Why today's calm may not herald a storm

There are compelling reasons to expect markets to endure

DON STAMMER

Sharemarkets have been unusually calm this year.

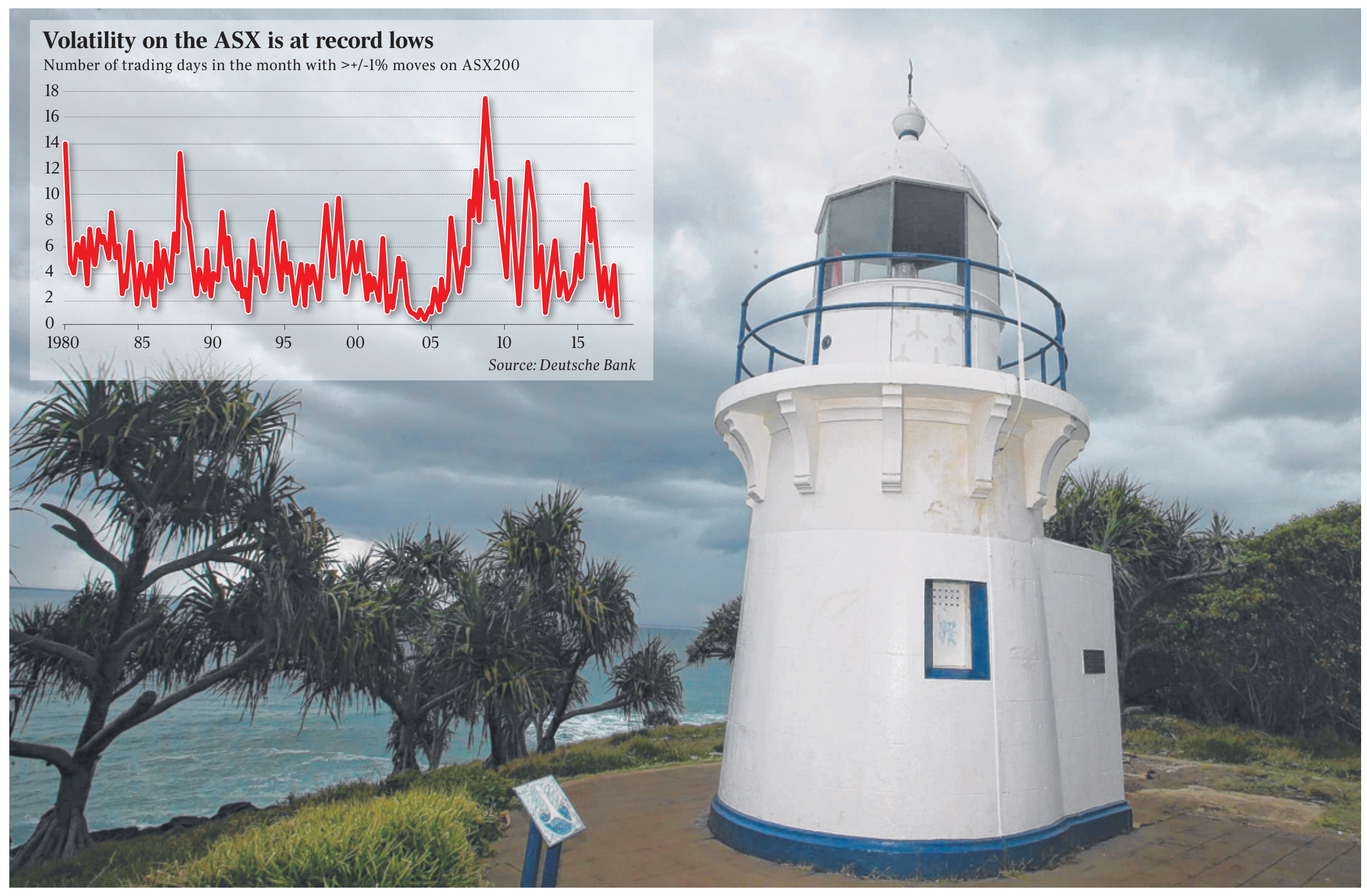
In the US, the much-watched index of sharemarket volatility called the Vix is sitting at about half its long-term average. Meanwhile, Australian shares — long-described as "high beta" since they've traditionally risen and fallen more in price than shares in other rich countries — are also tracking along a smooth path.

