Weekly Review

WEALTH

❸ THE CONSTRUCTION RISKS FOR PROPERTY INVESTORS | ❻ THE HYBRIDS THREAT TO RETAIL INVESTORS | ❼ FOUR FINANCIAL GIFTS FOR THE FAMILY

– Issue – 7 Oct. 2016

Developers are offering huge interest rate returns to enable them to complete apartment buildings for – mostly – Chinese buyers. But mass non-settlement is a real risk.

BY ROBERT GOTTLIEBSEN • EUREKA REPORT • 5 OCTOBER 2016

An SMSFs warning bell on apartments funding

It's not often that I put out a specific warning to self-managed superannuation funds and other investors seeking very high yields from risky interest-bearing deposits.

Key Point

- ***If offshore buyers default, and attempts to market the apartment contracts to other overseas investors is not successful, then significant losses will be incurred by developers and their lenders.***

All of us are being affected by the low yields in so many areas of the market. Inevitably it is forcing many people to take higher risks and, of course, that includes investing higher amounts in banks and other share securities than would otherwise be the case. But risk taking can go too far.

According to Credit Suisse, a great number of SMSFs are taking on mezzanine debt in the form of loans to apartment developers. Usually these loans are quasi-equity and carry interest rates of between 10 and 15 per cent.

Chinese buyer concern

It is always possible that the loans will be repaid in full with interest, but in a great many of them the risks being taken outweigh the rewards. One of the biggest areas of concern that I have in Australia is the fact that we are experiencing an inner-city eastern states apartment boom on the back of Chinese and other Asian buyers who have paid a 10 per cent deposit on apartments.

As a result of these deals, many billions of dollars in apartment developments have been started and will approach completion in the next two years. As I have explained before, the Chinese buyers at best can get another 20 per cent of the principal out of China but that is all they can manage.

The Australian banks have shut the door in their face, partly as a result of pressure from the Australian Prudential Regulation Authority and partly because they are scared of the market. Already Meriton's Harry Triguboff alerts us that 50 per cent of the apartments bought by the Chinese are not settling on completion. Other reports indicate the rate is likely to be much higher.

Feverish efforts are being attempted to find other overseas buyers or funders. While an apartment is being built, another overseas buyer can buy the original 'off the plan' purchase. But once the apartment is completed it cannot be purchased by an overseas buyer so it must be sold to the locals. There is already in Melbourne a two-tier market, and that secondary market discount looks likely to increase unless the rescue efforts to sell these apartments to other overseas buyers is successful.

I think most local apartment buyers know the risks. But what is not understood is the multi-billion dollar financing liabilities that any mass non-settlement by the Chinese will

Continued on page 2 ...

CONTENTS

ARTICLES

IMPORTANT INFO

Continued from page 1 ...

create. The developers who started these projects gained their initial funding from the banks, but the banks limit their liability to about half of the total cost. So developers are offering huge interest rates to enable them to complete the buildings.

Other developers have purchased land and have permission to build the apartments, but are seeking extra funding. If the attempt to market the defaulting Chinese apartment contracts to other overseas investors is not successful, then significant losses are going to be incurred by developers. A large number will be wiped out and so will those who loaned money on high interest rate securities. I don't believe it is worth the risk, even though the rewards are tempting.

If we have a weak Melbourne-Brisbane-Sydney apartment market caused by Chinese settlement difficulties, will it spread to the rest of the dwelling market? Most of the Chinese have bought in inner-city areas and it will affect apartments close to the Chinese demand areas, but as you move into highly sought after suburbs the impact will become less and it will be marginal in the outer suburbs. Adelaide and Perth will not be affected, but Perth has its own problems.

Commonwealth Bank

And talking about risk and reward on interest-bearing securities, as we all know the Commonwealth Bank has greatly reduced its term deposit interest rates after it increased them some two months ago after official interest rates were reduced. It was a public relations exercise because the rate rises were given as part of the reason for not passing on official rate interest rate falls to mortgage holders. I think the banks have a good set of reasons for not passing on all the official rate decreases, but the sharp increase in term deposit rates engineered by the CBA turned out to be part of a game.

Looking at the CBA term deposits, the plus-3 per cent two-year rate has been abandoned and only the 36 to 47-month rate of 3.2 per cent remains of the old higher rates. If you place your money on deposit for five years, the interest rate is between 2.75 and 2.85 per cent – well below the three to four-year rate. One-year term deposits are down to between 2.4 and 2.5 per cent. I think the politicians who questioned CBA chief executive Ian Narev should have been much tougher on this aspect of the bank's funding. But they didn't seem to understand the significance of what had taken place.

Meanwhile, APRA has changed the deposit rule which means that in the future the banks will not need to raise as much local deposit money to satisfy the regulator's requirement. That means that in 2017, unless there is a big increase in demand for bank loans, there is less likely to be a war on deposit interest rates.

The money market is becoming less confident that there will be another official interest rate reduction in 2016, but I still think it is on the cards for early next year. If there is no interest rate reduction that might at least stabilise deposit rates at these very low levels. But even at very low levels I prefer a bank deposit to those high interest rates offered by property developers.

Renewables recant

In your emails following the weekend many of you gave me a hard time over my remarks on South Australian renewable energy. And you were justified.

