

create, accumulate, protect

**Economic Review**  
1<sup>st</sup> Quarter 2011

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## **1. Executive Summary**

- **2010 was characterised by a solid rebound in global economic activity (+4.7%), although not all countries enjoyed similar experiences.**
  - Structure of the European Union in terms of how the influence each country can exert on its interest rates and public expenditure has been a contributing factor to current issues in Portugal and Ireland and will likely require amendment.
  - A country's Terms of Trade (TOT) are a strong measure of its financial living standards. Australia's TOT has never been higher and has recently reversed a downward trend over the past century.
- **In the long run, house prices and rents can't stray too far from people's income.**
  - In the US between 1970 and 2000, the house price to rent ratio reverted to its long run average four times.
  - Australia currently ranks 4th and 2nd respectively of the countries tracking above their long term house price to rent and income averages.
  - Between 2007 and 2009, Australia was one of just four countries not to experience residential house price falls, largely due to our low unemployment rate.
  - Future movements in residential house price will likely be driven by the unemployment rate, interest rates and government policy.
  - We do not typically recommend that clients invest in residential property as equivalent expected returns can be generated from other asset classes that offer superior liquidity, greater diversification and lower transaction and holding costs.
- **Our preferred approach of investing client fixed interest funds via wholesale managed trusts adopting the Asset Class investment approach has also produced higher returns than alternatives such as term deposits, bank bills and online saving accounts over the past one, five, seven and 10 years.**

If you have any concerns or wish to discuss your financial position or investments, please do not hesitate to contact us.

## 2. Economic Review

### The Global Economy

2010 was characterised by a solid rebound in global economic activity (+4.7%), although not all countries enjoyed similar experiences.

Whilst many developing economies, particularly in the Asian region, were significant outperformers, many developed nations saw only modest growth in consumer spending and housing market activity. These two sectors are crucial to many economies, particularly in the U.S where consumer demand comprises 70% of the economy.

Consumer demand relies on consumer confidence. In the U.S, low interest rates are an attempt to encourage businesses to employ more people, which underpins consumer confidence.

Whilst the U.S economy has grown for five consecutive quarters and the recession 'officially' ended in June 2009, unemployment remains just below 10%. This statistic contributed to a recent poll that showed 74% of Americans still didn't believe the recession had ended<sup>1</sup>.

### Worries Persist for Some

It's human nature to view our present or future situation through the prism of recent experiences. Many fear that every little dip in markets is a prelude to the next collapse.

But good news is becoming more prevalent.

In the U.S, retail sales are up 7.3%. The Dow Jones index is up 70% from 2009 lows. Most large company balance sheets have never been in better shape. China's growth is moderating towards a more sustainable 8.5% pa.

However, public indebtedness remains a growing concern, particularly for the U.S and many European economies. Many wonder how successful the massive bail out packages have been in fixing problems exacerbated by the GFC.

Ireland was recently bailed out by the European Union (EU), but is now paying the EU an interest rate of 5.8% pa which is likely to be higher than economic growth, causing its debt/Gross Domestic Product (GDP) ratio to continue to grow. A devaluation of Ireland's currency would help make its exports more competitive to stimulate economic growth, but being part of the Euro currency means this is not an option.

### Challenges in Europe

A root cause of Ireland's current mire is how the EU operates.

Each member country of the EU has the power to control its own fiscal policy (e.g. government spending), but cannot control its own monetary policy (e.g. interest rates). So over the past decade when low EU interest rates were prudent for its largest economy, Germany, they were a disaster in Ireland where the economy was particularly strong. As a result, cheap debt fuelled an Irish property bubble that has spectacularly exploded and resulted in massive bank losses.

Whilst these matters present a medium term challenge for Europe, there remain larger, longer term issues to be confronted.

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<sup>1</sup> CNN Research Poll, September 2010

The main issue is government pension schemes, which are simply not sustainable. The table below illustrates the ageing populations of the five largest EU economies<sup>2</sup>:

Total		Over 65		Over 65 as % Total	
Today	2060	Today	2060	Today	2060
309M	331M	89M	149M	29%	45%

The rising number of pensioners is why France has recently been trying to raise the retirement age for its citizens by two years to 62 (still below Australia's 65), as future welfare liabilities can't be funded by a smaller population of workers/taxpayers.

And which country has the most sustainable pension system in the world? Australia is the answer, thanks to our compulsory superannuation system.

Whilst public finances paint a sorry picture in many countries, the global corporate sector is looking increasingly robust. The morality of this situation so near to the end of the GFC may be perverse, but it is the reality we are left with. One way or another, the public debt hangover needs to be resolved.

The build-up of debt was caused by developed economies using cheap and readily available funds to buy goods and services from the developing economies. The solution now appears to be the cashed up developing economies spending their wealth for the benefit of all.

### The Australian Economy

The continuing strength of Australia's major trading partners, namely China & India, has provided a huge boost to the domestic economy.

