Weekly Review

WEALTH



– Issue – 4 Nov. 2016

***There is a frightening amount of change on the horizon, but much of it should be lovingly embraced.***

BY ROBERT GOTTLIEBSEN • EUREKA REPORT • 2 NOVEMBER 2016

# The big Australian stocks in disruptors' sights

Sometimes we feel really scared that the world as we know it is going to be changed too much. So, today, let me take you on a journey where the companies that you know are going to be disrupted, but in which total community prosperity will be enhanced.

### *Key Point*

- ***In Australia and overseas, big businesses are in many respects trying to hold back the 21st-century tide.***

### Energy

Let's start in China. The Chinese sensed that its American export bonanza was faltering, which would be a major disruption.

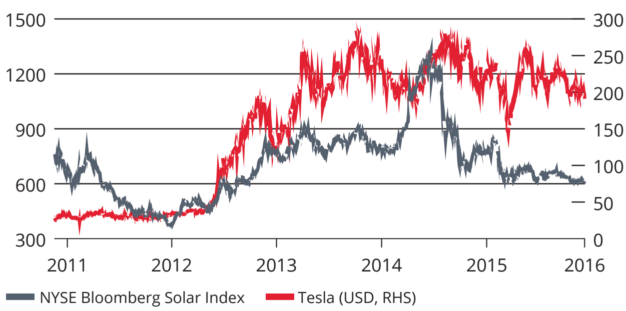
But Chinese manufacturing is now on the rise again, albeit that this time the big consumers are the Chinese themselves rather than the Americans. As it happened, the Chinese did not expect the garden to be as rosy and cut back their iron ore and coal production too far. Australia is a winner from the resulting higher coal and iron ore prices.

We must expect scientific disruptions given the speed and intensity of research being conducted. To illustrate, scientists are working very hard to change the energy world, as we know it.

I have been reading that there is a substance in the pipeline which may completely disrupt the solar energy business – and also the total energy sector. While I am always suspicious of very new concepts, let me take you on the journey even though development may take longer than the researchers expect.

Currently our solar energy is generated via silicon, which is obtained from special sorts of sand. It requires a high energy and expensive process to produce solar panels.

**Chart 1: Solar and Tesla (past 5 years)**




Source: Bloomberg, Eureka Report

Our solar energy panels only absorb a small portion of the energy that is in sunlight. There is now a material being developed that will absorb far more of the sun's energy and which is produced at a much lower cost than silicon. We will need to watch the progress of such materials, but they are an example of how by using computers to speed the research process technology can transform industries in a much more rapid way than was the case in the past.

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And the researchers of this new substance say they will produce solar energy at nearly zero cost, which means that "Mr Tesla" Elon Musk and his batteries will boom. If the scientists win then many other parts of the energy business, led by the current solar technology, will face a different world – but overall it will be a much healthier economy.

### Telstra

But there are many more conventional disrupting developments outside scientific research. As I mentioned on September 21 in ***Why investors should monitor their customer journeys***, our Anglesea home was being connected to the NBN. After the initial difficulties with Telstra it turned out to be a very smooth exercise – although on some channels internet TV is slow. Others in the community are reporting NBN problems, so this is going to be a slow, expensive process. But I can see from what has been delivered to me that, over time, accessing the NBN is going to be a commodity and a major disruption to Telstra.

The advantage that Telstra had in owning the network is no longer there, so margins will be reduced. At the moment Telstra is being compensated by payments from the Government as part of the deal with the NBN. Accordingly, it is doing well but, going forward – say, four or five years – those payments will be slashed and Telstra will be in a much harsher world.

Its rivals, Vodafone and Optus, are beginning to wake up that they are going to need to invest in the mobile world. This long-term disruptive threat contributes to Telstra being on such a high yield. In effect it is paying out most of its profits and the market is suspicious that such dividends can be maintained. Markets have every right to be nervous because, like banks, telecommunications is a capital-intensive business that requires constant investment.

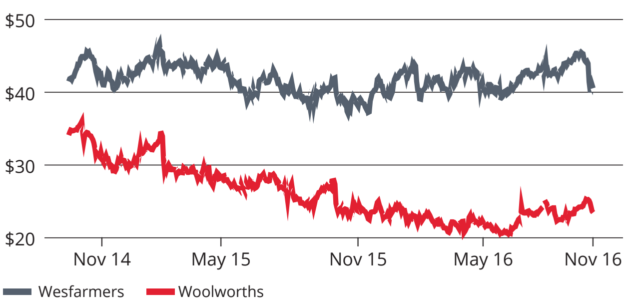
The NBN deal insulated Telstra from this but that won't last forever, so in time a more conventional approach to profits distribution will be required.

### The supermarkets

In the retail disruption arena we are now seeing full confirmation of the fact that the volume of supermarket sales in not rising rapidly and Woolworths and Coles – and particularly Woolworths – are trapped in a fight over a relatively stagnant market.

The first disruptor is Aldi, which is winning in the low priced goods space because it has a much lower cost model than either Coles or Woolworths (who use their big supermarket model to cover a much wider range of markets).

**Chart 2: Supermarket share prices (past 2 years)**




Source: Bloomberg, Eureka Report

The company that is most exposed to Aldi is Woolworths, because it needs to invest large sums to overcome the years when the Masters hardware gamble sucked the life out of the supermarket business.

For its rival, Wesfarmers, luck is a fortune. The coal price has jumped once again and that means that Wesfarmers will have cash running through its veins from coal operations to help it in its retail operations. You will remember that Woolworths went into the hardware business in 2011 to starve Wesfarmers of Bunnings' cash for the then recently purchased Coles supermarket business. Coal boomed, so there was cash aplenty for Wesfarmers and, in any event, Bunnings was completely unaffected by Woolworths' Masters.

> **"There is now a material being developed that will absorb far more of the sun's energy and which is produced at a much lower cost than silicon.**

In the last coal boom Wesfarmers so loved the annual coal cash generation it foolishly did not sell the asset. Hopefully management will do it this time.

But we shouldn't forget that there are three other disruptors to the conventional retail food businesses. The first is low interest rates, which curbs spending of older people trying to live on their own savings. Retiree spending will be further curbed by the vicious attack on self-funded retirees who currently supplement their private income with the government pension (see below).

The second supermarket disruptor is the low cost restaurant/take-away business. As working families with mortgages gain more revenue because their repayments have been lowered they are spending more of this money paying someone else to do the cooking, and that hurts supermarkets.

So in a very strange way lower interest rates have become a disruptor for supermarket growth.

And, of course, we have online retailing.

Supermarkets like Coles are being disruptors themselves by moving into insurance and credit cards. Banks and insurance groups will need to watch out.

### Banks

And on the bank front, I am watching an increasing number of business loans being organised outside banks. The interest rates are higher but they are tailored much more skillfully to the needs of the customer. At this stage banks don't seem to be suffering but I believe that as smaller enterprises become more important in driving our economy so they are going to use non-bank finance in greater amounts. These non-bank organisations are simply easier to deal with.

In this context, it is fascinating to see the non-bank movement trying to mobilise capital to help developers who are in trouble with apartments. There are some very innovative deals on the planning stage. They may fail but the combination of bank regulation and the lack of knowledge to assess businesses are holding our banks back. That means they are not growing their revenue line substantially, so profit growth will have to come via lower costs, which in turn will require more investment.