When I saw the television images of the broken transmission towers it was clear that the state renewable energy policy had nothing to do with the power failure in the latest storms. I got that wrong. But that should not obscure the fact that if any state is going to increase its renewable energy content to very high levels on the basis of current technology then it needs a back-up should, for example, the wind not blow.

Whether that back-up is in its own state or a neighbouring state is less important, although if it is in a neighbouring state you need to make sure that the transmission is secure with alternatives in case of breakdown.

Rising supply within the higher-density apartment sector threatens to put downward pressure on apartment prices and rents.

BY CALLAM PICKERING • EUREKA REPORT • 5 OCTOBER 2016

The construction risks for property investors

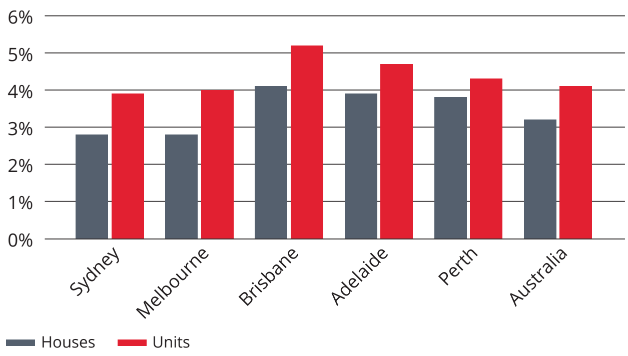
Residential construction has been a bright spot for the Australian economy, supporting growth during a difficult period, but the ongoing boom presents a risk for property investors.

Key Point

- ***The concentration of construction in higher-density properties means that the construction boom won't have the same spillover effects that we have seen during past booms.***

New data on building approvals, which typically leads construction activity by a good 12–18 months, suggests that residential construction will remain strong into 2018. This rising supply, particularly within the higher-density apartment sector, threatens to put downward pressure on apartment prices and rents. We are already seeing this to some extent with apartment price growth in Sydney and Melbourne trailing that of detached housing.

Chart 1: Australian residential rental yields (annual)



Source: CoreLogic; via CP Economics

Adding further concern, newly negotiated rents are falling across most cities and rental yields have tumbled to their lowest level on record (summarised in Chart 1). With so much new supply set to be completed over the next two years we can expect rents and yields to fall further before they begin to improve.

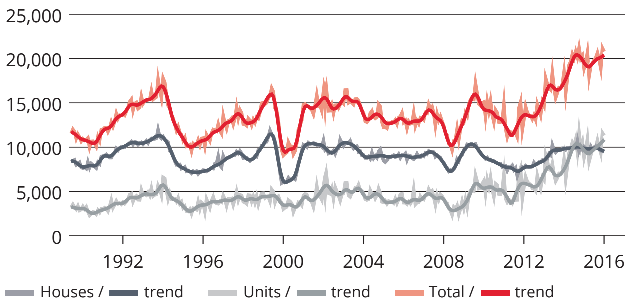
Earlier this week the Australian Bureau of Statistics released new data on building approvals, which measures the number of houses and apartments approved for construction. It is a useful leading measure of residential construction activity and one of the measures closely watched by policymakers across the country.

Building approvals rose by 0.6 per cent in August on a trend basis, to be 4.4 per cent higher over the year. Monthly approvals currently sit slightly below their peak established in April 2015.

Growth has been concentrated in higher-density approvals, which should come as no surprise to those readers who frequent inner-city Melbourne and Sydney. Approvals for private higher-density dwellings have increased by 12.4 per cent over the past year and currently sit at their highest level on record.

Approvals for private detached housing have been somewhat weaker and currently sit 5.3 per cent below its peak. Month after month we are seeing a shift towards inner-city apartment living. This is partly being driven by changing preferences but also by necessity – people want to live where the jobs are. The narrowing of Australia's manufacturing base, as well as the rise of services, is forcing Australians towards inner-city jobs.

Chart 2: Australian building approvals – number of approvals (seasonally adjusted)



Source: ABS, CP Economics

A construction boom will inevitably give rise to concerns about oversupply. Have property developers over-invested in response to rising property prices across Sydney and Melbourne?

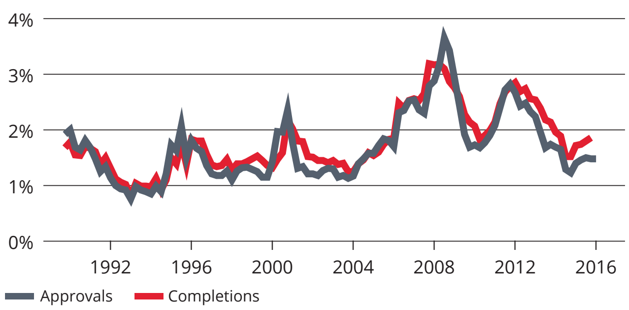
> **"With so much new supply set to be completed over the next two years we can expect rents and yields to fall further before they begin to improve.**

There is no definitive answer to this question. Estimating under and oversupply in the housing market is a complicated business and typically there are too many unknowns to arrive at a definitive answer.

