

# Weekly Review

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*A multi-dimensional relative value analysis makes it possible to determine relative value across all ASX-listed debt securities and hybrids, not just those from a single group.*

BY PHILIP BAYLEY • EUREKA REPORT • 3 FEBRUARY 2017

## How to identify value in the listed debt market

Facing the prospect of a sizeable shortfall of new listed debt securities in 2017, where do investors find value in the secondary market?

### Key Point

- **The algorithm used to undertake this analysis can explain more than 80 per cent of the variation in the yield to call/maturity of the securities analysed.**

This is especially problematic in a market that has moved from being cheap to expensive over the last year or so.

While the prices in the market may be higher overall than in an earlier period, there will always be some variation among individual securities, with some being cheaper and others more expensive. This is a matter of relative value.

Analysts will strive to identify those securities that are cheap relative to others in the market, and seek to buy those securities in expectation of an upward price movement as other investors recognise the relative value offered. The process is reversed for those securities identified as being relatively expensive.

Unfortunately, the process typically used to identify relative value is very limited.

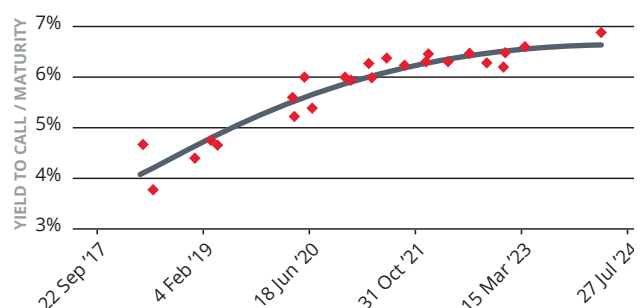
### The standard approach to identifying relative value

For a given group of securities, a chart is created that plots the yield to call/maturity against the call/maturity date of each security. Then a line of best fit is positioned between the dot points created.

Those securities appearing above the line of best fit are relatively cheap and those appearing below the line are relatively expensive. That's it. Simple!

The process is intuitively appealing, taking the appearance of a normal yield curve as shown in Chart 1.

**Chart 1: The standard approach to identifying relative value**



Source: ADCM Services

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## IMPORTANT INFO

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But this approach fails to take into account the other characteristics of each security that may impact on its value and therefore its yield to call/maturity. Not to mention any current factors that may be impacting on the future prospects of the issuer of the security.

These other considerations are left to be discovered, assessed and then factored into the value of the security by analysts or individual investors.

### A new and improved approach to identifying relative value

The analysis typically undertaken to identify relative value can be improved by including the other quantifiable characteristics of individual securities that can impact on the value of those securities. Doing so takes the analysis from being two-dimensional to multi-dimensional.

This just leaves current factors affecting the future prospects of the security issuer to be considered, before a final determination of relative value is made.

The quantifiable characteristics not considered in a two-dimensional analysis of relative value include, but are not limited to:

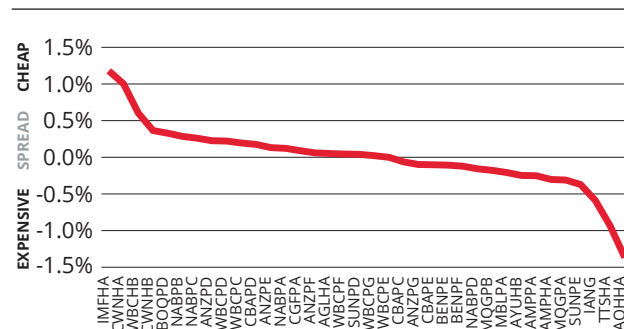
- the credit quality of the issuer of the security;
- the final maturity date;
- if there is an earlier call date(s) (there is optionality here – the securities may not be called when expected);
- the size of the issue (which can affect liquidity in the secondary market), and;
- differences in the complexity of individual securities.

In a two-dimensional analysis this last characteristic is dealt with by grouping bank hybrid securities together as shown in Chart 1 in the first article, and doing the same for subordinated debt issues and senior debt issues. But in the case of the latter two groups this can result in the relative value analysis being limited to just a few securities in each group.

Moreover, it tells potential investors nothing about the risk and return trade-offs available between each group. Relative value is considered within each group in isolation of the others.

If the product complexity indicators assigned by Australia Ratings, and described **in the foregoing article** (*Debt securities deliver strong 2016 returns*), are used in a multi-dimensional relative value analysis, it is possible to determine relative value across all ASX-listed, non-government debt securities. The results of the analysis can be quite accurate in terms of the extent to which the differences in yield to call/maturity observed can be explained.

**Chart 2: The new and improved approach to identifying relative value**



Source: ACDM Services

Importantly though, it is not the explained differences that determine relative value, it is the unexplained differences.

The differences explained allow a fair value yield to call/maturity to be calculated for each security, relative to all the other securities included in the analysis. The variation in the market yield from the fair value yield, up or down, indicates a security that is relatively cheap or expensive, respectively (never forgetting that further consideration needs to be given to factors that may be currently impacting the future prospects of an issuer, before making a decision to buy or sell the security in question).

