



**JUNE 2013**

## AIA 'Investor Update'

Welcome again to 'Investor Update'. In the last issue, we said we would 'spice it up' a bit this month, so we have a larger issue for you. Roger Montgomery discusses return on equity, and Elizabeth Montgomery talks about income v's capital growth. We also have Jodi Elliss on Defending your portfolio, Alex Wise talking about alternative investments and Dr Stephen Nash on aspects of inflation which affect retirees. Enjoy the read

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### When Growth is Not Good.

#### Roger Montgomery

Do you remember ABC Learning Centres? It was April 2006 and the shares were trading at more than \$8.00 and profits were growing at a fantastic rate. They had risen from about \$11 million in 2002 to over \$80 million in 2006. The problem was that the return on equity was declining.

It is return on equity that will help you to identify the great companies to safely invest in, and it is return on equity that will save your portfolio from permanent destruction.

Warren Buffett said not all growth is good and to understand what he was talking about, you need to know something about return on equity.

### Upcoming Events [\[view events schedule\]](#)

**AIA National Conference**  
**Early-Bird rate continues**  
[Details on website](#)

#### Melbourne Information Meeting

11<sup>th</sup> June 2013 1.00pm  
Telstra Conference Centre, 242 Exhibition St Melbourne

#### Sydney North Shore Information Meeting

12<sup>th</sup> June 2013 7.30pm  
Chatswood Club, 11 Help St Chatswood

#### Gold Coast Information Meeting

12<sup>th</sup> June 2013 9.30am

#### Sydney One-Day Seminar, Estate Planning

14<sup>th</sup> June 2013 9.00am  
SMC Conference Centre, Goulburn St Sydney

#### Brisbane One-Day Seminar, Improve your investing skills.

15th June 2013, 8.30am, Bronco's Leagues Club

#### Chermside Equities Discussion Group

17<sup>th</sup> June May 2013 7.00pm  
Chermside Library

**When Growth is Not Good (Cont'd)**

Imagine you have a business, even a good one. You invested \$1 million dollars in it, bought a shop and in the first year, it produced a real cash profit after tax of \$400,000. That's a 40% return. Now suppose another shop came up for sale in another area for \$400,000 and you decided to buy it. As it happens you are really good at running the first store you bought but you have found running the second store a little harder. Travelling between them is a challenge and so you bring in a manager for the second store.

The result is that after a year of owning the second store it produces a profit of \$20,000. Meanwhile the first store produces another \$400,000. The second store has generated a return of just 5%.

Many business owners – and I know one or two – would say this is still satisfactory, because profits have gone up. In the first year your business made \$400,000 and in the second year, profits have gone up to \$420,000. Profits of your new 'group' grew by 5%.

Thinking about this situation another way reveals what a poor investment the second shop is.

You first have to remember that you gave your business more money, so profits should have gone up. A rocking chair to sit in and a bank account are all you need to make profits go up. Invest \$1 million in a bank account and then put in another \$400,000 the year after and the interest you earn in the second year will be higher than in the first. You have grown the profits and it has been no effort at all.

So when a company increases its profits, this is nothing spectacular if, to generate the growth, the owners have invested more money in the company. This is purchased growth. Shareholders have funded the opportunity for the directors to look good. The situation is even worse if that additional money generates a return that is less impressive than the rate available from a bank account. In addition, if a higher return can be earned somewhere else, for the same risk or the same return for less risk, then the reality is that you don't want to put more money into the business. You don't want it to grow. It is better that the \$400,000 is taken out of the business, rather than employed to purchase another shop. The \$400,000 should be invested elsewhere at a higher rate or even at the same rate in a bank account, which has a lot less risk.

Where to from here?

Life Planning  
Financial Strategies  
Asset Protection

Marriott Resort & Spa  
Surfers Paradise

28th July – 31st July

[www.investors.asn.au](http://www.investors.asn.au)

**AIA National Conference****Sunday 28<sup>th</sup> to Wednesday 31<sup>st</sup> July 2013****Where to from here?**

**The 'Early-Bird' specials have finished but  
you can still get the \$100 saving!**

**Just not the chance to win accommodation  
or the free Masterclass**

**Members rate remains  
\$725**

Come to the annual conference and learn from industry renowned speakers, including, Brian Parker, Alan Hull, Colin Nicholson, Julia Lee, Roger Montgomery, Louise Biti, Elizabeth Mornan, and many others.

