Cuffelinks

Showcase 2015

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Contents

Foreword

Chris Cuffe, March 2016

Welcome to the Cuffelinks Showcase 2015, a free ebook exclusively for subscribers.

Our team has scoured through the Cuffelinks archive of hundreds of articles published in 2015. What strikes me when I review the content is how well most articles have stood the test of time, and the wide range of subjects covered. The Australian Investors Association calls Cuffelinks, "Australia's foremost independent financial newsletter for professionals and self-directed investors."

We have selected the highlights based on originality, popularity and quality of insight. Apologies to any writer who missed out because there were many excellent articles to consider.

Since Cuffelinks started publishing in February 2013, over 250 market professionals have written for us. We have avoided product promotions and jumping on the daily news bandwagon, and focussed instead on enduring stories that give investment insights and valuable opinions. Many of our articles discuss the challenges of saving for retirement, asset allocation and superannuation policies. The need to educate and inform will intensify with the $2 trillion in superannuation heading for $9 trillion by 2040. We have explored at length the significant future stresses from an aging population, changing demographics and tight budget constraints.

My thanks for being part of the Cuffelinks community, reaching around 14,000 subscribers to the weekly newsletter and 25,000 regular visitors to the website. We know from annual Reader Surveys that we have a highly engaged readership from diverse backgrounds.

Thanks also to our prestigious group of corporate sponsors, whose commitment to financial education and knowledge allows Cuffelinks to remain free for its readers while our range of services continues to expand.

Chris Cuffe

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Portfolio construction

Being an investor – Hamish Douglass

Three rules to invest by – Martyn Wild

The opportunity cost of low fee structures – Rob Prugue

The numbers tell the story for index investing – David Bassanese

The Ten Commandments of Transformation – Marcus Padley

Even Buffett has evolved from Ben Graham – Roger Montgomery

Being an investor

by Hamish Douglass on December 16, 2015

In December 2009 I wrote that "we are in the business of investment and not speculation". To be in the business of "investment" is to have a mindset that when purchasing shares on stock markets, you are buying an entitlement to a share of the cash flows that a business will produce over time. Your job as an investor is to assess (if you can) the likely cash flows a business will generate over its lifetime, discount these cash flows back to the present value (at an appropriate discount rate) and determine whether you are likely to generate an acceptable rate of return via buying a share in the business at the prevailing share price. Conversely, speculation involves trading in anticipation that a share price will move upwards or downwards over a short time horizon, typically less than 12 months.

In 2008, John Bogle, founder of The Vanguard Group, said in a speech to a conference of Financial Planners:

"Investing to me, is all about the long-term ownership of businesses, focussed on the gradual accretion in intrinsic value that is derived from the ability of our corporations to produce the goods and services that our consumers and savers demand, to compete effectively, to thrive on the entrepreneurship, and to capitalise on change, adding value to our society."

"Speculation is just the opposite. It represents the short term, not long term, holding of financial instruments, not businesses, focussed (usually) on the belief that their prices, as distinct from their intrinsic values, will rise."

Warren Buffett neatly summarised the difference between investing and speculation when he said: "Investment is an activity of forecasting the yield on assets over the life of the asset. Speculation is the activity of forecasting the psychology of the market."

Mark Twain waxed on the dangers of speculation when he said: "There are two times in a man's life when he should not speculate; when he can't afford it, and when he can."

In our view, any true investor should aim to generate a satisfactory return on capital over time while minimising the risk of a permanent capital loss.

While investing appears easy, very few people maintain outstanding investment records over the long term. I have spent considerable time thinking about the attributes of successful investors that I admire, and aspire to, and have set out my observations below:

Incorporate a margin of safety

Benjamin Graham who co-authored Security Analysis (1934) and authored The Intelligent Investor (1949) coined the phrase "Margin of Safety". Graham's margin of safety is the difference between a stock's price and its intrinsic value. In theory, the further a stock's price is below its intrinsic value, the greater the margin of safety against future uncertainty. I believe the concept of margin of safety to be one of the most important principles for investors.

Seth Klarman, founder of Baupost said: "A margin of safety is necessary because valuation is an imprecise art, the future is unpredictable, and investors are human and do make mistakes. It is adherence to the concept of a margin of safety that best distinguishes value investors from all others, who are not as concerned about loss."

Invest within your circle of competence

I believe that if an investor can objectively understand the limits of their circle of competence and focus their expertise within that circle they will develop a competitive advantage which should translate into better investment decisions. The most outstanding investment records have been built by people who specialise, develop a deep understanding and stay within their circle of competence. While there are many good investment opportunities outside one's circle of competence, there is a substantial disadvantage in attempting to become an expert in too many things. I have described investors who try to be experts at everything to be like a "fly in a bottle", i.e. moving around continuously but making no progress.

I am reminded of this by the words of John Kenneth Galbraith when he said: "One of the greatest pieces of economic wisdom is to know what you do not know" and those of Confucius: "Real knowledge is to know the extent of one's ignorance".

Charlie Munger, the Vice Chairman of Berkshire Hathaway and Warren Buffett's business partner, said: "The game of investing is one of making better predictions about the future than other people. How are you going to do that? One way is to limit your tries to areas of competence. If you try to predict the future of everything, you attempt too much. You're going to fail through lack of specialisation."

Be prepared to walk away

Unfortunately, our inbuilt biases (bias of sunk costs and loss aversion tendency) make it difficult for investors to walk away from investment opportunities or sell investments when something has gone wrong. The inability to ignore sunk costs can lead to irrational decisions, particularly if an investor has spent considerable time (and money) researching a potential opportunity. An investment firm with multiple analysts may make an investment in order to reward the effort put into the research and to avoid the analyst feeling they have wasted their time. If the due diligence does not support an investment case or does not demonstrate a sufficient margin of safety (adjusted for risk), then the investor must be prepared to walk away and wait patiently.

In addition, people's loss aversion tendency is to strongly prefer avoiding losses rather than obtaining gains. This can lead to poor and irrational investment decisions whereby investors refuse to sell loss making investments in the hope of making their money back. I believe that good investors pay no attention to the purchase price of an investment in deciding the rational course of action regarding whether or not to hold or sell. The rational investor will consider their best estimate of the likely return on the investment on a forward looking basis and compare that return to the next best alternative use of the capital.

Do not overly diversify

In our view, very few investors have achieved outstanding long term investment records by holding a widely diversified investment portfolio. By definition, additional stocks dilute the contribution to future returns of the best investment ideas within the portfolio. While a portfolio not correlated to single factor risk is important, it is not necessary to overly diversify by the number of investments to adequately manage risk.

Warren Buffett said on diversification: "Diversification is a protection against ignorance. It makes very little sense for those who know what they are doing" and Charlie Munger said: "The academics have done a terrible disservice to intelligent investors by glorifying the idea of diversification. Because I just think the whole concept is literally almost insane. It emphasises feeling good about not having your investment results depart very much from average investment results."

Focus on the batting average

I have observed that long term outstanding investment track records are built upon good "batting averages" rather than a few "out of the ball park" decisions. To develop an outstanding batting average, it is far more important to minimise the inevitable investment mistakes than be obsessed with trying to find the 10x investment winners. Many investors are very happy to talk about their investment winners but very few talk about their error rate. Charlie Munger commented: "It's a good habit to trumpet your failures and be quiet about your successes."

However, maintaining an outstanding batting average is extremely difficult. It requires time, focus, discipline, patience, extensive investment due diligence and the ability to forgo opportunities. At Magellan, we are obsessive with the rigour of our investment research, which I have often described as "inch wide and mile deep". Extensive investment due diligence and staying within your circle of competence is critical to achieving a low error rate and improving the investment batting average. We note that very few tennis players have won the US Open or Wimbledon with a high unforced error rate.

Have a medium term investment horizon

The vast majority of investment managers increase the degree of difficulty of producing superior long term returns by focusing on a short term investment horizon. It is our view that the "institutional imperative" of beating the market benchmark over short periods (quarterly or yearly) is counter-productive. A short term investment focus often rules out many mispriced investments on the fear that they will underperform the market in the short term.

I believe investors with a longer term investment horizon have a significant and easy advantage over investors with short term perspectives. At Magellan, we do not regard the short-term performance of an investment as important. We base our decisions on the rate of return we assess an investment will earn over the next three to five years. In doing so, we do not get caught up with a false precision as to timing. Warren Buffett said: "I have no idea on timing. It's easier to tell what will happen than when it will happen." When we have a high conviction as to "what will happen", we are prepared to invest and wait.

Think in terms of probabilities and not in single point estimates

While the investment process appears straightforward, it is very difficult (if not impossible) to accurately estimate the free cash flow that many businesses will generate over time. In reality, there is a wide range of potential outcomes making it difficult to determine a single point estimate of intrinsic value. It is therefore important for investors to think in terms of probability. However, most investors are attracted by the simplicity of assuming a single point estimate. The reality is that the outcome an investor has in mind is their best or most probable estimate. However, there is a distribution of potential outcomes around this outcome known as the distribution curve. The shape of the distribution curve can vary dramatically depending on the nature and competitive strengths of an individual business. More mature businesses, less subject to economic cycles have particularly strong competitive positions (Nestlé would be an example) and tend to have a tighter distribution of valuation outcomes compared to less mature businesses (like technology and biotechnology companies), or those subject to economic cycles (such as banks), or those subject to significant competitive forces.

Challenge your own ideas (invert the problem)

In our view, confirmation bias is one of the primary causes of investment mistakes. Indeed, investors often seek or rely upon information which confirms the decisions they have made and they become overconfident. Instead, good investors should seek to challenge the status quo and find information that disproves their investment thesis, minimising the risk of confirmation bias. It is much more important to ask yourself why you are wrong than why you are right. Charlie Munger said: "We all are learning, modifying, or destroying ideas all the time. Rapid destruction of your ideas when the time is right, is one of the most valuable qualities you can acquire. You must force yourself to consider arguments on the other side." He also said "Invert, always invert: Turn a situation or problem upside down. Look at it backward. What happens if all our plans go wrong? Where don't we want to go, and how do you get there? Instead of looking for success, make a list of how to fail instead – through sloth, envy, resentment, self-pity, entitlement, all the mental habits of self defeat. Avoid these qualities and you will succeed. Tell me where I'm going to die, that is, so I don't go there."

Do the analysis and think independently

In 1965 Warren Buffett wrote in his letter to investors in the Buffett Partnership: "We derive no comfort because important people, vocal people or great numbers of people agree with us. Nor do we derive comfort if they don't. A public opinion poll is no substitute for thought."

It is also important to understand that being contrarian does not make you a good investor. Many investors have caught "falling swords" by seeking to be contrarian when other investors are panicking. We undertake extensive analysis before making a contrarian investment call in order to avoid catching the falling sword. Our investment returns over time will depend on whether our analysis of the economics and competitive positioning of a business is correct. Benjamin Graham stated: "You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."

Investment temperament (controlling your biases)

In our view, inherent tendencies give humans the wrong wiring to be successful investors. A great investor will be obsessed about analysing the facts, will always be rational in deciding a course of action, will understand the limitations of their own knowledge, will continuously challenge their best ideas and will remain completely unemotional in their decision making notwithstanding the environment they are in. Numerous successful investors study behavioural economics to understand (and try to counteract) common human cognitive or psychological biases that can lead to poor decision making. Cognitive biases are "hard wired" as we are all liable to take short cuts, over simplify complex problems and be overconfident in our decision making ability. I have previously written about 10 cognitive biases that I think are important to understand as an investor; confirmation bias, information bias, loss aversion, incentive caused bias, oversimplification tendency, hindsight bias, groupthink, restraint bias, neglect of probability and anchoring bias (see June 2012 investor letter).

Training investors to remain unemotional in their decision-making is almost impossible. Evolution did not have investing in mind when designing the biology of the human body. In times of extreme stress (like during a market crash) our brain causes the adrenal gland to release the adrenaline hormone that leads our heart rate and blood pressure to increase. If we were still cavemen about to be attacked by a wild animal, the release of adrenaline would no doubt have enormous benefits. However, as an investor you need to remain extremely calm and rational during times of immense stress and you do not want your body to release adrenaline. With this in mind, it is unsurprising that few investors are able to take advantage of periods of extreme market pessimism. Conversely, during extended bull market environments, the human brain will likely release endorphins as investors watch ever increasing share prices and perceived prosperity. It is probably unsurprising that numerous well known investors train themselves in stress management techniques such as yoga and meditation.

Warren Buffett famously said: "I will tell you the secret to being rich on Wall Street. You try to be greedy when others are fearful and try to be fearful when others are greedy."

Understand opportunity cost

Economists define opportunity cost as the cost of an alternative foregone to pursue a course of action. In our view, few investors properly consider opportunity cost when deciding to make an investment. An investment opportunity looked at in isolation can often look attractive. A proper assessment of opportunity cost takes into account both the expected return and risk in comparison to the next best alternative. In assessing an investment opportunity, we look at what the investment will do to the portfolio's expected return, quality attributes, volatility risk, and currency exposure and if it shares underlying business risks with other portfolio holdings. Only by properly assessing a multitude of factors is one able to assess the opportunity cost of undertaking a course of action. Often, the best course of action is to invest in what you already own.

I have often drawn the analogy that we consider our portfolio to be like a football team. Our portfolio consists of around 25 players and each player has a role to play in winning the game. Some stocks play a defensive role and some play an offensive role. We seek to place the best players in each position and when considering a new investment, we ask ourselves which player (or stock) are we prepared to replace it with. By doing so, we are actively assessing the opportunity cost of new investments.

Charlie Munger said: "Everything is based on opportunity costs. Academia has done a terrible disservice: they teach in one sentence in first-year economics about opportunity costs, but that's it. In life, if opportunity A is better than B, and you have only one opportunity, you do A. There's no one-size-fits-all. If you're really wise and fortunate, you get to be like Berkshire. We have high opportunity costs. We always have something we like and can buy more of, so that's what we compare everything to."

I end with another (and final) quote from Charlie Munger that I think well summarises the qualities of a good investor:

"Preparation. Discipline. Patience. Decisiveness"

Hamish Douglass is CEO, CIO and Lead Portfolio Manager at [Magellan Asset Management](). This material has been prepared by Magellan Asset Management Limited for general information purposes only and must not be construed as investment advice. It does not take into account your investment objectives, financial situation or particular needs.

