

BLa BLa BLa

IN THIS ISSUE

Lizard brains

Personal tax changes following the passage of the carbon tax legislation

Extension of reduced minimum pension payments for 2012–13

Funeral plans

Cash rates diminishing

BLA from around the world

Christmas hours

LIZARD BRAINS

You would think that in preparing this edition of *BLa BLa BLa*, we would lead with a story covering the European debt situation and provide a summary of exactly ‘where things are at’. There is no doubt that the European situation has been the major influence on financial markets over the latter part of 2011, so it would be the logical issue to deal with in this forum.

The problem, however, is that *BLa BLa BLa* takes approximately two weeks from writing to distribution. And over recent months the political situation in Europe has been changing almost daily, with markets reflecting these highs and lows. So trying to write an article on the European situation that will hold up until the newsletter is distributed would therefore prove to be a very difficult task.

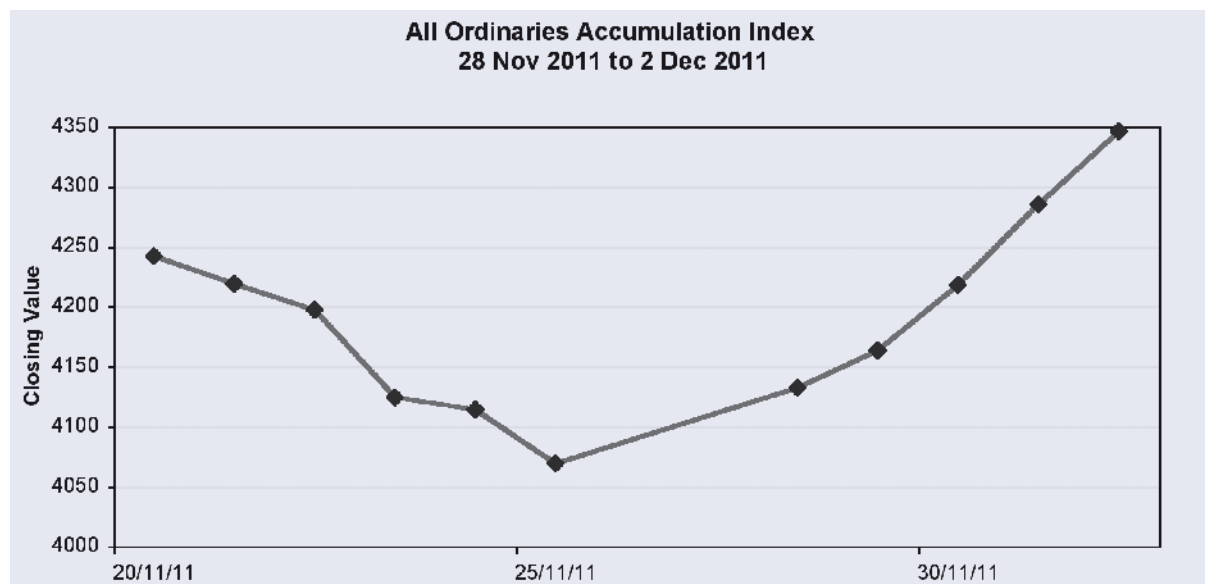
Nowhere is this better seen than by looking at the share markets in late November and early December.

In the week beginning Monday 21 November 2011, the

Australian share market (as measured by the All Ordinaries Accumulation Index) fell every trading day on the back of negative European sentiment. The market opened at 4242 on Monday 21 November and closed at 4219, 4197, 4124, 4114 and 4069 over the course of the week. These five consecutive days saw the market fall 4%, with the media and financial commentary painting a picture of ‘death by a thousand cuts’.

But the following week (beginning Monday 28 November) saw five positive days of trading, with the market closing at 4132, 4163, 4218, 4285 and 4346 over the course of the week. In these five days the market put on some 6.8%, with market analysts attributing this to ‘an improved political outlook within Europe’.