[Visit the website for details and to register](#)

**Amazing rate on accommodation**

We have been able to negotiate an extremely attractive room rate this year of \$175 per night at the Marriott Resort. Of course, other accommodation options are available also.

### When Growth is Not Good (Cont'd)

If, each year, you invested the \$400,000 from the original shop into a new one that produced a return of 5%, the business would have many shops earning 5%, and each year the business would be worth less and less even though profits would be growing.

Many investors don't understand this concept – that there is growth that will destroy wealth. They happily allow the management of a company to keep the money 'to grow the business' and willingly accept a low return. For the investor, that low return is actually costing you money because you could have earned a better return elsewhere. It is called opportunity cost. Investing the money in the business at a low rate of return has cost you the opportunity of earning more or earning the same, but with more safety, elsewhere.

For example, the following table shows that an investor in a company that generates a 5% return on equity and that keeps all the profits for growth rather than paying those profits out as a dividend, will lose half their money.

**Table 1: How to lose money despite profits and capitalisation rising**

	Year 1	Year 2
Equity at Beginning	\$1,000,000	\$1,050,000
Return on Equity	5%	5%
Net Profit	\$50,000	\$52,500
Dividend	\$0	
Equity at End	\$1,050,000	
Price Earnings Ratio	10	10
Market Capitalisation	\$500,000	\$525,000

Table 1 shows a company listed on the stock exchange and whose shares are trading on a price earnings ratio of 10 times. The price earnings ratio is simply the share price divided by the earnings. So if the share price is \$5 and the earnings are 50 cents, the price earnings ratio will be 10. It means that buyers of the shares are happy to pay 10 times the profits for the company.

In Year 1 when the company earned a profit of \$50,000, the stock market was willing to pay 10 times that profit or \$500,000 to buy the entire company. Another way of thinking about it is that the stock market thinks the company is worth \$500,000. Of course what the stock market thinks the company is worth and what it is

actually worth are very often two different things. Don't listen to what the stock market thinks.

The company begins Year 1 with \$1 million of equity on its balance sheet and in the first year, generates a 5% return on that equity, or \$50,000. Management decides that the money is needed to 'grow' the business and so no dividend is paid. As you are about to discover, that decision has cost shareholders a small fortune.

By keeping the profits, the equity on the balance sheet grows from \$1 million at the start of the year to \$1,050,000 at the end. In the second year, the company again earns 5% on the new, larger equity balance. A 5% return on \$1,050,000 is a profit of \$52,500.

The company is growing, equity and profits have increased and management is no doubt drafting an annual report that reflects satisfaction with this turn of events. But not all is as it first appears. Indeed management has, perhaps unwittingly, "duded" shareholders.

### Dividends and capital gains

As a shareholder your return is made up of two components – dividends and capital gains. If two dollars is earned and you don't receive one of those dollars as a dividend, then you should receive it as a capital gain. If, over time you don't, it has been lost and management may be to blame. Every dollar that a company retains by not paying a dividend should be turned into at least a dollar of long-term market value through capital gains.

The company has not achieved this and unfortunately lost its investors money. Even though the company appears to have grown – remember equity and profits are indeed growing – the reality is that as a shareholder you have lost money. How? The company 'retained' all of the \$50,000 of the profits it earned in Year 1. You received no dividends. All you got was capital gain but the capital gains were only \$25,000. In other words the company failed to turn each dollar of retained profits into a dollar of market value. So investors have lost \$25,000. If the situation were to continue, you should insist that the company stop growing and return all profits as dividends and if that is not possible, the company should be wound up or sold.

