the INVESTORS voice

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June 2017

THE END OF EASY MONEY

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Investors Helping Investors
The Australian Investors Association (AIA) is a national, non-profit , independent association of investors dedicated to helping other investors achieve their goals through education and advocacy.

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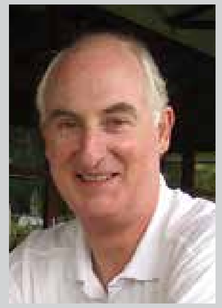
President's Message - June, 2017

By Graeme Bottrill



Presidents' Message – June 2017

Since my last message, we have had another budget. Ho hum! We will see if changes such as the Medicare levy increase, the levy on 'big' banks, schools funding changes, and the like, make it through the Senate. Superannuation was in the headlines for a short time, but thankfully no dramatic changes this year. A quick look at the history of superannuation is interesting, as we have now had mandatory superannuation in Australia for 25 years. One would have thought that after 25 years we would have our retirement incomes policy sorted, but not yet!

Mandatory superannuation was introduced by the Keating Government in 1992. Employer contributions began at 3% (4% if payroll > $1mill), rising to 9% by July 2002. We had restrictions on tax deductible contributions, but no limit on personal contributions. We had reasonable benefit limits (RBLs) but no limit on money out.
Then came the Howard and Costello 'Simpler Super' with no tax on end benefits for those 60 and over from 1 July 2007, no tax on a lump sum or a superannuation pension and RBLs abolished. Contribution rules and limits have been tweaked a few times since.

We have now seen our Treasurer's second budget, and a possible bonus for those wanting to change their home and put more into super (if you are aged 65+, and owned your home for 10 years). I have seen nothing that actually requires us to downsize. Some may take advantage of this, especially if they have room left in their $1.6 million cap. However, if they have close to the cap they will still be stuck with it and any excess will have to remain in accumulation where the income is taxed at 15%.

So now to turn to equities. A rather volatile space! The old saying of 'sell in May and go away' may have some substance this year. Currently, the markets appear to be easily spooked and although a Trump impeachment may be unlikely the talk and innuendo is enough to unsettle the markets. I mentioned last time that the market is driven by hope and fear, and so perhaps the latest US political scene is enough to cause fear. Whether Trump stays or goes, will the effect on the market be any different?

Many of us will soon be commencing an annual review of portfolios. The ASX200 closed on 30th June 2016 at 5233, and as I write this (21st May) it sits at 5727, a rise of 9.4%. However, the trend appears down and with almost six weeks to go until June 30th, who knows where we will finish. Maybe this year will be only marginally profitable. The banks share prices have had a patchy year so far, with CBA and WBC increasing 5 to 6%, but ANZ and WBC increasing 18 to 20% for the year to date. The May picture is rather dramatic though, with a combined loss of nearly $50 billion (from Bloomberg) in market value for the four banks combined. ANZ, Westpac and NAB have each fallen 10%, with CBA falling 8.5% from 1st May.

The sectors picture is also interesting with Energy, Industrials, Consumer Staples, Utilities and Financials all trending down, but with Healthcare trending upwards. Is there a message here?
Property has done marvelously of course and gold is pretty much where it was one year ago, but likely to tick upwards from here due to the safe-haven effect.

And this gives me the perfect opportunity to remind you of our Annual Conference from 30th July to 2nd August. We all know that this investing game takes skill and knowledge and the conference is the place to find both. You will hear about strategies for your portfolio, managing the new SMSF rules, analysis of various investment sectors, stocks for income, etc., and hear from Charlie Aitken, Craig James, David Bassanese, John Abernethy, Roger Montgomery, Marcus Padley, and others.
We must all work on our skills and get better at this 'Investing' job, or we suffer with less than an acceptable return.

THE END OF EASY MONEY

JORDAN ELISEO

When most financial market commentators talk about 'easy money', they're referring to either record low (and in some cases negative) interest rates, money printing, or some combination of both.

Since the GFC hit nearly a decade ago, there has been no shortage of this kind of 'easy money', with central banks collectively cutting interest rates nearly 700 times, or once every three trading days, as well as printing the better part of USD $15 trillion out of thin air.

Although some analysts believe this era of 'easy money' is ending, and look to recent interest rate hikes by the Federal Reserve to justify their forecast, this is view is contestable.

An analysis of current economic challenges (e.g. higher debt levels than when the GFC hit, continued low rates of growth, the impact of the ageing population), suggests further money printing and lower cash rates are more likely in the years to come. In Australia it seems likely that the RBA will reduce rates to below 1% in the coming year or so.

The end of 'easy money' is not about low cash rates or money printing, but instead refers to the incredible returns that broader financial markets have delivered to investors over the past 40 years.

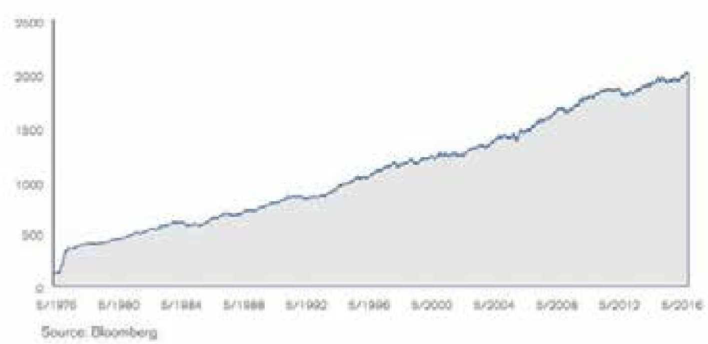
Ultimately history will judge the era just gone as one that was abnormal, and more importantly, unsustainable.

How Kind Have Markets Been?

It's sometimes hard to appreciate it when you're living through it every day, but the past four decades have been a truly 'golden-era' for financial markets.

The chart below captures this clearly, highlighting the largely uninterrupted growth of the Barclays Capital US Aggregate bond index from 1976 to 2016. It provided investors with annualised returns of 7.47%.

Barclays Capital US Aggregate Bond Index – Total Return



To put that return of 7.47% p.a. into context, and highlight just how extraordinary this is, consider two other pieces of information. Over the same time period, real GDP growth in the United States was just 2.8% p.a., whilst the return over the last 100 years for US Treasuries was just 1.7% p.a.

Investors need to ask themselves, 'What is more likely in the decade ahead?' Will fixed income investments continue to compound real wealth at nearly three times the rate of overall economic growth, or are returns more likely to mimic their historical averages at best? This would imply growth rates of comfortably sub 2%.

Given current yields it is almost certain that the latter is more likely. This view that is shared by bond king, Bill Gross. In an update in mid 2016 update he noted that the previous "40-year period of time has been quite remarkable – a grey if not black swan event that cannot be repeated…You have a better chance of observing another era like the previous 40-year one on the planet Mars than you do here on good old Earth".

Equity market investors will also find the going a lot tougher in the coming decade. The vast majority of the tailwinds that have helped drive the 'golden era' of returns over the past four decades are either largely played out, or have now turned into headwinds.

This is illustrated in the table below, which highlights eight of the major tailwinds of the last 40 years, and their likely impact in the future. 'Neutral' implies they will no longer drive equity market outperformance, and 'headwinds' implies they will actively reduce returns going forward.

Drivers of Equity Market Returns

Factor	Last 40 Years	Decade Ahead
Productivity Gains	Tailwind	Neutral
Declining Interest Rates	Tailwind	Neutral
Female Workforce Participation	Tailwind	Neutral
Declining Corporate Tax Rates	Tailwind	Neutral
Free Trade and Globalisation	Tailwind	Headwind
Demographics	Tailwind	Headwind
Private Sector Debt Expansion	Tailwind	Headwind
Valuation	Tailwind	Headwind

Source: ABC Bullion

Arguably the most important of all these factors is valuation, and the multiple of earnings investors are paying to own stocks today. In 1976, when this incredible era for financial asset returns began, investors were paying just over 10 times earnings to own blue chip stocks, based on the cyclically adjusted price earnings ratio (CAPE) for the S&P 500.

Today investors are paying close to 30 times earnings, nearly three times the valuation level of 40 years ago, and 60% above the long-term average. We are at nosebleed levels. The only other times markets have been more expensive than they are today was in 1929 before the Great Depression hit, and again in 1999, before the tech bubble burst.

There is no way to gloss over this. Although there is a bullish argument along the lines of 'there is no alternative' to stocks, based on negative real yielding cash accounts and close to record low yields across most of the fixed income spectrum,

market history is very clear that buying into equity markets at current valuations has ALWAYS proved a bad entry point given a ten-year investment timeframe.

What Can Investors Do About It?

The first thing investors should do is review their portfolio, and assess how exposed they are to the various risk factors that exist in the market today. Volatility is one of these risk factors, but far from the only one, and arguably not the most important. The other risks investors should factor in include credit risk, valuation risk, income risk, inflation, and of course liquidity, which tends to be highly sought after in periods of elevated market stress.

Secondly, investors should recalibrate their expectations about the kind of returns markets will offer in the coming years. Given current valuation levels, and the unresolved economic challenges ahead, investors would do better to focus on the preservation OF their capital, rather than the return they generate ON it.

There will always be great stocks, but anyone thinking a portfolio of financial assets will deliver total returns in the vicinity of 10% per annum in the coming decade is likely to be sorely disappointed. Our expectation is that markets will deliver zero in real terms, with downside risk to that forecast.

Finally, investors would do well to look at rotating a portion of their portfolio away from financial assets, and into real assets. As it stands today, real assets have never been cheaper relative to financial assets, as this 2016 chart from Bank of America Merrill Lynch highlights.

Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg, USDA, Savills, Shiller, ONS, Spaenjers, Historic Auto Group. Note: Real Assets (Commodities, Real Estate, Collectibles) vs. Financial Assets (Large Cap Stocks, Long-term Govt Bonds)

For many self-directed Australian investors, including the million strong SMSF army, these practical steps will likely require a handful of relatively simple portfolio adjustments which will stand them in good stead to weather the difficult investing environment ahead. - Wishing you every success.