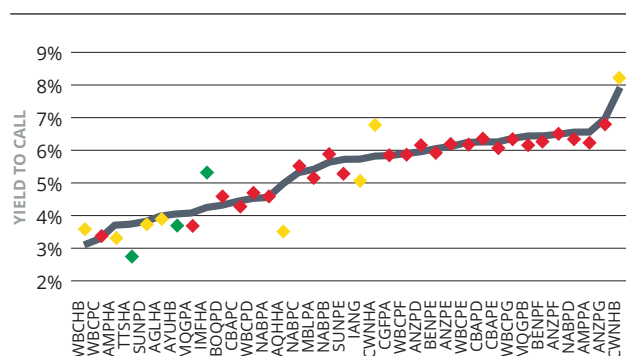
**“ It is not the explained differences that determine relative value, it is the unexplained differences.**

Using a multi-dimensional analysis, as described here, simply makes the process of identifying real relative value easier and more accurate.

Applying a multi-dimensional relative value analysis to the non-government, ASX-listed debt securities rated by Australia Ratings, based on yield to call/maturity as at the end of December, allows the following charts to be produced.

Chart 2 ranks each security analysed from cheapest to most expensive in terms of the relative value determined. The fair market value curve is the horizontal red line and the distance of the market value of each security from the red line presents as a rotated cumulative distribution, with the best likely relative value opportunities located at either end.

**Chart 3: Another way of looking at the relative value identified**



Source: ADCM Services

Chart 3 presents the results of the same analysis but the securities considered are ordered from the lowest fair value yield to highest, and positioned around the fair market value line according to actual yield to call/maturity. The colours of the markers used reflect product complexity as determined by Australia Ratings.

From Chart 3 it can be seen that less complex securities will tend to be lower yielding than the more complex but can offer better relative value when all other quantifiable characteristics are considered.

### **The benefits of taking a multi-dimensional view**

The algorithm used to undertake this analysis at the end of December can explain more than 80 per cent of the variation in the yield to call/maturity of the securities analysed. However, the explanatory power of the algorithm will vary from time to time.

Keeping all other things equal, the greater the explanatory power of the algorithm, the more rational the market is in terms of the yields observed. Conversely, if the explanatory power is found to be low, the market could be irrational.

Irrationality provides opportunity but more work needs to be done and care is required to identify the real opportunities.

*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.*

***With interest rates at record lows, holding large amounts of cash in your fund will guarantee low investment returns.***

BY TONY KAYE • EUREKA REPORT • 3 FEBRUARY 2017

# A cash strategy for SMSFs

Cash may not be as glamorous as other assets, but it is the oil that greases the wheels of well-run self-managed super funds.

## Key Point

- ***A well-used strategy by many self-directed investors is to lock in higher cash returns through longer-term term deposit accounts, using a staggered maturity approach so funds are locked away for different time periods, depending on one's cash flow requirements.***

It's also a key investment strategy for Australia's Future Fund, which in releasing its most recent results declared it would continue to offset its risk by holding sizeable quantities of cash. Indeed, at the end of September 2016 the Future Fund had 22.1 per cent of its total assets in cash, up from 15.1 per cent the year before.

The Future Fund is clearly hedging its broader investment strategy against increasing market volatility, using cash as its primary lever. Unfortunately it often takes a crisis to appreciate the value of a flexible and accessible cash hub.

In the accumulation phase, while you are still working to build your super balance, a cash reserve can be used to take advantage of investment opportunities and to keep your powder dry during a market downturn.

But it is once you shift into pension mode and are dependent on regular, reliable income from your investments that prudent cash management can make the difference between a worry-free retirement and a real headache.

Retirees need cash to cover periods when dividend or rental income falls, investments fail or funds are frozen as some were during the global financial crisis.

## A king-sized cash balance

According to data from the Australian Tax Office, self-managed super funds had a massive \$157 billion in cash holdings at the end of last year with the average SMSF having about 25 per cent of its assets in cash and short-term deposits.

Given that the average fund balance of around \$1 million, this translates into a lot of cash sitting in bank accounts and term deposits. It also highlights the importance of managing it profitably.

Why do SMSF trustees have so much sitting in cash? The answer is essentially the same as the Future Fund's reasoning.

"It's simply not a case of trustees dumping their money into cash holdings because they haven't considered the options," says Jordan George, Head of Policy for the SMSF Association.

"When trustees were asked why they held cash, they could offer valid reasons, including:

- Waiting for a better investment option;
- Reducing risk;
- A guaranteed income stream;
- Equities too volatile;
- Need liquidity to pay benefits.

"What makes this reasoning even more valid is the fact at about 48 per cent of trustees are paying some form of pension."

## How much cash is right?

Financial advisers suggest that retirees hold anywhere from 18 months to three years of living expenses in a super bank account and term deposits with staggered maturities.

This strategy will not only reduce the need to sell assets during a downturn, but give you breathing space to rebuild your capital. The strategy also assumes that you can get higher interest on a term deposit than your SMSF bank account. The best rates on one-year term deposits are currently about 3 per cent, better than most savings accounts.

Say you are a self-funded retiree with \$1 million in super earning \$50,000 a year. You might be advised to put \$50,000 in a bank account that can be accessed quickly, \$50,000 in a one-year term deposit and another \$50,000 in a two-year term deposit.

By staggering the maturities you can align your cash flow with your personal requirements. As each term expires the cash can be re-invested in new term deposits if it is not needed for short-term living expenses.

**“ By staggering the maturities you can align your cash flow with your personal requirements. As each term expires the cash can be re-invested in new term deposits.**

### **Where to stash your cash**

All SMSFs are required to open a bank account to accept contributions from members and income from investments as well as to pay expenses and pay out benefits. This account need to be separate from your personal cash to satisfy the sole purpose test (see Chapter 5 for details of the sole purpose test).

Most people simply go to their local bank and open a new account or accept the recommendation of their SMSF administration service. Either way, too many people accept what is offered without seeing what else is available.

