ZANACORP

Investment Insight

July 2017

Financial year 2017 has closed out with global equity markets and Australian property blasting to new heights. The potent combination of favourable economic growth data emerging from the US and China, together with continued fiscal reform and infrastructure spending by President Trump has been irrepressible. Economists and financial market commentators have found renewed vigour and confidence in the global economy. There is undeniable merit in this view. We maintain a more circumspect opinion based on the unchanged economic reality that growth remains underpinned by ever increasing global debt and unresponsively stagnant global income. The future world's economic millstone does not appear to have lightened.

We Built This City

Behold the marvel of man's engineering magnificence. What you are looking at is an impression of the new Australia 108 building Southbank. The latest residential tower in Melbourne under construction.

Flanked by our iconic Eureka Tower to its right, it rises **100 storeys** and **319 metres** into the sky comprising **1,105 dwellings**. Once built, Australia 108 will hold the title of Melbourne's tallest building, albeit fleetingly, as approval has been granted to James Packer's Crown to build One Queensbridge Street. Crown's uninspiring monolith, at 323 metres high, will then become Australia's tallest building and a testament to how much Melbourne will have changed in 30 years, paying homage to our state's gaming addiction and reliance on it's "take". Melbourne will have Australia's tallest skyline with over 100 buildings over 100m high. The world's most liveable city, but for how long?

Beyond Melbourne's CBD, cranes litter the horizon all over our suburbs, poignantly displaying our unrivalled construction boom. Even from our humble offices in downtown Elsternwick, 5 cranes are currently visible building residences. These 5 replace the 3 that have just completed their 8-10 storey human dog boxes within our eyeshot, each half empty, but sporting mandatory new cafés at ground level.

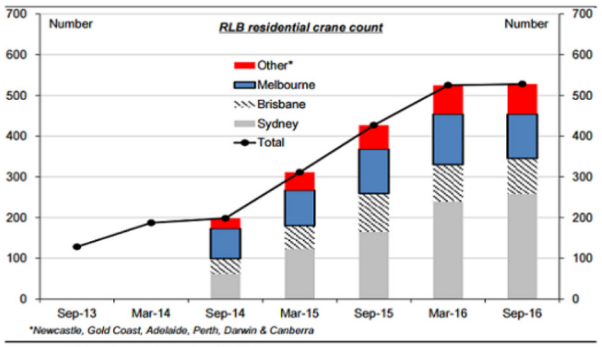
Sadly for your writer, a recent casualty of Melbourne's construction boom is the Dallas Brooks Hall. Remembered fondly, it was there in 1977 I celebrated my graduation being fortunate enough to be on stage to receive some gratuitous scholastic awards. Tired and run down, the site now makes way for salubrious penthouses nestled above an array of more affordable boxes to be sold to the throng of Gen Xers anxious to buy anything with money they don't have, to get a tax deduction and another rung up on the property ladder.

Construction activity is and has been, seriously important to Australia's recent growth and employment providing housing for our rapidly expanding east coast population and generating an all time high **9% of GDP**. Booming construction activity has filled the void created by the mining investment collapse of 2012, averting an unemployment nightmare and GDP black hole. Tried to get a tradie lately?

Unfortunately, as is often the case, **something that saves you can also kill you, if its dosage is not managed correctly.** Politicians and bankers have enjoyed a free ride with the construction boom of the last 5 years. However, having failed to devise the reforms necessary to underpin sustainable GDP growth, we have become increasingly dependant on the building and property boom. This means we need to keep on borrowing to keep on building. An uncomfortable alliance.

Domestically, it is difficult to comprehend the scale of the current construction boom. Ponder this for a moment, the number of fixed cranes atop dedicated residential **projects in Melbourne, Sydney and Brisbane is greater than the combined total of New York, Boston, Washington DC, Chicago, Los Angeles, San Francisco, Seattle, Portland, Phoenix, Austin, Denver and Toronto**. Something is amiss here.

