the INVESTORS voice

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WHERE TO FIND OPPORTUNITIES IN LARGE COMPANIES

AUSTRALIAN INVESTORS ASSOCIATION

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AUSTRALIAN INVESTORS ASSOCIATION

ABN 75 052 411 999

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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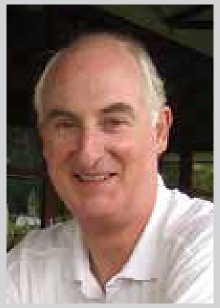
President's Message

By Graeme Bottrill



When I wrote three months ago, I made some comments about the patchy reporting season results, and said maybe we could expect some volatility as many of the top 20 or 30 companies disappointed the market. And yet, here we are, less than three months later, and the ASX200 has reached 6052 on 9th November, up from around 5700 through August, or a tad over 5%.

So what are we to make of this? Probably nothing! This just proves how unpredictable the market can be.
The achievement of the 6000 level is impressive considering the disappointments of the reporting season, but it seemed to me that it was a bit of a struggle. It is now ten years since the ASX200 high of 6828 on 1st November 2007, and it is timely to reflect on this past ten years. After ten years, the index is still more than 10% below the 2007 peak. Most developed country share markets are trading well above their 2007 values so why are we the stragglers?

Agreed, we have received an average of approx. 4.5% yearly dividend income over that time and the accumulation index is up by almost 40% on the November 2007 value, but if we have used those dividends to support ourselves then they have been spent and our capital is still diminished by 10%, and that is not adjusted for ten years of inflation. If the income was earned in superannuation in pension mode, then we have had to withdraw the mandatory 5+% anyway.

Many investors will be typically holding a mix of the top 10 to 15 stocks which accounts for 50% or more of the index. Pretty much the same result as holding an index fund in my view.
So what should we expect? We have the banks potentially near the top of the cycle; Telstra facing challenges; the housing market cooling down; energy markets in turmoil; and retailers and other sectors being disrupted by new technology.

We probably should not expect to see our market above its all-time high for some time. In fact, we have not had a correction for some time and some commentators are starting to hint that a correction may be due. I make no predictions but I have difficulty seeing any major factors to support any significant across-the-board increase from here.

So my conclusion is that a buy and hold strategy and simply investing in the top 10 or 15 stocks is bound to produce mediocre performance at best. AIA members are typically quite serious about their investing. They may seek professional advice, they do their research and pick their stocks and actively manage their portfolios. Success depends on work and application to the task.

In this December message, it is appropriate to reflect briefly on the year at AIA. Our State events have continued. We successfully ran our inaugural Investment Summit, and we continue to improve on the Annual Conference. We added some new member benefits, such as the conference video presentations on the website and we have even more in mind for next year.

In closing, I wish to thank all of our volunteers for their work this year and to wish everyone a happy and safe Christmas. Enjoy the break and come back enthused to tackle investing again in the New Year.

Enjoy the journey.
Graeme Bottrill

WHERE TO FIND OPPORTUNITIES IN LARGE COMPANIES

DAVID WALKER

There is so much confusion about the stocks in the ASX's large-caps index, the ASX 50. Some investors see them as 'blue-chips' by virtue of their size and longevity, and thus see them as long-term portfolio holds. Others think the ASX 50 is largely useless: a motley, concentrated index of variously cyclical, ex-growth or expensive growth companies, and in any event inferior to the global growth names on Wall Street, in Europe and China.

To explode these myths and generalisations about the ASX 50, we show that you can make adequate returns, for the risk assumed, in large Australian companies if you have a realistic understanding of what drives each one and how to invest in cyclicals, turnarounds, banks, insurers, miners and secular growth stocks.

The chart below shows the index pre-dividends over the last 10 years.

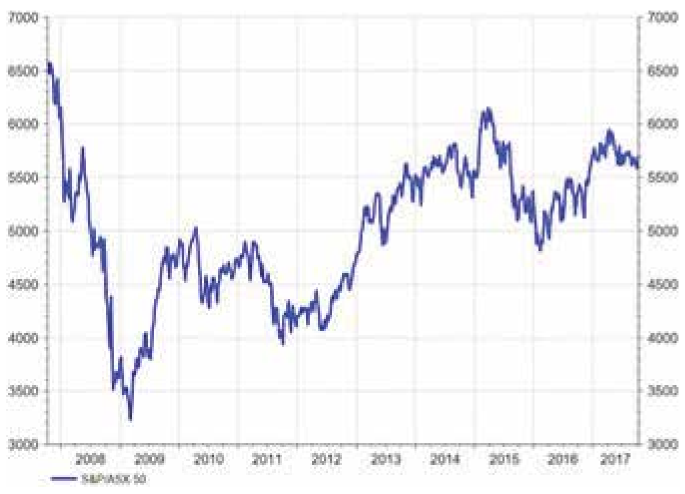


Figure 1. ASX 50 Index, last 10 years
Source: Thomson Reuters Datastream

This is quite disappointing. Despite 10 years of economic growth, population growth and massive monetary stimulus here (sustained record low cash rate) and offshore (same, plus quantitative easing) the index is still lower than it was 10 years ago. At least there has been a substantial recovery from GFC lows. The picture looks better if we go back further to the early 1990s:

> "The GFC-era crash in the index is starting to appear as an overshoot to the downside"

Figure 2. ASX 50 Index, since 1992
Source: Thomson Reuters Datastream

This very long-term uptrend is more consistent with what we should expect from the largest companies in an economy that has grown every year since 1991. With the passage of time the GFC-era crash in the index is starting to appear as an overshoot to the downside from the accelerated bull market that began the day the US-led coalition invaded Iraq in March 2003. This was subsequently fuelled by China's industrialisation and growth in demand for iron ore, and rallies in a small group of ASX leaders including CBA and Macquarie.

Australia's largest stocks have substantially underperformed Wall Street indexes (before currency effects) since the end of the GFC but over the last 20 years the ASX 50 outperformed for most of the time as the China-driven bulk commodities boom lifted the market's base:

Figure 3. ASX 50 Index vs S&P 500 since the GFC
Source: Thomson Reuters Datastream

Figure 4. ASX 50 Index vs S&P 500, last 20 years
Source: Thomson Reuters Datastream

Over the last 20 years the ASX 50 index has even outperformed a composite of world equity market indexes.

This disproves the increasingly popular notion the ASX's largest stocks should always have a lesser role in growth portfolios than in the past, when large companies dominated retail portfolios by default because direct investors did not have access to international equities or access to research and managed funds for small-cap equities. The truth is relative returns depend heavily on the period. Over the 40+ years most Australians save for retirement there is no reason, based on the historical record, to underweight large ASX companies as a group all the time.

The case for active stock-picking within the index also remains as strong as ever. While the index itself might rise or fall by 5-15% over an average calendar year, this masks large movements in individual ASX 50 names within a year. Over the year to 11 October, 22 large-caps rallied by more than 10%.

So it is entirely possible to make attractive returns in Aussie large-caps, including relative to offshore large-cap indexes.

How to make money in large caps: first, understand them for what they are

With the inclusion of Aristocrat Leisure in June (at the expense of Seek, which was demoted), the ASX 50 index now includes all GICS sectors. A valid criticism of the index is its notorious concentration in banks and miners:

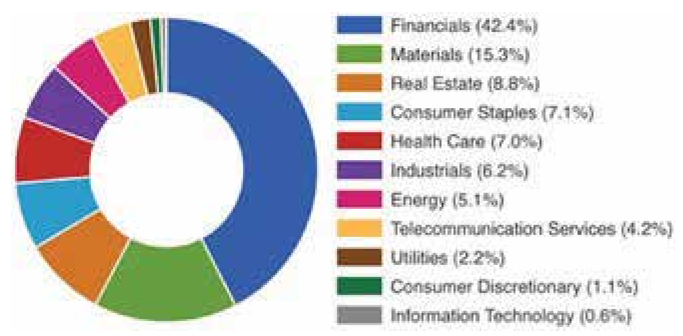


Figure 5. ASX 50 sector weights, 1/07/17 (bottom left)
Source: ASX50List.com

For us however, the main conclusion from this chart is not to dismiss large-caps entirely but instead to avoid index investing. Active management is essential to find and ride those re-ratings. Passive indexing leaves investors heavily exposed to cyclicals like banks and miners at the tops of their cycles.

The worst mistake with large-caps is to treat them all as permanent portfolio holdings because they are large, familiar names cultural to Australian investing. For example, we were sorry to hear the reasons many direct investors held on to BHP Billiton as its share price and dividend more than halved over 2014-15. These investors because they saw BHP as a "blue chip", safe to hold indefinitely and incapable of disappointment on this scale. For us BHP was just another mining stock, and therefore highly cyclical, and we sold out in the StocksInValue model portfolio in April 2015 at $32.70.

No large ASX company is a permanent hold just because it is large, old or has a heritage brand. There are no bottom-drawer, set-and-forget stocks in the ASX 50. All stocks of any size require constant monitoring for emerging downside risks and overpricing by the market. This is a demanding task requiring a powerful research database, a robust valuation framework, access to investor relations and the ability to ask the right questions.

Even so-called quality/defensive/lower-risk stocks with secular growth can be risky investments if they become too expensive. When Ramsay Health Care reached $74.90 in June, where it traded on a 26 PER and above our $73 valuation with a growth slowdown ahead in FY18, we trimmed the position and explained our reasoning in the next fortnightly model portfolio report. The subsequent guidance and result quality disappointments, then the recent bout of media management, misinformation, distortions and spread of misunderstandings by short-sellers, gave us opportunities to rebuild the position as low as $61.20. Today's package of private health insurance and prosthesis price reforms announced by the Federal Health Minister is a net positive for private hospitals and RHC closed 3.9% higher today at $66.08.

