



# EXTER'S PYRAMID AND THE "END OF EASY MONEY"

Investors today face an almost unique set of market, monetary and macroeconomic factors. Combined, these factors, and the interplay between them will have a profound influence on asset class returns in the next ten years, as this paper, which is broken down into five main parts will discuss.

It starts with a brief review of 2016, and the year that was, before moving on to the "End of Easy Money", and what we mean, as opposed to what the market more generally may mean by that expression. Given this paper has been primarily written for an Australian audience, including SMSF trustees and their advisers, it also features a section on the Australian investment story, before looking at Exter's Pyramid, and why precious metals form part of our own investment portfolio.



The report finishes with some key takeaways for investors and advisers, which, if we may be so bold, hope will help readers in some small way to protect and build wealth during the decade ahead.

Jordan Eliseo,  
Chief Economist, ABC Bullion



# 2016

## A Brief Review of the Year that Was!

Political black swans dominated the news agenda, and the attention of investors and financial market commentators for most of 2016. It was only a matter of time before the decline in support for mainstream parties and centrist politics across the developed world, which began in earnest in the aftermath of the Global Financial Crisis, showed up at the ballot box (see chart below).

### Erosion of the Political Centre



Source: Barclays Research. October 2016

For better or worse, 2016 will be remembered as the year we finally reached a tipping point, with election and referendum results on both sides of the Atlantic that only a few years ago

would have been entirely unimaginable to the vast majority of the population.

Given this backdrop, 2016 was an unsurprisingly turbulent year in financial markets, though investors who were able to ignore the temptation to buy and sell assets during periods of heightened volatility should have fared relatively well, with calendar year returns for 'balanced' investment strategies in Australia returning close to 7%.

Equities started the year on the back foot, falling circa 10% in local terms, with the ASX dropping well below 5,000 points by early February 2016, mirroring the weakness that was evident in bourses across the globe, with the S&P 500 dropping below 1850 points at the same time.

Concern regarding a potential financial crisis in China, and a negative reaction to the unexpected implementation of NIRP in Japan, plus fears over the then pending Brexit referendum and US Presidential election, all contributed to the early 'risk off' sentiment witnessed in 2016, which also saw gold and silver jump out of the gate with strong gains in the first three months of the year.

*"It was only a matter of time before the decline in support for mainstream parties and centrist politics across the developed world, which began in earnest in the aftermath of the Global Financial Crisis, showed up at the ballot box."*

But in a textbook case of "sell the rumour, buy the fact", a win for the Brexiteers, the Donald's against the odds victory in the US presidential election, and a No vote in Italian referendum ended up being great buying opportunities for risk assets. In the US, the Dow Jones is flirting with the magical 20,000 point level, whilst the Australian share-market is now some 22% higher than its February 2016 lows, with the vast majority of the gains coming after the US election, with a particularly strong performance from the big banks and other financials.

So strong has the rally in risk assets been in the aftermath of the Trump victory that well over USD \$100 billion flowed into US equity ETFs in the last two months of 2016. To put that number into perspective, inflows of that magnitude were equivalent to some 7% of total fund assets. USD \$100 billion is also more than one and a half times the value of the circa USD \$60bn in US equity ETF inflows seen across all of 2015, according to TrimTabs CEO David Santschi, who wondered "who's left to buy" in an environment where "investor appetite for US equities is seemingly insatiable".

Bond yields, which had hit a low around 1.40% (US10yr Treasuries) in the aftermath of Brexit, have risen almost non-stop ever since, hitting 2.60% by mid December 2016. Fixed income assets weren't the only defensive plays under pressure in the aftermath of the Trump victory, with precious metals, despite still recording gains of 9% for gold and 16% for silver across the course of calendar year 2016, also selling off in the final two months of the year, with huge outflows from gold ETFs in particular.

Heading into 2017, and consensus opinion appears to be that:

- Interest rates in the USA will head meaningfully higher
- Economic growth, inflation and bond yields will rise
- The USD will continue to appreciate whilst precious metals will continue to fall
- Risk assets like equities are the place to be

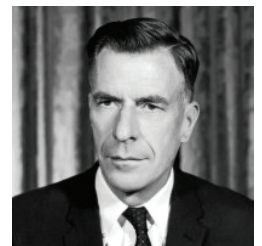
Whether or not this is what transpires across the course of this calendar year remains to be seen, though we are somewhat sceptical, with January 2017 seeing record levels of short interest in US bond futures, which at the very least would suggest a pause in the post Trump Treasury slump is overdue. Regardless, what happens in the next 12 months is not the primary concern of this research piece, which is instead focused on the "End of Easy Money", and the outlook for investors over the next decade, with a specific section dealing with Australia, and Australian investment portfolios.

Before beginning this report, it is only fair that we provide a disclaimer, though as we are not in the business of managing or promoting financial products, it is not the standard "past returns are no guarantee of future returns", "please read the PDS" or "be sure to speak to a licenced adviser" variety of disclaimer.

Instead, we've decided to include two of our favourite quotes to do with economic forecasting and investing, which we think are particularly relevant today, both for Australian individuals managing their own wealth, and for the finance professionals who are entrusted to protect and to grow the lifesavings of their clients.

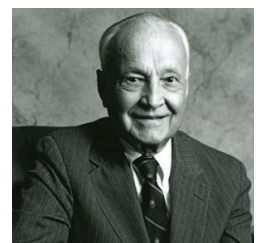
*"There are only two types of forecasters. Those who don't know, and those who don't know they don't know."*

**John Kenneth Galbraith**



*"The four most dangerous words in investing are: 'This time it's different.'"*

**Sir John Templeton**





# The "End of Easy Money"

## What it's Not

Ask most people what they mean when they talk about "Easy Money" in an investing context today, and you'll usually get an answer that focuses on two primary factors, namely the introduction of very low to negative nominal interest rates, and the implementation of a variety of money printing programmes (or "quantitative easing" for those who enjoy seeing pigs wearing lipstick), across much of the developed world.

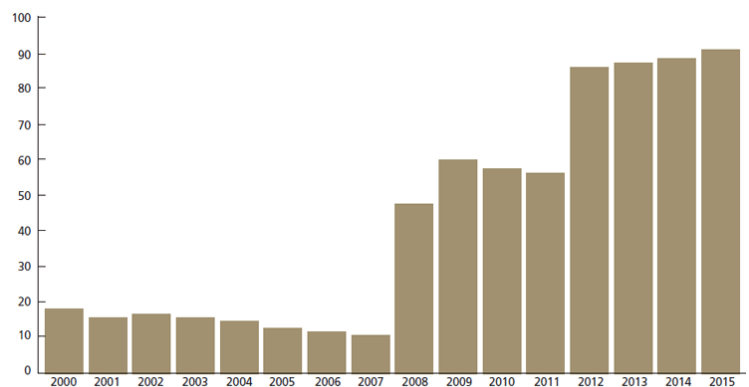
Previously the sole domain of African dictators and firebrand South African revolutionaries in ill-fitting army suits, these two forms of monetary policy extremism have become the norm in the "post" GFC world, with financial markets essentially hooked on a permanent dose of monetary stimulus.

Indeed, data released in late 2016 by JP Morgan Asset Management suggests that the world's top 50 central banks have cut rates some 690 times since the fall of Lehman Brothers, which works out at a rate cut every three trading days.

Given this largesse, it should be no surprise that by 2015, some 90% of the industrialized world was

anchored by 'real' cash rates close to or below zero percent, according to analysis undertaken by Gluskin Sheff (see chart below).

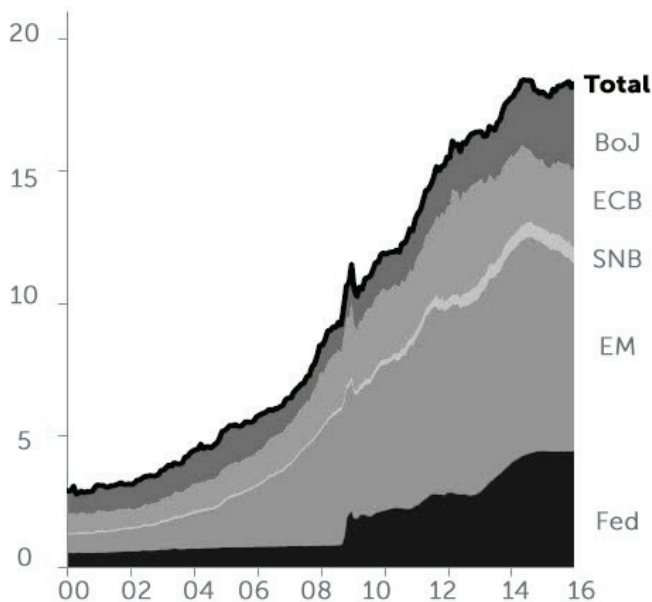
Share of Industrialised Economies GDP with Policy rates near/below zero



Source: IMF, Bloomberg, Harver Analytics, Gluskin Sheff

On the money printing front, the almost perpetual balance sheet expansion that we've seen by the Fed, the ECB, the SNB, the BoJ, the BoE, the PBOC, and a range of other emerging market central banks since the GFG hit is evident in the chart below.

