One Focus Capital

The Irregular

1 October 2015

Baillie Asset Management

Contents of this 'irregular' are:

1. *Introduction* ... 1
2. *The Issue - Price Volatility* ... 2
3. *Context* ... 3
   i. **Who you can trust** ... 3
   ii. **Appropriate Expectations – Price vs Value** ... 4
   iii. **Our Caution Index** ... 6
   iv. **Relevant History & Current Threats** ... 7
      a) Shrinking US Bad News ... 7
      b) Debt ... 12
   v. **Australia – The Bankable Proposition** ... 13
4. *Conclusion* ... 18

1. Introduction

This edition of the 'irregular' provides the most amount of bankable good news ever. This includes our inaugural 1976 edition on 'How to save $30,000 on a $20,000 home loan'.

We feel compelled to produce an 'irregular' when we see a critical issue subjected to the financial press's predispositions to be 'out of context', 'self-promoting', 'self-protective', misleading, deceptive and incompetent unless you want to table mischief-making as a cause.

The critical issue for writing this 'irregular' is market price volatility which is an unnecessary and harmful attack on your peace of mind. We don't believe there is a more important issue to be dealt with than an attack on your peace of mind.

> ***Our message is quite simple, you have a firmer base to your financial peace of mind than you would currently be aware of because of the people we know you can rely upon, because of the decreasing bad news in the US and because you can bank on bank greed.***

Our bias is centred around our valuation of your peace of mind about your family finances. Since the Global Financial Crisis all of our discretionary research capacity has been directed at the non-rational aspects of individuals' peace of mind about their family finances.

On November 11 the research findings will be used as a primary workshop tool at the Ageing and Living Well Think Tank and Innovation Collaborative at the Entrepreneurship, Communication and Innovation Centre at Adelaide University.

Whilst some of the material in this edition will become redundant as context changes, the principles and tools are perennial. We respectfully suggest you keep your copy for future reference and reinforcement.

2. The Issue - Price Volatility

The issue we identified is how do you reconcile the volatility of the market price of listed securities particularly the ordinary shares in companies that run businesses to the level of peace of mind your financial circumstances affords you.

Figure 1 evidences the issue. In the last six months the top 20 Australian listed companies as measured by market capitalization have experienced a market price fall of over 20% and a twelve month range of +/–12.04%.

We have provided the individual data for the top 10 which are the household names for Australian resident investment.

Figure 1 – Top 10 Australian listed companies as measured by market capitalisation

	Market Cap	1 Year Low	1 Year High	Low Since High	Range	Low Since High %
CBA	$119.2B	$70.15	$96.17	$70.15	+/ - 15.64%	-27.06%
WBC	$92.7B	$29.10	$40.07	$29.10	+/ - 15.86%	-27.38%
NAB	$76.7B	$29.15	$39.15	$29.15	+/ - 14.64%	-25.54%
ANZ	$76.6B	$26.38	$37.25	$26.38	+/ - 17.08%	-29.18%
BHP	$69.4B	$23.00*	$36.19	$23.00*	+/ - 22.29%	-36.46%
TLS	$67.1B	$5.23	$6.735	$5.49	+/ - 12.58%	-18.49%
WES	$43.1B	$38.06	$46.95	$38.06	+/ - 10.46%	-18.94%
CSL	$40.8B	$71.04	$102.43	$87.80	+/ - 18.10%	-14.28%
WOW	$30.7B	$24.11	$36.00	$24.11	+/ - 19.78%	-33.03%
MQG	$25.0B	$54.65	$86.20	$70.33	+/ - 22.40%	-18.41%
Top 20		3007	3775	2963.6	+/ - 12.04%	-21.49%

*includes South 32 to reflect demerger from BHP

Volatility is not a risk, it is the proxy chosen by the financial world to try and quantify the unquantifiable.

From your perspective, volatility is either a threat or an opportunity.

Your risk is not enjoying the optimal peace of mind your capital position and deployment affords you.

Your adult children's risk is not achieving a realistically achievable financial objective.

3. Context

Context is critical for the understanding of appropriate relativities.

Concerns about wars, financial crises, weather, recessions, commodity prices, inflation, pandemics, epidemics, will always exist to varying degrees particularly in a global context.

To maintain your peace of mind under all market conditions, we believe you must:

i. ***Understand Who You Can Trust***
ii. ***Have Reasonable Return Expectations - Understand Price and Value***
iii. ***Utilize Our Caution Index to prevent permanent losses of capital.***
iv. ***Understand relevant global history and current threats.***
v. ***Focus on assets providing decent sustainable earnings - Utilize the current bankable proposition to meet your receipted earnings targets.***

We are not served well by the fixation that markets and market commentators have about the normalisation of US interest rates.

In the current context, we place a much higher importance on the availability of credit compared to its cost for the following 3 reasons:

1. Lower commodity prices, particularly low oil prices and increased supply in the US.
2. Current and expected levels of inflation in the US.
3. The timing and impact of the introduction of the Nett Stable Funding Ratio to the Australian banking system.

i. Who you can trust

The Reserve Bank of Australia (RBA)

The Reserve bank has a mandate to mitigate the risk of financial disturbances that may have systemic consequences and to respond to financial system disturbances should they occur. The Governor of the Reserve Bank chairs the Council of Financial Regulators which consists of the RBA, Treasury, APRA and ASIC.

Lucy Ellis is currently the director of Financial Stability for the Reserve Bank.