### And another thing

And finally, as the retirement community starts to understand the magnitude of the changes the Abbott government introduced in 2015, which apply from January 1 next year, there is great anger. I don't think there is any chance of the legislation being changed so, **as I discussed last week**, those in the line of Government fire will need to look closely at how they handle this.

In the meantime, be very careful about downsizing your residential house if you are currently relying on the combination of the Government pension and private income to live.

***If inflation remains persistently low, it means many investors have mispriced the risk on investment property and equities.***

BY CALLAM PICKERING • EUREKA REPORT • 2 NOVEMBER 2016

# Low inflation must lead to an assets rethink

The Reserve Bank of Australia (RBA) decided to leave the cash rate at 1.5 per cent at its November meeting. The bank has now cut the cash rate by an accumulative 325 basis points since its cutting cycle began in November 2011.

### *Key Point*

- ***Once investors realise that the recent downshift in core inflation is not temporary we will see significant repricing across many asset classes.***

"Over the next year, the economy is forecast to grow at close to its potential rate, before gradually strengthening," said RBA governor Philip Lowe. "Inflation is expected to pick up gradually over the next two years."

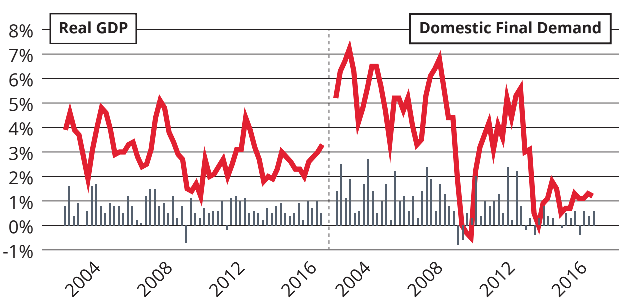
The RBA will release a new set of forecasts on Friday with the release of its quarterly Statement on Monetary Policy. Considerable uncertainty surrounds these forecasts, as is true of all economic forecasts, and tighter monetary policy is unlikely to be a consideration for the RBA next year.

In this article I discuss a range of economic issues arising from the statement released by Lowe and the RBA Board. This includes domestic demand and employment but also the sustainability of the RBA's inflation target (and what that means for asset pricing) and lending activity.

## Domestic demand

According to the RBA, "low interest rates have been supporting domestic demand and the lower exchange rate since 2013 has been helping the traded sector."

**Chart 1: Australian economic growth (seasonally adjusted, % change, 2002–2016)**



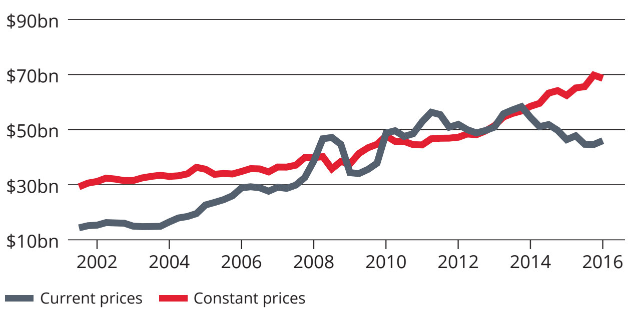

Source: ABS, CP Economics

Nevertheless, domestic demand – comprising household consumption, business investment and public spending – remains exceptionally weak by historical standards.

Chart 1 compares annual growth in real GDP against domestic demand. The former has exceeded the latter due to strong growth in the volume of commodities sold.

Unfortunately, net exports are not creating many jobs or encouraging greater corporate investment. The recent 'export boom' is largely an illusion since the income earned by mining companies has fallen 21 per cent from its peak despite the volume of commodities rising by 21 per cent over the same period.

**Chart 2: Australian mining income (seasonally adjusted)**




Source: ABS, CP Economics

Domestic demand is the main driver of employment and wage growth and is therefore a major contributor to domestic inflation. Tighter monetary policy isn't possible until we see a sustained improvement in domestic demand, which largely requires an improvement in business investment. We are unlikely to see that improvement until 2017-18 at the earliest.

## The labour market

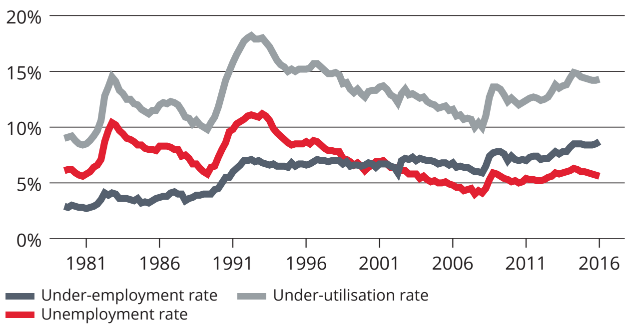
According to the RBA, "labour market indicators remain quite mixed." We have seen positive developments in the unemployment rate and part-time employment growth but this has been offset by a decline in full-time employment and aggregate hours worked.

Employment growth has slowed significantly since the beginning of the year. Employment rose by just 3900 people in September on a trend basis and is on track to increase

> **Tighter monetary policy isn't possible until we see a sustained improvement in domestic demand, which largely requires an improvement in business investment.**

by between 90,000 and 100,000 people in 2016. This is well short of the 298,300 people who gained employment last year.

**Chart 3: Unemployment measures (seasonally adjusted)**




Source: ABS, CP Economics

I touched upon this in greater detail last week but the unemployment rate currently underestimates the degree of spare capacity in the Australian economy (***Australia's rates reality is lower for longer***; 26 October). Measures of under-employment and under-utilisation do a much better job of explaining why core inflation has deteriorated.

The RBA remains reasonably optimistic on the Australian labour market noting that "forward-looking indicators point to continued expansion in employment in the near term." The key question is whether this expansion involves full-time jobs or continues to reflect part-time, low-income roles.

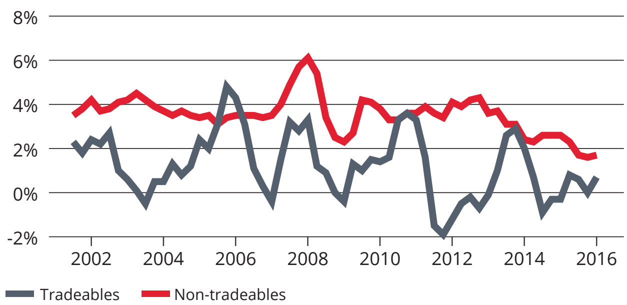
## Inflation

According to Lowe, "the September quarter inflation data were broadly as expected, with underlying inflation continuing to run at around 1.5 per cent." Core inflation remains at its lowest level in over three decades, reflecting the unique combination of low inflation globally and the decline in commodity prices.

The latter has improved somewhat in recent months, providing some upside risk for inflation, but the increase in commodity prices may prove short-lived since it reflects short-term supply dynamics rather than a sustainable improvement in demand. The RBA expects inflation to "remain low for some time."

