Cash crunch is coming for property investors

ROGER MONTGOMERY

The US property billionaire Sam Zell once observed, "liquidity equals value". You can own as many assets as you like, but if there's no liquidity their value is a lot less than what you think.

(Liquidity is the ability to be able to sell an asset to raise cash whenever you want at a reasonable price.)

Another way to look at the issue of liquidity is that cash is most valuable when nobody else has any. Most investors have now migrated away from cash. Witness, for example, the revelation this week that self-managed superannuation fund holdings of property have surpassed cash for the first time in at least 12 years. According to the ATO, nearly a quarter of SMSF net assets, or $162 billion, is held directly in commercial and residential property. The figure is considerably higher if investments in banks, REITS, unlisted property trusts and mezzanine debt is included.

Record aggregate cash balances in Australia may cause some to question the proposition that most investors are locked into illiquid assets. Keep in mind, however, that the cash is held by a relative few and certainly not by those holding the record levels of mortgage and credit card debt.

I have written here at length about the dangers, and even the likelihood, of a property correction. As a value investor I tend to be early in my warnings however I have since been joined in these concerns by the IMF, APRA, the RBA, the OECD and even ASIC. And while my primary concern remains for those who have leveraged to pay an inflated price for a generic asset such as residential apartments there are reasons to be justifiably worried about the broader Australian economy and even our financial system.

In the US, the financial instability brought by two of the past three US recessions (1990 and 2007) was due to declining real estate values.

In Australia our banks extend loans to households and small businesses, typically taking property as collateral. While the economy is operating normally, and in the absence of significant increases in rates, debt payments are met and defaults are low. But conventional lending to households and SMEs puts added pressure on financial institutions when the economy slows and property values decline.

When recessions are accompanied by significant declines in real estate values pressures are brought to bear on the financial system because a loss of income is accompanied by a loss of home equity and the likelihood of default increases dramatically.

No more free money

We have seen the end of quantitative easing by the world's largest central banks. Free money, zero interest policy and negative interest rate policy are all over and given the massive influence these policies had on flattening the yield curve and forcing savings towards asset speculation, the reversal of the former cannot occur without consequences for the latter.

This era of "free money" — was simply the source of liquidity supporting real estate values and development activity since the GFC. As interest rates begin to rise unhindered by central bank intervention demand for money declines as does demand for any assets it is used to purchase. Declining demand and tightening credit spells trouble for real estate.

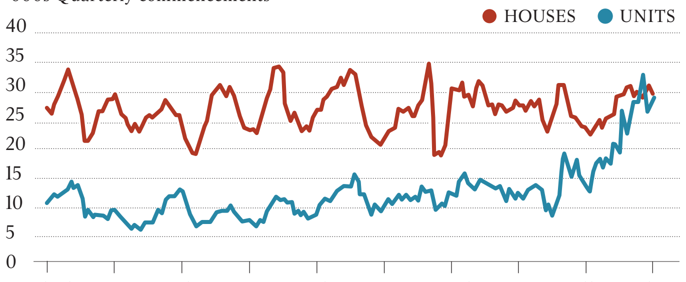
Low short-term rates and flat yield curves forced investors to look outside term deposits for a better yield. They migrated en-masse to corporate debt, then high yield debt (a euphemism for junk bonds), then equities and infrastructure-backed securities, private equity, mezzanine debt and commercial, industrial and residential property. As a result yields and/or capitalisation rates have been pushed down to levels only seen before the GFC.

These cash alternatives are very long-duration assets and buyers today are locking in unacceptably low rates of return for an extended period. If rates rise or incomes produced by these assets fall, their attractiveness to future buyers will fade and these "cash alternatives" do not enjoy the liquidity offered by cash. Any move towards the exit could therefore trigger a liquidity crisis that will impact not just individual investors but the entire financial system.