**Roger Montgomery is the founder and CIO of The Montgomery Fund, [www.montinvest.com](http://www.montinvest.com).**

**What's most important to you - income or capital?****Elizabeth Moran**

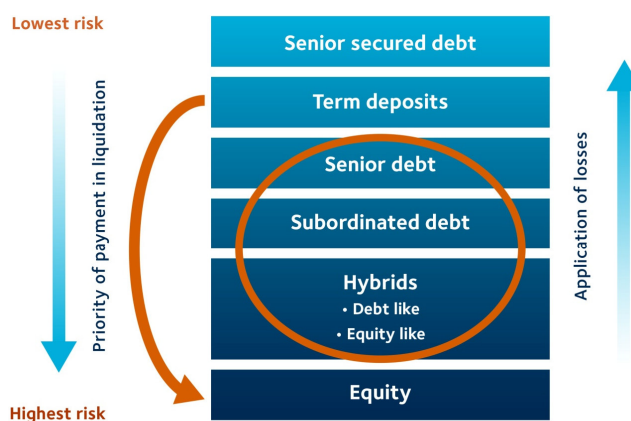
Everyone has different goals with their investment portfolios. Some investors just don't need and aren't concerned about their capital and income is everything. At last year's conference I met a man who really had no regard for capital preservation and as long as his income was maintained then his very high portfolio allocation to shares was, he thought, the best allocation for him. At the time I remember being surprised by his comments; didn't he have any plans to: retire, care for a partner, children, grandchildren, travel, or support charities? It turned out that he actually had a very large capital sum preserved; he was lucky enough to have a defined benefit superannuation scheme. So, no matter what happened to the markets he could rely on his superannuation. I think the point is though, that if you have any plans for your capital you should be concerned enough to think about preserving it.

By preserving capital, I mean minimising the risk that it can be reduced or lost entirely. Think about that for a moment, what investments guarantee return of capital? Not many in fact. Term deposits do and bonds also are guaranteed by the company or government that issue them, but there is no guarantee with shares, property or even managed funds. Your capital is at risk from a multitude of factors, many of which will be outside your control.

In the rush to lock in higher yielding investments in a declining interest rate environment, investors seem to be forgetting about the importance of capital preservation. We know from Australian Taxation Office data on SMSF portfolio allocations that SMSF investors are using funds to buy shares that were previously invested in cash and term deposits. While the higher income through dividends and franking credits is attractive, investors are giving up that certain return of capital. They also give up quite a bit more including the certainty of income (dividends can be cut; all four major banks cut dividends during the GFC by more than 10%, some closer to 20%).

This is where an allocation to bonds makes sense. Bonds are higher risk than term deposits, so offer higher returns but still offer the certainty of income and capital preservation. Bonds sit neatly between deposits and shares in terms of risk and return.

Figure 1 below shows a simplified bank capital structure. This shows the priority of payments should a bank go into liquidation. Term deposits are very low risk and sit near the top of the structure. As an investor, you'd expect to earn low returns because there is a very, very low risk that you'll lose any money. As you move down the structure you take on more risk and would therefore expect better returns. The lowest rung on the chart "equities" is where shareholders sit and they are in the highest risk, first loss position. Bonds are available in varying risk/ return options. Senior secured bonds sit at the very top of the structure and are lower risk than deposits as they are secured by specific assets such as property or mortgage loans. Bonds also sit in the orange circle as senior debt, subordinated debt or, the highest risk hybrids (which offer a mix of debt and equity characteristics).



Source: FIIG Securities Limited

**Figure 1**

By withdrawing money from term deposits and reinvesting in equities you are taking on a lot more risk. Importantly, bonds offer unique features that term deposits do not:

**1. Bonds offer fixed, variable and inflation linked interest payments**

Most term deposits are a fixed rate investment. If interest rates start to rise investors have to wait until maturity to take advantage of higher rates on offer, although they can break the agreement, but that usually involves a fee or loss of interest earned. There are three main types of bonds: fixed rate like term deposits, variable or floating rate and inflation linked.

Floating or variable rate bonds have an interest payment that is linked to a benchmark and in Australia it's the Bank Bill Swap Rate (BBSW). BBSW is calculated each business day. Floating rate notes usually pay interest



quarterly based on BBSW plus a margin. Let's run through an example, say the interest rate, set at first issue of the bond was BBSW + 3%. If BBSW was 3.25% at first issue then the interest rate payable to the investor for that first period (at the end of the quarter) would be 6.25%. Now if BBSW increased during that first quarter, due to expectations that interest rates would rise, to say 3.75%, at the first interest payment date, then the interest payment on that bond for the next quarter would be 3.75% + 3% = 6.75%. In this way floating rate notes keep pace with market expectations of interest rates. Investors don't have to worry about losing out on interest rate rises, nor reinvesting for short periods.

Inflation linked bonds work much the same way as floating rate notes except instead of the interest payment being tied to BBSW it is tied to the Consumer Price Index which measures inflation. So, inflation linked bonds provide a direct hedge against inflation.