In 2009, China accounted for 46% of global coal consumption and used twice as much crude steel as the EU, US and Japan combined<sup>3</sup>. In 2010, China will account for 20% to 25% of world growth and will buy more mobile phones than the rest of the world put together.

Australia's challenges will be stark compared to the EU – how to manage our prosperity?

The increasing importance of Australia's resources boom in our growing prosperity is evident in our terms of trade (TOT).

Our standard of living is impacted not just by the value of our physical output – as measured by GDP – but also by our purchasing power relative to the rest of the world. TOT measures export values relative to import values.

In a recent speech, Reserve Bank of Australia (RBA) Governor Glenn Stevens<sup>4</sup> gave a wonderful example of how our TOT is impacting our economy.

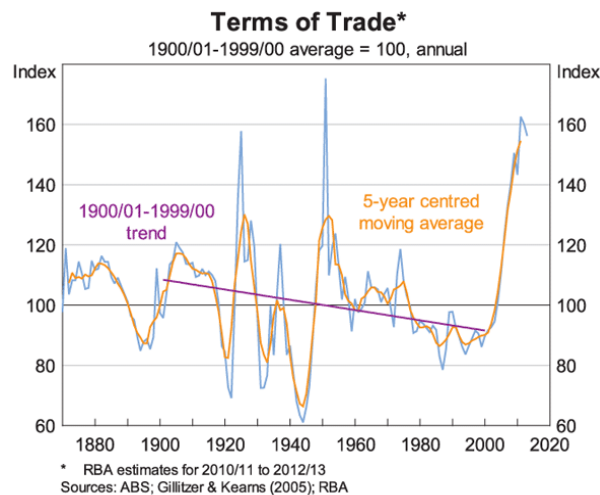
In 2005, one ship load of iron ore going to China was worth 2,200 flat screen TVs coming back the other way. Today, due to the surge in iron ore prices and falling price of TVs, one ship load of iron ore is equivalent to 22,000 TVs. That's a 900% improvement in five years.

The general point is that all other things being equal, a rising TOT raises our financial living standards. Australia's TOT has never been higher and has recently reversed a downward trend over the past century, as the graph below highlights:

<sup>2</sup> Germany, France, UK, Italy & Spain

<sup>3</sup> The Economist Magazine, 28 October 2010

<sup>4</sup> The Challenge of Prosperity – Glenn Stevens 29 November 2010



Whilst part of this higher income goes to foreign investors, a good proportion remains with local shareholders, employees and the government via taxes.

It is difficult to determine if the rise in TOT is permanent or temporary, but past peaks have not proven sustainable. This raises the issue of whether the current large investment in resource extraction will be profitable if commodity prices fall. The RBA is anticipating a 30% fall in iron ore prices in the medium term. Despite this, the RBA foresees a prominent role for the resources sector over the long term.

The strength of mining investment and the limited spare capacity in the economy – as evidenced by an unemployment rate nearing 5% - has caused the RBA to continue to lift interest rates. Higher rates have recently dented household confidence, resulting in people saving almost 9% of their income today, compared to -1% five years ago.

However, a moderation in consumer spending and housing investment is not necessarily a bad thing, as it provides room for mining investment without overheating the economy, which would lead to further interest rate rises.

Australia's economy is truly a standout in the developed world at present. However, importantly we must remember that no connection exists between a country's economic growth outlook and the performance of its equity and bond markets. For that reason, maintaining a diversified portfolio that includes exposure to Australia, U.S, Europe, Japan and the emerging markets remains as prudent as ever.

### **Happiness Index**

Although the U.S is experiencing growing GDP, consumer sentiment remains subdued. You could conclude that economic prosperity doesn't necessarily make people happy.

The UK Prime Minister David Cameron agrees. He has requested the Office of National Statistics devise a 'Happiness Index' to measure the British public's wellbeing, stating that 'there's more to life than money'. France and Canada have launched similar initiatives.

Measuring a country's progress beyond solely GDP statistics sounds like a great idea to us.