These days all the major banks and financial institutions offer accounts suitable for SMSFs, with three main choices:

- **Savings account.** The main advantage of a regular bank savings account is flexibility. They offer a variety of payment options such as BPay, phone banking, direct debit (not credit) Visa or Mastercard and cheque books. Interest rates are lower than rates available elsewhere but some savings accounts offer competitive rates for higher balances. Not all accounts are suitable for SMSFs so check first.
- **Cash management account.** CMAs typically offer tiered interest depending on your account balance. The top rate often only kicks in for balances of \$100,000 or more. For lower balances, you may be better off with a high-interest savings account. Most have a minimum opening balance and many charge an account-keeping fee.
- **Cash management trust.** CMTs generally offer a single rate of interest which is higher than rates on CMAs and savings accounts. In order to compete with other accounts CMTs generally offer a range of payment options. Most CMTs charge a management fee and many have a minimum account balance. You need to fill in a prospectus to open a CMT because technically you are investing in a unit trust that specialises in cash.

On a balance of \$100,000 you can earn interest of up to 1.95 per cent, or \$1,950 a year, and pay no monthly account fees or transaction fees. That's enough to cover most annual SMSF reporting and compliance fees. At the other end of the scale, some accounts are paying less than 1 per cent interest and charge a monthly fee of up to \$15 plus transaction fees.

But interest rates and fees are not the only salient features to watch out for. Cheque facilities are the feature most often lacking, which can cause problems if investment and other income is paid by cheque.

### **Less is more**

Many SMSFs make the mistake of opening multiple bank accounts, often through no fault of their own. It is easy to accumulate accounts when administration services and trading platforms offer discounts to use their linked account.

In some cases it may be difficult to avoid multiple accounts, but there are benefits in channelling all transactions through a single cash hub.

For starters, you will have all your contributions, pension payments, investment transactions, dividends and interest earned all in one place. Not only does this make it easier to follow your cash trail during the year but it will simplify end-of-year reporting easier as well.



***Tensions in the South China Sea are a serious threat to trade with China, while restrictions on Chinese investors have consequences for our apartments market.***

BY ROBERT GOTTLIEBSEN • EUREKA REPORT • 1 FEBRUARY 2017

# The China threats to Australian investors

In all the storms over US migration, visas and refugees we are inclined to take our eye off the main game for Australia – China.

## Key Point

- ***Australian investors need to take a cautious view when it comes to holding assets that may be impacted by government policies emanating from China and the US.***

The big thing we have learned about Donald Trump as the 45th US President is that unlike most politicians around the world he is actually doing what he said he was going to do and what the American people voted him in to do.

So now it's an established fact that he is about honouring promises (popular or unpopular), we need to look more closely at his China policy. It still remains likely that he will seek to do a deal with China, but we need to understand the potential impact of his China promises.

- In essence, Trump made it clear that he wants to ensure an open trade route through the South China Sea and he disputes China's sovereignty over this area.
- He threatened to classify China as a currency cheater, therefore placing a whole series of anti-Chinese measures into US trade policy that would restrict Chinese imports into the US.
- He is also proposing a special border tax where American companies who bought goods from overseas would not get a tax deduction for them but would get tax credits on exports.
- And, of course, he is not a fan of China's view that Taiwan is a united part of China.

These policies are absolutely different to anything we have seen in recent times from the US towards China. What makes the policies even more likely to be introduced is that Trump not only announced these policies but appointed Peter Navarro, an economics professor at the University of

California, as the director of the National Trade Council, which is a new White House policy group to be set up.

Navarro is one of America's most extreme hawks on China and has written several books on the subject, including 'Death by China'.

In addition, Wilbur Ross will be the commerce secretary. Ross has been highly critical of America's "dumb trade deals".

In other words, the people that were instrumental in designing the Trump policies are going to play important roles in their implementation. That makes it harder to gain flexibility. In the Chinese policy area I am being guided by the former chairman of Morgan Stanley Asia, Stephen Roach. I know Stephen, and he has a very deep knowledge of what happens in China and is writing with other authors on a web page called *Project Syndicate*.

## Long-term view: Trade and the South China Sea

So let's assume for a moment that talks break down and the US starts to act on its policies. China is the third-largest American export market and the fastest growing. Almost certainly that will be greatly curbed. A big slab of the Chinese funds created by the massive trade surpluses have in fact been invested in US treasuries. China has \$US1.25 trillion in US treasuries and other dollar-based assets. Indeed, it is China which has played a key role in funding America's budget deficits and, as we know, Trump plans to increase the US deficits, at least in the short term.

If he starts to act tough with China, almost certainly the Chinese will stop sending money to the US. And they might begin to sell their treasuries. Either of those two actions would cause American interest rates to rise sharply and substantially lessen the momentum of the Trump revolution. At least in isolation, if China starts to sell US treasuries, it will put the US dollar down. And Trump might reason that a falling dollar would cause Chinese loss.

**“ In Melbourne it is looking more likely that those constructing apartments for Chinese buyers will discover that many of the Chinese can’t fund the obligation and will renege on the deal.**

But if Trump was to actually go ahead with his border tax plan it would almost certainly push the US dollar up, and you have these two potential forces acting against each other which would cause enormous turmoil and uncertainty.

And of course, as we have discussed before, Australia’s prosperity comes from shipping raw materials to China and we will be affected very quickly if there is trade turmoil between China and the US. Now into that mix we throw the South China Sea. I think history will treat President Obama very unkindly on this issue.