A more productive way to work out when to buy, sell and hold large companies is to use the "Type" ratings in StocksInValue. We classify the ASX 50 as follows:

Rating	ASX 50 Stocks
Economic Cyclical	JHX, TWE, WES, WOW, CCL, TLS
Financial Cyclical	ANZ, ASX, CBA, CPU, LAG, MQG, NAB, QBE, SUN, WBC, MPL, AMP
Global Cyclical	AZJ, BHP, CTX, IPL, LLC, NCM, ORI, OSH, QAN, RIO, S32, STO, WPL
REIT	DXS, GMG, GPT, MGR, SOG, SGP, VCX, WFD
Utility	AGL, ORG, APA
Secular Growth	AMC, BXB, CSL, RHC, SHL, SYD, TCL

Figure 6. ASX 50 stocks by investment type
Source: Clime Asset Management

Some of these ratings are debatable and depend on personal opinion. TWE's recent superb run of growth might give the impression it can deliver secular growth but our long memories go back to the collapse in wine shares in the 2000s, after an earlier similar rally when too much capital flooded into the industry at the top of the price cycle. SYD and TCL enjoy steady growth in their operating metrics but might as well be considered as part-financial cyclicals given their security prices are closely (inversely) correlated with bond yields. This is why they are known as "bond proxies". Higher interest rates encourage substitution away from their attractive distribution yields and this weighs on the security prices. WOW is more defensive than building materials supplier JHX but its business is so mature it can't deliver the kind of secular global growth CSL can. BXB could be on the cusp of becoming more cyclical as competition in pallets in the US heats up and dampens the benefits of steady growth in consumption of consumer goods transported on pallets. TLS used to deliver slow but steady growth until competition increased and the NBN cut its legacy margins. CCL supplies branded consumer goods but is in structural decline as consumers turn away from sugar. All REITs are partly cyclical because they invest in property. AGL is exposed to fluctuating gas and electricity prices while ORG exports LNG, so there are cyclical themes here as well.

A hard-headed approach to each ASX 50 name, rather than labels and generalisations, is required.

The good news about investing in large-caps: identifying stocks for research is easier!

Investing in large companies is harder because they are complex and take more time to understand, but is easier because they tend to revert higher eventually after disappointing or going through cyclical downturns. Heavy share price falls in small companies can be a sign of impending insolvency but in large companies they normally precede cyclical recoveries or turnarounds. Your author's all-time favourite investing strategy is the ASX large-company turnaround, as these nearly always work and drive meaningful share price re-ratings. Large companies are widely owned by institutions themselves under pressure to perform, so underperformance is not often tolerated for long. There are some exceptions like AMP and CCL.

Time for equities research is limited for all of us but at least with large companies it's relatively easy to identify the ones to research: those out of favour. Typically within two years you'll find most of these have rallied. Of course the ones in structural decline don't and this is where the research skill comes in.

The search for quality at a fair price: how do large-caps rate?

'Quality' has become almost cultural in investing. The word is constantly mentioned in investing research and conversations with little discussion about what in particular the analyst means - and whether the quality features of a company are already priced into the stock by an efficient market. Always remember a company can be 'quality' but its share price can be high-risk if the earnings multiple is so high that a heavy share price fall looms if earnings disappoint.

The model portfolio will continue to trim or exit positions in quality companies if their shares become too expensive.

We define quality in a company as:

- High & recurrent return on equity, enabling value creation
- Self-funded growth from cash flows
- Earnings sensibly apportioned between retained and distributed
- Less cyclical or secular growth
- Competent and shareholder-friendly management
- Low to moderate gearing.

Stocks with these features do tend to outperform over time and fall less than others in bear markets, so it is worth searching for quality in companies of all sizes. Let's see how the ASX 50 stocks rate:

Quality feature	ASX 50 stocks
High & recurrent return on equity *	CSL, AMC, TLS, RHC, BXB, ALL, SCG, FMG, LLC, CBA, MPL,CPU
Self-funded growth from cash flows	Look for companies that have grown earnings without raising debt.
Earnings sensibly apportioned between retained & distributed	Look for companies that have grown dividends paid.
Less cyclical or secular growth	AMC, BXB, CSL, RHC, SHL, TCL, maybe WOW & GPT
Competent & shareholder friendly management	TWE, WES, WOW, ANZ, ASX, CBA, CPU, IAG, MQG, NAB, WBC, MPL, BHP, CTX, IPL, LLC, NCM, ORI, OSH, QAN, RIO, S32,M STO, WPL, DXS, GMG, GPT, MGR, SCG, SGP, VCX, WFD, AGL, ORG, AMC, BXB, CSL, RHC, SHL, SYD, TCL
Low to moderate gearing #	ASX, MPL, S32, TWE, LLC, CTX, IAG, RIO, WES, NCM, WOW, QBE, FMG, BHP, WPL, MGR, VCX, SGP, AGL, GPT

Figure 7. How the ASX 50 stocks score against quality criteria
Source: Clime Asset Management

* Defined as 15%+ average NROE over the last five years.
# Defined as Net debt/equity of less than 40%. Names are from a filter search in StocksInValue.

This analysis demonstrates no ASX 50 stock meets all six quality criteria though a good proportion meet some and most would have a decent average if all six criteria were combined into a score. The conclusion is a more sophisticated approach is required than hoping to find standout high quality in the large companies, especially if the investor wants to pay a fair price. The large companies are so well-researched by scores of sell-side and buy-side analysts that quality is highly priced at this end of the market, creating the risk of heavy share price falls if earnings disappoint.

Where the opportunities in large-caps are

Drawing together this analysis of quality, and the six rating categories above, we can arrive at a summary of where the opportunities in large caps are. The following are the reasons large company share prices move:

WHERE TO FIND OPPORTUNITIES
IN LARGE COMPANIES *continued...*

Equities get oversold in broad corrections
None – no bear market
Turnarounds: board, management and strategy changes.
ANZ, BHP, JHX, NCM, ORG, QBE, STO, WOW
De-risking & deleveraging, resumption of dividends, upside dividend surprise. ANZ, BHP, IAG, ORG, QBE, STO, WOW
Cyclical upturns. CTX, JHX, MQG, QAN, QBE, CSL, WES
Better world & Chinese growth. BHP, LLC, MQG, QAN, RIO, S32, OSH, WPL
GDP & consumer upgrades in Australia. Banks?, QAN
Lower or higher bond yields depending on the sector.
Higher yields – Banks, QBE.
Lower yields – REITs, TCL, SYD, healthcare.
Shifts in market understanding of risks & growth.
CPU, IAG, JHX, MQG, ORG, QBE, STO, BXB, RHC, CSL, WOW, VCX, AMP
Movement toward quality. ANZ, BHP, IAG, JHX, ORG, QBE, RIO, STO, WOW
PE Re-ratings on strong performance. CSL
Proving the shorts wrong. RHC

The intense research coverage of large companies ensures the market only has to get a sniff of any improvements to profitability and the stock will rally. This means investors don't have to wait when they are right about a large stock but it also means they have to be set early.
The model portfolio will continue to include the best opportunities as we see them.

David Walker: Senior Analyst, Clime Asset Management

AUSTRALIAN EQUITIES
IN A CHANGING WORLD

RUDI FILAPEK-VANDYCK

While US indices are celebrating one record new high after another in 2017, Australia is quietly experiencing a lost decade. Ex-dividends, the main indices are lower than they were ten years ago. Most share prices of blue chip stocks (BHP, Woodside, NAB, Telstra, ...) are reflecting this today.

An obvious observation to make here is that, clearly, circumstances and dominant dynamics are not the same for Australian companies (shares) as they are for their peers in the USA. So what are the key differences investors might want to pay attention to and, where possible, incorporate into their portfolios and strategies?

* The Australian share market is far more yield-oriented than most offshore markets. Alas, if prospects of higher interest rates and rising bond yields prove correct, this also means any headwinds will be harder felt;

* Global asset markets in recent years have been dominated by macro-trades and movements, such as central banks' stimulus and tightening, and Australia, representing only 2% of global equities has often been shown the dirty end of the stick by global funds flows. This also applies to Chinese markets opening up to international capital. Recent data-analysis confirms international funds have largely avoided Australia since early 2017;

* Canberra is far from the only political capital in disarray around the globe; think London, Madrid and Washington, but at least the Trump administration is keeping hopes alive for a pro-business agenda. Not so in Canberra where hopes and aspirations have turned into corporate despair and disenchantment. Energy prices are skyrocketing, with no medium term solution in sight. Banks, gold miners, power utilities and LNG exporters are at risk of direct government intervention. Meanwhile, uncertainty over the country's carbon target and policies rules. The previous agenda for more jobs through innovation has sunk into never-never land;

* Gone are the days of the Australian dollar trading above parity against the greenback, but the AUD has mostly remained stronger-for-longer in the post-GFC era, stubbornly ignoring all forecasts for a 6-handle in front of it, let alone a 5. Instead AUD/USD remains close to 80c, with short term journeys on either side of it. Whereas corporates in the USA have had their reprieve through a weaker USD, in Australia such periods of genuine currency relief have been few and far between;

* Similarly, the RBA might have shown itself a steady hand in the post-GFC era, the Australian economy and its finance sector have by far not enjoyed the degree of monetary stimulus employed in North America, Europe, the UK, Japan or China. Financial markets are now leaning towards RBA tightening by mid next year, but I still have my doubts. And so does Westpac's Bill Evans;

* As a previously close-knit, sparsely populated island economy, Australia has felt the disruption from the internet and new technologies much harder than most economies elsewhere. Domestic heavyweight blue chip companies are the oligopolies now forced to defend their market share and clientele. This has weighed upon performance and outlook. Still is;

* The sum total of all of the above is that Australian profits, in aggregate, are in 2017 at the level where they were back in late 2006;

* The Australian economy, like other developed economies, is made up of 50%-plus in consumer spending. Apart from negative wage growth (adjusted for inflation) and rising electricity costs, the prospect of property prices no longer rising and banks re-pricing their mortgages is weighing upon consumer sentiment and budgets. Forget about Amazon arriving in Australia soon-ish, consumers tightening their belts and changing spending patterns is likely to have a much larger impact on corporate Australia in the year(s) ahead;

* In line with all of the above, I note many share prices for blue chip stocks in Australia are essentially now moving through a broad, sideways channel. Such a channel is clearly visible on long term price charts for stocks like CommBank (CBA), Suncorp (SUN) and Wesfarmers (WES), while it is my view stocks like Woolworths (WOW), Metcash (MTS) and Telstra (TLS) are most likely in the process of developing their own sideways channel.

