Weekly Review

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– Issue – 9 Dec. 2016

Despite the prevailing logic in the financial advice industry, the Coalition's legislation actually outlawed segregation for tax purposes inside a super fund.

BY BRUCE BRAMMALL • EUREKA REPORT • 7 DECEMBER 2016

Clarifying the new segregation rules

Sometimes, even when you think you're on top of things, it turns out you're not.

A few weeks ago I wrote a piece – ***Pension cap elevates the segregation option*** – about taxation in super and an upcoming decision that those with more than $1.6 million in their pension fund were going to have to make.

Key Point

- ***It is difficult to understand how the ATO could stop segregation being used effectively across multiple funds. But there may still be ways around the new legislation.***

That decision was around choosing what assets to keep in the pension fund and what assets to leave in accumulation – otherwise known as "asset segregation" for SMSFs.

The piece was based on the prevailing 'logic' in the financial advice industry, that a $1.6m pension cap was going to require segregation of assets in a SMSF, between accumulation and pension. However, the logic had already been overturned (my apologies) with legislation.

It seemed likely to become a major plank of investment strategies going forward. That is, one of the investment decisions you would need to make as trustee was to choose, based on your own personal risk and return requirements, what assets you would leave in your $1.6m maximum 'transfer benefit cap' for your pension and what assets would be transferred back to accumulation.

However the legislation that was eventually passed, bringing in to force the Coalition's big super shakeup, actually outlawed segregation for tax purposes inside a super fund.

The government does not want you to be able to use segregation to manage your tax situation in your pension fund. It is, in fact, banning segregation for tax purposes.

Instead, a proportionate method will be used for tax purposes. Simply, all of the assets of the fund will be taxed based on the proportion that is in pension and the proportion that is in accumulation (which will be worked out by an actuary). If you have $2m in super, with $1.6m in pension and $400,000 in accumulation, then 20 per cent of gains will be taxed at accumulation rates and 80 per cent will be taxed at pension rates.

Segregation historically

Segregation has always been available to SMSFs from a tax perspective, but has not been widely used, largely because pension funds were allowed to contain an unlimited amount of funds. As a result, most people would generally have their entire super balance in pension, making segregation somewhat irrelevant.

Or they would use the proportionate method anyway, as it is administratively easier (and generally preferred by accountants).

But segregation certainly had its uses and potential benefits. For example, in two-member funds, where only one person

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was in pension, it might have made sense to have purposefully chosen assets backing the pension for tax reasons, and other assets backing the other member's accumulation account.

(Note: you will still be able to segregate assets for investment strategies for individual members, but not for the tax paid on earnings by the fund in super/pension.)

With the July 1, 2017 changes coming in to focus, it had been assumed by many that members or trustees would need to choose which assets were backing the pension and which went back to accumulation.

"But it sounds like they (the government) were listening to the chatter," says Aaron Dunn from the SMSF Academy. "They were listening to what was being said and decided that's not what they wanted. So, they took away that option."

Banning segregation from a tax perspective will take away a lot of guesswork, or a lot of crystal ball gazing, from what was likely to be the lot of SMSF trustees post July 1, 2017.

But using segregation did pose opportunities. And despite what the government appears intent on trying to achieve, segregation is unlikely to be dead.

It might have to take a different form.

Beating the segregation ban

Have two SMSFs.

Under the current legislation, the Government/ATO is aiming to stop SMSF trustees from using segregation within a fund to avoid paying taxes.

But it is difficult to understand how the ATO could stop segregation being used effectively across multiple funds (under current reporting requirements).

Aaron Dunn took me through the following example.

Let's take a member with $2.6m currently in pension in SMSF1, which includes a property worth $1m. In time for July 1, 2017, the trustee takes the $1m property and transfers it to a second SMSF (SMSF2).

There has been a CGT event, as it would be considered a disposal by SMSF1. But the transfer occurs while SMSF1 is in pension phase, so there would be no tax to pay.

SMSF1 now has $1.6m in pension. It then rolls back $1m from pension to accumulation. The member then has only used $600,000 in pension, of the $1.6m cap.

It then turns on a pension for the $1m property in SMSF2. This property is now the only asset in the SMSF and is, therefore, effectively segregated. If this is likely to be a high income, or high growth asset, and you've chosen it for that reason, then the segregation – according to what the experts currently believe – would have been achieved.

This would appear to be allowable under the new rules. But it's early days and something that will require extra consideration by the experts.

There will be some extra costs in setting up and running the second SMSF. But if the trustees believe that it will deliver dividends in excess of those costs, then it could be worth it.

Dunn said that it is too early to tell how all this will work in regards to reporting (to the ATO) the movements in and out of pension phase for SMSF1 and SMSF2.

So the strategy comes with a 'kids, don't try this at home' warning. At least not yet. There's no great rush to, as the new rules don't hit for six months. But the best brains in the business are still trying to work their ways through the new laws.

> **The government does not want you to be able to use segregation to manage your tax situation in your pension fund. It is, in fact, banning segregation for tax purposes.**

What are the potential downsides?

If the asset being transferred is property, then a potential downside is stamp duty in some states. This is something to check, state by state (potentially with your SMSF accountant). Dunn said that some states will not charge stamp duty, when the beneficiaries remain the same, but other states will charge it.