The South China Sea is not just an ordinary piece of water. In our region it is the trade route that supplies Japan, China and many parts of the region. If China takes control of this sea then it is, in effect, taking control over the region including Japan. As soon as China began to invest in building islands in the sea Obama should have acted. But he did nothing except issue meaningless words which the Chinese did not take seriously.

Now, with the military bases in place, it is much more dangerous situation. The American view is that unless there is a confrontation now it will be impossible in a few years’ time and China would have gained control of the region’s trade. Australia is in a hopeless position because we would normally support our major trading partner (China), but the US is essential to our defence. I am not going to even try to predict an outcome, but what is certain is that if this potential cocktail is understood by the markets we will see great fluctuation and those fluctuations will include big movements in our share market and our dollar. But that is to come.

### **Short-term view: Aussie apartments**

Right now the major Australian economic story which gets very little exposure in the conventional media outlets is the tightening of the restrictions on individual Chinese getting money out of China to fund residential property in Australia.

As I have pointed out before, local and overseas Chinese – say, two years ago – were 80-plus per cent of the Sydney apartment market and they are now well below 50 per cent. In terms of new purchases, the overseas component has fallen to 25 per cent and is declining rapidly.

In Melbourne it is looking more likely that those constructing apartments for Chinese buyers will discover that many of the Chinese can’t fund the obligation and will renege on the deal. Of course, it is true that the Chinese are very innovative and even now are finding ways around the restrictions.

But it is harder and harder. What is holding up the apartment market is that Treasurer Scott Morrison substantially damaged confidence in superannuation as a long-term savings vehicle, and Australians have turned to negative gearing of dwellings. That portfolio shift by Australians is shifting a lot of capital out of the share and debt markets.

Many Australians are adding a second or third home to their portfolio. And younger Australians who can’t afford to buy a house or apartment as a residence are able to do it as an investment because the interest and maintenance expenditure is tax deductible. The combination of the Chinese exodus and the big rise in negative gearing means that Bill Shorten’s policy of abandoning negative gearing on existing homes will certainly make residences more affordable, but there will be a big fall in the price. It will be a key battlefield in the next election.

So we suddenly find ourselves not only the flotsam and jetsam in the US-China trade wrangle but also watching our housing/apartment markets being altered considerably by actions in Beijing.

***Adjusted for inflation, the Australian dollar remains much higher than the Reserve Bank would prefer.***

BY CALLAM PICKERING • EUREKA REPORT • 1 FEBRUARY 2017

# Will the RBA step in to tackle the dollar?

The Reserve Bank of Australia meets next week for the first time this year, following a two-month break, and it has plenty to think about.

## Key Point

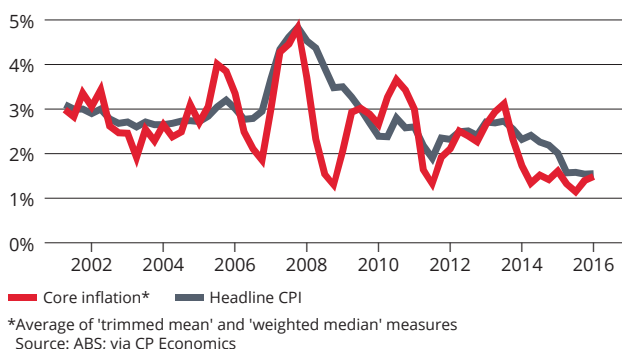
- ***To lower the dollar, the RBA could cut interest rates but the spread between Australian and US government bonds suggests that this might be more dangerous than many realise.***

Low inflation and a stubbornly high Australia dollar are likely to dominate discussion, while politico-economic concerns abroad may also weigh heavily on the economic narrative.

## Benign inflation

The most recent set of inflation figures, released by the Australian Bureau of Statistics (ABS), continue to set out a fairly benign inflationary environment. Core inflation, which is the average of the trimmed-mean and weighted-median measures that exclude volatile items, rose by 0.4 per cent in the December quarter and has increased by 1.5 per cent over the year.

**Chart 1: Australian consumer price inflation – seasonally adjusted; year-ended percentage change**

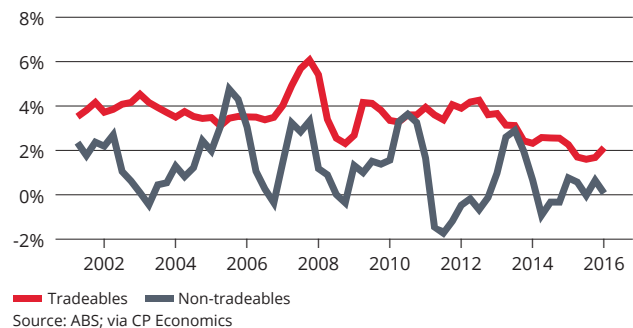


Core inflation, and headline inflation for that matter, remain well below the RBA's target of 2–3 per cent inflation over the medium-term. Headline inflation has now fallen below that target for nine consecutive quarters: core inflation hasn't reached 2 per cent since December 2015 and remains only a touch above its lowest level since at least the Second World War.

Some good news for the RBA is that inflation on non-tradeable goods – which can be used as a proxy for domestically generated inflation – picked up a little during the December quarter. Inflation on non-tradeable goods rose by 0.9 per cent in the quarter and is now 2.1 per cent higher over the year.

This is still some way off the 3–4 per cent growth for non-tradeables that was considered normal until a few years ago but it is also a lot stronger than the trough of 1.6 per cent established in June 2016. At the very least it suggests that wage growth may begin to pick-up and that can only be a good thing for the broader economy.