Jordan Eliseo - Chief Economist, ABC Bullion

BENEFITS OF SMSFS SET TO SHINE

DARIN TYSON-CHAN

While a lot of the sentiment around the superannuation reforms has been negative Darin Tyson-Chan suggests SMSF trustees should be looking forward to a period where their choice to run their own retirement savings vehicles will really pay off.

I don't believe anyone owning a self-managed super fund would be rejoicing at the changes to the retirement savings system handed down in the 2016 Federal Budget and set to be implemented on 1 July this year.

And it's not all over just yet. In April the government made another tweak to the legislation yet to come into effect proposing now that assets held under a limited recourse borrowing arrangement (LRBA) will be counted towards an individual's total superannuation balance.

Naturally enough while draft legislation had been formulated at the time of writing this article it was still going through the public consultation process so final details such as how an illiquid asset like property can be allocated to multiple fund members.

This is a bit of a body blow for SMSFs as LRBAs had always been an effective avenue to circumvent the ever diminishing contributions caps as assets acquired through these gearing vehicles were never included in the make up of a person's total superannuation contributions.
In all reality though this amendment is likely to be a double whammy considering the inclusion of assets held under an LRBA in a member's total superannuation balance could result in a breach of the $1.6 million limit.

As per the new super reforms any fund member with a total superannuation balance in excess of $1.6 million can no longer make additional non-concessional, or after-tax, contributions to their fund. This situation obviously has the potential to limit a person's capability to provide themselves with a self-funded retirement but also restricts their ability to make non-concessional contributions to pay off the existing LRBA.

What is most unpalatable is the lack of fairness these measures possess, unlike every single other budget measure that effectively prevents proper economic reform and budget deficit repair from happening, as they only affect one sector of the superannuation industry – SMSFs.

In reading to this point you could be forgiven for wondering what the relevance of the title is. After all the only thing the author has banged on about so far are recent developments penalising SMSF owners.

But as they say in the classics every cloud has a silver lining and despite the negative implications of the super reforms to SMSFs, like the one mentioned above, in general SMSF owners are likely to realise a couple of real benefits in regard to their retirement savings set up – control and flexibility.

It should really come as no great surprise considering research has shown us time and time again these are the two overwhelming motivating factors as to why people establish SMSFs in the first place.

And it will be these characteristics that may well see the sector and its trustees go from strength to strength during this tumultuous period of reform.

One example of how these elements will play into the hands of SMSF trustees is how compliance with the new transfer balance cap can be managed. Under the new rules earnings from assets being used to support a pension will only retain tax-free status as long as a person's total pension balance does not exceed $1.6 million.

In the main it means pension assets in excess of this $1.6 million threshold will have to be rolled back to the individual's accumulation account where the earnings will be taxed at 15 per cent.

If faced with the situation of having to roll back assets to an accumulation account the choice of asset to be rolled back should always be made to generate the most advantageous position for the superannuant.

And surely there can be no better structure than an SMSF to facilitate the most positive outcome. Due to both the transparency and member engagement of these funds the trustees can easily identify the assets in their fund that are the most profitable.

It then stands to reason they can consciously leave as many of these assets in the pension account of their SMSF where the earnings will be tax-free. On the flip side the less profitable assets can be rolled back where tax liabilities can be minimised through the lower income levels.

Similarly, the ability to implement strategies to manage reversionary pension is an advantage. The new legislation dictates a surviving SMSF member who receives a pension rollover from a deceased member will have the reverted pension counted towards their $1.6 million transfer balance cap.

Furthermore proceeds from a death benefit pension cannot be rolled back into the surviving member's accumulation account to comply with the $1.6 million transfer balance cap and must be exited from the superannuation system altogether.

As the wider SMSF community comes to grips with how to go about complying with this type of rule, new and inventive strategies allowing individuals to make the most of a bad situation are beginning to surface.

BENEFITS OF SMSFs SET TO SHINE *continued...*

Strategies such as one suggested recently by a technical expert whereby an SMSF member, instead of commuting or stopping a pension upon receiving the proceeds of a reversionary pension upon death to comply with the transfer balance cap, actually does the opposite and starts a new death benefit pension.

While the member might incur an excess transfer balance tax along the way of 15 per cent, assuming it's a first offence, it perhaps would allow them to eventually roll this pension back to their accumulation account.

In effect it would mean death benefit monies received would be able to remain within the superannuation environment that, despite all of the changes, still remains the most tax-effective savings vehicle on offer.

Again what better structure to enable the adoption of a strategy like this than an SMSF.

As stated earlier in this article the new legislation has not even come into play yet and as evidenced from the LRBA amendment perhaps there might be a few more surprises along the way.

And of course we're not suggesting SMSF members will be the only ones to implement more ingenious type strategies to deal with the reforms in the most beneficial manner.

But considering in most cases the members and the trustees of the fund are one and the same it means the ability to make decisions and moves in response to the reforms without messing around with communication and administrative impediments present with larger funds mean the advantage of having an SMSF will be more evident than ever as will be the ability for SMSF to simply shine.

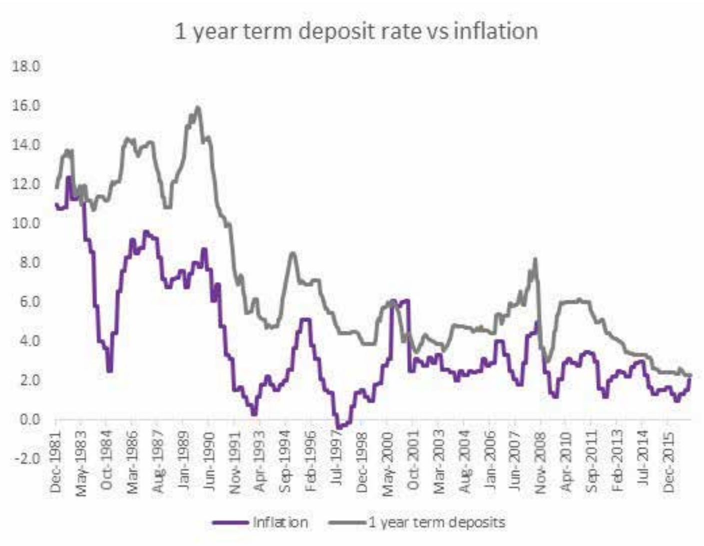
Darin Tyson-Chan, Publisher, Editor Self Managed Super

THE REAL INTEREST RATE PARADOX

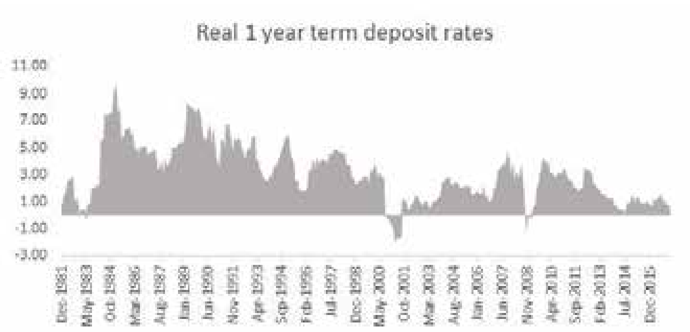
ANDREW JONES

The 80s were memorable for many reasons: fluorescent clothing, Oliva Newton John, the Americas Cup win, and average interest rate on one-year term deposits of 13%. There was no Government guarantee of bank deposits, and CBA had not even listed (that happened in 1991 at $5.40 per share).

Since then interest rates have been volatile, but on a steadily downward trend for the last 35 years. Similarly, inflation has come down significantly from highs of over 12% in 1982.

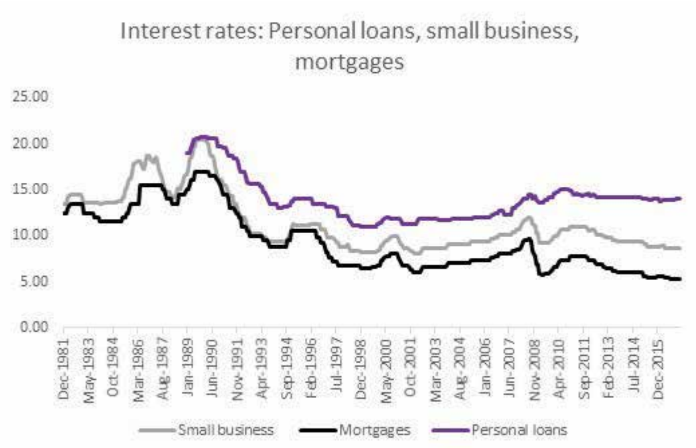


What conclusions can we draw from this chart? Obviously, term deposit rates are at a record low. But this is only part of the story. To determine the real value of a term deposit we need to look at the real return, i.e. the term deposit rate less the rate of inflation. If that gap is small, our real return is small. If inflation is greater than the term deposit rate as it was in 1998, 2001 and 2008, investors are actually losing money by putting it in the bank.
The chart below shows the real rate rates of return on term deposits since December 1981.



Clearly the real return on bank deposits has decreased over time. Some of this can be explained by the lower risk, attributable to the Government bank guarantee. In reality this chart shows that term deposits are just not a good deal. Real returns of less than 1% should not excite anyone.

Fortunately, there has never been more choice for Australians looking for a better fixed income return. With a moderate increase in risk, investors can earn significantly greater returns. The banks have been doing this for years. It is high time that retail investors get a chance to invest in similar assets. The chart below shows the rates that banks have charging on various types of loans since 1981.



A few things stand out. Mortgages and small business loan rates have been coming down since April 1995 and we all know why. Disruptors such as Aussie Home Loans and RAMS forced the banks to start pricing fairly.

Personal loans, however, are basically at the same place as they were 20 years ago. This is during a period when default rates have been low and the economy has been strong.
The story is more interesting when we look at real returns to the banks achieve on personal loans.

Real rates have gone up over the last 20 years. This is in the context of a generally stronger economic conditions and low default rates.

