Weekly Review

WEALTH

– Issue – 16 Sep. 2016

In capital growth terms, the property market largely remains a tale of two cities. But there are also great yield plays, if you know where to look.

BY NERIDA CONISBEE • EUREKA REPORT • 14 SEPTEMBER 2016

Australia's hottest property investment destinations

One of the most common questions I get asked by residential property investors is "where should I buy?"

Key Point

- ***Strong demand for select inner-city suburbs in Sydney and Melbourne is continuing to drive growth, while investors in some outer and regional pockets are experiencing solid yields.***
- ***Watch Property Point on Eureka Report, a new video segment aimed at keeping investors in tune with the Australian property market.***

The challenge when answering this is that all investors are different. Most investors look to achieve capital growth, but some less so and are more interested in the monthly rental cheque. And then there are the emotional aspects of buying property, with many buyers wanting to be able to see their property regularly or to buy in areas that they most identify.

Given the size of the residential property sector in Australia there is a suburb perfect for every type of investor.

Capital growth

While past capital growth is not necessarily an indicator of future growth, it does give us ideas as to the type of property that tends to do well. Not surprisingly, the strongest performing houses are in Sydney and Melbourne and the top three are all in suburbs that could be considered prestige, with prices well over $1 million. For units, there are much more affordable options.

In Sydney, the Bowral suburb of Burradoo has had the strongest median price growth in Australia over the past 12 months, driven by commuters looking for an alternative to the crowded Sydney market as well as those looking for a weekender. The inner-east suburb of Woollahra comes in third. In Melbourne, the beachside suburb of Hampton saw 30 per cent median price growth over the past 12 months.

For units, Ultimo in inner Sydney has seen the strongest growth, partly driven by strong white collar employment growth in Sydney's CBD. And although Queensland has not been performing as well as Victoria and New South Wales for price growth, there are suburbs that are achieving some of the highest price growth for units in Australia. Brookwater in Brisbane has seen 43 per cent growth over the past 12 months, while Noosa Heads has seen 37 per cent growth.

Table 1: Suburbs with strongest median price growth (y/e May 2016)

HOUSES	MEDIAN	ANNUAL GROWTH (%)
BURRADOO, NSW	$1,336,000	32.3
HAMPTON, VIC	$1,770,00	30.1
WOOLLAHRA, NSW	$2,660,500	29.8
UNITS		
ULTIMO, NSW	$745,250	46.1
BROOKWATER, QLD	$522,000	43
NOOSA HEADS, QLD	$630,000	37

Source: Corelogic

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The most in-demand suburbs

We regularly track those suburbs where we are seeing much more demand from buyers than people selling. With a shortage of stock, it would suggest that price growth is more likely.

Right now, houses in Melbourne and apartments in Sydney are seeing the strongest demand from buyers. In Melbourne, outer suburban Warrandyte is the most in-demand for houses, followed by inner-city Prahran and Brunswick. For units, it is inner Sydney with the north shore suburbs of Wollstonecraft and Cremorne and inner-west Drummoyne all seeing high demand.

Table 2: Suburbs seeing more demand from buyers than available housing (y/e August 2016)

HOUSES	MEDIAN PRICE
WARRANDYTE, VIC	$870,000
PRAHRAN, VIC	$1,331,000
BRUNSWICK, VIC	$863,750
UNITS	
WOLLSTONECRAFT, NSW	$910,000
DRUMMOYNE, NSW	$920,000
CREMORNE, NSW	$1,290,000

Source: realestate.com.au

High yield

Most investors look to residential property for capital growth, however some prefer a high average rental yield. Generally suburbs that achieve strong rental yield do not achieve strong capital growth. In some cases, prices can be declining.

For the highest rental yields, investors should look beyond the major capital cities. Houses in Zuccoli in outer Darwin are currently achieving rental yields close to 15 per cent, and although the mining town of Collinsville in Queensland has seen house prices decline, rental levels have remained relatively stable, also leading to a similar rental yield. Zeehan, a small town in western Tasmania, is currently achieving rental yields of 13.7 per cent.

For units, the best performer for yields is Thurgoona, an outer suburb of Albury. Stapylton on the Gold Coast and Deagon, an outer suburb of Brisbane are also achieving strong yields.

Table 3: Highest yielding suburbs in Australia (y/e May 2016)

HOUSES	MEDIAN PRICE	AVERAGE RENTAL YIELD (%)
ZUCCOLI, NT	$216,500	14.9
COLLINSVILLE, QLD	$70,000	14.9
ZEEHAN, TAS	$57,000	13.7
UNITS		
THURGOONA, NSW	$60,000	24.3
STAPYLTON, QLD	$160,000	17.9
DEAGON, QLD	$125,000	13.3

Source: Corelogic

Buying at the bottom of the market

There have been some large drops in prices for housing, particularly in mining towns in Western Australia and Queensland. This does create opportunity for buyers, however there is a risk that prices will keep dropping.

For this reason, it is a good idea to plan to hold a property for longer than two years, ideally for five years, if you are looking for capital growth. That way, even if you haven't bought at the bottom of the cycle, you should be able to ride out the declines. The other thing to consider is where price growth will come from. Some mining towns have very little other industry to support them.

The good news is that properties that have seen strong declines in prices generally have not seen the same decline in rental levels. Collinsville has seen prices drop by almost 50 per cent over the past 12 months. Rents, however, have not declined by as much and this town now has some of the

> **“ Not surprisingly, the strongest performing houses are in Sydney and Melbourne and the top three are all in suburbs that could be considered prestige, with prices well over $1 million.**

highest rental yields. The mining towns of Karnup and South Hedland in WA have also seen strong price declines.

For units, the holiday destination of Rainbow Beach in Queensland has seen big drops in prices, as has the coal mining town of Emerald. In Canberra, Campbell has seen a price decline of just over 44 per cent, surprising for the location but it may reflect a large number of new units in this city.

Table 4: Suburbs with the largest decline in prices (y/e May 2016)

HOUSES	MEDIAN	PRICE DECLINE (%)
COLLINSVILLE, QLD	$70,000	–48.1
KARNUP, WA	$464,000	–47.7
SOUTH HEDLAND, WA	$370,000	–45.6
UNITS		
RAINBOW BEACH, QLD	$205,000	–48.8
CAMPBELL, ACT	$465,000	–44.3
EMERALD, QLD	$180,000	–37.9

Source: Corelogic

I want to be able to negotiate a great deal

Conversely to those suburbs that have the most demand, there are suburbs that have more supply than demand. For that reason, it may be possible to negotiate a better deal.

