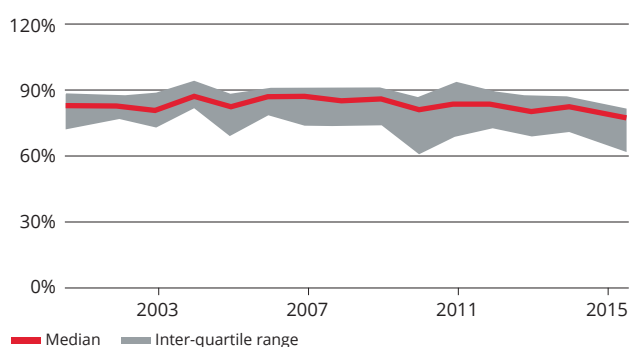
The data on deposits suggests that the average loan-to-valuation ratio for first home buyers has actually declined somewhat in recent years. That is, first home buyers are entering the market with higher deposits than they have in the past.

“Rising house prices have surely put a smile on the faces of many property owners but that is balanced against tighter regulatory conditions and lending standards and recently out-of-cycle mortgage rate hikes.”

“It’s not entirely clear why this is,” said Ellis. “And because a high loan-to-valuation ratio does imply higher risk both for the borrower and the lender, it might not be such a bad thing.”

Increasingly first home buyers are relying on the bank of mum and dad to put their deposit together. Although the share of first home buyers receiving direct help is relatively low I’d expect that has increased in recent years due to the large rise in house prices in Sydney and Melbourne.

Chart 4: First home buyer loan-to-valuation ratio*



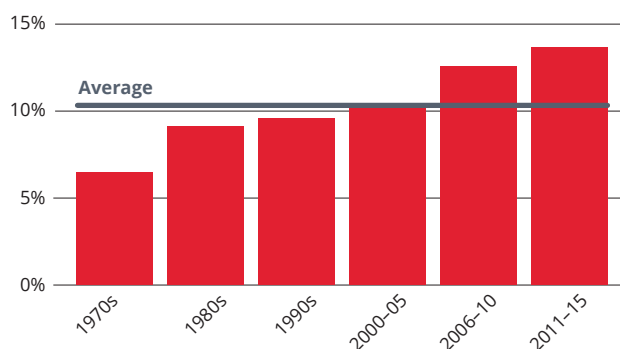
*Initial mortgage size divided by purchase price except for 2015
Source: HILDA Release 15.0; RBA via rba.gov.au

I have maintained for some time that the current environment is an interesting one for home owners and investors. Rising house prices have surely put a smile on the faces of many property owners but that is balanced against tighter regulatory conditions and lending standards and recently

out-of-cycle mortgage rate hikes by the major and minor banks.

Ellis doesn’t appear particularly concerned by developments in home ownership or the accumulation of debt. There is certainly a social or composition aspect to these developments, particularly in how they have evolved over the past two decades. Yet, more recently, it has become difficult to see how price growth has been consistent with wages or economic activity.

Chart 5: First home buyers that received loan from family or friends (share of all first home buyers)



Source: HILDA Release 15.0 via rba.gov.au

Investors obviously need to make that assessment as well. The analysis by Ellis should bring some comfort; as would the policies discussed by the Federal Government that are unlikely to address affordability and may, in some cases, push property prices higher.

BHP and Rio's blended ore will continue to meet most of the demand from Asian steel mills, but the demand for higher-grade ore will continue to rise.

BY TIM TREADGOLD • EUREKA REPORT • 21 FEBRUARY 2017

Potential in iron ore's dash to quality

Size matters in the iron ore industry, but so does quality. And if the current high level of demand continues for premium quality ore, then a door will be opened for small mines with high-quality ore to get back into business.

Key Point

- ***Winners from this increasing preference for quality over quantity include Atlas Iron and Mount Gibson Iron, as well as magnetite projects.***

China is the key to what's happening because, rather than buy ore of whatever grade is available, the preference has swung decisively towards material with a high iron content and a low level of impurities to help meet government orders to cut pollution in the smelting process.

The dash for quality is a reminder that in mining 'ore-grade is king', a point that can also be seen in demand for Australian metallurgical coal, the world's best steel-making coal.