So even though there might not be any capital gains tax, having to pay up to around 5.5 per cent in stamp duty, if applicable, could turn a good idea into a marginal one.

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

The information contained in this column should be treated as general advice only. It has not taken anyone's specific circumstances into account. If you are considering a strategy such as those mentioned here, you are strongly advised to consult your adviser/s, as some of the strategies used in these columns are extremely complex and require high-level technical compliance.

The problem with re-contribution strategies and weighing the 'retain in accumulation' and 'withdraw completely' options for exceeding the cap.

MAX NEWNHAM • EUREKA REPORT • 7 DECEMBER 2016

Tax with Max:

Can re-contributions avoid the $1.6m cap?

Q: *I am a 74-year-old and am interested in what I will need to do if I have $1.6 million in my SMSF at June 15, 2017. Could I pay myself an additional pension of $380,000 for the year and then re-contribute $180,000 before June 30, 2017, leaving a balance of $1.4m and $200,000 in my personal bank account.*

Then could I contribute the $200,000 on July 1, 2017, bringing my super balance back to $1.6m and reaching the new limit. By doing this would I have managed to get the required outcome from the $380,000 through a re-contribution by the first working day of the new financial year?

Answer: I am not sure what you are actually trying to achieve through this re-contribution strategy. There are, however, a number of problems in being able to do what you are proposing and whether or not any benefit would be achieved through this re-contribution strategy.

The first thing to establish is your ability to make non-concessional super contributions (NCCs). Once a person reaches 65 and is under 75 they are able to make both concessional and non-concessional contributions if they pass the 40-hour work test. This means, to be able to make any contributions in the 2017 and 2018 year, you would need to pass the work test.

If you're able to pass the work test the maximum NCC that you can make during the 2017 financial year will be $180,000. If you turn 75 during the 2017 financial year you will not be able to make any further superannuation contributions after June 30, 2017.

If you are still 74 at July 1, 2017 and will pass the 40-hour work test during the 2018 year, the maximum NCC you can make is $100,000.

the recently passed amendments to superannuation contribution limits the maximum NCC limit from July 1, 2017 will be $100,000. The ability to bring forward two years of future contributions, and make a contribution of $300,000, is only available to people who are under 65.

I am not sure whether you are wanting to use this re-contribution strategy to increase your tax-free super, or are wanting to make sure you are under the new $1.6m pension transfer limit that will apply from July 1, 2017.

If you are wanting to increase the tax-free component of your superannuation so that upon your death tax paid by non-dependents who receive the super will be decreased, you could only do this with $180,000 in the 2017 year and $100,000 in the 2018 year. This is dependent upon your age and passing the work test.

If you are wanting to use this re-contribution strategy to somehow avoid the $1.6m pension transfer limit, nothing would be achieved by taking a large lump sum and then re-contributing it after June 30, 2017.

The way the new superannuation pension transfer limit works is that after initially starting at $1.6m it will increase in $100,000 increments, in line with increases in the consumer price index (CPI).

Members with less than $1.6m in a pension account at June 30, 2017 will be able make further contributions – as long as they meet the relevant contribution tests – that are rolled into pension phase as long as the pension transfer limit is not exceeded.

Where a member of a super fund has less than the $1.6m limit in a superannuation pension account at June 30, 2017, and there is an increase in the pension transfer limit due to CPI increases, their pension transfer limit will increase proportionately in line with the increase.

For example, if 'Paul Costello' has $1.2m in a superannuation pension account at June 30, 2017 he will have used 75 per cent of the pension transfer limit. If by 2022 the pension transfer limit has increased to $1.8m Costello can make a further transfer to his super pension account of $450,000.

> **I do not believe the re-contribution strategy will work if you are wanting to try and maximise the amount that you will have in a superannuation pension account.**

After making the transfer Costello will have a superannuation pension account which totals $1.65m. Because Costello only had one quarter of the original $1.6m pension transfer limit left at July 1, 2017 he only receives the benefit from a quarter of the $200,000 increase.

In your situation with having $1.6m now in your super fund and more than likely not being able to make any further contributions after June 30, 2017 as you will be 75, I do not believe the re-contribution strategy will work if you are wanting to try and maximise the amount that you will have in a superannuation pension account.

Q. *With the requirement that amounts above $1.6m cannot be transferred to a pension account, I understand that one option is to retain the excess funds in an accumulation account. If this is the case how do you get access to the accumulation account balance and what is the tax treatment? Are withdrawals considered to be lump sums, and once you have withdrawn more than the tax-free limit you need to pay tax on them, or are they somehow still considered to be 'pension income' and the over 60s won't need to pay tax on the receipts?*

Answer: Where superannuation fund members have a balance in excess of $1.6m at June 30, 2017 they must either roll back the excess into an accumulation account or withdraw the funds from superannuation altogether.

When a member exceeds the transfer balance they will also be subject to excess transfer balance tax. For the 2017-18 year the tax rate is 15 per cent, and from the 2019 financial year the excess transfer tax will be 15 per cent on the first breach that increases to 30 per cent for a second and every subsequent breach.

