NEWSLETTER
December 2017

Edgeworth Partners

Introduction

Welcome to our December newsletter.

In this newsletter, we run the ruler over the property and share market returns not just for this month but for this entire year. We also reproduce some articles on behavioural finance that we recently published on our website.

Please enjoy our final newsletter for the year. As ever, please do not hesitate to get in touch if you'd like to discuss anything covered in these pages - or anything else that you would like assistance with..

Did You Know… the month of December

December has always been an important month in Australian history. The town of Albany became the first European settlement in Western Australia in 1826 (it was originally called Frederick Town. Glad they changed the name). Ten years later, the province of South Australia was proclaimed. In 1854, the Eureka Stockade took place in Ballarat, with the miners using the Southern Cross on a blue background as their emblem. Skipping ahead a few decades, December 1945 saw the first running of the Sydney to Hobart yacht race. 22 years after that and then Prime Minister Harold Holt went missing, presumed drowned, off Cheviot Beach in Victoria. On the fiscal front, the Australian dollar was 'floated' in December 1983 (meaning that the rate of exchange for Australian dollars and foreign currency would now be set by market forces -see our share market report to read about the ongoing benefits of that decision). Eight years later and the 'architect' of the float, Paul Keating, knocked Bob Hawke off his perch as Prime Minister.

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Property Report

As 2017 is drawing to a close, this is a good time to reflect on the performance of the property market during this year. According to data published by Core Logic, the 12 months to 31 October 2017 were generally good for Australian property investors - although there was substantial variation in different markets.

Investors in Perth and Darwin essentially lost money across the period. Perth house prices fell by 2.5% for the 12-month period, while Darwin prices fell by 5.7%. This is what happened to the market value. Investors also receive rent. Rents in Darwin are high, but not high enough to prevent the average investor losing money during 2017. In Perth, an investor collecting average rent was just able to bring their investment back above water.

Investors in Brisbane and Adelaide enjoyed capital growth of 2.7% and 4.6% respectively. Canberra returned 6.4%. Sydney did slightly better, with capital growth of 7.7%, although this includes a *fall* of 0.6% in the last quarter of the 12-month period. Melbourne's strong growth continued, with prices rising 11% and Hobart topped the nation annual growth of 12.7%. Interestingly, rents in Hobart remain high, such that the total return to an investor in Hobart was more than 18%. Notwithstanding this, Hobart remains the capital city with the lowest median price, at $396,000.

Sydney has the highest median residential value, at $905,000, clearly marking itself out as the most expensive city in Australia. Melbourne's median price is $710,000. Canberra is $580,000, but every other capital city has a median value below $500,000.

Regional (that is, non-capital) areas did relatively well across the period. Average capital growth of 4.9% was augmented by an extraordinarily high average rental yield of 5.5%, giving investors an overall return of 10.4%. The median dwelling price in noncapital cities is $350,000.

Of course, all of these figures are averages or medians. That means that any individual property is likely to vary from these figures. However, particularly in the larger markets, that variation should not be too substantial and so these average returns and median prices are a good indicator of what most property investors achieved.

To summarise: except for Perth and Darwin, property investors who held representative property investments, even in regional areas, did well in 2017. Of course, to have done well in 2017 they needed to have purchased their investment property in or before 2016.

What about property bought more recently – or property not yet bought? Especially in the dominant Sydney market, prices appear to be cooling. There are two main reasons for this. The first is that the Sydney market has achieved above-average returns for several years. As a result, some periods of neutral or slightly negative price changes are to be expected. Markets correct themselves and this is a natural and helpful economic phenomenon.

The second reason is that it became government policy to try to cool the investment side of the market. In early 2017, the main regulator of credit lending asked lenders to restrict interest only loans to no more than 30% of residential mortgage loans issued after that date. The lender's response was predictable (which is why the regulator made its request): interest rates on investment loans rose by as much as 0.4%. Given that many investment properties purchased with debt are negatively geared, this 0.4% represented extra cash that the investor needs to find each year to continue holding an investment property. As is the nature of things, when holding properties becomes more expensive, fewer people want to do it. Demand falls, and so do prices.

The regulator's response was quite an artful strategy designed to target property investors only. Given that housing affordability is at generally low levels, the last thing the regulator wanted to do was raise interest rates across the board. This would make it even more difficult for people to buy a first home. Because of the targeting, owner occupiers have not experienced an increase in their interest rates and they have therefore been able to continue to borrow at the same price as before.