Queensland’s high-supply environment combined with a slowing economy has meant that the top suburbs in this list are located in this market. The towns are a mix of beachside (Forrest Beach, Bowen), farming (Cloncurry, Chinchilla, Bundaberg North) and mining areas (Moura).

Table 5: Suburbs seeing more supply of housing than demand (y/e August 2016)

HOUSES	MEDIAN PRICE
FORREST BEACH, QLD	$235,000
CLONCURRY, QLD	$177,500
MOURA, QLD	$159,750
UNITS	
BOWEN, QLD	$210,000
CHINCILLA, QLD	$255,000
BUNDABERG NORTH, QLD	$225,000

Source: realestate.com.au

Capitalising on demographic change

Investing in housing in places experiencing demographic change has the potential to provide high levels of capital growth, but this can be difficult to pick. These are the areas that I consider to be worth considering.

Our analysis of fastest-selling suburbs, as well as those suburbs most in demand from buyers, is showing a drive for affordable locations, particularly in Sydney and Melbourne. For Sydney, there are now very few affordable options and the Central Coast is seeing a boost in demand. In Melbourne, outer-east Melbourne, particularly those suburbs in the leafy Dandenongs, are seeing elevated demand.

The suburb of Glen Waverley is consistently the most popular suburb with Asian property seekers on our site. This suburb has seen the most sales over $1m in Melbourne over the past 12 months. Strong demand is not necessarily coming from local residents but also from Chinese buyers looking to move to Australia.

Sydney’s CBD office demand is surging and more businesses are looking to grow. This has meant that there is greater demand for white collar workers and Sydney is now expected to attract more people from both interstate and overseas. Furnished apartments within the Sydney CBD, or close by, could be one property type to be considered.

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Morrison said the three main changes balanced each other out and would be revenue neutral to the budget in the medium term.

BY BRUCE BRAMMALL • EUREKA REPORT • 15 SEPTEMBER 2016

Morrison's super changes still have victims

Treasurer Scott Morrison has caved to pressure from his backbench on the $500,000 non-concessional contributions (NCC) superannuation cap, announcing a major restructure of its policy.

Key Point

- ***The changes will allow a greater number of Australians to continue to put in non-concessional contributions to their super. But the 'wealthy', with existing large balances of more than $1.6m, will not be able to.***

The $500,000 NCC limit, which was to be backdated to 2007, will be scrapped. The replacement rules will be similar to the existing rules, but with some major changes that will create some other "victims".

The existing annual NCC limit system will be kept, but with drastically reduced limits.

The current level of $180,000 a year for NCCs will be dropped to $100,000, but the three-year pull-forward rules for those under 65 will be retained, allowing people to put in up to $300,000 in a single year (versus $540,000 previously).

However, members will not be able to put in any NCCs once their combined super balances have hit $1.6 million.

There are potential losers here – and we will await the fine print – as it has not been determined how "reaching" the $1.6m will be measured.

The changes will allow a greater number of Australians to continue to put NCCs into their super. But the "wealthy", with existing large balances of more than $1.6m, will not be able to.

While the Coalition has given with one hand, it has equally taken away with the other.

The biggest losers

The new victims include 65 to 74-year-olds. The Budget night package was going to scrap the "work test", which would have allowed older Australians to continue to put both NCCs and concessional contributions into super until they were 74.

The work test means that in order to make voluntary contributions after age 65, members needed to work 40 hours in a 30-day period during a financial year.

Instead of being dumped, the work test is going to be kept. This is a significant setback for older Australians, with smaller superannuation balances, who might have been able to contribute to super as NCCs from the sale proceeds of, say, investment properties or share portfolios after retiring.

The second main victims come from those who might have benefited from the "catch-up" provisions. The start date for the catch-up provisions has been pushed back by one year, to July 1, 2018.

The catch-up provisions will allow those who hadn't been able to use their full concessional contributions cap ($35,000 for the over-50s and $30,000 for the under-50s for FY17, but $25,000 for all from FY18 onwards) to play catch-up on previous years.

For example, if a self employed worker was only able to afford to make $10,000 for four years, then in the fifth year, they could make their $25,000 of concessional contributions, plus another $60,000 (4 x $15,000) to make up for the previous years.

Importantly, the Government has not given in on the $1.6m transfer to pension (TTP cap). While this had some opposition in the Coalition party room, the Treasurer has been able to keep this cap.

Morrison said the three main changes balanced each other out and would be revenue neutral to the budget in the medium term.

Morrison's greatest problem with selling his superannuation reform came from within his own party room. Many Coalition members threatened to vote against it, after being savaged by their own rank and file party members during the election campaign. Many members claimed their volunteer numbers dropped off, as did donations, and directly linked it to the superannuation changes and in particular the $500,000 NCC cap.

> **"Instead of being dumped, the work test is going to be kept. This is a significant setback for older Australians, with smaller superannuation balances.**

Expect some backlash

While the changes might allay some concerns there, I wouldn't be surprised if there is a new backlash from the recently retired, who would have been looking forward to being able to make contributions up to age 74 via the removal of the work test.

A sizeable number of Australians continue to hold on to investment property, in particular, beyond their working lives, but need to sell some time after 70. Being able to tax-effectively contribute this money to super was a big selling point of the Budget night changes.

I won't be surprised if Coalition backbenchers who fought for the change might face further criticism from their local constituents on the backdown on the removal of the work test.

The fact that Morrison is claiming that he has been able to negotiate a peace deal with his backbench that is revenue neutral to the initial Budget night deal is important. He's still saying that most of these measures will only affect between 1 and 4 per cent of the population.

"These measures will ensure that 96 per cent of Australians remain better off or unaffected by the Government's superannuation reforms that will introduce greater flexibility and sustainability to our retirement income system," he said in a statement outlining the changes.

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, ***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.

Renowned stock picker Alex Waislitz, chairman of Thorney Opportunity Limited, explains his inside strategies for further accelerating returns.