The excess transfer balance tax is not payable on the superannuation pension account that has exceeded the pension transfer limit, but instead is paid on the notional income that the excess would have earned during the period that the superannuation account was in excess.

The rate used for calculating the notional earnings on the excess is the general interest charge. The benchmark indicator used for this rate is the 90-day bank accepted bill yield for short-term interest rates. The published rate for the 2015-2016 financial year, according to the Reserve Bank of Australia, was 9.2 per cent.

If a member chooses to roll back the excess superannuation over the pension transfer limit into an accumulation account the usual taxation of superannuation payments will apply. If the excess has been rolled back from a pension account the member will have clearly met a condition of release and effectively has total access to their accumulation account.

In the event of the member being under 60 they can access lump sum payments tax-free up to $195,000 with amounts withdrawn in excess of that being taxed at 15 per cent plus the Medicare levy.

Where a member is 60 or older any lump sum payments are received tax-free. The main difference to the member, as a result of having to transfer the excess super to an accumulation account, is that tax will be paid on the income earned on that account at 15 per cent.

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

The Australian economy contracted for the first time since 2011 in the September quarter.

BY CRAIG JAMES • EUREKA REPORT • 7 DECEMBER 2016

Economy shrinks: Wake-up call for Australia

- **Economy contracts**: The economy contracted by 0.5 per cent in the September quarter after an upwardly-revised 0.6 per cent increase in the June quarter (previously up 0.5 per cent). The Aussie dollar fell half a cent in response. It was the first contraction in the economy for 5½ years. Annual economic growth slowed from 3.1 per cent to 1.8 per cent.
- **Contribution to growth**: The biggest contribution to growth came from household consumption (+0.3 percentage points) followed by inventories (+0.1pp). The biggest drag on growth was public investment (down 0.5pp) followed by net exports (down 0.2pp) and dwelling investment, ownership transfer costs and commercial construction (all down 0.1pp).
- **Income**: Real gross national income rose by 0.9 per cent in the September quarter to be up 3.2 per cent on the year. In nominal terms GDP lifted 0.5 per cent in the quarter and rose by 3.0 per cent over the year.
- **Productivity**: Gross value added per hours worked in the market sector fell by 0.8 per cent in the September quarter after rising by 1.7 per cent in the June quarter. Annual growth was 0.7 per cent.
- **Industry sectors**: Eleven of the 19 industry sectors expanded in the September quarter. The strongest sector was Agriculture, forestry and fishing, up 7.5 per cent and adding 0.2 percentage points (pp) to growth. Finance and insurance services added 0.1pp. The Construction sector fell by 3.6 per cent in the quarter (-0.3pp). Mining, "Other services" and Rental, hiring and real estate services all took 0.1pp off growth.

What does it all mean?

This will turn out to be just a blip on the radar screen, but a very important blip. Many Australians have become complacent. And that includes businesses and politicians. The only way the economy can grow is by Australians spending, investing and employing. Australians didn't do this in the September quarter. Still, there was also seasonality involved in the weak result. The Reserve Bank has been intimating for some time, monetary policy is reaching its limits. Infrastructure spending may prove useful in coming quarters in providing fresh momentum to the economy.

In the September quarter the economy was hit by a perfect storm. Not only was there the reaction to the UK 'Brexit' vote, there was also the Federal election and then there was the uncertainty about the US elections. And clearly, when there is a lot of uncertainty around, consumers and businesses tend to delay decisions to spend, invest and employ. A big fall in public investment also accounted for the bulk of the contraction of activity in the quarter. Wet weather didn't help, causing a big drop in construction.

While spending measures of the economy were weak in the September quarter, income measures were actually quite strong. And the farm sector was also strong in the quarter and should also be a key contributor to growth in coming quarters. For those who may have forgotten after 25 years of consistent economic growth, a 'technical recession' involves two consecutive quarters of contraction in the economy. We don't believe there are grounds for another quarter of contraction. And indeed it would be amazing if there was some variant of 'recession' with a jobless rate of 5.6 per cent.

The Reserve Bank is always looking ahead and so must we. The outlook for the economy remains bright with record home building, a record winter crop, unemployment at 3½-year lows and super-low interest rates. Already the data for the December quarter has been more upbeat including retail spending and job ads.

The Reserve Bank warned yesterday that annual economic growth would slow before it picked up in 2017. That is our expectation also. The economy should grow near its 'potential' rate of 3 per cent in 2017. We continue to believe that interest rates will remain on hold in coming months. But no one will be thinking of rate hikes any time soon.

What do the figures show?

National Accounts:

Economic Growth: The economy contracted by 0.5 per cent in the September quarter after an upwardly-revised 0.6 per cent increase in the June quarter (previously up 0.5 per cent).

> **“This will turn out to be just a blip on the radar screen, but a very important blip. Many Australians have become complacent.**

The Aussie dollar fell half a cent in response. It was the first contraction of the economy for 5½ years.

The economy has grown by 1.8 per cent over the past year, down from 3.1 per cent growth in the year to June. Growth has averaged 2.7 per cent over the decade and averaged 3.0 per cent over the last 15 years.

The non-farm economy fell by 0.6 per cent in the September quarter after a rising by 0.7 per cent in the March quarter. Annual growth stands at 1.8 per cent.