Going up ... residential crane count soars 300% in 3 years



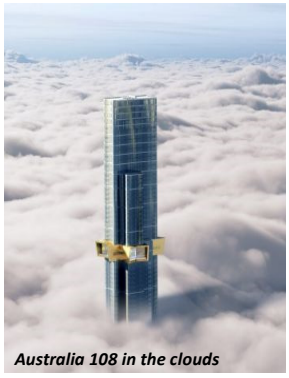
Source: Rider, Levett, Bucknall, UBS

Despite this activity, both Melbourne and Sydney rank in the Top 10 most unaffordable cities in the world. Home ownership amongst the 24-35 year old cohort has dropped from around 40% in 2002 to below 30% in 2014 (and falling). Over the same period, household debt to disposable income has more than doubled to 189% (RBA, June 2017).

Since 2011, although **interest rates have decreased** the proportion of households in **mortgage stress has increased** from 15% to 22%. Masking the fragility of this data from regulators is the fact that statistically, household "wealth" has increased due to rising property prices. As house prices in our most populated cities are growing faster than debt, the net gain or "wealth effect" stimulates consumption (60% of our GDP), as well as employment, thereby funding more cheap debt. Can you see a circular argument forming? All booms are built on logic that appears sound in one context, yet hopelessly flawed in hindsight.

In 2015, the IMF estimated that a 10% fall in house prices would reduce household wealth by 30%. Whilst we may not anticipate such a fall, the correlation between prices, debt and wealth and the sensitivity of consumption and spending to these factors is deeply insightful.

Corelogic's March 2017 **Pain and Gain Report** identified the apartment sector as an increasing cause for concern with 12% of investors **selling their properties at a loss**. A residential apartment glut appears to be forming.



Australia 108 in the clouds

Using water usage records, a 2014 study by Prosper Australia estimated that 1 in 5 Melbourne rental properties is unoccupied. That was in 2014! There is an awful amount of empty properties available to ameliorate our current housing shortage. A simple price fall could release many.

Never mind, don't let that get in the way, "investors" just want more of them.

There's Property, Property & Property

Our rudimentary analysis of Australia's current construction boom fails to differentiate between the various forms of construction (eg residential or commercial) or the type of dwellings (freestanding, duplex, low, medium and high density). These are important distinctions.

Since we are not real estate agents, we are unable to provide authoritative data as to the dynamics at play between the property variables. However, we all see the stark difference between the demand/supply parameters and **rising prices for owner occupied** residential dwellings and the stagnant prices for smaller investor targeted properties.

The property market, like all markets, requires buyers and sellers to know their product and know their values. The relationship between price and rents may be irrelevant to a buyer looking for a residence, yet critical to the analysis of an investor. Likewise, an exclusive well located penthouse property being sought by downsizing boomers for cash, cannot be compared to a 50 square metre one bedroom apartment sought by an investor using a bank's money (or "equity mate").

That some relationship exists between all sectors must be assumed and an oversupply in one, may impact the other. However, their respective valuation sensitivity to changing economic conditions may be highly divergent from each other. Property really is a horses for courses market. Many people do well and many do not. **Caveat emptor.**

The Paradox Of Our Time In History

We have taller buildings but shorter tempers,
Wider freeways, but narrower viewpoints.
We spend more, but have less,
We buy more, but enjoy it less.
We have bigger homes, but smaller families
More conveniences, but less time.
We have more degrees, but less sense
More knowledge, but less judgement.
More experts, yet more problems.
More medicine, but less wellness…

We've multiplied our possessions, but reduced our values,
We've learned how to make a living, but not a life.
We've been to the moon and back, but have trouble crossing the street to meet a new neighbour…

We write more, but learn less...
We've learned to rush, but not to wait.
We have more acquaintances, but fewer friends…

These are the times of big men and small character,
Steep profits and shallow relationships….
These are times of world peace, but domestic warfare.
More leisure, but less fun.
More kinds of food, but less nutrition…

These are times of two incomes, but more divorce.
Of fancier houses, but broken homes…
A time when technology can bring this letter to you,
And a time when you can either share this insight or hit delete.

As you read the above words, we suspect they induce very different thoughts and very different emotions based on the very different experiences we each have in our lives. The words ring so true of life in the 21st Century, don't they? They identify some of the gains & losses we've made in transitioning to our materialistic, egocentric digital age.

Yet such is life today, that often extremely useful and sometimes important snippets of information engage our busy minds and time poor lives for just a few minutes before we move on to the next thing we have to do. Time, it seems (or lack of it) is an enemy of thought.