We know, from first-hand experience, that these swings drive people crazy. When the share market racks up a pattern of back to back losses, the emails and phone calls start to come through, with some clients wondering whether they would be better served by cutting their



losses and moving back to cash. In a good week, like that beginning Monday 28 November, the calls and emails go mysteriously quiet.

When you think about this logically, it's quite odd. Over the space of a week, it's highly unlikely that the world has changed. So the economic and political factors that dominated the negative share markets in the week beginning Monday 21 November were still largely there in the following week. Additionally, if someone was prepared to cut their losses and move back to cash in the week beginning Monday 21 November, why would they not still be keen to do this in the following week, when their losses were a lot less? Yet, buoyed by a few positive days in the market, their mindset has changed.

We have seen this behaviour many times over the years. And while our *bucket approach* to investing attempts to remove the 'is it a good time to invest?' question, human behaviour often sees people make 'gut judgements' in the heat of the moment.

Perhaps the best recent example of this behaviour was in the final days of the global financial crisis (GFC). From the end of October 2007 through to early March 2009, the Australian share market fell some 54% to 3111.

What the media and financial analysts of the day did not see coming was a significant rebound in the markets. Over the next 13 months the ASX put on over 60% to close over 5000 points in April 2010.

There is no doubt that those who came out worst from the GFC were the investors who rode the share market down, then switched to cash near the bottom. These investors did not benefit from the rebound in the market. Even worse, some investors stayed in cash until the market rose to 5000 and then decided that things were OK again and re-entered the market. As we now know, at this point the Greek economic situation first came to public attention, causing the share market to immediately retreat 17%.

Traditional thinking says that the share market is 'efficient'. Being efficient means that the market absorbs all new, relevant information and immediately prices this information into the value of a share. For example, when the Reserve Bank of Australia (RBA) increases or decreases the official cash rate, the movement of every share on the ASX is supposed to reflect how the rate increase/decrease is going to affect that particular sector or company. When Silvio Berlusconi resigned as Italian prime minister, the subsequent movement in the price of every share in the market is supposed to reflect the implications of his resignation on each particular company.

It's true to say that the extent of market movement has to come down to something other than markets being efficient. Even the purists would struggle to believe that a 4% fall in the week beginning Monday 21 November, followed by a 6.8% rise the following week, can be purely attributed to the market being efficient.

The patriarch of modern economics, Adam Smith, came out with an analysis of market trends of production and consumption where he concluded that markets, if left alone, have an inherent potential of becoming efficient. It is as if there was an **invisible hand** that guides the market to a level that is good for society.

For example, if there is no demand for tomato flavoured ice-cream, the invisible hand will convince manufacturers not to waste their resources on producing it, but rather concentrate on more popular/profitable flavours. No one prescribes that the manufacturers must think like this; it is the invisible hand at work.

It's probably true to say that a similar invisible hand is responsible for the significant swings in the share market. Even the most strident believer of efficient markets will have trouble explaining the large swings that occur daily when, in reality, very little of the big picture has changed. Economists and analysts have pondered this issue for a considerable time.



Over the past decade a new strain of economics, behavioural economics, has gained considerable credibility. Unlike traditional economics, this is a blend of psychology and economics. The overlay of psychology, analysing how individuals react under different circumstances, could well be the invisible hand that traditional economics can't explain.

One of the most noted behavioural economists in the world today is Dr Terry Burnham of Boston, United States, author of the book *Mean markets and lizard brains*. Stephen and Scott were fortunate enough to meet with Terry over lunch recently to quiz him a bit further about his philosophy on markets.