Farm GDP rose by 8.0 per cent in the September quarter after falling by 0.3 per cent in the June quarter. Farm GDP rose by 2.3 per cent over the year.

At current prices, GDP rose by 0.5 per cent in the June quarter to be up 3.0 per cent on the year. The annual growth rate is still well below the decade average of 6.2 per cent. Over the year to September 2016, **the Australian economy was valued at $1,666 billion**.

Growth drivers: The biggest contribution to growth came from household consumption (+0.3 percentage points) followed by inventories (+0.1pp). The biggest drag on growth was public investment (-0.5pp) followed by net exports (-0.2pp) and dwelling investment, ownership transfer costs and commercial construction (all -0.1pp).

Inflation: In terms of domestic price pressures, the household consumption implicit price deflator rose by 0.2 per cent in the September quarter after a 0.4 per cent increase in the June quarter. Annual growth stands at just 1.0 per cent. Real non-farm unit labour costs rose by 0.6 per cent in the September quarter after falling 1.2 per cent in the June quarter. Real non-farm unit labour costs fell by 0.6 per cent over the year.

Productivity: Gross value added per hours worked in the market sector fell by 0.8 per cent in the September quarter after rising by 1.7 per cent in the June quarter. Annual growth was 0.7 per cent. GDP per hour worked fell by 0.9 per cent in the quarter to be up 1.0 per cent over the year. And hours worked in the market sector rose by 0.5 per cent in the quarter to be up 0.5 per cent on the year.

States & Territories: The only data available is state final demand (more accurate data would include net exports but it is not available for all states and territories). In the September quarter growth was strongest in the Northern Territory (up 4.7 per cent) from NSW, Queensland and South Australia (all up 0.1 per cent). SFD fell most in Western Australia (down 3.8 per cent) from ACT (down 1.3 per cent), Victoria (down 0.4 per cent) and Tasmania (down 0.3 per cent).

The ACT had the fastest annual growth rate in the September quarter (up 6.4 per cent), followed by NSW (up 5.0 per cent), Victoria (up 2.5 per cent), South Australia (up 1.6 per cent), Northern Territory (up 1.5 per cent), Queensland (up 1.2 per cent) and Tasmania (up 1.1 per cent). Western Australia contracted by 9.5 per cent.

Consumer spending lifts. Household spending rose by 0.4 per cent in the September quarter to be up 2.5 per cent for the year. Only five of the 17 sectors recorded weaker spending in the quarter. Spending fell most in Purchase of vehicles (down by 3.8 per cent) and Food (down by 0.8 per cent). Spending rose most in Communications (up 2.7 per cent) and Hotels, cafes and restaurants (up 2.2 per cent).

Industry sectors: Eleven of the 19 industry sectors expanded in the September quarter. The strongest sector was Agriculture, forestry and fishing, up 7.5 per cent and adding 0.2 percentage points (pp) to growth. Finance and insurance services added 0.1pp. The Construction sector fell by 3.6 per cent in the quarter (-0.3pp). Mining, “Other services” and Rental, hiring and real estate services all took 0.1pp off growth.

Other points:

Profit share rises. In seasonally adjusted terms, the ratio of profits to total factor income rose from 24.2 per cent to 24.4 per cent in the September quarter. **The wages share** rose from 54.0 per cent to 54.5 per cent.

Household savings ratio falls. The household saving ratio fell from 6.7 per cent in seasonally adjusted terms in the June quarter to 6.3 per cent. In trend terms household saving was steady at 6.5 per cent in the September quarter.

> **If the Reserve Bank is forced to revise down inflation forecasts as well as economic growth then it will put another rate cut on the table. But that remains to be seen.**

Imports rose as a share of spending. The imports to sales ratio rose from 0.371 in the June quarter to 0.373 in the September quarter.

The inventory to sales ratio rose from 0.615 per cent in the June quarter to 0.625 per cent.

What is the importance of the economic data?

The quarterly **National Income, Expenditure and Product release (national accounts)** from the Bureau of Statistics is the most complete assessment of Australia's economic performance. Detailed estimates are provided on incomes (wages, profits), spending (such as household, dwelling investment and trade (exports and imports) and production (comparing industry performance). Other data includes household saving and the economic performance of States and Territories.

The main use of the national accounts figures is as a historical record of economic performance. The information has little forward-looking value for currency, interest rate or share markets.

What are the implications for interest rates and investors?

The national accounts data is backward looking. But the data is taken into account by the Reserve Bank, serving as a base for forecasts. The Reserve Bank uses six-month annualised growth figures to ascertain how the economy is travelling. Even assuming a 1 per cent lift in the December quarter, annual economic growth would be below Reserve Bank estimates of 3.0 per cent.

If the Reserve Bank is forced to revise down inflation forecasts as well as economic growth then it will put another rate cut on the table. But that remains to be seen – inflation still looks to have bottomed, especially with oil prices pushing higher. We – like the Reserve Bank – expect the economy to lift over 2017, so it is still too early to talk about rate cuts. And the question has to be asked – at current levels, do rate cuts still work to lift spending and investment?

Income measures posted solid growth over the September quarter. Real gross national income rose 3.2 per cent over the year with net national disposable income up by the same magnitude. So there is no shortage of income to drive spending and investment decisions.