Please stop for a moment. The passage you have just read was not written in 2006, or 2012, or 2017. It was first penned in the 1980s by Dr Bob Moorehead, a pastor of Overlake Christian Church (Seattle), with minor subsequent edits in the early 1990s.

The full text of the essay can be found in the book "Words Aptly Spoken" published in 1995 drawn from various homilies delivered by Dr Moorehead to his congregation during his 29 year ministry.

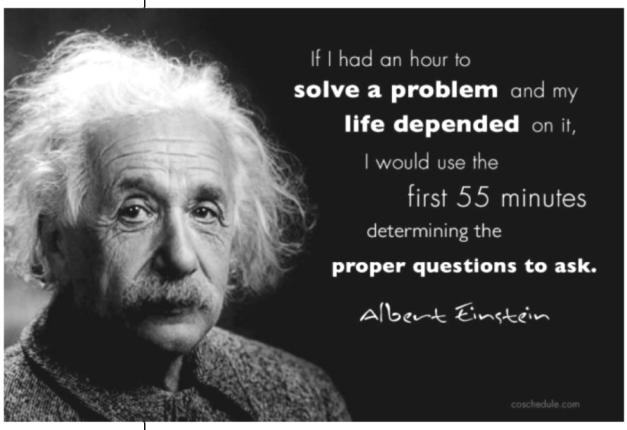
An underlying theme of the Paradox of Our Time essay is it demonstrates that although our everyday lifestyles may have changed over the last 50 years, basic human nature, aspiration and needs have not.

As investment advisers, we are not required to know too much about philosophical matters EXCEPT that **our raison d'etre is to assist clients to meet their financial goals**. In our view, this is one (of many) of the pre-requisites for people to truly enjoy their unique life's experience from beginning to end, with a sense of purpose and ultimately contentment. **To help clients to be happy in their own skin**, in both their financial choices along the way and with their financial outcomes. Irrespective of our age or station in life, we each must come to terms with this reality, as best we can. It is a deeply personal issue.

Investing Is All About Values

Although we are in the money business, we are acutely aware money (whatever its form) is intrinsically useless. It is a means to an end. Yet like an addictive drug, the less you have the more you want and the more you have the less satisfying it becomes. Most Australians have sufficient means to be fed, clothed and housed. With our needs met, most of our financial pursuits in life revolve around our core values.

To best help our clients, we need them to have dedicated the time and effort to establish and articulate what they value in their lives to form the basis of their financial goals.



Rattling off the usual bucket list of big ticket items to be a achieved by a certain age such as paying off the mortgage, home improvements, cars or holiday destinations are fine things to aim for. But really good financial decisions demand **delving a little deeper**, to determine what is really important to a person.

Values Vs Goals - The "Why" Question

The advantages of separating values from specific goals and making them the basis of decision making is often forgotten. The fundamental question of identifying **who we are, what makes us tick and what is important to us** is necessary in order to make the best personal financial choices. Identifying one's ideals makes the motivation to achieve them stronger, deal with the bumps along the way better and the satisfaction of getting there greater. Being unaware of these drives can leave people vulnerable and rudderless. Following others rather than listening to themselves, especially when it comes to matters of money.

Bucket lists tend to be filled with "things" that once attained are replaced by other "things". They tend to have no bottom and rarely provide lasting satisfaction. By contrast, ideals such as relationships, family, community, freedom, spirituality, self worth, legacy or often the desire to give back, are enduring and satisfying, even when incomplete. I remain humbled with the insight of a nephew who, when at school and a teenager, made a bookmark for his Nonna inscribed ***"the best things in life aren't things".*** We can all take something from that.

Thinking about your values (and each of us is different) provides critical insight into what you really want your life to look like and helps to prioritise **what you want your money to do for you.** With the **"why"** question answered, the task of defining the "what", the "how" and the "when" of investment becomes clearer. The likelihood (but not certainty) of achieving personal happiness also becomes greater and the mindless rat race just a little further away from our daily lives.

For example, should parents have an ideal to provide their children with the best education they can, or with a contribution to a home deposit, an investment target, strategy, timeline and funding is required for such goals. To maximise the chances of success, that money should be separated from the capital required to meet other personal goals and remain intact until the purpose is achieved. If it really matters, it will happen and the years of sacrifice will be rewarded.