The most severe impact on corporate profits and the outlook for growth in Australia has come from increased competition through disruption from new technologies and innovations. From FlexiGroup (FXL) to Telstra (TLS), to Seek (SEK), to Myer (MYR), to iSentia (ISD), to Greencross (GXL), to Wesfarmers; in all instances the answer investors might be looking for is the same.

Others, like oil and gas producers, have been hit indirectly with crude oil prices also now caught in a sideways channel, whereas banks and sections of the healthcare sector are now on the receiving end of government policies. Equally, there is a credible case to be made that significant changes will disrupt the wealth management industry in years to come.

For investors the crucial questions to ask are whether today's disruption is ultimately annihilating defensive moats, and whether the leading companies in a given sector are strong and flexible enough to adapt and stay on top. It appears in some hard hit sectors even the strongest can do no better than carving out a long term sideways channel (Wesfarmers, the major banks) while in other sectors even moving sideways is simply not on the cards (retailers, telecommunication).

With this knowledge at hand, investors can deploy multiple different adaptations. They can adopt shorter term trading strategies. They can focus solely on non-affected sectors and companies. They can decide to only invest in affected companies when near the bottom of their established trading ranges. They can opt for passive investment products that eliminate the risk for owning individual stocks. They can decide to invest overseas where a genuinely raging bull market makes achieving positive returns a lot easier.

They also can decide to at least direct some attention, and research, towards today's emerging disruptors in the Australian share market. Smaller companies do carry a higher risk profile, if only because of the potential for elevated share price volatility, but recent years have shown many of ASX-listed "New World" prodigies are not as volatile as many fear and shareholder returns have been much higher than with blue chip stocks under siege.

As such, I highly recommend investors put the following names on their radar (in no particular order):

- Appen (APX); global leader in the development of high-quality, human annotated data for machine learning and artificial intelligence
- Altium (ALU); high quality developer of PC-based electronics design software for engineers
- Integrated Research (IRI); high quality consultant for business-critical computing
- Kogan (KGN); Australia's largest online department store
- NextDC (NXT); independent operator of data centres in main capital cities
- WiseTech Global (WTC); leading global platform for integrated supply chain logistics management
- Xero (XRO); New Zealand based provider of the fastest growing, most advanced cloud oriented accountancy software

Plus the following beneficiaries from (or non-affected by) today's technological innovations:

- Aristocrat Leisure (ALL); strongest sector performer globally now moving into fast growing online gaming
- Amcor (AMC) & Orora (ORA); strong, solid and defensive growth across international markets
- Corporate Travel (CTD); leading B2B travel services provider, worldwide
- CSL (CSL); Australia's leading biotech unaffected by governments tightening purses, with ongoing strong growth prospects
- Domino's Pizza (DMP); leader in its field, early tech adopter and innovator, currently bottoming out after de-rating since last year
- TechnologyOne (TNE); leading IT consultant in Australia helping companies migrating onto the cloud
- Treasury Wine Estates (TWE); 25% luxury product with access into Asian middle class

Of course, none of these lists are finite and I am sure once investors refocus their own research and analysis, they will find plenty more examples that can be included, but the above mentioned stocks have established a track record which suggests these success stories won't turn into a fly-by-nighter anytime soon.

Rudi Filapek-Vandyck is Editor of online data, analysis and financial news service www.fnarena.com

DIVIDENDS BRIGHTEN THE SHAREMARKET PICTURE

JULIA LEE

Payouts at a record high despite Telstra cut.

Dividends have always played a key part in the returns from the Australian sharemarket. Although the Australian market is struggling to regain the record-high levels seen in 2008, returns look better if dividends are included.

Since the peak of the market on 1 November 2007, the Australian sharemarket is down 15 per cent, while the accumulation index, which includes dividend returns, is up 32 per cent. This highlights the importance of dividends in returns to shareholders in Australia.

	1 year	1 year + divs	Peak 2007	2007 + divs	17 years	17 years + divs
ASX 20	+11%	+16%	-14%	+39%	+73%	+273%
ASX 200	+11%	+15%	-15%	+32%	+85%	+292%
Midcap 50	+9%	+13%	-11%	+32%	+143%	+404%
Small Ords	+4%	+7%	-41%	-18%	+15%	+119%

Source: IRESS, Bell Direct Research, at 13 September 2017

Reporting season is an important time for investors and professional fund managers. It's a time to reset portfolios based on the newly released information. There's a known effect around the months following reporting season whereby companies that beat expectations will continue to outperform over the next six months. Hence, it's an opportune time for investors to identify where the strong trends are and which companies offer earnings growth.

The good news is that for income investors, dividends being paid out by Australian companies are at a record high. In the month of September, it is expected that those companies listed on the market will pay out more than $16 billion in dividends. That's a growth of around 15 per cent from the previous year.

(Editor's note: Do not read the following ideas as stock recommendations. Do further research of your own or talk to a financial adviser before acting on themes in this article).

Disappointment from traditional defensives

Defensive shares are usually ones that are characterised by consistent earnings and a high dividend. These shares usually are in the utilities, telecom, staples and property sectors. These sectors often outperform when markets are falling, as investors seek shelter in dividends. Dividends can act as a buffer to falling prices because they are paid out regardless of share-price direction.

This reporting season has seen disappointments from the traditional defensive stocks such as Telstra (TLS), QBE Insurance (QBE) and Transurban (TCL).

QBE Insurance in recent years has seen a series of profits downgrades. Earnings unpredictability has meant the share price has been under pressure. This stock should be benefiting from the global macro environment of increasing interest rates. Unfortunately, another year of sub-optimal returns has investors cautious despite the macro headwinds coming the company's way.

Transurban came out with a good result but the market was disappointed by the outlook. The guidance provided implies a lower growth year for the company, which trades at a premium yield compared to interest rates. The key risks of investing in a company like this are rising bond yields, project delays and lower-than-expected traffic numbers.
Telstra operationally came out with a result that met guidance. The stock was hit by the capital review and the prospect of lower future dividend payments. Investors need to evaluate whether most of the bad news is now out of the way and hence the share price has stabilised.

Stagnant earnings can mean dividend cuts

If the earnings outlook is not strong, dividends are more likely to be cut or cancelled. The biggest lesson came from Telstra this reporting season. Historically, Telstra has paid out 90-100 per cent of underlying earnings as dividends. This will now be 70-90 per cent of underlying earnings.
While Telstra still aims to increase dividends over time, this seems aspirational over the medium term and looks a longer-term target. Hence, Telstra lost more than 10 per cent of its value in August.

The market outlook for dividends has been skewed by Telstra's cut to its dividend payout policy. Excluding Telstra, dividends are expected to increase by 0.1 per cent. Including Telstra, dividends are expected to be down half a per cent.

Increasing dividends are related to increasing profit

Income investing is more than getting dividends. It's also about getting a sustainable dividend. Generally, companies that have increasing profits are also more able and more likely to increase dividend payments over time. Companies like Sydney Airport, Westpac and SG Fleet not only have earnings growth in common but also share-price outperformance and growing dividends.

> **Dividends being paid out by Australian companies are at a record high**

Dividend growth from mining

Traditionally, investors don't expect strong dividends from mining investments. A strong recovery in commodity prices and strong cash flow have seen strong earnings and dividend growth from the miners. Dividend growth from miners was positive at 3.7 per cent, with expected dividends in 2018 revised higher.

Dividend growth from miners

	FY16	FY17	FY18
BHP	40c	107c	Capital return
Rio Tinto	210c	301c	Capital return
Fortescue	15c	45c	New div policy
Woodside	104c	127c	
Northern Star	7c	9c	

urce: IRESS, Bell Direct Research, as at 25 August 2017

Source: IRESS, Bell Direct Research, at 25 August 2017

Conclusion

All in all, the Australian share market can be one of the most tax-effective ways to generate income. This reporting season has once again proved that increasing profits are linked to rising dividends and conversely falling dividends are linked to falling profits.

While the outlook for dividends is looking weaker for investors in 2018, that's due to the dividend cut expected from Telstra.

This reporting season has been one that has highlighted the importance of growth in earnings to support the growth in dividend payments. From an earnings perspective, the Australian share market has seen growth and this is forecast to continue into the current financial year.

Julia Lee: Bell Direct

LESSONS FROM THE OCTOBER 1987 CRASH

What investors can learn from the events of 30 years ago

TONY KAYE

Three decades ago, global stock markets went into complete meltdown, wiping out the wealth of millions of investors across the world, including many Australians. This week it's worth revisiting those events and overlaying them with the current market conditions.

For investors, the key is to focus on the fundamentals of what you are investing in, and to be acutely aware of the dangers of over-borrowing.

This year's Nobel Prize winner in economics, Professor Richard Thaler, made a disturbing admission last week when asked to interpret the present conditions on the US stock market. Recognised for his ground-breaking research into behavioral economics at the University of Chicago, Thaler said he could not explain the "miniscule volatility in the stock market" in the context of rising concerns around global geopolitical and economic events.
"We seem to be living in the riskiest moment in our lives, and yet the stock market seems to be napping. I admit to not understanding it. Psychologists have often talked about animals freezing or running, and it seems like investors are in freeze mode."