Many commentators without a good understanding of the fixed income asset class still proclaim bonds will lose value in a rising interest rate environment. This can be true of fixed rate bonds and these are the bonds that are most commonly issued by governments. But it's clearly incorrect for floating rate notes and inflation linked bonds.

## **2. Interest is paid either quarterly or half yearly for most bonds**

Interest on most term deposits is paid at maturity, although if the term exceeds 12 months, it is usually paid annually. Banks will pay more frequent interest but the interest earned is usually reduced to compensate. Fixed rate bonds pay half yearly interest and floating rate notes and inflation linked bonds usually pay quarterly interest, great for those investors in retirement wanting regular cash flow.

## **3. Liquidity – the ability to access your funds**

Term deposits are not liquid investments; investors agree to forgo access to those funds for a pre-determined period. If investors want to access their funds they are usually faced with break fees or penalty interest.

Bonds are generally liquid investments, that is, can be easily exchanged for cash in the secondary market, where they are actively traded. There is no requirement to hold bonds until maturity. There are no fees as such to transact; brokers take a small margin between buyers and sellers, similar to the way foreign currency markets work.

## **4. Bonds offer the opportunity for capital gain**

Because there is an active secondary market for bonds, their prices can fluctuate. This means that there is an opportunity for capital gain. Fixed rate bonds will show the greatest variances due to the fact their interest payment is fixed and if interest rates fall, these bonds will be highly sought after and the bond prices will rise. So, a term deposit will protect income as will a fixed rate bond, but it is only the fixed rate bond that has the capacity to increase in capital value. This provides an important protection, particularly when interest rates are moving lower.

## **5. Better returns for a marginal increase in risk**

Investment grade corporate bonds are currently offering yields to maturity of up to 6.5%, well over the best term deposit rates.

### **Strategies for the current environment**

It's easy to get carried away in the hunt for yield but here are a few general suggestions:

1. Invest a little of your portfolio to get those high returns and not a lot
2. Be protective, you are the only person that truly has your best interests at heart
3. Spend the time looking at the fundamentals of any investment. What fundamentals have driven the price higher, can it go higher still, and is it fair value? Are you being properly rewarded for the risk involved?
4. Keep diversification within your portfolio and consider adding bonds for a small increase in risk over term deposits while retaining certainty of income and a higher return.

Note: Elizabeth Moran will be presenting at the AIA National Conference in July. The two hour workshop will show you how to construct a fixed income portfolio using real parameters and expectations.

## Defending Your Portfolio

Jody Elliss – Investor Centre

The nature of investing has changed dramatically in the last 10 years. We now have the federal reserve banks of major economies buying more than 50% of their government bonds to finance their government. We have economies like Japan and America printing money to finance bond purchases and even the UK has allocated \$375bn to government debt purchase – apply named “gilts”. This has never been seen before and bodes for a significantly different investment environment.

For retail Investors, it means that we need to take up what has been termed RO-RO (RISK ON – RISK OFF). With inflation very low and almost “deflationary”, long term investment strategies must not only take into account “return on capital” but also “preservation of capital”. The astute investor can no longer rely on the traditional BHP investment methodology (Buy, Hold, & Pray).

Contract’s for Difference (CFD’s) have been around since the beginning of the 21<sup>st</sup> century. Whilst, using them to leverage a position is a HIGH RISK strategy, they can also serve a completely different purpose. They are ideal for Investor Insurance positions and are vastly superior to other market hedge positions for individual stocks in the Australian market.

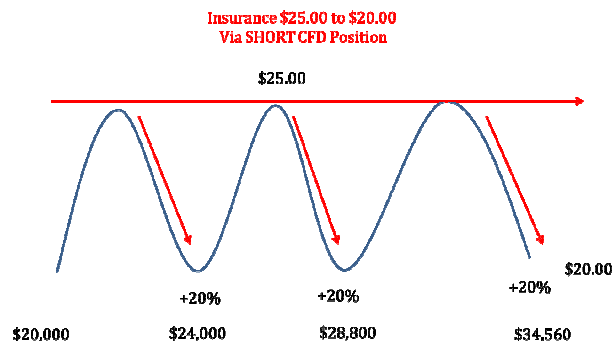
They offer Three (3) unique features:

- 1) The majority of the top 1,000 stocks can be insured
- 2) The investor derives an income for the insurance position (CFD’s pay the Investor for insurance).
- 3) Used correctly – losses tend towards (but are not equal to) \$0 while gains can be enormous.

