> "The chase for yield is a fad with dire consequences when the fashion changes."
> ROGER MONTGOMERY, MONTGOMERY FUND

Rising bond rates spell bad news for assets

ROGER MONTGOMERY

Let's take a quick look at the portfolio of a typical investor: there'll be some shares for growth, some fixed interest, hybrids or infrastructure stocks for income and some property for diversification. So which of these are at risk from the rising bond yields we have been warning investors about all year?

The answer is all of them. Interest rates act like gravity on the value of assets; the higher the interest rates go, the greater the gravitational impact on asset prices. Irrespective of whether we are talking about bonds, shares, farmland or businesses, all assets are worth less when interest rates rise.

So, for example, investors (and I use the adjective loosely) who geared up to buy apartments for their kids amid a frenzy-inducing fear of missing out are facing an abyss and are about to do their dough. We already know that mortgage debt as a percentage of both income and GDP is at a record I hope those apartment investors don't blame their kids. Make no mistake, rising bond yields are bad for assets. And bond rates are rising.

During the turn-of-the-century tech boom, anyone investing in low-growth, high dividend yielding stocks in boring industries such as infrastructure were regarded as boring. In fact, in 1999 Warren Buffett was not described as the "Oracle of Omaha"; he was a pariah, one of the many who they said had "missed" the tech boom. He had failed to see how the internet would change the world and was "washed up".

In the most recent boom, it was precisely those same "washed up" stocks that investors couldn't get enough of. Forced by low returns on cash deposits, investors stampeded into higher-yielding shares, unwittingly taking on equity market risk for mere bond-like returns.

As shares were pushed higher, the most expensive stocks became those of companies with the highest dividend payout ratios. Higher dividend payout ratios however mean lower retained earnings for growth. The most expensive companies then were those with the lowest self-funded growth.

Another group of companies that became expensive were those that the weighted average cost of capital calculation favoured. The formula valued most highly those that were 100 per cent funded by debt. When low interest rates raise the values of companies with the most debt, something is seriously awry.

Since 2015 I have been warning investors that the chase for yield is a fad with dire consequences when the fashion changes. Low interest rates were corrupting their sense of risk and this was being reflected in the fact that the most expensive stocks were those with the most debt or the lowest growth.

Snap back to reality

Thank Donald Trump for the snap back to reality. Bond rates that were already rising since June spiked quickly, precisely as I have warned. Back in 1994, bond rates rose 200 basis points in just a few weeks.

Unsurprisingly, Sydney Airports — geographically located on a vacant block at the end of a global cul-de-sac — has been slammed. Transurban, the operator of the cul-de-sac, has also been slammed, REITs and utility stocks likewise.

So where will it end? It won't. Those commentators who believed low and even negative interest rates would stick around for a long time were succumbing to the same "this time is different" groupthink that suckered in the tech investing bunnies of 1999 and 2000.

Debt is at record highs in Australia — not good as bond rates start to climb, by the way. Mortgage debt as a percentage of both income and GDP is at a record, credit card debt is also at a record and government debt will also expand.

And companies that borrowed heavily to buy back shares, pay special dividends or pay for overpriced acquisitions will find their profligate ways coming home to roost.

All this while aggregate P/E ratios for the ASX 200-ex banks and the S&P 500 remain at, or near, historic highs.

It has always been the case that during the early stages of rising rates, the stockmarket goes up, because investors are buoyed by expectations of economic growth. History also shows us that the enthusiasm ends as continued rising rates on bonds and cash become more attractive.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund. www.montinvest.com

Where ETF money flows

TONY KAYE

Australia's exchange-traded funds market is surging towards the 2016 finish line at a blistering pace, with net capital inflows in October topping $600 million.

At this point, total inflows in the current quarter are on track to easily surpass the $1.02 billion of investor funds that flowed into the 150 or so ETFs listed on the Australian Securities Exchange during the three months to the end of September.

So, if all goes according to plan — for the ETF product issuers, that is — the total inflow of funds into Australian-listed ETFs for calendar 2016 should be in the vicinity of $5 billion, and potentially more.

This bumper year should push total funds under management across the ETFs space beyond the current $24 billion level, further demonstrating the ongoing attraction of these products for investors.

Behind that attraction, of course, is the reality that ETFs are a low-cost entry point for those wanting exposure to whole market indices or asset classes through a single security, and they provide the in-built flexibility to buy and sell on-market at will because they're listed, as opposed to unlisted managed funds.