In the markets that had become superheated, this has been a very neat piece of work from the regulator. As we have said before, the people and government bodies pulling the strings on Australia's macroeconomic policy generally do a good job of things.

2018 is unlikely to see such strong across-the-board growth investment property values. That said, no one purchasing an investment property should be that fussed about what happens in the 12 months immediately following the purchase. Investment properties are long-term investments. Investors need to expect to hold their property for at least 10 years, and generally much longer than this, to reap the full benefit from this type of investment.

The Share Market

Australia's share market also had a good year (at least, the 12 months to the end of November 2017). The ASX 200 finished the 12-month period around 10% higher. Add to that an average dividend yield of around 4%, and the total average market return becomes around 14%.

That is a very good year.

Very few people would have expected this result. Remember, November 2016 was when Donald Trump was elected as the US president. In the 12 months prior to his election, the Australian sharemarket had not performed particularly well. Things did not seem especially promising. No one was suggesting that our market was about to start a steady climb that would last for the next 12 months.

As we have said before, this is the whole point about the sharemarket. No one knows in which direction it is about to move. Short-term prices are subject to sudden 'shocks,' such as the 'Trump bump.' But the whole logic of a shock is that people do <u>not</u> see it coming.

In the longer term, however, the sharemarket tends to reflect whatever is happening in the general economy. This is a lot more predictable. For example, Australia has not had a technical recession for the last 26 years. This is unprecedented for a developed economy such as Australia's - indeed, in June 2017 we overtook the Netherlands for the mantle of longest run without a recession. 104 quarters, and counting.

There are many and varied reasons for Australia's economic outperformance. We did well with the mining boom. That boom ended (and Perth property copped it). But when the boom ended, we could lower our interest rates to help household spending. What's more, our floating exchange rate let us take advantage of a lower Aussie dollar to attract and better service export markets (which include things like tourism, which

is essentially an export market). Underlying all of that, we remain a 'destination country' - our population is growing at about twice the rate of other developed economies. As The Economist magazine put it recently, our population growth means that Australia must build a city roughly the size of Britain's Birmingham… every five years. (Happily, all of our cities are nicer then Birmingham!)

Population growth is also underpinning various residential property markets.

The association between a solid economy and immigration is nothing new in Australia's economic history. For example, economic historian George Megalogenis has compared Australia's immigration policy with the extent to which Australia has coped with international economic crises, such as the recession of the 1890s, the two world wars, the great depression, stagflation in the early 1970s and the global financial crisis of the late 2000's. To summarise, when Australia has open immigration this provides a boost to the economy that reduces the impact of economic downturns. At times when Australia's borders have been relatively closed, such as prior to the great depression, the effect on our economy of international downturns is worsened.

Sharemarkets bounce around with much greater volatility than property markets. For that reason, no one really knows whether 2018 will be a good year for sharemarket investors. What we can say is that the period between now and the year 2028 is likely to be a good one. Australia still has a fundamentally strong underlying economy. It is worth investing in - but just make sure you have at least a 10-year timeframe whenever you invest in the share market.

The best gift voucher in the world

First published on our website on 10 November 2017

Christmas is coming and you probably know someone who is really hard to buy a present for. You might be tempted to buy them a gift voucher. Can we suggest you think again? Unfortunately, gift vouchers are generally a really bad idea. We know, we know – we sound like the Grinch. But let us explain.

You've probably heard of the Nobel Prize. This year's peace prize was awarded to an Australian organization, founded in Melbourne 10 years ago: the International Campaign to Abolish Nuclear Weapons. Well done to all involved!

The Nobel Prize is also awarded for economics. The 2017 award went to an American economist named Richard Thaler. Thaler is a 'behavioural economist' – which means that he studies the way people think about their money. If you ever get the chance, read some of his stuff or listen to a podcast. He is a very funny man.

Thaler is best known for identifying a phenomenon known as 'mental accounting.' Mental accounting is where people link a specific dollar with a specific purpose. In doing so, they forget that money is fungible. Fungible is a fancy word that essentially tells us that 'any dollar will do' – you do not need to use a specific dollar to pay a specific expense.