It was an interesting interpretation of investor psychology, especially given his timing. This Thursday marks the 30th anniversary of the October 1987 stock market crash and, as the US stock market continues to break new records, some experts are becoming concerned that the market's fundamentals are not stacking up.
The US stock market set a new milestone once again overnight, breaking through 23,000 points for the first time -- more than 4,600 points, or 16 per cent, higher than where it sat this time last year before the election of US President Donald Trump.

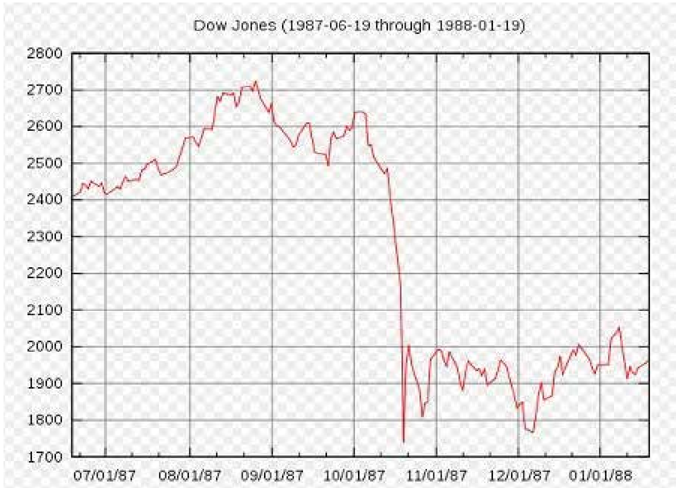
But can the US market keep charging ahead? Hindsight, of course, is a wonderful thing. Back in 1987, as stock markets around the world moved further and further into record territory, there was a sense the party would never end.
Mergers and acquisitions activity was rife, as corporate raiders borrowed large swathes of capital from banks and debt markets and paid inflated prices to buy up other companies and expand their reach. Stock prices soared, often just in anticipation that a takeover bid could be coming.

By the end of August 1987, the US market had risen by 44 per cent in 12 months. Just about anyone with some spare capital to invest was in the market, with many small investors who had never even owned shares before buying into stocks that, on most accounting measures, were heavily overvalued. To make things worse, many had borrowed up to the hilt, taking out second mortgages on their homes, just to buy into the stock market dream. Something had to give, and it did.

> "The key is to focus on the fundamentals of what you are investing in"

The first market sparks

On Wednesday, October 14, 1987, the US market dropped a record 3.8 per cent amid rampant selling as the first signs of investor nervousness began to take hold. Many put the sell-off down to geopolitical concerns, overlaid by high interest rates and the sense that many companies were too heavily in debt.



The selling rout continued the next day, with the Dow Jones Industrial Average falling another 2.4 per cent, followed by a new record 4.6 per cent drop on the Friday.

Then, on Monday, October 19, after having lost 11 per cent in value over the preceding three trading sessions, the Dow plunged 22.6 per cent over a few frantic hours as large-scale computerised institutional selling triggered mass panic among retail investors.

By the end of the session, a record 600 million trades had been recorded on the New York Stock Exchange and the market had lost more than $US500 billion in value. In today's value terms, the same percentage downturn would have wiped off more than $US5 trillion from the market.
The Dow's 508 point collapse sent other stock markets around the globe into freefall, ours included.

The onset of Black Tuesday

As a then financial reporter on The Australian Financial Review, I knew Tuesday October 20 was going to be a massive working day. So did everyone else involved in financial markets, from brokers to fund managers and everyone in between.

Well prepared for the day's events, or so I thought, I walked down Collins Street in Melbourne to the Australian Stock Exchange. But, as I walked onto the trading floor, and stood behind a throng of stockbrokers standing shoulder to shoulder, I quickly realised I, like many, had underestimated what was about to occur.

The financial bloodbath that unfolded shook Australia's corporate sector to its foundations, sending scores of companies broke and many retail investors into bankruptcy.

The opening bell sounded, and all hell broke loose. On what became known as Black Tuesday here, the All Ordinaries Index plummeted 516 points, or 25 per cent, as panicked Australian and international investors sought to liquidate their positions en masse.

Standing at least 20 deep, the brokers shouted seemingly endless sell and buy orders recorded on sheets of paper to the chalkies manning the boards, who could barely keep up as they scrambled along the overhead walkway from one company to another to jot down the trades.

Source: The Age

By midday, the share prices of Australia's biggest companies had dropped more than 20 per cent. And by the end of the trading session the floor was overflowing with paper.

My coverage of those momentous events appeared on page one of the AFR the next morning. There were no websites back then. The memories of those exhausted, shell-shocked brokers and chalkies are hard to forget, not to ignore the near-term aftermath as lenders began calling in their loans. Corporate heroes quickly turned into villains, and many investors were forced to liquidate assets to pay off their debts.

Another person who remembers the events extremely well is Geoff Wilson, now chairman of Wilson Asset Management, who back in 1987 was based in New York City and working in institutional sales at McIntosh Hanson Hoare Govett (taken over after the crash by Merrill Lynch).
"The actual day was one of excitement and trepidation. What would the Dow do? The market started falling from the open and was down around 200 points late morning," Wilson says.
"I had a lunch booked … and, as I was too distracted, I cancelled it. In the afternoon the Dow continued to fall until the close."
"In shock that night we all went out for a drink, not knowing what Tuesday might bring."
"It changed everything. I was of the view it would take years and years for the market to recover. Amazingly, the Dow was up to its previous crash high after two years. It made me realise the time to buy is when blood is running in the street. To take a long-term view when investing, and work against your emotions."

Veteran stockbroker Brett Spork, a former chief executive of E*Trade Australia and an executive director of Macquarie Financial Services, was working in London at the time for a specialist Melbourne broker, selling Australian equities to UK funds.

"I guess my main recollection was the enormous storms that hit the UK on October 15 and 16. It was a surreal event, with winds gusting to 190kph – and over 15 million trees uprooted."
"I lived close to the city, so I had no trouble getting to work – but, for a few days, it was like a ghost town. With regards to UK fund managers, their Australian portfolio was generally one of their lesser worries."
"Having said that, I recall several being heavily invested in the 'entrepreneurs' – Bond Corp, Bell Resources, Adsteam, and so on."

InvestSMART's Head of Funds Management, Alastair Davidson, was working in the Japanese warrant market in London for Baring Securities.
"Monday 19th was a falling market, but not too bad. We were at dinner at a friend's house when someone said, 'have you seen what's happening on Wall Street?'."
"It was deathly quiet on Tuesday morning as we were an over-the-counter market – usually the phones started at 7am and kept going until 5pm (I had three phones on my desk). Nobody calling and nobody was answering when I called – very strange. It was like that all week."

Manny Pohl, chairman and chief investment officer of ECP Asset Management, was a partner at South African stockbroking firm Davis, Borkum Hare, which is now also owned by Merrill Lynch. Pohl says investment values declined, but the real impact was on the business where volumes declined by 75 per cent overnight.
"In times of systemic trauma, not only do previously uncorrelated assets and markets become correlated, but liquidity disappears. So, it is prudent to ensure that a business has the ability to withstand a one in 100-year traumatic event, even though it is unlikely to eventuate."

Learning from past mistakes

Perhaps Lee Iacocca, the then Chrysler Corp chairman, had the most pertinent quote of the time when he proclaimed the day after Black Tuesday: "The borrowing has to stop. The market slide was a shot right between the eyes that had better wake us all up to the simple fact that we can't keep romping forever on borrowed money."

Thirty years on, and with several market corrections in between 1987 and now, including the more recent global financial crisis, there are strong lessons for all investors.
Focus on the fundamentals of what you are invested in, or are planning to invest in, and don't let greed get in the way.
With stock market valuations high, corporate and household debt levels running at record levels again, and interest rates on the rise globally, there's a message in there for everyone carrying too much debt on their shoulders.

Tony Kaye: Editor at InvestSMART.

HOW WE CAN POSITION OURSELVES TO SUCCESSFULLY OUTPERFORM THE ASX

DAVID ROBERTSON

The expectations of most investors, regardless of the method of gaining exposure to the Australian stock market, would be to at least achieve the returns offered by the major indices, either the ASX200 or the All Ordinaries. However it is not unreasonable for them to want to seek a higher return if they are choosing direct shares or managed funds.

One alternative could be the use of exchange traded funds which are designed to track alternative indices. There are issues with ETF's as some are not directly backed by the underlying stocks so the actual market returns don't always equate to the ETF return in much the same way that an index fund may not accurately reflect the underlying market.

In Australia, the pursuit of alternative investment strategies makes sense when you consider that our stock market is one of the most highly concentrated in the world. The S&P/ASX200 exposes investors to excessive concentration risk, based on the fact that the Top 10 companies by market cap represent approximately 50% of the index.

As we all know, four of the top five companies are banks and financials make up over 40% of the index. This concentration is further evidenced by the correlation of the S&P/ASX200 to the S&P/ASX20 being 99.2%. The remaining 180 stocks aren't contributing much to the overall index due to the sheer size of the largest 20 companies on the ASX relative to the others!

Another option is to look at growth stocks which could include the likes of global success stories such as ResMed, Aristocrat Leisure, Ramsay, Cochlear, REA Group and Seek. Whilst these stocks have low dividend yields relative to the big banks, Telstra and Wesfarmers, their Total Shareholder Returns had been superior while the growth method of selecting stocks has outperformed the value method as their P/E multiples exceeded long term averages and in turn they were bid up by the market.

In the long term shares prices will tend to reflect the movements in underlying earnings and if high profile stocks such as Domino's in recent years disappoint on the earnings front the market will punish them severely than they would a less 'glamorous' stock.