Nevertheless, one useful technique is to compare building approvals or completions against population growth. This measure doesn't say anything about the rate of housing formation or average household size but it does provide a rough proxy that might prove useful for investors.

Chart 3 shows that supply imbalances have eased in recent years as residential construction has increased. There is a great deal of divergence from state to state; relative supply is rising fastest in South Australia (where annual approvals exceed population growth) and slowest in Victoria (ratio of 1.9) and NSW (ratio of 1.6).

Chart 3: Population-to-residential construction ratio – quarterly (trend)



Source: ABS, CP Economics

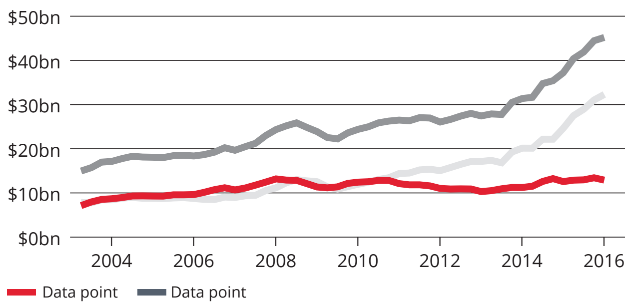
This would provide some evidence in favour of the view that supply shortages can help to explain the residential property boom in Sydney and Melbourne but also the weakness across the rest of the nation. It's also consistent with the recent decline in newly negotiated rents. Perhaps the most interesting implication though is that it indicates that the greatest risk of oversupply may currently exist outside of Sydney and Melbourne.

In analysing housing supply issues we can't just focus on approvals or construction activity completed. We must also assess the value of construction yet to be done. The data indicates that we still have a huge pipeline of construction that needs to be completed and this will keep residential construction activity at a high level through to at least 2018.

Chart 4 shows the construction pipeline for detached and higher-density properties.

The concentration of construction in higher-density properties means that the construction boom won't have the same spillover effects that we have seen during past booms. Construction of detached housing often leads to a renovation boom, but that isn't possible in the higher-density sector.

Chart 4: Residential building construction – value of work in the pipeline (original)



Source: ABS, CP Economics

Those living in apartments are also less likely to purchase household goods, particularly high-quality household goods, so the retail response to the construction boom may prove muted compared with past episodes. So it's a mixed bag for key retailers, such as Harvey Norman, Myer and David Jones, who tend to outperform during construction and renovation booms.

Investors will need to balance these risks. They know by now that the housing market isn't quite as buoyant as it was during 2014 and 2015. The big gains are over and finding strong capital growth will require more research and greater due diligence than it has in the past.

Rental yields are often a minor consideration for property investors – hence the popularity of 'negative gearing' – but it would be foolish to ignore the recent fall in newly negotiated rents. The size of the construction pipeline all but ensures that rents will fall further over the next couple of years.

> **The narrowing of Australia's manufacturing base, as well as the rise of services, is forcing Australians towards inner-city jobs.**

A word on monetary policy

Finally, I wanted to touch briefly upon the Reserve Bank of Australia's board meeting this week. As expected it decided to leave the official cash rate at 1.5 per cent. The cash rate has been cut by 325 basis points since October 2011.

According to the RBA, "the Board judged that holding the stance of policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time." The board statement offered little insight into the future direction of policy, although the market still believes that the next move is down.

The market is currently pricing in a 24 per cent change of a rate cut in November and a 78 per cent chance of a cut by June next year. Market expectations will shift later this month on the back of new inflation figures for the September quarter (out October 26), as well as the usual raft of monthly releases such as employment and retail sales.

There is a clear reluctance from the RBA to cut interest rates further, emphasised in governor **Philip Lowe's testimony** before the House of Representatives last week, but I'm not convinced that their reluctance is credible. The bank has been reluctant to cut interest rates for the past two years but has folded each time our economic transition has been challenged by low inflation or an excessively high dollar.

Inflation remains the most important consideration for monetary policy but policy decisions elsewhere, particularly from the US Federal Reserve, will have important implications for the RBA. The Federal Reserve is expected to hike rates later this year but if they don't we may be faced with an Australian dollar that pushes towards US80c, which would undermine some of the recent improvement in our non-mining sector. If this eventuates then the RBA has little choice but to cut interest rates further regardless of its current reluctance.

Institutional investor participation in hybrid issues has jumped this year, highlighting their worth.

BY PHILIP BAYLEY • EUREKA REPORT • 4 OCTOBER 2016

The hybrids threat to retail investors

It seems that 2016 is likely to go down as the year in which institutional investors became much more interested in hybrid notes. Increased institutional issuance in hybrid notes is likely to have both positive and negative implications for retail investors.

Key Point

- ***The hybrid market is a relatively illiquid market meaning institutional involvement will massively effect price - and may push the trade to the wholesale domain.***

The trend appears to have started with Macquarie Group's Capital Notes 2 issue, which listed on the ASX in December last year. Macquarie advised the ASX of the top 20 noteholders when trading in the notes commenced.

AMP's Capital Notes issue also commenced trading on the ASX at around the same time but no advice was provided on the top 20 holders of AMP's $268 million of Capital Notes. It was the same when Westpac's $1.3 billion of Capital Notes 3 commenced trading in September.