Many investors and commentators claim the low volatility in sharemarkets signals choppy times ahead. In effect, they're warning about a "volatility paradox": today's calm will cause tomorrow's financial instability.

It's time for a "history in a nutshell" moment. This is the fourth time in 90 years that the US sharemarket has been so calm for so long. The other occasions were the bull markets of the 1960s and 1990s (when low volatility didn't end the good times); and the run-up to the global financial crisis (when low volatility was a precursor to a market collapse). Larry Fink, the chair and chief executive of BlackRock, the world's largest fund manager, visited Australia last week. He said volatility at historical lows was a big issue facing equity investors, but he "cannot foresee anything economically that would cause a spike in volatility".

I agree. To my thinking, the risks arising from the current low volatility in sharemarkets are being overstated. For example, in a recent presentation to Australian institutional investors, a global equity fund concluded: "Calm and stability lead to imprudent behaviour. When volatility drops, many investors let their guard down and increase their exposure to risky assets, often confusing risk with volatility ... the return of volatility has the potential to do a lot of damage." And six months ago a portfolio manager for an international fund argued: "We don't expect this low-volatility regime to continue indefinitely or maybe not even much longer ... US stock volatility has collapsed, but we have reason to believe it will rise again — and perhaps by a lot."

I recognise there are many ways in which a sustained period of low volatility in asset markets could bring on changes in investor behaviour that would heighten the risks of future instability. For example, investors might see lessened volatility as indicating reduced risk. They might ignore the need for a core holding of safe assets. They might take on excessive debt. Some investors, seeking more excitement than mainstream markets are providing, might even rush into flighty and risky investments such as cryptocurrencies.



GLENN HAMPSON

Solid economic foundations suggest we may weather the storm, if and when it comes

In my view, the prevailing view among investors and commentators seriously understates the impact — and the persistence — of the favourable influences on share markets. They include: highly accommodative monetary policies in the major economies (now being gradually unwound); minimal inflation in most countries; low interest rates; the moderate quickening in US growth from the September quarter of 2016; the broadening in the global economic upswing in 2017; and market expectations the US will see tax reform and additional infrastructure spending.

BlackRock's Fink put it succinctly: "We have a world doing well economically with very good synchronised growth."

In due course, the positive (and generally mild) tailwinds I've listed will lose their power, or be fully allowed for in average share prices, or new headwinds will take over. The calm we've been seeing in sharemarkets will then disappear — with good reason — and be replaced by a heated debate on how deep and long-lasting the sell-off in shares will be. Investors should expect that scenario, in the early days of the next sharemarket correction — whenever it comes — and naysayers will be jumping out of the woodwork saying "we told you so" and "these are early days in a savage and prolonged bear market in shares".

Sometimes, as in 1987 and 2008, the collapse in share prices is extreme and prolonged. Sometimes, as in 1994 and early 2016, confidence soon returns. The best guide to what lies ahead for sharemarkets is generally the state of the US economy. If the US is sliding into recession, investors should expect a long and sustained slump in share prices. If the US economy seems likely to avoid recession, investors might prepare for an early rebound in shares.

Don Stammer is an adviser to Altius Asset Management and Stanford Brown Financial Advisers. The views expressed are his alone.

don.stammer@bigpond.com

Life insurance: buy it inside or outside super?

MONICA RULE

When you take something for granted, you generally don't give it much thought. A young person, starting out in their early working life, could easily feel this way about superannuation. Since retirement seems a long way off and other priorities are more pressing, superannuation and its associated benefits could be of little interest to a young employee. But what if something happens to prevent you from ever working again?

Superannuation and the insurance it provides becomes an important consideration — the cost and benefit of insurance has been an item of debate throughout the year. Of course, there are questions around how young somebody might be to pay life insurance or indeed whether someone quite senior needs to review their cover too.

But let me tell you about one case. I recently spoke with a family member about this very issue. Over time, his life has changed; he has married and had his first child. All of a sudden he has started to consider what would happen if he could no longer contribute to his family's security. Now he is investigating whether he has sufficient life insurance cover through his superannuation fund.