Whilst prior to the establishment of the Council of Financial Regulators (CFR) we had reason to criticise some of the conclusions from the head of research at the RBA, since the CFR was formed in 1998, we don’t second guess the RBA. They have access to the deepest and most timely financial and economic data in the county and have shown high levels of capability at an international level.

Australian Prudential Regulation Authority (APRA)

Wayne Byres, the recently appointed head of APRA, following his very successful position at the Bank of International Settlements in Basel has sworn the following oath:

'Trust is the foundation of my professionalism. I will serve all interests in good faith. I will compete with honour. I will pursue my ends with ethical restraint. I will create a sustainable future. I will help create a more just society. I will speak out against wrong doing and support others that do the same. I will accept responsibility for my actions, in these and all other matters. My word is my bond.'

Glen Stevens, the current governor of the Reserve Bank's comment on the above is enlightening.

'In the end you can't legislate for culture or character. Culture has to be nurtured.'

Coupled with the above oath, APRA consistently prove that they can be trusted and following the HIH debacle, they are a proactive regulator.

APRA have been proactive in limiting the fuel to house prices through investor loan restrictions, they've reduced Australia's dependence on global wholesale funding and they are now actively protecting us from hot money.

Due to the resources available to them, they are able to manage the bank lobby as well.

Australian Securities and Investment Commission (ASIC)

The enforceable undertakings imposed on banks following the financial planning scandals evidences that apart from the 10 question test on its money smart website, the name and shame list and the review of credit worthiness of applicants for interest only residential property loans, that you are enjoying forceful protection.

Treasury

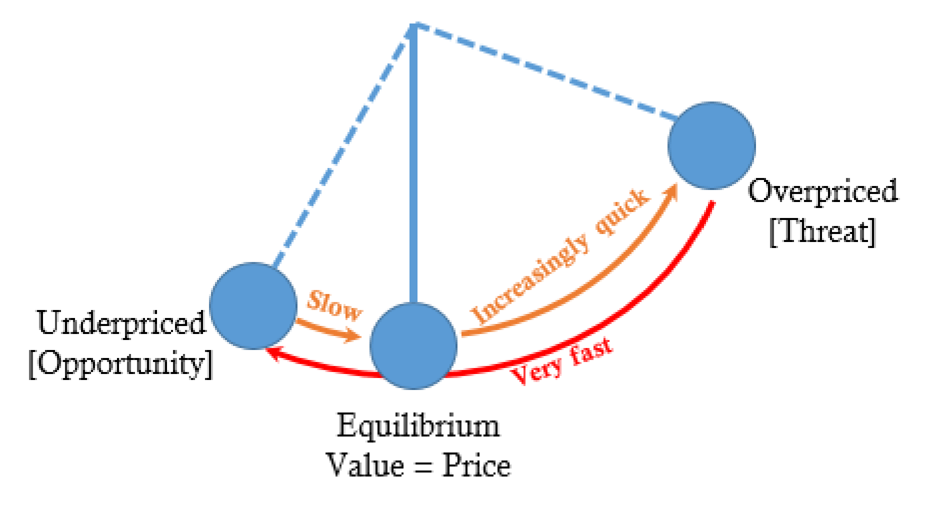
We have a natural bias against the Treasury given it usurped the tax offices control of tax policy some decades ago but we were pleasantly surprised at the treasury representative pointing out in public that some of the opposition's policies on superannuation surcharges would cost more to implement that the tax that would be saved.

ii. Appropriate Expectations – Price vs Value

The pendulum in action

It is useful to think of asset price movements as a pendulum.

Figure 2 – Asset price pendulum



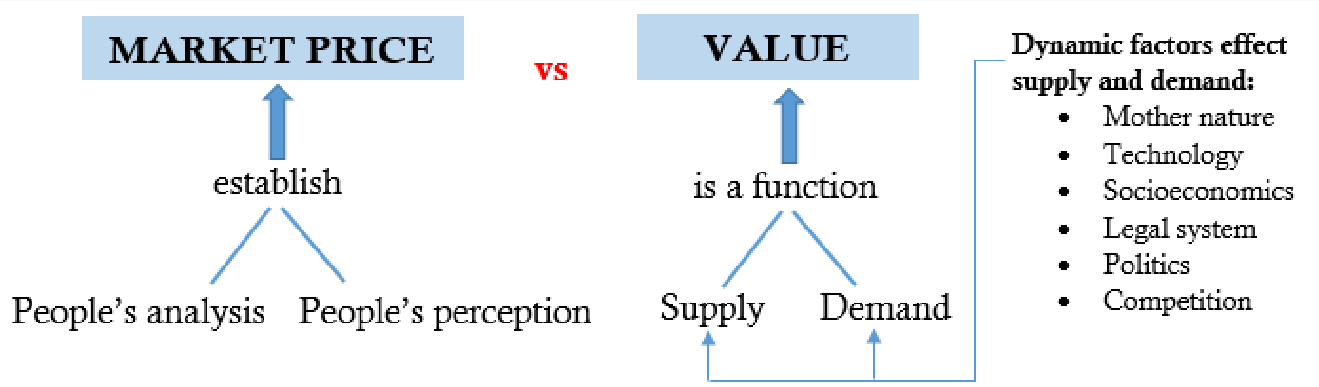
Whilst we can't predict short term price movements, we can conclude:

- Asset prices move from being underpriced and overpriced and back again.
- When the pendulum is vertical; price and value coincide but this occurs for only small amounts of time.
- Price movement (volatility) is either a threat or an opportunity.
- Overpriced assets can very quickly become underpriced assets due to overreactions (human psychology).
- The property pendulum because of acquisition and disposal costs takes a longer period to evidence itself compared to listed securities.
- Asset price pendulums move at different speeds and have different amplitudes.