BY MITCHELL SNEDDON • EUREKA REPORT • 14 SEPTEMBER 2016

A billionaire's TOP stock picks

It was almost 12 months to the day Alex Waislitz last paid us a visit. A lot has changed for us and Waislitz. Most importantly, the discount to net tangible assets (NTA) has closed in his listed investment company, **Thorney Opportunity Limited** (TOP), as his concentrated portfolio of stocks started to fire.

Since we initially recommended Thorney in September 2015 the share price has 're-rated' nicely and followed the fortunes of the underlying holdings. When we first looked at Thorney seven stocks made up 90 per cent of the portfolio, and that remains the same today. What does not remain the same is the discount to NTA. Given there is no discount, I am moving the call to a Hold.

The conversation continued after the **cameras stopped rolling**, and Waislitz reiterated his views on the core holdings that may appear expensive now:

- **AMA Group Limited (**AMA): "AMA had a very strong profit result and there are significant synergies to be extracted from its recent merger. There are still plenty of opportunities ahead for the company because, even after the recent merger which made it the largest player in the sector, it still only has about 4 or 5 per cent market share. So it's very possible to see that they could double current market share within a few years."
- **Money3** (MNY): "The environment for non-bank consumer lenders continues to improve at a fast rate as the major banks pull away from that sector of the market because of their own regulatory capital requirements. The new leadership from the board down is robust and focused on building a far more efficient and profitable and cash flow driven business with a rapidly growing order book in the automotive lending sector."
- **Service Stream** (SSM): "The continuing and accelerating roll-out of the NBN means Service Stream is in a great position for more growth. They are very well positioned with a nationwide workforce and good contract flow as was evidenced by their profit result. They have a strong balance sheet, which means they can fund growth through working capital."

We also spoke about the investment that has yet to play out, and Thorney's involvement in it:

- **Austin Engineering** (ANG): "The Thorney group helped lead moves to recapitalise the ANG balance sheet and put the company in a great position to largely repay its bankers. This will give the company sufficient runway to focus on operational improvements and complete its review of assets. The new leadership team at board level is currently reviewing CEO candidates and this will obviously help implement their strategy. It's not clear yet exactly where we are on the mining cycle but it does feel like the worst is over. We are certainly seeing more new orders and a much fuller tender book for ANG at present."

There was also plenty more talk about the company's upcoming IPO, which we will have more information on once the prospectus is released. The new fund will be looking to replicate past successes in the Thorney private fund such as investing in Webjet pre-IPO at approximately 17 cents a share. **HOLD**

With its recent sale of Autohome shares for $2.1bn, Telstra now has $1.5bn that it wants to give back to shareholders.

BY JAMES CARLISLE • INTELLIGENT INVESTOR • 14 SEPTEMBER 2016

Your guide to Telstra's share buy-back

Share buy-backs – especially big ones like Telstra's – do a lot to stir the pot of public debate. To some they're a case of Santa come early, showering gifts on shareholders; to others they're a sign of a company down on its luck, bereft of imagination and opportunities for growth; and to still others, they're a way of making a balance sheet 'more efficient' to somehow conjure up additional returns.

Key Points

- ***Telstra will buy-back $1.5 billion worth of shares***
- ***Only makes sense for certain shareholders***
- ***Use Telstra's calculator and/or seek advice***

The truth is more prosaic. A share buy-back is simply a means of giving shareholders back a chunk of their own money, and whether it makes sense or not depends on whether it's best for shareholders to have the money or for the company to keep it.

The effect of a share buy-back is almost identical to that of a dividend, except that instead of returning cash to all shareholders and all shareholders maintaining the same interest in a slightly reduced pie, the cash is only returned to those shareholders that wish to take part, whose share of the pie is proportionately reduced.

Herein lies the magic, if there is any. Because all shareholders are different – particularly in terms of tax – it makes more sense for some to get their money out than for others, and an off-market share buy-back enables them to do this. For those not participating, they will maintain their investment, which will be a slightly larger share of a slightly less valuable company.

It gets even better when the buy-back is conducted off-market via a tender, because the keener some shareholders are to take part, the bigger the discount they'll accept, and the more the non-participants will see their proportionate share increase. So the tender process should spread the benefits on offer more fairly among all shareholders.

But we're getting ahead of ourselves. Before we consider whether it makes sense to stay or to go, let's run through what's actually happening.

What's happening?

With its recent sale of Autohome shares for $2.1bn and continued strong free cash flow, Telstra now has surplus capital that it wants to give back to shareholders.

In addition to paying out around $3.8bn in dividends this year, management has decided to return another $1.5bn by buying back shares. This is comprised of a $1.25bn off-market share buy-back, followed by a $250 million buy-back of shares on the market.

The off-market buyback will be conducted via a tender process, and holders of shares bought on or before August 17 will be eligible to take part. The forms will need to be received back by the company's registrar (Link Market Services) by 7pm on Friday 30 September. Tenders can also be lodged online via **Telstra's buyback page** (when you click you'll need to go through a brief verification process).

Under the tender, shareholders can submit a price at which they'd be prepared to sell their shares. The offers will be accepted from the bottom up, until the $1.25bn target is reached, so that those accepting the biggest discounts are more likely to have their offers accepted.

You can also select a minimum price at which you'd be prepared to sell your shares, and/or you can opt to have your shares bought back at whatever is the final price that would make that possible.

The price paid by Telstra will be the same for all shares bought back and will be the lowest price at which it can buy-back shares worth $1.25bn, taking all the different tenders into account.

Should you take part?

So should you take part? Here's where it gets difficult because, as we've noted above, everybody is different (particularly in terms of tax) so there is no one-size-fits-all answer. The way it works is that the price eventually paid for the shares is split between a capital component (which the Australian Taxation Office has indicated will be $1.78) and a dividend component (the rest of the price).

> **"Because all shareholders are different … it makes more sense for some to get their money out than for others, and an off-market share buy-back enables them to do this.**

On the dividend component, you'll pay tax at your marginal rate offset by a full franking credit, as with a regular dividend; and on the capital component you'll be subject to capital gains tax (CGT) on the difference between the cost of the shares and $1.78 per share plus an adjustment based on the difference between the market price and the final buy-back price (see section 4.1 of **Telstra's Buy-Back Booklet**). The CGT discount will be available if you've held the shares for more than a year and if you make a capital loss then it can be used against capital gains in the current year or carried forward to future years.

So the buy-back is likely to be more attractive to people (or super funds) on low tax rates, and/or who stand to make a capital loss on the shares and can make good use of it against gains elsewhere. And, of course, the lower the discount on the buy-back price, the more attractive the deal will be.