Alternatively, people closer to retirement, say 55 or over, looking to grow an income stream but with limited capital, would not be well suited to a negative geared investment property. Property is well suited to generate long term capital growth, rather than income and loans need to be paid back. We commonly encounter people who are **asset rich and cash flow poor** who for many reasons are unwilling to liquidate assets. Unfortunately, paying everyday bills takes cash not capital.

It is evident that aligning values with goals and then matching these with financial capacity, the right investments and the time necessary to implement and execute a plan produces the best outcomes.

For couples, taking time out together and discussing ideals and reaching common goals can lead to a greater sense of partnership and purpose in a relationship, as well as satisfaction. When couples (or individuals) can picture what is important to them, the inevitable compromise between a financial choice A or B is easier to make and an element of accountability is introduced into their decision making.

There is no doubt that money provides the means to secure many of the "things" we need in life. But no one ever has enough. Our observations over the decades lead us to the conclusion that the happiest people are those that know how to ration it best. They seem best able to meet their personal aspirations, many of which cost very little.

If possible, avoid falling victim to the outside world and friends who value what they see rather than what they feel. Consumerism and conspicuous consumption are very often unrewarding. People often become slaves to banks by borrowing more than they should, defining themselves by their home or suburb, but forfeiting their aspirations.

Tinkering With Rental Property Rules

The May 2017 Budget may seem like forever ago, as well as being of little interest to most Australians, negative gearing was retained, move on. For quantity surveyors, new apartment developers and new property investors on the other hand, it was something of an earthquake.

A "sleeper" in the Budget papers was a re-writing of the tax rules in relation to depreciation of a property's fixtures, fittings, plant and equipment. New rules now affect all properties acquired after 9th May 2017 where the fixtures & fittings were also acquired after that date.

Existing investors are largely unaffected by the depreciation changes as they are not retrospective. The main change affecting these (and all other) investors will be that travel claims to inspect regional/interstate investment properties are no longer available.

The Budget measures seem to single out investors who buy newly built properties where the value/cost of new fixtures and fittings is high and by implication, so is the standard depreciation claim. From now on, NO DEPRECIATION CLAIM is available on plant and equipment acquired after 9th May 2017 except by the person who paid for it. Subsequent owners will only be able to claim depreciation on fixtures, fittings, plant and equipment they actually pay for themselves.

Washington Brown, quantity surveyors, have calculated the purchaser of a new $800,000 high rise apartment will be $30,000 worse off after 10 years – or around $58 per week.

We expect new "off the plan" contracts, especially those of larger developers with good lawyers, to be significantly restructured in an effort to defeat the new rules. Presumably, rather than buying a complete property package, investors will choose and pay for their fixtures separately from the structure. Problem solved, but with added costs.

It is disappointing that the government continues to avoid property tax reforms that would accelerate and promote the supply of new affordable dwellings. Instead, it chose to protect existing interests and bury new projects in paperwork in order to raise a paltry $260 million over 4 years. ScoMo, this will not go down as one of your better ideas.

Victorian Stamp Duty Changes

STATE REVENUE OFFICE VICTORIA

In an effort to at least recognise Victoria's housing affordability crisis, the recent Victorian budget included both concessions and penalties designed to assist First Home Buyers (FHB) and release vacant properties for either rental or sale.

Amongst the changes to be announced were:

- Exemptions to stamp duty for FHB from 1st July 2017 on properties under $600,000 with tapered benefits up to $750,000. This replaces the 50% exemption
- Vacant Residential Property Tax (VRPT) to apply from 1st January 2018 on vacant properties in certain metropolitan municipalities. Affected properties will attract a tax of up to 1% of the capital improved taxable value of the land
- From 1st July 2017, exemption from stamp duty for "off the plan" (OTP) properties will be restricted to buyers who intend to acquire and occupy as their Principal Place of Residence (PPR) and only up to certain dutiable values. For investors, the stamp duty "holiday" for OTP purchases is over
- Stamp duty exemption removed for investment property transfers between spouses after 1st July 2017