Chart 4 shows inflation on tradeable and non-tradeable goods. The former largely reflects global factors, while the latter is largely driven by domestic factors such as wages. Inflation on non-tradeable goods has gradually eased over the past few years reflecting the broad-based weakness in domestic demand and the softest wage growth experienced since at least 1998.

**Chart 4: Consumer price inflation (year-ended % change; seasonally adjusted)**




Source: ABS, CP Economics

The speed at which inflation returns to target – assuming it does – will be determined in part by whether the Australian dollar depreciates further against our major trading partners and whether commodity prices continue to rise. The former will boost inflation on tradeable goods, which as we can see above often creates volatility, while the latter will support domestic demand and eventually hit non-tradeable inflation via stronger wage growth.

Complicating matters somewhat is that commodity prices and the dollar tend to move in-step. Higher commodity prices support the Australian dollar and vice-versa. So we are unlikely to see an event that would simultaneously push commodity prices higher, the dollar lower and return inflation back to its target quickly.

## The inflation target and real interest rates

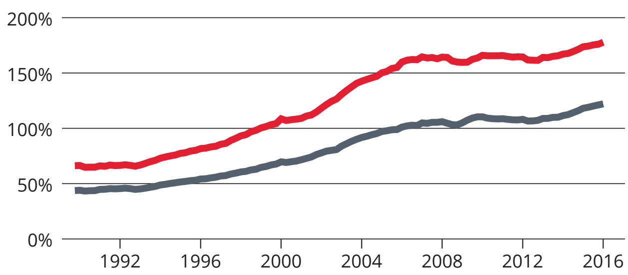
I am somewhat sceptical about the RBA's capacity to maintain its inflation target over the next few years. I don't think that markets or investors appreciate how difficult this will be.

> **It is difficult to envision how the RBA will be able to maintain inflation within its target band.**

Over the past two decades, headline inflation has increased by around 2.5 per cent on average each year. That sits smack bang between the RBA's annual inflation target of between 2–3 per cent.

This has been achieved via three distinct factors, a) a structural decline in the cash rate from 6 per cent in 1997 to 1.5 per cent in 2016; b) a more than doubling of household debt as a share of nominal GDP; and c) a once-in-a-lifetime commodity price boom.

**Chart 5: Australian outstanding household debt**




Source: ABS, CP Economics

These three structural factors are beginning to unravel. The cash rate is now at 1.5 per cent and has limited scope to go lower than 1 per cent. Household debt in Australia is currently higher than in any other country and has been cited as a financial stability risk by both the RBA and the Australian Prudential Regulation Authority (APRA). The commodity price boom ended years ago and is unlikely to be replicated; though prices have improved a little recently.

In the absence of these three factors it is difficult to envision how the RBA will be able to maintain inflation within its target band. This is important for domestic investors because it means that most financial assets are mispriced.

For example, mortgage holders are overestimating the rate at which inflation will reduce the value of their debt. More generally they are overestimating how cheap credit actually is.

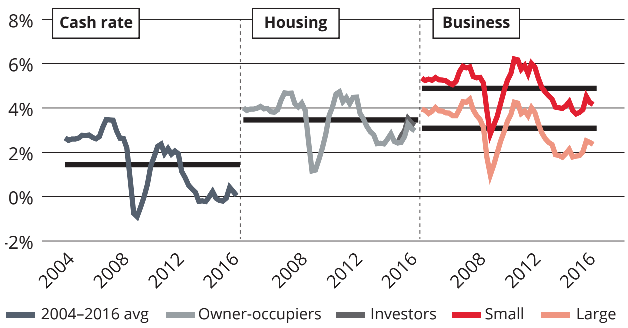
Chart 6 compares the cash rate, mortgage rates for investors and owner-occupiers, and business rates for small and large businesses. I've also adjusted these interest rates for inflation, which gives us the real interest rate. It is real interest rates that ultimately determine whether monetary policy is tight or loose or how big a burden your mortgage or business loan really is.

Mortgages for investors are currently 24 basis points below their 12-year average and 85 basis points higher than during their low point in June 2014. This is due to a combination of softer inflation and wider spreads between mortgages and the cash rate.

Many investors have purchased investment property on the basis of historically low interest rates. But if inflation remains persistently below the RBA's target band then they have mispriced the risk they now bear. The same is largely true of equities.

Basic finance theory states that if the real interest rate is low then the rate of discount used to determine the present value of future earnings will also be low, which means that the present value of those earnings will be high. If the discount rate used is actually higher than most believe – due to a structural shift in inflation that most investors treat as temporary – then the present value of future earnings is actually overstated.

**Chart 6: Australian real interest rates (quarterly; adjusted by core inflation; variable)**




Source: ABS, CP Economics

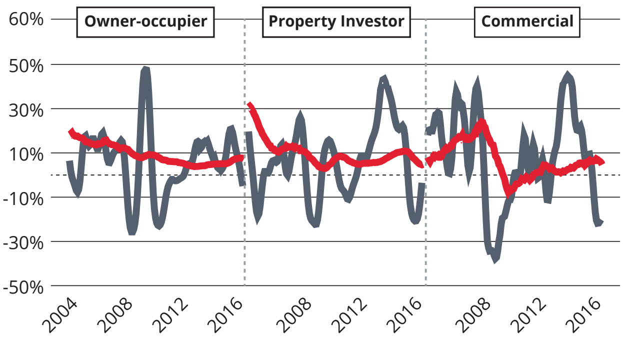
I don't know how long it will take before investors realise that the recent downshift in core inflation is not temporary but when they do we will see significant repricing across many asset classes. The main two effected will be domestic housing and equities.

> **“ It is real interest rates that ultimately determine whether monetary policy is tight or loose or how big a burden your mortgage or business loan really is.**

## Credit and lending growth

According to Lowe, “supervisory measures have strengthened lending standards and some lenders are taking a more cautious attitude to lending in certain segments.” Turnover across the housing market is down, usually an indicator that dwelling prices will fall, although auction clearance rates remain quite strong.

**Chart 7: Australian credit and lending growth (year-ended % change)**




The big issue for the housing market and the economy more broadly relates to lending activity. Chart 7 compares mortgage and commercial lending activity. We can clearly see that new lending activity has fallen over the past year.

If this persists then we can expect two important implications: a) lower house prices; and b) weaker investment across the non-mining sector.

Slower house price growth is already beginning to hit household spending in both Victoria and NSW. So investors should be keeping a close eye on lending and credit growth as it will provide insight into not just house prices and business investment but also household spending and retail conditions.

Finally, a decline in lending activity also puts more pressure on state and federal governments to fill in the gap. Austerity or fiscal discipline in the current environment will translate into softer economic growth and a decline in our balance of payments. Neither situation is compatible with the fairly rosy economic picture created by the RBA.

***More Australian investors are warming up to the concept of impact investing, where they can invest in securities that are aligned to specific projects and social outcomes.***

BY JOHN CONROY • EUREKA REPORT • 3 NOVEMBER 2016

# How social impact investing is paying off

While notions of ethical investing have been around for decades, a new strain of the movement has emerged that looks to put the space on a firmer footing.

### *Key Point*

- ***Although social impact investing in Australia is still in its early stages, there are numerous government bond issues in the pipeline and more corporate issuers are getting into the groove.***

'Impact investing' combines the good intentions of ethical investing with one key additional pillar – measurability.