Despite whatever results we have achieved in the past, it is long term future returns that are the most important. Through this lens, we can analyse the Big 4 banks, Telstra, retail giants Wesfarmers and Woolworths and reasonably form a view that all of these companies are facing headwinds or increased competition in their industries that are likely to prevent them from replicating the type of growth they've managed over the last decade or so.

Whilst it is true that the banks may not perform as well over the next 10 years as they did over the last 10 years, they may still perform well enough to warrant being in a portfolio.

Their strategy has often been to respond to these challenges by making significant workforce cuts as they aim to satisfy the analysts and investors by squeezing out mid-single digit annual earnings, this is short term not long term strategy as returns can be impacted in the longer term if the right staff are not utilised by the company concerned.

It is for this reason that we need to look outside the ASX Top 20 or even Top 50 to find the next stock or stocks that will achieve the level of income we want with the capital gain we need to beat inflation and provide better diversification of earnings. We are seeking 4-5+% income with better than inflation growth in values over the medium to long term. A diversified portfolio of healthy dividend paying stocks, especially those with the added bonus of fully franked dividends can provide this level of income and boost our overall portfolio returns.

Australian share investors, retirees included, need to have a long-term focus of 7-10+ years in order to cope with market volatility yet should regularly review their portfolio holdings for opportunities to re-balance through buying and selling where necessary. The daily 'noise' in the markets where the investor is bombarded with concerns and headlines of Brexit, Greece, Terrorism, North Korea, Politics or whatever the latest issue thrown up that will see the end of the market, is just that, noise, the world goes on and it pays to stay the course on market cycles that are approximately 6-8 years or longer to obtain better long term total returns.

A practical strategy which has the potential to outperform the ASX indices, which equity investors can implement immediately without undue complexity, is one that includes:

- Building a diversified portfolio that includes 20 or more stocks on an equal weighting basis rather than by market capitalisation

- Exposure to companies outside the Top 20 ASX that have considerably higher potential for growth and operate businesses that may differ from just banks, resources and property

- Focus on dividend paying companies that have a higher yield than the market average and pay fully franked distributions for maximum tax benefits and increased income returns

- Quarterly rebalancing where applicable that provides the opportunity to acquire stocks that have fallen in price and divest part of some companies that have increased significantly in value

Such a portfolio can (and should be) the core of most Australian investor's funds, with the remainder featuring exposure to other categories such as global assets, fixed income, property and potentially alternatives. Given asset allocation is responsible for around 90% of average returns, the key decision for an investor will be what percentage this core should comprise of their overall portfolio that they feel comfortable with and enables them to achieve the return levels they need.

With interest rates at record lows and the prospect of rates remaining this way for quite some time, a 5-7% dividend yield plus capital gains looks very attractive when compared with 2-2.5% on term deposits that offer no capital growth and are not keeping up with inflation.

David Robertson: Portfolio Manager, YBR REI HDY Share portfolio

ALTERNATIVES VS TRADITIONAL INVESTMENTS

HOLLY GROFSKI

The Credit Suisse Global Return Investment Year Book is thought leadership from Credit Suisse Research and the world's foremost experts. The Year Book has data spanning 114 years of history across 25 countries. The companion publication, the Credit Suisse Global Investment Returns Sourcebook extends the scale of this resource further with detailed tables, graphs, listings, sources and references for every country.

According to the Credit Suisse Yearbook 2014:
- Term deposits will lose investors 0.5% a year until 2043 once inflation and tax is taken into account
- Government bonds will make you zero in real terms
- Listed shares for this three-decade period don't look to deliver past 3% per annum

Retaining good fundamentals in a portfolio always remains important. It used to be that a mix of small-, mid- and large-cap stocks could help minimize a portfolio's correlation to any one individual stock benchmark, for instance, the local stock exchange. To further diversify and reduce risk, an investor could include international stocks to broaden global exposure. However, over the past few decades, this approach has become less attractive as the correlation between most local stock exchanges and international stock exchanges has steadily risen.

The global financial crisis (GFC) of 2008 demonstrated that the diversification benefits of investing across asset classes can be illusory when correlations between these asset classes are high.

Too many investors saw the value of their portfolios drop dramatically because of a lack of genuine diversification (measured in terms of underlying correlations rather than asset class titles) within their portfolios.

As a result, building genuine diversification in portfolios presents a challenge to investors and their advisers. If shares, property, cash and term deposits struggle to reduce portfolio risk, generate income or drive performance, the logical conclusion is to seek out products that have lower correlation to the traditional asset classes. The "traditional" asset classes have long enjoyed a social status or herd acceptance of being the right class of investment in which to allocate the majority of a portfolio. This social legacy status is no longer deserved. In such a climate then it makes sense to be investing in alternatives such as currency.

The currency asset class could be seen as the answer to fixing this dangerous correlation problem in most portfolios. Or at least a large part of the answer. While many might argue, the answer is alternatives in general, most alternatives can't be considered as a stand-alone asset class with returns superior or comparable to the fixed income and equity markets. Currency can.

To say the world's largest and most liquid market is an "alternative" is a form of protectionism from the industry traditionalists, much in the same way the music industry titans resisted change within and the way TV broadcasters are resisting the move to digital platforms such as online streaming 24/7. Resistance to the future doesn't mean it goes away. It is progress and it won't be stopped. Currency is a major asset class and investors who fail to adequately allocate to currency will not have a strong defence against the increasing correlation of traditional asset classes in the future.

When currency is viewed as a separate unrestrained source of whole returns, rather than as a restrained secondary risk to manage, currency should take a share in global portfolios possibly comparable to those of bonds and equities. As a generalisation, it appears that while adding currency to a portfolio of bonds and equities can increase the average annual returns, the biggest benefit appears to be in reducing volatility of returns and periods of drawdowns.

Currency can provide systematic positive total returns over the long run, in much the same way as equity and bond markets do. We assessed currency returns in an unconstrained form, rather than the possible returns based on managing currency exposures inherited from being long an international bond or equity benchmark (i.e. currency overlay).

Therefore, we view currency as an asset class insofar as it is a source of liquid systematic positive returns over time with low correlation with existing asset classes. Why now? There are two reasons for now viewing currency as a source of long-term systematic returns.

First, with the end of the fixed-exchange rate arrangement of Bretton Woods in 1973, and the more widespread adoption of capital-account convertibility for developed world currencies in the late 1970s/early 1980s, we now have at least twenty years of free floating currencies. This time period covers major dollar uptrends and downtrends, strong recovery phases and recessions, and numerous idiosyncratic events. Therefore it should be sufficient to determine whether there are sources of consistent currency returns.

Second, evidence of the positive currency returns can be supported by the increasingly long and diverse sets of track records of actual returns delivered by currency-only investment managers including FXIQ. In the past, the available track records used to discern whether active currency management could lead to superior performance often had to be gleaned from international bond manager performances, who made active decisions not only in currency, but also on curve, duration and spread.

On balance, it would appear that currency should feature fairly prominently in any global portfolio with allocations in the order of 20% or above, rather than say 5%. Thus, currency should be viewed more like a "traditional" asset class, rather than an "alternative" asset class.

Currency markets tend to move on macroeconomic factors and broad trends. The same cannot be said for equities, and if investors are looking for a return in this world, which is set to remain low-return and austere for many years to come, the currency market looks to be an excellent asset class.

Holly Grofski is founder of Global Merces Group of companies

MID YEAR 2017 ECONOMIC
AND PROPERTY OUTLOOK UPDATE

DAMIAN HORTON

Overview

We still see a phase of rising bond rates coming, and a corresponding softening of yields and asset prices. This will affect all asset markets, including property. The search for yield which has been prevalent over the last few years will transform into a search for income growth.

A focus on income growth means a continued focus on the Sydney office market. The strength of the Melbourne economy means that Melbourne offices can also be considered. There may also be some emerging regional tourism-related opportunities, but Brisbane, Perth and Adelaide will remain difficult environments for investors. Asset selection, as always, is of paramount importance.

Economic update

Patchy gross domestic product (GDP) growth has confirmed our view of continued slow economic growth, a weak labour market, soft household income and retail sales and contained inflation. The structural shift from mining regions towards non-mining business-related services and regions particularly Sydney and Melbourne continues.

In Brisbane, the full impact of the fall in mining investment was delayed by a shift of resources to building inner city apartments. The impending residential apartment downturn will have a negative impact on the economy. Perth also remains weak, with further negative impact expected, as the remaining gas project finishes.

Housing interest rates have already risen through rising bank margins, particularly for investment and interest-only loans. That, together with tightening loan to valuation ratios (LVRs) and equity pre-commitment requirements on developers, will take the heat out of the high-rise residential boom. It is much harder to get a project away now. Hence the widespread recognition of the impending downturn in residential property and building markets. The negative shock of this downturn will mean continued soft overall economic growth.

Two further US Federal Reserve rate rises have also confirmed that we are embarking on a phase of rising cash and bond rates. This is particularly important for property investment markets through the relationship between bond rates and yields (see our article "Making sense of commercial property yields" in Insight, Winter 2017). In Australia, cash rates will remain low for some time. However, bond rates have already started to rise and will continue to do so in step with the US.

Property markets update: Office markets

The Sydney office market has gone from strength to strength, with tightening leasing markets driving effective rents, firming yields and further property price growth. With strong business growth forecast to come, we believe that the Sydney office market has further to run, and even at substantially higher prices, on a five-year horizon Sydney commercial property is (broadly speaking) undervalued in relation to forecast expected returns. These conditions point to the possibility of a 1980s-style boom.

The strength of the Victorian and Melbourne economies has resulted in upgraded growth forecasts, with a flow-on to the office market. The loss of the motor vehicle industry and parts of the power industry have had an impact, but the economy and employment have been good over the last year, suggesting continued strong, albeit lower (than Sydney), growth in Melbourne.