Let's draw all this together. Term deposits are at historically low returns. More importantly, real returns on term deposits have come down consistently for the last 20 years, in some cases hardly keeping pace with inflation.

In contrast the real return on personal loans has been increasing giving the banks exceptional returns for the risk.

Peer-to-peer lending

Until recently access to the personal loan asset class was limited to banks and credit unions. Peer-to-peer lending gives retail investors the opportunity to access this asset class for the first time.

In the USA and the UK, peer-to-peer lending has become mainstream with over $20 billion dollars lent in 2016.

Peer-to-peer lenders match people looking to borrow money with people who have money to lend. Most peer-to-peer lenders have chosen to focus on consumer credit and small business loans. Small loans like this allow greater diversification, and lenders benefit from substantial data available to the peer-to-peer platforms. This allows them to make informed credit decisions.

Leading peer-to-peer lenders like RateSetter and Society One target the top tiers of creditworthy borrowers. They compete against the banks (not payday lenders) for borrowers. Rates offered to borrowers are often lower than those offered by banks as peer-to-peer platforms operate more effectively than banks and pass on costs savings to borrowers and lenders.

Two peer-to-peer models have developed, one from the USA and the other from the UK.

	Key Features	Resulting Dynamics	Open to	Leading Australian platform
UK Model	• Simplifies the investment process, lenders choose the amount and the term (1 month to 5 years) and [illegible] rate at which they are willing to lend. • Peer to peer platform maintains a provision against losses	• Majority of investors are retail • RateSetter Australia has matched $11.8m of loans and RateSetter UK has matched ~$3b with no loss of principal or interest to any investor	• All investors aged 18 or older • SMSFs • Minimum investment $10	RateSetter
US Model	• Investors select individual loans based on risk grades and return requirements • Lenders should aim to have a highly diversified portfolio of loans to minimise the impact of defaults	• US model is dominated by wholesale investors (hedge funds and banks) due to the analysis and diversification required	• Wholesale or sophisticated investors with net assets of at least [illegible] or gross income >[illegible] for more than 2 years	SocietyOne

What are the risks and returns?

Peer-to-peer lenders are not banks, so they do not benefit from the Government deposit guarantee. However, many investors have found that by choosing a platform that allows some sharing of the risk between investors (e.g. a shared provision fund) or ensuring a diversified portfolio of loans, they can earn healthy returns with an acceptable level of risk. For example, RateSetter's current market rates after fees are:

1 month	3.3%	Principal and interest repaid at the end of the month
1 year	4.8%	Interest paid monthly, principal repaid at the end of the term
3 years	7.8%	36 equal monthly principal and interest payments
5 years	8.6%	60 equal monthly principal and interest payments

Source: RateSetter website, 1 May 2016

The best peer-to-peer platforms provide detailed information to allow investors to assess the risks. This includes data such as historical default rates, size of provision fund, number of borrowers and key borrower characteristics. Some platforms, like RateSetter, allow investors to download their entire loan book so that the investor can conduct their own analysis on the loans and track record of the peer-to-peer platform.

Andrew Jones – RateSetter Australia

Note: all data in charts sourced from the RBA.

What is Bitcoin?

CARISSA PRITCHARD

> ***The root problem with conventional currency is all the trust that's required to make it work!***

Exceptional returns, 123% in 2016 and strong CAGR predictions, 45% annually for the next 9 years, Bitcoin instantly accelerates and diversifies investment portfolios. However Bitcoin is more than the hot new asset class – it is the foundation of the global economic transition, the ultimate hedge against geo-political instability.

According to the Reserve Bank of Australia, Bitcoin is defined as a "digital representation of value that may be accepted by some parties as a means of payment and can be transferred, stored or traded electronically." It is also an algorithm, a digital / virtual / crypto / currency, a chain of digital signatures and a blockchain.

The Australian Government classifies Bitcoin as an "asset", and legislation now allows Bitcoin investment in Self-Managed Super Funds (SMSFs). The physical outcome of Bitcoin investment may appear simply as high returns and long-term growth, yet financial security isn't about forecasted figures. It doesn't matter what the numbers say if they can't be trusted. The current geo-political climate is far from secure. History has proven fiat currencies decline in value due to their expanding monetary bases, "Over the past 20 years the United States dollar has lost 53% of its value, the British Pound 47%, the Euro 40% and the Australian dollar has lost 64%."

In the current economic system, the origin and provenance of money is hidden. The public doesn't know how much money the government prints compared with the fraction held in reserve or how bankers hedge funds, or create derivatives like collateralised debt obligations (CDOs). Although the system continues to collapse, there are no consequences (except to the tax-payer). The $700 billion financial-sector rescue plan of 2008 marked the fourth time the US government has interceded to prevent the ruin of a private enterprise and the entire financial sector.

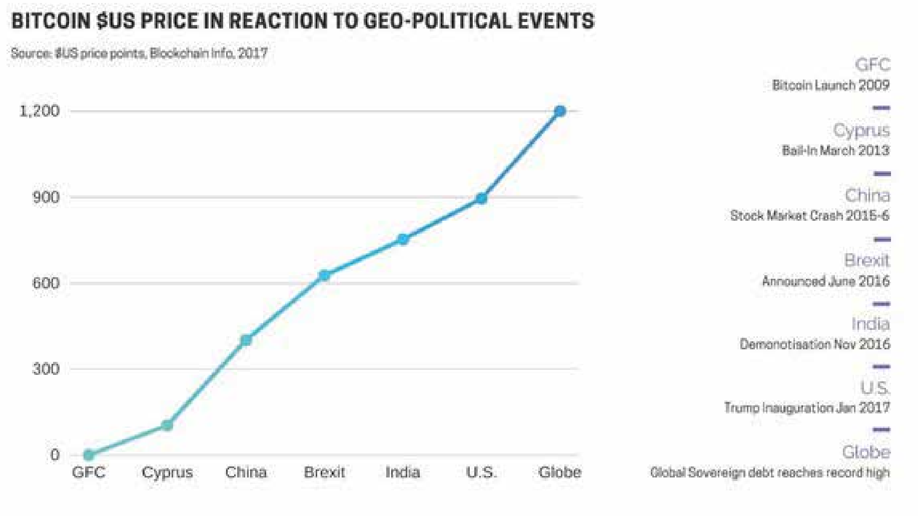
The U.S. Financial Crisis Inquiry Commission into the 2009 GFC reported its findings in January 2011. It concluded that the crisis was "caused by widespread failures in financial regulation; financial firms acting recklessly and taking on too much risk; an explosive mix of excessive borrowing and risk by households and Wall Street and systemic breaches in accountability and ethics at all levels."

Why Bitcoin?

In 2009 a digital currency was launched by "Satoshi Nakamoto" – the name is merely a pseudonym – the creators chose to remain anonymous. The Bitcoin community capped the total supply of Bitcoin at 21 million with a pre-defined, known distribution schedule. Why?

"The root problem with conventional currency is all the trust that's required to make it work. The central bank must be trusted not to debase the currency, but the history of fiat currencies is full of breaches of that trust. Banks must be trusted to hold our money and transfer it electronically, but they lend it out in waves of credit bubbles with barely a fraction in reserve." Satoshi Nakamoto

Conversely, the Bitcoin network is based on a transparent, distributed system; everyone agrees on its value and the protocol evolves by consensus. Unlike fiat currency or standard assets, it is not controlled by a central government, bank or authority, and thus it cannot be devalued, seized or stolen. Therefore, as financial crises ripple the world, Bitcoin's value continues to rise.



The future value of Bitcoin

Like land, they aren't making any more Bitcoin. If you invested $10,000 in 2011 it would be worth $30 million today. Further, considering Bitcoin's market cap is currently at approximately $US21 billion, compared with Apple's $US240 billion, it creates perspective on how early in the game it is for Bitcoin.

How to buy and invest in Bitcoin

Founder and CEO of Australian Company, Bitcoin Trader, Nathan van den Bosch explains, "Bitcoin is an entirely new concept, let alone a new asset class; there are immense mental and logistical obstacles to acquisition – understanding the Blockchain, hot wallets, cold storage, private keys, public keys... It's fine for techies who have endless hours to invest in research – but it's a huge barrier for everyday investors. Ironically, it's one reason returns are so high – but we won't always see a CAGR like 2016 (81.7% - compared to Gold at 8.88% or Real Estate at 5.68%).

Van den Bosch has a Bachelors of Economics from Sydney University, a Masters of Commerce from University of New South Wales and more than 20 years' experience trading innovative IT systems. After seeing people's entire life savings wiped out by the GFC, Van den Bosch says he was "Outraged; it was entirely the result of a fraudulent, fractional banking system. Then we witnessed the devastation in Cyprus – people's funds were confiscated straight out of their so-called 'safe' bank accounts – again in Greece. People had worked 40-50 years to put that nest egg away. It was outright theft. Imagine the devastation of having your entire life savings stolen? Now there's a technological solution that can prevent such a catastrophe from ever occurring again."

Bitcoin Trader was established, "to provide guidance on compliant investments in Bitcoin given the minefield of legislative considerations." This minefield included understanding Australian Tax Office classifications, Capital Gains Tax (CGT), Goods and Services Tax (GST), the treatment of Bitcoin for personal use; the Australian Corporations Act 2001, the Australian Financial Services Licence ("AFSL"), the Anti-Money Laundering and Counter-Terrorism Financing Act 2006, Compliance and reporting under the Superannuation Industry Supervision Act 1993 (SIS Act).

For SMSF Investors, trustee also need to consider the legal requirements of SMSF Trust Deeds and, since there wasn't one, the Bitcoin trader created the first compliant Bitcoin Annual Audit Process. "On top of all that," Van den Bosch muses, "our SMSF clients didn't want to store their Bitcoin under the bed."

Bitcoin Trader sourced the best cold storage device, Vault solutions (safety deposit boxes), Custodial services, and Bitcoin insurance. "Now all you need to do is fill out a few forms, make a bank transfer and your Super is safe."