"The main difference with impact investing is that it focuses very much on measurable benefits, as opposed to just assumed benefits," explains Peter Munro, an advisory board member of Impact Investing Australia as well as a partner at business consultancy A.T. Kearney.

"For example, green bonds generally will spend on non-coal but that does not necessarily know how much benefit to a community is produced in any kind of measurable fashion – so that's not impact investing.

"But if it is green energy in a particular community, and I can document the air quality improvements, and that was the purpose of it; that's impact investing."

But Impact investing is not just centred around the environmental space. Indeed, in Australia the biggest focus has been around issues like alleviating social disadvantage, whether it be around affordable housing, education, foster care, or otherwise.

### The beginnings of an investment asset

One of the most highly acclaimed investments has been Social Venture Australia's Newpin (New Parent and Infant Network) bond, which aims to reduce the burden of foster care on the NSW Government. If providers are able to facilitate the successful return of fostered children to their original home beyond a target rate (and for at least 12 months), the profits flow to investors.

Launched three years ago with capital of $7 million, the bond has returned an average 12.15 per cent per annum to its 60 investors and has four years to run. It has also restored a total of 130 children to their families.

SVA – which got its start by turning the failed ABC Learning business into an $800m a year operation, Goodstart – has four other social impact bonds on its books. There's also four more state-government linked bonds in the pipeline, including one addressing homelessness in South Australia and another focused on child protection in Queensland, both set to go to market in 2017. It also plans to launch a $15m venture capital development growth fund next year, and is seeking high net-worth and retail investor interest.

Munro says the Newpin bond is the sort of program which "clearly and unambigously meets the requirement of 'measurability'", which he admits is still a work in progress.

**Table 1: Division of Impact investing in Australia, by investor group (survey of 123 respondents)**

| | MIN (A$M) | MAX (A$M) | MEAN (A$M) | TOTAL (A$M) | TOTAL NUMBER OF RESPONDENTS | NUMBER OF RESPONDENTS DISCLOSING PORTFOLIO SIZE/FUNDS MANAGED |
|---|---|---|---|---|---|---|
| INSTITUTIONS | 3.0 | 89,000 | 11,034 | 331,026 | 34 | 30 |
| NOT-FOR-PROFITS | 0.4 | 400 | 42.7 | 1,026 | 34 | 24 |
| TRUSTS AND FOUNDATIONS | 1.0 | 230 | 41.0 | 1,272 | 45 | 31 |
| INDIVIDUALS | 0.1 | 10 | 4.3 | 34.1 | 10 | 8 |
| TOTAL SAMPLE | 0.1 | 89,000 | 2,781 | 333,358 | 123 | 93 |

> **Launched three years ago with capital of $7 million, the Newpin bond has returned an average 12.15 per cent per annum to its 60 investors and has four years to run.**

"As yet there is not an over-arching authority (for authenticating benefits), there is a series of different organisations that come up with different ways of doing this," he says.

"The aim is to build the rigour of measurability so it that it becomes almost like an auditable trail, much the way economics is audited – it's a complicated thing to do, but the data that is available is slowly getting better."

## Moving beyond 'niche'

Impact investing has been around for 15 years but has only been gathering steam in Australia since about 2013, when it was given some authority by a **UK-led G8 Taskforce.** It has since grown here to see about $500m invested last financial year.

While a recent survey found 50 per cent of investor organisations active in the space, they had on average less than 5 per cent of funds allocated to the area.

Ian Learmonth, a former Macquarie Bank executive and now a director at Social Ventures Australia, says there is increasing awareness in the market about the impact investing arena.

"For a lot of the mainstream players, it has been a wait and see approach, mainly because they have felt the size of transactions to date have been relatively small, what with transaction costs," he says.

Former director at ratings agency Standard & Poor's, Phil Bayley, says, at least in the bond space, while **green bonds have taken off** – having raised $2.3 billion in Australia so far – impact investing bonds in the social space "are still very much a niche product", primarily because issues have been very few and largely to only "sophisticated, socially responsible investors."

As for their investment grading?

"There is no more risk with a green bond than there is with any other investment-grade corporate bond. As for SBBs (Social Benefit Bonds), the risks can be much greater but the potential returns are also greater," he says.

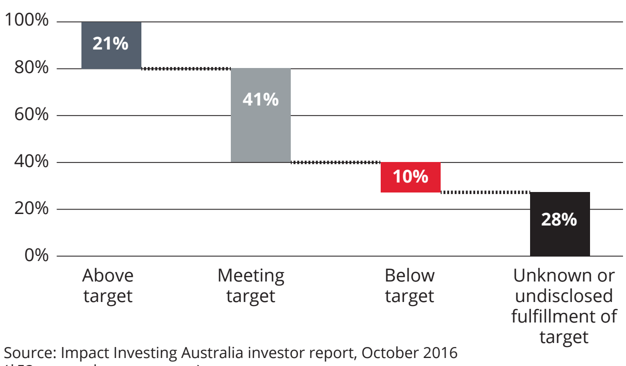
But SBBs are gaining more repute, with the International Capital Markets Association in June announcing updates to the Green Bond Principals, which included expansion of the range of acceptable uses for green bond proceeds to include projects with social objectives.

Super fund HESTA has capitalised a new SVA fund – which will invest in social and affordable housing – while Good Super, NGS Super and Christian Super have all invested in social impact bonds. (SVA's first fund, which is no longer open, returned 6.6 per cent in 2014 and 7.5 per cent in 2015).

## Strong returns to date

Munro is quick to point out that the results for impact investing products have so far been strong.

**Chart 1: Meeting, beating or failing expectations? Performance for Impact Investing products, FY2010–15**




Source: Impact Investing Australia investor report, October 2016
(*53 respondents to survey)

"The first set of **market-based data** on performance of Australian impact investment products finds that returns across all asset classes are positive and tracking within expected return ranges," he says.

The Australian findings on returns echoes research elsewhere, Munro says.

> **While a recent survey found 50 per cent of investor organisations active in the space, they had on average less than 5 per cent of funds allocated to the area.**

"Studies have been done that say more social benefit conscious funds tend to perform better. There's no evidence they perform worse," he says. "But it's still early days ... the body of evidence is still forming."

Elsewhere, NAB has seeded a million-dollar impact investing readiness fund while QBE has earmarked $100m towards impact investing programs.

## A missing link

Yet, the Australian market lacks an organised intermediary to facilitate links between investors and impact investing products like Big Society Capital does in the UK. The group was launched by the UK government to guide funds in the space, much like Australia's Clean Energy Finance Corporation (which has enjoyed market-beating returns).

"Their job is really to act as a wholesale provider to stimulate market development. An equivalent organisation here would certainly be a good development," Munro says. "That would be nice to see; but is not yet on the horizon."

Learmonth says the governments can play a role on other fronts, too, with state governments pursuing more outcome-based contracting and the federal government providing support for fledgling social enterprises and their investors.

"We see pockets of that around," he admits.

As for the impact investing being a cop-out for social or political activism in areas close to an investor's heart, Munro says no.