### 3. Investment Market Review

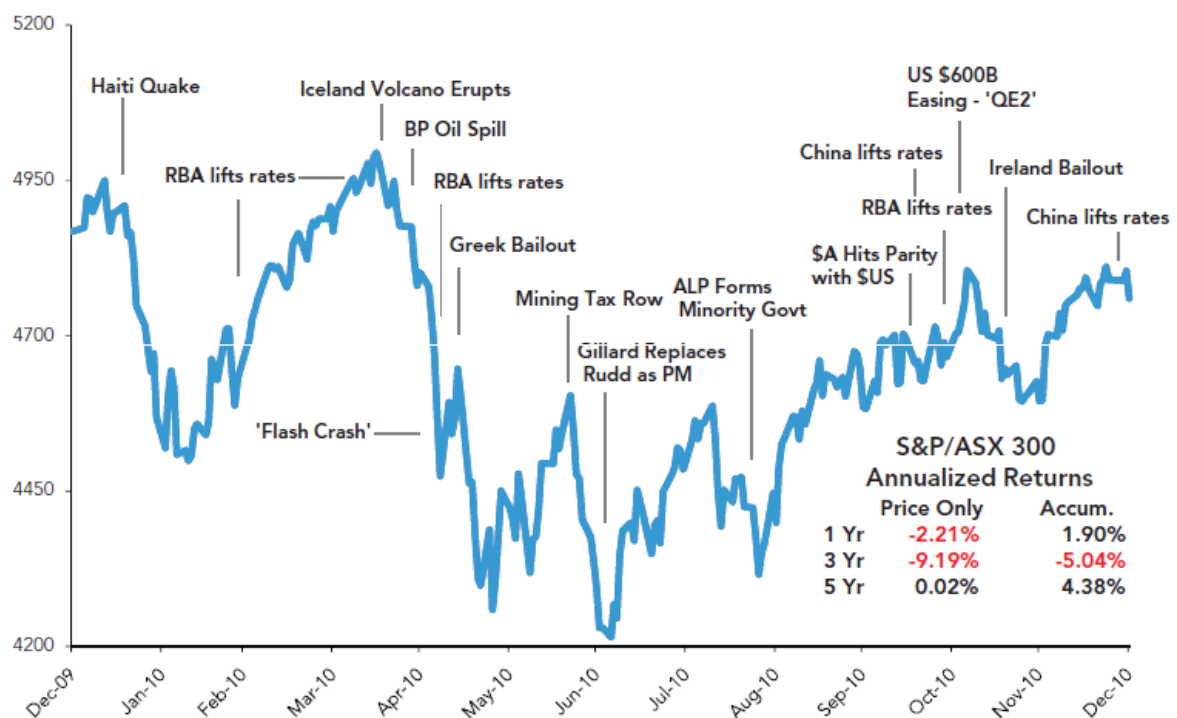
The second year coming out of the GFC was more mixed than in 2009, as investors looked for convincing signs of economic recovery in the US and Europe and were worried about the legacy on public balance sheets of the bank bailouts. On the positive side we had the continued resilience of emerging economies, most notably China and India.

Stocks performed well in most countries in 2010 despite fears of a double dip recession, particularly in the US. Of the 45 major countries, 37 posted positive sharemarket returns in 2010. Including dividends, the Australian stockmarket rose 1.9% in 2010. In the US, the S&P 500 Index (being the 500 largest companies) rose 12.8%.

Whilst the 100 largest Australian companies rose only 0.8%, Australian small companies shone in 2010 to be the best performing asset class globally. The ASX Small Ordinaries Index was up 13.1% in 2010.

The graph below overlays the major events of 2010 against the performance of the Australian ASX 300 Index:

#### AUSTRALIAN STOCK MARKET PERFORMANCE S&P/ASX-300 Index with Major Events during 2010



Source: Dimensional Fund Advisers

The Australian dollar was the second best performing currency against the US dollar in 2010, reaching parity for the first time since being floated in 1983. It also hit record highs against the euro and 25 year highs against the pound sterling. These gains were fuelled by Australia's higher relative interest rates, the ongoing strength in commodity markets and local economic concerns in the US, Europe and Britain.

If we exclude currency impacts from returns, Australian large (and mostly blue chip) companies were the worst performing asset class in 2010. This is an example of why style diversification, i.e. including small companies and international equities in a portfolio, is essential.

Further support for diversification is evidenced by the 5 and 10 year returns of fixed interest securities. Despite our relatively high interest rates in Australia at present, international bonds have outperformed Australian bonds over these periods.

Our preferred approach of investing client fixed interest funds via wholesale managed trusts adopting the Asset Class investment approach has also produced higher returns than alternatives such as term deposits, bank bills and online saving accounts over the past one, five, seven and 10 years.

A hedged international share portfolio returned 10.4% in 2010, which was significantly higher than the Australian market despite our robust economy. This outcome supports the academic research that shows no link between a country's economic growth and the performance of its bond or equity markets.

Despite the uncertain economic recovery in the U.S, it is worth noting that U.S mutual bond funds had the largest client withdrawals in more the 2 years in the week ending 15 December 2010 – totalling US\$8.62bn – on investor optimism and expectations of higher interest rates in 2011<sup>5</sup>.

As an example, the 10 year US Government Treasury Note yield rose from 2.49% on 4 November 2010 to 3.35% on 22 December 2010. Note that as yields rise, bond prices fall. This is why the December quarter experienced small falls in fixed interest returns for longer dated securities.

Unfortunately for investors moving funds out of these bond funds, they had already incurred these bond losses and missed the gains in the stockmarket. **This is further evidence of why investors need a skilled and knowledgeable adviser to help them determine how much risk they need to take with their investments to achieve their ideal life, establish an appropriate target asset allocation and then remain disciplined with their investments over the longer term.**

Please refer to our Quarterly Performance Reporting graphs for further information on investment market returns to 31 December 2010.