Three rules to invest by

by Martyn Wild on September 3, 2015

There are three investment rules by which to live in the current volatile environment – the same three rules we think by which investors should *always* live.

Very simply, they are:

1. Diversify sensibly but not gratuitously
2. Be opportunistic only at the margin
3. Stick to the plan and give your strategy the time it needs to work (this infers the actual existence of a plan. Surprisingly, not everyone has one!).

Most people do not want markets to fall. However, declines can be a useful experience for investors because they provide a real-world test of your investment strategy, your expectations and fortitude. When people invest in equities, for example, they often expect them to go up 10% a year or some similar figure. However, what is often conveniently forgotten is that even if they do that *on average*, they rarely do it year in and year out. What falling markets provide is the valuable experience all investors need to have when investing; particularly in 'growth' assets.

Develop your own plan and stick to it

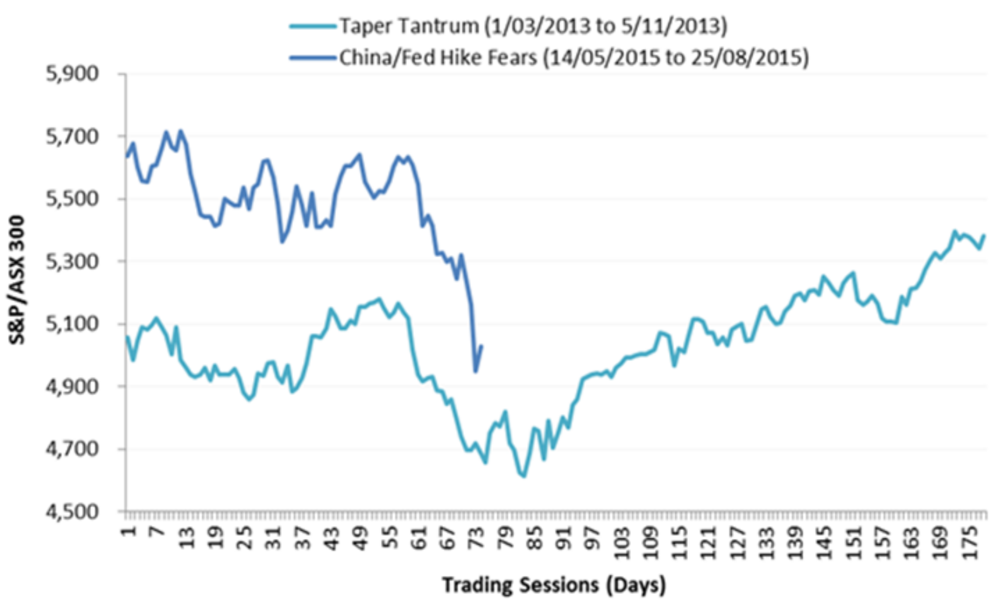
This is why you need to stick to the plan. Typically, 90% of the movement in the value of a standard 70/30* balanced fund comes from one asset class: equities. Now as you become more defensive, so your 'factor risk concentration' (or sensitivity) to volatile assets diminishes. This is why conservative funds are less volatile than growth funds, but it is also why their expected return is lower. Swings and roundabouts. The amount of diversification you employ should be consistent with your tolerance for risk and appetite for return. 'Over-diversifying' may save you in the short run, but will cost you when you retire.

In volatile times such as these, there is a natural, human temptation to just *do* something. Our view is that if your investment strategy was correctly matched to your risk tolerance to begin with then market gyrations (down *and* up) should just be part of your long-term investment journey. So does that mean that we don't advocate short term adjustments to the strategic asset allocation? Not quite. If you believe you (or your investment manager) have skill in short-term investing, by all means give it a go … but only at the margin, i.e. in small size.

Our tactical asset allocation process has been proven to add returns for minimal risk over 3+ years at a time but its risk budget is small. It relies on being right on average on many *small* investments held over the *long term*, rather than taking a few *large* bets over *short* periods, as is often the temptation. Savvy investors can still take advantage of opportunities when they arise, but they should still rely on the main game plan to deliver the vast majority of their investment outcomes.

Difficult to buy when others are selling

It may be instructive to consider the effects of prior sharp selloffs. Driven by specific events, fear can feed on fear to produce an oversold situation. For example, the so-called 'taper tantrum' of 2013



took the Australian market from above 5,100 to 4,600. As it turns out, it was the start of a significant market rally. But who's willing to take a punt on this market correction?

Use the past and the present to clarify your future expectations by all means, but stick to your plan. Let's say you have decided to take 5% of your portfolio to chase tactical opportunities. Plan ahead so that you know what your reaction will be should it go against you. Therefore, before making the tactical trade, ask yourself the question: "What loss can I take before I have to pull up stumps?" and write it down. As required, reconstruct your portfolio on the basis of your findings.

*70/30 refers to a multi-asset balanced fund with 70% growth assets and 30% defensive assets. Defensive assets are generally fixed interest securities and cash. Growth assets are everything else.

Martyn Wild is Head of Diversified Strategies at BT Investment Management. This article is for general education and does not consider the circumstances of any person. Investors should take professional advice before acting on any information.

The opportunity cost of low fee structures

by Rob Prugue on January 29, 2015

Beware the investor who knows the price of everything but the value of nothing. Fees are obviously important, but managers should ultimately be evaluated based on their ability to add net and real value to a portfolio.

The fees and costs associated with fund management and superannuation have rightly become an important concern for investors. It is natural that all investors want to acquire the 'best' possible investment option at the lowest possible cost. Particularly in today's world of sustained low cost of capital, maximising net income and returns are hugely important.

Focus on net returns, not only costs

In the ongoing debate surrounding fees, too many investors are putting the cart before the horse. Common sense dictates that when comparing fund manager performance, the logical metric on which to focus is *net return after fees and taxes*. But by approaching investment strategy with a 'fee budget', investors are eliminating from consideration the very investments that might help them achieve higher net returns.

By way of disclosure, I joined an industry super fund close to its launch, and continue to have *all* of my super managed by the same fund. So I am raising this issue as a member of the industry fund structure. To paraphrase Peter Drucker, that which gets measured gets managed. Wearing my other hat as a principal of a major fund manager, my bias is towards metrics directed at diversifiable, sustainable and net returns, after fees and taxes.

There are of course other costs associated with superannuation, such as custody and administration, to name but two, and we should not confuse these separate issues. To be clear, my comments here are squarely focused on management fees charged by product providers.

The broad conversation on the fees and costs associated with our industry is healthy and welcome. It is particularly positive given the likelihood that future costs of capital, and ultimately asset class gross returns, will likely be noticeably lower than yesteryear's 'CPI++' asset class medium-term returns. Today, even the most optimistic forecaster is struggling to suggest any normalised gross returns above CPI. And if we add health care as yet another future expense needed to be immunised, a likely benign real cost of capital environment proves even more problematic for investors.

My concern, nonetheless, is that as the long term cost of capital and asset class returns remain benign, almost by definition the need to break away from benchmark returns will increase. By committing to a more rigid fee budget, perhaps a consequence is the inability to access a more diverse and less benchmark-aware product pool.

To make matters worse, it appears as though within this low return world comes increased market volatility and uncertainty. In my view, we have migrated from a world of market 'volatility' to one of 'uncertainty'. Whereas volatility can be quantified, market risk and expected returns are becoming all too difficult to quantify. Looking at historical data from similar periods of prolonged market instability – the US in the 1970s and Japan in the 1990s – may give a sense of what this may mean to investors. During these periods, these market indices were ranked fourth quartile within market league tables, even on a net of fee basis.

Closer to home, if one looks at benchmark-agnostic Australian equity funds with truly long term track records, they surely wouldn't exist were they unable to deliver net returns above benchmark. In the Mercer Universe of long-only Australian equity managers over a ten-year period, the median manager has outperformed the index on a net of fees basis. This should appeal to the average fund member. There is also a common misconception that active funds are more volatile than the broad benchmark. It's the benchmark which has shown larger increases in volatility, at least more so than the active manager's net returns.

SMSF asset allocation

Ironically, while fees impact *all* members and superannuants, the focus of the debate has been more pronounced and visible within institutional and industry super funds. We have seen a growing army of individuals opting-out of well-diversified industry and retail funds in favour of their own SMSF. The size and depth behind this growth continues to astound me.

According to recent ATO statistics, the SMSF asset pool is heavily skewed towards cash and term deposits. Even under normal circumstances, let alone within this low return environment, this asset class is least able to fund retirees. When one considers that administration and charges associated with running an SMSF often exceed their *gross* nominal cash or term yield, how 'safe' is cash when immunising future pension income?

Any share allocation which may exist is often directed to a mere handful of blue chip Australian names, and almost zero allocation to offshore investments. In the cases where SMSFs do access actively managed Australian equity funds, it's often through Listed Investment Companies (LICs) where, ironically, management fees and entry charges (the cost of an IPO, for example) can be prohibitive.

Many SMSF holders do not appear to appreciate the extent of the choice and level of control that industry or retail fund members already have in selecting investments. It is individuals' desire for control, combined with a blind spot to the actual costs of establishing and running their SMSF, which has helped fuel the SMSF behemoth.

So we now have a situation where some institutions appear overzealous within their fee budgeting, while at the same time, many individuals almost disregard fees and charges within the continually growing SMSF sector.

Preoccupation with lowest fee options

This focus on fees needs moderation and greater debate. Moving towards *the lowest* fee option may only lock in broad market volatility. Equally, seeking one's independence can often be *the highest* fee option. Either way, my fear is that some will confuse price with value, or more specifically, with value-add.

Fees *do* matter, but they don't matter more than sustainable net total returns (net of fees, taxes, and of course, inflation). It is important to remember that in the long run, the lowest fee option can have the highest opportunity cost.

Rob Prugue is Senior Managing Director and Chief Executive Officer at [Lazard Asset Management](#) (Asia Pacific). His views are general in nature and readers should seek their own professional advice before making any financial decisions.

The numbers tell the story for index investing

by David Bassanese on May 14, 2015

With the strong growth in index funds and exchange traded funds (ETFs) in the Australian marketplace in recent years, debate is again swirling on the benefits of active versus passive investment management. Some commentators have suggested that index-oriented investments are merely for 'dumb' investors, who have no real skills in picking mispriced securities likely to outperform the market. If this were true, it would follow that these investors are leaving money on the table. By either investing in the development of these skills – or hiring talented active managers – they could produce better returns. It has been suggested that over the very long run, 'sensible investing' in 'quality' stocks will beat an index. How true is this?

The evidence suggests most active managers don't outperform the index

Fortunately for participants in the ongoing active v passive debate, whether active managers outperform a market-cap weighted index is ultimately an empirical question. The evidence seems overwhelmingly in favour of passive investment, both in Australia and overseas. According to the latest SPIVA Australia Scorecard by S&P Dow Jones Indices, tabulated below, about 78% of active Australian general equity managers underperformed the S&P/ASX 200 Index over the five years ending December 2014. The performance of local international equity managers, Australian fixed-income managers, and listed property managers was somewhat worse. Over the latest three-year period, the scorecard was slightly better for Australian equities active managers, although 6 in 10 managers still underperformed.

Even if active managers *were* able to consistently outperform the market, moreover, their degree of outperformance would need to *exceed* their management fees to beat some of the low cost ETFs and index funds available. As an example, a fund that charged a 1% p.a. management fee plus a 10% out-performance fee (charged before deduction of fees) would need to generate a return of 10.95% p.a. to offer the same return to an investor in an index product that rose by 10% in the year and charged a management fee of 0.15% p.a.

Active outperformance is unlikely to persist

Of course, the above evidence suggests that some active managers can outperform the market. The challenge investors face, therefore, is in identifying these superior managers. Picking active managers that consistently outperform is not easy. As the old truism goes, past performance is not a great indicator of future performance.

The chart (on next page, top), for example, is based on research on Australian active equity managers from Mercer Consulting which tracked the performance of investment managers across two three-year investment periods. How many of the funds that performed well in the first period also performed well in the second period? In other words, how persistent was outperformance?

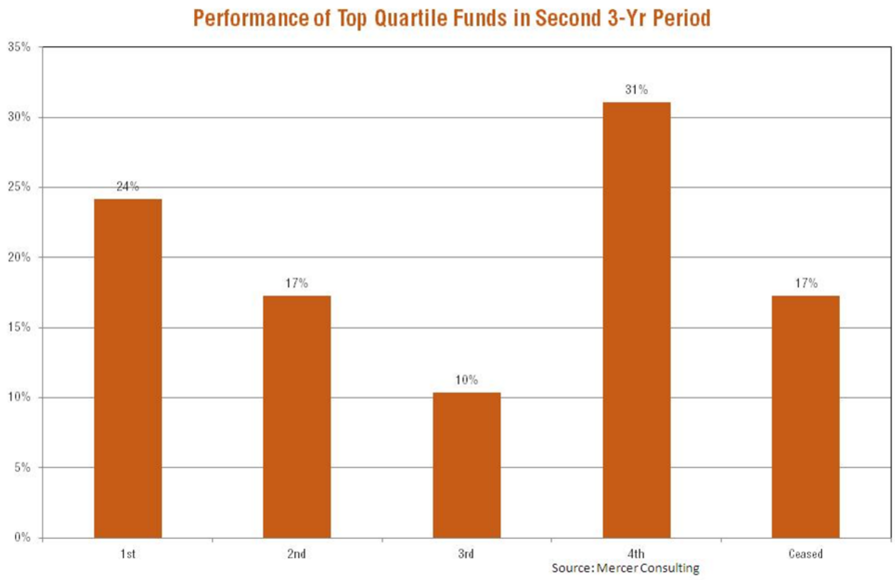
Only 24% of the 29 funds identified by Mercer as enjoying top quartile investment performance in the three years to September 2010 were also able