In light of this, we have decided that the lead article in this month's BLA BLA BLA will not be about Europe, market performance or predictions of the future. Rather, we thought it appropriate to step outside the square a little and investigate the science of behavioural economics, to see if this is the invisible hand that makes markets and investors

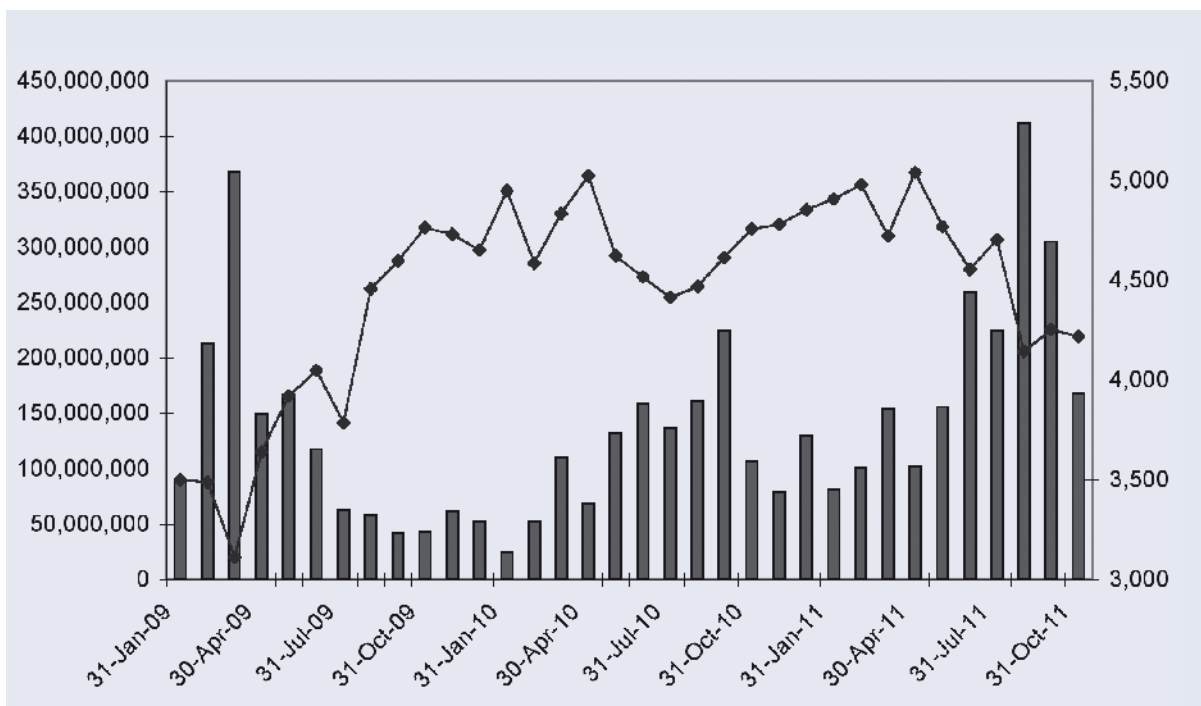
so jumpy. Much of the following commentary comes from Terry's book.

If you were to ask an experienced investor for the key to investing, one would expect the answer to be along the lines of 'buy low and sell high'. But there are two inherent problems with this answer.

Firstly, it is only with the benefit of hindsight that we know if markets are high or low. We can speak with some certainty about relative highs or lows (for example, the market is higher now than it was in March 2009), but we are only guessing as to whether the market will be higher or lower at any given point in the future.

Secondly, people do not follow the rules. Whether we call it the invisible hand or (as Terry Burnham calls it) the lizard brain, we sell low, knowing it is low (relatively speaking). This is seen very clearly in the graph below.

The data used in this graph came from one of the major fund managers we use. It shows (in bars, measured in



dollars on the left-hand scale) the month by month inflow into 'cash' investments. These investments were at the expense of other investments (such as shares, balanced funds, property funds) that were sold down to invest in cash.

The dotted line (as measured by the right-hand scale) shows the monthly midpoint in the Australian share market (as measured by the All Ordinaries Accumulation Index).

The bars and line are virtually mirror images of each other. When the Australian share market was in decline (early 2009, mid 2010 and mid-late 2011), individuals sold their investments and went to cash. They stopped investing in cash after the share markets started moving upward again, but retreated back to cash after the next wave of market uncertainty came along. This is a classic case of shutting the gate after the horse has bolted.