All of this is explained in greater detail in Telstra's Buy-Back Booklet, available from **its website**. In particular, in Section 4.6 (on page 19) there's a table setting out how the proposal might pan out for people on different tax rates. We've reproduced parts of this in Table 1, but with the market price lowered to near-current levels ($5).

It's important to note that the prices and some other details will change, but it provides a good basis for working through the various possibilities. Telstra also provides (via the same link given above) a buy-back calculator, which you can use to test different scenarios.

Road-testing

Bear in mind that it might also be worth participating even if you don't want to reduce your holding, because you can always buy the shares back on the market, but this is likely to be less attractive for most situations as you'll have to absorb the discount. There are also risks to this approach as the price may change between the Buy-Back and when you replace the shares.

There is also a risk that the ATO might classify such a transaction as a 'wash sale' – where shares are bought and sold within a short period for the main purpose of obtaining a tax benefit. In such circumstances, the tax office might disregard the transaction and any tax benefits might be lost. So if you're considering such an approach, make sure you consult with your tax advisor.

After extensive road-testing of **Telstra's Buy-Back Calculator** and while noting that we're not able to provide personal advice, we'd say it's hard to find scenarios where those on the highest tax rates will benefit from participating. At the other end of the spectrum it looks like super funds will benefit in most situations at least as compared with selling on market, and even when repurchasing the shares as long as the discount isn't too big. In the middle, things get more marginal.

Everybody is different, though, so we'd recommend having a play with the calculator yourself, running through the methodology in Section 4.6 of the Buy-Back Booklet, and/or speaking to your personal tax advisor.

Table 1: Illustrative examples

ASSUMING MARKET PRICE = $5.00; DISCOUNT = 10%; COST BASE = $4*						
	0%	SUPER FUND (15%)	21%	34.50%	39%	49%
BUY-BACK PRICE ($)	4.5	4.5	4.5	4.5	4.5	4.5
AFTER-TAX PROCEEDS OF BUY-BACK ($)	5.67	5.25	5.03	4.62	4.49	4.18
AFTER-TAX PROCEEDS OF SALE ON ASX ($)	5	4.9	4.9	4.83	4.81	4.76
PROFIT/(LOSS) FOR BUY-BACK AND REPLACING SHARES ON MARKET	0.67	0.25	0.03	(0.38)	(0.51)	(0.82)
PROFIT/(LOSS) FOR BUY-BACK VS SELLING ON MARKET	0.67	0.35	0.14	(0.21)	(0.32)	(0.57)

* **This also assumes zero brokerage, that the Telstra shares have been held for more than a year, and that capital losses can be used against gains held on shares that have also been held for more than a year.**

** **Note that thes are illustrative examples only, based on Telstra's buy-back calculator; we recommend making your own calculations and/or speaking to your tax adviser.**

Understanding the influence of Australia's changing demographics is essential to understanding the performance of the business sector.

BY CALLAM PICKERING • EUREKA REPORT • 14 SEPTEMBER 2016

Can retail head-off the ageing squeeze?

An ageing population creates a unique challenge for Australia's retail sector. Older Australians spend significantly less than younger households, according to **research** from the Reserve Bank of Australia, with a higher share of that spending allocated towards essential services rather than retail goods. It represents a significant threat to retail stocks over the next couple of decades.

Key Point

- ***Retailers need to be aware of this challenge and take steps to mitigate the risks or diversify.***

Understanding Australia's demographics and the influence of those demographics is essential to understanding not only the Australian economy but also the performance of our business sector. Strong population growth, for example, creates a ready and growing market for goods and services, while rising female participation in the workforce boosts household incomes.

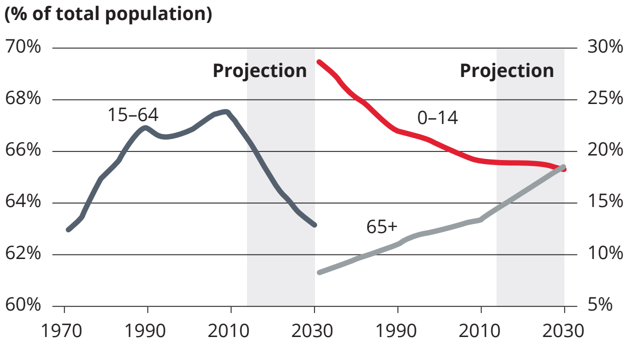
An ageing population is perhaps the most interesting demographic factor affecting the Australian and global economies. Our personal preferences and spending habits change as we age. So too does our tolerance for risk.

For decades Australia benefited from favourable demographics: Strong population growth and rising female participation in the workforce being two prime examples. The economic influence of the 'baby boomers', who were at their most productive throughout the 1980s and 1990s, also had a strong influence on Australia's economic success.

This has changed over the past decade as the first 'baby boomers' have entered retirement and the boost from rising female participation has diminished somewhat. Even population growth isn't what it was at the peak of the mining investment boom.

The share of the Australian population aged between 15 and 64 years old – the so-called working age population – is set to decline significantly over the next 15 years to a level not seen since the early 1970s. By 2030 it is estimated that Australia will have more people aged over 65 years old than children under the age of 15.

Chart 1: Population shares by age



Source: ABS, RBA

This presents a set of challenges for the Australian economy that will influence economic outcomes and investment behaviour over the next couple of decades. If the experience overseas is any indication – with the likes of Japan and Germany further along in this process – then we can expect slower economic growth and greater difficulty balancing the budget.

Retail sector

Corporations will rise and fall on the back of the shift in consumer preferences. It should come as little surprise that our income and spending patterns differ as we get older. Older households, for example, tend to earn and spend less than the average person. They also tend to save less as they run down their superannuation income or rely on the aged pension.

Chart 2, obtained via research from the RBA back in 2014, shows how spending and income differs according to age group. Household disposable income and spending peaks when the primary income earner is between the ages of 45 and 54 years old.