Most superannuation funds offer three types of insurance for their members:

1. Death cover that pays a benefit to beneficiaries upon a member's death; or a payment to the member if they are diagnosed with a terminal illness.

2. Total and permanent disability (TPD) cover that pays a benefit if the member becomes seriously disabled and unlikely to ever work again.

3. Income-protection cover that pays an income stream for a specified period if the member cannot work due to temporary disability or illness.

Most employer superannuation funds are required to offer their members a minimum level of life insurance based on the member's age. Generally the member can increase, decrease, or cancel the insurance cover. However, if members want to take out extra cover above the standard level through their superannuation fund, they may be required to undergo a medical examination.

The pros and cons

People sometimes wonder whether they should have insurance cover inside or outside of their superannuation fund. There are pros and cons with either scenario. The benefits in having insurance cover inside your superannuation fund are:

- It is cheaper because most superannuation funds purchase insurance policies in bulk. Whereas, insurance cover outside of superannuation will depend on a person's age, health, lifestyle and job risk.
- It is easy to manage because the insurance premiums are automatically deducted from the member's super account.
- Some super funds automatically accept members for insurance cover without the requirement of a medical examination. This is because superannuation funds spread risk among their members.
- Members can choose the amount they will be covered for.

The disadvantages in having insurance cover inside superannuation are:

- The type of insurance and the level of cover are usually limited. Some insurers that provide cover within superannuation funds put caps on their levels of cover. If the cover is outside of superannuation, the levels of cover might be more flexible depending on the person's age and health. Insurance coverage usually also ends when a member reaches the age of 65 or 70. Policies outside of superannuation may cover the person for longer.
- If the member moves to a different superannuation fund or ceases working for their employer, their cover may end.
- There may be delays in receiving benefits as the insurer first pays the benefit to the member's superannuation fund, which then distributes it to the member's beneficiaries.
- The insurance premiums are deducted from the member's superannuation account so there is less money available for the member when they retire.
- Life insurance and TPD (total and permanent disability) insurance proceeds held outside of superannuation are paid to the member or their beneficiaries directly tax free.
- Most income-protection policies held inside superannuation provide for only two years' worth of income protection.

About 80 per cent of superannuation members sign up for the default insurance cover with their employer superannuation fund.

Although it is cheaper, it may not be anywhere near what a person needs. Often life cover in superannuation is usually only for \$100,000 to \$200,000 when in reality people may need closer to \$500,000 to \$1 million to protect their family.

One option is for people to consider a second life-insurance or income-protection policy outside of their superannuation fund to cover the shortfall. I would recommend getting financial advice on this, though, to see if that is appropriate for your circumstances.

If you are considering switching superannuation funds, make sure you find out whether you will get the death, total permanent disability, or income-protection cover you want in the superannuation fund. You should also ask whether the new fund will allow you to transfer your current level of cover before you roll your superannuation savings into the new fund.

You will need to check the type of insurance cover, how much cover you have, and how much you are paying for the cover. Also check how you are classified for insurance. For example, if you have been classified as a smoker you may be paying more for your insurance than you need to, especially if you are not a smoker.

Unforeseen things happen. It's wise to investigate early what is available to us that can give us some security if we can't work anymore. Superannuation is not just a savings scheme for a far-off retirement. Its insurance can also be of some help to those whose careers come to an unexpected end.

Monica Rule is a Superannuation Specialist and author of The Self Managed Super Handbook — www.monicarule.com.au

Investment grade versus high yield bond — Your call

ELIZABETH MORAN

The global bond market is a bit like an amazing buffet: so many bonds to choose from, making it difficult to work out how to invest.

One ways is to consider the risk you are prepared to take. Then determine your allocation split between investment-grade bonds: low risk, think ASX top-40 companies, with a very low chance of anything going seriously wrong; and sub-investment-grade or high yield, being higher risk, with more chance something indeed could go wrong.

This sounds easy enough but with returns very low by historical standards, it's easy to be tempted by the 5-10 per cent returns on offer from high-yield bonds.

It's important to understand the additional risks and the reasons you are being paid so handsomely. Very broadly, I'd suggest most investors target a 70 per cent allocation to investment-grade and 30 per cent high-yield bonds.