"I don't think it's a cop out, I think it's a complement. One doesn't replace the other, they do somewhat different things," he says. "It is another way of enhancing activism, because now you're voting not just with your feet and your voice, but also with your money.

"If we could channel more money in that direction that would be better."

***A change in ratings rules by credit ratings Standard & Poor's back in 2013 could come back to bite holders of 2012 AGL Energy subordinated notes.***

BY PHIL BAYLEY • EUREKA REPORT • 2 NOVEMBER 2016

# AGL Energy noteholders face a long wait

AGL Energy has $650 million of subordinated notes listed on the ASX (AGLHA). The notes are callable in June 2019, and the final maturity date is in June 2039.

***Key Point***

- ***With the group's subordinated debt not due until mid-2039, AGL's noteholders may have to be extra patient.***

Will the notes be called as expected or will the notes be left outstanding until the final maturity date is reached?

This is a question that has been asked about a number of similar ASX-listed subordinated notes issues in recent times. The Origin Energy and Crown Resorts subordinated notes come to mind.

The reasons for asking the question in each case are different but the outcome is the same for investors, if the notes are not called when due. Investors face being locked into their investment for much longer than originally intended, or incurring a likely capital loss if they seek to sell-out in the meantime.

There has been a recent change in AGL Energy's dealings that prompts the question in the case of the subordinated notes.

The subordinated notes were a part of a $2.7 billion rush of corporate subordinated note issuance seen in 2012. That volume of issuance has not been seen since, and in part, that is due to the ending of a game that was being played at the time.

### How the ratings game worked

The game was based on the granting of 'equity credit' by the major credit rating agencies, Standard & Poor's in particular, and issuers promising the agencies that early call options on the debt would not be exercised, while promising investors that the calls would be exercised. The agencies granted the equity credit and investors priced the debt on the assumption that it would be redeemed five years or so later.

The game also involved exploiting the different conditions the agencies attached to granting equity credit.

S&P was arguably the most generous, granting up to 100 per cent equity credit. The AGL Energy subordinated notes initially received 100 per cent equity credit from S&P.

With 100 per cent equity credit, the whole subordinated debt issue would be treated as equity and not debt, when assessing the credit quality of the issuer. For the issuer, this created the opportunity to raise some very cheap 'equity'.

Fitch Ratings and Moody's Investors Service were not as generous and would only grant a maximum of 50 per cent equity credit. But where S&P would only give equity credit up until the call date on the notes, Fitch and Moody's would give equity credit for up to 50 years or even longer (depending on the final maturity date of the notes).

But all good things must come to an end and S&P took away the punch bowl in April 2013, when it changed the rules for granting 100 per cent equity credit and cut the equity credit to 50 per cent on subordinated debt issues from AGL Energy, Origin Energy, Santos and Tabcorp, among others.

Naturally, none of the issuers were happy about the change but all took it in their stride. Each had the option to immediately redeem their subordinated notes, but none chose to do so.

### Ramifications for AGL noteholders

However, earlier this year AGL Energy made a change that seems to have gone largely unnoticed. It obtained a credit rating from Moody's and ditched S&P.

The rating obtained from Moody's, 'Baa2', is equivalent to the 'BBB' rating assigned by S&P but under Moody's equity credit criteria AGL's subordinated notes are ineligible for consideration. The notes must have a minimum term to maturity of 60 years to obtain equity credit.

The two Crown Resorts subordinated note issues meet this requirement.

> **There has been a recent change in AGL Energy's dealings that prompts the question in the case of the subordinated notes.**

Thus, with no equity credit given to the AGL Energy subordinated notes, there is no equity credit to be lost if the notes are not called in June 2019. Therefore, there's no incentive to exercise the call and replace the notes with a new issue to ensure the continuation of the equity credit.

The notes pay a coupon of 380 basis points over the 90-day bank bill rate, which will step-up by just 25bps if the notes are not called. Is 415bps over the 90-day bank bill rate too much to pay for subordinated debt that will not have to be repaid until June 2039?

Come June 2019 the spread paid over the 90-day bank bill rate for credit risk and term to maturity may well be different from what it is today, but the spread paid on recent debt issues from comparable issuers suggests that not calling the notes in June 2019 may be attractive.

Qantas recently sold senior ranking, 10-year bonds at a spread of 280bps. In May, Lend Lease paid a spread of 326bps for senior ranking, 10-year funding.

What price should be paid for 20-year subordinated funds?

In the prospectus for the issue, AGL Energy stated that it may well suit its capital structure to leave the notes in place after the call date. Moreover, AGL Energy can commence buying back the notes on-market after June next year.

When investors realise that they may be locked into an investment that will run 20 years longer than anticipated, the market value of the notes could plummet.

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.

***The Future Fund missed its return target in the last financial year, and has warned that it will be difficult to achieve its longer-term hurdle rates in the current low-return environment.***

BY BRUCE BRAMMALL • EUREKA REPORT • 3 NOVEMBER 2016

# Future Fund lessons for self-managed investors

Australia's single largest superannuation fund missed its target in FY16. Missed it by a bit, too.

And the collective knees of the Future Fund's leadership are quivering.

### *Key Point*

- ***Investment returns in your SMSF cannot be viewed in isolation. They need regular review, and a dose of realism.***

They have a target and, on a long-term basis, they are currently ahead of it. But the problem is, in a low-return environment, they're worried that the bar has been set too high for the short and medium terms. And, as with anyone who is facing a difficult target, they would like the bar lowered.

The Future Fund's investment return target is inflation plus 4.5 per cent to 5.5 per cent. Last year, inflation was 1.3 per cent, so its return should have been around the 5.8 per cent to 6.8 per cent mark. It only achieved 4.8 per cent.

Peter Costello is the current chairman of the Future Fund. He's also the former Federal Treasurer and the man responsible for setting up the Fund and, by virtue of nominating the parameters, setting its targets.

But he's now pessimistic about future investment returns, based on a limited ability by governments to create stimulus.

"Today, investors face a low-return environment … this is unlikely to be a short-term phenomenon."

The suggestion is, essentially, that trying to achieve approximately 5 per cent above inflation – if inflation is sitting at 1.5 per cent to 2 per cent – is potentially too big an ask.

Now Costello is buttering up the powers that be that they might need to accept what the rest of us have been discussing for more than a year. And that is returns are likely to be lower for longer.

"The board is engaging with the responsible Ministers to maintain a clear and shared understanding of these issues. This will ensure that the investment mandate properly reflects the Government's risk and return expectations, the prevailing investment environment and the longer-term ability of the Future Fund to help ease pressure on the budget," Costello said in the fund's annual report.

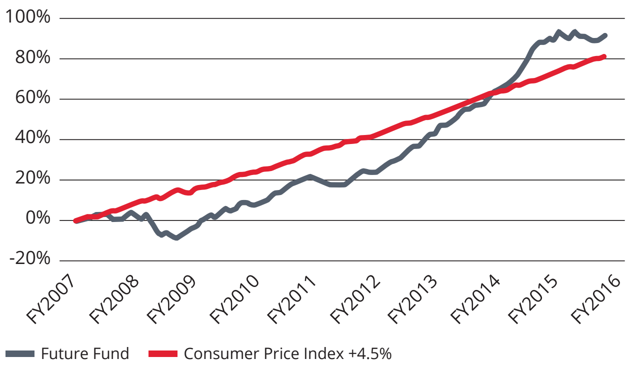
Read: "Lower your expectations and our targets, please."