This swing to quality over quantity is a reversal of how Australia's two most important export industries have been treated over the past 20 years – but it also represents a return to how both started in the 1960s with Japan seeking premium iron ore and coal for its one-time world-leading steel industry.

Back then it was Japan that discovered it had a steel-industry pollution problem, which is one reason why its steel mills bankrolled the start of the world-class iron ore mines in the Pilbara region of Western Australia. The original projects, such as BHP Billiton's Mt Whaleback mine at Newman and the Paraburdoo mine of Rio Tinto, delivered super-premium lump ore assaying 65 per cent iron and better.

Today, the average grade of ore from the operations of BHP and Rio is closer to 55 per cent, a result of mixing lower-grade ores with the best of the remaining lump ore to achieve a blended product that meets steel-mill specifications, and the enormous quantities demanded.

The 'Pilbara blends' of BHP and Rio are similar in composition to the material delivered by the third big producer, Fortescue Metals.

Blended ore will continue to meet most of the demand from Asian steel mills but there is also a hunt underway for more of the 65 per cent ore that launched the Pilbara iron ore industry and which has recently returned as a preferred ore for the steel-making process, even if it attracts a premium price.

For long-term followers of the mining industry, what's happening today in iron ore is a reminder that it is always the best ore which produces the highest profits, simply because the more metal in an ore the more cash it can generate and the less waste material that has to be dumped.

The great ore shift

Rio chief executive, Jean-Sebastien Jacques, picked up the quality over quantity theme last week after releasing his company's annual profit result, saying that Chinese Government policy was driving a shift from low-grade iron ore to higher grade material.

"It is absolutely clear that the Chinese Government is pushing hard to restructure high-polluting blast furnaces and therefore reduce capacity, but when you look at what would happen, it would remove the low productivity, high-polluting blast furnaces in order to drive the productivity of the best blast furnaces, and in that sense it would be an opportunity for us because we would see a switch from low-grade ore to higher-grade ore," Jacques said.

Boiled down, Jacques was effectively saying what every miner already knows: 'grade is king'.

The Chinese-led change in demand for premium quality iron ore could have a profound effect on the Australian mining industry, putting some projects under pressure because of grade and/or impurity problems forcing the operator to accept a price discount, while high-quality mines are paid a premium price.

Winners from this increasing preference for quality over quantity include Gina Rinehart and her Roy Hill mine, which produces ore grading more than 55 per cent iron content but has the added appeal of low impurities which attract a discount because of their potential to affect the quality of steel.

“The dash for quality is a reminder that in mining ‘ore-grade is king’, a point that can also be seen in demand for Australian metallurgical coal, the world’s best steel-making coal.

A boost for magnetite

Two other potential winners from the drive for quality are two magnetite processing plants operated by Chinese companies in WA, the Karara project which has ASX-listed Gindalbie Metals as a minority partner, and the Sino Iron project which is locked in a long-running legal dispute with one-time member of the Australian Parliament, Clive Palmer.

Widely dismissed as unprofitable and ill-timed adventures in iron ore processing because of high initial construction costs and extensive (and expensive) processing, the magnetite projects take ore grading less than 40 per cent iron and convert it into a super-premium product assaying up to 68 per cent iron with significantly lower levels of impurities; thanks to the processing which removes damaging silica, phosphorous and alumina from the end product.

A hint as to how well the magnetite processors are performing after years on the sidelines can be found in the share price of Grange Resources, a Tasmanian magnetite processor delivering material grading around 67 per cent iron. Over the past eight months, Grange’s share price has risen by 200 per cent from 8c to 26c.

Small by conventional iron ore industry standards Grange is producing around 2.5 million tonnes of finished product from its Savage River project and, like the two magnetite mines in WA, is Chinese owned – a reflection of China’s hunt for high-quality, low-polluting, ore.

Other small producers of high-quality ore are enjoying a similar uplift as Grange, as was pointed out in my latest *Minefield* column (*[Small ore rising](#)*, February 1) with Mount Gibson Iron moving closer to a decision on redeveloping the mothballed Koolan Island mine off WA’s Kimberley coast, and Atlas Iron proceeding with the development of its Corunna Downs project.