Older households spend a lot less on durable goods than younger households. Older households have already accumulated these goods and as household budgets tighten

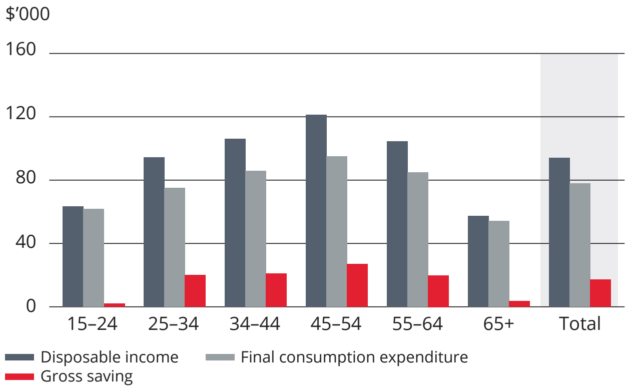
> **“If the experience overseas is any indication ... then we can expect slower economic growth and greater difficulty balancing the budget.**

they may become reluctant to upgrade or replace unless it is truly necessary.

Older households also spend more on essential services, such as health and aged care services. Younger households spend a lot more on discretionary services such as travel, accommodation and eating out at restaurants.

Chart 2: Household income, consumption and saving*

(by age of household reference person, 2009–10)

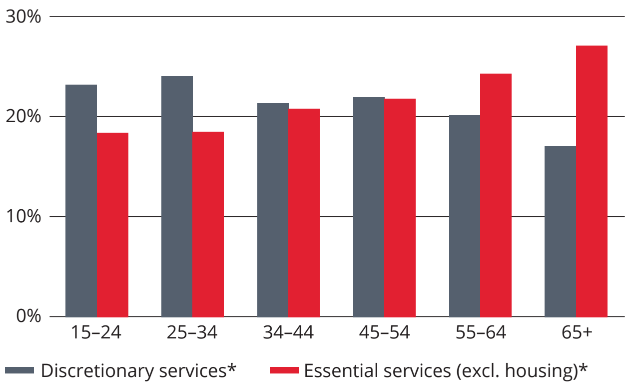


*Household average
Source: ABS

Strong growth in health and aged care services will put further pressure on federal and state budgets. Recent years have shown how difficult it is to not only cut expenditure but to make cuts to areas that voters deem essential. Few services are more essential than health and aged care services.

Chart 3: Consumption of services

(by age of household reference person, 2009–10)



*% of total consumption
Source: ABS, RBA

We also cannot forget the important link between household spending and GST revenue. The federal budget is under assault from a variety of angles and fixing the problem will require strong leadership and ambitious reform.

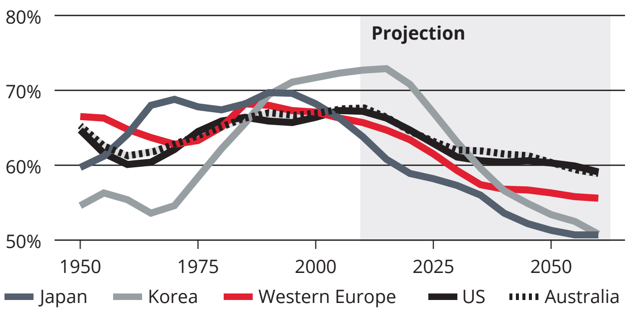
If I was an investor focused on retail stocks I'd be asking whether retailers are aware of this challenge and whether they have taken steps to mitigate these risks or diversify their brand. Many retailers have been, for example, slow to react to or acknowledge the threat of online shopping. Could that happen once again?

Online sales and exports will be no refuge for Australian retailers since most developed economies are suffering a same – if not greater – problem. Increasing exposure to developing markets such as China and India may be an option for Australian retailers as the middle-class in both those countries expands.

Chart 4, obtained via a **speech** given by RBA deputy governor Philip Lowe, compares the working age population across a variety of developed countries. The challenge is greatest in Japan and South Korea, followed by Western Europe, most notably Germany, and then Australia and the United States. This is very much a global challenge and retail stocks will be affected across the board.

Chart 4: Population aged 15–64

(% of total population)



Source: United Nations

This phenomenon could be offset to some extent by the fact that the income of older households has grown more quickly over the past two decades than the average household. The 'baby boomers' are asset rich and many have the capacity to maintain their spending habits into retirement. History

> **Increasing exposure to developing markets such as China and India may be an option for Australian retailers as the middle-class in both those countries expands.**

suggests, though, that they will become more cautious as their enter retirement.

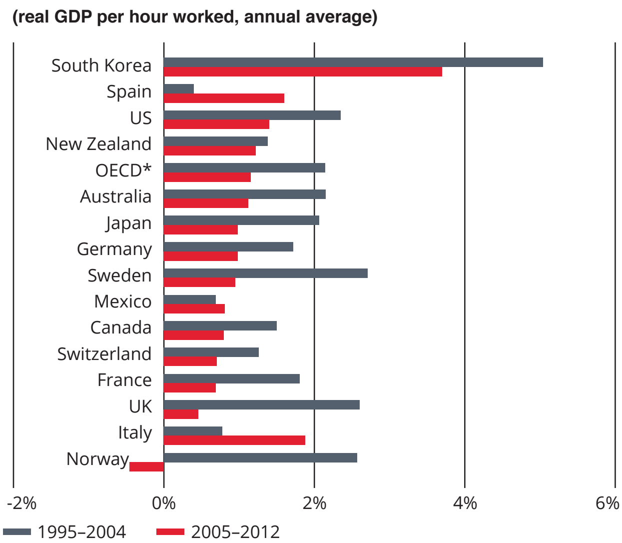
Productivity and risk-taking

The influence of an ageing population can be offset by several factors. One is higher levels of migration, which is the path that successive federal governments have chosen to address the issue. Increasing our intake of working-age individuals can help to flatten out our age profile but it is only a stop-gap measure.

The only real solution to an ageing population is stronger productivity growth. Making better use of our resources is the one sustainable path towards greater living standards and a healthy and vibrant corporate sector.

Australia's productivity performance over the past decade has been poor but not inconsistent with the experience of most developed economies. There is a great deal of debate as to why this has occurred. The global financial crisis and resulting sovereign debt crisis is certainly one possibility.

Chart 5: Labor productivity growth



*1995–2004 period estimate based on 28 out of 34 countries
Source: IMF, OECD, RBA

An ageing population has important implications for how a society thinks and acts on risk and innovation. We know, for example, that entrepreneurs are more likely to be in their 30s or 40s. Younger workers also tend to take up newer technologies at a faster rate than older workers. Older workers tend to become more risk-averse when it comes to investment decisions as they approach retirement.