Report 1: Percentage of Funds Outperformed by the Index

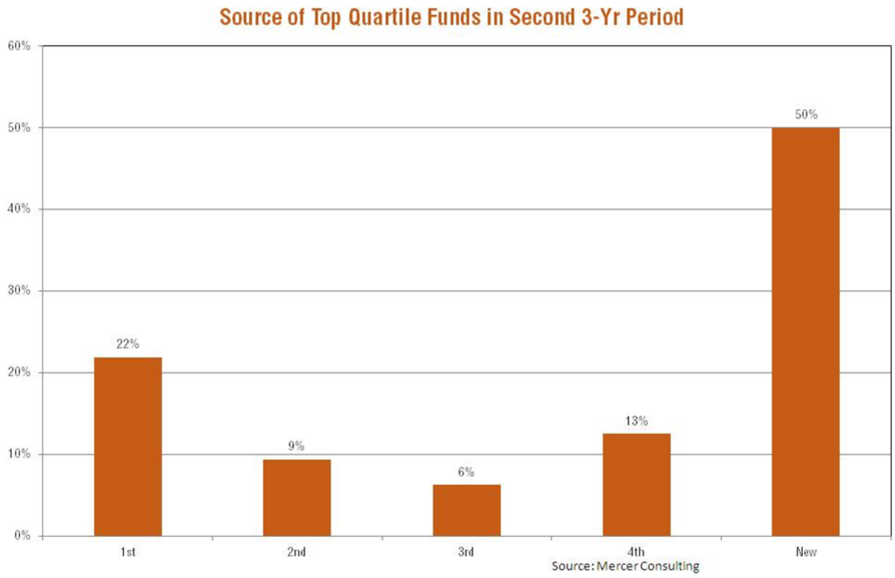
Fund Category	Comparison Index	One-Year (%)	Three-Year (%)	Five-Year (%)
Australian Equity General	S&P/ASX 200	61.44	63.14	77.56
Australian Equity Small-Cap	S&P/ASX Small Ordinaries	23.71	12.24	18.56
International Equity General	S&P Developed Ex-Australia LargeMidCap	80.58	88.21	86.09
Australian Bonds	S&P/ASX Australian Fixed Interest Index	94.12	86.54	85.71
Australian Equity A-REIT	S&P/ASX 200 A-REIT	91.67	80.00	80.22

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 31, 2014. Charts and tables are provided for illustrative purposes. Past performance is no guarantee of future results.

to produce top quartile performance in the three years to Sept-ember 2013. In fact, statistically speaking, the most likely scenario (31%) is for a top quartile performer in the first period to end up becoming a fourth quartile performer in the second period. Meanwhile, almost one in five of these top performing funds ceased operation (or were merged/ taken over) in the second three-year investment period.

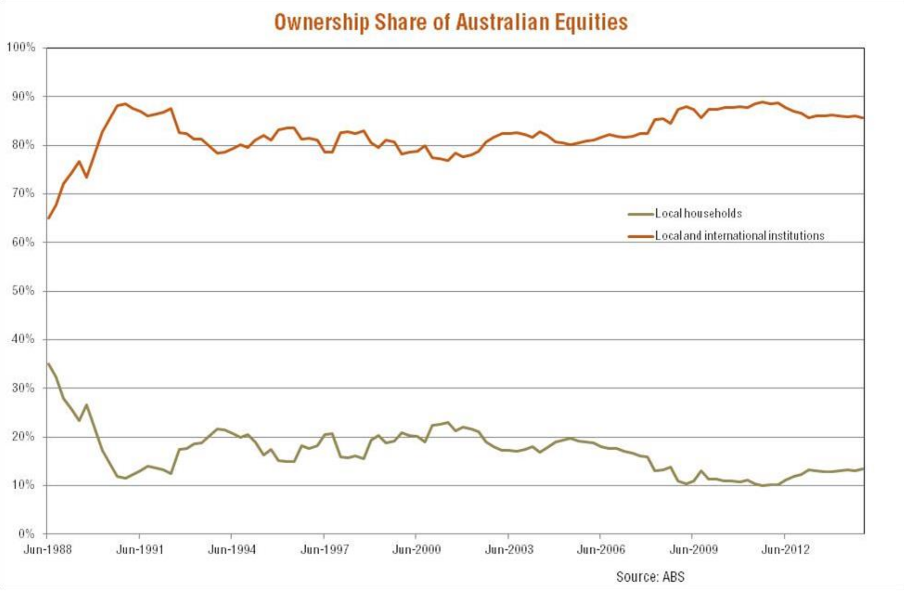


Indeed, according to the Mercer Survey, of the 32 funds with top quartile performance in the three years to September 2013 (among 126 funds covered), 16 – or 50% – of these funds were new to the market.



Active managers dominate the market so it's hard to outperform

Due to the fact that institutional money – which is still predominantly active in nature – tends to dominate ownership and therefore trading in the Australian equity market, not all managers can outperform the market all of the time. This is because for every 'winning' trade, there will equally be a 'loser' on the other side. As seen in the chart below, of the $1.6 trillion worth of 'listed and other' equities in Australia as at end December 2014, a whopping $1.4 trillion – or 83% – was owned either by domestic institutional investors, or foreign owners (which are also largely institutional). Households directly owned only around $200 billion, or 13%. The collective attempt of active managers to beat the market is akin to a zero-sum game.



There is more to indexes than tracking cap weights

Due to the development and continued innovation in indexation, there are now a number of indices which recognise the limitations of traditional cap weighted indices, including some offered in Australia by BetaShares. These 'smart beta' indices, such as fundamental weighted indices, combine the benefits of index funds (i.e. low cost, transparent, diversified, rules based) along with the potential to outperform the market cap benchmark.

We're a long way from passive investment distorting the market

There has been some conjecture that the continued growth of index investing and ETFs may contribute to potential market distortions. We are a long way away from that. According to Morningstar Research estimates, passive investment strategies account for around 8% of Australian managed funds. At these levels it's unlikely rebalances in such products will be a major influence on market pricing. With only about $18 billion funds under management, Exchange Traded Products account for only about 0.7% of the $2.4 trillion managed funds industry as at March 2015.

Even in the United States – where passive investment is estimated to account for a much larger 24% of funds under management in 2013 – it still seems evident that active managers have a hard time beating the market. According to S&P's latest survey, for example, 88% of large-cap US managers failed to beat the S&P 500 index in the five years to the end of 2014.

There is no doubt that there do exist a select number of active managers who have a strong track record of persistent outperformance. We firmly believe that active management has a role to play in investors' portfolios, and often find ourselves discussing how ETFs can be used in combination with high quality active managers. However, when considering the active versus passive debate, we believe it's important to be armed with the empirical facts.

David Bassanese is Chief Economist at BetaShares, a leading provider of Exchange Traded Products on the ASX. This article is general information and does not address the personal needs of any individual. This article was originally published on the BetaShares blog.

The Ten Commandments of Transformation

by Marcus Padley on April 9, 2015

If Heaven had been an investment bank, God the CEO and Moses the salesman, Moses might have come down from Mount Sinai bearing two entirely different stone tablets, the Ten Commandments of equity investment perhaps, a philosophy designed to sell investment products and keep them sold with as little hassle from their clients as possible. They might have read something like this:

1. The market always goes up
2. Buy and hold
3. Invest for the long term
4. Diversification
5. Rely on the miracle of compounding returns
6. Invest in businesses not stocks
7. You can't time the market
8. If you aren't willing to own a stock for ten years don't think about owning it for ten minutes
9. Our favourite holding period is forever
10. In the short term the market is a popularity contest. In the long term the market is a weighing machine.

And much like the real Ten Commandments most of us would have adopted these subliminal directives without really arguing them through or asking "Do they make us happy" because I'm not sure they do. Are we happy to ignore the short term and focus on the long term, to put our faith in the endless repetition of history? Are we happy that no-one is responsible for the performance of our investments in the short term? Are we happy with the position that the product seller knows best? Are we happy to accept a bunch of philosophies designed by product sellers to keep us invested and serve their purposes first and ours second?

Well I'm not. Buy into these and prepare to be bored and more than likely disappointed because quite honestly a well balanced portfolio isn't going to get you far, not after fees, tax, inflation and the odd crash.

If you, like me, don't want to settle for a managed fund's performance letter once a year, don't want to trust in the long term when the market collapses and want something a little more transformational then read on, because for your investing delight let me propose an alternative Ten Commandments, the Ten Commandments for any investor looking to do better than average, which is all of you. Here they are, the Ten Commandments of Transformation:

1. **Focus on just a few stocks.** You cannot transform yourself with 20 plus stocks let alone a balanced fund. If you want extraordinary returns find one to five stocks that you get to know very well. This is crucial because diversification undermines transformation.

2. **Do the work.** Spend one hour doing work on a stock and you will end up in the top 1% of people that know anything about it. Do ten hours work and you end up in the top 0.00001% of people that know anything about it. Someone who has followed and traded the same stock for a year has an even bigger edge. Get to know stocks. Not all stocks, just a few. Find some favourites.

3. **Be contrarian.** There is no transformation in playing with the herd. Learn to identify extremes. Armageddon is opportunity. I doubled my money in Elders last year. Could have tripled it. Doing the work and spotting the turn, this is where the money is, in what the market doesn't expect not what it knows.

4. **Develop a technical discipline.** I don't believe that technical analysis will make you rich alone but it is a tremendous risk management system. A share price is not a line on a chart, that line is the representation of thousands of people saying "You're right" or "You're wrong". That's a useful piece of information. So listen. And when they start telling you you're wrong, don't be smart.

5. **Ten ears are better than two.** Expand your group of investing friends, even the dull and ignorant have their stories, you only need one or two ideas a year and so what if you waste a few hours over a bottle of wine and strike out.

6. **Use everything.** Use fundamental research and technical trading skills. It's all contributory information so use it all. Too many value investors and traders are blinkered. Why? Pride? There's no place for that.

7. **Don't make mistakes.** You cannot transform yourself with good stocks if bad stocks are constantly chopping you down. Controlling losses is easy because they are right there in front of you on your spreadsheet. Sort them out first.

8. **It's about stock prices not businesses.** It's an arrogant investor that thinks their money is invested in a business when the herd controls the share price. Share prices are half psychology, half value, not 100% of one or the other.

9. **No ego.** There is no-one that good at investing. No-one that cannot learn something new. You will change your methods many times before the end so be flexible, respectful, open-minded.

10. **Enjoy it.** No-one does anything well when they have to.

Come back in another 32 years for the updated edition of the Ten Commandments of Transformation, because there's a lot more to learn.

Marcus Padley is a stockbroker and the founder of the [Marcus Today] share market newsletter. He has been advising institutional clients and a private client base for over 32 years.

Even Buffett has evolved from Ben Graham

by Roger Montgomery on July 16, 2015

Ben Graham is regarded as the intellectual Dean of Wall Street. He literally invented equity security analysis at a time where bonds were all the rage, and a couple of his mantras have stood the test of time. His 'Mr Market' allegory is of course a brilliant retort to the efficient market theories on which an entire generation has based their trust through index funds. And it's his idea that the three most important words for an investor are 'Margin of Safety'.

Interestingly, however, if Ben Graham had access to a computer back in the 1930s and 1940s, I suspect he might not have reached some of his other conclusions.

Whilst many investors use Ben Graham's models for intrinsic value to evaluate the attractiveness of companies, we don't. Let me explain why.

Moving on from Ben Graham

First, though, I am a little nervous about publishing an article advocating against a strict Graham-approach, as it may put a few noses out of joint. So I have referenced what I believe to be the pertinent quotes that have reinforced my conclusion that value investors should move on from many parts of Graham's framework.

In the 1940s, Ben Graham (who passed away in 1976) "was one of the most successful and best known money managers in the country." (quoted in the book, *Damn Right,* by Janet Low, page 75). In 1949, an eager Warren Buffett read Graham's book *The Intelligent Investor* and the rest, as they say, is history.

Warren Buffett regards Graham's book *Security Analysis* as the best text on investing, regularly referring investors to it and his other seminal work, *The Intelligent Investor*. One of my favourite Graham publications is *The Interpretation of Financial Statements*.

It might surprise many value investing students to know that, thanks to his long-time partner at Berkshire Hathaway, Charlie Munger, Buffett has moved far from the original techniques taught by Graham. Ben Graham advocated a mostly, if not purely, quantitative approach to finding bargains. He sought to buy businesses trading at a discount to net current asset values – what has been subsequently referred to as 'net-nets'. That is, he sought companies whose shares could be purchased for less than the current assets – the cash, inventory and receivables – of the company, minus all the liabilities.

Graham felt that talking to management was sort of cheating because smaller investors didn't have the same opportunity. Whilst the method had been very successful for Graham and the students who continued in his tradition, people like Warren Buffet, Walter Schloss, and Tom Knapp, Graham's ignorance of the quality of the business and its future prospects did not impress Charlie Munger. Munger thought a lot of Graham's precepts "were just madness", as "they ignored relevant facts" (also quoted in *Damn Right*, page 77)

So while Munger agreed with Graham's basic premise – that when buying and selling one should be motivated by reference to intrinsic value rather than price momentum – he also noted "Ben Graham had blind spots; he had too low of an appreciation of the fact that some businesses were worth paying big premiums for" and "the trick is to get more quality than you pay for in price." (*Damn Right*, page 78)

When Munger referred to quality, he was likely referring to the now common belief held by many sophisticated investors that an assessment of the strategic position of a company is essential to a proper estimation of its value.

In 1972, with Munger's help, Buffett left behind the strict adherence to buying businesses at prices below net current assets, when, through a company called Blue Chip Stamps, they paid three times book value for See's Candies. Buffett noted; "Charlie shoved me in the direction of not just buying bargains, as Ben Graham had taught me. This was the real impact he had on me. It took a powerful force to move me on from Graham's limiting view. It was the power of Charlie's mind. He expanded my horizons". Furthermore, "… My guess is the last big time to do it Ben's way was in '73 or '74, when you could have done it quite easily." (Robert Lezner, 'Warren Buffett's Idea of Heaven', Forbes 400, 18 October 1993, page 40).

So Buffett eventually came around, and the final confirmation that a superior method of value investing exists was this from Buffett: "Boy, if I had listened only to Ben, would I ever be a lot poorer." (Carol J. Loomis, 'The Inside Story of Warren Buffett', Fortune, 11 April 1988, page 26).

Investing techniques evolve

Times in the United States were of course changing as well, and it is vital for investors to realise that the world's best, those who have been in the business of investing for many decades, do indeed need to evolve. In the first part of the twentieth century, industrial manufacturing companies, for example, in steel and textiles, dominated the United States. These businesses were loaded with property, plant and equipment – hard assets. An investor could value these businesses based on what a trade buyer might pay for the entire business or just the assets, and from there, determine if the stock market was doing anything foolish.