Ultimately, what does Bitcoin mean to Van den Bosch?
He explained: "My eight-year-old daughter was having a tantrum one morning. I warned her if she kept carrying on I wouldn't give her money for a chocolate milk from the school canteen. She just got worse.
Eventually he exclaimed, 'That's it! I'm not giving you any money for your Moosy Joosy!' She replied, 'I don't need your money – I've got my own!' Then she went to her piggy bank and withdrew $1.

Bitcoin is my piggy bank.

Carissa Pritchard: Head of Content & Communications, Bitcoin Trader
www.bitcointrader.org.au

FAMILY PLANNING - THE FORGOTTEN PART OF RETIREMENT PLANNING

BRIAN HERD

It's time for many families to face some facts.

The consequence of living longer is not only a lifestyle issue for us, it is also a financial issue for us and our families. Later life is a series of transitions in which we may find our parents, for example, having to make formative and expensive decisions about where they will live. If it is an aged care facility, get ready for a financial hit that previous generations never had to confront.

As adult children, we have the chance to share in an open and frank discussion with our ageing parents, for example, about some crucial aspects of their future which could have a significant impact on our financial futures.

The trouble is many Australians suffer from the family cringe factor or an avoidance mentality when it comes to confronting their family's future as opposed to their individual future. We are addicts of the 'Pleasure Principle' - we only want to think about the pleasurable things in life in retirement and returns on our investments – not what it will cost us or our parents to live in later life.

As a result, we see the continuing pattern of parents still financing their older adult children either to rescue them from financial oblivion or simply because that's what parents do. Such generosity will come back to haunt us when we have to face the harsh reality of financing our aged care.

Not only that, financial planners suffer from the same malaise. When helping clients plan for their retirement, there seems to be a short-sighted assumption that retirement is a lengthy period of self-centred, joyous, healthy activity culminating at some stage in our inevitable celestial transfer. Planners translate these assumptions into a nagging fear for the client expressed in the mantra - "Do you have enough to live on in retirement?"

In an effort to show how clever they are and to ingratiate themselves with their clients, they will often sell products to clients that are very tax effective – "Earn $50,000 a year in retirement and pay no tax!" - in the form of complying annuities and the like, but which are clothing the client in a financial straight jacket. When the demands of dependency and aged care arise either for themselves or their parents, access to the products can be more like accessing Fort Knox than your humble savings account.

This tunnel vision also ignores a problem that will confront our baby boomers in their retirement, and more immediately, their parents.

With ageing parents living longer, the spectre of our parents becoming dependant arises. At any time we, as the adult children, could be faced with the big 'C' - change (or crisis management) as the result of some medical or lifestyle emergency suffered by our parents. If we have not discussed these issues with our parents in advance and made some plans for them, we as the children, can be faced with significant financial and emotional stress and strain in having to make arrangements for them in a time of crisis.

In these circumstances, when no collective preparation has been done, the need for families to act quickly and impulsively, can often lead to bad decisions and even disputes amongst the children resulting in family implosion."

I recently had just such a case when the mother of 3 adult children who had been living alone suffered an unexpected medical crisis which meant she could no longer live independently. She had the option to move into an aged care facility, but needed to pay a Refundable Accommodation Deposit of $300,000.00 which she didn't have. The 3 children, who were all retired themselves, could not agree or could not afford to share in the cost of the RAD for their mum. One child in particular, could not access the necessary lump sum amount immediately because of the way his investments had been structured. While it was eventually resolved with our assistance, (mum moved in with one of the children) the experience left the 3 children bitter enemies of each other and a family deeply divided and factionalised. Life can come a full circle where the parents become the dependents and the children, the carers. Just talking with our parents about their key financial, legal and health care issues and even their long-term care needs can help them, and the children, plan for the almost inevitable crisis. Asking them, for example, if they have a Will, an Enduring Power of Attorney and an Advance Health Directive can be very important.

As well, most adult children don't know where their parents keep important papers, what their passwords are or simply don't know anything about their parents' affairs. Parents should be encouraged to share this information with their children, as it is their children who will usually have to address these issues when the crisis hits.

For those who may find it difficult to raise these matters with their parents, a 'Conversation Checklist' which provides a list of the important issues to be discussed with our parents can be a useful starting point.

Financial planners should also open up their vista and see the benefits, both for their clients and for value adding to their business, to simply ask their clients, "How are your parents?" They should also understand that the demands of retirement are not only related directly to their clients, but inevitably will extend to their clients' families.

Having the courage to face family facts is not invading their privacy, but a great way to can help us cope individually and collectively, and to ensuring the financial future of our families.

Brian Herd
Elder Law Services
CRH Law

> **"As adult children, we have the chance to share in an open and frank discussion with our ageing parents"**

TOM'S STORY
LONGEVITY RISK, THE GREAT UNKOWN

ELIZABETH MORAN

There are some things in life that we'll never know. How long we will live is one of those great unknowns. Professional investors, like life insurance companies, typically refer to this as longevity risk; where the life of an insured client proves longer than forecast. This means that payments to the client go on for longer than expected, exceeding the assets the insurer holds, resulting in a loss of money.

We can assess longevity risk as it might apply to your investments by imagining you know in advance, that you will live to 80 or even 90. Would that change the way you think about your working life, savings, and superannuation? How about a worse case where you live to 65, leaving behind a financially illiterate spouse who goes on to live another 20 years? Would that alter your approach to your finances and portfolio allocation?

I want to recount a meeting I had with a client recently, because it really reinforced a few key fixed investment themes. Let's call the client Tom. Tom's very first comment to us in the meeting was that he had 'passed his use by date'. He has a degenerative condition and his doctors had not expected him to live to his current age. While Tom's life expectancy has some boundaries, they come with a complication. He has been told that to live his life comfortably, he will need approximately $150,000 per year to cover his medical care.

Tom was fortunate enough to have built a fairly substantial portfolio of property and shares. However, he had the foresight to realise he needed greater capital stability, so approached us to establish a bond portfolio to help him meet his future needs. Share market volatility meant that he could not rely on shares as he had done in the past, and property, while a good source of income, did not offer the ongoing liquidity that he would need.

Tom's strategy has been to gradually sell down his share portfolio and invest in bonds with a high income stream over a range of maturities. The suggested portfolio includes 11 bonds, with a spread of risk, sector, maturity dates and types of bonds.

Most of the bonds are fixed rate to ensure cashflow of approximately $95,000 per annum. We included three inflation linked bonds and, while inflation is not a high risk in the short term, Tom needs to be sure he can fund his care, and so we included some protection. Two of the inflation linked bonds return principal and interest quarterly, boosting cashflow.

We have also included two short dated high yield bonds, making up about 13% of the portfolio, with yields of over 6% p.a.

Two important features of the portfolio are cashflow and capital preservation. The $95,000 cashflow will pay for much of the care. Some remaining shares and property will also contribute. Another strategy we employed was to have a bond mature each year allowing access to capital without having to sell bonds.

The first bond matures in 2018. Then there is at least one bond maturing every year until 2025, ensuring he can access his capital.

Two of the 11 bonds held are issued by international companies, and seven of the 11 are not listed on the ASX. This adds diversification to his portfolio.

The portfolio has an overall yield to maturity of 4.1% p.a.

Tom still intends to hold shares and property, but his bond portfolio will be fundamental in meeting his goals.

If your lifespan is unknown and you are planning on, or in retirement, here are a few portfolio suggestions:

1. Reduce investment risk over time as investors age because they do not have the same time to recoup losses as younger investors. Tom is reducing risk by selling down his shares and adding lower risk bonds with greater certainty.

2. Hold long dated assets that mature over longer terms; much the same way that bonds, in Tom's portfolio, mature annually to help meet expenses. There are some very long term bonds available out to 2035 and beyond.

3. Add inflation linked investments. One of the main threats to purchasing power in retirement is inflation, so inflation linked bonds should be included in every portfolio. If you are in your eighties, long dated inflation linked bonds might be 'a bit ambitious', as one client once told me. However, if you plan to leave behind an inheritance or look after a spouse, they can still be sound investments that protect the holder of the bonds, be it you or your beneficiaries, from inflation.

4. Annuities and longevity insurance are worth investigating.

Company	Maturity/ Call date	Bond type	Yield to maturity	Investment
Apple Inc	28/08/2022	Fixed	2.67%	$105,067
Downer Group Finance	29/11/2018	Fixed	3.57%	$103,308
G8 Education	07/08/2019	Fixed	6.06%	$103,300
IMF Bentham	30/06/2020	Fixed	6.16%	$103,500
Qantas	11/06/2021	Fixed	3.59%	$114,800
Rabobank	11/04/2024	Fixed	3.56%	$111,836
AGL Energy	05/11/2021	Fixed	3.62%	$528,365
Suncorp subsidiary, AAI	18/11/2020	Floating	3.74%	$105,723
Ale Finance Company	20/11/2023	Inflation linked	4.64%	$142,332
MPC Funding	31/12/2025	Inflation linked	5.25%	$70,641
Praeco	15/08/2020	Inflation linked	5.14%	$38,449
Source: FIIG Securities				$1,527,321

Note: Prices current as at 28 April, but subject to change

You can learn more at www.fiig.com.au or www.thewire.fiig.com.au

Elizabeth Moran
Director Education and Research FIIG securities

CASH FLOW - A CRITICAL MEASURE

KARL SIEGLING

As part of the Cadence Investing Series, we have discussed the psychology of the market, as well as a number of fundamental measures commonly used by the investment industry.

This article discusses cash flow, which in our opinion, is the most important of all the fundamental measures. We will discuss operating cash flow and free cash flow separately.

Operating cash flow

Operating cash flow measures the amount of cash a company generates from its daily operations. This can be very different to the profit a company generates.

A company may sell many products in a year and offer credit to customers to buy those products, which they have purchased from suppliers. While this strategy may deliver a good profit, it does not produce any operating cash flow.

In fact, in this example the operating cash flow would be negative. The company has paid cash for goods but not received any cash in return yet.

A property trust may buy properties with debt and rent them out to tenants at yields lower than the interest rates on debt, then subsequently revalue the properties upwards by, say, 10 per cent, thus producing a "healthy" profit.