### Central Bank Assets - USD \$ Trillion



Source: Citigroup, National Central Banks, Not FX adjusted

As you can see, in the past few years, the better part of USD \$15 trillion in "wealth" has been created out of thin air by the world's major central banks. This money has been used to purchase a variety of financial assets, from US treasuries and agency backed securities, to European government bonds, JGBs and even ETFs in Japan, where the BoJ is now a top 10 shareholder in 90 percent of listed firms, according to JP Morgan.

The pace of balance sheet expansion shows no major sign of slowing any time soon, with the ECB and the BoJ currently in the drivers seat. By the middle of 2016, collective central bank stimulus was averaging close to USD \$200bn a month, a staggering number that actually exceeded the pace and value of money creation that we saw during the supposed peak of the financial crisis way back in early 2009.

In essence, Mario Draghi and Haruhiko Kuroda are printing the entire economic output of Australia, and then some!

Whilst question marks regarding the efficacy of low to negative real interest rates and money printing continue to grow, this is not the kind of "Easy Money" we think will soon come to an end.

Indeed, we see even more extreme monetary policy on the horizon, including further reductions to the already record low cash rate in Australia, as well as more money printing and yield curve targeting in Europe, the UK, Japan and even the USA, where the Fed may have to reverse course to assist a US economy that is now late cycle.

Even more troubling, it appears likely that the drum-beat to eliminate high denomination bank notes will only grow louder in the coming years, an act of financial repression that is sadly being cheered on by a variety of financial commentators and journalists who are in effect carrying water for an already omnipotent financial establishment.

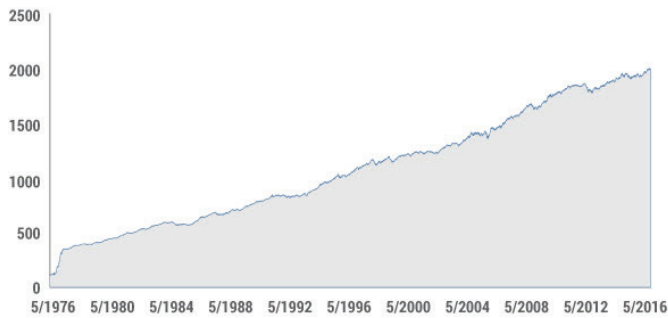
### What is Easy Money?

The admittedly rather boring graph on the next page sourced from Bill Gross's June 2016 investment outlook titled "Bon Appetit" is what I'm talking about when I discuss the "End of Easy Money". It highlights the performance of the Bloomberg Barclays Capital US Aggregate bond index, which has delivered investors a compound annual return of 7.47% for 40 years, with little volatility along the way.

When one stops to think about it, it is quite extraordinary to think that one could have compounded wealth for four decades straight at close to 7.50% per annum, with little volatility and zero equity market risk, especially as real US GDP growth averaged just 2.80% per annum over the same time period.

*"Indeed, data released in late 2016 by JP Morgan Asset Management suggests that the world's top 50 central banks have cut rates some 690 times since the fall of Lehman Brothers, which works out at a rate cut every three trading days."*

### Barclays Capital US Aggregate Total Return Value Unhedged



Source: Janus Capital Group, Bloomberg

Equity markets, despite their substantially higher volatility, have also been incredibly kind to investors over the this timeframe, with compound returns of closer to 10.50% per annum according to the same market update from Bill Gross that the above chart was sourced from.

There is a long list of reasons that help explain the strong equity market performance of the past four decades, including favourable demographics and the concomitant decline in dependency ratios, a quadrupling of the female labour force participation rate (relative to the late 1960s), productivity gains, trade globalisation and the re-emergence of China onto the world economic stage, declining rates of inflation, falling interest rates and perhaps most importantly, the veritable explosion in private sector debt levels which accompanied the democratisation of credit.

A less frequently discussed but still important contributor to this period of equity market strength has been the slashing of corporate tax rates across the OECD. Starting at close to 50% in the early 80's, company tax rates are barely half that today. That is an extraordinary (and non-repeatable) decline that is responsible for some 30-40% of the real market EPS growth we've seen during this time frame, according to fund manager and ex Wilson HTM quant strategist Damien Klassen.

The seemingly perpetual deficits run by developed market sovereigns, especially in the United States, which act as an effective subsidy to private sector earnings, have also been a factor.

Finally, we've seen significant multiple expansion in the past 40 years. Back in 1976 investors in the S&P 500 were only willing to pay a price of eleven times cyclically adjusted earnings, a

number that is some 35% below the long run average.

It proved a good entry point!

### That was Then - This is Now!

The long list of factors that helped drive the exceptional returns investors have earned on financial assets across the last 40 years have largely run their course, portending lower returns in the future.

Sovereign bond markets have no chance of repeating the returns of the past forty years in the period ahead, with Gross's June 2016 article suggesting yields would need to drop to -17% (no, that is not a misprint) to replicate the returns of the past.

Indeed, based on current yields, sovereign bonds are almost certain to disappoint investors in the next decade, with a May 2016 research piece by McKinsey titled "Why Investors May Need to Lower Their Expectations", suggesting that returns for US and European bonds across the next two decades will likely range between 0% and 2% at best. Those numbers might sound shockingly low relative to our immediate past, but they are actually in line with historical averages for the past 100 years, so would be in no way unusual.

The outlook for equities is equally challenging, with a handful of the factors that helped drive gains in the past four decades now turning into headwinds, as the table below illustrates.

### Factors Driving Equity Market Returns

Factors Driving Equity Market Returns	Last 40 Years	Decade Ahead
Productivity gains	Tailwind	Neutral
Declining Interest Rates	Tailwind	Neutral
Increased Female Labour Force Participation	Tailwind	Neutral
Declining Corporate Tax Rates	Tailwind	Neutral
Free Trade and Support for Globalisation	Tailwind	Headwind
Demographics	Tailwind	Headwind
Private Sector Debt Expansion	Tailwind	Headwind
Valuations	Tailwind	Headwind

Source: ABC Bullion

Demographics and elevated private debt levels will limit economic and therefore earnings growth going forward. Interest rates will likely stay low

for years to come, but the largest part of the decline is clearly behind us. The same can be said for the huge decline in corporate tax rates, even if the Trump administration does succeed in pushing one last cut through.

Inflation is close to record lows now, but will almost certainly head meaningfully higher across the course of the next decade, whilst the political winds have now definitely changed course, and for some time are likely to blow in an anti "free-trade" (as society has come to understand it) and globalisation direction.

Productivity, company earnings (as well as GDP and employment growth for that matter) will also be negatively impacted going forward by the paucity of business investment we've seen across the developed world in the past decade. This is perhaps the least widely discussed negative side effect of the record low interest rate policies embraced by central banks the world over in the aftermath of the GFC, which have encouraged companies to sacrifice their future in two key ways.

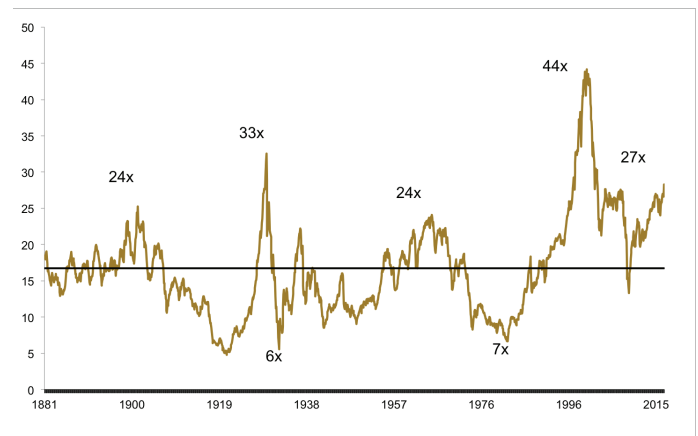
Firstly, record low rates have forced boards to prioritise ever higher dividends to satisfy yield dependent investors, with payout ratios at or near all time highs the world over, whilst debt-funded stock-buybacks (which are cheap given current borrowing costs) have been the easiest way to get an earnings boost, a temptation that has proved impossible to resist in an environment where genuine sales driven growth has been sadly lacking.

*"Beginning 2017 at 27x CAPE, stocks are some 60% more expensive than the long run average (16.5x), and fast approaching nosebleed levels. Indeed, the only two times stocks were more expensive than they are today were back in 1929, just before the Great Depression hit, and in 1999, just before the tech bubble burst."*

Higher payout ratios and stock-buybacks do nothing to promote earnings growth over time. They also arguably leave balance sheets in a more fragile state than they would otherwise be, especially when, as per a Barclays research note from late 2016, US companies are paying out more in dividends and stock-buybacks than they are generating in free cash-flow.