If Koolan Island gets a green light it will neatly link the past with the present because what’s happening in today’s hunt for high-grade ore is similar to what happened in the 1940s when the island supplied BHP’s Australian steel-making business into the 1960s, with its high-grade ore a winner with Japanese steel mills – until it was overpowered by the massive volumes of ore generated by mines in the Pilbara.

The bulk of Australia’s iron ore exports will remain the 55 per cent blended material of the big miners as they seek to deliver a product of uniform quality to make steel-making easier.

The downsides of high-grading

But the demand for higher-grade ore will continue to rise as China tightens its environmental pollution laws – and that could revive a debate as old as the iron ore industry itself: will Australia be forced to ‘high-grade’ its iron ore deposits to satisfy customer demands.

High-grading in the mining industry can be the cause of premature closures because it is a process which involves extracting the best material first, leaving lower-grade ore behind which might not be commercially viable to mine.

Avoiding high-grading is one reason why the big iron ore miners adopted their ore-blending strategy to extend mine life, and why Chinese investors opted to develop the vast quantities of low-grade magnetite ore.

Blending and magnetite processing are in the long-term interests of the Australian economy. High-grading is not, though it does represent a way for small miners to get back into production after being sidelined during the three-year iron ore downturn.

Learning financial literacy from a young age is likely to lead to a more satisfying life and ultimately less stress.

BY CAROL TAWFIK • EUREKA REPORT • 23 FEBRUARY 2017

Starting early: Financial literacy lessons for children

Few will disagree that financial literacy skills are a major component of a successful and secure adult life. Parents undoubtedly want to raise financially empowered young people who can take their steps into adulthood with confidence and who have the ability to make good investment decisions to achieve their dreams.

Key Point

- *Many technologies can supplement the delivery of a message in an engaging manner.*

So should money matters be left to accidental learning or conscious parenting? Research tells us that parents are a child's key educator when it comes to their own future money habits and should be keenly aware of the role that they play. While many may feel they lack the tools, insight or the confidence when it comes to a deliberate approach to financial learning, the good news is the opportunities to make a real positive impact are broad and can start anytime with conversation.

Why it's important

The American Psychological Association's [research](#) continues to recognise money as the most cited source of stress. While sources of financial stress can be broad, prevention is always the best antidote. Entering adulthood with decision-making confidence can have a huge compounding effect when the impact of time is factored into the equation. It is a truly valuable foundation from which to leapfrog. Good decision making and participation in investment early on can lead to a more satisfying life and ultimately less stress.

When we think of financial literacy learnings for children and young people, the mind likely goes to a picture of a piggy bank and perhaps several piles of carefully stacked coins. Concepts such as budgeting, goal setting, saving and being prepared for a rainy day are, of course, essential core learnings for adult life which parents often deliver via pocket money.

The scope of financial literacy can certainly also extend well beyond the traditional concepts when really taking stock

of daily decision making – how we assess value, prepare for unforeseen events, exercise social responsibility, understand our consumer rights and translate global economic events are some examples. Below is some further food for thought:

1. Navigating a complex landscape

Financial literacy is vitally important, perhaps now more so than ever, as the financial landscape continues to evolve (the range and complexity of financial products and services is ever widening). This can demand a higher base level of understanding in a range of financial contexts. Age appropriate discussion with kids around things like conflicts of interest, assessing value and influence-advertising can be important in an environment where choice seems only to be increasing. Spending time talking about the importance of seeking out relevant information, comparing alternatives, knowing what questions to ask and where best to ask can add to real life insight. I wrote [here](#) recently about research which indicated that of people who had sought financial advice, the majority looked to friends and family primarily. Achieving better outcomes and net results might mean paying for professional unconflicted services, so identifying trustworthy sources of information or advice can also form part of the learning.

2. Using technology

A strong school of thought suggests children may better grasp the value of money when dealing with actual cash rather than money in the digital form. Young people today will undoubtedly be part of an increasingly digital world, so embracing technology in teachable moments may be far more relevant. The great news here is that the opportunities are aplenty. Using an online savings account for the savings portion of pocket money will allow children to grasp banking concepts and applications and see compound interest at work. Involving children in online grocery shopping creates great opportunities, for example, in working closely to a budget and differentiating between needs and wants. Furthermore,

“ Instead of financially rewarding them for two or three hours of potentially half-hearted effort, instead reward the completed ‘job’.

there are plenty of mobile apps (some specifically designed for children) and online calculators with great visual outputs. From working to a saving goal to illustrating the effect of discipline through the magic of compound interest, many can really effectively supplement the delivery of a message in an engaging manner.