At the time, investors knew they were selling at a low point. Regardless of the fact that they did not know where the market was going, they did know that the share market was significantly lower than where it had recently been. However, as shown on the graph, this did not stop individuals selling (in droves) their assets and going back to cash. If investors know that the name of the game is to 'buy low and sell high', then what invisible hand made them 'buy high and sell low'?

There are essentially two culprits behind this. The first is the media, where it is true to say that bad news sells more papers. What people seem to forget is that journalists and the media in general have no more idea about future market direction than anyone else. The direction in which the market moves tomorrow, next month or next year is yet to be played out. It will depend on economic and political announcements that unfold over this time frame.

For example, anything could happen next month to drive markets one way or the other. Although all eyes are currently concentrated on developments in Europe, a 'market driver' could come from the United States, Asia or

anywhere else in the world. A journalist giving a prediction that 'worse is yet to come' has no idea what will eventually happen with future rounds of quantitative easing in the United States, nor do they know whether the European Central Bank, the International Monetary Fund, France, Germany and other countries will act decisively enough, and soon enough, to alleviate the pressures from Europe. How the market responds in the future will be governed by factors such as these and many more. None of these factors are known today.

The role of the media is obviously very crucial in this regard. For investors to ignore the fundamental 'buy low and sell high' principle, *knowing that the market was 54% lower compared to where it had been*, there had to be an overriding factor to convince them that this was the right course of action.

If we look at (see box opposite) the media of the day, it is not hard to see this. If we consider the financial press over the final days of the GFC (January to March 2009), the consistent theme of most articles was that 'worse is yet to come'. We know with the benefit of hindsight that this was in fact the turning point for equities, however, the media of the day was painting an extremely high probability of the United States falling into a double dip recession, or even depression. No matter what news you read, the spin was for worse to come.

What we now know happened is that individuals placed greater probity on 'opinions of future losses' than they did on 'actual losses'. There is no other explanation as to why many rational investors would appear to act so irrationally.

This introduces us to the second culprit, one that we do not have to look far to see, our lizard brain.

As the title suggests, the concept of the lizard brain in modern investment decisions is the topic of Terry Burnham's book *Mean markets and lizard brains*. The general theory being put forward is that human evolution is slow, in comparison to changes in our environment and technology. Our environment is changing at a greatly



accelerated rate compared with any other time over human development but our brains are simply not evolving and keeping pace. To a large degree, Terry suggests that we are making 21st century decisions with a brain that is many centuries behind the pace.

Fundamental to this theory is the concept of 'split brain investing', accepting that different parts of the brain perform different tasks. Many rational calculations are carried out in part of the brain's prefrontal cortex, which is located above the eyes. When we think about our investments in analytical terms, the prefrontal cortex is boss. Compared to other animals, humans have an extremely large prefrontal cortex, which explains our superior reasoning ability. While we are therefore uniquely able to make rational decisions, the lizard brain is also involved – and more involved than we suspect.

Lizard brain is shorthand for the less cognitive, less abstract mental forces that influence human behaviour, most of which have nothing to do with lizards.

The lizard brain is great for finding food and shelter, but terrible for navigating financial markets. Many financial problems occur when we use the lizard brain to make monetary decisions. Instead of using the analytical part of our brain, we often default to the older parts of our brain that helped our human ancestors survive for tens of thousands of years before financial markets were created. Lizard brains are pattern-seeking, backward-looking systems that allowed us to forage successfully for food and repeat successful behaviours. These systems helped our ancestors survive and reproduce, but financial markets punish such backward-looking decisions. Consequently, our lizard brains tend to make us buy at market highs and sell at market lows.

We should not be surprised by the suggestion that our bodies struggle to keep up with the change in our environment. There are numerous examples:

- Our blood is 'thick'. It is common practice today for individuals to take an aspirin a day in order to thin

Print media headlines in the last days of the GFC

With the benefit of hindsight, we know that the bottom of the share market was 6 March 2009. We also know that it increased by more than 60% over the next 13 months. With the benefit of this hindsight, we know that this was not the time to be selling down shares and moving to cash.