Our reflection is that the existing shareholders have had realistic expectations met and their loss is one of missed opportunity.

We maintain our peace of mind by focusing on the intrinsic value of our investments, not daily share prices.

Figure 3 – influencing factors on market price vs value



In the long run, market prices move towards their intrinsic value. Therefore, we invest in businesses where we are confident the value will be higher in 5 to 10 years' time.

For investments in business, the following is critical for your peace of mind:

- ***Duration of Earnings***
- ***Durability of Earnings***
- ***Management team who you respect and trust***
- ***Paying the right price for earnings***

Example 1 - Appropriate Expectations for CBA

For those that owned CBA shares on 1 September 2014 and kept them they have experienced a 5% lift in receipted earnings the same as the 5% lift in earnings despite the second half experiencing a 3% fall in earnings. At the rights price of $71.50, CBA produces a 5.87% yield grossing up to 8.34% with franking credit. At the peak price in the last 12 months, the dividend yield fell to 4.37% receipted or 6.2% pre-tax.

Anyone who paid over $90.00 for CBA bank shares would be quite demoralized because they paid 25% more than was necessary for a predictable level of receipted earnings. So the volatility in CBA share price only affected purchases within the last 12 months and long-term investors who did not trade missed an opportunity, but their realistic expectations were met.

Given the competitive and regulatory framework there was no compelling reason to buy CBA shares a year ago nor today despite them having raised sufficient capital to both be in the top quartile of global banks CET1 ratios and to put the goal posts back to where they should be in capital adequacy for residential property secured mortgages.

Example 2 – Residential Property

We first used our pendulum analogy with owner occupied residential property.

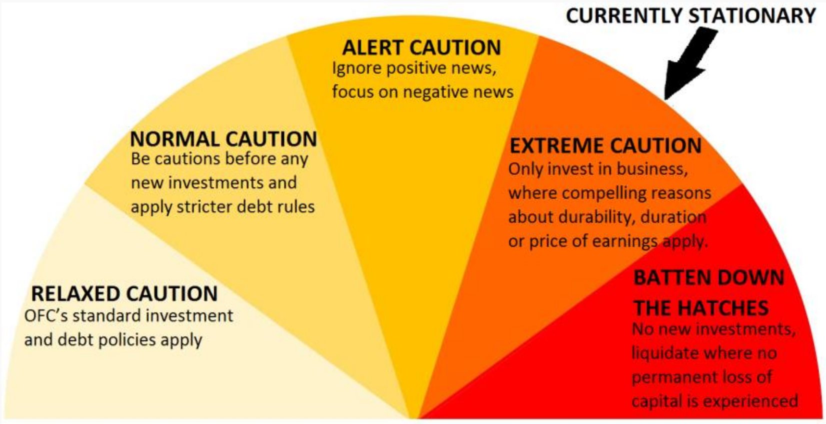
Many of you know of our white, light grey, dark grey, black price tool in designing pricing strategy for residential property. We don't believe that residential property can be valued at better than plus or minus 5% in normal market conditions and +10% to –5% in buoyant conditions.

Our conclusion on the pendulum is drawn from actual auction attendance over 30 years where we deliberately spotlight when the next bid could secure the property unconditionally. In other words the property is officially on the market.

iii. Our Caution Index

Our Caution Status Diagram (in figure 2 below) is our most important tool in maintaining your peace of mind and preventing permanent losses of capital under all market conditions.

Figure 4 – One Focus Capital's Caution Status Diagram



Despite medicated interest rates in the US, the Greek Fiasco, the Syrian tragedy, the Chinese economic transformation, and the demoralized Australian economy, we are stationary at the present in mid-Extreme Caution.

The trigger that pushed us to limit investment into business ownership, housing of business and loans to business to only those that had compelling criteria was the cessation of Quantitative Easing (QE) in the United States in October 2014.

The 'Taper Tantrums' the previous year had reversed the positive direction in Alert Caution.

iv. Relevant History & Current Threats

a) Shrinking US Bad News

The reason we analyse US data so assiduously is that Australia, let alone the rest of the world, is often collateral damage when the US waves its arms around or it gets a cold. If the US has a cold we get the flu and this won't change whilst I am alive and it is our current account deficit that makes this so.

The current volatility is certainly not a repeat of the Global Financial Crisis, but is as a result of it.

After we identified and analysed the six major contributors to that crisis we developed our 'unsupervised school boys in the lolly factory' analogy.

The Global Financial Crisis was born in the United States where the repealing of the Glass Steagall Act in 1999, coupled with the Y2K fiasco, coupled with the Sarbanes-Oxley Act, coupled with September 11, gave rise to 'classes of school boys' gaining free and unsupervised access to the lolly manufacturers, ruining the hygiene with their overindulgence and then exporting defective financial lolly stock overseas, as well as infecting all financial lolly retailers in the US.

In 2010, 12% of the US banks (some 880) were under the conservatorship of the Federal Deposit Insurance Corporation (FDIC). A year earlier we described the US economy as being on an ice covered lake and whilst the US was heading to shore, the ice was thinning via mortgage foreclosures and falling house prices. To make matters worse the US Government, with no historic precedent to rely upon, was battling to restore confidence in the government guarantee behind the world's reserve currency.