Seasonality played a role in the September quarter. Usually spending grows by 0.9 per cent in real terms, but in September quarter 2016, the economy fell by 0.3 per cent in original terms – the first time this has happened in 34 years (since September 1982). So if activity was delayed, this could find its way into the December quarter numbers, leading to a far greater bounce in economic activity.

Craig James is the chief economist of CommSec.

Investors in Australian shares are on the cusp of a 10-year period of poor returns, with cash actually

BY SCOTT FRANCIS • EUREKA REPORT • 7 DECEMBER 2016

Why five-to-seven years isn't adding up

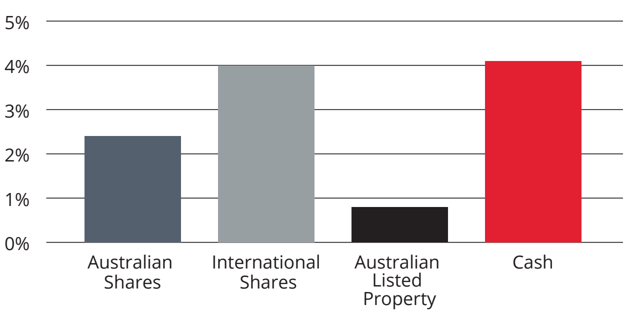
As I started out as an investor, I remember thinking that managed funds would clearly be the best investment vehicle for me. They have the benefits of a professional manager and the administration is done for you. Also, while I didn't fully understand them, I felt fees didn't seem like too big a deal because I was confident my fund manager would outperform the average market.

Key Point

- ***The 'five-to-seven-year' rule for expecting a positive experience for investing in shares is being challenged, although post-GFC investors who used 2009 as a buying opportunity have been rewarded.***

I understand, now, that the reality of investing in managed funds is quite different. As I looked around the glossy fund manager brochure starting out as an investor, I noticed that the most common time frame suggested for a successful investment in a share-based managed fund was five to seven years.

Chart 1: Total returns (income and growth) from asset classes, 1 Jul 2007–30 Jun 2016



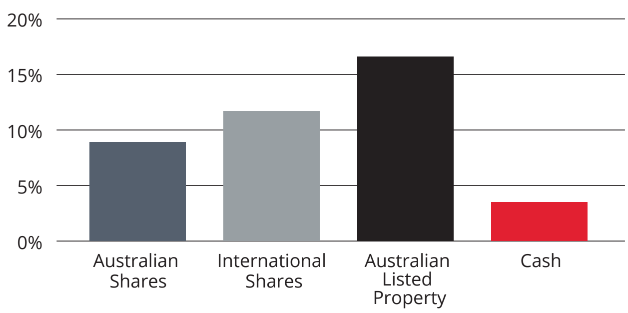
Source: Vanguard

One thing that the investment period from end-2007 to now has shown us is that the 'five-to-seven' year wisdom is not good enough for all periods. The Australian share market hit a peak in late 2007 closer to 7000 points than 6000 (the All Ords was 6779 in October of 2007).

Chart 1, based on average share market returns, provides some initial data for us to look at as investors over a nine-year period from July 1, 2007 to June 30, 2016 – close to the market peak through to this year. It is worth noting that nothing particularly dramatic has happened in the months since July that would substantially change this – leaving us right now about six months away from a 10-year period of poor returns, well beyond the 'five to seven' year period often cited as a holding period for growth assets.

Looking at this data, it is clear that the key Australian asset classes of listed property and Australian shares have provided an extended period of below average returns. In this case they trail the returns from cash. It is worth noting that the returns from these investments include both the price movement and dividends paid – in the case of Australian shares, the price movement has been negative over this period but a stream of income has been paid, leading to the overall positive return.

Chart 2: Market 'rebound' total returns, 1 Jul 2009 – 30 Jun 2016



Source: Vanguard

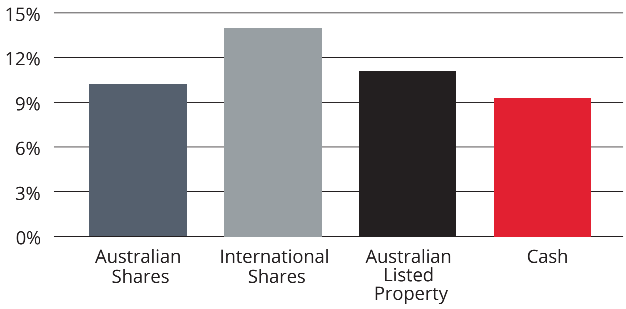
The bottom of the market then happened in early 2009 – in the case of Australian shares they fell in value by around 50 per cent (bottoming in the low 3000s). This is a tremendous loss of value but consistent with market falls in 1987, the early 1970s and the Great Depression in Australia.

So, what has happened since then? The following data shows the period from July 1, 2009 (just after the market bottomed) to June 30, 2016. It shows that investors who used 2009 as a buying opportunity have been rewarded. Interestingly, the worse performing asset class from 2007 to 2016 (Australian listed property) has had the strongest return since 2009.