However, as the previous graph shows, this is exactly what individuals were doing. This gut instinct, guided by the lizard brain, compounded the losses for many. But one doesn't have to look far to see what encouraged individuals to take this action.

In the first six months of 2009 the financial press was overwhelmingly negative about the possibility of any economic or share market improvement. Over this period negative economic comment outweighed positive comment by 6:1. An investor looking for a lead on where things may be going would have received only negative sentiment when reading the financial press. This would have played into the hands of the lizard brain.

We have provided (below) a handful of typical headlines from the major financial newspapers over January to June 2009. It is understandable why an investor reading these articles would take the flight to safety. Quite clearly, the financial press did not have any divine insight into future share market direction.

- 2/1/09 – Economy may be worse a year from now
- 4/1/09 – Recession may not end in 2009
- 8/1/09 – World may be in worst recession since WWII
- 29/1/09 – The current stimulus plan: An \$800 billion mistake
- 3/3/09 – Fall in US household wealth likely to spur a long recession
- 4/3/09 – There is ample reason to worry about slipping into a depression
- 5/3/09 – History reveals odds of recession snowballing into depression
- 29/3/09 – A new plan needed as the cycle grows vicious
- 4/4/09 – Uncharted territory
- 5/5/09 – Pandemics and depressions – the swine flu could take an economic toll
- 1/6/09 – Improvements in the economy are not sustainable

their blood and reduce the chance of a heart attack. The viscosity of our blood stems from its superior clotting ability, which was of significant importance to our ancestors who had frequent wounds and died too young to worry about heart attacks.

- Babies that are solely fed on breast milk are often vitamin D deficient. Vitamin D is created by contact with sunlight. This was not a problem for our ancestors, but with our movement indoors, the natural levels of vitamin D are inadequate.
- We are 'programmed' to enjoy the taste of unhealthy foods more so than healthy food. For our ancestors, the more calories they ate, and particularly the more dietary fat they consumed, the better. Ancestral humans who ate more of what we term 'junk food' were better able to survive and reproduce than their competitors.

When we consider that we moved from hunting and gathering to agriculture only in the last 10 000 years, it's not surprising that our bodies are taking some time to catch up. It should also not be surprising that our brains have also taken time to evolve.

If we think about our ancestors, their brains focused on patterns that brought results. If they knew that animals frequented a particular place at a certain time of day or year, they would work around that. Their brains were pattern-seeking, backward-looking systems. It is very difficult to remove tens of thousands of years of this programming.

To a large extent, the decision-making human is living in an unnatural environment today. We are effectively built for one world and living in another. Although the decision-making part of the brain has developed, there is still a large part of the brain that is thinking about how to club the woolly mammoth.

By its very nature, investing requires us to be forward-looking to anticipate future events. Our lizard brains, however, are designed to look backwards. Thus the lizard brain causes us

to be optimistic at market peaks (after rises) and pessimistic at market bottoms (after falls). Investing is fundamentally different from many ancestral tasks. Rather than do what worked best in the past, investing requires staying a step ahead of others. Thus there can be no stable relationship between information and the correct course of action.

It also explains why personal financial decisions can be so difficult to make, and why the right decisions so often elude us. The lizard brain makes us impatient, which is why studies find that most people will choose a gift of \$10 today over \$11 tomorrow (which is in fact an annualised return of over 3000% for waiting one day). It explains why investment decisions are so difficult. We feel the pain of losses so greatly that we're compelled to sell when prices are low. Similarly, we're so excited by investments that are rising in value that we end up buying more.

Investing is the ultimate cognitive situation where we need precisely to restrain our instincts in order to make money. Unlike neutral games of chance, or ancestral problems like gathering and hunting, financial success means suppressing our gut response. In other words, by understanding how our brain works when it comes to personal financial decisions and by recognising the impulses of the lizard brain for what they are, we can come to better conclusions and act accordingly.