Unfortunately, people frequently dedicate 'specific' money to a specific purpose. Thaler demonstrated this by asking people two questions. In the first question, Thaler presented the following situation:

> *You have paid $10 for a paper ticket to the movies. As you arrive at the cinema, you realise that you have lost your ticket. The ticket was not registered. If you wish to see the movie, you will need to purchase another ticket and pay another $10. Would you do this?*

Less than half of the people presented with this situation said that they would buy another ticket. Having lost their ticket, more than half of the people would skip the movie. Thaler then developed a second question which went along the following lines:

> *You are going to the cinema and you will buy your ticket when you arrive. When you arrive you discover that you have lost a $10 note. A ticket to the movies will cost $10. Will you still purchase a ticket and watch the movie?*

In the second case, almost 90% of people said that they would still buy a ticket and watch the movie. Only 12% of people skipped the movie.

Thaler points out that there is actually no difference between losing a $10 note that will let you buy a ticket to get into a cinema and losing a $10 ticket that will also get you into the cinema. In each case, you have lost $10 and it will cost you another $10 to watch the movie. But people treat a $10 ticket and a $10 note differently – even when they are both intended to be used for the same purpose.

So, what's all this got to do with gift vouchers? As we said above, gift vouchers are absolutely irrational. They perform the same function as cash, but they are much more restrictive. For example, if you spend $50 to buy somebody a gift voucher, often that voucher will expire within a particular period. What's more, the voucher can only be used in a particular store. It is much more restricted than the cash that you used.

Basically, a gift voucher represents a loan to the retailer. The purchaser gives the retailer money, but the retailer hasn't given the purchaser anything yet. It is up to the recipient to decide whether the 'loan' is repaid by using the voucher. Not surprisingly, many retailers try to avoid repaying these loans by making it difficult to use their vouchers. For example, few retailers will give change when somebody uses a voucher. A retailer might issue a $50 gift voucher , but if a person spends $48, the retailer does not give them $2 change. Instead, the retailer says that the customer can only use that $2 towards the purchase of something of equal or greater value. The total spend will now be more than $50. Basically, the retailer says that they will only repay the loan if the recipient spends more than they borrowed. Try that one on with your bank!

Gift vouchers make money the opposite of fungible. Gift vouchers force recipients to apply mental accounting.

But there is hope. A family we know cottoned on to this when considering how to give young friends a birthday present. Lots of kids give each other vouchers – kids love shopping, after all. So, this family created its own 'voucher' on a piece of A4 paper. It was nicely coloured in and it promised, in big bold letters, to be the "best voucher in the world." It would be accepted everywhere, would never expire and if you did not spend it all you could keep the change.

Then they stuck a $20 note to it.

Food for thought this Christmas!

More on mental accounting

First published on our website on 17 November 2017

Last week, we introduced the concept of mental accounting. We want to continue the theme this week as part of our 'behavioural economics month.'

Mental accounting can be seen every day with little expenditures like gift vouchers. However, sometimes people apply mental accounting to much bigger parts of their financial management. And that is where it can get expensive.

To recap, mental accounting is a common mistake people make with their money. When people apply mental accounting, they dedicate specific money to a specific purpose – ignoring the fact that money can be applied in many different situations.

A common situation that financial advisers come across is where people inherit money. They often wish to keep that money separate from their other finances. A common approach is for adult beneficiaries who also have children to want to keep 'grandma's money' separate from all their other money. The idea is that Grandma's money will go to Grandma's grandkids when they (grandma's kids) die themselves.

While we like the sentiment, it's often not the best use of money. After all, when people die their estate is generally realized – that is, most or all of the assets are converted to cash and the cash is put into one large pool. Because it all ends up as cash, it does not matter how the asset was held prior to the estate being realised. So, our advice to people who receive an inheritance is typically to include that money amongst the rest of their wealth and do everything they can to make it grow further. After all, maximising wealth is actually the best way of maximising their kids' eventual inheritance.

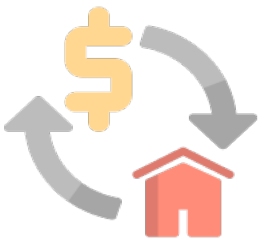
Alternatively, if our clients really don't need Grandma's money, it can often be a good idea to pass it on to their kids now and help them do something sensible like buy their first home.

