According to us newsletter

Summer 2013/14

Honing in on what matters...

The most often asked question of investment managers is how they see the future unfolding from an investment return perspective. This time last year, many would have been relieved to see the markets up but also cautious, given the obstacles they could see ahead e.g. continuing political clashes in the US over the federal budget and debt ceiling.

But, in true fashion, it was not the issues which the market could foresee but the element of surprise that caused the major ruction during the year i.e. the announcement in May that the US may start to end its program of buying bonds earlier than expected. Nonetheless the market recovered its poise shortly after this and posted a solid year of gains, defying the guarded predictions.

However, with markets now having risen locally just over 30% since the start of FY13, a more laser like focus is being brought to bear on companies, whose performance expectations have been raised by virtue of their valuations. But recognising companies cannot operate in isolation, I explore, in this era of ultra-low interest rates, where it may be worthwhile channelling resources to get a ‘bigger bang for your buck’.

Separately, Self Managed Superannuation Funds (SMSFs) continue to garner attention, given their increasing popularity, as evidenced by their rising numbers. The benefits they provide, namely of control, transparency and flexibility, are well documented. However, as more money finds its way into SMSFs, it is attracting promoters of products and operators with promises of various kinds. With the benefits they provide come certain rules by which SMSFs must abide. In this vein, Jackie Cook provides a checklist of what a SMSF can invest in - perhaps the number one question posed by trustees.

Finally, we wish you well for the festive season and hope you have a refreshing summer break. And hope for another prosperous year.

Where is the Growth?

By Geoff Greetham, Executive Director

Universally global economies are struggling to generate reasonable growth despite unprecedented levels of monetary support by many central banks and substantial fiscal stimulus by their respective governments.

This was confirmed by the International Monetary Fund (IMF) in October and Organisation for Economic Cooperation and Development (OECD) in November both lowering their growth forecasts respectively.

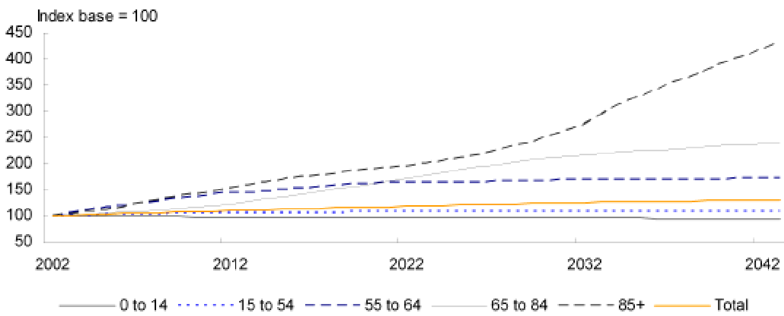
At the core of this is a lack of inflation. This is despite the US monetary base alone expanding by some 300% since the September 2008 collapse of Lehman Brothers. People were fearful at the time that such an expansion, in order to save financial markets, would eventually lead to runaway inflation. In fact, concerns in recent times have shifted to disinflation (a period when the inflation rate is positive, but declining over time) and even deflation (a sustained fall in the general price level – the opposite to inflation) – the latter being an issue for Japan for almost two decades.

There is no doubt though the impact of low cost producers of manufactured goods should not be overlooked. Euphemistically, Asia and in particular China has, during this time, been ‘exporting deflation’ in the form of cheap clothes, electronics and other consumer items. Nor should we ignore productivity improvements, through automation and technology, as contributing to this.

Such an environment of low inflation/disinflation/possible deflation makes it harder to generate growth for many reasons:

- Governments struggle to ‘fix’ budgets (without the benefit of inflation pushing up tax receipts) and reduce debt levels (through the ‘invisible creep’ of inflation reducing the value of that debt over time).
- Wage growth becomes restricted with consumption in turn restrained and even being reduced as people focus more on paying down their own debt.
- Companies necessarily find it more difficult to increase profits much above economy wide nominal rates of growth in the face of such reduced demand.

Australia - Population growth indices by age group



For many investors, the above is reflected in an acceptance of future lower returns. The preparedness to buy bonds when yields are so low historically is an example. With such low inflation, attaining annual returns above 5% becomes that much harder but therein lies the challenge.

A report by global fund manager, Fidelity, issued some months ago put this challenge into context and echoed our thoughts as to where better returns may lie.

In valuing the potential earnings of companies, the market is seen to be efficient at forecasting and 'pricing' near-term earnings. As a corollary, however, it is less effective in evaluating potential longer term earnings. An opportunity thus exists to exploit this.

Over short time frames, a company's share price is driven more by a higher valuation i.e. a higher Price to Earnings (P/E) ratio being applied to its earnings with its attendant focus on near term earnings. In the long term, performance is more heavily correlated to changes in that earnings growth.

So, armed with the comfort that earnings 'win out' and presuming one is able to capture the potential value of those earnings in their valuation model (which is at the heart of our process), the priority becomes identifying high quality earnings growth compounding companies. That is, companies exposed to structural growth themes whose earnings are less sensitive to the business cycle i.e. better positioned to achieve that elusive growth by their own means rather than relying on a general uplift from the economy.