> **One thing that the investment period from end-2007 to now has shown us is that the 'five-to-seven' year wisdom is not good enough for all periods.**

The 1987 crash is the most recent of the big falls in Australian markets, happening towards the end of 1987. To look at the 10-year recovery from this, we can look at returns from July 1, 1988 to June 30, 1998. Interestingly, as Chart 3 shows, the returns following this downturn don't look all that different to what we are looking at in this current post Global Financial Crisis period – reasonable returns without anything particularly spectacular.

Chart 3: Post '1987 crash' returns, 1 Jul 1988 – 30 Jun 1998



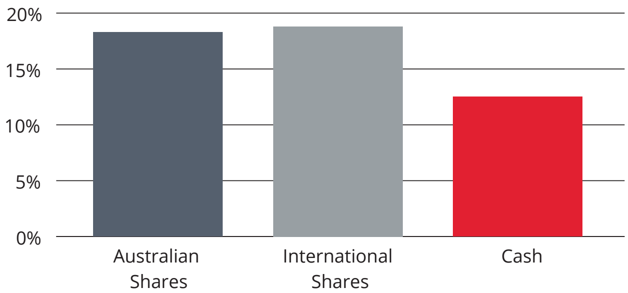
Source: Vanguard

The period in the early 1970s was also a poor period of returns from Australian shares. For the period June 1970 to June 1975 a $10,000 investment in the average share market portfolio fell from $10,000 to $6900 when you include the value of dividends received. This might not seem like a historically large fall, but when you consider that inflation was above 10 per cent for an extended period of time, it was a significant destruction of purchasing power for investors who owned shares.

This recovery seems spectacular enough with 18-plus per cent returns for a period of 10 years. I am sure we would all sign up to that today if we could. However, with inflation relatively high over that period, and cash returns of 12.5 per cent, the returns from shares were only 5.8 per cent higher than that – a reasonable return for the risk of investing in shares.

It is, of course, a little harder to find market data around the time of the Great Depression. A book of Australian Historical Statistics was produced for the Australian Bicentennial and contains some share market data back to the late 1800s. It shows that at June 30, 1929 the All Ordinaries index was at 52.5 points, and over the next two years fell to 30.2 points. This is consistent with a fall of around 50 per cent, as the highest and lowest points will have been more extreme than these end of financial year values.

Chart 4: Share market recovery, 1 Jul 1975– 30 Jun 1985



Source: Vanguard

The market then recovered over the 10 years from June 30, 1931 to almost exactly double to a value of 60.3 by June 30, 1941. Over this period the market yield was always above 4.5 per cent, with a peak of 8 per cent – adding to the returns from the price-index doubling.

Final word

Clearly the 'five-to-seven-year' rule for expecting a positive experience for investing in shares is challenged by this current period, where we are on the cusp of a 10-year period with negative price returns.

It is interesting to look back to previous market downturns; investors who were disciplined, and held Australian shares after a downturn, were rewarded over the next decade.

That said, I don't think it can be argued that subsequent returns will necessarily be positive or exceptional, rather that shares have provided returns in excess of cash over these periods.

Early evidence is that this is certainly the case for investors who bought shares around the bottom of the market in 2009.

Strong commodities demand is benefitting miners, but the companies supplying the mining equipment and other services are getting mixed results.

BY TIM TREADGOLD • EUREKA REPORT • 6 DECEMBER 2016

An uneven road for mining

There is rarely a straight line in any recovery, and that's certainly the case with Australia's mining services sector.

It blossomed this year before appearing to stall, even as most metal prices continued to rise.

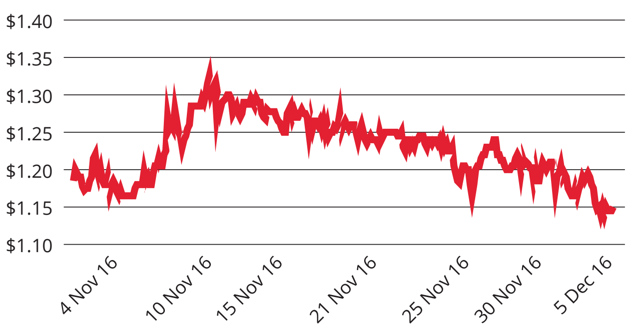
Key Point

- ***Mining groups will invariably use their increased cash flow to pay down debt, but there's also likely to be a rise in capital expenditure on new and existing projects. That's good news for mining contractors.***

Ausdrill, a specialist mineral drilling contractor, is a useful guide. A significant beneficiary of the first flush of the mining recovery its share price has paused since *Eureka Report* last looked at mining services four months ago (***How grubstaking is feeding a mining services revival***, August 17).

Back then Ausdrill was trading at $1.17, having risen 550 per cent from the start of the year when it was as low as 18c. It continued to rise after our report to a 2017 peak in September of $1.75.

Chart 1: Ausdrill share price, past month



Source: Bloomberg, Eureka Report

On Monday Ausdrill closed at $1.15, with the decline from its September peak price broadly mimicking the fall in the price of gold since September from $US1348 an ounce to $US1170/oz.

Servicing gold exploration and mining companies is important to Ausdrill, but it's not the company's sole focus. It has clients mining or exploring for copper, iron ore and a number of other minerals, which have not suffered a sell-off like gold. In fact, most have risen since August.