We will be forever grateful to Bill Evans, the economist from Westpac, who in 2004 directed us to study the Case Shiller Composite 20 house price index in the US

In 2010 we alerted you to the elevated importance of the change in trend of employment in the US because this would determine how long it would take the US to get back on terra firma.

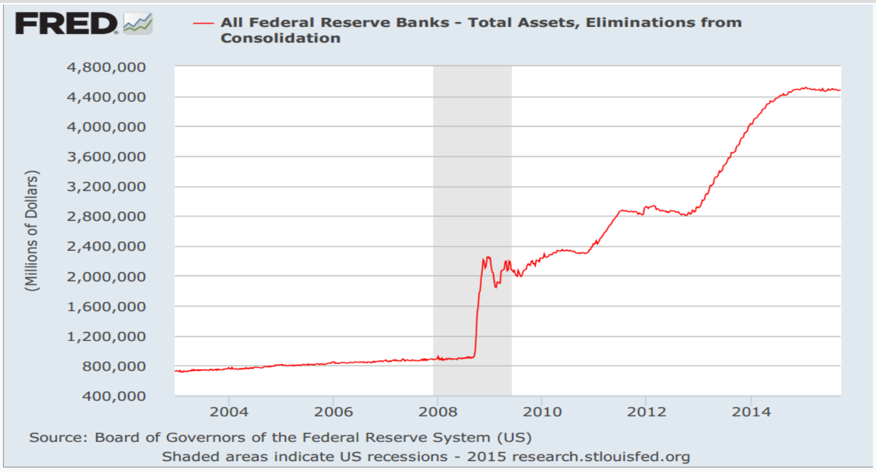
In late 2011 we pointed out that we faced a precipice in fair value return because of the combination of Quantitative Easing and Zero Interest Rate Policy that would hit in 2013/2014.

We did point out the long term extrapolation of this problem thanks to James Montier of GMO LLC.

6% fair value return reducing to 4% would increase the capital needed to produce $100,000 per annum from $1.65 million approximately to $2.5 million.

By September 2013 the US was back on terra firma, with respect to the impact of falling house prices.
Figure 3 provides the context of the United States quantitative easing where an additional US $3.7 trillion was pushed into banks and mortgage lenders to provide funding for business and in particular employment growth.

Figure 5 – All Federal Reserve Banks (US)



A limitation of figure 5 is that you can't identify the level of cash flow the Fed is receiving, what amortization on the mortgages is occurring, and what is the change, if there is any change, in the value of the marketable securities. We will ignore the last two and approximate the first now.

Our favourite graph on the recovery of nominal employment after every recession after the second world war in the US became redundant in September 2014. Six years after the bottom the US had the same jobs numbers as existed pre the GFC induced recession.

Figures 6 and 7 show why the US suffers a 'secular stagnation'.

Figure 6 – 'Breadwinner' Economy (US)