For 20 years, Melbourne has had a comparative advantage over Sydney. Readily available and cheap land for residential, industrial and office developments has contained rents and property values, making it a more cost-effective place to situate back-office functions for national operations. That will continue to boost the demand for office space and we have increased our forecasts of demand, rent and price growth in the Melbourne market.

Development phase

The Sydney and Melbourne office markets are entering a substantial development phase which will change the logic of office investment. Over the next ten years, 3.3 million square metres (sqm) of office space in Sydney and 2.3 million sqm in Melbourne will be built. Given that some of these developments will be refurbishments, net additions will be circa 2.4 million sqm in Sydney and 1.5 million sqm in Melbourne.

This development phase and net additions of this quantum will eventually have an impact, and five year forecast returns are much stronger than ten-year forecast returns for both Sydney and Melbourne. Repositioning and exit strategies will be needed to manage this cycle.

Canberra, Brisbane, Perth and Adelaide Office

The Canberra office market should see strong prospective returns over both short and long terms. Canberra's oversupply is easing, particularly for better quality space in Civic. However, the risk to be considered is that Canberra remains a dominant tenant, two-tiered market.

Despite strong recent sales, it is early for countercyclical investment in the Brisbane, Perth or Adelaide office markets. They face a period of weakness before they absorb the excess stock created during the boom.

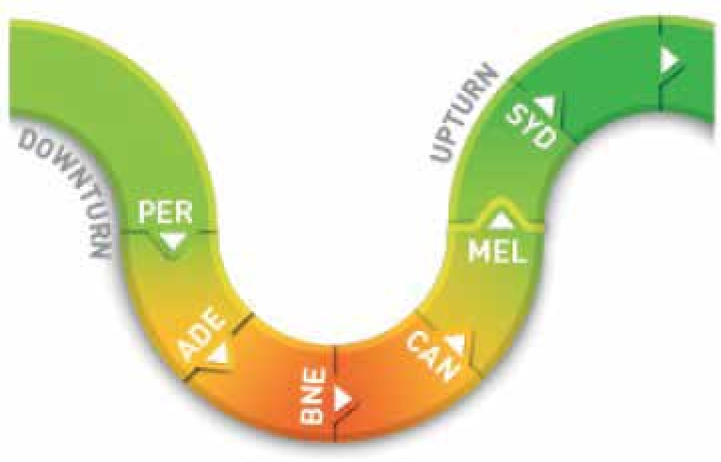
Other asset classes

Amongst other property classes, weak retail sales growth and the impending arrival of Amazon have heightened emerging concerns about the strength of retailers and centre returns for retail property. The property risks are heightened for weaker centres, but returns to strong centres should remain solid.

Industrial property is still recovering from the GFC. Availability of land is keeping development highly competitive. Recent strong returns have been driven by firming yields, allowing a reduction of effective rents and some rises in land values. Rising bond rates and softening yields will reverse this, squeezing development feasibilities and leaving returns solid but not spectacular.

The current hotels development boom is focused primarily on business travel in capital cities. The boom will oversupply business travel markets and the use of investment apartments as serviced apartments may potentially worsen matters

> "the Sydney office market has further to run"



further (think Airbnb). As recreational tourism continues to recover over the next decade however, there will be a need for more tourist hotels and services in regional markets.
During the recent period of falling interest rates, investment returns were boosted through the impact of lower rates on yields and asset prices.

This happened, not just for property, but for all asset classes including infrastructure, equity markets and, of course, bonds. Rising interest rates will unwind a lot of these gains, causing a softening of yields and prices across the board.
It is now evident that we are embarking on a phase of rising interest rates worldwide, driven initially by US Federal Reserve cash rates, underpinning higher bond rates. Indeed, expectations of further cash rate rises will cause bond rates to rise by more than cash rates. It's not yet clear how quickly or how far bond rates will rise but the recognition that they will do so will encourage investors to switch from the search for yield to a search for income growth.
Asset returns over the next five years will generally be lower than the last five. That includes infrastructure, equities and bonds, as well as property. Currently, weight of money is still driving firming pressure on yields, even in low growth markets. This will eventually change and investors should begin to look for rental growth to drive values and total returns. In that respect, the Sydney and Melbourne office markets are the obvious candidates.

Damian Horton: Head of Property, Cromwell Property Group

LATEST SUPER CHANGES:
25-POINT SMSF GUIDE TO ATO'S HOT ISSUES

TRISH POWER

Since 1 July 2017, superannuation has become a lot more complicated, especially for Australians running self-managed super funds. Regular readers of SuperGuide already know my view, that the administration necessary to support some of the major July 2017 changes is ridiculously onerous for both SMSF trustees and the ATO.

Putting grumbling aside, we now just have to get on with it and deal with this more convoluted world of superannuation that now imposes a $1.6 million transfer balance cap (and its diabolical administrative requirements – last grumble), monitoring of every individual's total superannuation balance, and more frequent reporting to the ATO, to name the most significant changes from a compliance point of view.

Recently, ATO assistant commissioner Kasey Macfarlane spoke at an industry conference, outlining the key issues facing SMSFs since the super changes took effect from 1 July 2017.

As a preliminary comment, Ms Macfarlane said that in the lead up to July (that is, from when the laws were enacted in November 2016 through to July 2017), the ATO was focused on providing 'practical and relevant guidance and support for SMSFs…working from our preferred stance that prevention is always better than correction'.

Since July 2017, Macfarlane stated that the ATO remains committed to 'early engagement, early certainty and practical support to the SMSF sector' and continues to approach compliance from a prevention rather than correction point of view.

25-point SMSF guide to significant July 2017 changes

The ATO believes that the concepts of an individual's transfer balance cap and an individual's total superannuation balance are central to almost all of the changes that took effect from 1 July 2017. The three main areas the ATO is concerned with from a practical point of view are:

- visibility of up-to-date information about a member's superannuation interests (to enable SMSF trustees and the ATO to monitor an SMSF's members in relation to the new caps and limits in place)
- SMSF asset valuations
- Regulatory and taxation risks of certain planning arrangements.

The 25 points in this SMSF guide cover key issues concerning:

- Total superannuation balance
- Transfer balance cap
- Transitional CGT relief
- SMSF event-based reporting
- SMSF asset valuations
- Certain planning arrangements

Total superannuation balance

1. How is a TSB measured? A person's total superannuation balance (TSB) is measured and determined annually at 30 June, based upon relevant asset values supporting the person's accumulation phase and retirement phase interests as at 30 June.

2. TSB can limit contributions, and affect offsets. A person's TSB immediately prior to 30 June affects a person's contributions caps, and their ability to access several tax offsets during a financial year.

3. SMSF administration. A SMSF member's TSB also affects how the SMSF is administered. Since 1 July 2017, an SMSF cannot use the segregated method to calculate its exempt current pension income if one or more of its members has a TSB greater than $1.6 million, and at least one of its members is receiving a pension from the SMSF.

Transfer balance cap – main rules

4. What is the transfer balance cap? Transfer balance cap (TBC) is solely related to a person's retirement phase interests. The TBC places a $1.6 million limit on the amount or value that an individual can transfer into the tax-free retirement phase across all of their retirement interests.

5. What does not count towards the TBC? TBC only relates to the movement of capital in and out of the tax-free retirement phase, which means that pension payments, investment earnings and losses, capital growth or capital losses, do not count towards a reduction or increase in a person's transfer balance.

6. What typically counts towards the TBC? Most common events that affect a person's TBC is: starting a pension, or, when partially or fully commuting a pension and the person receives a lump sum payment or they transfer the amount back to their accumulation interest.

7. LRBA payments may also count. Certain limited recourse borrowing arrangements loan repayments also count towards a person's TBC.

8. Transition-to-retirement pensions and the TBC. A transition-to-retirement pension (TRIP) does not count towards a person's TBC, UNTIL the person turns 65, or when the person notifies the SMSF trustees that he or she has a met a condition of release (such as retiring). The TRIP automatically moves into retirement phase when the person turns 65, which means the current value of the TRIP then counts towards the SMSF member's transfer balance.

Transfer balance cap – continuous tracking required

9. Transfer balance must be constantly tracked. Unlike the total superannuation balance (which is measured as at 30 June), a person's transfer balance must be tracked on an ongoing basis, through the transfer balance account. If the person doesn't track his or transfer balance, then he or she will be exposed to an increased transfer balance tax liability.

10. Net balance matters. The net balance of the individual amounts tracked through a person's transfer balance account at any given time, determines whether that person has exceeded their transfer balance cap (TBC) at the end of any given day.

11. Excess transfer balance tax. If a person does exceed their TBC, then they are subject to excess transfer balance tax and are required to remove the excess from their tax-exempt pension account. The excess transfer balance tax liability continues to accrue daily, until they no longer remain in excess of the TBC.

Transfer balance cap – transitional CGT relief

12. Temporary transitional CGT relief applies from 9 November until 30 June 2017. Relief is applicable if one or more of the fund's members needed to take action because they would be detrimentally affected by the new transfer balance cap, or they are affected by the removal of the tax-exempt status for earnings on assets that support TRIPs (also refer to point 8).

13. Must actively apply for CGT relief. If eligible for transitional CGT relief, the SMSF trustee must actively elect do so using the CGT schedule accompanying the 2017 SMSF Annual Return (SAR).

14. Must elect before due date for 2017 SMSF annual return. The election is irrevocable, and must be made by the due date of the SMSF's 2017 SAR. Note that there was never a requirement to make an election before July 2017, and SMSF members can still decide whether to elect to use the transitional CGT relief, provided the election is made by the due date of 2017 SAR.

