Why cash is back, wearing its crown

Holding money is most valuable when nobody else has any — like now

ROGER MONTGOMERY

Why have interest rates have been rising globally and why are those rising rates a negative influence on both the value and market price of your assets?

A simple rule to remember when it comes to investing is this: the higher the price you pay, the lower your returns. If, for example, a non-dividend-paying company's shares are going to trade at $20 each in November 2028 — 10 years from now — then paying $5 for them today will deliver you a 15 per cent compounded annual return. But paying $10 for those shares today will only deliver you a 7 per cent annual compounded return. It really is that simple: the higher the price you pay the lower your return, and the lower the price paid, the higher your return.

Flipping this idea, if I know that a business is going to generate $20 of cash flow in November 2028, what is that future $20 worth today? The answer depends on the rate used to "discount" that future cash flow back to today. If a 15 per cent return is demanded on our investment over the next 10 years, the value of that $20 in the future is worth $5 today. However, if you are satisfied with a 7 per cent annual return on our money, then that future $20 is worth $10.

Can you see what has happened here? By lowering the rate of return we require from our investment — from 15 per cent to 7 per cent in the example above — we have increased the present value of a future cash flow, from $5 to $10. In other words, when interest rates (required returns) fall, the value of an asset rises. The reverse is also true. In our example, if interest rates were to rise from 7 per cent to 15 per cent, the value of that future $20 falls from $10 to $5.

As interest rates rise, asset values fall. And that applies to all assets — businesses, shares, property, land, everything that produces income. All you have to remember is that rising interest rates affect asset values the way gravity affects everything on Earth.

And as the value of income-producing assets fall, banks are less inclined to lend, which reduces liquidity, and reducing money available to speculate on non-income-producing assets such as art, wine, cars and low-digit number plates.

Rising rates and risk

The year 2018 is proving to be a transition year. While US 10-year bond rates have been rising for more than two years — from a low of 1.36 per cent to more than 3.2 per cent today — the market only appears to have received the message this year. Indeed, the one-year forward price-to-earnings multiple of the S&P 500 has fallen by 17 per cent this year. That's big. In the GFC year of 2008, the PE ratio compressed by 18 per cent.

Consequently, and especially if rates keep rising, those investors who paid record prices for everything from property to collectibles could now experience poor returns. The only question is whether those lower returns are accompanied by higher volatility than what many have become accustomed to.

So how did we get here? Quite simply, Quantitative Tapering, followed by Quantitative Tightening (QT), not only by the US Federal Reserve but also by the European Central Bank and Bank of Japan. They have affected bond demand and supply, crowded out corporate bonds and triggered a funding squeeze for the banking system.

Additionally, US President Donald Trump's larger budget deficits need to be funded with bond issues, which are adding to the supply of bonds.

So, what we have today is more US bonds being issued by the US Treasury at a time when there is less bond buying by central banks. Meanwhile, the ECB and BoJ are also reducing/tapering their demand for bonds. When supply goes up and demand goes down, bond prices have to fall, and consequently bond rates have to rise.

Back when the US Federal Reserve was buying all of those US Treasury bonds, investors wanting a better yield had to invest in bonds issued by US corporates. Consequently, the corporate bond market boomed. One consequence of the boom was the spread between the US Treasury bond and US CCC-rated "junk" bond narrowing to just 3.15 per cent. In other words, so desperate for yield were investors they were willing to lend money to the riskiest companies at just 3 per cent above what they were willing to lend money to the US government.

But now, with the Fed reducing its bond buying and with the US government issuing more bonds to fund its deficits, the higher yields on government bonds are starting to look more attractive.

Consequently, investors who were overweight corporate bonds are selling those bonds, pushing their yields higher too. You can see this in the market value of corporate bond ETFs such as the iShares IBoxx US Dollar Investment Grade Corporate Bond Fund (LQD), down from more than $US116 to $US111 since August.

Arguably more meaningfully, the switch from US corporate bonds to US Treasuries — and the resultant higher corporate yields — is occurring at a time when a record 47 per cent of all US corporate bonds are rated the lowest BBB investment grade, and 14 per cent of S&P 1500 companies are considered "zombie" companies unable to pay their interest from earnings before interest and tax.