This is likely to be a wider problem than just for Australia's sovereign wealth fund. It will impact across the funds management industry, on any manager who has a target that is set based on sizeable scoring above an annual inflation rate.

**Table 1: Future Fund statistics**

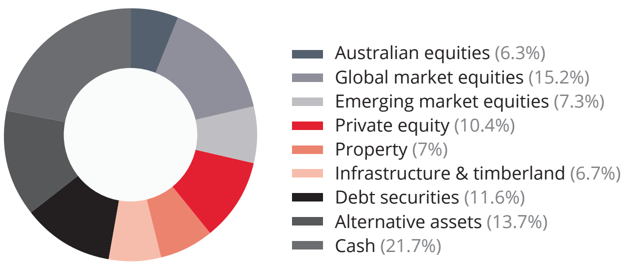
| | |
|---|---|
| BALANCE AT 30 JUN 16 | $122.8bn |
| RETURN FOR 2015/16 | 4.8% |
| RETURN OVER 10 YEARS | 7.7% pa |
| EARNINGS FOR 2015/16 | $5.6bn |
| DOUBLED CONTRIBUTIONS OF$60.5BN | |

**Chart 1: Cumulative Future Fund and CPI +4.5% pa returns**




Source: Future Fund annual report

**Chart 2: Future Fund asset allocation at 30 Jun 16**




Source: Future Fund annual report

> **"Costello is buttering up the powers that be that they might need to accept what the rest of us have been discussing for more than a year. And that is returns are likely to be lower for longer.**

## Setting return targets

But what about SMSFs? And what about their targets?

There are no rules that state that an SMSF trustee must hit a particular target. It is up to the trustee to set, or not set, a particular rate of return to be chased.

Most won't. If they do, it should be covered in the "investment strategy", which is a legally required document. (I am constantly surprised by the number of SMSF trustees who are operating without this document. If you want a refresher on its importance, please see this column.)

An investment strategy should lay out the sorts of risks that the trustees are prepared to take in order to achieve the required retirement income streams that the members are seeking. It shows that the trustees have taken the responsibility of their duties seriously.

But my real question is, "should SMSF trustees set down their expected rate of return?" Yes, and no.

In the "no" corner, the case would be built on it setting yourself up for failure and that the target is meaningless, with no consequence (i.e., unlike those running the Future Fund, you can't be sacked for failure).

For those SMSFs whose investments are centred on a proportion in Australian shares and the remainder in cash, the returns are going to be strongly based on a small return from cash, then biased in the direction of where the ASX 200 moved for the year.

The "yes" case would be built around setting achievable targets and then holding yourself/yourselves accountable to them. It should, in theory, lead to better diversification of assets, potentially away from the cash/Australian shares targets and into some international shares, property and bonds.

FYI: For instance, have a look at Table 1 again. The Future Fund has only 6.3 per cent of its funds invested in Australian shares and nearly four times that amount invested in international shares (international and emerging markets). Though there is likely to be a percentage of Australian business assets in "private equity" and "infrastructure and timberland".

If yes, then what are suitable targets? Some will choose an inflation base, with an outperformance kicker. Others, more focussed on Australian shares, might choose something related to the ASX200 accumulation index.

## Having a focused investment strategy

If you set one, ideally it should be in the fund's investment strategy. And it should be reviewed regularly, to make sure that it is relevant to the sorts of returns that you need/want.

For example, in your earlier years of investing via your SMSF, you are more likely to chase higher returns and accept the higher risks that come with that. As you move into your 50s, if you have achieved a reasonable investment sum, you might wish to dial back the risk and accept the lower medium-term returns that follow.

Often, in retirement, and the older one gets, the idea of taking high risk is not fathomable. And more and more of the investment funds will be directed towards income-based, or lower-risk, assets, such as cash and fixed interest. In those cases, the sought-after returns need to be reduced, in line with the likely returns from those asset classes.

A good investment strategy will have these risks considered. Although there are no real rules around what needs to be in an investment strategy, the better ones will run for 5-10 pages and won't simply be a list of asset classes with upper- and lower-end percentages next to them.

The Future Fund is managing money for the nation – specifically to pay the unfunded liabilities associated with the old government defined benefit funds. The federal Government may begin to draw on it from 2020 to pay what isn't funded through consolidated revenue.

Even though the Future Fund is ahead of its long-term objective (seen via the worm chart above), Costello is looking into the future to say that the inflation plus 4.5 per cent to 5.5 per cent is unlikely to be hit in coming years. If the board wants the investment target changed, it is going to have to do some lobbying. The heads of the board and the senior executives are on the block.

> **An investment strategy should lay out the sorts of risks that the trustees are prepared to take in order to achieve the required retirement income streams that the members are seeking.**

As the trustee of your SMSF, you don't need to worry about getting the sack. But you need to be constantly vigilant about the investment decisions that you have made.

Reviewing your investment strategy, regularly (though regularly is not defined), is an important duty of a trustee. And whether or not you decide to hold yourself accountable to an investment target is therefore your decision.

You should take into account what's happening. And potentially consider the impact of what is seen as inevitable – the expected lower returns that the investment world claims is unavoidable.

And there's nothing wrong with setting a target. Failure will occasionally happen. But it will probably give you more of a focus. And push you to look at some options for diversification.

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

***The WA billionaire's forays into beef and fertiliser ingredients is more than just a curiosity.***

BY TIM TREADGOLD • EUREKA REPORT • 2 NOVEMBER 2016

# Rinehart's cattle call traces iron ore pathway

If following the mega-rich and how they invest their spare cash is a strategy that appeals, then it's getting awfully hard to ignore the best part of $1 billion which Gina Rinehart has plunged into agricultural-related assets.

***Key Point***

- ***The mega-rich are endorsing the investment theory that Asia's adoption of a Western diet will drive demand beef, dairy, wine and other foodstuffs.***

Already the owner of beef breeding properties in Queensland and NSW, the Western Australia-based iron ore billionaire has launched three new farm-linked investments in the past month.

Rinehart's first deal in early October was the smallest, the $7 million purchase of 1500 prime Wagyu cattle destined for one of her properties near Dubbo in western NSW, where they will be bred and sent to other properties in Queensland.

A few weeks later, but only after a bidding duel with a syndicate of rival cattle owners, she won the approval of the board of S. Kidman & Co to acquire one of Australia's great pastoral empires.

For $386.5 million Rinehart, and a minority Chinese partner, get a century-old business that runs 185,000 cattle on 101,000 square kilometres of pastoral lease across four states.

Capping off a busy month for the miner returning to her family roots in the pastoral business was a $400m plunge into potash, a fertiliser which boosts crop yields and can be an essential additive in some soils low in potassium.