15. Re-set cost bases must be based on asset values as at 30 June 2017, or earlier relevant date. Applicable re-set cost bases and any deferred gains must be determined in accordance with applicable asset values at the time that relief applies. Depending on whether the segregated or unsegregated method is used, this may be as at 30 June 2017, or an earlier date when relevant assets were commuted back to accumulation phase. Note also that it is the SMSF trustees' responsibility to maintain records of asset values and re-set costs bases, as well as deferred gains, but this detail does not have to be reported in the 2017 SAR.

Transfer balance cap – SMSF event-based reporting

16. Transfer balance events must be reported. Under the proposed rules, from 1 July 2018, SMSFs must report to the ATO, events that affect a fund member's transfer balance in relation to the Transfer Balance Cap, and these events must be reported through the Transfer Balance Account Report (TBAR).

17. When is event-based reporting necessary? According to the ATO, this new form of reporting is only necessary if an SMSF has one or more members in pension phase (also known as retirement phase) and one of those fund members has an event that affects their transfer balance in the relevant reporting period (which may be a monthly or quarterly reporting period, depending on what the final rules look like). 'Nil' events are not required to be reported, which means only SMSFs with members directly affected are required to report.

18. What events must be reported? The most common events to be reported are: the values of any retirement phase pensions that an SMSF member is entitled to receive (including reversionary pensions); the value of any commutation of a super pension by an SMSF member; any structured settlement that an SMSF member receives and contributes to the SMSF; and, certain limited recourse borrowing arrangement loan repayments that give rise to a transfer balance credit.

19. Extra reporting means ATO can warn you about exceeding your transfer balance cap. According to the ATO, event-based reporting is necessary so the ATO can warn you if you are close to exceeding your $1.6 million transfer balance cap (TBC), or whatever the indexed cap is going to be from 1 July 2018.

SMSF asset valuations

20. Assets must be valued at market value. Before July 2017, SMSF trustees were already required to value fund assets at market value to:

- enable SMSF trustees to prepare the financial accounts for the fund
- when acquiring assets between the SMSF and a related party
- when disposing of certain collectables and personal use assets to a related party
- when determining the market value of an SMSF's in-house assets to a related party, and
- when determining the value of assets that support a member's super pension and to meet minimum pension payment requirements.

21. Market valuation of SMSF assets now serves 4 new purposes. Although SMSF trustees have pre-existing obligations to value SMSF assets, since the July 2017 changes came into effect, SMSF asset valuations serve an even greater purpose. SMSF asset valuations are now required for the following compliance purposes:

• determine the value of existing retirement phase pensions as at 1 July 2017, for transfer balance cap purposes.
• determine the value of new retirement phase pensions on or after 1 July 2017 for transfer balance cap purposes
• determine the market value of assets that are eligible for the transitional CGT relief during the 2016/2017 financial year
• determine the market value of assets supporting a fund member's retirement phase and accumulation accounts, for the purposes of calculating a fund member's total superannuation balance.

22. The ATO provides detailed guidance for SMSF trustees when valuing fund assets.

ATO warnings about certain planning arrangements

23. Dodgy SMSF schemes. While only a small number of SMSFs engage in planning schemes that are high risk in terms of breaking the super rules, the ATO considers warning SMSF trustees about these risks is a vital part of the ATO's role. Examples of such schemes include dividend stripping arrangements, arrangements intended to divert personal services income to an SMSF, non-commercial limited recourse borrowing arrangements, contrived property development ventures with related parties, granting of a legal life interest over a commercial property, and arrangements where a person deliberately exceeds their non-concessional contributions cap to manipulate taxable and tax-free components. For more information, see ATO's Super Scheme Smart campaign.

24. Use of reserves by SMSFs. The ATO flags that although the establishment of a reserve within an SMSF is not strictly prohibited, the ATO warns that there are limited circumstances where the use of reserves is suitable, and are unlikely to be suitable where they are to be used to circumvent the transfer balance cap or the total superannuation balance rules.

25. Starting a second SMSF to reduce tax bill. According to the ATO, starting a second SMSF is a strategy that is often suggested as a means of overcoming the restriction on SMSFs being able to use the segregated method to calculate their exempt current pension income, due to one of its fund members having a total superannuation balance that exceeds $1.6 million. Starting a second SMSF is not immediately a compliance issue, but where the second SMSF is then used to manipulate tax outcomes, then the ATO will take a closer look.

Trish Power: SuperGuide

THE BIGGER FOOL THEORY

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THE BIGGER FOOL THEORY
Reprinted from the Investors Voice of June 1998

Talking of being un-fooled there is the bigger fool theory. It states that in a boom in shares, or property, or whatever, it can pay to buy at a foolish price because before too long, an even bigger fool will come along and offer you a higher, even more foolish price.

The problem is (there is always a problem with these fine theories) that we live in a finite world and the supply of fools is not limitless. So the smart thing is to ensure that you are no later than the second-last fool when the crunch comes and the boom becomes a bust.

BUILDING SMSF VALUE WITH BORROWING

TIM MILLER

The use of Limited Recourse Borrowing Arrangements (LRBAs) has been through significant reform since being introduced in 2007 but has remained a legitimate way to acquire property within an SMSF.

It's not a contribution

Whilst acquiring property directly involves an SMSF having significant capital, the use of LRBAs, and in particular related party LRBAs, has become an intriguing strategy for SMSF investors looking to increase the value of their fund without making significant non-concessional contributions. It is certainly a consideration for those that are some way from retirement who are looking at ways to accumulate benefits for retirement without locking contributions away, given the lack of confidence the superannuation system provides many investors.

Preservation

Given that all contributions are preserved until a condition of release is satisfied, there is a reluctance for those with long working lives ahead of them to invest their surplus funds into a vehicle that gives them no access to that capital and has the potential of imposing severe penalties if they do. However, given the chance to lend money to an SMSF where you can effectively claw back that money at any stage in the lifecycle of the transaction, this may be more appealing.

Holding Trustee

From a cost point of view, outside of the standard property costs, the main cost is setting up the initial holding trust arrangement and holding trust company which is a separate entity to the trustee of the fund. It is not compulsory to have a company act as the holding trustee but it reduces issues associated with separating assets of the fund from personal assets. These costs have come down significantly since 2007.

ATO Guidance

In 2016 the ATO released Practical Compliance Guidelines, PCG 2016/5, and a Taxation Determination, TD 2016/16, to address the issue of ensuring that any related party LRBA is established and maintained on an arm's length bases. These documents, primarily PCG 2016/5, identify safe harbour rules that the ATO deems appropriate to satisfy an arm's length transaction therefore ensuring that the income attributable to any LRBA asset is taxed at the concessional superannuation tax rate. TD 2016/16 utilises the safe harbour rules provided by the ATO to highlight how non-arm's length income can be avoided.

Of course, these ATO guidelines are exactly that, guidelines, and there is nothing preventing an SMSF trustee from creating terms that they determine to be on an arm's length basis, perhaps as a result of seeking out a loan from a commercial provider and replicating them. It will then be incumbent on the trustee to justify to the ATO that the loan is arm's length in the event the ATO reviews the arrangement.

Application of Safe Harbour Rules

Let's consider what a related party LRBA arrangement might look like. The ATO safe harbour rules provide the ability to lend up to 70% for a period of 15 years. The guidelines also propose an interest rate based on the Reserve Bank of Australia Indicator Lending Rates for banks providing standard variable housing loans for investors, utilising the rate indicated for May prior to the Financial Year the loan is entered in. The May 2017 rate was 5.80% meaning this is the appropriate rate for a loan entered into for 2017/18 year.

Property transactions

Given the reduction of the non-concessional contribution limit to $100,000 with a bring forward capacity of $300,000, subject to a member's total superannuation balance, this strategy may be particularly beneficial if an individual has access to sufficient funds to contribute but is restricted by the new caps.

As indicated, the LVR requirements for property is 70%, regardless of whether the property is commercial or residential, and the current interest rate is 5.80%.

Let's look at an example of a two member SMSF that currently has $300,000. The fund identifies a property valued at $750,000 that is currently being rented out at $550 per week. Between the two members they have the capacity to contribute up to $600,000 in which case the fund could acquire the property outright. Instead they choose to lend the fund $500,000. On a $500,000 loan at 5.80% over 15 years, the fund is looking at repayments of roughly $4,165 per month meaning the fund needs approximately $50,000 worth of income to meet the repayment requirements. At the current rent the fund will receive $28,600 per year, some of which will go towards the ongoing costs of the property. Assuming a shortfall of $30,000 the members can consider concessional or non-concessional contributions or a combination. Alternatively, they may look at increasing the rent, subject to rental valuations in the area.

Rental Yield

The yield would obviously be determined by the nature and location of the property. One thing to consider is that for a small business operator looking for a business premises their rental payments are in effect contributing towards the ongoing acquisition of the property rather than in to someone else's pocket. This is where an understanding of the arm's length requirements are just as important as the terms of the loan.

Limited Recourse

If the SMSF trustees/members, as the lender, has some requirement for liquidity outside of superannuation, or no desire to retain the property, then the LRBA accommodates this by allowing the asset to be sold and the loan repaid. If they have made some gains along the way they will be retained in the fund over and above the liability to pay out the loan. There is the potential that the property value decreases and if it decreases below the value of the loan then there is a diminished repayment to be made.

Understanding the rules

This article highlights the use of LRBAs with related party loans in accordance with the ATO safe harbour guidelines. LRBAs can provide a similar investment opportunity via a commercial lender for SMSFs that have an eye on property without the immediate ability to fund it outright.