According to the RBA's deputy governor Philip Lowe, "this higher risk aversion of older citizens means that as the population ages, access to capital for more risky firms, especially start-ups with little business history, is likely to be more restricted and more expensive."

In addition Lowe notes that "if ageing societies become inherently more risk averse and less supportive of innovation ... then we are likely to face a greater challenge than we have to date in generating productivity growth."

This may be offset to some extent by the fact that an older workforce, on average, creates an incentive for businesses to find and implement labour-saving techniques. So far though, this doesn't seem to have had much effect on productivity of workplace technology.

It's also worth noting that Australia's relatively good demographics – that is, the fact that our demographics are not as bad as other developed economies – could be viewed as an opportunity. If an ageing population hits productivity growth then surely it will hit other economies more forcefully than it does here. In theory, that could support the competitiveness of those Australian firms who compete in global markets.

How this translates into market performance is a little unclear. It clearly puts pressure on stocks that operate in the retail space and I'd expect the relative performance of those stocks to be worse than they have been in the past.

But we also know that markets are highly distorted at the moment; relying less on fundamentals and more on monetary policy and expectations surrounding monetary policy.

As such, the observation that retail stocks face structural headwinds is perhaps not as actionable as it would have been in a pre-crisis economy. Nevertheless, if the influence of monetary policy on global stock markets begins to diminish then investors should be aware of the influence of an ageing population on the performance of Australian and global equities.

Subdividing land and building investment properties can be a tax minefield when it comes time to sell.

BY MAX NEWNHAM • EUREKA REPORT • 13 SEPTEMER 2016

Tax with Max: Deconstructing property subdivisions

Key Point

- ***The profit on investment properties can attract capital gains tax or be taxed as business income, depending on the ownership structure. In cases of doubt, the Tax Office recommends investors apply for a private binding ruling.***

Q. *I purchased an investment property in August 2014 that cost $890,000 as joint tenants with my husband, with us owning 35 per cent each, and a friend owning 30 per cent. The home was rented out until May 2016 when the tenants were evicted due to non-payment of rent and has been privately advertised for rent since then.*

The property has been subdivided into two blocks that have a total cost – including purchase cost plus stamp duty, other acquisition costs, and subdivision costs – of $1,190,340. Block one represents 42 per cent of the original property while block two is 58 per cent.

I have two options as to what we can do with the property if we can't find a tenant. The first is to sell the block with the existing house on it in and sell the second block as vacant land. The current cost of the block with the house on it is $560,340 with it having a value of $760,000. The cost of the second block is $630,000 with it having a value of $650,000.

The second option will be to demolish the existing house and build two new residences on each of the blocks and sell them. I estimate the construction costs for each house will be approximately $400,000, with each house and block being sold for $1,350,000 in 12 months' time.

What I would like to know is the following:

- *If I decide to use option one, selling the existing house and land and the new block as separate items without any further improvements, will the profits be taxed as capital gains or as business income?*
- *If we decide to demolish the existing house, build two new residences and sell them, will we be regarded as conducting a business and therefore have to pay tax on the total profit made?*
- *Will we need to register for GST if option two is chosen and how will that affect the profit we make?*

Answer: You should not be surprised to learn that according to the Australian Taxation Office, if your intention was to buy the property and sell it for a profit, it regards any profit made on the sale of the properties as business ordinary income and not a capital gain. This would mean tax would be payable on the full profit rather than receiving the 50 per cent general discount.

Interestingly I do not know of any cases that have been brought by the ATO to test its interpretation of the capital gains tax regulations. This could be because the ATO has not amended tax returns treating the profit not as a capital gain but rather as business income, or the ATO has not wanted to have its interpretation of tax law tested by the courts for fear of losing the case.

The unfortunate fact for taxpayers, under our self-assessment system where every tax return lodged is not checked for accuracy, is that the ATO tends to guide taxpayers in what they should be doing from an income tax point of view by issuing rulings, determinations and opinions.

There have been numerous cases of where the ATO's interpretation of income tax legislation is incorrect, or it changes its mind. One example that affected self-managed super funds was the ATO's opinion that, when the segregation of assets method was used for an SMSF with members both in accumulation and pension phase, separate bank accounts had to be used for the different types of member accounts.

This was the stated policy of the ATO for many years up until recently. In a 180-degree about-face the ATO's position is, allegedly due to modern accounting systems that are able to differentiate between members in either accumulation or pension phase, that SMSFs can now have one bank account.

The other problem for taxpayers is that there is conflicting advice on the ATO's own website. In the section that deals with capital gains tax the ATO states, "all assets you acquired since tax on capital gains started on 20 September 1985 are subject to CGT unless specifically excluded".

The exclusions quoted are a person's home, cars and most personal use assets such as furniture. At no point in this general introduction to capital gains tax is a statement saying

> **In cases of doubt, such as exists in relation to your investment property, the ATO recommends that taxpayers should apply for a private binding ruling.**

that assets purchased for the purposes of resale at a profit are excluded from the CGT system, and taxed as normal income.

In cases of doubt, such as exists in relation to your investment property, the ATO recommends that taxpayers should apply for a private binding ruling. The problem is the methodology used by the ATO in deciding the tax treatment for a ruling is influenced by its understanding of how the tax legislation should be applied, and therefore maximises tax revenue collected.

Despite there being no court cases that have tested the ATO's interpretation of whether the CGT system applies to subdivided land, I do remember reading a case that was decided in the favour of the taxpayer. In this case it was found that the profit on the sale of an asset was taxable under the CGT system because taxpayers are able to maximise the selling value of an asset, and actions taken to do this did not always mean the profit was made as part of a business and therefore was not ordinary income.

I believe that if you are able to argue that the property was first purchased for the purposes of producing rental income and to produce a capital gain, and therefore was not part of a profit undertaking or scheme, the profit made under your first option should be taxed as a capital gain with the 50 per cent discount applying.

If you decide to demolish the existing home, build two new residences, and then sell them, this could be held to be part of a profit-making undertaking or scheme and therefore all of the profit would be taxable as ordinary income.

No matter what the CGT treatment will be, if a decision is made to build the two new residences, your property partnership will need to register for GST. It will be able to claim all of the GST included in the costs associated with building the two residences, but then GST will need to be included in the selling value of each property.

Because the original property was purchase without GST included in its cost you will be able to use the margin scheme to calculate how much GST will be included in the selling value of the properties.