This suggests that for both issues there were no individual holdings of any significant size. But in Macquarie's case the top 20 listing revealed that institutional investors had taken up just over 20 per cent of the $531m Capital Notes 2 issue. And the largest investor acquired a holding of 3.2 per cent of the notes issued.

But this is small beer in comparison to the levels of institutions investor participation in the hybrid issues seen so far this year.

CBA was first to market in March with its $1.45bn, PERLS VIII issue. The Top 20 listing released by the CBA showed that institutional investors took up more than 36 per cent of the issue and the largest investor acquired almost 20 per cent.

The figure for the subsequent issues from Westpac and NAB are similar.

Westpac's $1.7bn Capital Notes 4 issue saw the Top 20 holders account for 35 per cent of the issue and the largest 17.6 per cent. In NAB's case, the top 20 holders account for more than 38 per cent of its $1.5bn Capital Notes 2 issue and the largest holder more than 20 per cent.

The use of nominee companies by institutional investors disguises who holds the beneficial interest in the notes acquired but, interestingly, it is the same nominee company and account that holds the largest interest in all three issues undertaken so far this year.

The good news for retail investors is that institutional participation at these levels signals that the professionals now see value in the hybrid issues that have come to market this year. This may be attributed to the sell-off seen in the market last year or it may just be a reflection of the dismal lack of yield available anywhere else.

But this may be the only good news there is.

The hybrid market is a relatively illiquid market in comparison to the share market and even the wholesale bond market. Institutional participation at up to $300m a pop, as in the case of the NAB Capital Notes 2, will see the secondary market price of the notes hammered when the institution decides to sell down or even exit entirely.

Institutional investor participation at these levels also suggests that the time is fast approaching when hybrid issuance can switch to the wholesale market, just as subordinated debt issuance did in 2014. There has been no retail subordinated debt issuance **from the banking sector since 2013**.

Wholesale issuance of hybrid notes has occurred before. AMP sold $275m of hybrid notes in the wholesale market in March 2015 but the view at the time was that the size of the issue reflected limited institutional demand.

But now if one investor is fronting up to take $300m at a time, then institutional demand has increased significantly and 'wholesale issuance only' may not be far away. It will certainly be cheaper for issuers to go down this path and it may even allow regulators, such as ASIC, to sleep more comfortably at night.

Philip Bayley is an independent consultant to debt capital market participants and is associated with Australia Ratings.

There are multiple ways to commence some familial wealth transferral.

BY CAROL TAWFIK • EUREKA REPORT • 4 OCTOBER 2016

Four financial gifts for the family

The act of giving can be extremely fulfilling. For some, this might particularly be the case where that involves family members or loved ones.

Key Point

- ***An early start in the financial planning journey can yield life-changing habits and results.***

Over my years advising private clients, the conversation around estate planning and succession has increasingly brought to light a real desire for some to commence some familial wealth transferal during their lifetimes.

Notably, a recurring theme in these discussions is that the client has frequently sought to gift with purpose, and to make a real impact with an ongoing benefit rather than simply giving for giving's sake.

From helping younger ones to get started on their savings journey to children who might already be well established, a trusted adviser can act as a great sounding board in helping you achieve a meaningful outcome when it comes to assisting the next generation in their financial lives. Sometimes even seemingly small seeds can harvest lasting reward. Here is some food for thought:

The advice step

Encouraging engagement with your own network of professionals can make for a great introduction to, and foundation for, good financial management into the future.

While those in their 30s and 40s may benefit from comprehensive planning, there is no reason it cannot start earlier on with younger children or grandchildren wanting to make better use of their savings and get investment fundamentals under their belt.

As the saying goes, the first step is always the hardest. Helping to facilitate the first step could, however, open the gateway to one starting on the road to their highest potential.

Super competency

As perpetuated in 2015 federal Budget, and subsequent recent adjustments, the ability to contribute to superannuation has diminished significantly over several years. Under new proposals, from July 1 next year the concessional contribution limit will reduce to $25,000 for all. This means that a final push to make larger contributions in one's 50s is no longer what it once might have been.

Unless there is a concerted effort to start early, it will be difficult for many to accumulate sufficient retirement funding within the superannuation environment, let alone arrive at the $1.6 million tax-free pension cap.

We know that with the effect of compounding investment returns, even seemingly small but consistent contributions early on can have a marked impact on one's accumulated balance over time.

Things like a mortgage and childcare obligations can, however, make it near impossible for a young family, for example, to justify extra contributions into superannuation regardless of the evidence presented as to its merits.

Potentially doing so on behalf of an adult child can have an expanding effect that will pay dividends well into the future. The preserved or restricted nature of superannuation also maximises the likelihood that the funds will be utilised for the purpose they were intended.

The insurance question

Whether it is cost, lack of understanding or the quintessentially Australian 'she'll be right' attitude, the country's underinsurance problem has been well documented. **Lifewise** states that while 83 per cent of Australians have insurance on their car, only 31 per cent have income protection insurance.