Underemployment—The Stat That Matters Most

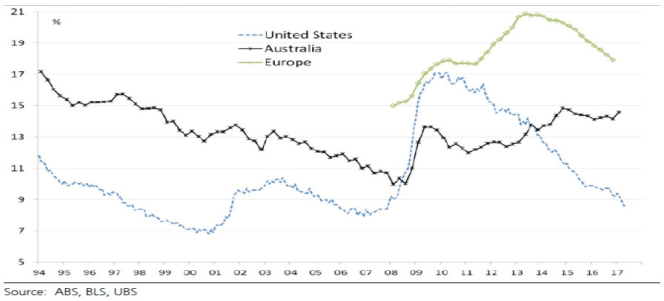
With consumption being the main driver of growth and borrowing a main driver of consumption, global debt remains as big a problem now, at lower interest rates, as it did before the GFC.

Servicing borrowed money takes first claim against future income. With many individuals highly geared, jobs not only need to be retained, but they also need to generate sufficient income to meet the cost of repayments as well as future savings, living and lifestyle costs.

Reducing interest rates was the immediate post GFC remedy to ease the cost of debt. It has now passed its use by date. Except for Europe, most countries are now trying to "normalise" interest rates from their ultra low levels. A most delicate exercise. Ideally, if inflation were to rise, wages could be lifted making higher interest rates easier to manage. The difficulty is global excess labour capacity keeping wages stubbornly low. This is particularly true in Australia, where although the headline unemployment rate is below 6%, more people than ever before are employed on a casual/part time basis but seek more paid hours to cover costs. Although not unemployed, they are underemployed. This cohort is increasingly made up of younger workers.

The chart below indicates Australia is heading to where the US and Europe have been, approaching a 15% under-employment rate. The domestic trend impairs future growth and crops debt servicing ability. Resources are generating our income, not people. Watch this space.

Underemployment Trends—Australia is Heading The Wrong Way!



Source: ABS, BLS, UBS

Australian Banks Downgraded - Interest Rates Rise!

Australia's largest banks had their credit ratings downgraded in May 2017 by S&P Global Ratings and in June 2017 by Moody's. Indicating all is not peachy in Australia's financial sector, the downgrades point to growing pressures and vulnerability in the sector with exposure to high levels of private debt secured by assets valued at elevated prices.

One day after the June downgrade, Westpac lifted its interest rates for variable interest only loans by 34 basis points, citing pressure from the banking regulator (APRA) to limit loan growth. This move follows the Federal Government's budget decision to impose a $6.2 billion levy on the banking sector and more recently the SA state tax. Banks, having gouged customers for years, now find they have few friends.

We suggest highly geared investors be alert to the evolving changes in credit markets. Interest only loans, which have comprised 40% of bank lending in recent years are now on the nose and interest rates are likely to continue to rise. Meanwhile, owner occupiers with principal and interest loans continue to enjoy (as they should) protection from these changes.

The differentiated interest rates that existed in Australia until the 1990s are returning. Investors used to pay 1% more than owner occupiers for property loans and that regime is making a comeback.

Diversification in Australian Shares - Good Luck

Diversification is fundamental to good investing. Insofar as equities are concerned, a diversified portfolio seeks to maximise returns by investing across all industry sectors and reducing downside risk by not owning too much of any single stock or sector. In theory this is simple.

The challenge of investing in Australia particularly for DIY investors, blind-sided by franked dividends, is that our stock market is obtusely lop sided, mirroring our economy. Alarmingly, our 4 largest companies are all banks. Of our biggest 10 companies, all except BHP and CSL sell their goods or services domestically with relatively little exposure to overseas markets.

June 2017 ASX200 Top 10 Companies	June 2017 ASX 200 Weighting	June 2014 Price	June 2017 Price
Comm Bank of Aust	8.47%	$80.88	$82.81
Westpac Bank	6.29%	$33.88	$30.51
ANZ Banking Corp	5.05%	$33.34	$28.72
National Aust Bank	4.95%	$32.78	$29.59
BHP	4.72%	$35.90	$23.28
Telstra Corporation	3.72%	$ 5.21	$ 4.30
CSL	3.61%	$66.55	$138.03
Wesfarmers	2.98%	$41.84	$40.12
Woolworths	2.07%	$35.22	$25.54
Macquarie Bank	1.88%	$59.63	$88.50
	43.74%		

Perusing our Top 10 companies table, these companies comprise 43% of the ASX200 and are concentrated in either banking or retail (borrowing or spending). Genuine diversification is clearly difficult for "Mum & Dad" investors.