Investors in the higher quality investment-grade bonds — rated AAA down to BBB- on the Standard and Poor's rating scale — can expect the bonds to perform consistently; that is, pay interest every three or six months and repay face value at maturity. They make great defensive assets as they give investors certainty.

This is how bonds earn the "sleep at night" description. Allocating a good portion of your portfolio to investment grade lets you employ a set-and-forget or hold-to-maturity strategy with confidence. S&P's assesses the probability of default in global investment-grade bonds in a five-year period as 0.96 per cent. Australia's record is even lower.

Default doesn't mean loss, just that a payment has been missed. It may mean payment later or eventual wind-up.

The downside is that rates of return are relatively low for investment grade bonds.

Two bonds just rated investment grade, Qantas and Lend Lease, have relatively short terms — due to mature in April and May 2020 respectively — and yields of 2.88 and 3.17 per cent a year. These household names are low risk with returns to match, but aren't the best rates in the investment-grade space. There are less well-known investment-grade securities with returns of about 4.5 per cent a year, with one very out-of-favour outlier at 6.6 per cent.

Sub-investment-grade or high yield bonds — rated BB+ down to D — step up in risk and return. Most of these will also perform to expectations, but there may be unexpected events that cause prices to fall, adding volatility.

Careful analysis can reap rewards but the chance of something going wrong increases significantly. S&P's assesses the probability of default across global sub-investment-grade bonds in a five-year period as 15.29 per cent — 15 times more than investment-grade counterparts.

To take on that extra risk, investors must do their homework and play close attention to the drivers of the company, profitability, cash flow and balance sheet, the debt levels and when debt or bonds become due for repayment.

How the bond fits into the group structure and where it sits in the debt maturity profile are also factors. Other downside risks to assess include regulation, competition, new competitors, disruptive technology, commodity prices and management.

There are few choices in Australia, but if we skip across to the US, the most developed market, some big household names issue sub-investment grade bonds, such as cosmetics company Avon and rental car company Hertz. Avon has a fixed-rate bond maturing in August 2022, showing a yield to maturity of 6.95 per cent a year, and it is rated BB- — three notches higher than the Hertz bond, maturing in October 2024 at B-.

Surprisingly, the Hertz yield to maturity is practically the same at 6.94 per cent per annum. The returns on both bonds are equity like and very appealing. But the fact that the Hertz bond yield is the same as Avon given its lower credit rating and longer term mean there's more to investigate.

US denominated sub investment grade bonds have had terrific returns in the past year but are trading in the tightest range in 20 years. Many companies are in

FLOAT WATCH

Software house has deep pockets

Cape Range Limited

ASX CODE: CAP
SHARES ON OFFER: 30 million
LISTING PRICE: 20c
MARKET CAPITALISATION: \$15.1m
LISTING DATE: TBA

SIMON HERRMANN

The accounting industry — just like most other industries — has changed rapidly over the past decade as technology has driven innovation.

Businesses are required to quickly respond to an ever-transforming environment, and the arrival of big data analytics platforms has allowed companies to better manage day-to-day accounting tasks.

Studies show that global revenues of the accounting software market have exceeded \$US10 billion in 2016 and the Asia Pacific region will probably remain one of the key growth drivers over the coming years.

> The business was entirely funded by the founders and no external capital has been raised to date

The forthcoming listing of Cape Range offers Australian investors the opportunity to invest in an Australian software company focused on accounting and business intelligence services.

Cape Range recently acquired Biztrak Business Solutions, an Asia-focused company offering software solutions to 18,000 companies with more than 37,000 users. Biztrak software applications cater for small and medium enterprises in a number of sectors including retail, logistics, health care, financial services and education.

Founded in 1995, Biztrak is far from being a start-up: The business was entirely funded by the founders and no external capital has been raised to date. The Biztrak business is cash-flow positive and has grown organically since inception, while in-house R&D capabilities allow the company to launch new products quickly and cost-effectively. However, potential funding demand, competition and its geographic focus are principal risks.

More than \$5 million has been raised to date and the IPO is expected to close shortly with a targeted listing in mid-November. Nonetheless, a long-term investment horizon is required, however a tightly held share register and an undemanding pre-money valuation of \$9.1m are attractive qualities.

Simon Herrmann is an investment analyst at wise-owl.com