> **“Unless there is a concerted effort to start early, it will be difficult for many to accumulate sufficient retirement funding within the superannuation environment, let alone arrive at the $1.6m tax-free pension cap.**

Unfortunately most know too well the devastating effect that unforeseen illness or injury can have; the financial impact potentially crippling. Experience has shown that these impacts can be far reaching as parents and grandparents may step forward in a time of crisis to offer support in any way possible. Most often, and naturally, this assistance will be financial.

Cost, or the perception of, is frequently cited as the key inhibitor to adequate protection in the form of insurances. Funding personal insurance premiums on behalf of children can ensure the peace of mind that not only they and their families are protected but also that one’s own well-laid financial plan is not suddenly and unexpectedly placed at risk.

Education contribution

Many a discussion has been held regarding contributions to grandchildren’s education costs. While there is increasing propensity for grandparents to take involvement, for the majority, fully funding school fees is an unviable prospect given the potential quantum and duration of the commitment. There are, however, other alternatives which are in keeping with the objective.

Co-curricular activities and school extras – like laptops, textbooks, musical instruments, sporting equipment and uniforms, etc – can potentially run into the thousands over and above the headline annual school fee. And many schools offer optional excursions and overseas trips aimed at complementing and deepening the academic experience.

Making contributions to the ‘extras’ not only relieves financial pressure on the parents but can be a great way to support and foster a grandchild’s particular interest or future educational outcomes – without the potential overcommitment.

When it comes to intergenerational wealth transfer, what might be appropriate will of course very much depend on the specific circumstances; and while the possibilities are endless, they must speak to what is most important to you.

It might pay to think a little outside the box. In any event, having children involved in the advice process can be most valuable in cultivating a strong sense of financial literacy and responsibility, which in itself is a wonderful legacy.

Carol Tawfik is a licensed financial advisor at Affinity Private.

There are signs already that the potential recovery in the largely forgotten small iron ore sector will be worth watching.

BY TIM TREADGOLD • EUREKA REPORT • 4 OCTOBER 2016

Iron ore juniors stage a comeback

Life is returning to small iron ore stocks devastated three years ago by soaring costs and a plummeting iron ore price, which combined to wipe out much of the sector and left the industry to large miners.

Key Point

- ***Having been pushed to the edge of a cliff, a rising price and high-grade deposits may make some iron ore juniors the sweetest 'fish' off all.***

The future of iron ore will remain largely a business for big companies able to operate in a way that delivers the economies of scale needed in bulk mining, where transport costs are critical to success or failure.

But flying below the leaders – that group comprising BHP Billiton, Rio Tinto, Fortescue Metals Group and Hancock Prospecting – are a band of minnows which own high-grade ore deposits which can command a premium price and which are benefiting from a massive fall in costs.

It is the combination of a price, which has crept up from less than $US40 a tonne during the depths of the crash to around $US55, and the sharp costs decline which has seen a restart in development plans by small miners.

Two of the possible restarts have the benefit of minimal transport costs because they are on islands off Western Australia's Kimberley coast, have most necessary handling equipment in place, and have ore so high in quality that it sometimes has to be blended down to meet steel mill specifications.

Koolan Island, one of Australia's oldest iron ore projects, was developed by BHP in the 1950s and brought back to life in 2007 by Mount Gibson Iron, only to be closed two years ago when a sea-wall protecting the main pit on the island (which is below sea level) ruptured, flooding the workings.

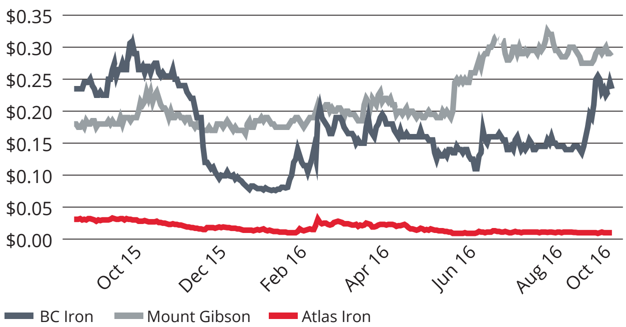
Cockatoo Island, in the same area of Yampi Sound north of Derby, is also showing signs of being revived with a complex legal dispute moving closer to a settlement and the receiver of failed owner Pluton Resources offering the business for sale, promoting the exceptional grade of ore remaining as up to 68 per cent iron in part versus the industry standard of 62 per cent.

A third small iron ore revival situation emerging is BC Iron, which is currently posting reasonable profits from its Iron Valley mine in the Pilbara region of WA (shadowed by the majors), but has also recently dusted off plans for the much bigger Buckland project.

Atlas Iron, one of the small iron ore miners to suffer a near-death experience, remains in production but is essentially controlled by its creditors while Mineral Resources, a diversified service provider, has its own Carina mine and operates the Iron Valley mine for BC Iron.

There is no guarantee that the small iron ore miners will get any bigger, but some of them are examples of an old investment saying about "little fish being sweetest".

Chart 1: Iron-ore junior share prices, past 12 mths



Source: Bloomberg, Eureka Report

The small survivors are also an example of the benefit flowing to the industry from the sharp reduction in operating costs that are a result of stronger management able to enforce wage reductions, tighter operating schedules and an abundance of surplus (and cheap) capital equipment.