More important than any of the above factors when assessing potential returns for the decade ahead is valuation, and the current multiple investors are paying to own stocks today. As discussed earlier, back in 1976, when this incredible era for financial asset returns began, investors were paying just over 10 times earnings to own stocks. That is a much more conservative multiple compared to the price investors in 2017 are paying for equity ownership. This can be seen clearly in the chart below, which plots the cyclically adjusted price earnings ratio (CAPE) for the S&P 500 over the past 100 plus years. It also shows the earnings multiple investors were paying at key bull market tops and bear market bottoms over this time period, and the long run average.

### S&P 500 Cyclically Adjusted Price Earnings (CAPE) Ratio - 1881 to 2016



Source: Shiller CAPE, Yale

Beginning 2017 at 27x CAPE, stocks are some 60% more expensive than the long run average (16.5x), and fast approaching nosebleed levels. Indeed, the only two times stocks were more expensive than they are today were back in 1929, just before the Great Depression hit, and in 1999, just before the tech bubble burst.

To illustrate just how hard it's going to be to make money in equities in the decade ahead, consider the table below, which highlights the CAPE levels and the "real" price for the S&P 500 at previous market peaks. It also displays CAPE levels and "real" prices 10 years later, as well as the returns generated by equity markets over these periods.

### S&P500 CAPE Peaks and Subsequent 10 Year Returns

CAPE PEAKS			10 Years Later			
Year	CAPE	S&P 500 "Real" Price	Year	CAPE	S&P 500 "Real" Price	10 Year Return
1901	24.41	262.03	1911	14.75	256.51	-2.10
1929	32.56	437.76	1939	16.45	219.13	-49.94
1966	24.06	710.40	1976	11.19	421.51	-40.64
1999	44.20	2053.93	2009	20.32	1244.10	-39.43
2016	26.89	2271.72	2026	??	??	??

Source: Shiller CAPE, Yale, ABC Bullion

As you can see, it is not a pretty story, with 10 year "real" price returns that were at best essentially flat (after 1901), or down somewhere in the vicinity of 40-50%. Remember too that these are the full 10-year returns, which assume an investor didn't panic and sell at an inopportune time. At their worst, drawdowns throughout these periods were between 55-80%.

There is no way to gloss over this. You can make a bullish "there is no alternative" argument for stocks based on negative real yielding cash accounts and close to record low yields across the majority of the fixed income spectrum, but market history is very clear that buying into equity markets at current valuations has ALWAYS proved a bad entry point given a ten-year investment

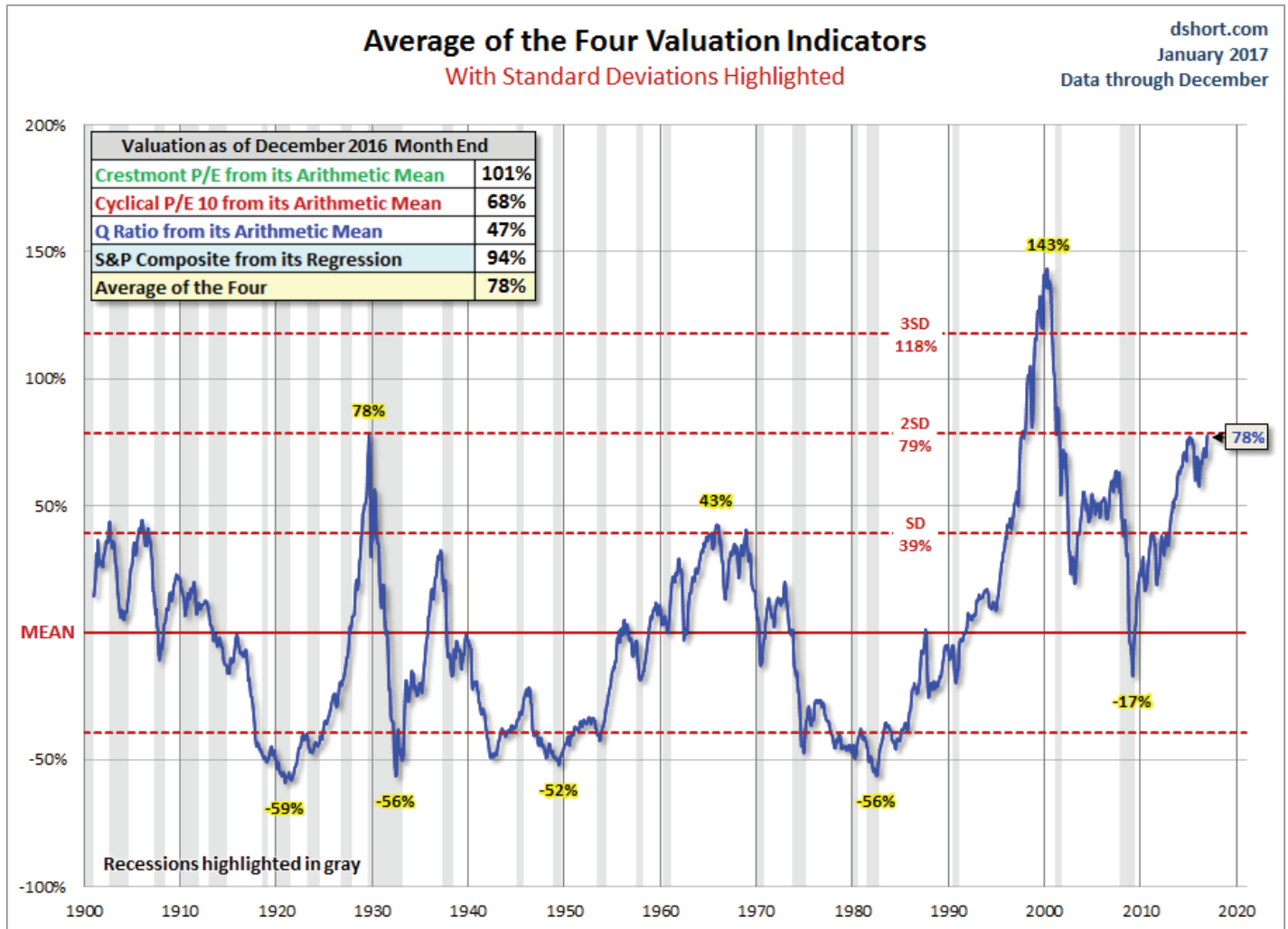
timeframe. Therefore, unless "this time is different", market returns are likely to be highly constrained between now and the middle of the next decade.

It's not just looking at stocks through the CAPE ratio lens that suggest stocks are expensive either. Warren Buffet's supposedly favourite indicator, the Market Cap to GDP ratio, as well as the Q ratio (total price of market divided by replacement cost of all companies), also suggest the market is extremely expensive.

Analyst Doug Short, who runs a monthly market valuation based on four separate indicators, suggests that the market is almost 80% above "fair value" today.

*"The history books are likely to end up recording that this 'golden age' of investment returns in financial markets as one that was unbelievably rewarding, but ultimately abnormal, and most importantly, unsustainable."*

Valuation Indicators for US Equity Market



Source: Doug Short

Forty years of exceptional returns, and a healthy dose of recency bias has understandably caused many an investor, adviser and asset manager to believe that returns of 7.50% per annum for low risk assets and +10% per annum for equities and other growth assets are now 'the normal'.

But the history books are likely to end up recording that this 'golden age' of investment returns in financial markets as one that was unbelievably rewarding, but ultimately abnormal, and most importantly, unsustainable.

The era of easy money is over!



## The Australian Story

Australian investors in financial assets have also enjoyed a 'golden era' in the past 40 years, with substantial increases in our local share market, and in domestic fixed income assets. In the four decades to end June 2016, the local stock market rallied by just over 12% per annum; whilst bond investors enjoyed annualised gains of closer to 10%, with substantially lower volatility.

Impressive as these returns have been, the real story in Australian investment, particularly for the past 25 years, has been in our residential property market, which is now valued at over AUD \$6 trillion, or well over three times the country's total annual economic output.

### Property – a Love Affair!

Property has been very kind to my family, with my Nonno (grandfather), able to achieve the dream of home ownership within a decade of arriving in Australia, way back in 1950.

Purchased for £3,000 in 1957, the house he bought is now worth closer to AUD \$650,000, a tidy return of close to 8% per annum for sixty years. Today, my cousin lives in that very same property, located in St Morris, Adelaide, where

she is busy raising the fourth generation of our family to follow in the footsteps of our Nonno and Nonna.