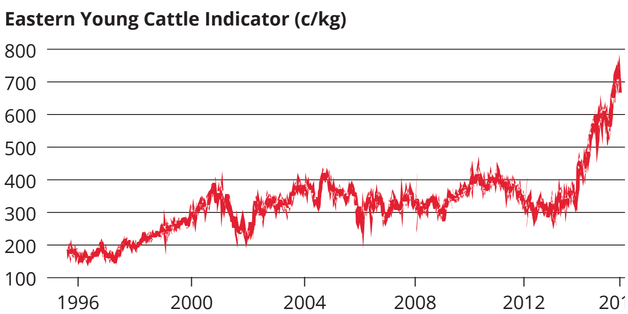
The fertiliser investment neatly combines Rinehart's two major interests, mining and farming, but it is also interesting because of its location in the English county of Yorkshire, which introduces another aspect to her recent moves: a modern currency play – with a touch of history attached.

For $US300m Rinehart has acquired a parcel of shares in Sirius Minerals plus a future royalty on the value of potash produced at the North Yorkshire Polyhalite Project, with polyhalite being a type of fertiliser rich in potassium, magnesium and sulphur. She also gets the right to buy 20,000 tonnes of polyhalite a year for use on her Australian properties.

The fact that Rinehart's Sirius investment involved $US50m for Sirius shares and $US250m for the royalty is a flashback to the time her late father, Lang Hancock, negotiated a similar royalty on most of the iron ore mined by Hamersley Iron (now Rio Tinto) in the Pilbara region of WA.

It was that 2.5 per cent royalty which laid the foundations for the $10bn fortune which Rinehart and her sometimes fractious family control today.

**Chart 1: Australian cattle price benchmark, 1996 to present**




Source: Meat and Livestock Australia, Eureka Report

Apart from the royalty structure the Yorkshire investment is a rare step for Rinehart into a foreign destination. Until now most of her investments have been in pure-Australia (although, while not well known in Australia, the Yorkshire potash project is located near the historic coastal town of Whitby – home of James Cook, one of the first Englishmen to visit Australia).

The North Yorkshire Polyhalite Project is a potentially massive development and calls for a deep mine and underground tunnels to deliver the raw material to a processing centre at an all-up cost estimated at $US2.6bn.

> **The fertiliser investment neatly combines Rinehart's two major interests, mining and farming.**

Rinehart has bought an early and cheap seat at the fertiliser table thanks to the the collapse of the British pound after the country voted to quit the European Union.

From an exchange rate of close to $US1.50 as recently as May the pound today is down 18.5 per cent to $US1.22 – and US dollars are what Rinehart has to invest, because that's the currency in which she sells iron ore.

### The billionaires harvesting new fields

Following Rinehart, and other rich Australians adding farming interests to their private portfolios, is more than a curiosity because it is often the people who have made money in one field who repeat the money-making process in another.

Andrew Forrest also made his fortune in iron ore but is now busy building his farming interests, like Rinehart.

Media and industrial equipment billionaire Kerry Stokes has also been expanding his agricultural interests, as have top retailers, Gerry Harvey and Brett Blundy.

Australian agriculture has also proved attractive to foreign investors, as shown in Rinehart's Chinese partner in the Kidman deal and a move by British billionaire, Joe Lewis, into another famous cattle business, Australian Agricultural Company (AA Co), via the conversion of debt instruments into equity.

Lewis, who Forbes magazine estimates is worth more than $US8bn, made his fortune as a currency trader and investor who famously teamed up with George Soros to attack the pound in 1992, a deal that generated billions of dollars in profits and allegedly "broke" the Bank of England.

AA Co, which was once owned by the late Robert Holmes a Court (and then by his widow, Janet) is a business of roughly the same size as S. Kidman with cattle stations across northern Australia.

The strategy being followed by the mega-rich beef investors is a top level example of an investment theory that Asia's adoption of a Western diet, with its high intake of protein and calories, will drive demand for products such as beef, dairy, wine and other foodstuffs.

It is a concept likely to prove successful, but it will not be without the risks that go with all forms of agricultural investments as has been demonstrated recently by the collapse in the share prices of Bega Cheese and Bellamy's after encountering problems marketing infant health milk in China.

Other listed Australian agricultural stocks have also blossomed and faded over the past 12 months, in a demonstration of the risks that all farmers face with challenges varying from seasonal changes (floods, fire and frost), crowded markets because of low barriers to entry, government regulation and health scares.

But, for the average investor, it's comforting to see that the mega-rich reckon that agriculture is starting to enjoy the same Asian-demand boost that drove mining over the past decade.

***The spouse contribution tax offset, asset allocation and catch-up contributions can significantly boost the balances of younger super savers.***

BY CAROL TAWFIK • EUREKA REPORT • 2 NOVEMBER 2016

# Three boosters for younger super starters

Following the May federal budget and release of draft legislation, we now have relative certainty around the superannuation environment post July 1 next year. For some, the changes will mean that immediate recalibration and restructure is required – for example, retirees with pension balances over $1.6 million.

***Key Point***

- ***With the golden age of superannuation ending, it pays even more to get going early.***

It is, however, those in the early stages of their working life who would be wise to think about the new super world; and how time can overcome some of the disadvantageous developments. The challenge here will be getting the spotlight shining on retirement planning when the need may seem so far away.

The recent changes announced include cuts to the amounts that can be contributed to superannuation, specifically a reduction in the non-concessional contribution limit to $100,000 per annum from $180,000 and a reduction in the concessional contribution limit to $25,000. The concessional contribution limit, which captures the superannuation guarantee and any additionally pre-tax sacrificed amounts, for example, will apply to all regardless of age from July 1 next year. The cessation of age-related caps means that there will no longer be the ability to make greater use of superannuation in those years leading up to retirement, as has historically been commonly advised.

The combined impact will mean many younger Australians may struggle to accumulate a healthy balance in the superannuation environment, let alone make full use of the $1.6m tax-free pension cap. This means that placing sole focus on things like mortgage repayments and funding school fees before thinking about superannuation in the later years of one's working life may need strategic rethinking. The good news is, time can be the secret weapon if put to use.

### Start small but start early – the magic of compounding

Put simply by Benjamin Franklin "Money makes money. And the money that makes money, makes money". Compounding investment returns is a powerful force which essentially harnesses the impact of time, getting it to do the hard work. This means that simply starting small, being consistent and – most importantly – getting an early start with investment can have a truly remarkable effect over time.

Taking a basic example, an investor contributing $200 per month from age 35 all the way to age 65 will have contributed around 33 per cent less than one who started the very same regular investment plan 10 years earlier at their age 25. Their ultimate retirement balance would, however, be almost half (assumes 6 per cent p.a. return) making for a compelling case. The benefit of grabbing the opportunity as early as possible cannot be emphasised enough. And when coupling with the tax benefit associated with a pre-tax (or tax deductible) contribution to superannuation, the strategy makes for a powerful and super efficient combination.

### 1. Spouse contribution tax offset

Under new proposals the spouse super contribution rebate will be broadened by increasing the income threshold for which the rebate will apply. A $3000 super contribution for the lower income spouse (earning up to $37,000 from July 1, 2017) will provide the contributing spouse with a $540 personal taxation offset. Missing out on superannuation contributions for even short periods results in major long-term imbalances. A sometimes forgotten allowance, the tax benefit creates great incentive to keep superannuation contributions up for a member of a couple who may be out of the workforce or has reduced working hours for a period of time.