All producers are also benefiting from the modest price recovery and the lower exchange rate against the US dollar – two moving parts in the profit equation which can change suddenly and are beyond the control of the miners. Fitch Ratings, in a recent report on the iron ore industry, forecast a fall soon to $US45/t, a level which it reckons will become the long-term price.

Of the three small-iron case studies, BC's Buckland project looks the hardest to achieve given its cost and the need to develop the mine, a railway connection and port facilities.

> **Flying below the leaders are a band of minnows which own high-grade ore deposits ... and which are benefiting from a massive fall in costs.**

Two possible development options are being considered and both depend of signing up a partner with deep pockets but the potential iron ore cash cost on a per tonne basis is interesting.

If developed as an eight million tonne a year project costing $880 million it could produce ore at a cash cost of $32/t, less than half the current Australian dollar iron ore price of $72. At 18 million tonnes a year the cash cost per tonne of Buckland ore falls to $29.

On the market, BC has come close to doubling over the past month with a rise from 13.5c to 24c.

Pluton's primary asset, the Cockatoo Island mine, is a more complex possibility given the legal issues which include a breakdown in the relationship between the Australian company and its Chinese partner in the project.

However, if Cockatoo Island does get a simplified ownership structure it is a mine which Pitcher Partners, the receivers of Pluton, reckon still contains more than 46 million tonnes of ore averaging 68 per cent iron (which is diluted to 62 per cent).

Like Koolan Island the mine itself sits below sea level and is being kept dry by continuous pumping. The sea wall is believed to need repairs but most major items of capital equipment, including a ship loader, remain in place, ready for a restart.

Mount Gibson, the owner of Koolan Island, is the small iron miner most likely to re-invest in the industry thanks to four factors:

- It has an existing operation on the Australian mainland at Extension Hill, inland from Geraldton in WA's Mid-West region, with another nearby orebody, Iron Hill, an option to keep cash flowing amid a restart at Koolan;
- It received a hefty $86m insurance payment in June a result of the sea wall failure (with more possible under business interruption insurance);
- It already has around $400m cash in the bank from earlier year operations, and;
- Redeveloping Koolan Island, according to a Macquarie Bank analysis, would probably cost less than $90m, roughly the same as Mount Gibson's insurance payout.

Macquarie reckons redeveloping Koolan Island is highly likely with cash costs after a restart expected to be around $35/t and annual production expected to be around four million tonnes.

On the market, Mount Gibson got its biggest kick along after the insurance settlement was announced in mid-June, lifting the stock from 19c to 33c. It has since retreated to 29.5c, but Macquarie reckons it has a 12-month price target of 47c.

Multiple factors could swing the revival of the small iron ore sector. The price of ore is obviously a critical factor, but so too is the exchange rate and the ability of the miners to keep a lid on costs.

But having been pushed to the edge of a cliff (and with some going over the edge) the potential recovery in a largely forgotten sector should be worth watching.

Responses to the questions we didn't get to answer in our most recent Advisor Q&A.

BY BRUCE BRAMMALL • EUREKA REPORT • 6 OCTOBER 2016

Advisor Q&A: Addressing your super challenges

Another great webinar with *Eureka Report* readers last Thursday. Thanks again for joining in, and if you wish to watch the webinar please **click here**.

Some of the questions present us with challenges, partly because we are having to make educated guesses until such time as we see the legislation. There's common sense … and then there's meddling with super. Unfortunately, some of the laws made in the past have made little sense.

But there were a number of questions that Carol Tawfik and I didn't get to answer last week. And a few others that I think are worth returning to. So, today's column is turned over to providing responses to some of those questions, which I know will have a broader appeal.

Excess contributions

***Q**: One of the draft changes is that employees can make tax deductible contributions up to $25,000 less what their employer has contributed. Can this "excess" contribution be deducted against any other taxable income? Like rent, dividends, etc? Will the "excess" contribution still be subject to tax at 15 per cent inside super? –James*

Answer: Yes, the intention of the legislation is to get around the almost universally silly "10 per cent rule" that currently exists. This rule means that if you earn more than 10 per cent of your salary as an employee, you can only make concessional contributions via your employer.

If you worked part-time somewhere (say, two to three days a week as a teacher) and had a part-time business, or consultancy, that you could only make deductible contributions via your employer.

If you earned, say, $100,000 a year, half as an employee and half as self-employed, then you would get $4750 (9.5 per cent Superannuation Guarantee on $50,000) in super from your employer, but you couldn't make a tax-deductible contribution to super from your self-employment (unless you were a bona fide employee of your business).

Worse, if you did want to make some salary sacrifice contributions to super, you could only do so if your employer offered salary sacrifice. And there was no law that said they had to.

The new rules will allow virtually anyone to make a tax-deductible contribution to their super at some stage during the financial year. Most would be wise to do this in the latter part of the financial year.

But, yes, you will still be limited to $25,000 (from next financial year). So, if your employer puts in $12,000 a year as SG into your super fund, you will need to know this and will be limited to putting in $13,000. Yes, it will be deductible against other income.

And yes, it will still then pay 15 per cent tax on the way in. But you will then get a tax deduction on that amount.