Iron ore, for example has risen by 40 per cent from $US56 a tonne in mid-August to its latest price of $US78/t. While most investment banks are forecasting a correction in the new year after Chinese steel mills have restocked, iron ore is a useful pointer to the overall rising trend in mineral prices.

Some of the other service companies mentioned in our August story have risen, some have fallen, and what makes that mixed bag interesting is that the only mineral to have fallen in that time is gold.

Two other drilling companies, Swick and Boart Longyear, have seen their share prices slip by 11 per cent and 21 per cent, respectively. Engineering and equipment service providers have risen. Lycopodium is up 8 per cent, Monadelphous 5 per cent, NRW 18 per cent, Emeco also 18 per cent, and Mineral Resources (which also mines a number of minerals, including iron ore) is up 19 per cent.

Copper, widely considered a bellwether metal for the wider minerals complex, has risen by an eye-catching 25 per cent since August, from $US2.15 a pound to $US2.69/lb. Nickel is up 14 per cent and zinc has continued its spectacular recovery, adding another 17 per cent to $US1.24/lb, meaning it has doubled since the start of the year.

The mining services outlook

What's next? That's a question which every investor asks after a turn in the market as significant as that which has occurred in resources, where even the heavily discounted oil and gas sector is enjoying some respite after more than two years in the sin bin.

Thoughts from investment banks about the next phase of the resource recovery are interesting. Citi generated some significant numbers last week in a report, which started by noting that the last time commodities rallied as strongly as they have in recent months was back in 2009–10.

That price surge, which peaked in 2011, was matched by a doubling in capital expenditure on mining projects from $US60 billion in 2009 to $US125 billion in 2012, a building

> **The dispensation of the cash starting to build in the mining companies is the key to what happens to the service companies, with signs emerging of preparations for an increase in the flow of work.**

boom which has been largely responsible for the commodity glut that is now being absorbed.

"Citi's European Mining Services team wrote a note back in August highlighting that the combined capital expenditure for the big four mining houses (Rio Tinto, BHP Billiton, Anglo American and Vale) peaked at $US56.8 billion in calendar 2012 and we think it will trough at $US17.8 billion in calendar 2017," Citi said in its latest comment.

Two important points emerged from Citi's research. That capital spending is "highly incentivised" by higher commodity prices, and that capex is bottoming at around 70 per cent from the peak.

Other investment banks echo the Citi view that a fundamental shift has occurred in resources. The effect on mining companies is being compounded by sharp cuts to their operating costs, which is boosting free cash flow and setting the scene for a restart of mothballed mines and the development of new mines, which will boost the services sector.

UBS described the current climate for miners as a period of "printing money" with spare cash being dedicated, initially, to further reductions in debt followed by higher dividends for shareholders.

Once the debt and dividend obligations are met it will be the turn of capital expenditure.

Goldman Sachs, once regarded as the biggest commodities bear in the banking world, acknowledged that tag but also said in a report last week that it was "no longer the commodity bear".

The changed view from Goldman Sachs is actually quite remarkable, with its iron ore price forecast for the next 12-months almost doubling from $US36/t to $US65/t. The 12-month copper price forecast has been lifted from $US1.91 a pound to $US2.18/lb, while zinc is up from $US1/lb to $US1.27/lb.

A new cash stream

The dispensation of the cash starting to build in the mining companies is the key to what happens to the service companies, with signs emerging of preparations for an increase in the flow of work.

NRW last week made a move to expand its business base by making a bid to buy the failed Hughes Drilling from its administrators for an undisclosed price.

Swick also announced that it had picked up a new contract covering three mines which would take its rig utilisation rate to 77 per cent, with 60 rigs out of a fleet of 78 in active service.

Of all the signs pointing to a continuation of the recovery in mine services, it is the UBS comment about the big miners printing money which is the most optimistic. So is the bank's calculation that BHP Billiton will see its debt load shrink from $US26.1 billion this financial year to $US18.1 billion next year, before tumbling to $US9.7 billion in 2018.

By 2020, according to UBS, BHP Billiton could be sitting on net cash of $US5.6 billion, an unlikely situation given shareholder dividend demands and the temptation to improve old mines and develop new ones.

That's exactly what will underpin the ongoing service companies recovery.

Bailador's retail raising provides the opportunity for investors to lift their holding, or they can hold off for NTA discounts down the line.

BY MITCHELL SNEDDON • EUREKA REPORT • 8 DECEMBER 2016

Portfolio Update:
Add more Bailador?

Fully underwritten Share Purchase Plan giving Bailador shareholders the opportunity to purchase up to $15,000 of additional Bailador shares with no brokerage or transaction costs. Bailador intends to raise $2 million after raising $15.45m from wholesale and institutional investors in late November.

Key Point

- ***The major dilutionary effect has already taken place and the brokerage savings are likely minimal.***

BAILADOR TECHNOLOGY INVESTMENTS (BTI) / HOLD

Price at review	Max. portfolio wght.	Business risk	Share price risk
$1.03	10%	Med–High	Medium

The offer

The purpose of the raising is to top-up the cash balance for future investment opportunities. The purchase price will be $1.03, the same price the placement took place at. Shareholders can apply to purchase five different parcel sizes from 1000 shares up to 14,563.