**Chart 2: Consumer price inflation – year-ended percentage change; seasonally adjusted**



But we continue to see little inflation on tradeable goods. This is partly due to low inflation abroad, which is thankfully improving, but also an Australian dollar that remains stubbornly high.

## Dizzying dollar

In 2017 so far the Australian dollar has appreciated 4.4 per cent against the US dollar; 3.4 per cent against the Chinese renminbi, and 3 per cent against a trade weighted index of currencies. Chart 3 shows the percentage change in the Australia dollar compared to our major trading partners during 2016 and 2017.

With the real exchange rate – the standard exchange rate adjusted for inflation – still 14.4 per cent above its long-term average, it is clear that the Australian dollar remains

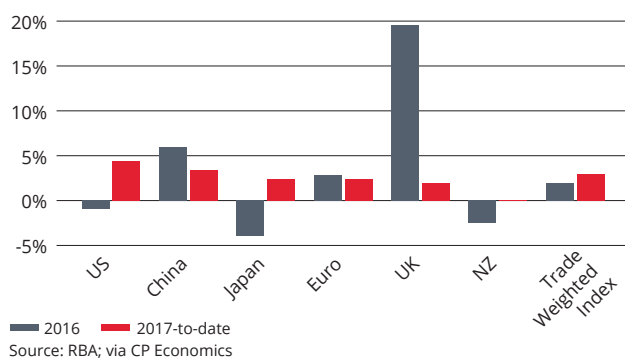


## “Core inflation hasn’t reached 2 per cent since December 2015 and remains only a touch above its lowest level since at least the Second World War.

much higher than the RBA would prefer. I see three central reasons why this is the case, which I also discuss on video with Editor Tony Kaye.

- First, commodity prices, led by iron ore and coal, have increased throughout 2016 and supported the dollar. Australia has long had a commodity currency and shifts in the price of iron ore and coal directly feed into the value of our currency.
- Second, interest rates in Australia continue to exceed rates in the United States and other developed economies. This helps to attract foreign capital to Australia and supports the value of our currency.
- Third, Australia maintains a AAA credit rating which makes federal government bonds one of the few remaining AAA rated assets. This makes Australian dollars an attractive investment for fund managers looking to hold high quality assets.

**Chart 3: Australian exchange rate percentage change**



Analysts expect commodity prices to decline throughout 2017 as some of the temporary supply issues that pushed prices higher last year begin to dissipate. Speculative activity in futures markets is also likely to normalise at some point and that should see commodity prices return to a level that is more consistent with underlying demand and supply.

Higher commodity prices are supporting mining revenue and profitability and has given Australia its first trade surplus since early 2014. Nevertheless, it’s far from ideal for the non-mining sector and creates a significant challenge for that

sector as it tries to rebound from what has been a relatively tough decade.

### The RBA’s options

The RBA has few tools with which it can lower the value of the Australian dollar. ‘Jawboning’ has been one technique, where bank officials take down the dollar in an attempt to shift market sentiment, but it has proven ineffective in the past.

Another technique is that the bank can simply cut interest rates further but the tightening spread between Australian and US government bonds suggests that this might be more dangerous than many realise.

The graph below shows the spread between Australian and US federal government bond yields. It includes one short-term bond, the two-year rate, and a longer-term bond, the 10-year rate.

The spread on two-year government bonds currently sits at around 62 basis points; by comparison, the spread on 10-year government bonds sits at 30 basis points. The former is at its lowest level in 10 years, while the latter hasn’t been this low since early 2001.

**Chart 4: Spread on Australian and US government bond yields (1995–2017)**



Given the likelihood that the US Federal Reserve hikes rates this year – possibly on two or three occasions – there is a very real chance that the spread turns negative.

**“ The tightening spread between Australian and US government bonds suggests that this might be more dangerous than many realise.**

Many will remember that the period from 1997 to 2000, when the spread was last negative, coincided with the Australian dollar falling below US50c. I wouldn't expect that to occur this time but I also wouldn't be surprised if we tested US60c either.

Historically Australia has always needed an interest rate premium to attract foreign capital and a negative interest rate spread against the US raises the question: why invest in Australia when there are greater returns to be found in the US?

Australia runs a sizable current account deficit, which means that we rely on foreign capital to drive investment and maintain existing growth. A negative spread suggests that some Australian investors may choose to invest overseas rather than doing so domestically.

It would take a bold central bank to cut interest rates in such a scenario but if the RBA does then it will certainly get more bang for its buck on the currency side than it has in the past.

The key question is whether it is willing to risk capital flight and a decline in our current account deficit?

A key question for the RBA is whether the recent sell-off in US government bonds is temporary or persistent. In other words, will Donald Trump make good on his fiscal and tax policies? If the answer is no, then the RBA has more scope to cut rates. But if Trump delivers, then monetary policy in Australia is largely exhausted.

However, regardless of whether the RBA cuts further it appears as though the Australian dollar is reaching a tipping point. A lot will depend on commodity prices, but narrowing spreads and the likely end of Australia's AAA credit rating will put downward pressure on the dollar. If commodity prices shift downwards, as analysts expect, then the dollar could very quickly end up below US70c and fall to levels that we haven't seen in well over a decade.

***In some cases for those in receipt of a TTR pension, it simply might not be worth continuing to work.***

BY BRUCE BRAMMALL • EUREKA REPORT • 1 FEBRUARY 2017

# The TTR dilemma: will it pay to quit work?

One question is going to be dogging the minds of those in receipt of a transition-to-retirement (TTR) pension in the lead up to June 30.