3. Being business savvy

Financial literacy will also encompass awareness around the entrepreneurial and vocational sense. As the landscape continues to evolve, kids of today will need to demonstrate their worth and competitiveness in employment or business as they enter into adult life. Attaching a bargaining value to household chores can be problematic when most homes likely expect everyone to ‘chip in’ and do their bit to some extent. The concept that work provides money is easy enough for most children to grasp. However, when it comes to wanting to earn extra dollars, encouraging children to assess and consider the value they can offer, as well as to negotiate and put forward their case, may be a small step in preparation for

their real-world realities. Instead of financially rewarding them for two or three hours of potentially half-hearted effort, instead reward the completed ‘job’.

Financial learning can be a lifelong process that often starts with responsible management of pocket money. As parents look to prepare children as best they can for the real world, thinking broadly about what financial literacy and competence means simply starts with more conversation and the recognition of role parents play as key influencers. The more age-appropriate knowledge and hands-on experience children accumulate in a broad set of contexts the better their future behaviors and, in turn, the higher their confidence to participate, get better outcomes and achieve lower-stress lives.

Carol Tawfik is a Certified Financial Planner and advisor with Affinity Private.

The legislators have thought of everything when it comes to assessing whether someone will exceed the \$1.6m pension limit.

BY MAX NEWNHAM • EUREKA REPORT • 23 FEBRUARY 2017

Tax with Max: More pension cap questions

Q. I don't understand the concept of selling shares to crystallise capital profits prior to the introduction of the \$1.6 million cap. Why would this need to be done, as the shares are shown at their market value each year and as a result the gains have already been recognised?

A. Just because the shares held in an SMSF are shown at their market value each year does not result in the gain being recognised for tax purposes. The increase or decrease in the market value of shares results in an unrealised gain or loss that does not affect the tax paid by a super fund.

This means if the shares in your fund had a cost of \$500,000, and over time have been revalued to a market value of \$1m, your fund has unrealised capital gains of \$500,000. The strategy to sell shares while still in pension phase, before assets are allocated to an accumulation account due to exceeding the \$1.6m pension transfer cap, would result in a tax-free gain being made.

Thankfully, the legislators when drafting the legislation introducing the \$1.6m pension transfer balance cap included capital gains tax concessions. The CGT concessions mean, where a member has to transfer assets back to accumulation to reduce their pension account balance to below \$1.6m, the member can choose to have the value of the assets reset to their market value at that time.

This means the strategy of selling shares while still in pension phase is not necessary. As a result of the CGT concession, the shares in a fund transferred back to accumulation will have protected any unrealised capital gain that has built up over the time the shares were held.

Q. I am not sure how an SMSF should process the Transfer Balance Cap and Transfer Balance Account? For the accumulation account receiving the excess over \$1.6m, are we expected to have a different HIN and separate cash holding account? Given that segregation ends on June 30, I am presuming that the old system of having an accumulation sub-account under the main pension account is no longer acceptable.

A. There are no extra actions that trustees need to take when assets are transferred back to an accumulation account due to a member exceeding the \$1.6m limit. Just because a fund has been in pension phase for many years there is nothing stopping the excess being commuted back to a new accumulation account set up to receive the excess.

There will not be a need to change share registrations such as a HIN, and also there will be no requirement to set up a new bank account that would be linked to the accumulation account. Super funds have always been able to have members in both accumulation and pension phase.

Because SMSFs with a member that has exceeded the \$1.6m cannot use the segregation method, this requires them using the proportional method. Under the proportional method an actuary calculates what portion of the income each year relates to the pension accounts and what relates to accumulation accounts.

Q. I receive two pensions from my SMSF. One is account based and the other is a market linked pension with an initial term of 20 years. I am now halfway through that term meaning that, in the current financial year, the payment factor will be 9.0. How will my market linked pension be valued for the \$1.6m cap?

A. The legislators have thought of everything when it comes to assessing whether someone will exceed the \$1.6m pension limit. For lifetime pensions the annual pension receivable is multiplied by 16 to arrive at a value for the pension limit.