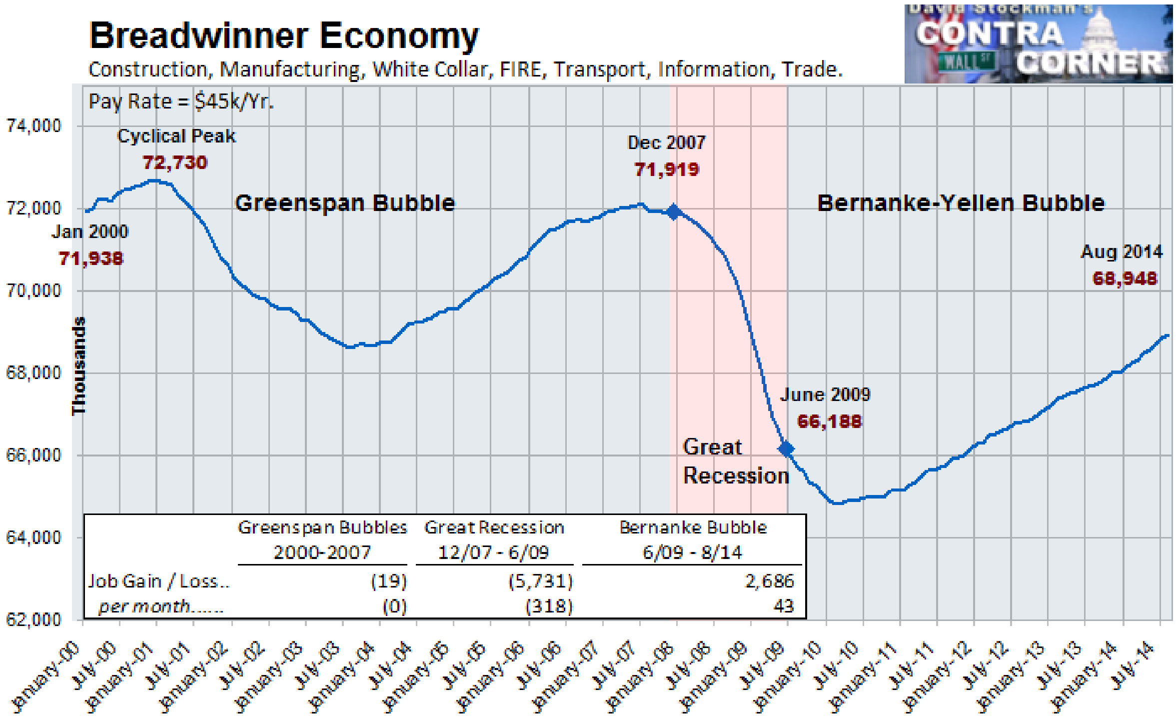
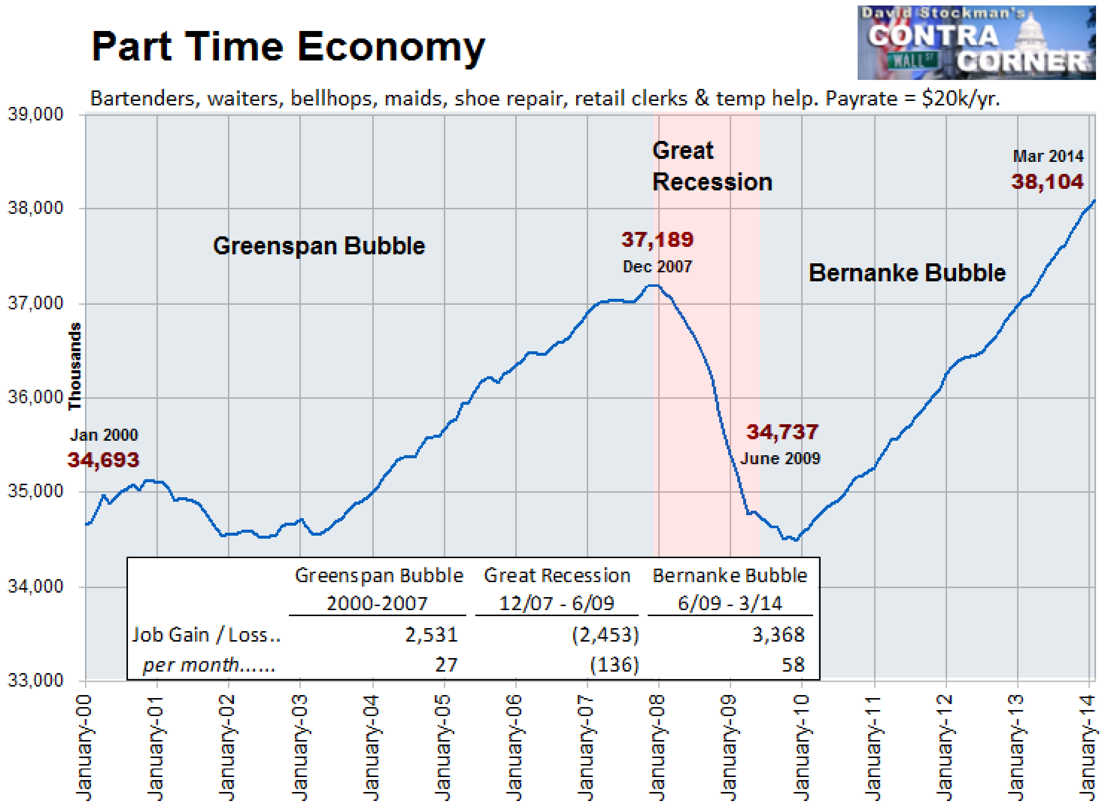


Figure 7 – Part Time Economy (US)



The changing ratio of private sector employment to public sector employment is very positive in terms of sustainability.

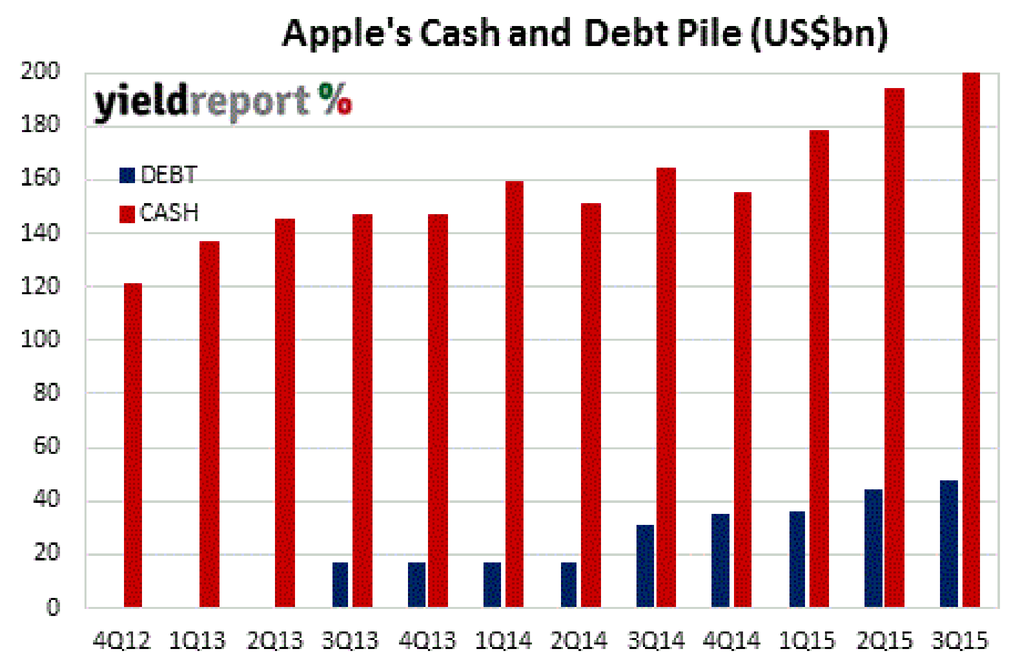
However there has been no growth in real terms in the private sector pay earned and only modest real earnings growth in public sector wages.