The property trust in this example would in fact produce a negative operating cash flow. Rent received would be lower than interest paid and the property revaluation produces no cash. Investors often say "cash is king," and in the end, cash is king. If a business does not produce cash flow, there is a good chance it will not be around in the long run. This is why we pay particular attention to big differences in reported profits and reported operating cash flows.

One of the most useful things all of our portfolio managers do is to reconcile profit to operating cash flows. This process can help prevent large investment errors.

At a basic level, the process of reconciling cash flows to profits involves a closer look at revenues, expenses, debtors, creditors and inventory, or stock in hand. Large discrepancies in these numbers can often spell trouble, or at the very least, they need to be carefully explained by management.

Free cash flow

Free cash flow is derived from the operating cash flow outlined above. It takes into account major expenditures on, for example, property, plant and equipment, the purchase or sale of a business, and major expenditure on maintaining or growing business assets.

The distinction here is that even though a business may produce good operating cash flows from its daily operations, the cost of maintaining or buying new equipment, say, every five years, may actually turn a business with good operating cash flows into a business that loses money at the free cash flow line.

Conversely, a business that makes only moderate operating cash flows but employs little to no capital in making those operating cash flows may actually produce an acceptable free cash flow. It is important to understand whether the big capital investments made to generate an operating cash flow actually exceed that cash flow or provide sufficient return to justify the capital investment.

How does operating and free cash flow help us?

It is all very well making the effort to establish the operating and free cash flow for a business, but what do you then do with this information?

It is fair to say that different investors use this information in different ways, and in times of euphoria it could also be argued that some investors tend not to trouble themselves with cash-flow numbers.

We take the operating cash flow of a business and divide it by the market capitalisation of the company to get a "proxy" for operating cash flow yield as a percentage, for example, 12 per cent operating cash flow yield.

Similarly, with free cash flow, we take free cash flow for a business and divide it by the market capitalisation of that company to get a proxy for free cash flow yield, for example, 10 per cent free cash flow yield.

These two measures give a simple percentage return for a company under consideration for investment. There are much more complicated measures, such as return on equity, return on investment and return on incremental investment.

In our daily modelling of companies, we find that operating and free cash flow yield measures are usually more than enough to determine whether a company offers compelling value from a return on cash flow perspective, without the added complexity of other measures.

We would argue that of all the fundamental measures we undertake, these two cash-flow measures are the most important. While slightly more complicated to calculate than the fundamental measures we have written about to date, they are well worth mastering.

Many investment books cover the basics of calculating cash flows and all basic accounting courses would cover this area of analysis.

A good understanding of cash-flow multiples has the added benefit of keeping investors out of trouble when it comes to companies with inflated or fabricated profits, which do not translate into cash flows. It is much more difficult, if not impossible, to easily manipulate cash flows.

Keen followers of corporate collapses may have seen the film Enron: The Smartest Guys in the Room. While very entertaining, one of the astounding things that came out of the film was that providing investors with balance sheets and cash-flow statements in the United States was not compulsory at the time of the Enron collapse. As a result, Enron management found it much easier to manipulate profits by booking, for example, the next 20 years of profits in the current reporting year! Had investors been provided with a cash-flow statement or balance sheet, it would have been clear that profits did not match cash flow as clients clearly had not prepaid revenue 20 years in advance!

As a consequence of Enron-style collapses, the United States has now made it compulsory for US companies to provide a cash-flow statement and balance sheet — a requirement that has always existed for Australian-listed stocks.

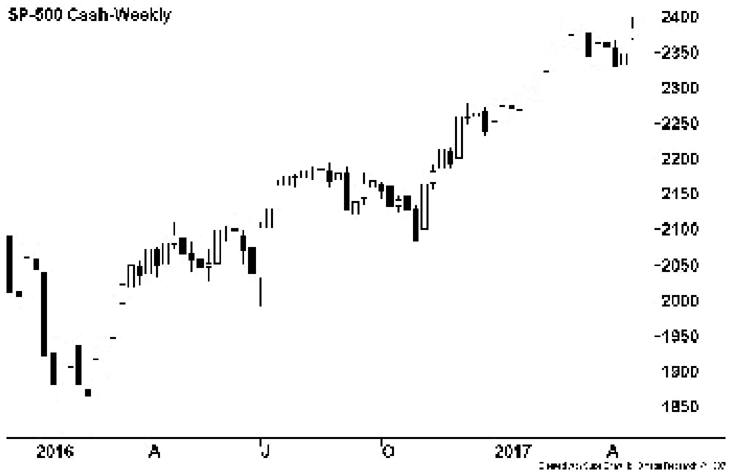
Since we have the benefit of a cash-flow statement and balance sheet in Australia, we should use it.
Karl Siegling, Managing Director & Portfolio Manager, Cadence Capital Limited (ASX: CDM).

To learn more about Cadence Capital please visit www.cadencecapital.com.au. To view the full Cadence Investing Series visit www.cadencecapital.com.au/investing-series

I LIKE INDEXED ETFS

ALAN HULL

The world's major stock markets are enjoying a bull run and our market is rising along with them. Unlike the U.S., however, where the rally is broadly based, our stock market is rising in a far more sedate manner. The following charts of the U.S.'s SP-500 index and our local S&P ASX200 index demonstrate this difference, with our market rising approximately 20% since early 2016 and the SP-500 up around 26%.



The other obvious difference in these two markets is their overall volatility. In very simple terms, the ASX200 index is bouncing around much more than the SP-500 index. When we compare these two markets, our market has a lower rate of return and is experiencing greater volatility. Any fund manager will tell you that this makes the U.S. markets a more attractive proposition for investors and traders.

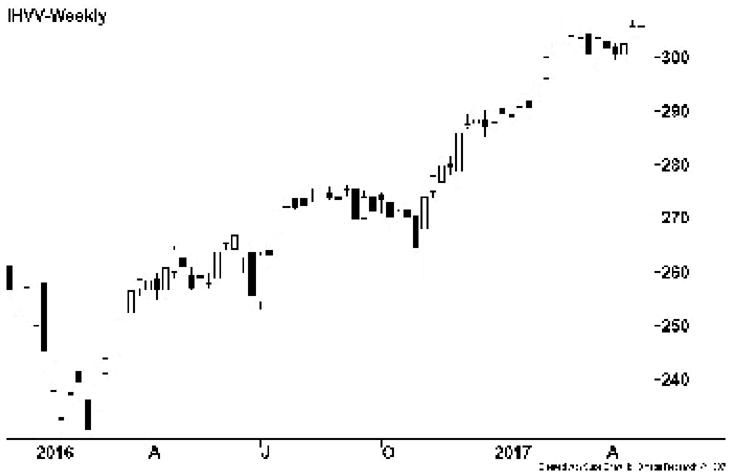
Facing this choice, an investor may decide to allocate a portion of investment capital to the U.S., and begin to contemplate exactly how to go about this. There are several issues to be dealt with here, the first being that the U.S. is comprised of two major equity markets: the New York Stock Exchange (NYSE) and the NASDAQ.

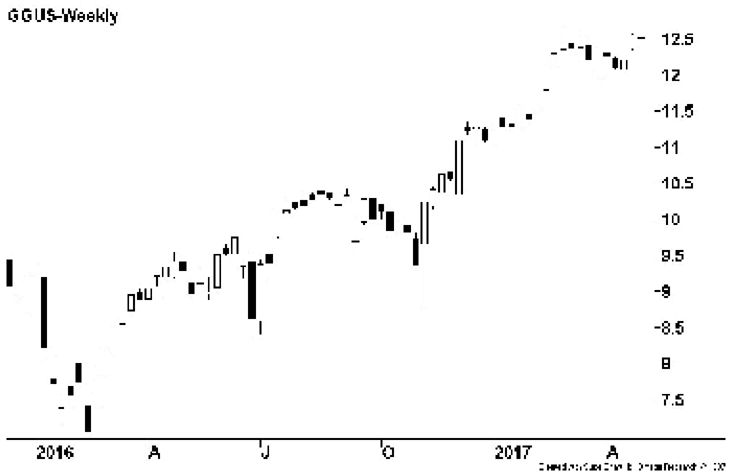
This means that to create a portfolio of U.S. stocks investors need to master two markets, not just one. Access to an international trading platform and the ability to deal with the administrative issues of managing offshore investments will be required. In the case of the United States, the paperwork can be rather onerous. In fact, there are service companies set up just to help Australian investors deal with this administration overhead.

We also have the complication of the currency exchange rate. The timing of overseas money transfers determines the amount of foreign currency received in exchange for Aussie dollars. If the Aussie dollar gets stronger while offshore investments are held, this will offset some, or possibly all, of the gains made in these investments.

Obviously there are quite a few hurdles to overcome for the DIY investor wanting to tap into foreign markets. This explains the fanfare Exchange Traded Funds (ETFs) have been getting in recent times as they effectively leapfrog an investor over these issues. In order to access the SP-500 index directly, an investor simply buys an ETF in exactly the same way s/he would buy a share like CBA or BHP.

There are several ETFs over U.S. stock market indexes. My two preferred options are iShare's IHVV and Betashare's GGUS. Both ETFs track the U.S. SP-500 index which covers both the NYSE and NASDAQ markets. An investor doesn't need to use separate ETFs for each market. These two ETFs can be compared graphically with the earlier chart of the SP-500 to see just how well they track the index. See below.





One reason these ETFs closely resemble the SP-500 index is that they both employ currency hedging, alleviating any concerns about the direction of the exchange rate between the US dollar and the Aussie dollar. However, whilst these two charts are very similar in shape, there is one key difference between them. IHVV rises by the same proportion as the SP-500, whilst GGUS rises at about twice the rate of the SP-500.