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<sup>5</sup> 'Bond Investors Pull Most Money in Two Years', Bloomberg, Charles Stein, 22 December 2010

## 4. Investing in Residential Property

The past year has seen a spike in media attention pointing to Australia being amongst the most expensive housing markets in the world. This conjecture gains greater prominence against a backdrop of house price corrections in many developed countries over the past three years.

Whilst Australia has avoided substantial house price corrections to date, it is hard to dispute that our housing isn't expensive relative to historical measures. This paper focuses on current issues with investing in residential property as an asset class.

### Background

We all need somewhere to live, and most of us opt for the peace of mind of owning our own home rather than renting, especially as one's residential property is not subject to capital gains tax. Familiarity with 'bricks and mortar' leads many people to favour including residential property in their investment portfolio.

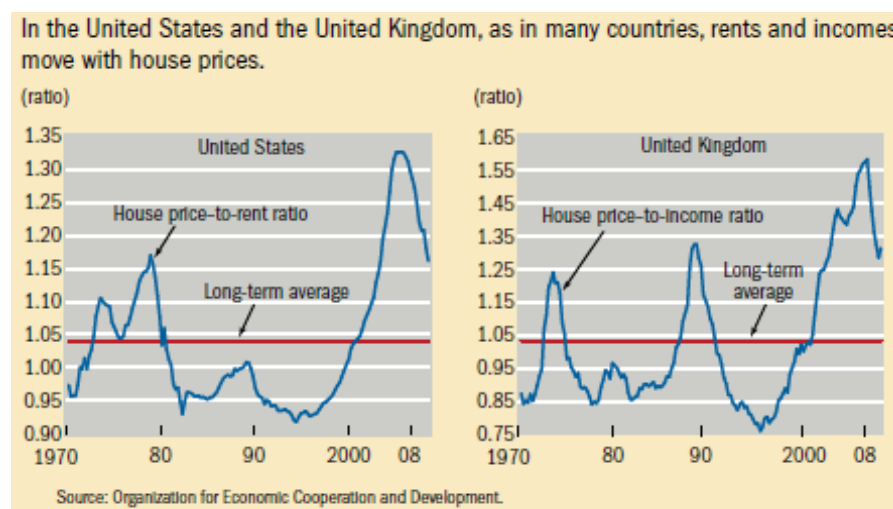
In Australia, 1 in every 3 new mortgages currently arranged is for investors<sup>6</sup>. Glenn Stevens, Governor of the Reserve Bank of Australia (RBA), has warned against the widely held assumption that 'a low risk, easy, guaranteed way to prosperity is just to be leveraged into property'. This assumption is not helped by the common view that property prices in Australia never go down.

### Economic Theory on Residential Property Prices

Economic theory asserts that over the long run house prices, rents and incomes should move in tandem. Why? Consider house prices and rents first.

Buying and renting are alternate ways of meeting our basic need for shelter. Therefore in the long run, house prices and rents can't stray too far from people's income.

In the US between 1970 and 2000, the house price to rent ratio frequently returned to its long run average, i.e. since 2000, the ratio of house prices to rent rose dramatically above the long term average, but has since started to move back towards the average as illustrated below (left):



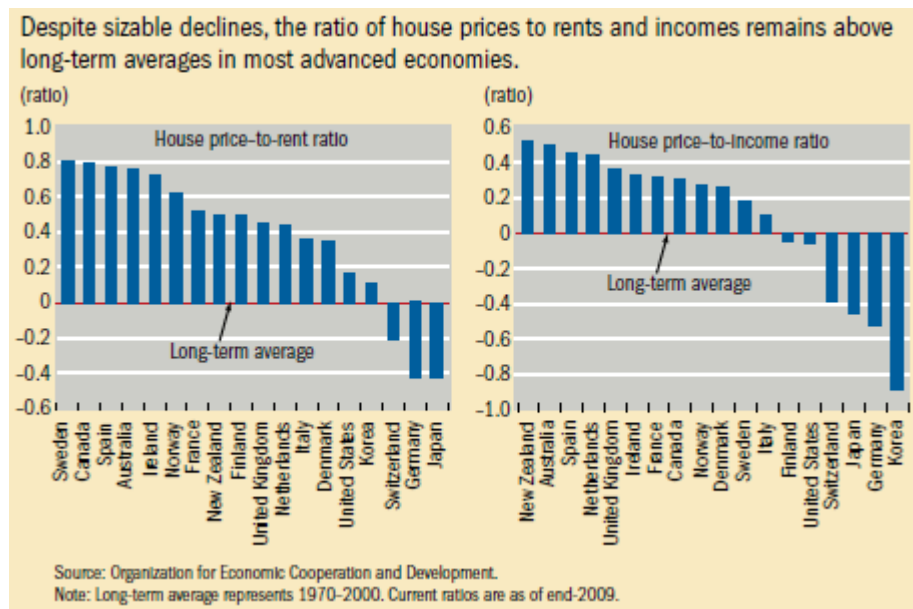
The graph (right) also illustrates that in the UK over the same period, the house price to income ratio has regularly reverted back towards the average.