I would not be surprised, as interest rates on these bonds rise, that the high levels of leverage results in a significant number of downgrades to these BBB bonds by ratings agencies. Perhaps even more worryingly, a credit market record level of CCC-rated high yield (junk) debt is due to be refinanced in 2019 and 2020.

When companies on the edge of being financially viable see their bond ratings fall and their interest rates rise, they start laying off staff or go under. As the market casts its shadow before it, the time to be concerned is probably now.

With lower returns expected for aggregate benchmarks such as the S&P 500, it is now more important than at any time in recent years to employ caution to one's investing. Now is the time, if there ever is a time, to pursue strategies and managers that emphasise the preservation of capital rather than full participation in rising markets.

Even if sentiment causes market prices to rise in the next few months, the structurally changed stance of global central banks means that asset valuations are heading in the opposite direction.

And that brings us to cash. Back in the "recession we had to have", cash was king. Recently, cash became a liability earning punitive returns that nobody wanted. But cash is most valuable when nobody else has any. That time appears to have arrived.

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

www.montinvest.com

Sick of work? How to get your hands on super

MONICA RULE

Are you sick of working and wish you could retire and live off your superannuation? But when can you get your hands on your super?

To be able to access your super savings, you need to meet one of the conditions of release under superannuation law. The most common condition is reaching your preservation age. Superannuation fund members born prior to June 30, 1961 would have met their preservation age. People born after this date will need to wait until they turn 57, 58, 59 or 60.

If you have not reached your preservation age, then you may be able to access your super under financial hardship grounds or compassionate grounds. To qualify under financial hardship grounds, you need to have been receiving commonwealth income support payments (e.g. NewStart, disability support, parenting payment, carer's payment, or widow's allowance) for at least 26 weeks. If you do qualify, then you can access up to $10,000 in 12 months. To qualify under compassionate grounds to pay for such things as medical treatment, mortgage repayments or pay for funeral cost of dependants, you need to apply to the Australian tax office.

If you have reached your preservation age, you can access super while you are working. You do not need to cease work or reduce work hours. However, your super must be accessed as a transition to retirement income stream where a total pension of no less than the minimum limit and no more than the maximum limit must be withdrawn each financial year.

If you decide to resign from work after reaching your preservation age, you may be able to access your super as a lump sum payout or as a retirement pension benefit. If you are 60 or older, and work for more than one employer, you can access your super without resigning from all of your jobs. That is, you can leave one job and continue working for other employers. You do not have to give up all paid work. If you are under 60 however, you do have to cease working for all your employers.

It gets better when you are 65 or over. You can access your super any time after your 65th birthday. It does not matter whether you continue to work or not.

Since July 1, 2017, superannuation fund members 18 or older can also access their super to fund a deposit for their first home. The maximum amount is $15,000 per year up to a total of $30,000 across all years. People who previously owned a home in Australia may qualify if they satisfy the ATO's financial hardship provisions.

If you ceased work due to a physical or mental illness, you may be able to access super as a lump sum or pension permanent disability benefit. You may be able to access a lump sum or pension terminal benefit if your doctor has certified your illness is likely to result in your death in 24 months.

There has been a recent review of early access to super rules by Treasury, which is due to formally conclude in March next year.

Minister for Women, Kelly O'Dwyer, announced last month that women leaving abusive relationships will have easier access to their partner's superannuation as well as getting early access to their own super as part of a package of government measures to help improve financial security.

The changes though limited were welcome by legal groups: Helen Matthews, the legal and policy director at Women's Legal Service Victoria, said the service had been campaigning for easy access to information about their partner's superannuation via the ATO as well as a streamlined small claims property process. "These reforms are life-changing for women fighting for fair financial outcomes in our family law system," Matthews said.

The financial advice sector is divided on early access to super as regulators try to get the balance right between a fair system and ensuring that all workers get the full compounding benefit of super over a working lifetime.

A recent straw poll conducted by SMSF Adviser revealed that SMSF professionals were fairly divided on this proposal with just over half of the 306 respondents in favour of allowing victims to access their perpetrator's superannuation assets, while others were against the idea or supported in limited circumstances.