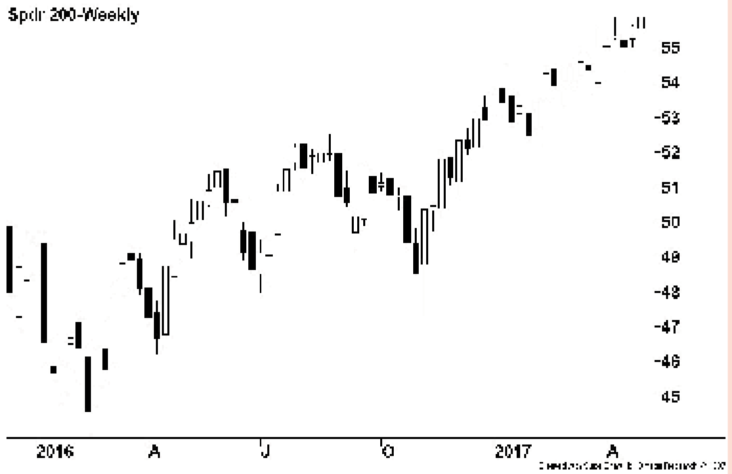
GGUS is geared slightly more than 2 to 1 against the SP-500, while IHVV has no gearing. To gain access to the U.S. markets in my conservative blue chip growth portfolio, I prefer to use the more sedate IHVV. When trading and watching the markets daily on the other hand, I can be more aggressive in my approach and take advantage of GGUS's gearing.

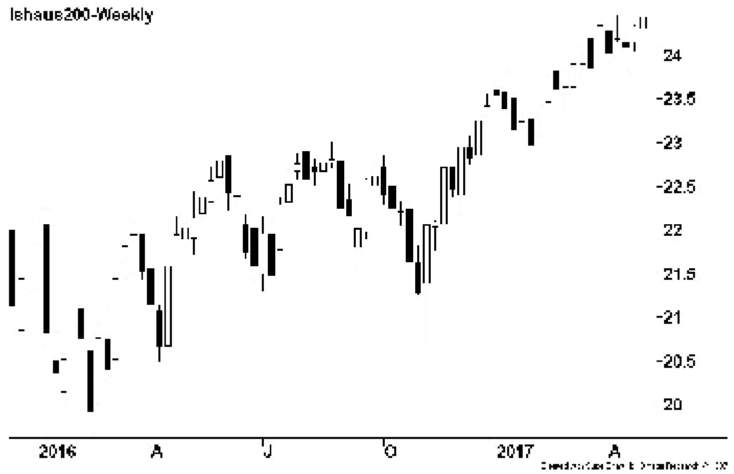
Within my blue chip portfolio I treat the U.S. like a sector and allocate a portion of my total capital accordingly. The problem I have been experiencing recently is that even though our market is rising, we are seeing a narrow advance. This means that there are very few sectors that are outperforming the broad market, and only a few key shares driving these sectors.

Normally if an investor can't find enough shares to fill a portfolio, the convention would be to leave the unallocated capital in cash. However, this isn't going to work too well if the market is trending up over time. Staying in cash would mean falling behind. One solution would be to be over exposed to the few outperforming sectors, but this is a breach of sound risk management principles. Here again we can turn to index ETFs for a convenient solution.

Rather than leave any unallocated capital in cash, it can be used to buy the entire market. This is a much better baseline when the broad market is rising. Referring to the earlier chart of the ASX200, our market is indeed rising over the medium term. Of course, if not entirely confident our market is rising, an investor can use a mix of both cash and index ETFs. This mix can be adjusted at any time.

The obvious choices here are SPDR's STW and iShare's IOZ. Both are ETFs over the ASX200 index, and they behave very similarly to each other and the ASX200 index. They both appear below and can be compared graphically with the earlier chart of the ASX200 index





Here is the simple logic that underpins this tactic. An investor owning 4 shares from two sectors that are outperforming the broader market, with the remaining capital tracking the index, will outperform the market. Simply matching the broader market performance in recent times has proven challenging as investors have been compromising share selection to own enough shares to make up a whole portfolio. My advice is don't do it. Sell suspect shares and leave the money in an index ETF.

Please visit the issuer's website and read the fact sheets and performance data carefully before buying an ETF. These sites are well laid out and easy to navigate, even for the not so technically minded. This is not advertisement for certain ETFs, but recommendations made independently through my personal analysis. My main message is: I like index ETFs.

To enroll in one of Alan's free online courses please visit his website at www.alanhull.com

Alan Hull, Author and Educator

6 Signs You Should Sell

CHRIS STOTT

> **Another signal to sell a stock can be when its share price hits a rolling 12-month low.**

As active fund managers, we continually assess our investment portfolio to determine if we should maintain our positions in investee companies. We give consideration to a broad range of factors and monitor investee companies for signs that may represent a catalyst to sell.

Signs that may contribute to our decision to exit, or at least re-evaluate, our investment in a company include:

1. Director selling

We are generally sceptical when a company's board members substantially sell-down their position. Typically, a company's directors have more insights into that business than anyone else in the market. Therefore, when directors (particularly executive directors) sell their shares, this can sometimes amount to a vote of no confidence in the company.

Furthermore, when a director reduces their equity in a company (their 'skin in the game'), the alignment of their interests with the company's shareholders also reduces.

Therefore, we closely scrutinize Change of Director's Interest Notices announced to the ASX, which disclose when directors are selling securities in a company. This can be an important signal for us to sell or at least investigate the reason for the sale.

2. Share price is at a 12-month low

Another signal to sell a stock can be when its share price hits a rolling 12-month low. When this occurs, it frequently indicates there is a fundamental issue with the company and it has lost the support of the market. In our experience, once a company's share price falls to its one year low, it will often continue to fall.

Conversely, when a company's share price hits a 12-month high, this can reflect a degree of momentum in the market that could drive its share price higher.

A scan of the daily share market tables reveals those listed companies that have hit 12-month highs and lows.

3. The 'story' changes

We look for company managers who take a disciplined and consistent approach to setting and implementing their strategy. We meet with investee companies regularly (at least bi-annually after results announcements) and this gives us the opportunity to ask some of the same questions over a period of time. A lack of consistency in a company's message raises concerns about the business's strategic direction and is a key factor impacting our investment decisions.

4. Incentive structures change

We spend considerable time and resources understanding what drives a company's CEO and executives to ensure they are motivated to act in line with shareholders' interests. Incentives are critical to our understanding of the leadership team's motivations, which can impact their decision-making. In effect, incentive structures shape a company's behaviour and when incentive structures are changed, the company's behavior also changes.

For example, if a CEO is incentivised to aggressively grow the company, this may lead to a debt-fuelled buying spree leaving a hole in the company's balance sheet.

5. The founder sells-out

We consider it a significant positive for a company if its founder maintains equity in the business he or she helped to establish. The founder's 'skin in the game' demonstrates they have faith in the business and ensures their interest in the company's long-term success. Therefore, when a founder sells, or substantially sells-down, their stake in a company we query the future prospects of that business.

6. Large investors exit

A shareholder owning more than 5% of a company must notify the market if they cease being a substantial shareholder.* We closely watch substantial shareholder notices announced on the ASX to identify if large investors are entering or exiting a company. When one of these large investors announces it is no longer a substantial shareholder, it may indicate they are planning to completely exit their holding. As large positions can take many weeks (or even months) to unwind, this may put downward pressure on the company's share price in the short-term.

While we can only make inferences from substantial shareholder announcements, they can provide valuable insights which may feed into our investment decisions. Investors should note that when large shareholders announce they are no longer a substantial shareholder, they may only be temporarily exiting, or modestly reducing, their holding in the company. For example, fund managers of open-ended investment vehicles may be forced to sell some of their shares in order to fund redemptions.

A final word

We monitor investee companies on an ongoing basis to identify factors that may signify a catalyst to sell or sell-down our position. In some instances, a decision to sell is based on an aggregate of some of the signs discussed above. In other cases, one factor alone is so significant it is a catalyst to sell. Taking an active approach to investing is critical to identifying the sometimes subtle signs that a company may no longer represent a worthwhile investment proposition.

Chris Stott
Chief Investment Officer / Portfolio Manager
Wilson Asset Management

* A shareholder is a substantial shareholder if they own five per cent or more of a company

HOW YOUR HOUSE IS ASSESSED AFTER A MOVE INTO RESIDENTIAL AGED CARE

LOUISE BITI

For many people who make the move into residential aged care, their home is likely to be the most significant remaining asset. They may be faced with a major decision of whether to sell or keep the home, unless a spouse or other family member continues to live in the home.

This is an important decision that needs to be made with consideration of the impact on:

- Age pension entitlements
- Aged care fees
- Capital gains tax
- Inheritance plans
- The cost of renovations and/or maintenance, and
- Personal preferences.

Concessions that were previously provided for the assessment of the home when calculating both residential aged care fees and the impact on age pension entitlements have mostly been removed over recent years.

These changes do not mean you need to sell your former home, but it is likely that greater pressure will be placed on managing cashflow if you choose to retain your former home. It is important to understand the rules and carefully review options and strategies to fund your cashflow needs.

This article provides an overview of the assessment rules and how the rules have changed in recent years.

Determining the assessment of the home

The rules for assessing your former home depend on which year you moved into permanent residential care and whether you are looking at the impact on fees or Centrelink/Veterans' Affairs (DVA) benefits. This is summarised in the table below.

Date enter residential care	Impact for MTA (care fees)	Impact on Centrelink/DVA entitlements
1 July 2014 to 31 Dec 2015	**Asset** – exempt if a protected person lives there. Otherwise at capped value (currently $162,087.20) **Rent** – exempt if paying some DAP	**Asset** – exempt while spouse lives there. Otherwise exempt for up to two years or while rented and some DAP paid **Rent** – exempt if paying some DAP
1 Jan 2016 to 31 Dec 2016	**Asset** – exempt if a protected person lives there. Otherwise at capped value (currently $162,087.20) **Rent** – assessable income	**Asset** – exempt while spouse lives there. Otherwise exempt for up to two years or while rented and some DAP paid **Rent** – exempt if paying some DAP
1 Jan 2017 onwards	**Asset** – exempt if a protected person lives there. Otherwise at capped value (currently $162,087.20) **Rent** – assessable income	**Asset** – exempt while spouse lives there. Otherwise exempt for up to two years only **Rent** – assessable

Notes:

- DAP is the daily accommodation payment that can be paid for accommodation instead of a lump sum refundable accommodation deposit (RAD).
- The protected person definition includes a current spouse. It also includes a carer who has lived there for at least two years or a close family member who has lived there at least five years. The carer or family member also needs to qualify for a means-tested income support payment from Centrelink or Veterans' Affairs.