Under the margin scheme, the GST included in the selling price is one-eleventh of the difference between the purchase price of each block and the selling price.

In your question you stated that the purchase cost was $890,000. This would mean that block one would have a purchase cost under the margin scheme of $373,800 and block two would have a cost of $516,200. With the selling price of $1,350,000 for each block the GST on block one would be approximately $88,700 and $75,800 for block two. As a result of having to pay the GST on the two properties the profit made on this venture would be reduced by approximately $164,500.

Due to the complex tax nature of what you are proposing to do you should seek professional advice before taking any action.

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

More and more investors are directing their capital into ethical investment products. But, as with any product, it's important to know what you're buying.

BY TONY KAYE • EUREKA REPORT • 9 SEPTEMBER 2016

The spotlight shines on ethical investing

New Zealand's government-backed superannuation savings scheme operator KiwiSaver has been enveloped by an investments storm over the past month that's left a trail of destruction.

Key Point

- ***Defining your ethical boundaries is important, and so is buying in at the right price. Strong returns have driven up the prices of many companies with high environmental, social and corporate governance standards.***

It's an embarrassing and messy situation, with Australia's Westpac, ANZ and AMP among several KiwiSaver partners linked to investments in companies making anti-personnel mines, cluster bombs, nuclear reactors and other weapons via a fund run by US-based investment giant Vanguard.

For all parties concerned, the ethical implications of holding such investments, even indirectly, are obvious. The public backlash has been enormous, too. Which is why, over the last week, most of KiwiSaver's service providers have announced they are offloading their weapons exposures.

On the surface, it would seem that ethical investing strategies by big corporations still have a long way to go. But investors committed to responsible investing practices, and to excluding investments in funds and companies that don't tick all the boxes in terms of sustainability, protecting the environment, and the rights of people and animals, shouldn't be too disillusioned.

In reality, despite a few isolated incidents and inconvenient truths, the options and safeguards around ethical investing are now better than ever. As well as a wide range of specialist ethical funds providing full transparency to investors in terms of their investment methodology and company holdings, more and more Australian managed funds are offering ethical choices.

"Even if you're agnostic about the benefits of environmental, social and corporate governance (ESG) investments, the products available are very useful in getting people engaged in their investing," says Jonathan Ramsay, director of portfolio construction and consulting company InvestSense.

InvestSense recently created two funds to cater for the strong demand from retail product providers. Its Dark Green Opportunities Fund has no direct or even indirect exposure to fossil fuels, uranium, defence industries, extractive industries, gaming, alcohol or tobacco stocks. Its Light Green fund relaxes those constraints such that it only needs to avoid direct exposure to those sectors.

The great ethical shift

According to the Responsible Investing Association Australasia, more than $630 billion of funds, almost half of Australia's total investments, are now being invested responsibly.

RIAA's annual benchmark report, released in July, found that a significant step-up in consumer demand had resulted in billions of dollars shifting from mainstream to responsible funds.

"In observing the significant and consistent growth in responsible investment we can say without a doubt that this isn't just a passing trend, but an evolution of the entire sector that is now being driven strongly by consumer demand and engagement with where they invest and bank their life savings," says chief executive, Simon O'Connor.

Strong investment returns

Better still for investors is the fact that ethical investment funds have been delivering solid returns to investors for some time, in many cases outperforming the broader market.

O'Connor says investors who have "embraced the evolution have reaped the rewards", with responsible investment outperforming and returning greater benefits than their mainstream peers over the last one, three, five and 10 years.

"Every year we see more Australians opening their eyes to the opportunities to invest ethically and responsibly. You can invest with confidence, aligning your money with your morals, and it's not just a 'well-intentioned' philanthropic approach, it is generating great returns for savvy investors."

> **Despite a few isolated incidents and inconvenient truths, the options and safeguards around ethical investing are now better than ever.**

Australian Ethical's head of ethical research, Stuart Palmer, says that for investors, the "ethical dimension" needs to be focused on where a fund is investing as well as the returns.

"There needs to be a clear framework behind how the investment decisions are being made. Our charter focuses on positives and negatives, avoiding those areas that are having harmful impacts."

Chart 1: Strong ESG performance vs an equally weighed market benchmark

Source: InvestSense, CAER, Bloomberg

But Ramsay says one of the key factors for investors with good ethical intentions to consider is their entry price, with "quality stocks" (such as those with dependable earnings and low leverage) and stocks that are good quality from an ESG perspective having rallied strongly in the post-GFC environment.

"Many of them do appear to be getting quite expensive. We firmly believe that in the world of investments, nothing should be done at any price," he says. "With ethical investing, as with all investing, care must be taken not too overpay."

Five things you should know:

1. **Your ethical boundaries** – There are no regulated definitions around ethical investing, and an industry that may be considered unethical to some may be perfectly acceptable to others. For example, is a rail company unethical if it has a contract to transport iron ore? A sensible approach is to rule out specific industries and then consider other holdings on a case-by-case basis.
2. **About positives and negatives** – Positive and negative screens are key in the ethical investing process. Positive screening involves looking for companies that are actively involved in areas or activities aimed at protecting the environment, for example, or who are focused on medical breakthroughs. Negative screens are used to filter out companies involved in harmful areas, such as miners, oil production, tobacco or old growth forest logging.
3. **Where you're investing** – The number of funds being tagged as ethical is ballooning, but some are more ethical in their approaches than others. Transparency is key. A recent Bloomberg study found a number of so-called ethical investing funds in the US have holdings in oil and tobacco stocks.
4. **Constructing a portfolio** – For self-directed investors, including self-managed super fund trustees, it's relatively easy to build a custom ethical investments portfolio based around your ethical objectives. But diversification is key, as being exposed to only a handful of companies in certain sectors carries higher risk and the potential for lower returns.
5. **A valuation point** – Don't overpay to follow a specific company or ethical quality objective. It's still important from an investment perspective to focus on value.

Battered by geopolitical woes and economic stagnation, Europe's business people are looking for safe havens.

BY TIM TREADGOLD • EUREKA REPORT • 15 SEPTEMBER 2016

Why the super rich are liking gold

Migration is a two-way street in Europe. People coming in are easy to see. Money flowing out is less obvious but is a potentially bigger issue and the one that is working in Australia's favour as nervous Europeans seek safe havens for their capital.