How can we achieve this?

When the stock is in genuine up-trend the stock is left to run in “capital gain” mode. If the stock is in an obvious downtrend, we can take up a DEFENSIVE position by selling CFD’s on a 1 to 1 ratio against the stock holding. This is known as going short. Any fall in capital value will be converted to an equivalent increase in CFD capital. While the defensive position is held with a small deposit of the share-holding value (leveraged from about 3% depending on the stock and the provider) the provider PAYS INTEREST on the short position. The return on the short position is effectively 30% per annum (this varies

with CFD providers). In a bizarre twist, it can be far more lucrative to have a stock that is falling rapidly in value than one that is slowly appreciating in value.



The concept is simple but the actual decision making process can be a bit daunting for investors. Knowing exactly when to go DEFENSIVE and when to release a defensive position can be a difficult decision that is easily made with 20-20 hind sight but difficult to execute on the day. This requires knowledge of the individual stock and knowledge of the general market that is affecting the stock. This is called “Relational Investment Profiling” or “RIP”.

In this day and age where the regular smart phone has more processing power than NASA did 20 years ago, we have advanced computer modelling that can effectively profile each individual stock and greatly assist the complex decision making process of defensive action on a stock by stock basis.

The Portfolio Defender software has been designed to do just that task. It can profile an individual stock and then allocate a defensive strategy where the stock goes into decline. Rather than the original trend-line methodology that has proved ineffective for most stocks, Portfolio Defender profiles the stock in a relational manner (RIP) taking into account local market conditions that also effect this stock. This software quite often points to a defensive position or the release of a defensive position before the obvious break in trend.

### Case in Point – RIO



Approximately 12 months ago, RIO was trading at just over \$65.00. RIO above was trading 12 months later at \$55.00, yet the majority of Investors are still holding RIO as it is a “good stock” listed in the top 10 stocks in Australia.

Portfolio Defender profiled RIO and recommended *defensive* positions where the left (red) flag indicates. It recommended to release insurance when the right (black) flag indicates. It is NOT advocating to *sell*. Rather the profiling software is designed to evaluate RISK of CAPITAL LOSS. The software excels here because any losses – where the stock inadvertently gains value – means that the loss in the CFD is only equal to the capital gain experienced by the underlying stock.

In this particular example If you had \$100,000 worth of RIO on 3<sup>rd</sup> May 2012 it would currently be worth approximately \$85,000 and the majority of Investors would be hoping for the share price to rise. However, taking up the designated *defensive* positions with an equal number of RIO CFD's at the designated times represented an additional \$55,000 in insurance income – well and truly compensating for the \$15,000 net capital loss.

Depending on your tax structure, this may be taxable income. However, it is for once a nice tax problem to have where you have generated a surplus \$55,000 from a \$100,000 investment in 12 months. This return is slightly diluted as you were required to have an additional \$5,000 in your CFD account to initiate your insurance positions.

The software did not catch every small move down, but it caught all the major moves. It requires about 1 minute of maintenance each day to realistically defend your portfolio. In this day and age of Risk On – Risk Off, - we now have a computer program that can effectively RO-RO our investments to obtain highly effective yields, regardless of market direction. In the current uncertain economic times and greater market volatility, learning to defend your portfolio is an absolute imperative.

### Why consider alternatives?

#### Alex Wise, Chief Operating Officer, Select Asset Management

Alternative investments continue to grow in popularity because they provide investors with the important benefits of diversification. Their lower correlation with traditional asset classes means that when blended with mainstream investments they can help to smooth out an investor's portfolio returns over time. This is important as many investors have significant exposure to traditional market risk, and diversification is particularly valuable for investors during times of market volatility and uncertainty.

The limitations of diversification across many traditional asset classes has been highlighted, particularly during times of market stress, with many traditional investments exhibiting similar behaviour and losses at precisely the time that investors need diversification the most. Over the last 30 years academic theory around constructing investment portfolios has not changed significantly, while the markets themselves and investor risk tolerances have in some cases both changed dramatically. In fact, many traditional asset classes have become more correlated with one another over time, a reason why many institutional investors are seeking increased exposure to alternative investments.