Example 1:

Alice moves into residential aged care in April 2017. Her husband Archie continues to live in their home. The home is not included in the calculations of aged care fees payable.

For age pension purposes Alice and Archie continue to be assessed as homeowners and the home is remains an exempt asset.

Example 2:

Myra is single and lived alone before she moved into residential aged care in December 2016.

She agreed to pay an accommodation payment of $350,000 and chose to pay $300,000 as a refundable accommodation deposit (RAD). The remaining $50,000 was converted into a daily accommodation payment – DAP. Myra rented out her former home.

For age pension purposes the rental income is not assessed. Myra remains a homeowner and her home is an exempt asset. This may change if she no longer rents her home or pays the rest of the accommodation payment as a RAD or sells the home.

When calculating her aged care fees and the level of government subsidies paid on her behalf, her home is assessed at the capped value (currently $162,087.20) and the rental income (after allowable deductions) is assessable.

Example 3:

If Myra moved into care in April 2017, for age pension purposes she will only remain a homeowner for up to two years (or until home is sold) and the rental income (less allowable deductions) is assessable income.

When calculating her aged care fees and the level of government subsidies, her home is assessed at the capped value of $162,087.20 and the rental income (after allowable deductions) is assessable.

Conclusion

The current rules for anyone moving into residential care from 1 January 2017 make it important to seek good advice if you want to retain your former home.
Consideration should be given to the costs of preparing the home for rent as well as the ongoing maintenance and expenses. Be careful, however, with reviewing outcomes over just a one-year period. The amount of pension received could change considerably at the end of two years when the switch to assessment as a homeowner for Centrelink/DVA purposes comes into effect. At that point, income could be reduced.
Seeking advice from a financial planner experienced in aged care can assist with reviewing the options for funding a move into aged care and strategies to manage ongoing cashflow.
Louise Biti, Director Aged Care Steps

FUNDAMENTAL INDEXING:
ACTIVE MANAGEMENT PERFORMANCE WITH INDEX FEES?

DAVID BASSANESE

It is perhaps no surprise that investors are being increasingly drawn to the benefits of low-cost index investing as, despite their best efforts, regular industry surveys tend to find that most actively managed (and more expensive) equity funds fail beat their market benchmarks.

That said, if we define the market as the S&P/ASX 200 Index, it turns out there is a strategy than can offer investors potentially market beating returns over time, whilst still retaining the indexing benefits of transparency and low management cost.

Which strategy? It's called "fundamental indexing" and underpins the strategy of two of BetaShares flagship Australian and US equity exchange traded funds, the BetaShares FTSE Australian 200 ETF (ASX Code: QOZ) and the BetaShares FTSE RAFI US 1000 ETF (ASX Code: QUS).

Fundamental indexing is an innovative and still relatively low cost strategy which has been shown over time to both beat traditional market-cap weighted market indices and most active managers.

The Fundamental Factors used by the BetaShares Fundamental Index ETFs
As set out below, the BetaShares Fundamental Index ETFs use four equal-weighted measures of company size to determine the index weights:

These factors have been chosen because:
- They reflect a company's economic footprint and are not price related
- They are widely accepted indicators of company size, easily accessible and broadly available
- They are top line accounting measures that are less susceptible to manipulation

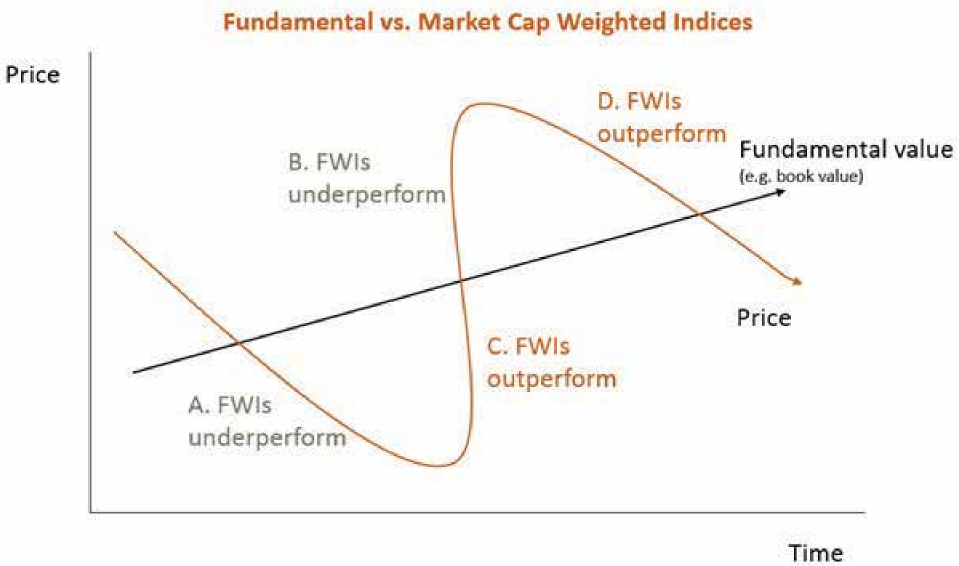
- 5-year averaging helps to smooth peaks and valleys in accounting data
- The methodology is transparent, repeatable and, based on historical measures, correlates with attractive performance outcomes compared with market cap weighted indices.

Using this indexing strategy, the FTSE RAFI Australia 200 ETF comprises the 200 companies with the highest 'fundamental values' amongst companies listed on the ASX. Similarly, the FTSE RAFI US 1000 ETF comprises the 1000 securities with the highest 'fundamental values' amongst US listed stocks.

Why fundamental indexing beats 'the market'

Fundamental indexing works precisely because the traditional approach to indexing suffers from a tendency to overweight expensive stocks and underweight cheap stocks.
How so? Note that traditionally market indices (such as Australia's S&P/ASX 200 Index or America's S&P 500 index) use a market-cap weighting strategy. This means that if the price of a stock rises in value, the index will effectively increase its weighting to the stock – irrespective of whether the lift in prices was fundamentally justified. Similarly, stocks that fall in value will have a reduced weight in the index, even if their price fall was unjustified by fundamentals, and these cheap stocks could be poised to bounce back in the future. This can lead to a performance drag for market-cap weighted indices as expensive stocks then tend to underperform and cheap stocks outperform.

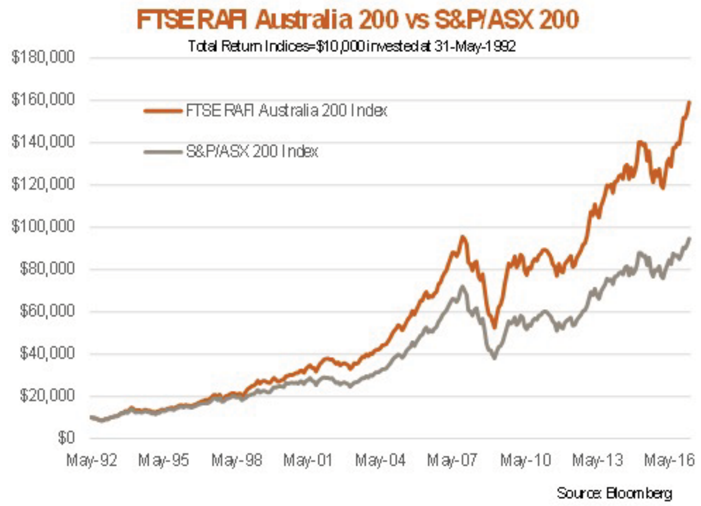
In contrast, by simply breaking the link with market price, fundamental indexing avoids the market-cap weighting problem of overweighting expensive stocks and underweighting cheap stocks. As expensive stocks start to underperform and cheap stocks outperform, fundamental indexing strategies tend to outperform market-cap indexing strategies.
The weighting differences are illustrated in the diagram below:



Of course, fundamental indexing does not always outperform – but this is usually during temporary (often speculative) periods when market momentum continues to favour already expensive stocks and disfavour cheaper (better-value) stocks. As and when stock valuations normalise, fundamental indices then more than make up for their temporary period of underperformance relative to market-cap weighted indices.

The Proof is in the Pudding: Fundamental Indexing Performance

When it comes to the benefits of fundamental indexing, the facts speak for themselves. As seen in the chart below, the FTSE RAFI Australia 200 Index – which, since its launch in July 2013, QOZ has aimed to track - has historically tended to outperform the S&P/ASX 200 index by around 2% p.a. QOZ itself was launched almost 4 years ago on the Australian market, and up until end-March 2017 its underlying index had produced an annualised return of 11.25% p.a., compared with 9.81% for the S&P/ASX 200 Index. After fees, QOZ has produced a return of 10.72% p.a. over this period.



Not only has the fundamental indexing strategy underpinning QOZ consistently beaten the market historically, it has also shown most active managers a clean pair of heels. Perhaps this is not unexpected, as according to the research, most active managers do not consistently beat the market.

Indeed, as seen in the table below, were QOZ dubbed an 'active manager', its performance would have ranked it at #2 among the 211 Australian large-cap managers tracked by MorningStar. Furthermore, QOZ would have ranked in the top quartile of active managers on a 1 year, 5 year and 10-year basis.

Period (to 31/03/2017)	Rank	Number of managers	Percentile Rank	Total Return (%, p.a.)	Quartile
1 year	2	211	Top 1%	27.2%	1
5 year	16	181	Top 9%	12.3%	1
10 year	7	141	Top 5%	6.1%	1

Since its inception in the late 1980s, the FTSE RAFI US 1000 Equity Index has produced an annualised return of 14.3% p.a., compared with 12.3% p.a. for the S&P 500 Index – an outperformance of 2% p.a.