## Key Point

- ***If you're over 60, you can change a TTR into an ABP by the act of resigning from a position of paid employment.***

"Is it still worth working if my pension fund is going to be taxed, or do I just chuck it in and fully retire?"

It's a legitimate question. But the answer will depend on how much new tax your TTR pension fund is going to pay, versus the income (or net income) you receive from employment.

In some cases, it simply might not be worth it. And the option of going fully into retirement might make financial sense.

## A case study

Let's take an example: A 60-plus-year-old member with a \$1.5 million TTR pension fund. (Remember that anything above \$1.6m will have to be transferred back to accumulation in any case.)

That super fund is earning reasonably well. It's earning income of \$75,000 a year (5 per cent), but there are also some capital gains being made each year from the sale of some assets of, say, another \$25,000 (after the one-third discount for assets held for longer than a year).

As a result of the new changes, TTR pensions will be taxed.

On the \$100,000 income of the fund, tax of \$15,000 will be payable.

(However, while TTR pensions will pay tax under the new rules, account-based pensions, or ABPs, will continue to be tax exempt. I'll come back to this.)

If our 60-plus-year-old is working a part-time or casual job in their semi-retirement and earning less than \$15,000 a year, then they might wish to consider resigning. (Perhaps even only temporarily ... see more on this below.)

Why? By doing so, their TTR pension could be changed to an ABP. Your TTR can be converted to an ABP for anyone over 55 who permanently retires from the workforce, or for those over 60 who end an employment arrangement.

If the member was to resign – and the fund was changed from TTR to ABP – the fund would save \$15,000 in income tax payable. By quitting their employment, they would lose \$15,000 income.

In one of those unusual tax quirks they would actually not be any worse off, financially, by quitting. And would get many hours of their life back.

If the \$15,000 from paid employment was the only income earned by the member, then it would not be taxed as it is under the tax-free threshold.

This would be further complicated if the \$15,000 from the part-time job was not the only taxable income being earned by the member. Let's say they were also receiving \$50,000 in net income from other investment assets (such as shares or investment properties).

The \$15,000 in extra income from the part-time job, at this point, would effectively be taxed at 34.5 per cent, leaving \$9825 after tax.

By resigning the part-time job in this position, they would be forgoing a net \$9825 in income, but picking up \$15,000 in reduced tax from the conversion of the pension fund from TTR to ABP. They would actually be ahead by stopping work!

Earning approximately \$22,900 gross (or about \$15,000 net after 34.5 per cent tax) would be the break-even point.

Obviously, at higher marginal tax rates, the equation would become even more perverse.

This is the tax quirk – probably an unintended consequence of the new rules.

In what I've described above, the extra tax burden on your super (\$15,000 in new tax to be paid on your TTR pension), means that you are going to work for nothing (to earn

**“ In one of those unusual tax quirks they would actually not be any worse off, financially, by quitting. And would get many hours of their life back.**

\$15,000-\$30,000, depending on your marginal tax rate).

Some will make the decision that it's not worth going to work to earn \$50,000 (gross, pre-tax) if they are going to have to pay an extra \$15,000 in tax on their super.

And for those working full time...

Look at it another way. This is equally brutal. It's known, roughly, as an increased 'effective marginal tax rate' (though this normally applies to those who earn extra income but, as a result, lose government benefits, such as family tax benefits, etc).

Let's say that this same person with a \$1.5m TTR pension fund is still employed full-time and is earning \$100,000. On this salary, income tax (including Medicare) of approximately \$26,632 would be paid.

But as of July 1, their TTR pension will pay an extra \$15,000.

So by working and earning \$100,000 a year, our member is going to be taxed in excess of \$41,600 a year in his/her overall income, inside and outside super.

Some people in this position might also consider whether it's worth it.

### **How to switch a TTR into an ABP**

It can be quite simple, though it comes with some risks; that is, resigning, but not being able to find another job.

If you're over 60, you can change a TTR into an ABP by the act of resigning from a position of paid employment. That means, essentially, quitting a job.

If you're able to find another job straight away ... little financial harm has been done.

If you have multiple jobs, then you might only need to quit one of those jobs. If you are a director of many companies,

you might only need to resign from one of those directorships.

But this is an area that has some dangers surrounding compliance. Make sure you get advice from your accountant or financial advisor.

### **But money isn't everything...**

Of course, it partly depends on why you're working. If you're working to keep your mind active, rather than for the money, then quitting and moving in to full retirement might be unpalatable.

If your TTR super fund balance isn't anywhere near \$1.5m then the overall new tax on the TTR might be considerably less than \$15,000.

If you have a \$300,000 TTR pension fund, then, using similar percentages as above, the pension fund income might be \$20,000 on which \$3000 tax would be paid.

If this is a boat that you've found yourself in, get some professional guidance from your accountant or financial advisor.

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](#).*

***A combination of a rising iron ore price and falling costs has many small players looking ripe, or close to ripe, for the picking.***

BY TIM TREADGOLD • EUREKA REPORT • 1 FEBRUARY 2017

# Minefield: Small ore rising

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

## Key Point

- ***For iron ore, Credit Suisse is tipping a price of \$US55 as the 2017 average, Macquarie sees \$US54, and UBS has forecast \$US56. But ANZ disagrees, and is forecasting an average of \$US67 for the year.***

Life has returned to the small end of the iron ore mining industry after three bruising years, but for how long is a critical question.