Although 40 years of data is not extensive, it does suggest the long run average relationship acts as an anchor, whilst over the short term house prices drift away strongly and for long periods.

<sup>6</sup> The importance of property, Simon Moore, IFA Magazine Issue 531

One reason that house prices can increase rapidly is that the supply of housing cannot be adjusted quickly. Another is the interaction of housing and financial markets. Because houses serve as collateral, increase in house prices can have a feedback effect: once collateral values increase, banks are prepared to lend even more to households, which feeds the price boom.

The graph below shows the house price to rent and income ratios for developed economies compared to their long term averages as at December 2009. Australia currently ranks 4<sup>th</sup> and 2<sup>nd</sup> respectively of the countries tracking above their long term average.

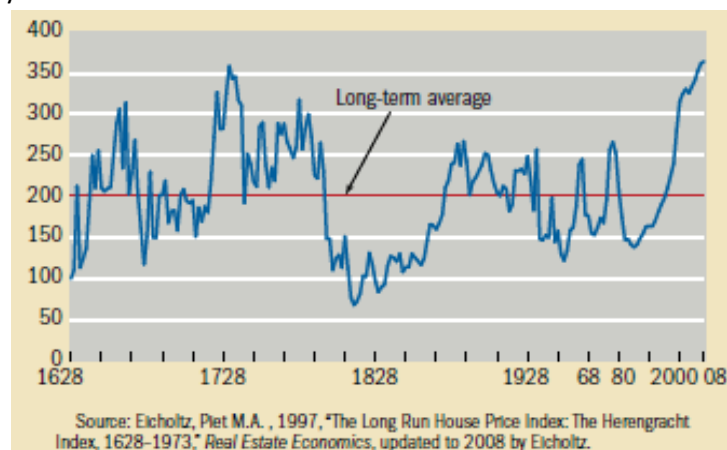


It would be helpful to look at house price data that extends beyond a period of 40 years. Fortunately some data does exist.

### Long Term House Price Growth

From a historical perspective, it is not the trend but the volatility in housing prices that is distinctive.

The longest history of house price data available is from the Herengracht neighbourhood in Amsterdam, dating from 1625<sup>7</sup>. Up until 1970, house prices in this neighbourhood had only grown in line with inflation, which means no real growth was experienced. Since 1970, the rapid growth in prices has caused the real price growth rate over the past 375 years to double – which is still a very modest investment return. And whilst no price trend has been evident, there have been numerous cycles as shown below:



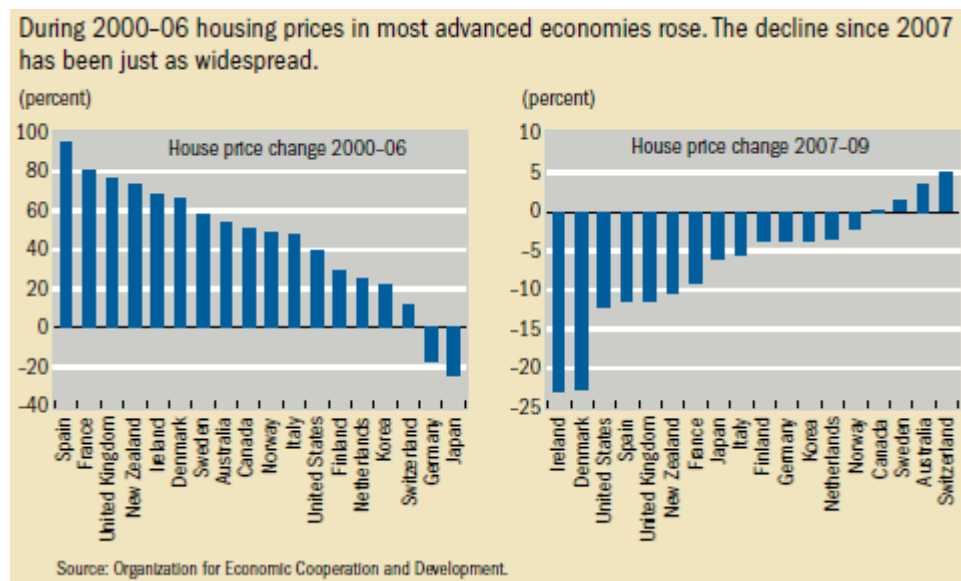
<sup>7</sup> Finance & Development, March 2010 – Prakash Loungani

Whilst prosperous economic times raised house prices, the inevitable shocks knocked prices back down. Some countries that have experienced strong price shocks in recent times include:

- In Norway, a country with limited available land to develop (a similar story we hear in Australia), real house prices declined between 1900 and 1950, and only recovered to their 1900 level just before 2000<sup>8</sup>;
- In the UK, from 1955 to 2000 real house price growth was only 1% - and this includes London.