The trading volumes from the ASX show that the 12-month average number of monthly ETF transactions reached 63,843 in September, and the average value of monthly transactions for the 12 months to September reached $1.89 billion.

xhead

That ETFs are a popular choice for retail investors is undisputed, and the rapid growth in the number of products available in Australia is testament to that.

But what's most interesting around the latest ETF inflows numbers is where investors' money is actually going.

There are two clear patterns in the data flows.

• The first is that while home-market bias is still evident, with investor inflows into products providing exposure to the broad Australian market remaining strong, the dollar inflows into international equity ETFs are also robust.

In fact, over the year to date, inflows into internationally-focused ETFs have been higher, totalling $870 million compared with around $840 million for Australian-focused ETFs.

The bulk of the money continues to be channelled into ETF equities products, covering the ASX 200 index, the US S & P 500, and the MSCI World Index of the largest developed markets.

• The second clear behavioural investment pattern that emerged was an acceleration in the 'hunt for yield' — quite likely a reflection of low interest rates and an increased demand from those in retirement phase wanting better returns to generate regular income.

Supporting this, the BetaShares Australian Dividend Harvester — which provides investors with exposure to large capitalisation Australian shares and franked dividend income, paid monthly — was the biggest puller in terms of equities funds in the September quarter. According to data from Morningstar, the ETF attracted inflows of $94.2 million, compared with $51.5 million in the June period.

It was followed by the Vanguard Australian Shares Index ETF and the Magellan Global Equities Fund, with each taking in around $83 million in fresh shareholder capital.

Yield hunters

The fast-growing pool of funds now being directed into fixed interest ETFs reflects a renewed focus by investors on capital protection against their exposure to expensive equity markets, with many recognising the opportunity to chase higher yields in bond ETF products as interest rates begin to rise in the US and other parts of the world.

It is also a clear indication that more investors are recognising the benefits of products that offer higher real returns and greater flexibility than standard bank income products such as term deposits.

Figures from the three months to the end of September show a very strong uplift in inflows into both Australian and international fixed interest products. From a net outflow position of close to $60 million in the June quarter, the investor tide into Australian fixed interest ETFs turned completely in the September period to show positive inflows of more than $200 million. Likewise, inflows into international fixed interest ETFs tripled from $21 million in the June quarter to around $60 million in the three months to the end of September.

That trend was well reflected in the Australian ETF numbers, with the biggest fund inflows overall in the September quarter — just under $124 million — going into the Vanguard Australian Fixed Interest ETF.

A further $46.7 million was directed into the BetaShares Australian High Interest Cash ETF, which aims to generate returns above the 30-day bank bill swap rate and provide monthly income distributions. The fund has achieved this key objective ever since it was launched in 2012.

Over the year to date inflows into fixed income ETFs have been just shy of $500 million, compared with $440 million in 2015.

"Fixed income products continue to attract considerable investment, with 22 per cent of total ETF flows going into domestic fixed income products and 5.5 per cent into international fixed income products," ANZ noted in its latest ETFs report.

"The inflows into international fixed income ETFs are of particular note, as this was the last key asset class made available to Australian ETF investors. There are only five ETFs in this asset class which have all been open to investors for less than a year (all five were launched in December 2015), pointing to strong demand for international fixed income exposure among ETF investors seeking further diversification."

In the bigger scheme of behavioural investment patterns, the fixed interest uplift is simply part of the ongoing evolution of the ETFs sector with more products becoming available in the Australian market.

It also reflects the continued diversification of ETF holdings by investors, especially into international products and other asset classes to reduce risk.

Tony Kaye is the editor of Eureka Report, which is owned by financial services company InvestSMART Group.

Evolution most of golden moment

ISABELLA ZHONG
METALS

Hold onto your hats. Financial markets could be set for a wild ride and gold bulls may want to bet on the precious metal.

Shares of Evolution Mining have fallen 21 per cent over the past three months as gold has fallen from its highs. The yellow metal is down 12 per cent from its August peak, although it has bounced off its lows in recent weeks.

Evolution Mining could be an attractive way into gold as the miner not only offers exposure to the gold price but is poised to get an earnings boost from higher production and lower costs. It also pays a 1.4 per cent dividend.

The short term outlook for the gold price remains captive to the pace and extent of U.S. interest rate rises. Higher interest rates are bad news for gold as they make the zero-yielding asset less attractive. Economists expect a hike in December but the pace at which rates are raised is unclear given mixed signals about the strength of the U.S. economy.