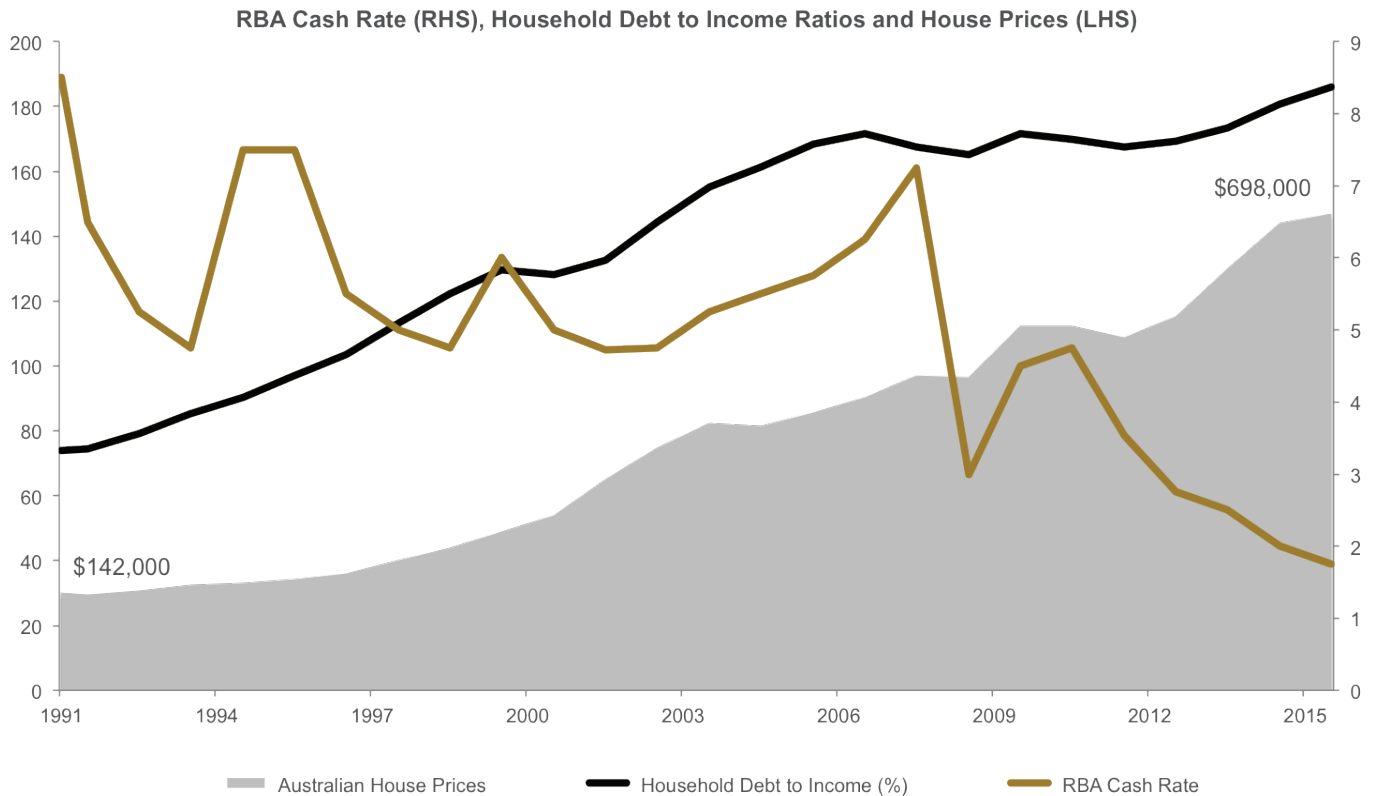
Our family has also been fortunate enough to participate in the boom in residential housing and in commercial property that has taken place across the past few decades, in a story that would no doubt closely reflect the experience of hundreds of thousands of migrant families who moved to Australia in the aftermath of WWII.

At a macro level, the story of Australian property, the impact it has had on our economy, and how things have changed in the past quarter century are perhaps best told through the next two charts, both of which cover the period December 1991 to end June 2016.

The first chart highlights the decline in the RBA cash rate over this period (gold line), which fell from 8.5% in late 1991 to 1.75% by June last year (it was over 15% in 1990), the incredible rise in Australian capital city house prices (grey shaded area), and the veritable explosion in private sector debt to income levels (black line), which have increased from barely 70% to over 180% in the past twenty five years.

Note that we've rebased the Australian house price data (sourced from the Real Estate Institute of Australia), to a starting index value of 30, so that the graph scales in an easy to read manner. In dollar terms, the average capital city house price has risen from AUD \$142,000 to AUD \$698,000 over this time.

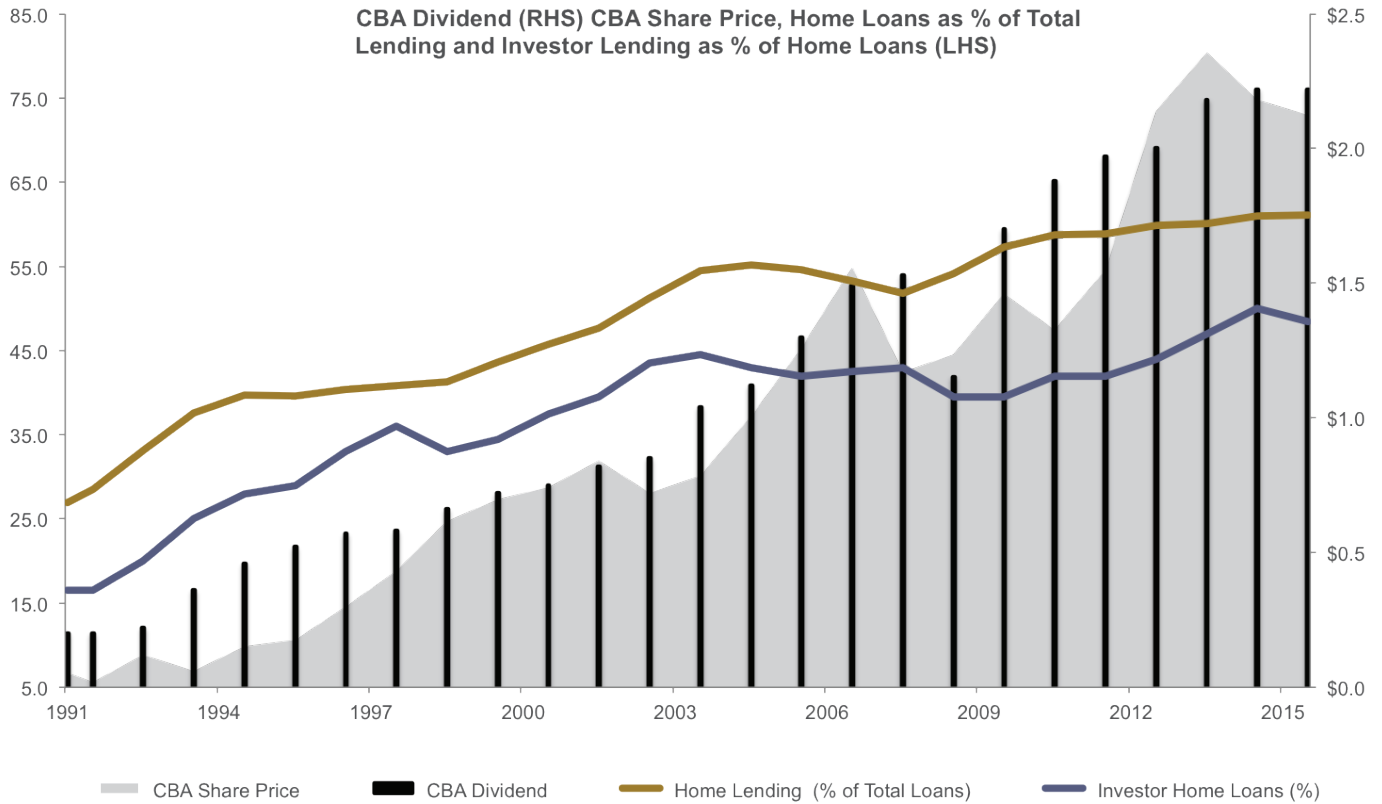
### Borrowing Costs, Debt Levels and House Prices



Source: RBA, ABS, Bloomberg, REIA, ABC Bullion

The second chart below highlights the incredible eleven-fold increase in both the CBA final dividend over this time period (black column chart), from AUD \$0.20 to \$2.20, and the share price of the stock itself (shaded area), which had risen from AUD \$6.64 to over AUD \$70.00 by end June 2016.

### CBA Dividend and Share Price plus Bank Lending Profiles



Source: RBA, ABS, Bloomberg, REIA, ABC Bullion

What an investment it has been!

Just as importantly, the graph above also plots the percentage of total bank loans that are directed toward housing (gold line), and how that has changed over the past 25 years, as well as the percentage of those home loans that are directed toward investors (blue line), rather than owner occupiers.

As you can see, home loans now comprise more than 60% of total loans, whilst investor loans as a percentage of home loans have essentially tripled, from 16.5% to 48.5%, over this time period.

The table below plots the start (December 1991) and end (June 2016) points for all the data points in the above two graphs, as well as the actual median capital city house prices for Sydney, Melbourne and Brisbane, the capital cities of the states which account for close to 80% of the Australian population.