An unexpected surge in the iron ore price when combined with lower costs is helping financially-stretched miners retire debt and dust off expansion plans.

It's not a boom, but it is a welcome reprieve from conditions which forced many small iron ore miners out of production, unable to compete with the low costs of the mega-miners such as BHP Billiton, Rio Tinto, Fortescue Metals, and Brazil's biggest miner, Vale.

While the price rise from less than \$US40 a tonne at this time last year to around \$US83 today is helping everyone exposed to iron ore, the real key to the revival is the cost side of the equation, as shown in this week's December quarter report from Fortescue.

Five years ago, Fortescue was enjoying a gross profit margin of around \$US72. Today, even with the iron ore price down 33 per cent from its 2012 average of \$US120, the profit margin is roughly the same thanks to costs falling from \$US48 to \$US12.54.

A similar picture can be seen across the iron ore industry, with the combination of a higher price and lower costs helping small miners reset their businesses to handle what some analysts believe will be a return to lower prices later this year.

Credit Suisse is tipping a price of \$US55 as the 2017 average, falling to \$US48 in 2019. Macquarie sees \$US54 falling to \$US47 next year. UBS reckons the price will average \$US56 this year.

ANZ disagrees. It is forecasting \$US71 for the first three months of 2017 with an average of \$US67 for the year.

Those price tips are a guide to what might lie ahead. In the meantime it's worth looking at some of the recent action in the sector and the revival in fortunes for some small iron ore stocks.

## Atlas Iron (AGO) ●

Once a star with a stockmarket value of \$4 billion, Atlas suffered a near-death experience in 2015 when a low iron ore price and high operating costs forced the company into a debt-for-equity swap with its creditors.

That deal exploded Atlas's share register tenfold, from 915 million shares in 2014 to 9 billion shares today, with the dramatic increase in the number of shares on issue a factor in the stock spending most of 2016 at 1c, or less.

Since early October, as the iron ore price staged its miraculous recovery courtesy of Chinese demand, Atlas has been moving up, briefly touching a 12-month high of 5c, before slipping back to recent sales at 4.4c, a price which values the company at \$402 million.

Atlas has a long way to go before it can be described as rebalanced, thanks to last year's monster share issue which left 70 creditors (mainly service providers and investment funds) owning 70 per cent of the stock. Many of them should be seen as potential sellers.

Set against the problem of an unstable share register is the improving financial health of the company, which is trading profitable. Atlas made a hefty (\$54m) debt repayment last month and earned a credit-rating upgrade from Standard & Poor's.

At the current iron ore price Atlas is posting strong profits and preparing to develop a new mine at Corunna Downs, which will replace the ageing Wodgina operation.

Because it trucks ore to Port Hedland, an expensive way of handling a bulk commodity, Atlas will never be able to match the low costs of the bigger miners with their railway systems.



**“ In horse-racing terms Mt Gibson is a stayer, having survived the iron ore price crash and the collapse of a retaining wall which led to the flooding of its flagship mine on Koolan Island off WA’s Kimberley coast.**

But if the iron ore price stays high, or just slips back to the \$US67 forecast by ANZ, Atlas will achieve its primary aim of survival, and with Corunna Downs to come it should achieve its next goal of having more cash than debt by mid-year.

### **Mount Gibson Iron (MGX) ●**

The last time Minefield looked at Mt Gibson was seven months ago when it was trading at 27c and sitting on a cash pile of \$400m from mining operations and a big insurance payout.

This week, the stock is trading at 37c and the cash pile has grown to \$447m, roughly \$34m more than the company’s stockmarket value of \$413m.

In horse-racing terms Mt Gibson is a stayer, having survived the iron ore price crash and the collapse of a retaining wall which led to the flooding of its flagship mine on Koolan Island off WA’s Kimberley coast.

Ongoing iron ore production is coming from a series of small but high-grade deposits near Geraldton in WA with the Extension Hill pit recently worked out and the new Iron Hill scheduled to start in the current quarter.

What’s next for Mt Gibson includes a possible restart of mining at Koolan Island and the possible development of additional deposits near Iron Hill.

A wildcard in the company’s hand is a second insurance payout for business interruption at Koolan Island, topping up the \$86m already received for property damage.

Investment banks have a mixed view of Mt Gibson, with Macquarie highlighting the 40c per share cash backing for a stock trading at 37c.

### **Flinders Mines (FMS) ●**

Until last week not many investors had heard of Flinders Mines, a stock with a plan to become a WA iron ore miner but with a share price of less than 3c and a market value of less than \$100m.

That changed suddenly when its biggest shareholder, New Zealand-based Todd Corporation, unveiled plans for a major iron ore project near Karratha on WA’s north-west coast.

The Balla Balla project of Todd is not new. The ore deposit has had several owners over the past decade, include Atlas Iron, and will be expensive to develop and operate because it contains a low-grade form of iron called magnetite, the same material which has caused former billionaire, Clive Palmer, and his Chinese partner problems at their Sino Iron project.

The proposal which Todd unveiled for Balla Balla includes infrastructure assets that could provide a railway to link the iron ore assets of Flinders with the port needed for Balla Balla.

There is a long way to go for both Balla Balla and the Flinders proposal, and some of the current interest is probably related to the WA State election in early March.

Speculators, however, like the story and have pushed Flinders shares up to a 12-month high of 8c, valuing the stock at \$250m.

### **BC Iron ●**

Three months ago BC Iron, a company effectively controlled by media owner Kerry Stokes, was showing every sign of losing interest in iron ore, with a management presentation at the November annual meeting suggesting a diversion into agriculture, industrial minerals and/or goldmining.