Although alternative investments are often considered somewhat niche, there is a wide spectrum of alternative investments available which can offer investors access to a range of risk and return sources not available from traditional investments such as share markets to which many investors are heavily exposed. Some carefully researched alternative investments can provide access to returns that are uncorrelated with traditional investments, and these can protect capital in periods of market downturns without severely eroding the overall performance over time. The challenge for individual investors remains how to access these investments.

### A quick recap: what are alternative investments?

Alternative investments are those investments which lie outside the traditional universe of shares, property and fixed interest. They can include non-mainstream asset classes such as private equity, commodities, infrastructure and precious metals, and alternative investment strategies where fund managers may invest in mainstream markets, but in a different way, for example, long/short equity to generate returns less

dependent on the market direction. Examples include hedge funds and managed futures/trading funds. There is no precise definition of ‘alternative’ or even ‘mainstream’, as the definition may change over time. This is because some alternative investments become more accepted as greater numbers of investors start to include them in their portfolios. It also varies between investment markets. For example, in some countries real estate is still considered an alternative investment whereas in Australia it is generally regarded as mainstream.

### Challenges for investing into alternatives

The alternative investment universe has grown substantially since the lows of the GFC. US investors, particularly endowment funds, pensions and other fiduciaries charged with asset protection in the longer term, have been increasing the use of alternatives in their portfolios. Alternative strategies (such as hedge funds and managed futures) and alternative assets (such as commodities, private equity, infrastructure and gold/precious metals) have formed an important part of that strategy.

However, alternative investment selection, portfolio construction and monitoring can provide significant challenges for individual investors. Investing in a single alternative investment manager creates substantial manager risk in a portfolio and experienced and professional investors tend to avoid this approach. Accessing alternatives requires specialist expertise. The skills required to realise the full benefits of alternative investments should always include:

- \* The ability to assess which opportunities are worth exploring further,
- \* The ability to perform the required due diligence,
- \* Experience and industry networks,
- \* The ability to discern which investments are appropriate for clients, and
- \* The ability to access certain structures and offshore domiciled funds.

### Single investments versus a diversified portfolio

Alternative investments increase portfolio diversification. A diversified portfolio which includes assets with different risk and return profiles is difficult to build. A diversified portfolio helps reduce overall risk without necessarily impacting expected returns. A single manager fund exposures an investor to idiosyncratic risks associated with a single manager, for example key

man risk associated with a well known portfolio manager.

Alternative investments provide access to specialist investment opportunities. Some of the best opportunities are normally only available to sophisticated investors like large pension schemes or endowment managers. In turn most of these single managers are only available to wholesale investors. A diversified portfolio can provide access to these “best of generation” investment managers with high alpha potential.

### How much should be allocated to alternatives?

Investment views on allocation weightings vary. Typically a diversified portfolio can hold between 10% and 35% in alternative investments at any one time. Over the years in the investment industry there have been attempts to classify alternative investments into defensive and growth categories. The purpose of this was to match the industry terminology used to classify mainstream asset classes like shares and fixed interest.

Many expert investors and their consultants deal with the categorisation issue through the creation of a separate ‘alternatives’ allocation within a diversified portfolio. The existing asset classes within the portfolio are then proportionately reduced to take into account the inclusion of alternatives.

### Summary

In summary, alternative investments can bring lower correlation with traditional asset classes which means that when blended with mainstream investments they can help to smooth out an investor’s portfolio returns over time. Many institutional investors tap into these returns by building a diversified portfolio of alternatives investments with a target weighting often in excess of 10%. Building a portfolio of alternative investments requires expertise in understanding complex investment strategies and the ability to undertake due diligence including business risk due diligence. Given these challenges, even some of the largest investors seek a qualified partner to help build an alternative investment portfolio.



## Inflation as a moving target; how inflation volatility increases towards retirement

By Dr. Stephen Nash

### Introduction

Inflation means different things to different people. Specifically, it can be observed that expenditure categories can vary dramatically, depending on relative income levels, as essential items make up a higher proportion of expenditure for lower income groups. This observation is supported by a recent UK study, which will be referred to as the IFS report.<sup>[1]</sup> In this piece we will cover the following main topics:

- some preliminary matter in the IFS report,
- inflation basket changes in the UK,
- inflation basket variations, and
- The outlook for energy prices.

Finally, we draw these various arguments together, as they specifically relate to investment planning.