### Australian Economic Data Points

Australian Economic Data Points	Dec-91	Jun-16
RBA Cash Rate (%)	8.5	1.75
Home Loans (%) of Total Loans	26.91	61.1
Investor Loans (%) of Home Loans	16.5	48.5
Household Debt to Income ratio (%)	73.97	185.99
CBA Final Dividend per share (\$)	\$0.20	\$2.22
CBA share price (\$)	\$6.64	\$72.95
Sydney Median House Price	\$183,000	\$1,023,000
Melbourne Median House Price	\$137,000	\$725,000
Brisbane Median House Price	\$121,000	\$495,000
Australian Median House Price	\$142,500	\$698,220

Source: RBA, ABS, Bloomberg, REIA, CBA, ABC Bullion

Gross rental yields for housing have also more than halved over the past two decades, now sitting at just above 3%, whilst the national house price to rent ratio is now over 30:1, according to data from Core Logic. Absent further capital gains, investors in Sydney property won't get their money back until 2052!

Now correlation does not necessarily imply causation as the saying goes, but the story of the above two charts and the table is very clear. And that story is that the incredible rise in property prices, as well as the rise in the share prices and dividends Australian banks have been able to deliver over the past two and a half decades, has been driven by a generational decline in borrowing costs, explosion in ever cheaper housing debt, and the concomitant change to the fundamental business model of our largest banks.

The housing supply shortage argument trotted out by many commentators has played a marginal role, but it is simply not credible to argue that it has been the primary driver of these developments.

*"The incredible rise in property prices, as well as the rise in the share prices and dividends Australian banks have been able to deliver over the past two and a half decades, has been driven by a generational decline in borrowing costs, explosion in ever cheaper housing debt, and the concomitant change to the fundamental business model of our largest banks."*

## What Happens Next?

There are two primary points worth communicating about the extraordinary developments we've seen take place in our housing market in the past twenty-five years.

The first of those is that whoever has benefitted from this price growth, either through direct property, ownership of shares in our largest banks, or some combination of the two, deserves to be praised for such a fantastically profitable investment. They've kept it simple (I mean that as a compliment), backed a consistent winner, and reaped the rewards!

The second point is that, just like the 'golden era' for financial asset price appreciation is almost certainly behind us, so too is the period of rapid Australian house price appreciation, and the dream run for Australian financial stocks.

When it began, Australia was coming out of a "recession it had to have", with a once in a century mining boom in our future, whilst compulsory superannuation was in its infancy. We had high cash rates, manageable if not low debt to income ratios and a banking industry that predominantly funded business investment, with home loan books dominated by owner-occupiers.

Today, Australian property is an entirely different proposition. After all, this is a market that is now:

- More reliant on debt-financed speculative investors than ever before
- Offering record low yields whilst asking for record high prices
- Subject to an extraordinary expansion of supply in the coming years.

The primary buyer of the asset (Australian citizens) has also never been more indebted, whilst today they also have a substantial portion of their financial wealth ring-fenced inside superannuation. They are also currently facing an era of higher underemployment and negative real wage growth, something that will likely continue for a large part of the next decade.

The changed profile of the property market itself, coupled with the different circumstances and objectives of the primary buyers of property are important points for SMSF trustees to be aware of.

Many trustees no doubt entered the property market decades ago as owner-occupiers, with conservative borrowing profiles. They sought 'the Australian dream', and a place to raise their families, not rapid wealth accumulation.

My parents, and especially my grandparents before them definitely fit this profile.

But the fact that many trustees aren't/never were highly leveraged property speculators dependent on cheap debt and constantly rising house prices doesn't alter the fact that the fundamental nature of the Australian residential property market has changed.

The marginal buyer is now a debt laden property speculator reliant on perpetual capital appreciation to justify their investment. Absent this, their love affair with property will sour very quickly, with profound ramifications.

One final factor worth mentioning is the fact that the regulatory environment, which could not have been more favourable to residential housing in the last two decades, will likely change in the years ahead.

Whether it's alterations to negative gearing rules, removing the exemption of the family home

from the assets test for pensioners, eliminating the CGT-free status of Australian owner occupied housing, a more stringent clampdown on foreign buyers, banning SMSFs from borrowing to purchase, stricter APRA regulations regarding the growth in investor loan books, altered risk weightings and capital requirements, or some combination of the above of course remains to be seen.

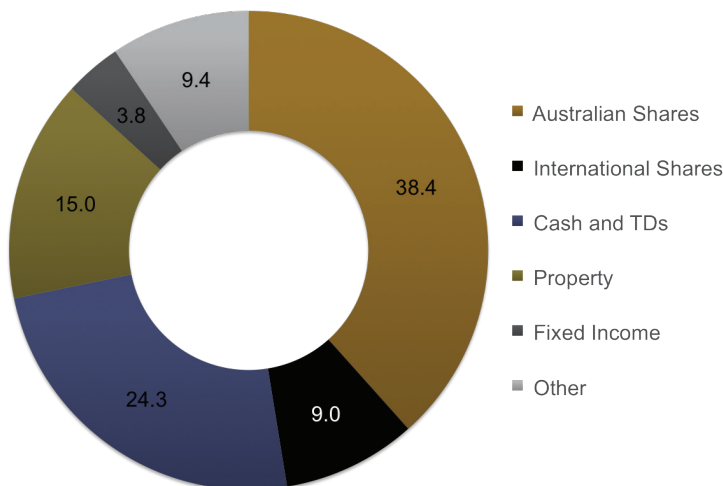
We are of course not suggesting that the government, the RBA or APRA will deliberately try to engineer lower prices, but some form of change is inevitable, and once made, it will not necessarily be as house price friendly as the current environment.

## Implications for Australian Investors

The change in the outlook for property investment poses a particular challenge for investors in Australia, including many SMSF trustees, whose portfolios today are, to one degree or another, heavily reliant on the continued health and growth of our housing market.

To visualise this, consider the pie chart below, which plots the average asset allocation for SMSF portfolios in Australia, based on data contained in a September 2016 survey by Class Super.

Australian SMSF Investment Portfolios



Source: Class SMSF Benchmark Report, asset class exposure based on look through analysis of managed fund exposure

*“Any declines in the housing market, or indeed even just a prolonged period of largely stable prices in nominal terms whilst wages, rents and inflation play catch up, will have a profound effect on the average Australian investment portfolio, as well as the overall financial position of many Australian households.”*

In essence, these portfolios, and the investors they belong to are primarily engaged in a combination of:

- Providing cheap loans to companies that are in the business of home loan creation (via cash accounts and term deposits lent to the banks)
- Owning the companies that create home loans (shareholdings in the Big Four and other financials)
- Directly owning the asset class that the loans are funding (property ownership inside the SMSF, but especially family homes and investment property held outside of superannuation, with data from Digital Finance Analytics suggesting as many as 40% of SMSF trustees also own an investment property outside their SMSF)

Investment in this house price boom has been fantastically profitable, as discussed earlier, but one need not be a rampaging property bear to recognise that a more challenging environment lies ahead. Indeed, there are no shortage of warning signs today, including the circa 10% price declines seen in the Perth residential market in the last few years, the record levels of supply coming to the market on the East Coast (with a growing number of anecdotal stories about the sweeteners developers struggling to move stock are now offering), and the uptick in vacancy rates we’re seeing in parts of the country.

Research also suggests that today, close to 25% of Australian mortgage holders are in some form of mortgage stress, and would struggle to cope with rate hikes of even fifty basis points.

Any declines in the housing market, or indeed even just a prolonged period of largely stable prices in nominal terms whilst wages, rents and inflation play catch up, will have a profound effect on the average Australian investment portfolio, as well as the overall financial position of many Australian households.

Interest rates will almost certainly have to decline further, reducing the already record low returns on cash and term deposits, whilst a combination of an increase in non-performing loans and/or flat to negative earnings will almost certainly lead to lower share prices for banking stocks. Critically, it will also put pressure on the dividend payouts the banks are currently delivering, a repeat of what happened during the GFC, when the CBA for example cut their dividend by 25%.

Considering the enormous weighting to financials in the ASX 200, it's hard to envision a sustained bull run in the overall equity market should a scenario of flat to falling house prices come to pass in the coming years.

SMSF trustees and the professionals helping them protect and build wealth should keep these challenges front of mind when reviewing and constructing an appropriate portfolio for the decade ahead.



## Exter's Pyramid and Physical Gold

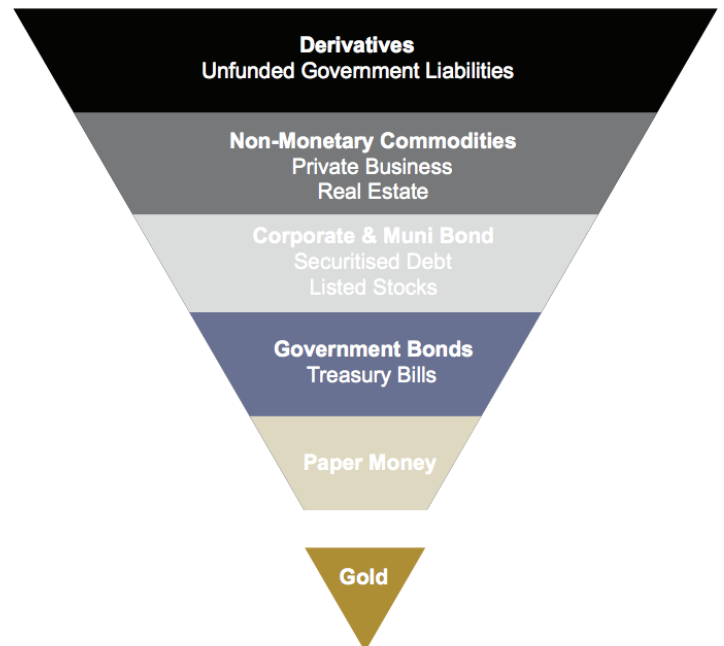
Born in 1910, John Exter was a Harvard and MIT trained economist. He had a distinguished career that included various stints working for the Federal Reserve, the International Bank for Reconstruction and Development, and First National City Bank, where he was a Vice President (at a time when that title actually meant something).