But somewhere between the 1960s and the 1980s, many retail and service businesses emerged that had fewer hard or tangible assets. Their value was in their brands and mastheads, their reach, distribution networks or systems. They leased property rather than bought it. And so it became much more difficult to find businesses whose market capitalisation was lower than the book value of the business, let alone the liquidating value or net current assets. The profits of these companies were being generated by intangible assets and the hard assets were less relevant.

To stay world-beating, the investor had to evolve. Buffet again: "I evolved … I didn't go from ape to human or human to ape in a nice, even manner." (L.J. Davis, 'Buffett Takes Stock', New York Times Magazine, 1 April 1990, page 61).

Many investors cling to the Graham approach to investing even though some, if not many of his brightest and most successful students, moved on decades ago.

If you want to adopt a value-investing approach, there is no doubt in my mind that your search for solutions will take you into an examination of the traditional Graham application of value investing. It is my hope, however, that these words will serve as a guide towards something more relevant, and whilst unable to be guaranteed, more profitable.

If you have tried to adopt the Graham approach and had some success, well done. Now move on.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is for general educational purposes and does not consider the specific needs of any investor.

Retirement

Make your money live forever – Chris Cuffe

The comprehensive income product for retirement – Jeremy Cooper

CIPRs are coming and that’s exciting – David Bell

We should be encouraging self-sufficiency – Noel Whittaker

How VicSuper evolved its retirement income model – Michael Dundon

Make your money live forever

by Chris Cuffe on March 13, 2015

"A man's dying is more the survivors' affair than his own." – Thomas Mann

"The beginnings and endings of all human undertakings are untidy." – John Galsworthy

While these quotations from Mann and Galsworthy are usually correct, it doesn't have to be that way. Surely an important part of anyone's life is deciding what happens to their assets when they die. It never ceases to amaze me how little thought people put into estate planning and creating a lasting legacy. It's bad enough that an estimated 45% of Australians do not have a valid will, and most have not made a binding death nomination for their superannuation. But how many people put even a fraction of the time into deciding what should happen with their money as they do in accumulating it in the first place? Neat clichés like 'the dead don't care' do not resonate with me – perhaps that is just the forward planner in me and I may be an outlier.

Putting aside your religious beliefs, let's assume you have departed this world and you are looking down from the heavens on the distribution of your hard-earned money to your loved ones. As Shakespeare wrote in Hamlet, *"What dreams may come, when we have shuffled off this mortal coil, must give us pause."* The children are squabbling over whether to sell the family home, there's a stepson you hardly knew claiming his rights, and your spouse has met a new partner with five screaming kids from a previous marriage. Your sister says you told her you would always support your siblings, and there are family members in your old house grabbing your stuff while they can.

You think you're in heaven and you've gone to hell!

Address the basics

In thinking about estate planning, I believe it is essential that the following basics are covered while you are alive and have your marbles intact:

- Make sure your wishes are clear, unambiguous and in writing. Written instructions usually mean a will, but in addition to this I like to have a one to two page 'plain English' summary (that your solicitor should tick for consistency with the will) to ensure there is no misunderstanding.
- Ensure you cater for all situations, such as if you die, your partner dies, you both die together, providing for the children's needs if they are under 18 (such as who will look after them and whether the carer should be paid).
- 'Complete the package' and ensure you have an Enduring Power of Attorney (for money/finance decisions) and Enduring Guardian (for health decisions) appointed as well as having a documented Advance Care Plan (dealing with resuscitation, organ donation, and where you wish to be cared for when the time for natural dying comes).
- Ideally, discuss your intentions with your family, so they have a chance to contribute and understand before you are no longer there to influence.
- Develop a strategy that ensures your estate is well-managed by people you trust who know what to do with wealth.

Beyond these basics, I want to focus on the possibility of both creating a multi-generational legacy and enjoying giving while you're alive.

Create a fund for future generations

It's natural to care for your own children and grandchildren who you know and cherish while you are alive. But what about their children? What can you do that might also benefit future generations of your descendants?

If your resources are sufficient, one idea is to establish a trust that has the purpose of meeting particular costs of your direct descendants (being your children, your children's children, their children and so on). The costs that come to mind are what I think of as *'must have safety-net costs'* such as medical insurance, trauma insurance, school education and tertiary education. Plan for only 50% of the tertiary education costs so the recipient has 'skin in the game' and an incentive to complete the chosen study.

Imagine the satisfaction of knowing that whatever happens to the family finances, your great grandchild can be confident of a good education and decent health. Who knows what the future brings, as many a family fortune has been destroyed by poor investing or wasteful spending. With Australia facing decades of increasing budget deficits, both health and education expenditure will be targets. We may head more down the US path of user pays and denial of services. While it is hard to estimate what future school, university and hospital costs may be, it's highly likely to be much higher than today.

The trust should have independent trustees and avail itself of investing expertise, so the money lasts as long as possible into future lifetimes (and who knows, future descendants themselves may end up having the means to contribute to the trust so that it lasts longer). In practical terms, any descendant wishing to have such costs met would apply to the trustees. You could even 'force' another gift on them (one that I am passionate about) and insist that any recipient must first complete a basic course in financial literacy before they are eligible to participate in the trust.

Imagine the day your daughter's grandchild graduates from university to become a doctor and makes a toast to you (long past!) for helping to make the event possible through vision and generosity.

Help your children while you're alive

If you started having children at 30 and you live until you're 90, chances are your children will be retired when they inherit your estate. If they've done well already, they probably don't even need the money, and all you are doing is giving more money to an already financially secure person.

If you live in the crazy property markets of the east coast of Australia, and your children are of a mind that they would like to live in a similar location when they leave home (and perhaps be near you), then it is likely that they will struggle to buy their first home given the prohibitive entry level to now get into the property market. So assuming your own financial needs are met, what better way to help your children than to assist them with their first purchase. Consider gifting the deposit or some type of interest free loan so the capital can one day be recycled again or protected in situations of divorce.

Leave an enduring gift to society

Buffett once said in his letter to the Gates Foundation: *'I want to give my kids just enough so that they would feel that they could do anything, but not so much that they would feel like doing nothing.'* I am a big fan of this quote.

Again, if your resources are sufficient, once you have provided for your family, to me there is no better way to leave an enduring gift to society than to set up a Private Ancillary Fund or establish a sub-fund with a Public Ancillary Fund. Any money put into such vehicles is fully tax deductible. The money is invested within the ancillary fund (which is a tax free environment) and from there a minimum of around 5% per annum of your account balance must be donated to charity. Your investment in the fund can last for many years, spinning off a never-ending stream of donations for charity.

[I'll declare an interest here, as I am the founder and Chairman of Australian Philanthropic Services, a not-for-profit organisation that specialises in setting up and administering such vehicles.]

It was not until I reached the age of around 50 that the thought of mortality really entered into my thinking. Perhaps this was from watching my own parents age (and one of them recently passing away). That realisation comes with greater attention to how I can help people while I am alive and after I cross that great try line in the sky!

Chris Cuffe is co-founder of Cuffelinks; Portfolio Manager of the charitable trust Third Link Growth Fund; Chairman of Unisuper and Chairman of Australian Philanthropic Services. The views expressed are his own and they are not personal financial advice.

The comprehensive income product for retirement

by Jeremy Cooper on March 13, 2015

[Editor's note: The abbreviation CIPR (pronounced 'sipper'), comes from the Financial System Inquiry and it is quickly becoming part of the superannuation industry lexicon. We need another word or abbreviation. Such a clunky set of letters will do nothing to encourage engagement with post-retirement products. Suggestions welcome.]

The retirement income stream market in Australia is unusual by global standards, being dominated by the 'balanced' account-based pension (ABP). It has usually been recommended to investors on the basis of underlying investment choice, flexibility, control and liquidity.

As observed by the Financial System Inquiry (FSI) in its final report, and made clear by their impairment during the GFC and in its aftermath, the average 'balanced' ABP can't adequately manage the unique risks of retirement. It should be viewed as part of any retirement portfolio, rather than the entire solution.

So it makes sense that the FSI recommended that all large APRA-regulated super funds 'pre-select' a comprehensive income product for retirement (CIPR) that addresses the need for retirees to have:

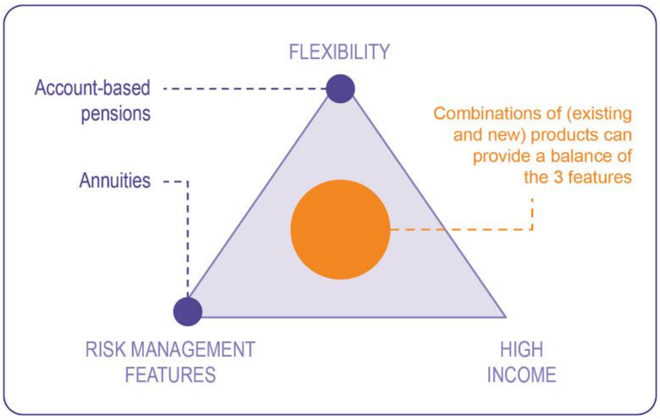
- high income
- risk management features
- flexibility

The FSI believed that this requirement is likely to be satisfied by using a combination of products, starting with the ABP. This was illustrated in the FSI's final report as follows:

Desired features of retirement income products

The final report suggested the potential for a wide range of CIPRs which, in addition to the existing ABPs and annuity products, included combinations with:

- deferred lifetime annuities (a product commonly used overseas, but not yet here)
- group self-annuitisation schemes (GSAs) (a new concept)
- deferred GSAs and
- other future innovations.



Making the comprehensive income product more understandable

One challenge faced by the broad, non-prescriptive CIPR concept is that any product or portfolio will have to be easily understood and evaluated by fund members. To provide guidance, minimise subjectivity and promote more consistency of retiree outcomes, we might wish to consider the use of a balanced scorecard approach. The scorecard would assign a qualitative rating to each strategy or feature addressing the three CIPR requirements.

The scorecard could be developed by APRA using its standards-making power under broad principles that could be set out in the SIS Act. This process would allow for appropriate consultation with the industry. Designing the scorecard would, however, involve making some qualitative decisions about the differences between certain retirement income strategies. For example, a core principle should be that an investment strategy or asset allocation alone does not satisfactorily deal with longevity risk. Higher expected returns should be a positive, but income volatility should lower the rating. Similarly, CIPRs that did not have an express inflation management strategy or a means for combating sequencing risk would also get lower scores under the balanced scorecard idea.

Using a scorecard would enable easy comparison for retiring fund members and their advisers, and provide some regulatory guidance, without reducing the ability of fund trustees to tailor their offer to the specific needs of their own members (e.g. taking into account different demographic factors and the like). The balanced scorecard would essentially operate as a 'nudge', using a transparent rating system to influence the behaviour of product providers and retirees alike.

Recognise every retirement is different

To take our retirement income system to the next stage of its evolution, the CIPR concept must be impactful, while at the same time allowing tailoring, innovation and the accommodation of different demographics, account balances and so on. After all, every retirement will be different.

It also needs to be palatable. Given that workers are already forced to save some of their own wages through compulsory superannuation contributions, further compulsion is unwarranted. Murray has highlighted though, that the system is letting retirees down in leaving them exposed to risks that they cannot manage on their own.

Disclosure of the ratings to consumers in a meaningful way could be key to the success of the concept. Getting the disclosure right will involve attention to other global examples and, ultimately, consumer testing. Something similar to the ENERGY STAR® ratings used for new electrical appliances in Australia might be a start. Ideally, the rating system would be something that consumers will understand and trust.

If done properly, it should be possible for the scorecard to highlight trade-offs between risk management, flexibility and returns. If retirees, as consumers, come to understand that they cannot have the highest income with full flexibility and be protected from every risk, then advisers and funds can have a discussion about the mix that they provide.

The scorecard is likely to be both informative and slightly normative in effect. Funds and product makers are likely to respond to the incentive to seek higher, rather than lower, ratings. A low-scoring CIPR would still be compliant and there would be nothing preventing retirees from investing in it. Retirees might be advised to opt for a low-scoring CIPR because they have, for example, substantial assets, an expected inheritance or a longevity product in another structure. Similarly, the scorecard would not supplant advice and is really a 'labelling' idea. It would necessarily be only part of the process of determining the appropriate retirement strategy for a retiree. There is no silver bullet solution in retirement.

More choice for retiring members

There is only upside in introducing CIPRs. A CIPR simply provides more choice for retiring members. Super funds will be free to retain their existing range of retirement options and to introduce new products alongside CIPRs. Retirees would have no obligation to participate in a CIPR. In every way a CIPR would be a 'choice' product, especially when compared with MySuper. Whereas MySuper requires a young, typically less-interested worker to do nothing or opt-out, a 'nudged' CIPR requires a mature, engaged retiree to opt-in. This is a key point.

It is a well-recognised feature of pension systems around the world that a retirement solution put forward by the fund itself carries with it an implicit recommendation that it is appropriate. This, again, positions the CIPR as a useful policy initiative. Fund trustees will be aware of the duty of care involved. The underlying policy purpose of the CIPR concept is to provide better risk management for retirees than is currently being afforded to them.

The retirement phase is the remaining aspect of super that needs to be brought into the 21st century. If the idea of some sort of qualitative filter or signal, such as the balanced scorecard, is embraced by the industry, then the CIPR might just be the springboard for super to become recognised as the world's leading retirement income system.

Jeremy Cooper is Chairman, Retirement Income at Challenger Limited, former Chairman of the Super System Review (the Cooper Review) and Deputy Chairman of ASIC from 2004 to 2009.

CIPRs are coming and that's exciting

by David Bell on October 29, 2015

It appears that CIPRs (Comprehensive Income Products for Retirement) will soon eventuate. The Government has finally released its response to the Financial System Inquiry (FSI). Among many recommendations across different segments of the finance industry, the Government supported the FSI's recommendation for CIPRs to be created by all institutional super funds for their non-defined benefit default members. This is a really good thing – a sound recommendation, sensibly endorsed by the Government. If the regulators (in terms of developing policy) and industry (in terms of design and implementation) get this right, then the vast majority of Australians should experience a better financial retirement outcome.