2016 in the Spotlight

Market behaviour over the past year provides a classic example of how fundamental indexing tends to win out over time.
As seen in the table below, the fundamentally weighted FTSE RAFI Australia 200 Index started the year effectively 'overweight' in the resources sector compared with the market-cap weighted S&P/ASX 200 Index – reflecting the fact resource stocks fared poorly in 2015 and their market capitalisation had fallen relative to underlying measures of value such as earning and book value. To offset this overweight, the fundamental index was underweight in health care stocks which had a strong 2015 and had increased in market capitalisation.

These sector positions helped the fundamental index outperform in 2016 as resources rebounded strongly and health care stocks lagged.

However, it was not just sector positioning that helped the fundamental index outperform last year. Stock weightings within each sector saw sector returns based on fundamental indexing outperform those produced by market-cap indexing in 10 of the 11 industry sectors. Fundamental indexing does not just produce relative sector tilts based on relative valuation, but also value-based stock tilts within each sector.

Performance Attribution: 1-Jan-16 to 31-Dec-16

	Starting Index Weights (%)		Sector Returns %		Contribution to Return Differential
	FTSE RAFI 200	S&P/ASX 200	FTSE RAFI 200	S&P/ASX 200	(pp)
Basic Materials	15.0	10.6	60.9	40.9	4.59
Communication Services	5.9	5.3	1.2	-2.2	0.18
Consumer Cyclical	5.7	5.1	10.8	11.9	-0.03
Consumer Defensive	10.2	7.3	9.6	6.4	0.49
Energy	3.9	4.0	24.4	14.5	0.96
Financial Services	39.8	40.5	11.2	10.1	1.42
Healthcare	2.8	6.9	14.7	1.8	0.28
Industrials	7.4	7.5	25.5	10.3	0.58
Real Estate	6.4	8.1	13.7	12.9	-0.25
Technology	0.7	2.2	14.6	7.1	-0.05
Utilities	2.0	2.3	22.7	20.3	-0.07
Total			21.6	13.5	8.10

Passive Indexing: There's more than one way!

In summary, with Fundamental Indexing it is possible to construct a relatively transparent and low cost passive indexing strategy that not only potentially beats 'the market"'– as defined as a market-cap weighted index – but performs admirably when compared with most actively managed funds.

David Bassanese
Chief Economist BetaShares

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Calendar of Events

Please Note:
As AIA events are confirmed, details are posted to the AIA website www.investors.asn.au
Please note topic is subject to change.

DATE	DAY	TIME	EVENT	VENUE
NSW / ACT				
12-Jun-17	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
14-Jun-17	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
07-Jul-17	Friday	12.30pm	Hills District Discussion Group	Beecroft Presbyterian Church, Mary St Beecroft
10-Jul-17	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
12-Apr-17	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
04-Aug-17	Friday	12.30pm	Hills District Discussion Group	Beecroft Presbyterian Church, Mary St Beecroft
09-Aug-17	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
14-Aug-17	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
01-Sep-17	Friday	12.30pm	Hills District Discussion Group	Beecroft Presbyterian Church, Mary St Beecroft
11-Sep-17	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
13-Sep-17	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
VIC				
28-Mar-17	Tuesday	7.00pm	Greensborough Discussion Group	Diamond Valley Library, Greensborough
29-Mar-17	Wednesday	7.00pm	Kew Discussion Group	Phyllis Hore Room, Kew Library
30-Mar-17	Thursday	4.00pm	Melbourne Bayside Discussion Group	Private address; contact Kevin Macdonald for detail: km.macdonald@bigpond.com
06-Jun-17	Tuesday	6.30pm	Melbourne Information Meeting	Telstra Conference Centre, Room 1, Level 1, 242 Exhibition Street Melbourne
07-Jun-17	Wednesday	7.30pm	Blackburn Discussion Group	Naturalist Club of Victoria, 1 Gardenia Street Blackburn
27-Jun-17	Tuesday	7.00pm	Greensborough Discussion Group	Diamond Valley Library, Greensborough
04-Jul-17	Tuesday	6.45pm	Geelong Discussion Group	St George Workers Club, Geelong West
05-Jul-17	Wednesday	1.00pm	Frankston Discussion Group	Private address; contact Bill Shirley for details: bill.shirley63@bigpond.com
25-Jul-17	Tuesday	7.00pm	Greensborough Discussion Group	Diamond Valley Library, Greensborough
26-Jul-17	Wednesday	7.00pm	Kew Discussion Group	Phyllis Hore Room, Kew Library
27-Jul-17	Thursday	4.00pm	Melbourne Bayside Discussion Group	Private address; contact Kevin Macdonald for details: km.macdonald@bigpond.com
08-Aug-17	Tuesday	6.30pm	Melbourne Information Meeting	Telstra Conference Centre, Room 1, Level 1, 242 Exhibition Street Melbourne
09-Aug-17	Wednesday	7.30pm	Blackburn Discussion Group	Naturalist Club of Victoria, 1 Gardenia Street Blackburn
29-Aug-17	Tuesday	7.00pm	Greensborough Discussion Group	Diamond Valley Library, Greensborough
05-Sep-17	Tuesday	6.45pm	Geelong Discussion Group	St George Workers Club, Geelong West
06-Sep-17	Wednesday	1.00pm	Frankston Discussion Group	Private address; contact Bill Shirley for details: bill.shirley63@bigpond.com
QLD				
07-Jun-17	Wednesday	1.30pm	Brisbane Information Meeting	Wesley House, 140 Ann Street Brisbane
10-Jun-17	Saturday	11.30am	Brisbane Annual Celebrity Lunch	Tattersalls Club 215 Queen St Brisbane
13-Jun-17	Tuesday	7.00pm	Brisbane Managed Investments DG	Carindale Library, Carindale Shopping Centre
19-Jun-17	Monday	7.00pm	Chermside Equities Discussion Group	Chermside Library, Hamilton Road Chermside
19-Jun-17	Monday	9.30am	Gold Coast Information Meeting	Helensvale Community, Centre 31 Discovery Dr Helensvale
21-Jun-17	Wednesday	7.00pm	Brisbane Equities Discussion Group	Carindale Library, Carindale Shopping Centre
21-Jun-17	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
05-Jul-17	Wednesday	1.30pm	Brisbane Information Meeting	Wesley House, 140 Ann Street Brisbane
11-Jul-17	Tuesday	7.00pm	Brisbane Managed Investments DG	Carindale Library, Carindale Shopping Centre
17-Jul-17	Monday	7.00pm	Chermside Equities Discussion Group	Chermside Library, Hamilton Road, Chermside
19-Jul-17	Wednesday	7.00pm	Brisbane Equities Discussion Group	Carindale Library, Carindale Shopping Centre
19-Jul-17	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
30-Jul-17	Sunday	12.30pm	Gold Coast Workshop - The Fundamentals of Portfolio Construction	Marriott Resort & Spa, 158 Ferny Ave Surfers Paradise
30-Jul-17	Sunday	5.00pm	National Annual Conference	Marriott Resort & Spa, 158 Ferny Ave Surfers Paradise
08-Aug-17	Tuesday	7.00pm	Brisbane Managed Investments DG	Carindale Library, Carindale Shopping Centre
16-Aug-17	Wednesday	7.00pm	Brisbane Equities Discussion Group	Carindale Library, Carindale Shopping Centre
16-Aug-17	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
21-Aug-17	Monday	7.00pm	Chermside Equities Discussion Group	Chermside Library, Hamilton Road Chermside
21-Aug-17	Monday	9.30am	Gold Coast Information Meeting	Helensvale Community, Centre 31 Discovery Dr Helensvale
06-Sep-17	Wednesday	1.30pm	Brisbane Information Meeting	Wesley House, 140 Ann Street Brisbane
12-Sep-17	Tuesday	7.00pm	Brisbane Managed Investments DG	Carindale Library, Carindale Shopping Centre
SA				
13-Jun-17	Tuesday	7.00pm	Adelaide Information Meeting	Fullarton Park Community Centre, 411 Fullarton Road Fullarton
11-Jul-17	Tuesday	7.00pm	Adelaide Information Meeting	Fullarton Park Community Centre, 411 Fullarton Road Fullarton
08-Aug-17	Tuesday	7.00pm	Adelaide Information Meeting	Fullarton Park Community Centre, 411 Fullarton Road Fullarton
11-Sep-17	Tuesday	7.00pm	Adelaide Information Meeting	Fullarton Park Community Centre, 411 Fullarton Road Fullarton
WA				
06-Jun-17	Tuesday	7.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
20-Jun-17	Tuesday	7.30pm	Perth Discussion Group	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
04-Jul-17	Tuesday	7.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
18-Jul-17	Tuesday	7.30pm	Perth Discussion Group	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
15-Aug-17	Tuesday	7.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
05-Sep-17	Tuesday	7.30pm	Perth Discussion Group	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
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TRANSITION

A WORLD IN TRANSITION – POLITICS, ECONOMICS AND INTEREST RATES
POSITIONING PORTFOLIOS FOR A NEW INVESTMENT ENVIRONMENT

STOCK TIPS FROM THE EXPERTS

This year we have incorporated a ‘stock picking contest’ between fund managers. Various speakers will share their exclusive investment ideas and present and explain at least one tradeable investment idea exclusively to the conference attendees. They will make direct stock recommendations in their talks.

This is designed as a challenge between speakers and you have to attend to hear the stock tips. The published presentations will only contain the session outlines and not the actual stock picks.
We will publish the results prior to the 2018 conference and there will be a prize awarded to the winning ‘picker’.

SPEAKERS INCLUDE:

- Hon Wayne Swan MP
- Charlie Aitken
- Marcus Padley
- Roger Montgomery
- Mark Bayley
- Ben McVicar
- Brian Herd
- Louise Biti
- Colin Nicholson
- Rob Shand

STREAMS INCLUDE:

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- Growth
- Alternatives
- Superannuation & Retirement
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