At BL&A we work hard to suppress our lizard brains. We are the first to admit that the direction of tomorrow's share market is a mystery. Whether we like it or not, the fortunes of the Australian share market depend more on worldwide factors than on local ones. To make a definitive comment about where markets will end up in the short or medium term is nothing more than pure speculation.

Using our prefrontal cortex, we decided that the best way to take 'gut instincts' out of the equation was to have a rigid, non-emotional investment philosophy. It has always appeared logical to us to marry investment strategies to consumption time frames, as these are more predictable than the short/medium term direction of investment markets.



PERSONAL TAX CHANGES FOLLOWING THE PASSAGE OF THE CARBON TAX LEGISLATION

Since the last edition of *BLa BLa BLa*, the Gillard government has successfully passed its carbon tax legislation. As most would be aware, this will impose a levy on large producers of carbon dioxide. The cost of this levy will flow through to consumers in higher charges for property rates, electricity, flights, groceries and the like. To ensure that consumers (voters) are not adversely affected by these increased costs, the government has also introduced a compensation package for most taxpayers, the cornerstone of which will be a change in personal tax rates from 1 July 2012.

The changes in personal tax rates are shown in the table below.

The changes increase the tax-free threshold considerably, but higher marginal rates apply for the next two thresholds. This is designed to give the greatest level of compensation to those on low incomes, moderate compensation to mid-range income earners, and no compensation to anyone earning \$80 000 or more.

Of course the Australian tax system is far more complicated than this table suggests. We must also consider the impact of tax offsets, which vary enormously from individual to individual.

There is no doubt that these changes create both risks and opportunities. The change in the marginal rate of 30% to 32.5% for the most common tax bracket (\$37 001 – \$80 000) will see this rate higher than the company tax rate of 30%. It may well be that an unintended consequence of these changes will be to create an incentive for small businesses to incorporate rather than just operate under an ABN. It may also mean that the use of traditional tax shelters (such as pension funds) may need to be rethought in cases where other taxable income is low.

Given that these changes do not come into effect until July next year, we will discuss this issue in our May 2012 edition of *BLa BLa BLa*.

Income range (\$)	2011–12 rates (%)	Income range (\$)	2012–13 rates (%)
0 – 6 000	0	0 – 18 200	0
6 001 – 37 000	15	18 201 – 37 000	19
37 001 – 80 000	30	37 001 – 80 000	32.5
80 001 – 180 000	37	80 001 – 180 000	37
180 001 +	45	180 001+	45

EXTENSION OF REDUCED MINIMUM PENSION PAYMENTS FOR 2012–13

In the 2011–12 Federal Budget, the government announced that the minimum pension payment relief would be phased out. For 2011–12 the reduction would be 25%, and return to the standard minimum levels from 1 July 2012.

On 29 November 2011 the government announced that it intends to extend the 25% minimum pension payment relief to 2012–13. This measure reduces the requirement to draw down on portfolios which may carry unrealised losses due to continued volatility in share markets.

The table below outlines the minimum pension payments for 2012–13, increasing back to the standard minimum payment percentages for 2013–14 and future financial years for all account-based pensions, including allocated pensions and term allocated pensions.

In light of this recent announcement, all BL&A clients should reconsider their future pension payment requirements, along with any one-off lump sum needs.

Factor changes to allocated pensions and transition to retirement allocated pensions

Age at start of financial year	Minimum payment percentage for 2012–13 (%)	Minimum payment percentage for 2013–14 and future financial years (%)
Under 65	3	4
65 to 74	3.75	5
75 to 79	4.5	6
80 to 84	5.25	7
85 to 89	6.75	9
90 to 94	8.25	11
95 or over	10.5	14



FUNERAL PLANS

Viewers of day time television will no doubt be aware of the plethora of funeral insurance advertisements gracing our airways. As the end of each year means that we are one year closer to meeting our maker, we thought it appropriate to tell you a few things that the day time commercials do not.

There are three ways that you can cover future funeral expenses:

- pre-paid funeral;
- funeral insurance; or
- a funeral bond.