Bring it on!

I can't remember ever being so excited about a new piece of policy! Any super industry professional who is begrudging this change should self-reflect and consider a career change. Compared to other changes of the last decade or two, this one will have the greatest positive impact on the retirement outcomes of average Australians. The Wallis Inquiry (also a financial system inquiry) focused on regulation, competition and disclosure, and the outcome was arguably a collection of disclosure documents and a multitude of products that the average Australian doesn't understand, especially given our low national levels of financial literacy (see Do clients understand what advisers are saying?). The Cooper (Super System) Review created MySuper products which generated some efficiency gains but also, in my view, sowed the seeds of an unhelpful focus on fees to the possible detriment of net returns to members.

While much of the emphasis has been on efficiency during accumulation, the post-retirement solution has been left unaddressed. Here it is important to acknowledge history: Cooper's vision for MySuper was as a whole-of-life product: "*MySuper products must include one type of income stream product, either through the fund or in conjunction with another provider, so that members can remain in the fund and regard MySuper as a whole of life product*". However, this was not supported by the Labor Government at the time, potentially because MySuper already represented significant change. Murray's vision for CIPR is broader than Cooper's. It is a clean sheet of paper to research, innovate and create a default retirement solution for default members. At a minimum it focuses the industry on retirement outcomes in the presence of investment risk and uncertain lifetimes, and super funds will now be required to consider mortality outcomes.

The design of future retirement solutions

Currently the industry relies predominantly on account-based pensions and an age pension system which guarantees a level of income close to ASFA's definition of Modest Retirement Outcome. Who knows what future retirement solutions will look like? While not writing off the account-based pension, we may see greater use of both life products and mortality-pooling solutions. A post-retirement solution could incorporate basic financial advice. The best CIPRs will include multiple components blended together.

I have concerns that the concept of CIPR and even Murray's proposed (and endorsed by Government) objective of superannuation ("*To provide income in retirement to substitute or supplement the Age Pension*") are not fully formed. Perhaps it has been deliberately left this way as a concept which is then thrown to the industry and regulators to work through and devise the best solution.

It is the process which will drive numerous beneficial outcomes. I believe that at the heart it needs a retirement outcome engine (see 'Outcome engines' should be the heart of your business). This could be mandated and reviewed by APRA: for instance, it could be a requirement that every super fund must have an internal engine capable of modelling the distribution of retirement outcomes of their default members. The development of such an engine will ensure appropriately designed products, form the basis for trustee education, and could be used as the framework for member education and engagement.

Implications across the finance industry

The implementation of CIPR will have many flow-on effects across the industry. Those who think this is an issue solely for institutional super funds risk missing opportunities and facing threats. Consider the following possibilities:

- Actuaries will be in much greater demand across the industry, particularly within super funds. It is surprising how few actuaries are employed by super funds. We could now be entering 'the age of the actuary' as their skills in risk, mortality and modelling become more highly valued.
- Fund managers have the opportunity to design products and services that assist super funds implement successful CIPRs. Meanwhile some of their products and services may prove less relevant in a CIPR environment.
- Annuity products are likely to be more actively assessed and used by super funds as a component of their CIPR. Is the current market structure of the annuity industry in Australia in appropriate shape to support the potential demand? Effectively we have one dominant player, Challenger Life, and a couple of other large groups playing a small part. Is this deep enough to ensure price competition and the opportunity to diversify exposure? Perhaps we will see other new entrants or super funds negotiating solutions directly with offshore life companies.
- Asset consultants could play a pivotal role or could lose out, depending on how they have shaped their business. Some asset consultants, those with an actuarial practice (especially if the practice has a strong interaction with the investment practice) are well-placed to perform an integral role in assisting super funds to design their CIPRs. Those whose retirement practices are embryonic and based on simple solutions which do not account for mortality risk are at risk of losing business.
- Financial advice may be more heavily scrutinised. Most financial planning software fails to consider the range of mortality outcomes; financial plans are developed for a certain age (albeit some buffer can be built in). It would feel like a strange system if default funds have the systems and explicitly manage for mortality risk while financial planners do not.

Exciting change is upon us! Grasp the opportunity to develop better retirement outcomes for the average Australian. It is the biggest change the industry has experienced, and if we do it well, we will improve one of the best pension systems in the world.

David Bell is Chief Investment Officer at superannuation fund, Mine Wealth + Wellbeing. He is also working towards a PhD at University of NSW.

We should be encouraging self-sufficiency

by Noel Whittaker on July 23, 2015

It seems wealth creation has become a dirty joke in Australia. For months, there have been attacks on the money accumulated in superannuation; now Labor, the Greens and even the Reserve Bank have upped the ante by calling for a review of negative gearing.

It's an attack, not so much on the wealthy, but on middle Australia. Contrary to the spin, Australians who are using negative gearing to increase their wealth are not millionaires flouting the tax system – the majority of them earn less than $80,000 a year and are only buying a single investment property.

Let's think about a typical couple with secure jobs and earning $80,000 a year each. They are about to turn 50, have just paid their house off, and are well aware there's unlikely to be much of a pension available to them when they retire.

The options available to them are cash, property and shares. Cash is particularly unappealing, with rates at historic lows and likely to fall further. They are terrified of shares, which they regard as a bit of a punt and are becoming increasingly wary of super, due to the barrage of calls to change the rules.

The only option left for them is property. They are not interested in non-residential property, where vacancies of a year or more are common, so their choice of asset to build a portfolio for their retirement is residential real estate.

They decide to bite the bullet and borrow $450,000 at 5%, secured by a mortgage over their existing home, to buy a property for $450,000. Repayments of $3560 a month will have the property paid off in 15 years when they want to retire.

In Year One, the net income from the property will be $18,000, and the interest for the first year on their loan will be $22,500. Hence they are negatively geared to the tune of $4500 and should qualify for a tax refund of around $1250 each when depreciation allowances are taken into account. The total cost to the taxpayer is just $2500 – hardly the stuff that grand tax schemes are made of.

Now fast forward to Year Five, when their net rents are likely to have increased to $21,000, while their loan is down to $339,000. Their interest deduction for the year is just $16,950.

Lo and behold, they are now positively geared. In fact, the surplus rents may well push them into a higher tax bracket, unless our squabbling politicians have got their act together and agreed to personal tax cuts in that time.

By the time they get to 65, the debt should be paid off and the property could be worth $670,000, assuming capital growth of 4% per annum; producing rents of $24,000 per annum assuming annual increases of 3%.

Let's hope by now they're feeling better about their employer-paid superannuation, because they're going to need it. They're well outside pension eligibility, but the rents from the property probably won't be enough for them to live on, particularly with increasing maintenance costs as the property ages. Once they exhaust their superannuation, they'll be forced to sell the house to provide enough funds to live on. This will generate a hefty capital gains tax bill.

Let me stress that this is not the kind of strategy I recommend – I much prefer the flexibility and growth potential of a diversified share portfolio. However, the couple in question are typical of many Australians in their tax bracket. Instead of being attacked, they should be commended for trying to be self-sufficient, and for the substantial contribution to taxes they will make in the future.

Addendum from the Editor

As background to the negative gearing debate, I asked a suburban accountant about his client's income and expenses on investment properties. This practice is a small operation with a few staff in western Sydney, doing basic accounting work in the same way as thousands of other small firms. He sent me this table.

Although this is a tiny sample, it shows how different the experiences are. In cases where loans are repaid, there is strong positive net income. But others with maximum gearing, depreciation and interest in advance create sizeable deductions. In most cases, there is either net income or a small deduction.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. See www.noelwhittaker.com.au.

Gross rent and gross expenses on selection of investment properties, FY2013-2014

No.	Locality	Gross Rent ($)	Gross Expenses (incl dep&int) ($)	Net Rent ($)	Comment
1	Soldiers Point NSW 2317	18,086	17,795	**291**	Short-term
2	Colyton NSW 2760	19,019	21,660	**-2,641**	House
3	Hamlyn Terrace NSW 2590	20,857	20,278	**579**	Unit
4	South Wentworthville NSW 2145	16,790	5,508	**11,282**	House, no loan
5	Blacktown NSW 2148	17,145	9,244	**7,901**	Unit
6	Toukley NSW 2263	15,112	14,657	**455**	House
7	Werrington NSW 2747	20,947	9,798	**11,149**	House
8	Stanmore NSW 2048	24,513	4,286	**20,227**	House, no loan
9	Prairiewood NSW 2176	17,704	11,390	**6,314**	Unit
10	Hinchinbrook NSW 2170	23,548	26,837	**-3,289**	House
11	Liverpool NSW 2170	20,220	23,100	**-2,880**	Unit
12	Rivett ACT 2611	12,375	31,209	**-18,834**	House, max loan, high dep'n
13	Wentworth Point NSW 2127	21,320	36,396	**-15,076**	Unit
14	Melbourne NSW 3000	1,521	8,873	**-7,352**	Unit
15	Kirwin QLD 4000	15,697	24,261	**-8,564**	House
16	Holiday Home, Kiama NSW	15,469	35,100	**-19,631**	Short-term, max loan + dep'n

How VicSuper evolved its retirement income model

by Michael Dundon on July 30, 2015

The recent release of VicSuper's new non-account based pension (NABP) products for retirees signalled the first of a number of innovative solutions in the retirement income space. More importantly, we have evolved the philosophy and process we follow to help members achieve income security in retirement.

Our previous retirement planning approach

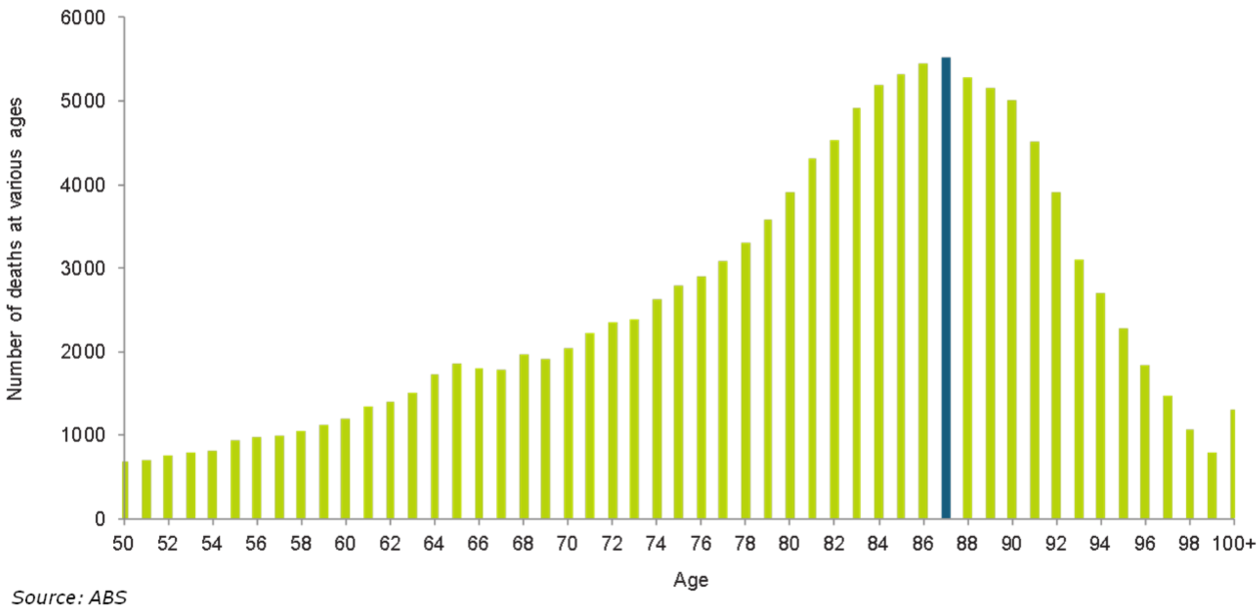
Until recently, VicSuper financial planners used a managed payout approach. In the main, they would recommend a strategy incorporating our account based pension (ABP) with an investment portfolio mix based on the member's risk profile. The higher the member's capacity for risk, the more aggressive the investment portfolio and a higher total return would be assumed. We would factor in other forms of income available to the member including the age pension, defined benefit pension and investment income, in preparing our advice. We were aiming to deliver a real level of income that was sustainable, with minimal volatility, which provided members with the flexibility to access capital as needed. Cash flow projections were based on a constant rate of expected return.

There were significant advantages to this approach: the member's control of investment capital was fully maintained, any returns above expectations could increase the income available, and it was easily implemented by risk profiling a member and investing into the ABP.

The evolution of our methods

However, there were also some weaknesses to this approach:

1. Firstly, there was no protection for members against outliving their savings. By basing the analysis on average life expectancies, the approach did not fully address longevity risk by basing the analysis on average life expectancies. This can be relevant to a significant cohort of members (see numbers to the right of the blue line in the diagram, next page).
2. The managed payout approach doesn't effectively mitigate against sequencing risk where the order and timing of returns could materially impact a member's income in drawdown phase. Historically, members responded to market volatility by taking less



Source: ABS

income and the 50% reduction in the minimum drawdown following the GFC allowed for this. However, taking a hypothetical 65-year-old member with $600,000 in their pension account, we felt that an income based on a minimum drawdown that was halved from $30,000 to $15,000 would not be a desirable outcome.

3. Much of the risk in retirement (inflation, longevity and market risk) was also borne by the member. This was traded off against the prospect or possibility of higher returns, however it differed from our approach in accumulation which is to provide default life and income protection insurance to members, and specific needs-based tailored insurance if the member saw a VicSuper financial planner.

4. Lastly, there was no direct asset-liability matching for the member in retirement. So if the member had a need for essential income, with anything below that being unacceptable, our approach in pension phase did not directly manage it. We actively manage this risk in accumulation by providing advice to the member (where appropriate) to use income protection and death and disability insurance to provide needs-based protection.

The probability of outliving savings is real

The ABP minimum drawdown requirements for a 65-year-old starts at a higher point (5%) than much of the recent research on safe withdrawal rates suggests is appropriate to provide a sustainable, indexed income stream with a minimal chance of failure.

This research based on Australian data suggests there is an almost even chance that a typical conservative 25% growth/75% defensive portfolio would be exhausted over a retirement period of 20 years assuming a 6% pa drawdown rate, adjusted for inflation (see table below).