It can, however, be hard to suddenly find the extra cash and justify making the contribution just prior to the end of a financial year; particularly with competing interests of a young family, for example. Planning ahead and instead opting for a regular contribution plan over the course of the year will likely better create the discipline to make it happen.

> **The recent changes mean many younger Australians may struggle to accumulate a healthy balance in the superannuation environment, let alone make full use of the $1.6m tax-free pension cap.**

### 2. Asset allocation

As well demonstrated in theory and in practice, a portfolio's asset mix will go the majority of the way to determining the long-term return and risk outcomes. When starting out in the workforce, many will hastily complete their superannuation paperwork without a great deal of thought applied to the investment option. This likely then means being placed in the default strategy, which will typically hold exposure of between 60 per cent and 70 per cent in growth-type assets. While this might be perfectly okay for some, it may represent a significant opportunity cost for others who could have had the appetite and profile for a higher-growth exposure. A seemingly small decision which, as history tells us, can have a marked impact over time.

### 3. Catch-up contributions

Slated to take effect from July 1, 2018 the proposed catch-up contributions allow one to utilise up to five previous years' unused concessional contributions where their balance is less than $500,000. Primarily aimed at those with interrupted employment, the new rule can have a broader application in allowing a super boost for some. The self employed with lumpy incomes will likely benefit but it will certainly also help those who have capacity to make extra contributions in a particular year simply because circumstances changed.

Be it an inheritance, a work bonus, a reduction in fixed costs and suddenly higher discretionary income, etc, utilising the catch-up concessional contribution strategy should be on the table. The benefit of concessional contributions is that they are tax deductible and represent an immediate tax saving alongside the favourable 15 per cent tax on earnings. The stalwart strategy to simply reduce the mortgage as quickly as possible with any surplus cash and think about superannuation later might warrant a rethink.

While some argue that those in their 20s and 30ss have had it too good or easy in some respects, there is no doubt that the golden age of superannuation will be a thing of the past. But opportunity exists for those who are informed, or informed enough to get advice and use the benefit of time to their advantage. This might just be where the baby boomers step in with some guidance for the collective good!

*Carol Tawfik is a licensed financial advisor at Affinity Private.*

***If it is alleviating financial stress, reverse mortgages are an attractive option for the 'asset rich and cash poor' retiree.***

BY SCOTT FRANCIS • EUREKA REPORT • 4 NOVEMBER 2016

# The pros and cons of reverse mortgages

Reverse mortgages, a financial product that allows people in retirement to take money to fund their cost of living while building a loan against the value of their home, often sit opposite to some key financial goals of people.

### *Key Point*

- ***A modest additional income from a reverse mortgage might have a significantly positive impact on quality of life, and still allow enough value in the home to support beneficiaries or access nursing care.***

From my experience most people like the idea of owning their home outright, and being able to leave a significant pool of assets when they pass away. A reverse mortgage, which effectively builds an ongoing and increasing loan against the value of a person's property in exchange for some immediate cash flow, sits opposed to those financial goals.

That said, reverse mortgages have become a better regulated financial product and, with the harsher age pension test coming from January next year, they are a personal finance option that people should be aware of.

We often hear about the plight of the "asset rich and cash poor" retiree. The reduced number of people able to access some part age-pension from next year will only exacerbate this problem, and reverse mortgages are certainly a financial product that deals with this – allowing people to access some of the value of their home as cash.

The key regulatory improvement came in 2012, with protections against 'negative equity' in reverse mortgage loans, meaning that what you ended up owing the lender could never be higher than the value of the house. This provides certainty that the only asset effectively used to secure a reverse mortgage is the property itself.

## Two key risks – interest rates and future cash access

A key input into any loan is the interest rate charged. A quick scan of interest rates available show that reverse mortgages have higher interest rates than standard loans – something around 6.0 to 6.5 per cent per annum appears to be standard at the moment. This, of course, is one of the key challenges around using a reverse mortgage; interest rates are significantly higher than a standard loan, and may rise in the future.

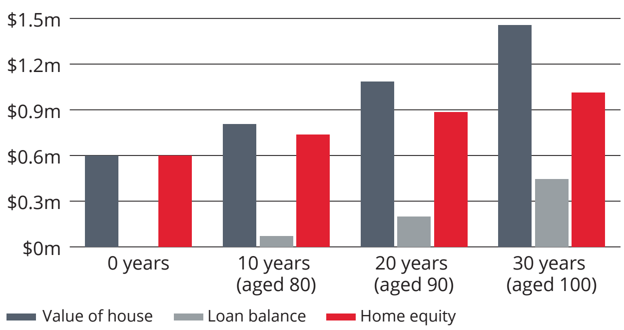
Another risk to be aware of is that if you have to sell your home in the future, perhaps to access nursing care, the loan has to be repaid at this point in time. This will reduce the amount of money that you have available at that point in time.

ASIC's *MoneySmart* website further discusses issues to be aware of in considering a reverse mortgage.

## Supplementing your income

Those negatives aside, I think there are situations where the benefits of immediate income might mean someone is prepared to use a reverse mortgage. A modest additional income from a reverse mortgage of $100 a week might have a significantly positive impact on someone's quality of life, without building up too significant a debt.

**Chart 1: 30-year reverse mortgage at 6.25%**




Source: Moneysmart.gov.au

To look at how this scenario might work, let's consider a person who is 70 years of age. They own their home worth $600,000 outright. Let's assume that they have $800,000 of assets which excludes them (from next year as a home-owning single person) from receiving any part age-pension. They are very conservative investors, holding most of that $800,000 in cash – currently returning them around $24,000 in interest per year.

> **“The key regulatory improvement came in 2012, with protections against ‘negative equity’ in reverse mortgage loans.**

Let us look at the situation if they were prepared to use a reverse mortgage loan, assuming an interest rate of 6.25 per cent (and using the calculator on the *MoneySmart* website). They want to access another $100 per week, which they suggest will significantly improve their quality of life. The calculations also assume that they currently have a home worth $600,000, and that home increases in value by 3 per cent per year. The summary of the situation follows in Chart 1.

It is interesting to note that a withdrawal at the rate of $100 a week, even over a 30-year period, will still see ‘home equity’ in the overall situation continue to grow.

One challenge with this calculation is that it does not take into account inflation. If we were to assume that inflation was around 2.5 per cent over the 30-year period, we would expect the value of goods and services to roughly double, or the value of money to halve over that period. That would make the home equity value of $1.012 million in 30 years time equivalent to around $506,000 in today’s dollars. In real (after inflation) terms, there has been a reduction in the value of home equity. This would have to be weighed against the benefits of receiving $100 a week over a 30-year period.

## Conclusion

Choosing to take out a reverse mortgage is not an easy decision – going into retirement while managing an increasing loan is hardly ideal. However, there are many people who struggle along through retirement with such a low level of income that it creates financial stress.

Using a reverse mortgage to access some additional spending money in a modest way might still allow people to keep enough value in their home to allow for supporting beneficiaries on their death, or accessing nursing care, while providing an immediate and ongoing improvement in their quality of life.

With reducing age pension access, an extended period of below-average sharemarket returns and historically low interest rates on cash investments, it might be a ‘backstop’ personal finance strategy worth keeping in mind.

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