Say you put in $10,000 into your super. Your super fund will pay $1500 in tax, leaving $8500 to invest in your super fund. But outside of super, you will get a tax return equal to your marginal tax rate on that. If you earn between $37,000 and $80,000, your tax return will be $3450. If you're above $80,000, your tax return will be boosted by $3900. And those on the highest marginal tax rate will benefit even more, but will likely be limited as to what extra amounts they can get into super.

Tax strategies (I)

***Q**: The new legislation says that income on balances that are less than $1.6m will be tax exempt, and any excess can be taken out. Presumably it makes sense to take all the low-yielding assets out as there is no cap on the income that can be made from the $1.6m? —Brian*

Answer: As I briefly discussed during the webinar, this is going to be a very personal decision. And one that will be based on your risk tolerance. And something I will do a longer piece about shortly.

Let's assume you have well over this $1.6m transfer to pension (TTP) cap. Assume $2.5m or more. And you've got a reasonable spread of assets. There's some cash, some fixed interest, property and shares (both Australian and international).

> **"The new rules will allow virtually anyone to make a tax-deductible contribution to their super at some stage during the financial year.**

What do you want to keep in the pension fund and what do you want to send back to accumulation?

This will depend on what sort of a risk you're prepared to take.

If you are prepared to take some risks and leave your growth assets in pension, perhaps you leave more of your shares/property in the fund. At least initially. They may grow in value from $1.6m to $3m over a period of time. If you're a particularly good stock/property picker, even more.

You may get your SMSF to a point, even after drawing a pension, via a growth strategy, that you're comfortable with the balance. You may then decide to sell some/all those assets and turn them into higher-yielding, lower-growth, assets (more fixed interest and property, or cash if interest rates turn higher in a few years).

Others may wish to have a lower-growth strategy, where they keep some high-yielding income assets in super, where they will pay no income tax on those assets. If you're managing to earn 5–6 per cent in income (fully-franked dividends, higher-yielding bonds, high-rent properties), you may decide to keep those assets in pension.

But the bigger your super balance, the bigger decision you are going to have to make about what assets are kept in pension and what assets are pushed back to accumulation (for those with bigger existing pensions now). For those who will turn on pensions in the future, you will be making big decisions from what you put into the pension.

Proportioning assets

***Q**: If you were fortunate enough to have more than $1.6m in your super account, is it allowable under the new rules to not segregate the fund into taxable and non-taxable, but to proportion the earnings according to the ratio of $1.6m to the total balance? Tax would then be levied on the taxable ratio. This would overcome the problem of selecting which assets to place in the non-taxable component. —George*

Answer: It's possible, even likely, that a proportionate rule will be allowed.

But my feeling is that you're going to have to nominate which assets are backing the pension and which ones aren't, when it comes to your SMSF.

If you're in an APRA-regulated fund, you will have two very different funds with two very distinct pools of cash/assets. There will be an amount of money invested in the pension fund and another amount of money invested in a super/accumulation fund.

But whatever is invested in the pension fund will likely be very clear cut, or may be best for you to choose what to put in there.

I can't see the government allowing a situation where it's not clear what assets are in the pension fund and what assets are in the accumulation fund. It leaves open the ability to manipulate what assets are where, based on the best tax outcome at the time of income being earned, or a capital gain being made.

The rule about the tax-free nature of a pension fund has generally been about "the assets backing the pension". Up until July 1 next year, this hasn't mattered too much, because the size of the pension fund was limitless and a minute from the trustees about moving any accumulated assets in the super fund to the pension fund was generally sufficient to allow the SMSF to pay nominal tax on whatever was in the fund in its entirety, if the member/s were predominantly in pension.

But, George, if you're talking about what element is considered 'taxable' versus 'tax-free' when you have to move some money from pension back to super, I would think that, absolutely, this would be done proportionately, unless it had been previously segregated.

Tax strategies (II)

***Q**: It seems like the Government is limiting the effectiveness of superannuation as a tax shelter. Should I be looking at alternative methods of reducing my taxable income for 2016-17, such as margin lending, and negative gearing on property for this year, or next year? —Lily*

Answer: Please have a look at the webinar. I'm not sure if I answered this question directly, or one that was similar. But this is what I have referred to as a 'three pots' strategy.

It really should be 3.5, maybe four, pots. See below.

> **The bigger your super balance, the bigger decision you are going to have to make about what assets are kept in pension and what assets are pushed back to accumulation.**

What I think people are going to have to do is to build their $1.6m in super, which will be tax-free.

Then they will need to build another pot of assets outside of super. Given that you can earn at least $18,200 tax free outside of super, you should probably have an amount of assets that will earn you this money outside super, tax free.

The third pot, on which you will pay a maximum of 15 per cent tax (but 10 per cent on capital gains) should probably be in accumulation/super.

If there's a fourth pot, then it is in negative gearing/margin lending strategies for those that these strategies are relevant for, which is those who have a high-risk tolerance, or those who have plenty of time to make a gearing strategy work.

Depending on your age, and willingness to accept investment risk, which gearing necessarily includes, you may well be a candidate for maximising your wealth strategies via the three main pots, plus the fourth pot that includes gearing strategies outside super.

But this fourth pot is fully taxable. While gearing strategies can make for good short and medium-term outcomes, it is generally designed to make for a big capital gain later, which will be taxable (at 50 per cent of the gain).