### Preliminaries

Inflation differs in the UK to inflation in Australia, for a variety of reasons, yet commonalities also exist. Specifically, the observation that less wealthy families have very different spending patterns from the very wealthy is similar between the UK and Australia. In order to review the variation in spending the authors of the IFS report do two things:

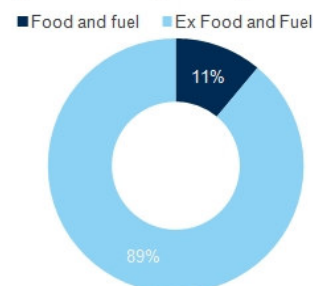
- **First**, the UK researchers classify spending into 12 categories: food, alcohol and tobacco, water, household goods and services, personal goods and services, public transport fares, catering, housing, domestic fuel, clothing, motoring, and leisure goods and services, and
- **Second**, the UK researchers split households into 10 equally sized income groups (referred to herein as 'deciles').

### Inflation basket variations in the UK

After these preliminary matters, the IFS report shows the rather striking variation in expenditure patterns, across asset [classes](#), as shown in the Figure 1 Below. Essential items, such as food and fuel comprise a much larger part of spending for lower income groups, when compared to high income groups.

Figure 1 shows, the approximate weights for the highest decile of income in the UK,

### High Income spending basket

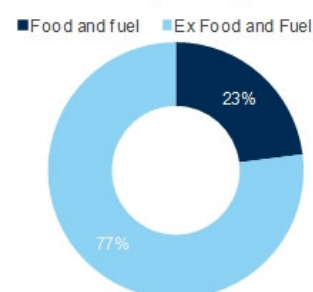


Source: FIIIG Securities, IFS, Figure 2.2

Figure 1 (Source: IFS Report, p.13, Figure 2.2)

In contrast, Figure 2 shows the spending pattern for the lowest decile,

### Low Income spending basket

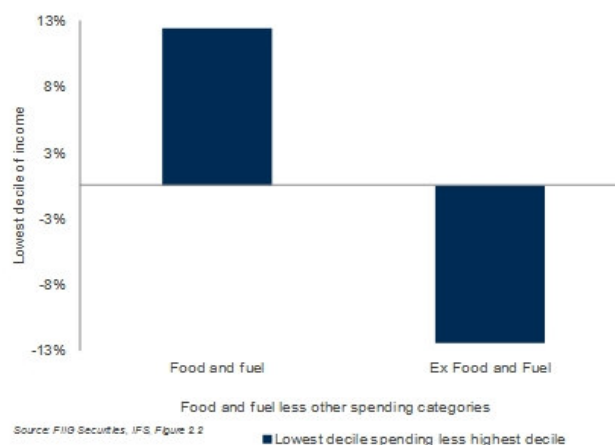


Source: FIIIG Securities, IFS, Figure 2.2

Figure 2 (Source: IFS Report, p.13, Figure 2.2)

Notice how the dark blue part of the pie chart, the volatile part that is influenced by variations in food and fuel, changes rapidly, from the highest to the lowest income decile. Figure 3 summarises the differences, which are quite large,

### Lowest decile of income less highest decile



Source: FIIIG Securities, IFS, Figure 2.2

Figure 3 (Source: IFS Report, p.13, Figure 2.2)

### Australian inflation basket presentations

Data on the variations in the CPI basket for each income level in the case of Australia, as we saw with the UK, is difficult to find. However, the ABS does show the variation in spending patterns using the household type (see figure 4 below).

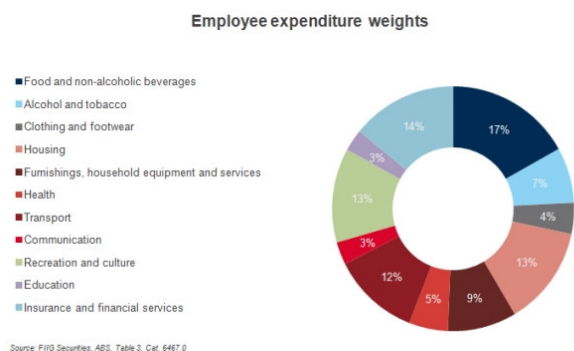


Figure 4 (Source: ABS, Table 3, Cat 6467.0)

Notice in Figure 4 how the allocation in the employee type to food is around 17%.

Now, notice in Figure 5 below, that this allocation significantly rises to 22% in the pensioner household type.