Tim Miller: Miller Super Solutions

PAYMENTS ABOVE ACCOUNT-BASED PENSION (ABP) MINIMUM
REASONS TO PROSPECTIVELY DOCUMENT A STRATEGY ASAP

JOSEPH CHEUNG AND BRYCE FIGOT

Payments above the account-based pension ('ABP') minimum annual payment have the potential to become a trap. The June 2017 SMSF Benchmark Report by Class Super states that 'the average SMSF pensioner withdraws about $74,000 annually on their pension over a series of 12 transactions and overdraws $24,000 above their minimum'. This means that the average pensioner is withdrawing more than 32% above their relevant ABP minimum and could miss out on significant opportunities unless timely action is undertaken! This article summarises the trap and examines the main reasons to prospectively document a strategy as soon as possible.

What is the trap?

For pensioners who receive payments above the ABP minimum for their ABP(s), the capital supporting the ABP(s) is reduced by the amount of pension payment(s). However, there is no corresponding debit to the pensioner's transfer balance account ('TBA')!

Where the pensioner had 'maxed out' their transfer balance cap, they cannot add any further capital to start a new pension that is in the retirement phase (i.e. a pension that will obtain a pension exemption). Therefore, drawing more than the minimum payment will exhaust the capital supporting the ABP(s) significantly faster than would otherwise be the case. Where the pensioner had not 'maxed out' their transfer balance cap, there will be limited capacity to add further capital to commence a new ABP.

What is a strategy to avoid this trap?

DBA Lawyers understands that many advisers in the SMSF industry have been contemplating various strategies to avoid this trap. A common theme in the strategies involves partially commuting some or all of the amounts above the relevant ABP minimum(s). The following is an example of one of the strategies:

- Pay all amounts above the relevant ABP minimum(s) as a lump sum payment from the pensioner's accumulation interest.
- Where there is no accumulation superannuation interest or the accumulation superannuation interest is insufficient to pay the amounts in excess of the relevant minimum ABP amount(s), these excess amounts are to be paid as a partial commutation of the relevant ABP.

What are the main reasons to prospectively documenting a strategy as soon as possible?

Compliance with the Australian Taxation Office's (ATO's) view

In relation to the partial commutation of pensions, the ATO's view (as expressed in SMSFD 2013/2 and TR 2013/5) is that the pensioner must consciously exercise their right to exchange something less than their full entitlement to receive future pension payments for an entitlement to be paid a lump sum. Where no documentation exists either before or at the time of payment, it is hard to prove that the pensioner consciously exercised their right. The ATO could decide that there was no partial commutation and that the amount was just paid as a pension payment in excess of the relevant ABP minimum(s).

Similarly, where the payments are allocated and the strategy documented 'after the fact', the ATO might take the view that that the payments did not come from an accumulation superannuation interest as it could not be proven that this was the parties' intention at the time of payment, and it was not a valid partial commutation. Accordingly, a conservative approach is to have relevant documentation completed and signed before the payment of the amounts in excess of the ABP minimum payment.

The onus of proof rests with the taxpayer. Also, the ATO may allege false and misleading disclosure and, in addition to winding back any tax benefit from the 'fabrication' of any documents that did not exist before the relevant commutation, may impose penalties of up to 75% plus the general interest charge.

> **The average pensioner is withdrawing more than 32% above their relevant ABP minimum and could miss out on significant opportunities unless timely action is undertaken!**

Achieving administrative efficiency and certainty under ATO reporting requirements — Transfer Balance Account Report ('TBAR')

The ATO new reporting regime associated with the transfer balance cap commenced on 28 September 2017 and applies from 1 October 2017. Broadly, the TBAR regime will involve a need to report on an events basis regarding events since 1 July 2017 that have an impact on the pensioner's TBA. (TBAR also extends to reporting where further information is required to calculate a member's total super balance or concessional contributions averaging amount from 1 July 2018.) For example, all ABP commutations will need to be reported. Reporting will be required whenever there are events that result in a debit or credit to the pensioner's TBA. SMSFs will not be required to report until 1 July 2018 due to an administrative concession. However, it is best practice for SMSFs to start reporting from 1 October 2017.

The ATO's rationale for the introduction of TBAR is to enhance visibility of each pensioner's TBA. There will be time limits for reporting events. TBAR is relevant for strategies to avoid the trap described above. Amounts that are paid directly from a pensioner's accumulation interest will not need to be reported. However, amounts that are paid as a partial commutation of the pensioner's relevant pension will need to be reported.

To the extent that pensioners (and their advisers/SMSF trustees) are not aware of their TBA, the TBAR regime could exacerbate this trap. For example, a late lodgement penalty may be imposed by the ATO if a pensioner's partial commutation in relation to the amount above the relevant ABP minimum is not reported on time.

The introduction of the TBAR regime is also likely to increase the administrative costs for SMSFs. If a strategy was not prospectively documented for all future payments above ABP minimums, the adviser/SMSF trustee may have to liaise with the pensioner prior to each payment regarding the treatment of any amount above ABP minimums. For example, they would have to decide on which pension account the payment is to come from, and whether the amount above the ABP minimum was to be treated as coming from the pensioner's accumulation interest or as a partial commutation. After making this decision, the SMSF trustee would then have to document each decision. The more payments there are during the year that are in excess of the relevant ABP minimums, the greater the frequency of the attendances and liaising required. Where an adviser is assisting the pensioner with the TBAR reporting, the extra attendances and liaising may translate to increased costs for the SMSF. The pensioner may also feel burdened by the extra amount of time needed to liaise with the adviser.

Moreover, advisers need to ensure their advice and services comply with the Australian financial services licence ('AFSL') regime. Where a strategy was not prospectively documented for all future payments above ABP minimums, advisers without an AFSL would be at further risk of attending on multiple occasions a 'restructure' of the pensioner's payments. We would generally recommend that pensioners be provided advice from a licensed adviser prior to the commencement or commutation of an ABP.

One way to achieve administrative efficiency is to prospectively document a detailed strategy for all future payments above ABP minimums. Less documents are involved provided that the strategy is applied consistently to all future pension payments. Less attendances are required from advisers — this should hopefully translate to reduced costs for the SMSF and more time and resources for advisers to perform other tasks. Prospectively documenting a strategy also adds certainty to the treatment of future payments. The adviser/SMSF trustee could then follow the documented strategy when reporting under the TBAR regime.

Conclusion

Unless SMSF pensioners take timely action and prospectively record a strategy for payments above ABP minimums, they may be at risk of falling into an inescapable trap. Naturally, developing a strategy to cover all future payments above ABP minimums is no easy task!

Joseph Cheung, Lawyer and Bryce Figot, Special Counsel: DBA Lawyers

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				
03-Jan-18	Wednesday	7.00pm	Sydney Inner West Discussion Group	Birkenhead Hotel, 206 Lyons Rd Drummoyne
08-Jan-18	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
02-Feb-18	Friday	12.30pm	Hills District Discussion Group	Beecroft Presbyterian Church, Mary St Beecroft
12-Feb-18	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
14-Feb-18	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
23-Feb-18	Friday	3.00pm	Northern Beaches Discussion Group	Dee Why Builders Club, 18-20 Fisher rd Dee Why
07-Mar-18	Wednesday	7.00pm	Sydney Inner West Discussion Group	Birkenhead Hotel, 206 Lyons Rd Drummoyne
09-Mar-18	Friday	12.30pm	Hills District Discussion Group	Beecroft Presbyterian Church, Mary St Beecroft
12-Mar-18	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
14-Mar-18	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
30-Mar-18	Friday	3.00pm	Northern Beaches Discussion Group	Dee Why Builders Club, 18-20 Fisher rd Dee Why
VIC				
25-Jan-18	Thursday	4.00pm	Bayside Discussion Group	Private Address, contact Kevin MacDonald km.macdonald@bigpond.com
30-Jan-18	Tuesday	7.00pm	Greensborough Discussion Group	Diamond Valley Library, Greensborough
31-Jan-18	Wednesday	7.00pm	Kew Discussion Group	Phyllis Hore Room, Kew Library
06-Feb-18	Tuesday	7.00pm	Melbourne Information Meeting	Telstra Conference Centre
07-Mar-18	Wednesday	1.00pm	Frankston Discussion group	Private Address, contact Bill Shirley bill.shirley63@bigpond.com
27-Mar-18	Tuesday	7.00pm	Greensborough Discussion Group	Diamond Valley Library, Greensborough
28-Mar-18	Wednesday	7.00pm	Kew Discussion Group	Phyllis Hore Room, Kew Library
29-Mar-18	Thursday	4.00pm	Bayside Discussion Group	Private Address, contact Kevin MacDonald km.macdonald@bigpond.com
QLD				
17-Jan-18	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
07-Feb-18	Wednesday	1.00pm	Brisbane Information Meeting	Wesley House, 140 Ann St Brisbane
19-Feb-18	Monday	9.00am	Gold Coast Information Meeting	Helensvale Community, Centre 31 Discovery Dr Helensvale
13-Feb-18	Tuesday	7.00pm	Brisbane Managed Investment Group	Carindale Library, Carindale Shopping Centre
21-Feb-18	Wednesday	7.00pm	Brisbane Equities Discussion Group	Carindale Library, Carindale Shopping Centre
21-Feb-18	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
13-Mar-18	Tuesday	7.00pm	Brisbane Managed Investment Group	Carindale Library, Carindale Shopping Centre
21-Mar-18	Wednesday	7.00pm	Brisbane Equities Discussion Group	Carindale Library, Carindale Shopping Centre
21-Mar-18	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
SA				
13-Feb-18	Tuesday	7.00pm	Adelaide Information Meeting	Fullarton Park Community Centre, 411 Fullarton Road Fullarton
13-Mar-18	Tuesday	7.00pm	Adelaide Information Meeting	Fullarton Park Community Centre, 411 Fullarton Road Fullarton
WA				
06-Feb-18	Tuesday	7.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
20-Feb-18	Tuesday	7.30pm	Perth Discussion Group	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
06-Mar-18	Tuesday	7.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
20-Mar-18	Tuesday	7.30pm	Perth Discussion Group	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs

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