As part of a retirement strategy review we looked carefully at the approach outlined above to determine if there was a better way of achieving our members' goals.

Our new approach – income layering

Recent research from Investment Trends supports the idea that guarantees and protection (associated with income that lasts for life, guaranteed minimum income payments, protection against market falls and indexed against inflation) become stronger drivers than high returns when retirees are considering retirement income products.

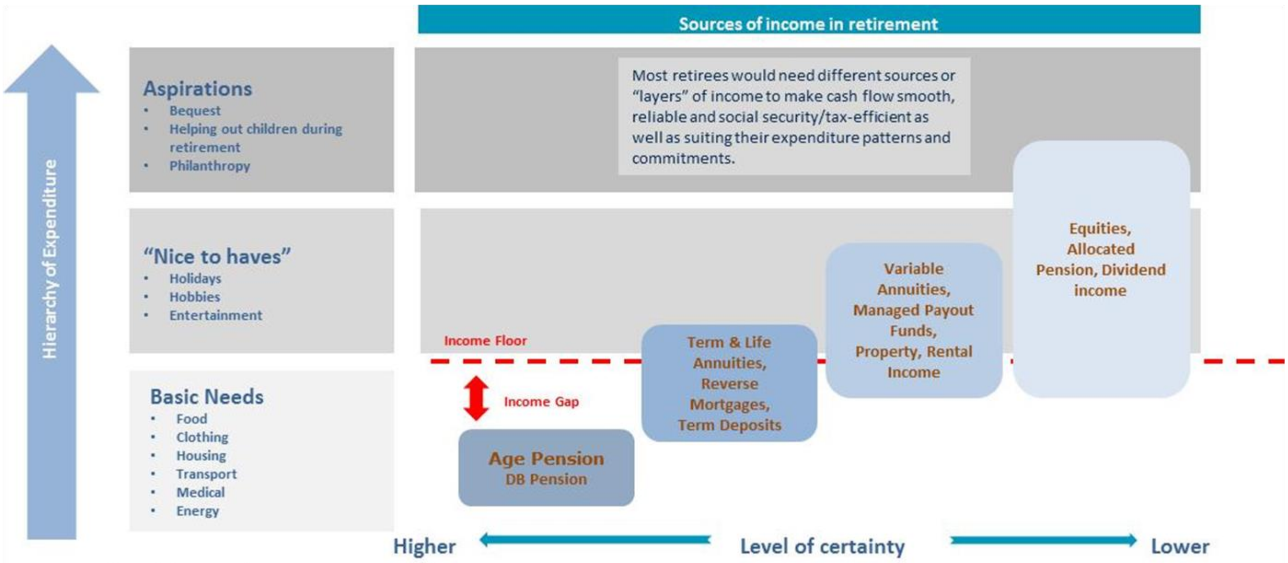
We began looking at different ways we could help our members achieve their goals and meet our best interest duty. One way to deliver this was to develop an objectives-based approach that used an asset-liability matching framework to generate retirement income. Since a member having insufficient income to meet their essential expenses was an outcome to be avoided <u>at all costs</u>, it was perhaps better to not target a strategy that will perform best if we guessed correctly about future market returns, so we took a member's worst case scenario off the table. One way of doing this was by implementing an income-layering strategy, defined as:

Income layering is a strategy that locks in a secure stream of retirement income before investing any remaining retirement savings in market-based products. It is based on the belief that securing income to meet the essential or basic needs should be of primary importance to the member.

Income-layering starts with detailed budgeting (as much as possible) for the amount of income a member requires each year in retirement, and splitting up this income into essential income and income that can be considered discretionary. 'Essential' income should cover the must-have basic expenses like food, clothing and shelter and also those items that define a member's lifestyle. That is, those things that are non-negotiable because they represent the essence of the member's life. The discretionary income covers lifestyle requirements that members would be

Asset Allocation	Withdrawal rate as a percentage of initial portfolio value							
25% Equities, 70% Bonds, 5% Bills	3%	4%	5%	6%	7%	8%	9%	10%
10 Years	100%	100%	100%	100%	97%	89%	82%	76%
20 Years	100%	88%	67%	51%	36%	30%	27%	18%
30 Years	85%	56%	33%	28%	17%	10%	6%	2%
40 Years	63%	33%	24%	11%	6%	3%	1%	0%

Sources: Portfolio Success Rates in Australia based on 25% growth/75% defensive portfolio (Drew and Walk 2014), and How Safe are Safe Withdrawal Rates in Retirement? An Australian Perspective (Finsia).



Source: Adopted from Retirement Incomes Options, PIMCO 2014

willing to do without if their retirement savings take a turn for the worst.

We've now implemented a new advice process that takes into account a member's health, expected longevity, liquidity needs and balances security with flexibility via internal business rules which guide an appropriate allocation between our various product solutions.

The income-layering approach has protection against longevity risk, and offers upside potential to improve a member's standard of living. As a priority, essential income is then secured over an appropriate timeframe by a combination of the age pension, any defined benefit pension entitlements, and our VicSuper NABP products. Of critical importance, however, is that the floor income provides as much protection as possible against inflation, longevity and market risk.

Other superannuation money can be invested in the ABP, in a portfolio that aligns with a member's risk profile. The capital allocated to meeting these two priorities is balanced against other factors, for example if a member has a particular liquidity need requiring significant capital to be available at short notice.

There's no single silver bullet solution

Whilst investing a member's entire super into an ABP may (or may not) result in a superior outcome, this depends on investment returns and the sequencing of those returns. The income-layering approach recognises that there is no one 'silver bullet' solution in that it uses both guaranteed income streams and an ABP to deliver an appropriate outcome for the member. It provides the member with peace of mind, flexibility, and the opportunity of a growing income in retirement if investment returns are good.

Michael Dundon is the Chief Executive Officer of VicSuper.

SMSF management

Let's debunk this myth about SMSFs and global shares

by Graham Hand on July 16, 2015

A week rarely passes without a market commentator criticising SMSFs for holding only 0.5% of their portfolios in global shares. Shame on all those trustees. Apparently, SMSFs are not diversified enough, they have insufficient exposure to great technology and consumer companies listed overseas, there is too much home bias. A typical institutional investor holds 20% to 25% of a default investment strategy in global shares (see, for example, APRA's Annual Superannuation Bulletin).

At the recent launch of his new global listed investment company, Geoff Wilson of Wilson Asset Management said, "About 65% of them [his investors] are SMSFs, which are grossly underweight international equities." Well-known broker Marcus Padley told his readers, "the biggest difference is that rather amazingly, considering the fall in the Australian dollar, only 0.5% of SMSF money is invested in international shares." And this week, high profile adviser Sam Henderson wrote in the AFR, "a quick glance at the ATO's asset allocation tables will clearly illustrate that SMSFs typically invest in Australian shares and cash and have very little exposure to bonds, international shares and property." It's a common assertion, but it's based on poor data.

The tiny number comes from a source that the industry should be able to rely on, the Australian Taxation Office (ATO). The latest reported statistics for SMSFs for March 2015 shows 'overseas shares' worth only $2.7 billion, while total assets were $595 billion, as shown in Table 1. That's 0.5%. Unfortunately, the data is misleading and counterproductive.

Table 1: ATO estimates of asset allocation for SMSFs, data extracted on 13 April 2015

Asset class	$ billion	% of all assets
Listed trusts	22.4	3.8
Unlisted trusts	55.9	9.4
Other managed investments	28.1	4.7
Cash and term deposits	157.4	26.5
Listed shares	193.1	32.5
Non-residential property	72.1	12.1
Residential property	21.8	3.7
Overseas shares	**2.7**	**0.5**
Other categories	39.6	6.9
TOTAL	**594.8**	**100%**

Source: Australian Taxation Office Self-Managed Super Fund Statistical Report, March 2015.

How does the ATO collect the SMSF data?

The ATO collects data on SMSFs via annual tax returns, but an SMSF can lodge its return up to a year or more after the end of the financial year. The ATO says its 'estimates' for March 2015 are extrapolated from 2012-2013 data, so the data is now two years old. Plus, the ATO guesses at some allocations. For example, it advises, "Assets in trusts are treated as though half were invested in equities and half in property." And all Australian.

There are obvious problems with old data, especially when the falling Australian dollar has increased the appeal of global equities since 2013.

However, the major problem is not the late data, but the categorisations. There is a wide range of global equity investments held by SMSFs which are categorised into listed trusts, unlisted trusts, other managed investments and even listed shares, and analysts are assuming these are all Australian equity investments.

Global equities are disguised in ATO data

It is obvious that SMSFs worth $595 billion must hold more than $2.7 billion in global equities, and even without knowing the exact numbers, global equities must make up a large proportion of many of the above categories. For example:

1. Managed investments or trusts

Consider the popularity of just two global equity managers, Platinum (funds under management

$29 billion, mainly Australian retail) and Magellan (funds under management $37 billion, of which Australian retail is $10 billion). Both these fund managers attract significant support from SMSF trustees. The global funds of Schroders, Lazard, Fidelity, Vanguard, BT, Colonial First State, AMP Capital, Henderson, Aberdeen, Ibbotson and dozens of other popular managers have large SMSF support, not only in broad markets but sectors like infrastructure and resources.

2. Listed Investment Companies

Again, many popular LICs are global, such as Hunter Hall, Perpetual, Templeton, Platinum, AMP Capital China, Global Masters and Magellan. The new global fund from Wilson is targeting $550 million and Wilson says 65% of his clients are SMSFs.

3. Exchange Traded Funds

ETFs are increasingly popular with SMSFs as they are easy to transact on the ASX, and match the desire of many trustees to reduce costs. In May 2015, there were 129 ETFs trading on the ASX with a market capitalisation of $18.6 billion. Flows into global equities are among the top few categories. In 2014, net inflows into developed market global equities ranked first at $1.4 billion.

According to the BetaShares/Investment Trends October 2014 ETF Report, the third most common reason for investors using ETFs (after 'diversification' and 'low cost') was 'to access overseas markets', and an estimated 63,000 SMSFs held ETFs at that date.

What's a more accurate number?

There is potential for 'sample bias' using any other source, because SMSF administration is highly fragmented among the 550,000 SMSFs. The best place to look is among the SMSF administrators which can delve 'real time' directly into the portfolios of the funds they administer.

Multiport releases a quarterly analysis of SMSF Investment Patterns, based on the 2,500 funds it administers. They assigned 14.4% of SMSF assets to 'international shares' for March 2015, a significant increase on the 10.7% from a year earlier. This is predominantly managed funds, plus ETFs and direct shares, as shown in Table 2.

In fact, Multiport believes the global exposure may be higher, because it does not include the global equity allocation in multi sector balanced funds. On the other hand, Multiport has a large proportion of 'advised' SMSFs, and advisers are inclined to use managed funds. A study of the Top 10 investments by dollars shows Magellan sixth and Platinum eighth, above Wesfarmers and Woolworths.

However, another leading administrator, SuperIQ, estimates that across its 11,000 funds, only about 5% is invested in global equities, although it rises with fund size to about 9% for larger funds.

In another survey, AMP Capital's 'Blue Sky Report' on SMSF opportunities, among the SMSFs which invest in managed funds, 36% say they invest in actively-managed international equities and 19% in index international equities. In July 2014, a Vanguard/Investment Trends report stated that the intention to invest in international shares by SMSFs almost doubled in the year to April 2014 from 12% to 22%.

Global equities in SMSFs much higher

SMSFs do hold more Australian shares and cash than balanced institutional portfolios, but the weaknesses in the ATO data mean there is no definitive source on the exact proportions. SMSF allocation to global shares is likely to at least 10 to 20 times the level in the ATO data. Maybe more.

In fact, the official statistics are measuring in the wrong area, because few SMSFs actually invest in global shares directly. SMSF trustees are eager to use managed funds, LICs and ETFs to gain exposure to global companies because they are far less familiar with transacting on foreign exchanges than they are on the ASX.

Given the importance of SMSFs in holding one-third of all superannuation and the retirement

Table 2: Exposure of SMSFs to international equities, as at March 2015

	31 March 2013 (%)	30 June 2014 (%)	30 Sept 2014 (%)	31 Dec 2014 (%)	31 March 2015 (%)
Direct Shares	1.7	1.8	1.8	1.9	1.7
ETF's	1.8	1.9	1.9	2.1	2.8
Managed Funds	7.2	7.8	8.0	8.5	9.9
Total %	**10.7**	**11.5**	**11.7**	**12.5**	**14.4**

Source: Multiport Pty Ltd

savings of over one million Australians, and the design of superannuation policy, the knowledge about what they invest in needs significant improvement. This applies to much of the official data produced on SMSFs.

The ATO needs to run up a few red flags about using the data. SMSFs are not as badly diversified as most claim.

Graham Hand is Editor of Cuffelinks.

Help! My SMSF audit report has been qualified

by Liz Westover on October 8, 2015

All SMSF financial statements are required to undergo an annual audit. The thought of or the reality of receiving a 'bad' or 'qualified' audit report for your SMSF can be a scary prospect. But unless you have deliberately done something really wrong, it shouldn't be cause for panic. Understanding what happens when an audit is undertaken and what the auditor's responsibilities are might help ease any anxiety.

An auditor's responsibility

When conducting an SMSF audit, an auditor is essentially undertaking two types of audit. One is a financial audit where they are literally looking at the numbers reported in the financial statements. An auditor must form an opinion as to whether the numbers reported are correct and give a fair representation of the financial state of the fund.

The second type of audit is a compliance audit where they are required to form an opinion on whether the SMSF has complied with superannuation laws. While auditors can report on any matters they believe to be relevant, the pro forma audit report itself is supplied by the Australian Taxation Office (ATO) and requires auditors to specifically sign off on sections of the Superannuation Industry (Supervision) Act 1993 (SISA) and the Superannuation Industry (Supervision) Regulations 1994 (SISR)

Three levels of audit reporting

An auditor can report their findings from the audit in three ways.

The first is a management letter, given to the trustees only.

The second is through the auditors' report, again given to trustees only. All SMSF trustees will be issued an auditors' report which will be either qualified or unqualified.

The third method of reporting is directly to the ATO, using an Auditor Contravention Report (ACR).