Low yields and capitalisation rates have rendered the income being generated from those assets insufficient to meet the obligations of the debt used to finance them. This is a classic sign of the end of a boom. And when it coincides with the end of historically cheap interest rates, a slowing economy (thank the end of the residential high-rise construction boom for that) and declining incomes, as well as ridiculously poor levels of productivity and possibly a strain on our financial system, the reversion to the mean could be painful. That pain will be a lot more acute than accepting a 2.5 per cent yield on your term deposit.

The residential construction boom

'000s Quarterly commencements



Source: Core Logic ABS

The perks of being predictable

Annuities are back in vogue, underpinning Challenger's success

GLENDA KORPORAAL

Brian Benari is the managing director of Challenger Limited, an investment management company that has led the revival of annuity products in Australia.

How do you explain an annuity to someone who has no idea what it is?

There's nothing complicated about annuities. Put simply, it's like a pay cheque in retirement. Retirees invest a portion of their retirement savings and, in return, an annuity will pay you an agreed income every month, linked to inflation if you like, either for a fixed term or for the rest of your life. This means you don't have to worry about running out of money.

Challenger is now Australia's largest provider of annuities. How has the market for annuities changed in the past few years and what sort of annuities are people buying?

Every day 700 Australians turn 65 and, as the baby boomer generation moves into retirement, demand for annuities is increasing very rapidly. Annuities are now very much in the mainstream for retirees. In fact the growth in annuities sales has been dramatic. In 2010 53 lifetime annuities were sold in Australia. Last year that number was over 9000. Retirees are sending a clear message that ensuring secure, predictable income for life is now a top priority.

Some advisers are still reluctant to sell annuities. They say they don't provide return for money. Do they have a point?

There are pockets of people who don't realise the benefits that today's annuities provide. Innovations in recent years mean there is now a range of products available that enable retirees to choose what's most important to them, such as level of income provided, a need to access capital or ensuring a portion of capital is returned to your estate if you don't live as long as expected. Today's annuities can balance these priorities to meet the needs of retirees.

RENEE NOWYTARGER

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'Retirees are sending a clear message that ensuring secure, predictable income for life is now a top priority'

BRIAN BENARI
MANAGING DIRECTOR, CHALLENGER

As an example, for $100,000 in a flexible lifetime annuity, a 65-year-old male will get $6280 a year for the rest of his life. And the annuity would give 100 per cent of your capital back to your estate if you died in the first nine years. Annuities are a form of insurance.

There are changes to legislation on annuities coming up in July. What impact will they have?

In last year's budget the government announced changes that will allow for a broader range of retirement income products, including deferred lifetime annuities. Legislation on this has progressed and we are expecting it to come into effect from July. This is good news for the ever increasing number of retirees as it will give them more options and more flexibility as they prepare for retirement.

Any personal investment gurus you admire?

Who wouldn't like an investor with a long-term outlook like Warren Buffett? Some of his top tips for investing are to focus on cash and cash flow

What are your personal investment philosophies?

At times when investing looks easiest and everyone is claiming to be an expert, that's when you need to be most wary!

What was your first or most important investment? Any lessons you have learned on your personal investing side?

It was a modest rental property in Perth which I bought with a small deposit and sold relatively soon after as the market turned. I learned that being able to hold assets during cycles is crucial. Therefore having assets that produce reasonable income and are not encumbered with excessive debt is key.

Challenger is also a big investor — where are you putting your money these days? How does the global market look to you?

Our investment goal is to match our long-term commitments to our annuitants with dependable income from long-term assets. We take a conservative view and invest in assets including government and corporate bonds and other fixed income, as well as other longer-term assets such as infrastructure and properties with long-term leases to tenants including state and federal government.

Are you expecting any changes from the budget?

I've learned over time not to predict what's in the budget. Last year's budget was very much focused on superannuation so you would think that would be less of a focus this year.

What sort of mix would you think the average retired person would put into annuities?

It changes depending on the needs of every individual but we find that generally retirees will put about 25 per cent of their savings into an annuity with the remainder of their super invested in other growth assets like equities and infrastructure.