While BCA Research analyst Robert Ryan expects a December hike, he argues it could turn out to be a policy mistake given the global economy is far from strong. Ryan is neutral on gold.

Deutsche Bank has a long-term price forecast of $US1,300 an ounce, which is slightly above the $US1,220 an ounce at which the metal currently trades.

For Evolution Mining, the equation is more complex than just the gold price: the miner is growing production with lower cost ounces. Deutsche Bank analyst Matthew Hocking expects Evolution will improve its all-in sustainable cost of production (AISC) to $860 an ounce in the December quarter from the $1,060 an ounce it recorded in the September quarter.

The analyst recently upgraded Evolution Mining to a buy with an $2.40 a share target price. At around $2.05 a share, the stock trades at 9 times forward earnings, which is slightly above its five-year average level but in line with multiples fetched by rivals Northern Star Resources and Regis Resources. Evolution Mining's free cash flow yield was a healthy 10 per cent in the first half of the year.

This is an edited version of a story which first appeared in Barrons.com

New deductions, offsets and bonuses are the silver lining in the super change cloud

MONICA RULE

The looming reforms to superannuation on July 1 have received a torrent of negative publicity.

But are you aware that some of the government's proposed super changes could provide you with tax deductions, offsets and bonuses on your super contributions? Many of these benefits are modest, but nonetheless an investor should never miss an opportunity.

If you are under 75 and self-employed, or you do not receive any super support from anyone (eg you are a retiree), or you receive employment income which is less than 10 per cent of your total income, then you can claim a deduction on your super contributions.

Unfortunately, under the current law, full-time employees are unable to claim a tax deduction on their contributions unless their employment income is less than 10 per cent of their total income.

However, the government proposes to remove the 10 per cent rule so that everyone will be able to claim a tax deduction on their contributions. If the proposed change becomes law, it means from July 1 anyone who is eligible to make concessional contributions of up to $25,000 per year can claim a tax deduction on their contributions.

The government also proposes that, from July 1, 2018, people will be able to use the "catch-up" concessional contributions cap. Under the catch-up rules, superannuation fund members will be able to contribute more than the annual concessional contributions cap of $25,000, if they haven't fully used the cap in the previous five consecutive years, and their superannuation balance does not exceed $500,000.

This means an individual can make concessional contributions in a single year of up to the $25,000 plus any carried-forward amount they have available from the past five years, starting from July 1, 2018, and claim the tax deduction on the entire amount contributed. The carried-forward amounts will expire if they remain unused after five years.

Individuals with an adjusted taxable income of up to $37,000 per year who have personal or employer concessional contributions made into their superannuation fund will receive a tax offset of up to $500. The (low income) tax offset represents a refund of the tax paid on concessional contributions made into the superannuation fund. The tax offset is calculated at 15 per cent of the concessional contributions made into the fund. The maximum tax offset claimable in a financial year is limited to $500 and the minimum amount is rounded to $10.

To qualify, the person must receive at least 10 per cent of their total income from employment or from running a business and they must not hold a temporary residence visa.

Separately, an individual can claim a tax offset of up to $540 for making super contributions for their low-income spouse. The tax offset is calculated at 18 per cent of the maximum $3000 non-concessional contribution. To be eligible for the full tax offset, the low-income spouse's annual income must not exceed $10,800. The tax offset gradually reduces once the spouse's income exceeds $10,800 and cuts out altogether once the income reaches $13,800.

To be eligible, the spouse receiving the contribution must be under the age of 70 and if they are aged 65 to 69 they must meet the work test (40 hours over 30 consecutive days). Both the contributing spouse and the low-income spouse must be Australian resident for income tax purposes and not be living separately and apart on a permanent basis at the time the contribution is made. Contributions made on behalf of the spouse will count towards the receiving spouse's non-concessional contributions cap. Contributions that are split into a spouse's superannuation account do not qualify for the tax offset.

From July 1 next year, the government proposes to increase the receiving spouse's income threshold from $10,800 to $37,000 and increase the cut-off threshold from $13,800 to $40,000.

Individuals up to the age of 70, who have made non-concessional contributions into their superannuation fund, will receive up to a $500 bonus superannuation contribution if their income does not exceed $51,021 per annum. The government will contribute 50c for each dollar an individual contributes in non-concessional contributions up to $1000.

Monica Rule is an SMSF specialist and author of The Self Managed Super Handbook — Superannuation Law for SMSFs in Plain English.

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Sitting Buddha at Gal Vihara, Polonnaruwa, Sigiriya Rock and frescoes

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