As income declines from the employee household type, which is related to the accumulation phase of investment, to the pensioner type which is related to the [retirement](#) phase of investment, one can notice that spending on food **increases** significantly. While direct fuel spending is not separated as clearly as in the case of the UK, it is possible to suggest that the patterns that are evident in the UK in terms of the allocation to food spending do appear to be somewhat common to Australia.

In other words, the transition from accumulation to retirement is typically associated with a fall in income, and with that fall comes a change in the basket that the retiree faces. Not only is that basket more dominated by basic items like food and fuel but those items are more volatile in price than the rest of the CPI basket.

**Pensioner expenditure weights**

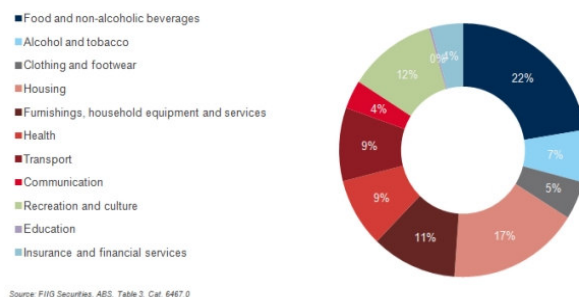


Figure 5 (Source: ABS, Table 3, Cat 6467.0)

Further, the RBA tends to focus on core measures of the CPI, not the volatile parts that feature in retirement spending. While one can understand that the RBA focuses on the non-volatile part of the CPI, this remains cold comfort for the retiree, who faces greater exposure to food and fuel as income falls.

### Outlook for gas and electricity

If energy is of higher relative importance to those in retirement compared to those in employment, then the outlook for energy prices is important. In the UK study the IFS quote the UK department of Energy and Climate Change (DECC), who expect a continued appreciation of energy prices, although the data is now a little dated.

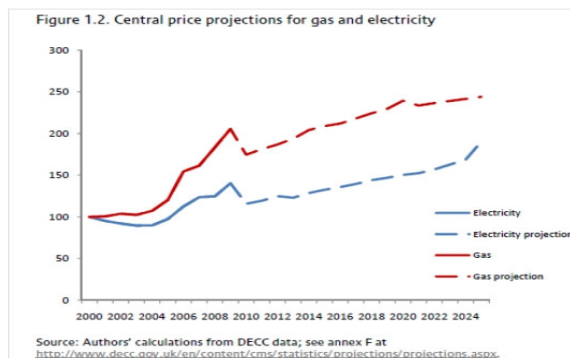


Figure 6 (Source: IFS Report, p.9)

While FIIG does not predict large increases in fuel price, as part of the expected investment scenario, FIIG has already pointed out the risks to oil price from tensions in the middle-east. As we pointed out recently, several factors are promoting the risk to the upside in the oil price which has recently remained firm in the context of a strong USD. The following are a list of those factors:

- Israeli fears about Iranian nuclear capabilities,
- Weapon transfer in Syria,
- Israeli involvement in the Syrian conflict, and
- Possible involvement of others in Syrian conflict, such as Turkey.

Importantly, the recent visit of the US president to Israel is a sign of how seriously the US administration is taking the current tensions in the region.

### Conclusion

If inflation is not on your mind, as an investor, then it should be.

Importantly, this note indicates that inflation is not a fixed target; it changes with income. Lower income means a more volatile basket will be chosen compared to the situation when higher income is enjoyed. As one plans for retirement, then one needs to take this fact into account, and this makes the need to insure against inflation all the more relevant. Just as you intend to relax in your retirement, variations in the more volatile parts of the CPI will impact you, as a retiree, more and more.

While the RBA focuses on headline inflation, large rises in essential items impact those who can least afford it the most, and rises in food and fuel may not, necessarily, translate into core inflation. In other words, even though core inflation may stay in a range acceptable to the RBA, headline inflation may be elevated for some time primarily due to increases in food and fuel. If that scenario proceeds, then those on lower incomes, especially self-funded retirees and pensioners, will be impacted most. This makes the case for the purchase of inflation linked bonds (ILBs) even more important than previously thought. ILBs protect the retirement income stream from the ravages of inflation, and thereby deliver a product that all retirees both need and deserve.

[1] IFS Commentary C119, “The Spending Patterns and Inflation Experience of Low-Income Households over the Past Decade”, Peter Levell and Zoe Oldfield, Institute for Fiscal Studies, ISBN: 978-1-903274-83-5, June 2011, London.

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