They look to the income from an annuity to pay for essential needs in retirement, like what you need to keep a roof over your head and healthcare costs, while money from the gradual sale of their growth assets goes towards paying for discretionary needs, like holidays or home improvements.

It's not a single investment that solves all problems for retirees but a combination of income assets like annuities and growth assets such as shares that work together to achieve the best outcome in retirement.

Last chance to salary sacrifice or unlock home equity under 'old super'

JAMES GERRARD

Have you ever missed out on something that was on sale and thought that the next time it goes back on sale you will grab it? There are similarities here with the superannuation changes due to close on June 30.

Back in 2007 under the regime of treasurer Peter Costello there was a window of opportunity to contribute up to $1 million into superannuation before the new "simple super" rules were applied. Today, a similar but slightly less attractive opportunity is in play.

We are waiting for the following rules to come into play on July 1:

- Pre-tax superannuation caps will be $25,000 a year whereas in FY2017 they were $50,000 a year.
- Post-tax superannuation caps will be $100,000 a year whereas in 2017 they were $150,000 a year.
- The three-year bring-forward rule on post-tax superannuation contributions will be $300,000 whereas in 2017 it was $450,000.

In relation to the funds which support your tax-free pension:

If you have more than $1.6m in superannuation you will not be able to make any after-tax contributions and if you have more than $1.5m you will not be able to take advantage of the bring-forward provisions.

Now, much of the attention surrounding the new super rules has been negative — but here's another way to look at it … here's a very last chance to do yourself a favour

Until June 30, the current, more generous rules apply:

- Pre-tax superannuation caps are $30,000 a year for those under 50 and $35,000 a year for those over 50.
- Post-tax superannuation caps are $180,000 a year.
- The three-year bring-forward rule on post-tax superannuation contribution is $540,000 for those under the age of 65.

Superannuation is a concessionally taxed environment and the preferred asset holding structure for most people in retirement.

So pumping as much money as possible into super is generally a good idea from a tax perspective. But what if you do not have $540,000 or $1.08m per couple (remember all the rules relating to the new super regime are per person) laying around in cash available to be stashed into superannuation?

If you have been thinking about putting more money into super for some time, do not think for too much longer.

There are a few options worth considering:

- The first option is to increase salary sacrifice contributions until the end of this financial year. As the current limit of $35,000 per annum for over 50s or $30,000 for under 50s reduces to $25,000 from July 1, why not use it up in the pay periods left this financial year? One important note is that both employer superannuation guarantee contributions and salary sacrifice amounts count towards the $35,000 pre-tax super contribution limit.
- The second option is to redraw equity from your home by way of a loan and contribute the loan money into superannuation. The money borrowed is not tax deductible to you and unless you meet a condition of release, you will not be able to access funds from super to pay the principal or interest on the borrowed funds. Consideration also needs to be given to interest rates. Assuming a 4 per cent interest rate for a loan against the family home, the net return from your superannuation account must be higher than 4 per cent in order to make it worthwhile.

Such a move is strictly for those with healthy balance sheets but low liquid assets. This approach may suit as a short-term bridging option to get the money into super before June 30.

- The third — and most extreme choice — is downsizing your home and using the freed-up cash to make a superannuation contribution. The main issue with this approach is timing.

The typical property auction campaign runs for four weeks followed by a six-week settlement period.

Assuming that you sell and settle before June 30, another complication is that the cash contribution to super needs to be receipted by your superannuation fund usually a week before the end of the financial year to meet the end of financial year cut-offs and processing times.

One other point is that the government is still toying with the idea of some form of tax assistance on "downsizing" but we will not know the final shape of things until the release of the federal budget on Tuesday, May 9

If you have been thinking about putting more money into super for some time now, do not think for too much longer otherwise the opportunity may pass and you may not have an option at all to contribute substantial money into superannuation.

Whether we see substantial changes in the May budget remains to be seen. Certainly, Treasurer Scott Morrison has left open the possibility of both housing and capital gains tax changes.

If there are further changes to superannuation they are most likely to be clarifications rather than anything else. This is certainly the main hope of the financial adviser community in Australia.

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