Closer to home, real house prices in Melbourne didn't surpass their 1891 peak until 2001.

In more recent times, the GFC has caused substantial house price falls in many countries, reversing the gains in the first half of the past decade as illustrated below:



Between 2007 and 2009, Australia was one of just four countries not to experience price falls, largely due to our low unemployment rate.

The ability to moderate house price cycles is important for economic stability. According to the RBA, housing accounts for 60% of Australian household assets and 58% of the total loan book for the Big Four banks. Therefore volatile house prices have a significant flow on effect through the economy.

The RBA is particularly interested to see the supply of housing increase in Australia to ward off further strong house price growth.

### How to Value a Property

When assessing whether a property is overpriced, you must first determine how a property should actually be valued.

That leads to a fundamental question – do property valuers actually *value* a property or just *price* them?

If you think about how a share is valued, it is based on the present value of expected cashflows adjusted for the risk of the underlying asset. The same methodology is applied to fixed interest securities and listed property trusts.

<sup>8</sup> 'Long-run house prices', The Australian, 23 May 2010

Residential property could be valued in the same manner, but typically isn't. What a property valuer will do is look for similar priced properties that have recently sold in the neighbourhood and then make adjustments up or down based on the relative qualities of the property. The subsequent final price is an estimate of what the property may sell for in the near future. This is not a true asset valuation process.

An estate agent in the U.S operating in a lower socioeconomic area that has experienced substantial falls in house prices over the past three years recently remarked that 'dwellings may be valued only on the rental income they offer to landlords, as the potential buyers of the property may not be offered finance [by the banks]<sup>9</sup>.

Whilst presented as a revelation, perhaps it's indicative of an asset class where prices have broken free of economic reality, but are now returning to it.

### **What causes Cycles in House Prices?**

In any asset class it is difficult to determine whether price rises reflect expected returns for taking investment risk or are a 'bubble' until after the fact.

Two of the primary drivers of house prices are the unemployment rate and interest rates. In an environment of low interest rates and low unemployment, the ensuing confidence often drives house prices higher.

However, government policy is often cited as the primary driver of step changes in house prices. Over the past 30 years in Australia, three particular policy announcements drove price changes:

1. In the late 1980s, house price growth was driven by the tax deductibility of negative gearing (i.e. cost of borrowing exceeding cashflow). This boom ended when interest rates shot up to the high teens.
2. In the early 2000s, the first home buyer's grant was introduced. The net result was that house prices almost immediately adjusted for the increased purchasing power that first-time buyers now enjoyed.
3. Over the past two years, government stimulus packages for new housing slowed or reversed some of the price easing that appeared to be occurring in Australia.

### **Possible Future Australian Government Housing Investment Policies**

It would be futile to try and speculate what new government policy could impact house prices, for better or worse. However, with housing affordability in Australia becoming a larger issue, and 1 in 3 new mortgages being for investors, it is not unreasonable to consider the possibility of the government removing some of the incentives for investors to purchase residential property, which arguably does not stimulate or sustain economic activity such as manufacturing.

The removal of negative gearing and the 50% capital gains tax discount are policies that could gain momentum over the next decade for reasons detailed below:

- Returns from residential property investment are primarily built on the expectation of capital gains, as rental income frequently does not cover the costs of purchasing and maintaining the property.
- Australian Tax Office (ATO) data shows that the percentage of landlords claiming a rental loss (i.e. negative gearing) has increased from 50% to 70% over the past decade. Only 3% of loss

<sup>9</sup> 'Nail down the valuation first', SMH 4 December 2010

making properties are owned by taxpayers with taxable income of \$200,000 or more. Taxpayers who earn \$80,000 or less account for 80% of loss making properties.

- In 1988-89, 608,000 taxpayers reported rental income, but by 2007-08 this had increased to 1,765,000 taxpayers, or 13.5% of all taxpayers. This suggests a widespread belief that property is an excellent medium-term investment.
- The residential property rental market is a loss making affair after expenses are deducted from rental income generated. This means landlords are relying on house prices to continue to increase to generate a positive return.

A tax deduction can only be claimed where it directly relates to the production of assessable income. If residential property as a whole is generating no assessable income, then one could argue negative gearing should not be allowed.

Unlike investing in bonds and equities, where the capital is used by financial markets to support innovation and entrepreneurial activities, there is no net increase to society's standard of living from rising house prices. It is simply a wealth transfer from potential buyers to existing owners.