Management letters

Auditors are required to provide their SMSF trustee clients with a management letter at the conclusion of the audit. In addition to addressing any major issues, the management letter can be an opportunity for the auditor to raise any minor concerns about the fund that didn't necessarily warrant a qualification or an ACR. Do not ignore any issues raised by the auditor or you may find a qualification the following year. For the most part, however, they are a good indicator of where difficulties may arise during the next 12 months and can help trustees comply with their obligations.

What does 'qualified' mean?

When an auditor finds no breaches or errors in the SMSF, they will issue an unqualified audit report. When a breach or misstatement is identified, they may qualify the report depending on whether it is material or not. The auditor will typically make a statement saying that they have formed the opinion that the SMSF is complying except for the breach/misstatement identified.

On occasion, an auditor may qualify an audit report even when there are no breaches or misstatements identified. This could be because they are unable to verify or confirm some aspect of the fund. For example, they may not be able to confirm the opening balances of a new SMSF client's financials if previous years' financials are not provided, or they may not be able to form an opinion on the value or existence of a particular asset. In these cases, even though an audit report may be qualified, it does not necessarily mean that the trustees have failed to comply with their legal obligations.

Qualified report and Auditor Contravention Reports.

Not all qualifications of audit reports will be reported to the ATO.

If an auditor qualifies an audit report, they then make an assessment based on ATO guidelines as to whether an ACR needs to be lodged with the ATO. In most cases, an ACR will be lodged where there is a material, significant, repetitive or unrectified (from previous years) breach or misstatement. In other words, details of financial or compliance breaches will generally only be reported to the ATO where the auditor believes they are significant enough to warrant reporting or the ATO requires them to.

If you receive a qualified audit report and no ACR has or will be lodged, it should be taken as a very serious warning that should the breach remain unrectified or occurs again, the following years audit report will not only be qualified again but will likely result in an ACR being lodged as well.

It is worth noting however that regardless of whether an auditor lodges an ACR with the ATO, the SMSF's annual return is required to be lodged by the trustee (or their tax agent) with a notification as to whether or not an audit report has been qualified.

Materiality

Generally, when auditors are looking at a particular issue, they will be assessing its materiality. In most cases, they will not be overly concerned with minor amounts or issues. If they find an error, they will make an assessment of whether or not it matters, in the grand scheme of things. They will look at an error or breach in the context of other breaches, the value of the fund, the percentage of the breach of total assets, and whether it is a repetitive or unrectified breach.

Don't panic

A qualified audit report is not necessarily cause for alarm. Look at the underlying causes of the qualification and seek assistance from the auditor and/or your professional accountant as to how to rectify the breach so next year's audit report won't be qualified.

Tips on making the audit go easy

- Provide your auditor with all the relevant information prior to commencement of the audit. Most auditors are able to provide a checklist of the documentation required.
- If your auditor asks for further information in writing, you are legally required to provide it within 14 days.
- If you think there is a problem with the fund, talk to your accountant and/or auditor. A good auditor will assist you to sort it out.
- Don't wait until the last minute to engage an auditor. You need to allow them time to conduct the audit. Remember, an SMSF annual return can't be lodged until after the audit has been completed.
- If you know there is a problem, seek to rectify it as soon as you can. There is a much better chance of a good outcome with the ATO if the auditor can report a breach as being rectified already.
- Check any major decisions on investments, changes to the SMSF structure or membership, payment of benefits or change in circumstances with your accountant BEFORE actioning them. This will ensure that all SMSF activity is undertaken in compliance with the law.

Liz Westover is Head of Superannuation at Chartered Accountants Australia and New Zealand. This article is general education only and professional advice should be sought for personal circumstances.

7 golden rules for SMSF investors

by Shane Oliver on October 22, 2015

Investing during times of market stress and volatility can be difficult. It's useful for SMSF investors to keep a key set of rules in mind.

1. There is always a cycle

The historical experience of investment markets – be they bonds, shares, property or infrastructure – constantly reminds us they go through cyclical phases of good times and bad. Some are short term, such as occasional corrections. Some are medium term, such as those that relate to the three to five-year business cycle. Some are longer, such as the secular swings seen over 10 to 20 year periods in shares. But all eventually contain the seeds of their own reversal. The trouble with cycles is that they can throw investors out of a well thought out investment strategy that aims to take advantage of long term returns and can cause problems for investors when they are in or close to retirement. In saying this, cycles can also create opportunities.

2. Invest for the long term

The best way for most investors to avoid losing at investments is to invest for the long term. Get a long term plan that suits your level of wealth, age and tolerance of volatility and stick to it. This may involve a high exposure to shares and property when you are young or have plenty of funds to invest when you are in retirement and still have your day to day needs covered. Alternatively, if you can't afford to take a long term approach or can't tolerate short term volatility then it is worth considering investing in funds that use strategies like dynamic asset allocation to target a particular goal – be that in relation to a return level or cash flow. Such approaches are also worth considering if you want to try and take advantage of the opportunities that volatility in investment markets throws up.

3. Turn down the noise and focus on the right asset mix

The combination of too much information has turned investing into a daily soap opera as we go from worrying about one thing to another. Once you have worked out a strategy that is right for you, it's important to turn down the noise on the information flow surrounding investment markets. This also involves keeping your investment strategy relatively simple – lots of time can be wasted on fretting over individual shares or managed funds – which is just a distraction from making sure you have the right asset mix as it's your asset allocation that will mainly drive the return you will get.

4. Buy low, sell high

One reality of investing is that the price you pay for an investment or asset matters a lot in terms of the return you will get. It stands to reason that the cheaper you buy an asset the higher its prospective return will be and vice versa, all other things being equal. If you do have to trade or move your investments around, then remember to buy when markets are down and sell when they are up.

5. Beware the crowd and a herd mentality

With crowds, eventually everyone who wants to buy will do so and then the only way is down (and vice versa during periods of panic). As Warren Buffet once said the key is to "Be fearful when others are greedy and greedy when others are fearful."

6. Diversify

Don't put all your eggs in one basket as the old saying goes. Unfortunately, plenty do. Through the last decade many questioned the value of holding global shares in their investment portfolios as Australian shares were doing so well. Interestingly, for the last five or so years global shares have been far better performers.

It appears that common approaches in SMSF funds are to have one or two high-yielding and popular shares and a term deposit. This could potentially leave an investor exposed to a very low return if something goes wrong in the high-yield share they're invested in. By the same token, don't over diversify with multiple – say greater than 30 – shares or managed funds as this may just add complexity without any real benefit.

7. Focus on sustainable cash flow

This is very important. There have been many investments over the decades sold on false promises of high returns or low risk (for example, many technological stocks in the 1990s, resource stocks periodically and the sub-prime asset-back securities of last decade). If it looks dodgy, hard to understand or has to be based on obscure valuation measures to stack up, then it's best to stay away. There is no such thing as a free lunch in investing. If an investment looks too good to be true in terms of the return and risk on offer, then it probably is. By contrast, assets that generate sustainable cash flows (profits, rents, interest payments) and don't rely on excessive gearing or financial engineering are more likely to deliver.

Final thoughts

Investing is not easy and given the psychological traps that we are all susceptible to – in particular the tendency to over-react to the current state of the markets – it might be best to simply seek the advice of a coach such as a financial adviser.

Shane Oliver is Head of Investment Strategy and Chief Economist at AMP Capital. This article contains general information only and does not take into account an individual's personal circumstances.

SMSFs: 8 reasons they are over-spruiked and over-rated

by Jonathan Hoyle on November 12, 2015

(Editor's note: This article may be construed as anti-SMSF, but far from it. In fact, the author has one, as does the Editor. We both believe that in the right circumstances, SMSFs offer tangible benefits over institutional super funds. But they're not for everyone …)

SMSFs have become the must-have financial fashion accessory for high-income earners and those seeking control over their superannuation investments. According to the ATO, there are 556,000 SMSFs in existence, comprising almost a third of the superannuation pie. For some, SMSFs offer a perfect mix of better control, inheritance planning and tax savings. For many, however, SMSFs are expensive, onerous and unnecessary. Too frequently, SMSFs are established by accountants and financial planners with an eye on revenue generation rather than with the best interests of the clients at heart. Despite their overwhelming popularity, here are eight reasons why you might pause before jumping on the SMSF bandwagon.

1. 'Til death do us part

An SMSF is like a marriage – it takes a significant commitment and a lot of hard work to make it run smoothly. If you are the type who doesn't like to commit for the long term, then an SMSF may not be for you. Even if you engage an army of advisers, accountants and auditors, you (as the trustee) are legally responsible for all the decisions made by the SMSF, for running the fund, completing the end of year tax return and audit, and for complying with superannuation laws. If this commitment is too much, then choose a retail or industry super fund as all the administrative, compliance and management responsibility is done for you.

2. Keeping up with the Joneses

Investment seminars, websites and ebooks on SMSFs are everywhere, and your golfing buddy has probably set one up. 'Best thing ever,' he says. Before calling your accountant demanding one, first determine what you want to do with an SMSF. If you see your current superannuation savings as readily accessible money to start trading today and making millions tomorrow, then you are most certainly going to end up disappointed.

3. Honey, trust me, I know what I'm doing

The ATO is quite clear about your responsibilities and the potential penalties.

'As a trustee of an SMSF, you need to act according to your fund's Trust Deed, the Superannuation Industry (Supervision) Act 1993 (SISA) – Superannuation Industry (Supervision) Regulations 1994 (SISR), the Income Tax Assessment Act 1997 (ITAA 1997), the Tax Administration Act 1953 (TAA 1953) and the Corporations Act 2001.'

Got that? The ATO continues rather more menacingly: '*If you do not follow the rules, you risk one or more of the following: your fund being deemed non-compliant and losing its tax concessions, being disqualified as a trustee, prosecution and penalties.*'

What does non-complying mean? '*A complying fund that has been made non-complying will suffer serious tax consequences. Your fund's total assets … are subject to tax at the highest marginal rate. Any income received in a financial year in which a fund is non-complying is taxed at the highest marginal rate.'*

And the penalties? *'If a trustee is prosecuted and is found guilty of either a civil and/or criminal offence under a civil penalty provision, the maximum penalties that may apply under Part 21 of the SISA are $340,000 (civil proceedings) and five years' imprisonment (criminal proceedings).'*

Engaging a financial adviser or an accountant to ensure you stick to the (highly complex) rules makes sense. But you are then up for another layer of fees. And what will you do if something should happen to you and you are no longer capable of running your SMSF? One-third of people aged 85 years and older have dementia. Will your partner know what to do in your place? Will they want to?

4. An SMSF! My kingdom for an SMSF!

In a report published in 2013, ASIC commissioned consultants Rice Warner to examine whether there was a minimum cost-effective fund balance for an SMSF. Rice Warner found that SMSFs with balances in excess of $250,000 were more competitive than the alternatives, provided the trustee was willing to undertake some of the fund administration. Those requiring a full administration service needed a balance of $500,000 to be more competitive.

As there are a range of fixed costs that an SMSF must incur (e.g. financial advice, administration, accounting, audit and actuarial costs) it is generally not cost effective for members with small balances to hold their superannuation through an SMSF. The cost of administering an SMSF and filing the tax return has fallen rapidly in recent years with the advent of better technology and you should not really be paying much more than $2,000 for this job (more if your SMSF has real complexity). Unless you are seeking advice about purchasing a property in your SMSF, planning to transfer in some business property or wish to gear up, there may be other more cost-effective options. Whilst there is no need to ransom your kingdom, for most, $250,000 should be the minimum.

5. Nothing is certain except death and taxes

You spend your whole life paying taxes. Wouldn't it be great if you could recoup at least some when the curtain closes? An anti-detriment payment (ADP) is a refund of contributions tax you have paid during your working life. This is an additional payment that can be made to your spouse or children if they receive your death benefit as a lump sum. It can be substantial. For example, a retail super fund with a $1 million balance and 50% taxable component, will spit out an ADP of some $37,000. You are unlikely to receive this if you are still running your SMSF, as funding ADPs in an SMSF can be problematic. Having your super in a larger retail fund can be more advantageous (albeit for your spouse or children) as these funds will have sufficient reserves to pay the ADP in addition to your death benefits. Beware single member funds with large hidden ADPs. If you are unsure, ask your accountant or adviser. Note, however, that the government is considering abolishing ADPs.

6. All your eggs in one sliced basket

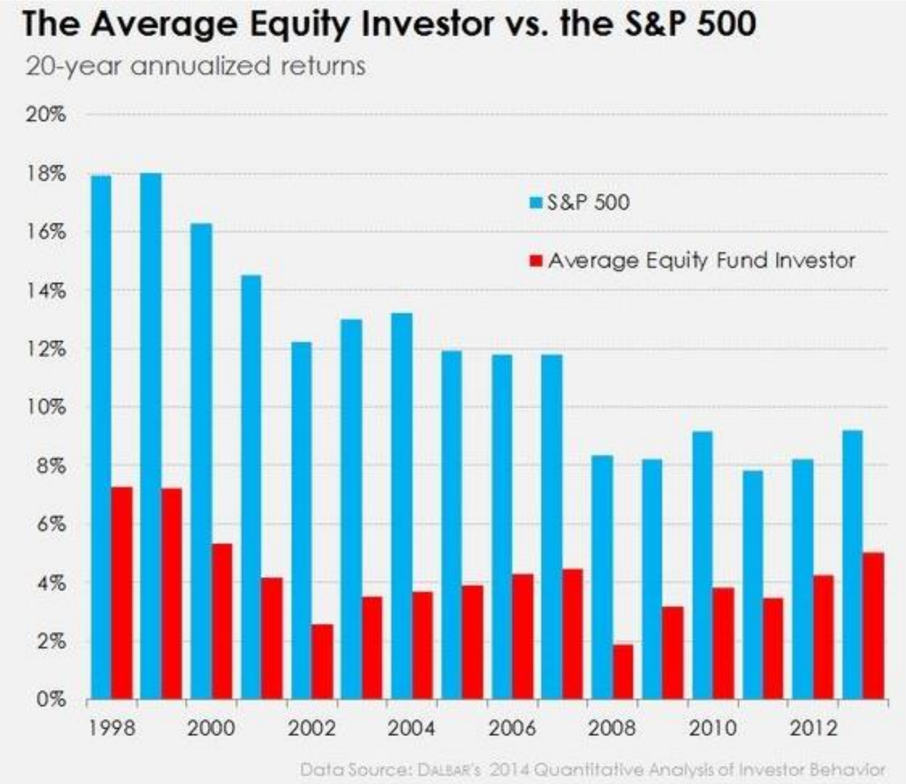
According to the ATO, cash accounts for 31% of SMSF assets, even those with $500,000 – $1 million balances, and 53% of the assets of those funds with less than $100,000. Australian shares appear to comprise another third of the asset base, though the figures are not too reliable. Multiport studies suggest that cash is more like 20%, but Aussie shares may be higher at 40%. Either way, most SMSFs comprise bank term deposits, bank hybrids and a whack of bank shares – akin to owning the senior, junior and mezzanine tranches of a single name Collateralised Debt Obligation (CDO).