He is perhaps best known for Exter's pyramid, a version of which is to the right. As you can see, it plots the various asset classes that make up the financial system (stocks/bonds/cash/derivatives) as well as other assets (private real estate and business) that individuals can choose to invest their capital in.

In essence the lower down the pyramid the safer the assets, whilst the assets further up the pyramid are typically the most risky, not only in terms of the risk of permanent capital loss, but also volatility and liquidity.

Private business and especially residential real estate are exceptions to some degree, in that whilst they're potentially illiquid (especially in difficult times when credit is constrained), they are not necessarily volatile on a day to day basis, with there also being little chance real estate will decline to zero value.

Exter's Pyramid



Source: Agora Financial, ABC Bullion

We think investors and advisers would do well to think of Exter's pyramid when they consider asset allocation decisions for the decade ahead, as it is arguably a much more useful way of visualising risk and return compared to the standard risk on x-axis, return on y-axis graphs that we've all seen.

In normal times, paper money should be able to earn a modest "real" return, with zero volatility and no downside risk. Decisions to re-allocate capital from "paper money" up the pyramid as it were, into assets like bonds, stocks, real estate and even private business are therefore able to be made from a position of safety, with a return premium required to compensate for the higher risk.

Today, at its most basic level, what extremist monetary policy has done, and will continue to do, is remove the "safety" of paper money. By guaranteeing that investors will lose real purchasing power if they stay in paper money, central banks have forced investors up the pyramid, in search of returns, either via capital appreciation, cashflows, or some combination of the two.

The problem of course is that with valuations where they are, and with yields on most assets at or close to record lows around the world, there is a real risk that investors are jumping out of the frying pan (paper money) and into the fire (financial assets).

## The Base of the Pyramid

And so we come to physical gold and precious metals more generally, which have been the largest asset class holding in my portfolio for over a decade now. I own gold for a number of reasons, including the fact that it:

- Historically outperforms financial assets in low 'real' interest rate environments like the one we're stuck in today
- Is typically the best performing defensive asset in environments where risk assets like shares decline, a factor that is likely to be highly useful considering current valuations in equity markets
- Is a simple, tangible investment that is highly liquid and easy to trade and to store
- Is a natural foreign currency play, giving me a chance to benefit should the Australian dollar fall in the years ahead.

But I also own physical gold because it lies at the very base of Exter's pyramid. The price may be volatile on a day-to-day basis now (unlike in Exter's day when money was officially linked to gold), but that only affects precious metals over the short-term, as anyone whose studied gold price returns since 1971 will attest.

The fact that investment demand from Western investors, including SMSF trustees, has grown as strongly as it has for the last few years, suggests more and more people are recognising these positive attributes, with ABC Bullion surveys suggesting trustees are allocating 10-20% of their portfolios to the yellow metal.

None of us can predict the future, but we can all read a history book, and unless "this time it's different", gold can't default like a corporate bond or an equity holding can, and it won't lose purchasing power over time like paper money is designed to.

*"Physical gold, as a highly liquid, internationally accepted, zero credit risk monetary asset with infinite duration; unencumbered wealth in its purest form, seems the simplest of safe haven investments that will act to protect capital over the course of the next decade."*

Instead, physical gold, as a highly liquid, internationally accepted, zero credit risk monetary asset with infinite duration; unencumbered wealth in its purest form, seems the simplest of safe haven investments that will act to protect capital over the course of the next decade.

The logic of a physical precious metal allocation within a well-balanced portfolio makes even more sense when one considers the fact that the price of real assets (like gold) relative to financial assets (stocks/bonds) reached a 90-year low in 2016, as per the chart on the next page from Bank of America Merrill Lynch.

### Ratio of Real Assets versus Financial Assets



Source: Bank of America Merrill Lynch, Global Financial Data, Bloomberg

As you can see, by the end of the 1970s, when assets like gold and oil were in a bubble,

whilst stocks could be bought for closer to 10 times cyclically adjusted earnings, the price of real assets relative to financial assets was closer to all time highs. It would have been a great time to sell gold, and invest in financial assets.

You can also see how different the picture is today, and how cheap real assets are on a relative basis.

Given there is no real asset that is easier to include in a portfolio than physical gold, history would suggest it stands to rise appreciably in the next decade, as investors seek protection from both the frying pan and the fire!



## Implications for Investors and Advisers

We make no apologies for the cautious tone this research note carries regarding the challenging climate investors face, with even the most optimistic of credible forecasters expecting lower returns from financial markets in the decade ahead.

Considering current valuations, the unresolved economic challenges, our extreme monetary environment and the political risks that grow by the day, we wouldn't be surprised at all if most financial markets deliver nothing in real terms over the next 10 years, with downside risks to that forecast.

Be that as it may, there is still plenty that investors and advisers can do. Below is a list of final observations, key takeaways, and potential suggestions that may be of some use, with the reminder that this report has been written with a 10-year view.

### 1) Prepare for the Worst

At the very least, investors and advisers would be prudent to prepare for the next decade as if it will be a zero-sum game. Don't build in real return projections of 8-10% per annum for 'balanced portfolios'.

That way, if on the off chance "this time really is different" and markets successfully navigate the record debt levels we currently face, the money printing, the record low to negative interest rates, the lack of business investment and the historically high valuations, and the next 10 years are a continuation of the last 40, then you'll be pleasantly surprised.

### 2) Advice is Going to be More Important than Ever

Whilst some might argue that the kind of market environment I've described in this report will make life harder for financial advisers and other professionals in the sector, I take the opposite view.

In a world where the financial pie no longer grows like it used to, or indeed doesn't grow at all, then the specialist skills of those who can give genuine value add advice, be it around asset allocation, manager or investment theme selection, and especially around tax and strategic planning, will come to the fore.

*“Considering current valuations, the unresolved economic challenges, our extreme monetary environment and the political risks that grow by the day, we wouldn’t be surprised at all if most financial markets deliver nothing in real terms over the next 10 years, with downside risks to that forecast.”*

Obviously advisers merely charging fund based fees whose business models are in effect reliant on a rising stock market are going to find it a lot harder in an environment where financial asset returns are unlikely to be kind.

Be that as it may, I see the role of advisers as becoming more, not less important, in the coming years, with an ever changing and more complex regulatory environment contributing to this trend.

Advisers can and will also play a critical role helping clients with some of the additional takeaways below.

### 3) Reassess Risk

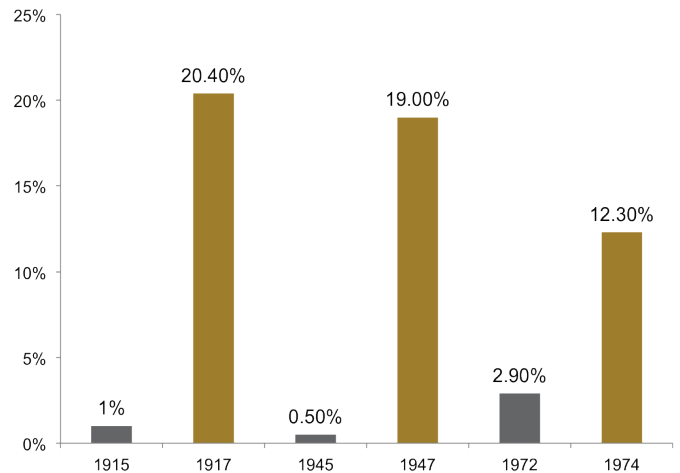
Last year, Callan Associates published research highlighting the fact that investors looking for returns of 7.5% per annum today would need to take on three times more risk compared to 20 years ago, as measured by standard deviation (or volatility) of total portfolio returns.

Whilst this was a useful report highlighting how much more difficult it will be to generate solid returns in the future, the more important fact investors need to be aware of is that volatility is not the only measure of risk they will need to deal with in the coming decade. The risk of higher inflation risk will almost certainly be a factor, as will credit risk, income risk, and liquidity risk on select investments.

And these risks can flare up remarkably quickly, with a study by Incrementum AG, a European based asset manager, highlighting how inflation rates in the USA skyrocketed in just 24 months

in the periods between 1915-17, 1945-47 and 1972-74 (see chart below).