Such structural growth drivers can be seen to arise from the following:

- Global population growth, being driven by developing countries, as well as a shift to urbanised as opposed to rural populations (consequence: less arable land, food supply/quality becomes an issue and a growing need to maximise a finite asset ie. the land).
- A burgeoning middle class, with those deemed to fall into this class, set to double by 2030 (consequence: more consumers seeking out discretionary items as well as a change in lifestyle e.g. diet and behaviours).
- An ageing population (refer graph previous page) through declining fertility and mortality rates (consequence: increased focus on health, with demand for a wider range of health products e.g. drugs and services e.g. hospitals).

It is these themes (plus others), which we believe warrant strong consideration in generating superior returns over time, particularly given the certainty with which they are likely to play out.

The Do's & Don'ts of SMSF Investing

By Jackie Cook, Financial Strategist

As a trustee of a Self Managed Superannuation Fund (SMSF), you have a great deal of freedom to select investments that you think will suit the needs of your fund and its members.

You must ensure, however, that investments are made for the 'sole purpose' of providing **retirement** benefits for the members of the fund. This means that members, relatives or associates of the trustees must not gain any **immediate** benefit from the fund's assets or activities.

Provided below is a checklist for SMSF trustees to consider when investing:

DO - Prepare an investment strategy

An investment strategy is a key document that is designed to show that you understand your responsibilities as a trustee. This will be one of the first documents that an auditor or the ATO will look at to see if you are taking those responsibilities seriously.

A SMSF can invest in the following investments:

- Direct investments (such as cash, term deposits, fixed income securities, shares, exchange traded funds (ETFs), gold/silver bullion and bonds).
- Direct property (residential houses, villas, units, as well as commercial property such as offices, warehouses, factory units, shops and land).
- Managed funds (retail or wholesale, domestic and international).
- Private unit trusts.
- A business (non-related party to avoid hassle) and business property.
- Non-traditional assets such as coins, antiques, art , taxi plate licences, ATMs.

DON'T - Put all your eggs in one basket

Diversification is critical in reducing your overall investment risk.

Also, for those property lovers out there, keep in mind that having illiquid assets in the fund is fine, as long as the fund can still meet its liabilities. This becomes more of an issue when a member reaches pension phase. You can't sell a bedroom to make a pension payment! You should always ensure you have a suitable amount of liquid assets in order to meet the liabilities of the fund.

DON'T - Acquire assets from a related party

SMSFs are prohibited from acquiring assets from a related party, unless the asset is business real property. There is also currently an exemption for listed securities.

NB: it was proposed that this exemption would cease 1 July 2013, however this proposal was abandoned.

That said, if the related party asset does not represent **more than 5%** of the market value of the SMSF portfolio, this will be allowed. However, caution must be exercised. A drop in the value of other SMSF assets or an increase in the value of the related party asset may result in that asset becoming over 5% of the portfolio.

DO - Always make investments at 'arms length' and on commercial terms

Any asset bought and sold must be at market value. Income received from an investment must be a market rate of return. Any interest paid on limited recourse borrowings (refer later) must be at market rates for similar types of loans.

DON'T - Lend money or provide financial assistance to a member or a related party.

Whilst lending money to your son or daughter to purchase a property at commercial interest rates may appear a sound investment decision, it is actually in breach of superannuation law. Additionally, any property owned by the fund cannot be rented by members or their families, even if rented out at a market rates.

However, as with acquiring assets from related parties, loans to a related party are allowed as long as the loan is not **more than 5%** of the portfolio.

DO - Consider gearing, if appropriate

In 2007, changes in legislation made it possible for SMSFs to borrow to purchase property. That said, there are strict rules placed around these borrowing arrangements and the borrowing must be **limited recourse**.

Over the years, there has been a sharp decline in amounts you can contribute to your SMSF and for which you receive a tax deduction. This therefore makes it worthwhile exploring gearing, as an option, to grow your super.

DO - Review your trust deed and investment strategy regularly

Changes to superannuation law are happening on an ongoing basis. Given this, there is a chance that your trust deed no longer complies with current legislation. If you are unsure, you should have an expert review it to ensure that it allows you to implement your desired investment strategies.

It is also important to review your investment strategy as your investments change over time. For example, over recent years, some trustees have become more risk-averse. If this was you, you need to ensure that your investment strategy reflects this. If your investment strategy says you should only have 10–30% in cash/fixed interest, and you now have 50–70%, then you are operating outside of the stated strategy of your super fund.

If in any doubt, please contact our office and we would be more than happy to discuss.

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Did you know....

Despite an overwhelming focus worldwide for governments to reduce budget deficits, the US, for example, has now run a deficit for 41 of the past 45 years, the UK for 52 of the past 61 years, Spain for 46 of the past 50 years, Japan since 1992 and countries like Italy, Portugal and France since 1960, 1977 and 1978 respectively. In this context, Australia has clearly been a model of "fiscal rectitude".

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Accordius Pty Ltd • ACN: 128 900 603 • AFS Licence No. 321955
Level 24, 333 Collins Street, Melbourne, VIC 3000 • GPO Box 2985, Melbourne, VIC 3001
Telephone: +61 3 8623 3378 • Fax: +61 3 8678 1235 • Email: information@accordius.com.au

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Your personal funds manager