Key Point

- ***Gold and Australian gold stocks are on the radar of Europeans frightened of the future.***

Gold, Swiss francs and US dollars are at the top of what is becoming a period of significant capital flight, a point noted while I was on a visit to some of Europe's financial centres this month.

London was the starting point to measure the mood after the successful "Brexit" vote, but it was in Paris, and the French holiday resort of St Tropez, that the low lights and the highlights of Europe's capital flight could be seen and heard.

The low point came when staying in a flat immediately adjacent to Notre Dame Cathedral at the same time a terrorist attack was being foiled. At the time I had no idea what was happening but it was impossible to overlook the fact that security was not being provided by French police but by the French army in five-man, heavily-armed, patrols, with not a smile to be seen.

In Australian vernacular this was a "dinkum event", and while some people might have missed it I was struck by the use of silent hand signals by the patrols as they moved around corners as if they were in a Vietnamese jungle a lifetime ago – with Vietnam a one-time trouble spot the French and Australians know a lot about.

Paris, to put it mildly, is nervous. Crowds are to be avoided and the economy is wilting, along with the rest of France. So concerned is French business that a "positive protest" was mounted (literally) when 600 French executives rode up and down the Champs Elysee in mopeds to demonstrate their confidence in the economy. The result, of course, was the opposite.

Preparing for an Aussie gold rush

If incoming migrants, and a stagnant economy which is bogged down by strict economic controls and inflexible labour laws, are one aspect of Europe today, there is the flipside of St Tropez. It's a resort of legend and a favoured hideaway of the rich and famous (though mainly in the hills to the north and the villages to the south).

It was while visiting some of the residents around St Tropez, backed up by an overnight stay in Monaco, that the other side of the European migration story could be heard (rather than be seen) because money doesn't make a noise another than a polite rustle over a glass of rose.

While there I was able to speak with a number of British expats who move seamlessly (and privately) between London and the south of France.

Perhaps it was because I was an Aussie financial scribbler lost in a sea of money that the prime topic of conversation was mainly the markets, share prices and share tips. Of particular interest was an Aussie's view of gold and Australian gold equities.

Having just spent a few days on a hardship posting to Western Australia's gold capital of Kalgoorlie to attend last month's Diggers and Dealers conference, I was well primed on gold – but nothing prepared me for the high level of interest in gold among the Brits in St Tropez and its surrounds.

The people asking the questions were not your average group of investors with limited understanding of the intricacies of financial markets but truly sophisticated professionals who read the fine print of legal agreements.

In one case the person in question who caught my attention was a London property billionaire (who asked to not be named) who had become fascinated by the speculative end of the Australian stock market in the way some people follow thoroughbred horses. At one time he had a stake in 50 small explorers and miners.

Company names, share tips, comments about management, and observations about characters active in the Australian market, was the lifeblood of conversations with the very rich of St Tropez, but on a level well beyond anything in Pitt or Collins streets, or Perth's St George's Terrace.

These are rich people with family and self-made capital beyond the scope of most Australians. They know where it came from, they know how to keep it, how to make it grow, and they have the financial firepower to move the mining sector of the Australian market.

> **“ The prime topic of conversation was mainly the markets, share prices and share tips. Of particular interest was an Aussie’s view of gold and Australian gold equities.**

But to me, the contrast of money in the south of France and Syrians and others sleeping in the streets in the north, plus the Notre Dame bomb-scare and memories of recent terrorist atrocities, was a stark reminder that Europe is not well.

Making the situation worse is the Brexit vote, which will eventually see the region’s second-biggest economy leave the comforts of a Euro-home to try its luck in the global village – much like Australia was forced to do 40 years ago.

Seasoned London investment bankers, including Bob Catto from Hobart Capital (and late of Williams de Broe), do not regret the Brexit vote. In fact they welcome it as a chance to break free of the restrictions being forced on a traditionally free-wheeling British financial system and economy.

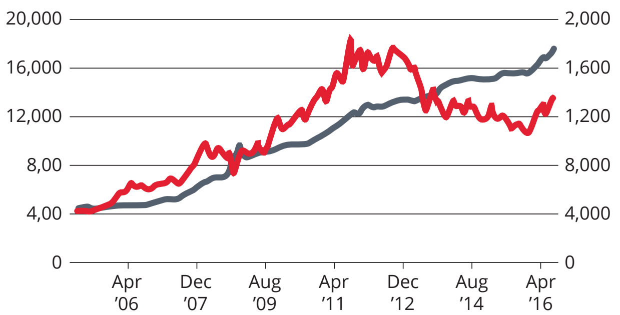
It’s easy to agree with Catto after seeing the absolute mess into which the French economy has fallen with its rigid rules strangling business, its appalling migrant crisis which seems to be on every corner, and its army-patrolled streets.

European fears on the rise

Conversations with Parisians, once they discover you are not British or American, seems to invariably turn to migration. Even the bar tenders and waiters want out of a country under a two-sided attack; economically by its own government and militarily by terrorists.

Chart 1: Big 4 vs gold price

Deutsche Bank has highlighted that the gold price – traditionally sensitive to the rate of central bank balance sheet expansion - has lagged the big four central banks' expansion since its sharp correction in 2013.



Aggregated balance sheet of the Big 4 — Gold Price (RHS)

Source: Deutsche Bank, Bloomberg Finance LP

Boil that equation down and you’re looking at a situation not seen since before Perestroika (Russian reform in the 1980s) and the fall of the Berlin Wall, a time when people living close to the East German border sewed gold coins into the lining of their coats in case a quick exit was required.

Gold is back for Europeans frightened of the future, and while the sharp price recovery of the first six months of 2016 appears to have paused, it is easy to see gold making a return in 2017, perhaps hitting the $US1700 an ounce mark suggested by Deutsche Bank three weeks ago.

Underpinning this hypothesis are the two other great drivers of gold:

- Negative interest rates and the prospect that at some stage governments in Europe might resort to “helicopter money”, the ultimate in pump-priming to try an ignite an inflationary outbreak, which would make gold look even more attractive than today, and;
- The wild card of Donald Trump being elected as the next US president, with the grave uncertainties that would unleash.

For Australian equities the story remains tilted towards gold and gold equities. Even the rich of St Tropez can see that and are undoubtedly using the conditions as a trigger to move money out of harm’s way into a safer place, which is what Australia looks like from the other side of the world.