**Inflation Rates Changes Across Two Year Periods**



Source: St Louis Fed, Incrementum AG

Similar results, with inflation spiking to the upside, have been recorded in Australia, with inflation rising to 15% in 1915 from essentially zero in 1913, from 2% in 1946 to over 10% by 1948, and to 15.4% in 1974, after starting the decade at just 3.4%.

**Australian Consumer Price Inflation Rates**

Year	Inflation Rate	Year	Inflation Rate
1913	0.1	1915	14.8
1946	2.0	1948	10.48
1970	3.4	1974	15.4

Source: Reserve Bank of Australia

It mightn’t feel like much of a threat today, but history shows that inflation dynamics can change very quickly. Food for thought if you’re considering locking money away for 3-5 years in a term deposit at some point during 2017.

To visualise another risk, consider the fact that debt in Lehman Brothers was still trading at 80 cents on the dollar right up until the day it went to zero cents in the dollar.

An extreme example indeed, but an illustration of how credit risk can turn seemingly safe assets from "worth less" to "worthless" in 24 hours.

Different assets are obviously more susceptible than others to these various risks. As such, when designing a portfolio, investors and their advisers would do well to judge each asset, and their portfolio as a whole, on a risk matrix that accounts for all of these factors, as well as the correlation and interplay between the various assets they might hold.

For reference, we've included the following table, which lists how we assess the major risks for six primary asset classes, including precious metals. This can serve as a guide for investors and advisers, though of course one might choose to use a numbering system (0-10) rather than zero/low/medium/high, and include other asset classes like REITS and listed infrastructure too.

Asset Class Risk Table

Risk Factor						
Risk Matrix	Volatility	Inflation	Credit	Income	Liquidity	Valuation
Cash	Zero	High	Low	Medium	Low	n/a
Bonds (Treasury)	Low	High	Low	Low	Low	High
Bonds (Corporate)	Low	High	Medium	Low	Medium	High
Equities	High	Medium	Medium	Medium	Medium	High
Property	Low	Low	Low	Medium	High	High
Gold	High	Low	Zero	Zero	Low	n/a

Source: ABC Bullion

Note that in the table above, the assessments are based on how we perceive that risk affecting the particular asset class in the decade ahead, therefore cash is low risk from a liquidity perspective (because it is highly liquid) but high risk from an inflation perspective.

Individuals and their advisers would also do well to assess each of these risks in terms of how important they are to their individual circumstances. For example, as I'm in my late 30's with the better part of three decades in accumulation phase ahead, volatility and income risk are of little concern to me personally, though valuation risk is something I'm particularly concerned about.

#### 4) Learn to Master Volatility

Even though as per the point above, volatility is not the only risk investors will need to navigate, it is the one that has traditionally plagued investors, who are prone to panic and sell out of assets at low points, all the while chasing other markets after they've already moved higher.

## Investor vs. Index Returns

Timeframe	Investor Returns	S&P 500 Index Return	Relative Performance
5yr	6.92	12.57	-5.65
10yr	4.23	7.31	-3.08
20yr	4.67	8.19	-3.52
30yr	3.66	10.35	-6.69

Source: DALBAR, 22nd Annual Quantitative Analysis of Investor Behaviour

For evidence of this, consider the table above, which comes from DALBAR, a research house specialising in quantitative analysis of investor behaviour. Using data to the end of 2015, the table highlights the 5 year, 10 year, 20 year and 30 year returns for US equity investors, compared to that of the S&P 500 itself.

As you can see, across the past three decades, a 'golden era' for financial markets, equity investors have dramatically underperformed the index.

Irrespective of which timeframe we look at, we see the same story emerge, with a 30 year return that is comfortably less than half of what the index returned.

This is an important point to consider, for if individuals are prone to panic even in the very best of investing time periods, then one can't help but fear what kind of decisions they'll make during a less rewarding era for markets.

Mastering, or at the very least learning to stomach volatility, and the impact it has on the actual investment decisions one makes, will be critical to protecting wealth in the decade ahead.

### 5) Asset Allocation will Remain Critically Important

Asset allocation is not going to get any less important in the years ahead, though it will not necessarily be easy to construct a genuinely diversified portfolio.

After all, across the vast majority of the past four decades, stocks, bonds and real estate have all strongly outperformed inflation, and their longer-run historical averages. Even cash has benefited from the three-decade decline in

inflation rates. If it can all go up together, then it can most assuredly go down together too.

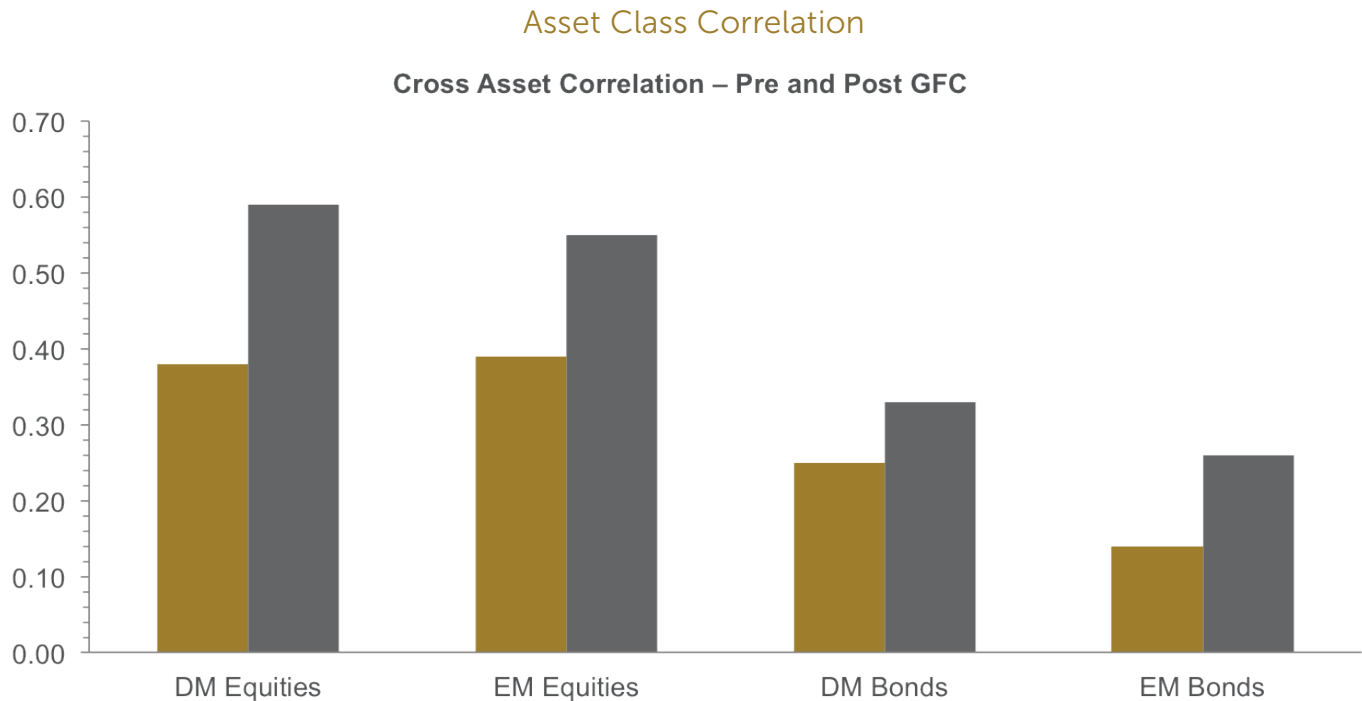
The difficulty in achieving genuine diversification is not just due to the questionable outlook for financial markets in the next decade. Another major factor is the fact that cross asset correlations have been on the rise for more than two decades. This subject was discussed in a great JP Morgan study from 2011 that highlighted the fact that the average correlation between 45 developed and emerging market equity benchmarks index had doubled in the previous 20 years.

Considering high levels of correlation typically point to a common source of risk, it should be no surprise that since the GFC, the trend of rising correlations has only become further entrenched, with markets more driven than ever by changes in monetary policy, as well as political developments.

*"Considering high levels of correlation typically point to a common source of risk, it should be no surprise that since the GFC, the trend of rising correlations has only become further entrenched, with markets more driven than ever by changes in monetary policy, as well as political developments."*

Correlations between equities and other asset classes (FX, commodities, fixed income) were also on average more than twice as high in the 5 years to end 2010, relative to readings seen in the first 5 years of the 1990s.

The chart below illustrates this clearly.



Source: Bloomberg, BT Financial Group Investment Forum 2015

At the end of the day, anyone can select a range of different asset classes to spread their money around, but that may not end up achieving much at all if those assets are highly correlated in extremis.