So with headline unemployment at 5.1% it is the just over the 10% score for U6 that is holding back the US, as is the loss of high paying jobs out of the banking sector and oil and gas sectors in favour of part time service jobs.

There is another by product of the above that relates to the Congressional Budget Office's pattern of revisions to the US fiscal 10 year projections.

Figure 8, combined with figure 5 of the Fed's balance sheet, are the foundation of our premise that you enjoy a much firmer 'peace of mind' footing than you realise.

Figure 8 – Apple



As previously stated, appropriate context is always critical and to have this you need to look at the Congressional Budget Office's (US legislative branch CBO) 25 August 2015 revision.

In the 2014/15 year the actual fiscal deficit was 2.8% of US GDP or US$485 billion against their initial forecast of 3.2%.

In its initial forecast for 2015/16 the CBO forecast was 2.8% or US$506 billion, but on August 25th this was adjusted down to US$426 billion or 2.4% of GDP.

Apple has in practice been lent US$70 billion interest free from the US tax office. Australian tax law would prevent Apple's free lunch. Very recently Apple borrowed AU$2.5 billion as part of their concentration risk policy and the interest they earn on their tax saved far exceeds their borrowing cost to pay dividends so their debt is riskless and profitable.

So Apple's contingent tax liability alone is enough to cover 17% of the US fiscal deficit but probably over 20% given the CBO's form.

When we combine the amounts of US corporate's overseas cash balances that have a contingent tax liability, then we conclude that the US fiscal position is much better than a deficit of 2.4% of GDP.

When this is coupled with the current trajectory of the US fiscal position and you add the undisclosed profit and cash flow of the additional US$3.7 trillion the Fed holds, if they are not in fiscal surplus now, we would be unbelievable surprised.

If not, they will get there by 2020 at the latest.

Under these circumstances the US faces very difficult and profoundly impactful decisions. If they raise interest rates their currency becomes more attractive but this will seriously threaten their exports which will feed back into the domestic economy. However the increased dollar will export inflation which in turn will lower the level of 'normal' interest rates.

The US is unhappy if inflation is 1% or less or 2% or more.

But we don't need to worry about the US bank's solvency issue, the FDIC balance sheet exceed the assets of the banks in conservatorship, nor the government fiscal position as we expect the actual deficit to be 2% of GDP in 15/16, nor the unemployment position as we expect headline unemployment to drop below 5%, but don't expect economic growth to rebalance for a lot longer than any of the publicised experts believe.

Secular stagnation is the way Laurance Somners describes the sluggishness of the US economy.

The two leg irons that still exist in the US are, firstly the 9% of mortgages houses that have nil or negative equity and the second is the underemployment reflected in U6. Both these leg irons have left a permanent dent in the psyche of the GFC impacted American consumer. We expect that the U6 leg irons to take another 3 years before it rectifies which coincides with the period that we believe the negative equity leg iron will also be removed.

Finally the US has 450 million barrels of oil in its stockpile, some 20% more than the five year average. Our previous nomination that the technological boom in fracking gas productivity would be the most significant contextual change in the short term has been more accurate than we had any right to expect.

b) **Debt**

This section of the irregular must be prefaced by the following statement.

> ***Never has debt been as useful in my 40 plus years in financial services but never has it been more dangerous.***

The OECD released its paper 'How to restore a healthy financial sector that supports long lasting inclusive growth' in June 2015. The fact that this paper was necessary speaks volumes.

The data in this paper proves that too many households have counter-productive debt and that it is bank self-interest that has driven this and the other instances of counter-productive debt.

> ***Counterproductive debt is evidenced by a meaningful reduction in choice because of existing levels of indebtedness.***

The above introduction leads us to the specific topic of debt and the change in truth that has occurred with debt because of ZIRP and QE.

I will deal with the danger first. ZIRP is using the cost of debt – interest – to encourage borrowers to invest in business capital and labour to fund additional economic growth. However, as has been the case in Japan for over a quarter of a century, depositor lenders supported this exercise. Given who the lenders are there has to be a heavy hit on the sustainable spending in the community that could have outweighed the interest rate stimulus benefit!

Whilst sustainability is most often used in the context of climate change, sustainability is equally critical in both micro and macroeconomics. In practice, sustainability is a precursor to stability.

QE has pushed enormous liquidity into the system to arguably an unhealthy level. When QE was announced, those of the Chicago school predicted hyperinflation. Instead of consumer price inflation we have had asset price inflation.

We really only want asset price appreciation if the asset becomes more economically useful and not because long term interest rates are at unsustainably low rates.

When we toss in the global volatility in exchange rates, where there can be hysterical reactions to logical adjustments, the waters can become very muddy indeed.

In the midst of this confusion all you can hope to do is accurately identify trajectories, identifying those that by their very nature are unsustainable, and know where you sit on the spectrum of both fear and greed. The firmer footing we claim that you can enjoy for probably five but certainly three years forward relates to a bankable proposition.

v. Australia – The Bankable Proposition

We are very lucky in Australia. Glen Stevens, our current Governor of the Reserve Bank, has an articulate and clear view of the unusual nature and contradictions that occur in our monetary policy stances, as does his successor, Dr Phillip Lowe.

Reading their publicised work is a mandatory component of our analysts' continuing professional development.

Equally impressive is the regulatory body APRA who regulate our banks, insurance companies and non SMSF super funds.