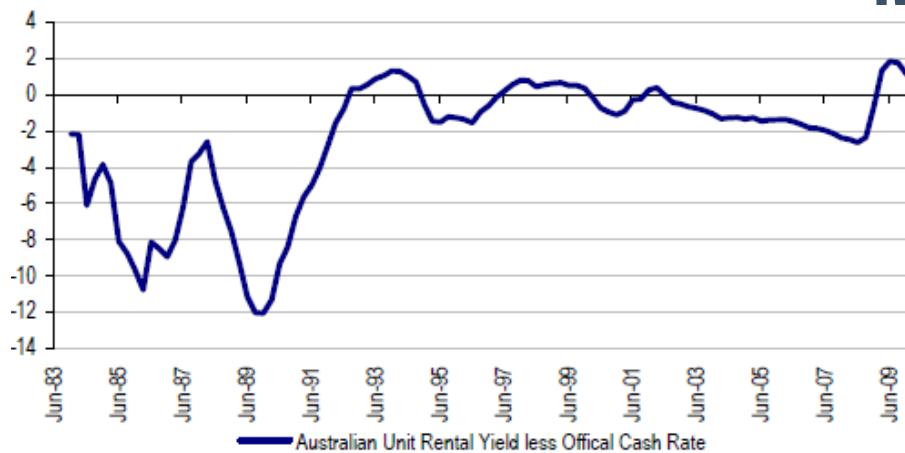
### **Residential Property investment attributes**

Australia's current negative gearing rules and 50% capital gains tax discount have encouraged many investors to include direct residential property in their investment portfolios.

Residential property shares many of the characteristics of real estate investment trusts (REITs). However, there are no reliable indices available that enable us to track the relative performance of residential property against other asset classes like shares over long periods of time. Differences in the quality and location of residential property further complicate matters.

At FYG Planners, we have a transparent investment philosophy framework that we use to invest our client funds that ensures they retain ownership. On balance, we do not typically recommend including residential property in an investment portfolio for the following reasons:

- Poor liquidity. We prefer gaining property exposure through highly traded REITS.
- Poor diversification. A residential property provides exposure to a single asset. Using REITS provides exposure to scores of underlying properties in a variety of locations and sectors, such as commercial, industrial, tourism and medical.
- Investing in REITs requires a smaller capital outlay compared to residential property.
- High transaction costs for purchasing and selling residential property compared to shares/REITS.
- High holding costs, which also often requires a considerable time management commitment.
- As noted above, the expected very long term returns from property are closely aligned with the growth of a population's income. Many investors may have an investment time horizon of 30 years. Based on history, equity markets have been less likely to produce negative real returns over a 30 year period compared to residential property.
- Gross rental yields for Australian apartments have generally ranged between 4% and 6% over the past 20 years. However over the past 30 years, rental yields less the official cash rate have often been negative, as shown in the graph below:



This graph reinforces the reliance of residential property investments on capital gains to produce a positive rate of return.

- Most clients already have significant exposure to residential property from their primary residence.
- A recent study<sup>10</sup> revealed that over the past 20 years in Australia, the effective tax rate of Australian shares was 20% (due to the imputation system) compared to 26% for residential investment property.

### Buying Residential Property in Superannuation

Many investors who purchase residential property do so through their self-managed superannuation funds (SMSF), as legislation allows SMSFs to borrow money to purchase property using limited recourse borrowing arrangements. However, recent clarification by the ATO on how this arrangement works may make this option less attractive for many investors.

A SMSF borrowing arrangement can only be used to purchase a 'single acquirable asset'. This means that if the property is improved via renovations – which would likely be necessary over the longer term – the single acquirable asset would change and the limited recourse borrowing arrangement would cease<sup>11</sup>. The newly improved property would then need to be transferred to a new borrowing arrangement, which would be costly and time consuming.

It is therefore essential to do long term strategic planning prior to purchasing a property in a SMSF via a borrowing arrangement.

### Current Australian Residential Property Market

As noted above, Australian housing is currently expensive relative to the rest of the world and long term averages.

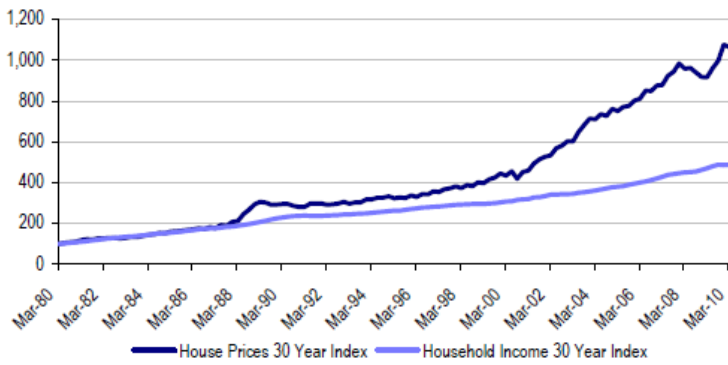
A recent research paper<sup>12</sup> provides information on the current state of the Australian residential house market:

- Since 1971, Australian house prices have grown at 9.1% pa, which has significantly exceeded household incomes at 6.8% pa. The past decade in particular has seen a divergence between house prices and income, as shown in Graph 1 below:

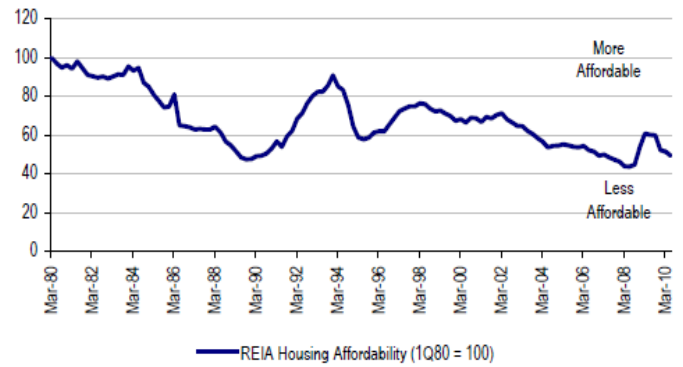
<sup>10</sup> Study by Russell Investments noted in The Australian, Geoffrey Newman, 2 June 2010

<sup>11</sup> Peter Burgess, National Technical Director of Self-Managed Super Funds Professionals' Association

<sup>12</sup> UBS Investment Research – 31 August 2010

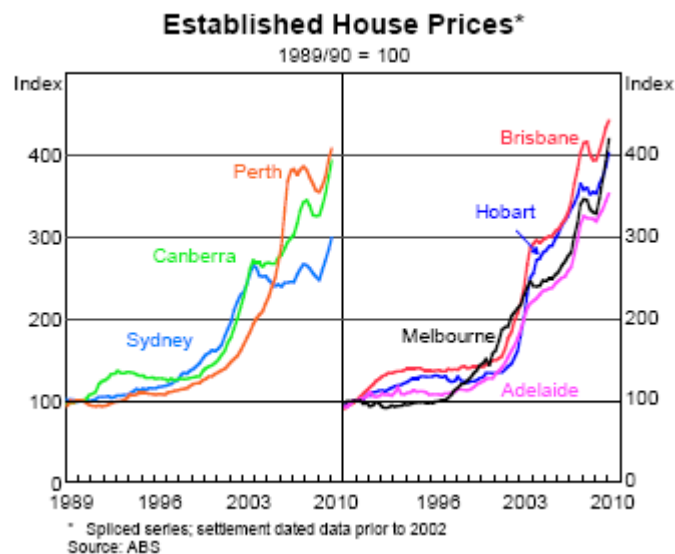


Graph 1: Source: ABS, UBS estimates



Graph 2: Real Estate Institute of Australia (1Q80 = 100)

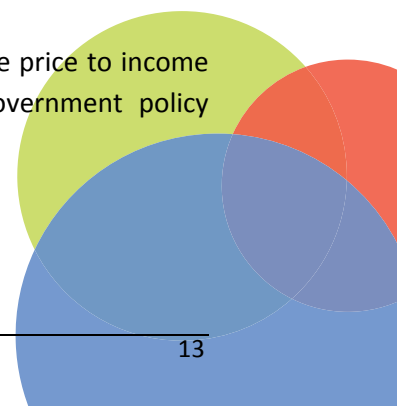
- Graph 2 tracks how housing affordability has changed over the past 30 years, with the trend indicating that Australian housing has become less affordable.
- Approximately 83% of Australia’s population live within 50km of the coast. If we benchmark Australia’s house prices to other coastal cities, the gap between Australian house prices and the rest of the world does narrow. However, whether geographic analysis is valid is not clear, as small countries like Norway and the UK have experienced lengthy periods of negative real house price growth and both countries have high density populations.
- Growth in house prices across the capital cities have varied over the past 20 years. Despite growing population pressures, Sydney house prices have grown the least, with Brisbane, Hobart and Perth leading the way.



### Australian Residential Property Outlook

It would be foolish to attempt to predict the direction of Australian house prices over the next decade. Whatever happens, it is likely that the unemployment rate, interest rates and government policy will drive change.

Continued strong growth in house prices would continue to increase the house price to income ratio and reduce housing affordability. Such an outcome may attract government policy intervention.



If prices stabilise and household income continues to grow, which is consistent with RBA expectations for income, then over the medium term the house price to income ratio should track closer to long term averages. Alternatively, a fall in house prices could hasten a return to historic levels.

A sharp house price correction would not be welcomed by either the government or the RBA, as it would place strain on the balance sheet of voters and our financial system. This is the current experience in countries like Ireland, and such outcomes weigh heavily on economic growth prospects.

### **Summary**

Many investors choose to invest in residential property as bricks and mortar is a tangible, familiar asset to hold in a portfolio.

Current house prices in Australia look expensive relative to recent decades. Despite a backdrop of strong employment and low interest rates, expectations of continuing strong house price growth could be tempered by government intervention if limiting the scope for growth was thought to be in the national interest.

Whatever your personal view on the Australian property market, it would be foolhardy not to acknowledge the possibility that capital gains may not always be counted on to bridge the gap between rental income and a fair return on your capital investment.

We do not typically recommend that clients invest in residential property as equivalent expected returns can be generated from other asset classes that offer superior liquidity, greater diversification and lower transaction and holding costs.