Around 55 per cent of respondents were in favour of amending the law to allow this, 26 per cent were against it completely, and the other 19 per cent supported it where superannuation was accessed by the victim of a violent crime.

Monica Rules is an SMSF specialist and author of The Self Managed Super Handbook — Superannuation law for SMSFs in plain English.

www.monicarule.com.au

The 18 golden rules for the active investor

RUDI FILAPEK-VANDYCK

He may not be perfect in all his views and calls, but Dennis Gartman, editor and publisher of the well-known Wall Street publication the *Gartman Letter,* still carries more day-to-day hands on financial markets experience than most of us have aged since birth.

Below are his rules of trading, as updated and released just a few days ago:

1. Never ever add to a losing position — ever

Adding to losing positions will eventually lead to ruin. All great market humiliations are precipitated by someone doing so such as the Nobel Laureates of Long-Term Capital Management, Nick Leeson, Jon Corzine and now optionsellers.com.

2. Trade like a mercenary

As traders/investors we are to fight on the winning side of any trade. We are pragmatists first, foremost and always with no long-term "allegiance" to either side.

3. Mental capital trumps real capital

Capital comes in two types: mental and real. Holding losing positions diminishes one's finite and measurable real capital and one's infinite and immeasurable mental capital always and everywhere.

4. We are not in the business of buying low and selling high

We are in the business of buying high and selling higher, or of selling low and buying lower. Strength usually begets strength; weakness, usually, begets more weakness.

5. In bull markets one must try only to be long or neutral

The obvious corollary is that in bear markets one must try only to be short or neutral. There are few exceptions.

6. Markets can remain illogical far longer than you or I can remain solvent

Lord Keynes said this decades ago and he was ... and still is ... right, for illogic does often reign, despite what the academics would have us believe about efficient markets.

7. Buy that which shows the greatest strength; sell that which shows the greatest weakness

Metaphorically, the wettest paper sack breaks most easily and the strongest winds carry ships the farthest and the fastest.

8. Think like a fundamentalist, trade like a technician

Be bullish when the technicals and the fundamentals run in tandem. Be bearish when they do not.

9. Trading runs in cycles

In the "Good Times" even one's errors are profitable; in the inevitable "Bad Times" even the most well researched trade shall go awry. This is the nature of trading. Accept it and move on.

10. Keep trading systems simple

Complication breeds confusion, simplicity breeds profitability.

11. An understanding of mass psychology can be more important than an understanding of economics

Simply put, "When they're cryin' you should be buyin' and when they're yellin' you should be sellin'!" But it's difficult.

12. Remember, there is never just one cockroach

The lesson of bad news is that more almost always follows ... usually immediately and with an ever-worsening impact.

13. Be patient with winning trades; be even more impatient with losers

The older we get the more small losses we take.

14. Do more of that which is working and less of that which is not

This works well in life as well as trading. If there is a "secret" to trading ... and to life ... this is it.

15: Clean up after yourself

Need we really say more? Errors only get worse.

16. Someone always has a bigger junkyard dog

No matter how much "work" we do on a trade, someone knows more and is more prepared than are we ... and has more capital.

17: When the facts change, we change!

Lord Keynes once said "When the facts change, I change". When the technicals or the fundamentals of a position change, change your position.

18. All rules are meant to be broken

But they are to be broken only rarely and true genius comes with knowing when, where and why.

Rudi Filapek-Vandyck is the editor at investor service FNArena.

www.fnarena.com

LIFT OUT A GREAT READ

THE AUSTRALIAN
THEAUSTRALIAN.COM.AU | FOR THE INFORMED AUSTRALIAN

Don't miss December's *WISH* Magazine

Gear up for a summer of glamour as *WISH* explores some of the world's best holiday hot spots. Travel to Tuscany to step inside Sting and Trudie Styler's luxurious Italian holiday home, experience an unforgettable tour of India by private jet, and discover why Byron Bay is a magnet for all types from bohemians to billionaires.

Plus, *WISH*'s essential guide to the very best Christmas gifts.

WISH is available with metropolitan editions of *The Australian.*

Pick it up Friday