For market linked pensions the value is calculated by multiplying the annual pension receivable by the number of remaining years for the defined benefit period, rounded up to the next whole number. This means in your case if your pension will be \$100,000, and with 10 years to go, the value of your defined benefit pension for the \$1.6m pension limit will be \$1m.

Q. My wife and I have equal 'proportions' in our SMSF and are both in pension phase. The assets of the fund consist of a

“ Thankfully, the legislators when drafting the legislation introducing the \$1.6m pension transfer balance cap included capital gains tax concessions.

share portfolio, a corporate bond portfolio and cash. Because I also have another pension, to comply with the \$1.6m transfer balance cap, I will have to roll back from my pension account to accumulation one-third of the SMSF assets.

Rather than complicate matters by trying to identify individual assets to roll back to accumulation, can we simply say that a ‘proportion’ – i.e. one-third – of all the assets are rolled back?

On June 30, 2017, would we need to reset the cost base for CGT on all shares and bonds that have made a capital gain, recognising that when an asset is sold one-third of any subsequent capital gain will be subject to CGT? Of course a third of all income will be subject to 15 per cent tax. Also, will we need an actuarial certificate for this year and subsequent years?

A. There are two options available to trustees that must roll back that part of a pension account that exceeds the \$1.6m limit. The first is to not claim a CGT exemption on assets transferred back to an accumulation account, and the second is to claim the exemption.

If the decision is made not to claim the CGT concession, any unrealised gains on assets transferred back to the accumulation account could be taxed if they are subsequently sold for more than their original cost.

If the trustees decide to claim the CGT concession there are two ways in which the concession will be calculated depending on whether the fund uses the segregation method or the proportional method.

A super fund that has all members in pension phase will be classed as using the segregation method. Where a fund has members in both accumulation and pension phase they can choose what method is used.

A segregated fund chooses what assets allocated to the accumulation account will be subject to the CGT concession. For each of those assets their cost will be reset

to the market value at the time the excess is rolled into the accumulation account. This will mean tax will only be paid if the investments allocated to the accumulation account are sold for a value greater than their transfer value.

Funds that use the proportional method, and want to claim the CGT concession, will have all assets of the fund revalued to market value at June 30, 2017. That portion of any gain made on the value of the fund supporting pension accounts at the time of the transfer will not be taxable.

Where a fund has existing accumulation accounts before the transfer of the excess, the percentage of the gain related to those accumulation accounts will be taxed. Trustees will have a choice of paying tax when lodging the 2017 tax return for the SMSF, or can defer paying the tax until the investment is sold.

In some cases SMSFs could be worse off by choosing to use the CGT concession. Before taking any action you should seek advice from an SMSF professional.

Max Newnham is a partner with [TaxBiz Australia](#), a chartered accounting firm specialising in small businesses and SMSFs.

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

General Advice warning: Eureka Report Pty Ltd: ABN: 84 111 063 686 AFSL No: 433424. This article may contain general advice and has been prepared without taking into account your objectives, financial situation or needs. Before acting on this information, you should consider if it is appropriate for your circumstances. Where the information relates to the acquisition of a product, you should obtain the PDS and consider this before making your decision

Without a revival in demand for diamonds, and much higher prices, it is possible to see Australia exiting the diamond industry totally in the next few years.

BY TIM TREADGOLD • EUREKA REPORT • 23 FEBRUARY 2017

Diamonds might not be forever for Rio Tinto

Investors in graphite stocks, one of the hottest sectors on the Australian stock market today, might find it useful to consider the fate of another form of carbon that once excited speculators but which is on the verge of disappearing altogether.

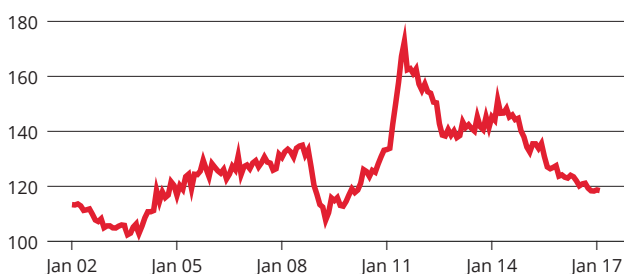
Key Point

- ***A US-based diamond-price information service reported last month that its diamond index for large gems (three carats and more) had fallen by 8.5 per cent in calendar 2016.***

Thirty years ago the ASX was littered with diamond hopefuls keen to catch a wave started by the discovery of the Ellendale and Argyle diamond mines in the northwest of WA and the Merlin mine in the Northern Territory.