The suitability of gearing as a strategy in your situation will require you to talk to a knowledgeable financial adviser. Someone who can talk you through the risks and help you understand how this may assist your wealth creation strategies in the longer term.

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.

Intelligent Investor is celebrating 15 years of outperforming the market by ... changing nothing.

BY TONY KAYE • EUREKA REPORT • 5 OCTOBER 2016

The key to a 15-year track record of outperformance

For investors in the share market, being able to stick to a proven strategy over the long term, and having the investment discipline to ignore inconsequential day-to-day events, is often a major challenge.

Across its varied content, *Eureka Report* has always advocated the importance of having a rigid investment methodology that, when adhered to, will help deliver long-term growth.

That same philosophy has been the driving force behind the spectacular investment returns over the past 15 years achieved by the equities research and investment team at *Intelligent Investor*.

John Addis founded *Intelligent Investor* back in 1998, but it wasn't until 2001 that the business started auditing the performance of each of its share recommendations.

Fifteen years have elapsed since that first report and the latest audited figures from Grant Thornton have recently been released. They show an average annual return of 13.9 per cent from a total of 486 Buy recommendations over the last 15 years. That compares favourably with 10.2 per cent annual return for the All Ordinaries Accumulation Index (adjusted for franking).

A 3.7 percentage point outperformance may not sound like much but it adds up. A $100,000 investment in the All Ords index on 1 June 2001 would have produced $432,000 by 30 June 2016. Intelligent Investor members following all recommendations over the same period would have an additional $280,000.

Many fund managers, stock-picking newsletters and research services publicise their hot stock of the month but far fewer track, independently audit and then publish the ensuing performance of each recommendation. Why does *Intelligent Investor* bother?

Addis says it comes down to accountability. "Understandably in my view, there's not much trust in financial services companies. It's always been important to us to build trust with our members and an independently audited performance report is one way of doing it."

Research director James Carlisle puts the success of the team's picks down to two factors. "All the analysts in our 10-strong research team have first-rate analytical skills but there's one crucial test each has to pass. They have to really get value investing – not in the superficial way but in a 'read a ton of books and fly to Omaha for the Berkshire Hathaway AGM kind of way'."

Carlisle, however, doesn't classify the team as Buffett-style purists, saying that the practice of value investing is less about the teachings of any one individual and more about the difference between price and value – specifically, how to get more of the latter in return for the former.

"There are different ways of going about this," says Carlisle, "but many more ways of not going about it."

Whilst the mainstream media and financial community talk of betas, capital asset pricing models, moving averages and retracements, Carlisle believes these are dangerous distractions. "Successful value investing means disregarding the white noise of daily market commentary and sticking to basic principles. We've been doing it for a long time and we're living proof it works."

Of the hundreds of recommendations made over the years a few stand out. Four-wheel drive accessory maker ARB Corporation, up 368 per cent (including dividends) since it was first recommended in August 2004, is an example of a good business purchased at a fair price that has grown through exceptional management and industry tailwinds.

RHG, the former RAMS Homeloans, was as a deep value play originally recommended at $0.95 that subsequently fell to just 4.6 cents. "It was a challenging time," says Addis, "but the value was there even if the sentiment wasn't." The stock was eventually sold at $0.56 after returning $1.13 in dividends, a total return of 78 per cent.

The second aspect concerns the longevity of team members. Senior analyst James Greenhalgh joined in 2002, James Carlisle arrived in 2003 and deputy head of research Gaurav Sodhi in 2009.

> **"Intelligent Investor's model Equity Income and Growth portfolios ... compare favourably to the annualised 7.6 per cent return of the All Ordinaries Accumulation index over the last 15 years.**

"There's a Hotel California feeling about the place," says Addis. "Once a genuine value investor realises they've found their spiritual home they tend not to leave. Very few analytical teams have the kind of corporate memory we do. I think it gives us a bit of an edge."

Still, the performance report does have its shortcomings, something Carlisle is keen to point out.

"It's impossible for investors to follow every buy and sell recommendation we make and the report assumes you don't have to sell any stocks to buy the ones we recommend. It's a transparent, audited tool for evaluating every recommendation we've ever made but as a proxy for our overall stock-picking skills it falls a little short."

Instead, he suggests using the performance of *Intelligent Investor*'s model Equity Income and Growth portfolios as a more realistic guide, which have returned 13.3 per cent and 10.2 per cent per year since inception in July 2001 and August 2001, respectively. These returns compare favourably to the annualised 7.6 per cent return of the All Ordinaries Accumulation index over the last 15 years.

What of the next 15 years? Addis isn't keen on making any predictions.

"I think it's a mistake to think the next 15 years will play out like the past 15 years. But one of the great things about value investing is that if you just focus on buying cheap stocks, everything else takes care of itself. That's what we'll be concentrating on."

Over the next few months we will be highlighting the winners and losers over the last 15 years and what members can learn from them.

InvestSMART and Eureka Report subscribers have full access to Intelligent Investor's Buy, Hold and Sell recommendations and extended research.

Click to read Intelligent Investor's full ***Recommendations Report 2016****.*

eureka report