People also often apply mental accounting when it comes to debt. Many people simultaneously have a debt and some money in a savings account. Typically, the debt will be incurring much higher interest rates than the person earns on the amount held in their savings account. So, if the savings were used to reduce the debt, the client would be better off.

Lenders have cottoned on to this, and many make an 'offset savings account' available to their borrowers. You may have heard of such an account: it links your savings account to your loan, such that interest is only charged on the difference between the loan amount and the savings amount.

For example, if you owe $100,000 on your loan and have $50,000 in an offset savings account, the bank will only charge interest on $50,000. This is the difference between your debt and your savings. Effectively, this lets you repay the loan while retaining the flexibility to 'redraw' your savings and use them for some other purpose. Offset accounts can be wonderful financial planning devices.

This brings us to one final example of mental accounting. Whenever you have debt, every dollar you spend is borrowed. This is because you could have dedicated that dollar to repaying your loan.



For example, let's say you owe $100,000 on your mortgage. Now let's say that your boss gives you a $5000 bonus that you weren't expecting. You decide to use that money to buy a holiday. Most people would not think that they have borrowed money for the holiday. The boss gave them cash and they used the cash to buy a holiday. But, again, this is a trick of mental accounting. The reality is that had they not taken the holiday, but instead repaid some debt, the debt would now only be $95,000.

Had they not gone on the holiday, they would have less debt. Effectively, they have borrowed the price of the holiday.

This happens because money is *fungible*: a dollar can be used for anything that can be bought using a dollar. The same dollar can be used to pay for a holiday or to retire debt.

Now, we don't want to sound like party poopers! Holidays are fun and people need them. But if you have debt, it often pays to avoid mental accounting. That way, you will know the true cost of every purchase you make.

100% off everything!

First published on our website on 24 November 2017

Here is an idea for you. There is no such thing as a discount. There is just the price.

As we head into Christmas, many people will be lured into retailers with the promise of discounts or price reductions. Many people can't resist the potential for a bargain – a sign promising 30% off is simply impossible to ignore!

Often, these people are giving in to a cognitive bias called *anchoring*. Anchoring is where people take an initial piece of information and use it as the foundation (or the anchor) against which they assess all future information. People can't get the first piece of information out of their head – which is why retailers publish an initial higher price before offering a 'discount.' The discount looks like a significant reduction in the price, and tricks a purchaser into thinking that they have bought something cheaply.

So, if an article was 'originally' advertised at $100, but I bought it for $70, I walk out of the shop thinking that I have saved $30. I haven't. I've just spent $70. But the retailer anchored me at a higher price.

We see anchors at work in investment markets as well. Auctioneers are notorious for it. "This property is easily worth $1 million. But we will open the bidding at $650,000. Can I have an offer of $50,000 above this?" And on it goes, with the auctioneer seeking to anchor and re-anchor people's bidding as the auction progresses.

And then there is the sharemarket. Most people anchor their thoughts about sharemarket investments to the purchase price paid for that investment. So, if shares are purchased for $10, this becomes the anchor for all future decisions about that share. This can become a problem. For example, if the value of the shares falls to $8 while you are holding it, then the fact that you bought it for $10 is now immaterial. You need to make your decisions based on whether it is worth selling the share for $8. But most people will find it hard to ignore that selling the share for $8 will crystallise a loss of $2. Their thoughts are anchored on the $10 purchase price. Lots of people hang on to a share until they 'get their money back.' Unfortunately, sometimes this becomes a long wait.

This is actually another cognitive bias – loss aversion. It causes many people to hang on to shares that have fallen in value. What's more, we often see people sell shares that have risen in value. If the $10 share rises in value to $12, then the investor can be tempted to sell and realise a $2 gain. What the investor needs to do is decide whether the share is now worth more than $12 if they keep it.

The point is the same: people need to re-anchor their thoughts about a share's value every day they hold that share. But most people anchor a first time and leave it at that. That's why history shows that people tend to be too keen to sell shares that have risen in value and keep shares that have fallen in value.

So, how do you overcome anchoring? Simple: remind yourself – there is no such thing as a discount. There is just the price that you agree to pay.

And when it comes to investing: yesterday's losses and gains are immaterial. Today, we just have the current price and an investment's future prospects. Assess everything against that.

The Legal Stuff

General Advice and Tax Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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