Ellendale, once owned by Rio Tinto, closed two years ago. Merlin, which is closely associated with Melbourne financier Joseph Gutnick, is operating on a small scale and recovering a handful of gems. Argyle, another Rio Tinto project and once the world's biggest diamond mine, is drifting towards closure.

Chart 1: 'Polished Prices' diamond index, past 14 years



Source: Bloomberg Eureka Report

Without a revival in demand for diamonds, and much higher prices, it is possible to see Australia exiting the diamond industry totally in the next few years.

Graphite is a long way from facing the fate of Australian diamonds but the lesson of trying to turn a commodity driven by speculation and the promise of a great future into a viable business is obvious, with the fact that both are made of carbon a curious coincidence.

Challenges for miners

The collapse of Ellendale was a particularly bitter lesson for investors in a commodity with a complex marketing structure and product valuations based largely on personal taste and variable consumer demand.

The attraction of the mine, located near Derby in the Kimberley region of WA, was its 'swarm' of diamond-bearing pipes (the geological structures which contain diamonds) and its flagship product; intense yellow gems which commanded a premium price.

Unfortunately for a number of owners who followed in Rio's footsteps after it sold the project in 2001 there were never enough high-quality gems in the pipes and extracting them proved more expensive than expected. In other words, Ellendale was not a viable business.

Argyle has been far more successful than Ellendale and is far bigger, but the same market forces are bearing down on a mine which was, until recently, a star among Rio's diverse collection of assets.

Rio, which has invested \$US2.1 billion over the past five years to maintain production by digging deeper at Argyle, confirmed the challenge in keeping the mine alive when it revealed a hefty \$US241 million write-down in the value of Argyle in its accounts for the latest calendar year and chief executive Jean-Sebastien Jacques warned about the outlook for the mine.

“A US-based diamond-price information service, reported last month that its diamond index for large gems (three carats and more) had fallen by 8.5 per cent in calendar 2016.

“It’s a pretty challenging market environment,” Jacques said. “Diamond prices are not great, except for the nice pink ones, so it’s a challenging situation.”

The specific nature of the challenge is that Argyle, already a very deep mine, needs another large capital investment to remain in production with the mining technique at the mine, block caving, requiring most of the capital upfront in preparing for production.

For Rio, that means committing capital today and hoping that diamond prices recover tomorrow, and that the costs do not rise too far as the mine gets deeper.

Losing lustre

A number of factors have hurt the diamond industry, including a crackdown by the Chinese Government on its citizens spending on luxury goods, an even more damaging attack by the Indian Government on its black economy, and the slow but damaging growth of the synthetic diamond industry, particularly for small gems of the sort which dominate Argyle’s inventory.

Rapaport, a US-based diamond-price information service, reported last month that its diamond index for large gems (three carats and more) had fallen by 8.5 per cent in calendar 2016. The index for one-carat stones was down 5 per cent. Half-carat gems were down 1.4 per cent while the index for

the smallest gems, of 0.3 of a carat, rose by 0.5 per cent.

Those price declines fed into Rio’s diamond operations, which include the Diavik mine in Canada, with net earnings from diamonds falling from \$US79m in 2015 to \$US47m in 2016, a modest return on diamond revenue which fell from \$US698m to \$US613m.

Erratic earnings have been a feature of the diamond business for a number of years as gem sales have risen and fallen, largely in accord with global economic growth and variable consumer demand for one of the world’s ultimate luxury products.

Good in some years, diamonds for Rio Tinto have become a hard way to get a reasonable return on capital, especially when compared with more profitable operations, such as iron ore, copper and aluminium.

If Rio does not commit additional capital to Argyle the mine is likely to be sold, if a buyer can be found, or closed, bringing to an effective end Australia’s once booming diamond industry – and serving as a warning to other commodity-based industries that they need a strong business case and not just speculative hype.

eureka report