Whether that happens will be a reason to watch the company. BC recently sold a small mine at Nullagine in WA’s Pilbara, has plans for a much bigger mine (and associated port) at Buckland and continues to share the profits from a joint venture mine operated by Mineral Resources at Iron Valley.

The iron ore recovery will have presented BC with an opportunity to push ahead with the wholly-owned Buckland project or take the opportunity to do something else with its \$32m in cash.

***The discovery that a synthetic graphene could be made out of soybean oil could stifle the graphite/graphene boom before it even gets going.***

BY TIM TREADGOLD • EUREKA REPORT • 1 FEBRUARY 2017

# Synthetics cast doubt over the graphite boom

Soy 'milk' is a common substitute for cow's milk in coffee shops but it might come as a surprise to investors in mining companies which have graphite, and its close associate graphene, as their primary target that soy might also be a graphene substitute.

## Key Point

- ***More needs to be done to see whether the graphene-making discovery can be scaled up to a commercial level. So far there has been limited reaction from share prices.***

Understanding the difference between graphite and graphene is a first step in comprehending the soy versus graphene situation which is causing a flurry of interest in the scientific community, thanks to work by Australian and international researchers.

Graphite is pure carbon, and effectively the highest form of coal. In some countries graphite has been burned as coal whereas its more modern use is as the anode in a battery used to store electricity, including lithium-ion batteries used to power electric cars, tools and buildings.

Graphene is molecular form of graphite which can exist as a single atom thick. It has multiple uses thanks to its great strength (200-times stronger than steel) and a high level of electrical conductivity.

Synthetic forms of graphite have been around for years, with an ongoing debate about which is best. The answer to that question is probably that both have their uses and both are enjoying a surge in demand as electricity storage systems become cheaper and more popular.

Graphene, which was discovered as recently as 2003, is graphite cut down to single sheets, with the discovery mechanism by two British-based researchers being as simple as slicing a piece of graphite down to its thinnest possible state and keeping hold of it using sticky tape – primitive, but good enough to win the 2010 Nobel Prize in physics.

Slicing graphite has always seemed an unlikely route to the commercialisation of graphene, with a number of research projects underway around the world to find simpler ways to 'grow' the material which, despite its high-tech reputation, is nothing more than a piece of carbon.

Enter a team of scientists from the Commonwealth Scientific and Industrial Research Organisation (CSIRO) and several Australian universities and their work using soy as their starting point to make graphene.

According to a statement released by the CSIRO earlier this week the trick is to heat soybean oil, which breaks the raw material down into a range of carbon-building units that are essential for the synthesis of graphene.

Other raw materials were also used in the work – led by the CSIRO's Dr Dhong Han Seo who co-authored the graphene study – including the leftovers from barbecues and other forms of cooking.

"We can now recycle waste oils that would otherwise have been discarded and transform them into something useful," Dr Seo said in a statement.

Until now other graphene making technologies have used a method called 'thermal chemical vapour deposition' which requires high temperatures (up to 1000 degrees Celsius) over a prolonged time, followed by vacuum processing.

The Australian discovery eliminates the need for expensive equipment because it occurs at normal air pressure.

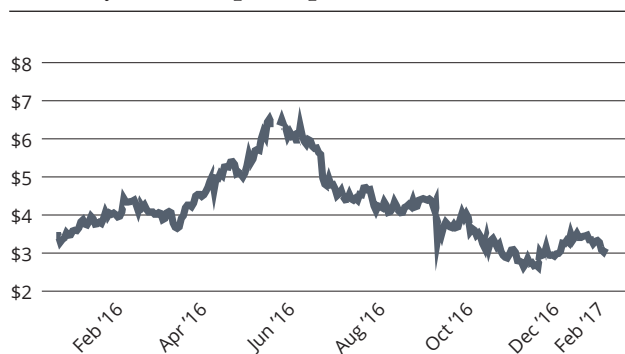
Test-tube production of graphene using the technique which has been named GraphAir involves heating soy oil for about 30 minutes, at which point it breaks down into carbon building blocks which is then poured over a sheet of nickel foil.

Rapid cooling of the soy oil on the foil leaves it as a thin sheet of graphene.

**“ So far, there has been limited reaction to share prices because most Australian-listed companies in the sector are looking for ways to commercialise graphite deposits.**

More needs to be done to see whether the graphene-making discovery can be scaled up to a commercial level, as well as comparing the cost of using soy oil with other raw materials and other graphene technologies.

**Chart: Syrah share price, past 12 months**



Source: Bloomberg, Eureka Report

For investors there is also the question of what the soy-to-graphene discovery means for companies investing in both graphite and graphene.

So far, there has been limited reaction to share prices because most Australian-listed companies in the sector are looking

for ways to commercialise graphite deposits, either by selling the raw material or undertaking limited forms of processing to add value.

Syrah Resources, the local leader of the graphite sector, has been under pressure on the market since news of the latest graphene development was released publicly on Tuesday. After closing at \$3.28 on Monday Syrah opened at \$3.18 on Tuesday and drifted lower to trade briefly below \$3 before climbing back to \$3.125 on Thursday.

Whether there is a link between Syrah's share price and the CSIRO's graphene announcement is impossible to say, but most other Australian graphite stocks have lost a little ground this week.

What might be worrying investors is that the rush to develop natural graphite resources could be overtaken by synthetic technologies even before the predicted boom in graphite and graphene demand takes off.