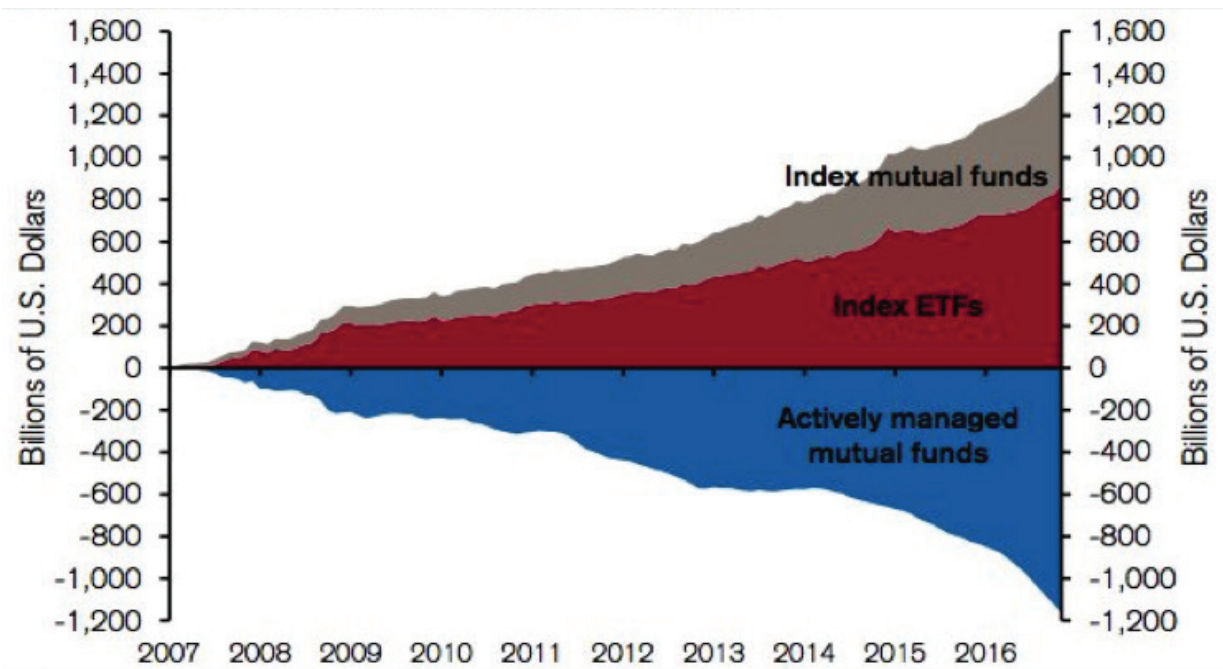
Investors and advisers looking for real diversification and genuinely robust portfolios must look for assets that are uncorrelated to financial markets.

## 6) ETFs and Passive Investments are Cheap – But You Get What You Pay For

We are fans of ETFs. They provide low cost access to financial markets, competition to active managers (many of whom have added little real value), and have opened up investment opportunities that would otherwise be entirely closed, or prohibitively expensive for many investors to access. There has also been significant innovation in the ETF space of late, with a variety of products that do more than passively replicate a particular index.

Having said that, we are concerned about the seemingly insatiable appetite for low cost passive investments on display today, with an article in the Financial Review from December 2016 highlighting a USD \$370 billion rotation from active to passive strategies in the USA. This is in many ways an acceleration of a trend that has been on display since the GFC hit, with a Credit Suisse research piece (which included the chart on the next page) from January 2017 stating that since the end of 2006; "investors have withdrawn nearly \$1.2 trillion from actively managed US equity mutual funds and have allocated roughly \$1.4 trillion to US equity index funds and ETFs".

## Flows from Active to Passive Investments in US Equities



Source: Credit Suisse, "Looking for Easy Games" – January 2017

We've seen a growing appetite for these kind of products in Australia too, with a Betashares report from January 2017 pointing out that the Australian ETF market had hit AUD \$25.8 billion in FUM, small beer in comparison to America, but it represents a nonetheless impressive compound annual growth rate of close to 30% for the period 2004-2016 inclusive.

As I said earlier, we are not anti-ETF or passive management per se, but at the very least, we think investors and their advisers should take note when you see headlines in the financial news media like "Exchange traded funds are taking over the world", with ETF aficionados talking about the "manifest destiny" of their products taking over the investment industry.

Indeed, in early January 2017, Vanguard CEO Bill McNabb posted an article on his company's website titled "Is Active Management Dead?", which highlighted the soaring popularity of index funds and passive investments.

We are particularly concerned considering current valuation levels. Personally, I'd be more than happy buying an ETF that tracks the S&P 500 if the market was trading below 10 times earnings.

But it's not. It's over 25 times CAPE today. A yield focused passive ASX ETF is more or less a play on Australian housing and bank stocks.

Obviously you can access that exposure cheaply, but in my opinion it's unlikely to be particularly rewarding in the decade ahead.

Likewise for the bond market. It's very unlikely the next ten years will mimic the last 40, where you could have just gone long a basket of treasuries and enjoyed positive real returns for decades with minimal volatility. If ever there was a market where you wanted to pay for expertise and specialist skills, then the fixed income market is surely that place today.

## 7) Keep it Simple Wherever Possible

Investors today are spoilt for choice. Irrespective of whether we are talking about direct stocks, international shares, commodity funds, managed funds, ETFs, derivatives, direct bond ownership, infrastructure, REITS, private equity, hedge funds, or precious metals, all of it is now available and accessible. Today, you can even buy fractional units in Australian residential property, or choose to have the spare change from your morning coffee purchase automatically invested into a range of diversified portfolios designed according to the principles of Modern Portfolio Theory.

Despite this seemingly never-ending menu of investment choice, we think investors and advisers will be better served keeping things as simple as possible in the years ahead.

This will be easier said than done, for as this paper has made clear, the equity and fixed income markets are unlikely to be kind to investors in the coming decade. You'll need to think about which stocks and sectors to avoid, as well as which ones to concentrate capital in.

Investors and their advisers will need to specialise, and work with expert managers in these areas to give themselves a good chance of protecting, let alone growing capital in these asset classes.

From a personal point of view, this is one of the reasons that I like owning physical gold. Provided you are buying an investment grade gold bar from an accredited refiner, which any investor, irrespective of their budget can do, then gold is the simplest of all investments.

## 8) Don't Panic and Make Wholesale Changes

There is obviously no shortage of economic clouds on the horizon, nor risks for financial market investors to navigate in the decade ahead. Be that as it may, individuals needn't panic. There is no need to rush out and sell the family home, nor divest all of one's shares in the big four banks.

Instead it's about making prudent and well thought out adjustments where necessary, so as to construct a portfolio that is better able to withstand the difficult environment ahead. Based on average SMSF allocations today, that could involve some combination of the following:

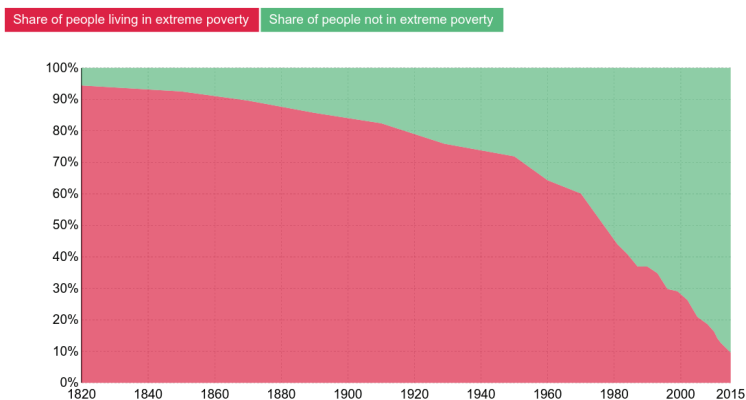
- Looking to decrease cash holdings over time, though do not ignore it as a tactical asset which can still play a role in a portfolio
- Review equity positions, with a possible switch to active, benchmark unaware fund managers for some portion of the equity allocation within a portfolio
- Increase physical precious metals exposure (it's still 0% for most investors)
- Increase fixed income exposure, but in a very targeted way, using expert help.

## 9) Lighten Up – the World is Awesome

"Whether it's the best of times or the worst of times, it's the only time we've got." – Art Buchwald

If you want a simple way to visualise how awesome the world is, and the progress we've made, consider the chart below. From Our World in Data, it shows the number of people living in extreme poverty as a percentage of the total population, and how that has changed over the last two centuries.

### World Population Living in Extreme Poverty – 1820 to 2015



Source: *Our World in Data, World Bank*

Humanity has seen similar progress when it comes to things like the decrease in rates of child mortality, massive increases in literacy rates, and the percentage of people living in democracies, which despite their flaws, still Trump all the alternatives (pun intended), as Churchill famously alluded to.

Life is pretty good!

As such, despite the challenges we're going to face in financial markets and in the global economy over the next decade, most people reading this report, who will undoubtedly be in the wealthiest 5-10% of the population already, are going to be A-OK, and should have much to look forward to.

Wishing you every success!

*Jordan Eliseo  
February 2017*



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With live pricing and online valuations, ABC Bullion offers unparalleled access to the global bullion market.



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- Low transaction costs with no storage fees
- Ability to top up or sell your metal back to ABC Bullion
- Ability to convert your Gold Saver holdings to physical metal at anytime.

The ABC Bullion Gold Saver is the perfect choice for first time bullion investors or for parents and grandparents looking to start a savings plan for their children and grandchildren.



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