When the banking, resources and retail sectors were strong, investors were unconcerned about diversification. However, the stagnation in prices over the last 3 years, as shown in the table, resulting in **compound returns of below 5% pa** has heightened their awareness.

Our June 2014 newsletter discussed Australia's 4 pillars (the banks) and in that context, when CBA was $81, described them as **"priced for perfection"**. Three years on, all 4 banks are either at or well BELOW their 2014 prices and are staring down the barrel of every Treasurer wanting to tap into their RBA protected profits. Looking forward 3 years, are bank share prices more likely to rise or fall? We suspect Newton's Laws of Gravity will be in play. Looking backwards, only 2 companies did well, CSL and Macquarie Bank. But who knew?

Now let's contrast the ASX returns with those of the Zanacorp panel of **international equity fund managers** held by all Zanacorp advised clients. Our managers are able to choose from a very broad universe of countries, industries and companies. These include global businesses such as Samsung, Google (Alphabet), Sanofi, Nestle SA, Apple, Oracle, AstraZeneca and Baidu, just to name a few. After fees, each Zanacorp fund manager has generated a compound return over 3 years in excess of 12% pa and **over 17% compound over the 5 years to May 2017**.

Our June 2012 newsletter highlighting the overseas opportunity said **"… make no mistake, in the years ahead we will look back at this time with either satisfaction or regret… choose wisely".** Pleasingly, most clients have enjoyed portfolio returns over 50% since that time.

We seek no kudos for our past investment advice. Our ongoing reward comes from the interaction with our many clients, who have placed their trust and confidence in us to manage their financial affairs. It's what we do and is **the WHY that all the staff at Zanacorp work for**.

Market Round Up

Shares, Bonds & REITS

Outside Australia, most equities markets have reached all time highs producing double digit returns for the year. Our All Ords Accum index eked out a 9% gain for the year. Over the last 10 years and pre the GFC, Australian shares have underperformed all other major markets (refer to indices from 10 years ago highlighted in the table below). Australian bonds and AREITS underperformed relative to previous years with single digit returns after many years of strong returns.

Residential Real Estate

Melbourne and Sydney house prices continue their relentless climb upwards with successive years of capital growth rates over 10% resulting in net yields of between 2%-3%. Properties located in suburbs attracting offshore buyers continue to break price records while those within a 20km radius of the CBD have enjoyed solid price increases. Apartment prices, as discussed, remain mixed.

So long as immigration levels on the east coast remain high and interest rates remain low it appears property prices will simply continue to rise. At current levels, they plainly defy any reasoned price to income metric. In any heated market, reason will always occupy second place behind expectation. Buyers continue to be drawn from every direction and are buying in expectation of continued capital growth. Bankers are crossing their fingers that the current cycle will never end. Inevitably it will. The continuing unknowns are when and how.

Interest Rates

Following APRA prudential regulation, banks have moderated the growth in lending. Although lending growth remains at three times income growth, banks have been demonstrably more discerning in their lending practices. The RBA has left official cash rates unchanged since August 2016 at 1.5%. Despite this, and out of sync, our banks have increased borrowing rates to protect their profits and margins. **Expect more of the same over the next 12 months.**

MARKET FACTS	June 2017	June 2016	June 2015	June 2014	5 Years Ago 2012	7 Years Ago 2010	10 Years Ago 2007	15 Years Ago 2002
Australian All Ordinaries	5,764	5,310	5,451	5,382	4,135	4,325	6,310	3,163
Dow Jones (US)	21,349	17,930	17,619	16,826	12,880	9,774	13,409	9,243
FTSE 100 (UK)	7,313	6,504	6,521	6,743	5,571	4,917	6,608	4,656
Nikkei (Japan)	20,033	15,576	20,235	15,162	9,008	9,382	18,138	10,621
Hang Seng (Hong Kong)	25,765	20,727	26,250	23,191	19,441	20,129	21,772	10,598
Dax (Germany)	12,325	9,680	10,945	9,833	6,416	5,965	8,007	4,382