A pre-paid funeral allows for payments to be made in instalments over an agreed period. Importantly, as well as the funeral having been pre-paid, all of the arrangements have been pre-made and it is simply a matter of one phone call at the appropriate time. This can be very relieving for the partner left behind at a period of great sorrow and stress. Pre-paid funerals are available directly from the funeral director of your choice. The most important aspect of choosing this option is to make sure that you choose a reputable funeral director who offers a pre-paid plan that is underwritten to ensure that your funeral would still continue should the company be sold or become insolvent. This is a question to ask when you are contacting funeral directors. Reputable funeral directors should also provide you with copies of contracts and financial statements.

You may have seen the advertisements for funeral insurance on television. To a large degree this is a rebadged version of term life cover. The major advantage/disadvantage with funeral insurance is that you must continue to pay it for as long as you live. That is, if you plan an early exit from this world you may benefit from this insurance, but if you plan to live a long life, you may pay out more than you receive as a benefit. In addition, the minute you stop making payments, the cover ceases and you will not see any benefit at all – this could be an important issue if you forget a payment/s and you then pass away.

A funeral bond is a managed investment that earns interest,

accumulated with the capital for the specific purpose of paying funeral costs. Importantly, to be classified as a funeral bond, it must also encompass the following:

- the interest must be added to the capital (all funds are inaccessible until death);
- the capital and interest is paid out only on death when it is paid to the estate or funeral director to cover funeral expenses only; and
- the funds must be invested in an independently managed funeral fund.

You can obtain a funeral bond from friendly societies, trustee companies and some funeral directors. You can also assign a funeral bond to be paid to a specific funeral director. As funeral bonds vary, you should check carefully the Product Disclosure Statement to ensure you understand what benefits will be payable and the costs involved (such as entry, exit fees and maximum investment amounts). If you choose to opt for a funeral bond, the possible pitfalls include that you may not have enough money when the funeral is required or that if you spend less than the value of the funeral bond, your beneficiaries will not receive the remainder of the funds as its sole purpose is to pay for a funeral.

For those concerned about Centrelink assessment, the amount pre-paid to a funeral director is not assessed for Centrelink purposes provided that you have a contract setting out the services, where no more expenses need to be paid. However, if you elect to use a funeral bond instead, it depends on the type of funeral bond you have whether it is counted against the assets and income tests or not. For example, a funeral bond assigned to a particular funeral director as prepayment for contracted services are not counted; however a funeral bond that does not meet this criteria, must meet other criteria to be exempted including not exceeding the Funeral Bond Allowable Limit (currently \$11,250). Funeral bonds that are not exempted are treated as financial investments and included in your assessable assets and deemed to be earning income under deeming rules. Your Centrelink Financial Information Services officer can provide you with further information on this issue.

CASH RATES DIMINISHING

The RBA decided to cut the official cash rate from 4.5% to 4.25% at its 6 December 2011 board meeting. It was the second consecutive month that the RBA cut the cash rate, with the central bank citing the likelihood of slowing economic growth as the reason for its latest move.

RBA governor Glenn Stevens said that Euro Zone financial and banking problems were likely to weigh on economic activity over the period ahead:

'Financial markets have experienced considerable turbulence, and financing conditions have become much more difficult, especially in Europe. This, together with precautionary behaviour by firms and households, means that the likelihood of a further material slowing in global growth has increased.'