Dilution effect

There's not much of a dilutionary effect, it works out to be approximately 1 per cent and the bulk of it has already taken place with the $15.45m raised. Usually we like a fair and equitable capital raising, one where retail investors aren't left out in the cold. In this case, where there are investment opportunities looming and you need to raise a large amount of capital and be sure you raise exactly what you want, a placement is a good way to secure it.

Do you take them up?

Do you want more? You are not getting this at an attractive discount. Yes, it is brokerage-free but depending on which broking service you use this is minimal anyway. The dilution has already taken place, too. So really the answer is take them up if you really want more, otherwise be happy to wait for a discount to appear.

As previously written here, we expect a discount to net tangible assets to appear from time to time with Bailador as short-sighted investors lose patience.

Expect more

Bailador is doing this raising because its cash levels are running low, and that will happen when you invest in a portfolio of illiquid assets. Bailador can't easily sell down to free up cash for the next opportunity and, as discussed in our previous update, as Bailador become bigger the more opportunities are presented to them.

What can you do when the cash pile is low and you have investment opportunities you want to get into? Raise capital. And we have no problem with this as long as the team keep kicking goals with the companies they buy into.

When it comes to finances, a time investment by both parties of a couple can translate into considerable long-term advantages.

BY CAROL TAWFIK • EUREKA REPORT • 5 DECEMBER 2016

The advantages of financial co-management

It is usually accepted that there can be great benefits to working in a team, and that what can be achieved as a unit is often far greater than what can be achieved by the individual.

Key Point

- ***There is great benefit to be had where household finances are effectively co-managed, tapping into successful team thinking.***

These include:

- Tapping into one another's strengths;
- sharing ideas and problem solving, and;
- a greater sense of accountability ... all concepts that are readily applied in the workplace setting.

When it comes to management of the household finances, the approach should perhaps be no different. However, in my experience the prevailing norm seems to remain that one member of a couple primarily takes the reins. This isn't necessarily the case out of disinterest. The potential demands of home, work, family life etc can make it seem much more efficient and a lot easier to allocate the bulk of the financial management and investment decision-making to one person.

Surely it's simply more economical from a time management perspective? While that might seem the case, there can be downsides to this approach.

Sharing the fiscal load

A time investment by both parties of a couple can translate into considerable long-term advantages – for the individual, the unit, and even the broader economy.

Goal-setting, having some sense of a vision for the future, is usually at the core of how we think about our fiscal management. In thinking about retirement lifestyle, for example, couples typically have a shared vision and work together to achieve their specified goals. Financial management will inevitably be one of the means to that achievement, so it makes good sense that all stakeholders are fully engaged. Small incremental gains or consistent actions might be all that is required in the achievement of an objective.

But without taking a team approach, there can be less sense of accountability. And even seemingly minor deviations – positive or negative – can have a marked and compounding impact over time. As is the case with clearly defined goals, accountability for one's own role is an integral component and the driver of team performance. Bringing team thinking into your personal financial planning can make all the difference.

The gender gap

Behavioural finance studies tell us that women and men can in general possess different traits when it comes to investment and money management. LouAnn Lofton's *Warren Buffett Invests Like a Girl: And Why You Should*, Too highlights that several of the characteristics that make Buffett a successful investor are traits which are temperamentally more feminine than masculine.

When it comes to decision making, a team will benefit from a rounded perspective and will be high performing when it is able to tap into the skill set and strengths of its members.

Losing a partner

Unfortunately death is an inevitability and that can mean that the sole survivor of the couple will be faced not only with the emotional stress but, perhaps, also the sudden burden of learning and becoming the money manager all at once.

In speaking to many clients over the years, the prospect of this can be incredibly daunting, even with the support of a strong professional network. Being engaged and making an investment of time when it comes to the financial co-management, can dissolve a great deal of that fear and create a considerably better sense of confidence and comfort in all.

> **“A time investment by both parties of a couple can translate into considerable long-term advantages – for the individual, the unit, and even the broader economy.**

Engaging the young

According to the May 2015 ***ANZ Survey of Adult Financial Literacy in Australia***, financial literacy is defined as “the ability to make informed judgements and to take effective decisions regarding the use and management of money”. There is no doubt that fostering healthy relationships with money in young people is crucial to good financial management in adulthood.

A **2012 report** from Girls Scout Research Institute says “preliminary data suggests that children are most likely to go to their parents for information on money and finances, but parents often fail to communicate with and teach them about these issues”.

It further reveals that while girls display great optimism in their future lives and attitude, they lack financial decision making confidence. With parents the primary example (girls looking mostly to their mothers), this highlights the strong influence and importance that both parents have in fostering and supporting financially confident young adults, which in turn supports a stronger economy.

Final word

While life’s demands can pull us in many different directions at once, there is great benefit to be had where household finances are effectively co-managed, tapping into successful team thinking.

While it does not come without an investment of time, the advantages can be far reaching from increasing prospects of achieving financial independence to setting a great example for young people.

The tremendous opportunity and influence of financially confident mums and dads can indeed go beyond the individual and ultimately contributes to the functioning of a strong and competitive economy into the future.

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