It is APRA and ASIC that help create the bankable proposition of receipted earnings from bank hybrids as illustrated by figure 9.

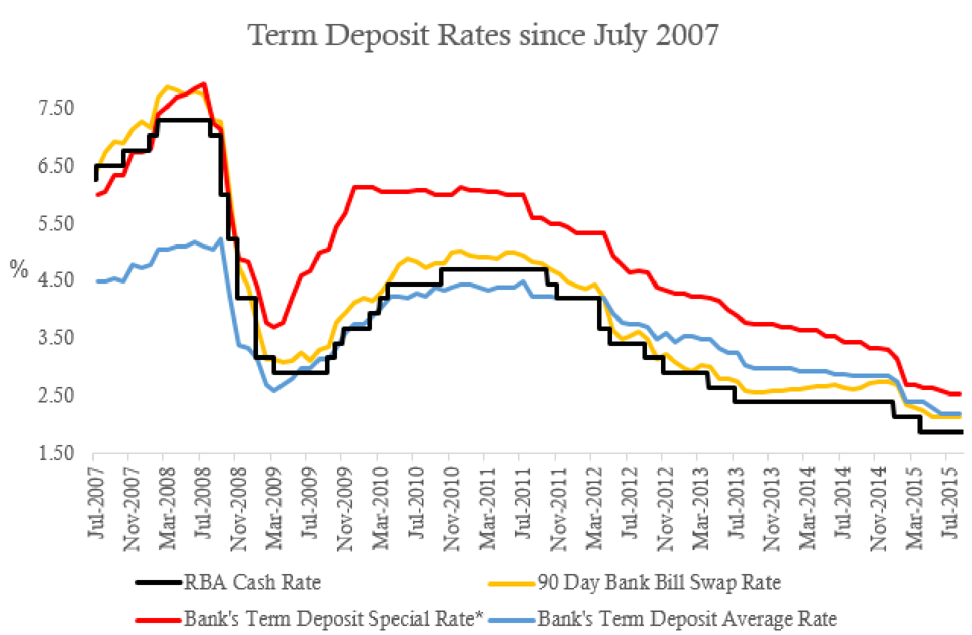
Figure 9 – Receipted earnings for Commonwealth, Westpac, ANZ and NAB hybrids

Year	Overnight Cash Rate	Highest Running Cash Flow from Big 4 Bank Hybrid	Receipted Earnings Target	% of Receipted Earnings Target Covered
01/08/2013	2.75	6.11	6% real +2.5% = 8.5%	71.9%
01/08/2014	2.50	6.04	6% real + 2.1% = 8.1%	73.8%
01/08/2015	2.00	6.15	6% real + 0.9% = 6.9%	89.1%

Following the GFC, APRA regulated that the banks needed to reduce their exposure to wholesale international funding by increasing their funding from domestically funded term deposits.

The graph below shows how quickly the banks jumped. To create the momentum the banks had to offer higher rates until they could profit from depositor inertia.

Figure 10 - Special Term Deposit Rates



**The term deposit 'average 'special' rate (all terms)' is a simple average of the five largest banks' 'special' rates.*

The 2 key points are:

1. The difference between Term Deposit special rates and average rates was highest between 2009 & 2014.
2. The shrinking difference between Term Deposit special rates and the 90 day Bank bill rate from 2010.

Don’t trust your bank. They are not your friend.

APRA is currently imposing two extraordinary capital raising impositions on the four majors and Macquarie bank and ASIC has added interest only financing to its beef about hybrid pricing by banks. APRA is also imposing one extraordinary imposition on all banks.

Some twelve years ago, Macquarie bank acting with the 4 majors proved to APRA they could use specially designed models to self-regulate their Common Equity Tier 1 provisions for loans secured to 80% of the value of residential titles.

Abuse of the system occurred so APRA has given the four major banks and the Macquarie bank until July 1, 2016 to put the goal posts back where they were. The other banks welcome back the level playing ground.

The ANZ bank and the Commonwealth bank have both declared that they have raised enough capital for the first imposition. The Commonwealth bank claims it has raised the capital for the second extraordinary too.

The second extraordinary has yet to be given a deadline, but relates to the head of APRA Wayne Byres wanting Australian Banks to be in the top quartile of global banks in relation to the new Basel Common Equity Tier 1 ratios; Australian banks, save the Commonwealth bank, are currently in the second quartile.

So that you can put bank greed into perspective, we should look at two bank specific examples and two industry examples.

First, last August the Commonwealth Bank issued a PDS for a hybrid security CBAPD priced at 280 basis points above the 90 day bank bill rate. The bid price for that security, a year after issue, is $86.81 per $100 issue.

It is this mispricing power that has led to ASIC putting a 10 question test on its money smart website. ASIC is very concerned that consumers are at the mercy of banks who have extreme knowledge and pricing power.

The mispricing is producing some $30 million plus of wealth shift to the bank per annum or over $200 million over the expected life of this security.

The subscribers have lost not only choice but some eighteen months of their interest income (permanently). Buyers on market can gain a contingent yield to maturity of 7.5% and a running yield of 5.9% if they have access to wholesale transaction costs.

We have yet to see bank directors offer to reduce employees pay but are very quick to charge borrowers more, pay less to depositors and even cut dividends to shareholders.