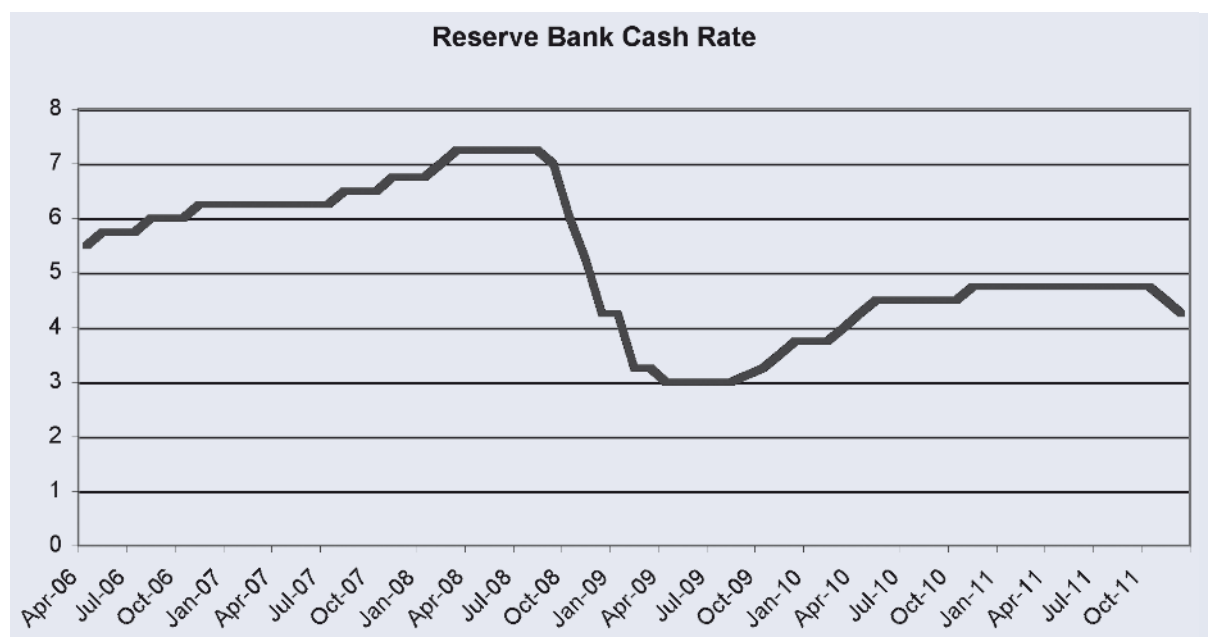
Traditionally, shares become more attractive when interest rates are lowered because the yield on shares compares favourably to the diminishing yield on cash and fixed interest investments. Listed companies that are net borrowers or have a high level of gearing see a greater benefit when interest rates fall as they obviously pay less in interest costs.

Lower interest rates are also a positive for financial stocks that hopefully will see more demand for their lending products.

From an analyst's point of view, interest rates are used to calculate the valuation of a listed company. If everything else stays the same, a fall in interest rates leads to a higher valuation for a stock. So falling interest rates are generally good news for the share market. It also goes without saying that reductions in borrowing rates will usually stimulate housing markets as well.

In terms of exchange rates, when interest rates fall it means that investors buying into our currency get a lower yield. This usually leads to investors considering alternative options to park their money, which can result in the A\$ falling. An interest rate drop usually means that our currency will follow suit.

For those BL&A clients with an overweight exposure to cash or bucket one, it may be prudent to reassess your consumption needs due to the possibility of diminishing returns from cash and fixed interest investments.



BLA FROM AROUND THE WORLD

At BL&A we like to think that we're somewhat unique. However, every now and then we're reminded that we live in a very large world and that we may not be the only BLA out there.

Over the past year several BL&A clients have stumbled across other BLAs in far and exotic corners of the earth. They have taken great delight in capturing these images and sharing them with us. If you come across any additional images in your travels, we're always keen to see them.



BLA beer in Helsinki. Thanks to Jan.



Blaa Blaa Blaa Sandwich shop in Kilkenny Ireland.
Thanks to Mike.



BLABLA Restaurant in Bamako Mali, Africa.
Thanks to John

CHRISTMAS HOURS

It's beginning to look a lot like Christmas. Our office will close at 1.00pm on Friday 23 December 2011 and reopen on Tuesday 3 January 2012. Over this period we will check our email (clients@blapl.com.au) and answering machine for urgent messages.

We'd like to wish all of our clients a very safe and restful Christmas and New Year break.

Chris, Deb, Doug, Frances, Kim, Lucy, Scott, Stephen, Steve and Wendy



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