The other specific example is the recent $3 billion ANZ raising. Unlike either the National or Commonwealth banks who did their respect shareholders' sovereignty over dilution decisions, the ANZ used the Corporation Act limit of 15% to make an institutional placement of $2.5 billion and a $500 million share purchase plan (SPP). An SPP limits individual shareholders regardless of the size of their holding to just $15,000 of additional shares.

Given the ANZ's access to wholesale markets and its capacity to negotiate low underwriting margins this exercise despite subsequent events was contemptuous of the non-influential shareholder rights.

The first of the two banking industry examples is the public statements of the banks following APRA's reaction to the banks not reducing the growth of their residential investment property loan book to 10% or less per annum requested by APRA in 2014.

The banks knowing that demand would exceed supply put up the interest rates on these investment loans declaring that they were forced to do this because of APRA policy.

Codswallop, there is absolutely no direct link and the banks have been aware of APRA's position for over a year.

There are four stakeholders in banking putting aside why there is a need for a regulator – being borrowers, depositors, employees and shareholders.

Those boards and senior employees of banks have a vested interest in maintaining the status quo but can appear righteous in stating their prime responsibility is to shareholders.

The second industry observation is that the banking lobby, extremely well-funded and staffed, has succeeded in reversing the Government commitment and Treasury advice that the banks should pay 0.25% on those deposits that carry a taxpayer guarantee. This is the price of doing business and should be borne by the shareholders.

The most telling reason I have reserved confidence that my Grandchildren won't become adults in a more corrupt banking system than exists is that the young analysts at One Focus value and demand transparency and proper governance.

We attended the inaugural Banking and Wealth Summit sponsored by Deloitte and run by the Australian Financial Review in Sydney last April.

So the gestation period for this irregular is 6 months, with the trigger to know that it may be necessary being the inaugural Banking and Wealth conference. In practice we attended that conference as your proxy seeking answers to the following questions:

1. Would the bank hybrids be more exposed to their 3 caveats or less in the short term?
2. Was dividend imputation under threat?
3. Was there any threat to non-assessable superannuation pensions for those aged 60 or more?
4. Was the quarantining of negative gearing being reconsidered?

Our findings were sufficient for us to want to pop the champagne corks.

Peter Costello was outstanding in his defence of the status quo in Superannuation, chiding the Government to think beyond the forward estimates period.

> ***Glen Stevens concluded his speech by identifying the root cause of misconduct were found in distorted incentives and the erosion of the culture that had placed a great store on acting in an ethical way.***

Stevens' conclusion was strongly reinforced by the Commonwealth Bank Independent Director.

Wayne Byres was articulate in his explanation of what APRA's agenda is which was unpopular with the bank executives in panel discussions; the major banks didn't want to revert to a level playing field.

The pleasant surprise was the Treasury representative pointing out that some of the opposition policies on superannuation surcharges were negative fiscally. In other words the cost and complexities of collection outweigh the benefits.

The final session on the second day was by an actuary from APRA who reinforced the news that had emerged in this summit: transparency and good governance were more important that compliance.

Bankable Proposition – Sophisticated Savings

We have created our new sophisticated savings fund which utilizes the current bankable proposition.

We believe bank hybrids are the most attractive they have been for the past 6 years. The interest rate margins are higher and their key risks are decreasing as APRA is forcing banks to strengthen their balance sheets.

Westpac, following the lead of the other banks, has announced a return on equity aspiration of some 14%. To achieve this Westpac has no choice but to issue hybrid securities. In order to qualify for Common Equity Tier 1 ratio inclusion cannot be pure liabilities, hence the three caveats.

As stated above ASIC is so concerned that retail investors don't understand these securities that there is a 10 question test to verify understanding on the money smart website. ASIC is also concerned at the pricing power banks have with these securities.

So whilst these securities can only qualify as Common Equity Tier 1 capital if they can be legally used as loss absorbing capital in times of extreme bank stress, we know that for the next three years at least bank greed will ensure they become less risky.

The exception to this, is if a substantial increase in unemployment triggers substantial house price falls, before the current mitigation to this risk becomes effective.

The Commonwealth Bank increased their payout ratio for dividends to 75.1% of net profit after tax. The franking credits attached to the 24.9% are normally useless to the shareholder except where they are used in lieu of interest for bank hybrids leading to, in practise, a direct leverage for the shareholder in ownership of profits.

But it is ASIC's second beef on the lack of credit-worthiness in many interest only loans for investment residential property, coupled with the increasing level of Common Equity Tier 1 that leads us to conclude that not only will hybrids be less exposed to their 3 potentially negative caveats but that in practice only one caveat presents a threat. That caveat is the limitation on the number of ordinary shares available for conversion in the event that a bank concludes its solvency is at risk.

We know that one bank solicited feedback from the wholesale market at a 500 basis points margin.

It will be a case of when not if that this issue comes to market and then you will be able to gain your receipted earnings return without direct investment risk.

4. Conclusion

We conclude you do have a firmer base to your financial peace of mind than you probably realize. This is without taking anything for granted nor needing a free lunch.

You can maintain your peace of mind under all market conditions as you understand the following (with our professional help and guidance):

i. ***Understand Who You Can Trust***
ii. ***Have Reasonable Return Expectations - Understand Price and Value***
iii. ***Utilize Our Caution Index to prevent permanent losses of capital.***
iv. ***Understand relevant global history and current threats.***
v. ***Focus on assets providing decent sustainable earnings - Utilize the current bankable proposition to meet your receipted earnings targets.***

If you require clarification of any element of the five tools above please contact our office. For the OnFocus Community members we will advise on whether you should do an 'Apple'.