7. You've got to call Australia 'home'

An SMSF must have the 'central management and control' (CMC) in Australia and the member must meet the Active Member Test so that the SMSF remains compliant. Therefore, if you are offered a long term position overseas, Houston we may have a problem. If you plan to leave Australia indefinitely, the SMSF will often need to be wound up as the CMC test will not be met and you cannot make contributions into the fund or any investment decisions.

8. I can beat the market!

And we save the best for last. SMSF providers regularly promote the benefits of running your own investment portfolio. Wonderful if you have a thorough understanding of financial markets, diversification, correlation, behavioural economics, volatility and the patience of Job. Otherwise, you are suffering from the over-confidence bias, the most well-documented of all the financial behavioural heuristics. The chart below from The Motley Fool uses research from DALBAR which shows investors underperform the market due to poor timing of entry and exit points.



Recep Peker, a senior analyst with research firm Investment Trends, says that trustees of many new SMSFs are convinced they can outperform the big funds. Indeed, 28% of SMSFs surveyed told Investment Trends that one of the reasons they set up an SMSF is a belief that, '*I can make better investments than the big fund managers*'. And in Lake Wobegon, all the children are above average intelligence.

Make sure it's suitable for you

In the right circumstances and for a well-informed trustee, SMSFs can offer significant benefits over traditional retail super funds. But remember Stanford Brown's Golden Rule of Investing No. 8 – *Don't Copy Your Mates at the Golf Club.* Just because it is right for them, doesn't automatically make it right for you.

Jonathan Hoyle is CEO of the Stanford Brown Group. This article is for general purposes only and does not consider the specific needs of any individual.

Top 10 hints for SMSF trustees before 30 June

by Monica Rule on May 28, 2015

As 30th of June approaches there are many things SMSF trustees should consider to make the most of their SMSF. Better not to leave the following until the last minute:

1. **Valuation.** The assets in your SMSF must be valued each financial year based on objective and supportive data. Refer to ATO publication, 'Valuation guidelines for SMSFs'.
2. **Contributions.** Ensure contributions are received on or before 30 June, especially if made by electronic funds transfer. A day too late could cause problems.
3. **Employer contributions.** Check whether Superannuation Guarantee contributions for the June 2014 quarter have been received by your SMSF in July 2014. If so, include the contribution in your concessional contribution cap for the 2014/2015 financial year.

4. **Salary sacrifice contributions.** Salary sacrifice contributions are concessional contributions. Check your records before contributing more to avoid exceeding your concessional contributions cap.

5. **Tax deduction on your contributions.** If you are eligible to claim a tax deduction, then you will need to lodge a 'Notice of intention to claim a tax deduction' with your SMSF trustee before you lodge your personal income tax return. Your SMSF trustee must also provide you with an acknowledgement of your intention to claim the deduction.

6. **Spouse contributions.** Spouse contributions must be received on or before 30 June in order for you to claim a tax offset on your contributions. The maximum tax offset claimable is 18% of non-concessional contributions of up to $3,000. Your spouse's income must be $10,800 or less in a financial year. The tax offset decreases as your spouse's income exceeds $10,800 and cuts off when their income is $13,800 or more.

7. **Contribution splitting.** The maximum amount that can be split for a financial year is 85% of concessional contributions up to the concessional contributions cap. You must make the split in the financial year immediately after the one in which your contributions were made. This means you can split concessional contributions made during the 2013/2014 financial year in the 2014/2015 financial year. You can only split contributions you have made in the current financial year if your entire benefit is being withdrawn from your SMSF before 30 June 2015 as a rollover, transfer, lump sum benefit or a combination of these.

8. **Superannuation co-contribution.** To be eligible for the co-contribution, you must earn at least 10% of your income from business and/or employment, be a permanent resident of Australia, and under 71 years of age at the end of the financial year. The government will contribute 50 cents for each $1 of your non-concessional contribution to a maximum of $1,000 made by 30 June 2015. To receive the maximum co-contribution of $500, your total income must be less than $34,488. The co-contribution progressively reduces for income over $34,488 and cuts out altogether once your income is $49,488 or more.

9. **Low income superannuation contribution.** If your income is under $37,000 and you and/or your employer have made concessional contributions by 30 June 2015, then you will be entitled to a refund of the 15% contribution tax up to $500 paid by your SMSF on your concessional contributions. To be eligible, at least 10% of your income must be from business and/or employment and you must not hold a temporary residence visa.

10. **Minimum pension payment.** Ensure that the minimum pension amount is paid by your SMSF by 30 June 2015 in order to receive the tax exemption. If you are accessing a pension under the 'Transition to Retirement', then ensure you do not exceed the maximum limit also.

Monica Rule is the author of The Self-Managed Super Handbook. See www.monicarule.com.au

Fintech and robo advice

Is there an Uber or Amazon of wealth management? – Graham Hand

Is there an Uber or Amazon of wealth? Part 2 – Graham Hand

What is robo-advice? – Jeroen Buwalda

Scenes from a roboadvice pitch to angel investors – Graham Hand

Is there an Uber or Amazon of wealth management?

by Graham Hand on March 5, 2015

"Even well-meaning gatekeepers slow innovation. When a platform is self-service, even the improbable ideas can get tried, because there's no expert gatekeeper ready to say 'that will never work!' And guess what – many of those improbable ideas do work, and society is the beneficiary of that diversity. I see the elimination of gatekeepers everywhere."

Jeff Bezos, quoted in *The Everything Store: Jeff Bezos and the Age of Amazon*, page 315.

"Spend the vast majority of your time thinking about product and platform. Many large, successful companies started with the following:

1. *They solved a problem in a novel way.*
2. *They used that solution to grow and spread quickly.*
3. *That success was based largely on their product.*

In the Internet Century, all companies have the opportunity to apply technology to solve big problems in new ways … if you focus on your competition, you will never deliver anything truly innovative."

Eric Schmidt, CEO of Google from 2001 to 2011, quoted in *How Google Works*, pages 91-93.

I recently read '*The Everything Store*', '*How Google Works*', and Walter Isaacson's biography of Steve Jobs and Apple. The creation of these three extraordinary companies in a short time from the vision of a few individuals left a nagging question in my mind at almost every page: can any company do to the Australian wealth management industry what Amazon did to Borders, what Apple did to Nokia, what Google did to all other search businesses? They are all remarkable stories of redefining how business is done, breaking the traditional rules and in the process, destroying much of their competition.

Markets where anything seems possible

It's the same with Uber, the ride-sharing service with operations in 53 countries and a market value of about US$40 billion. There are 5,500 taxi licences in Sydney worth about $400,000 each or $2.2 billion. In Melbourne, metro licences have fallen in value from $515,000 a few years ago to $290,000 on a combination of new licences and Uber drivers given access to the market. Uber has fought legal battles all over the world, as it is in NSW, but there's no denying the public demand.

It's a good example of a change in the way the global economy operates. It's a platform business that matches customers with drivers, turning employees into 'entrepreneurs', in a similar way to the thousands of businesses run from home using eBay as a distribution platform. And there are 'ubers' for all types of services such as cleaning and massage, and of course human resources with sites like Freelancer and Elance.

Amazon is portrayed in the book as a brutal competitor. When diapers.com (owned by a company called Quidsi) was gaining market share among mothers but refusing a takeover offer, Amazon reduced the price of diapers by 30%, and then launched a new service called Amazon Mom, with additional discounts. Quidsi executives estimated that Amazon lost $100 million in three months on diapers. Then Wal-Mart made a bid for Quidsi, and Amazon threatened to drive prices to zero if Wal-Mart won the bidding. The diapers.com founders sold to Amazon out of fear.

"The money-losing Amazon Mom program was obviously introduced to dead-end Diapers.com and force a sale, and if anyone had any doubts about that, those doubts were quickly dispelled with by Amazon's subsequent actions. A month after it announced the acquisition of Quidsi, Amazon closed the program to new members." The Everything Store, page 299.

Of course, the Federal Trade Commission investigated the deal but gave its approval. If Amazon and Uber can take such actions in the face of legal hostility, anything seems possible in the age of the internet.

Australia has its home-grown examples of severe market disruption, the most public being the turmoil created for newspapers from the success of realestate.com.au, seek.com.au and carsales.com.au, almost bringing the once mighty Fairfax to its knees.

Unlike Facebook and Twitter which have invented new 'social media' activities, companies like Uber and Amazon are killing off competitors. When Jeff Bezos convinced publishers to allow him to put their books on the Kindle, they thought he would charge a margin over the usual wholesale price of books of around $16. But by retailing books online for $9.99, Amazon reinvented the price point. It did not take long for booksellers like Borders and Angus & Robertson to go out of business. Despite the fact that Amazon made a loss in 2014, the market has spoken: its market cap is about USD170 billion.

The defining characteristic of these great American companies moving into retailing, mobile communications, social media, search, taxis, employing contractors and booking B&Bs is that they break the mould for the way business is done. New methods are often not appreciated by the incumbents until it is too late, and it is fanciful to predict what future disruptions will occur. When Mark Zuckerberg developed Facebook, he did not have a notion that it would become the way a billion people shared their most intimate secrets, and he certainly he had no idea how to make money from it.

What is major disruption in Australian wealth management?

By disruption, I don't mean somebody developing an online 'robo-advice' model (such as GuidedChoice, eMoney, Betterment and Wealthfront in the US or Stockspot and BigFuture in Australia) and collecting $1 billion in funds in a few years, although that would be considered a great success and will happen. With $2 trillion in superannuation, real disruption is at least $100 billion within a few years, which is only 5% of the market. Such numbers would worry the four major Australian banks, which are not only almost 30% of the market capitalisation of the ASX200, but wealth management is significant to them all. They also control the majority of financial advisers in Australia.

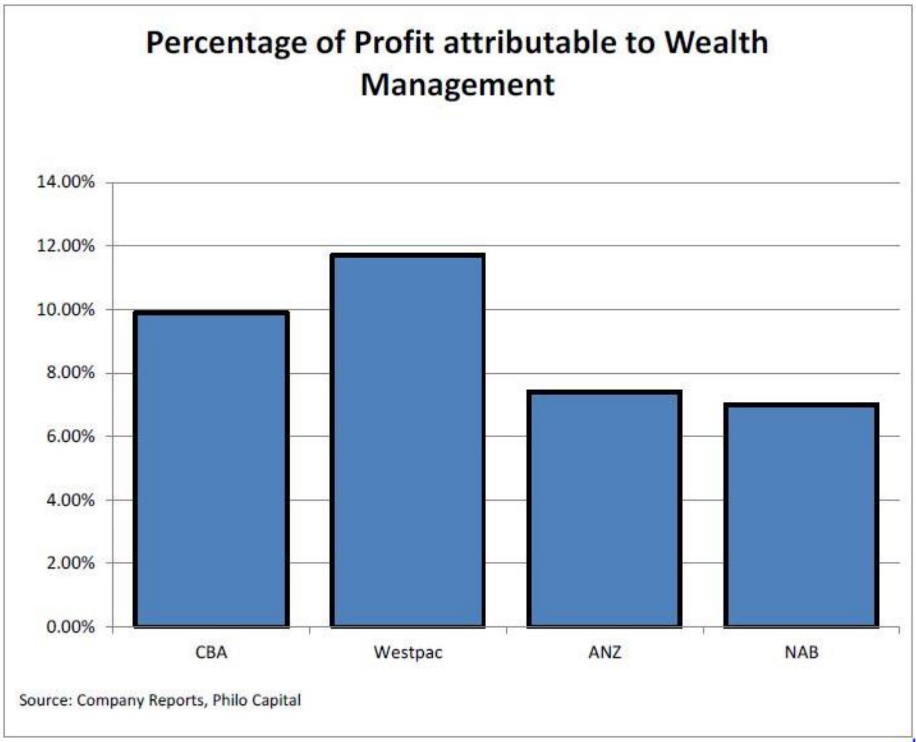
Where can disruption happen in the value chain?

Wealth management is usually broken into at least three parts:

- financial advice
- administration platforms
- asset management

Let's consider what happens if an investor uses a platform such as Colonial First State's (CFS) FirstChoice Wholesale, the most popular among financial advisers. It requires a minimum of only $5,000 so it is a retail product. On a typical and popular fund such as the Schroder Australian Equity Fund, CFS charges a fee of 1.02%, and splits it with Schroder. Call it 0.5% for CFS administration and 0.5% for Schroder asset management. CFS also has an Australian share index option for only 0.40%, where the asset management costs only a couple of basis points (0.02%). So we can generalise that major platform administration costs about 0.4%-0.5% with asset management on top of that. Financial advice costs are additional: it may be fee for service, say $350 an hour, or a percentage of funds, say 0.5%.

In simple terms, there's the Australian wealth management value chain. If a market disruptor comes in, they can easily remove the asset management cost by using index funds; they can automate advice based on an internet-based, self-service model; and investments can sit on a simple and inexpensive administration platform.



Would it be the equivalent of Amazon charging $9.99 for a book that previously retailed for $30, and destroying other booksellers?

I'm not looking here for the disruption of SMSFs holding $600 billion or one-third of all super. They are serviced by thousands of advisers, accountants and administrators as well as being users of the products of major banks, fund managers and the ASX. My focus here is on a single company coming in with a game-changing, disruptive product offering.

What will the disruptor do or look like?

1. It will not attack one part of the value chain. It will be end-to-end with a complete investment solution. For example, it will not be sufficient to only offer 'great asset management', as plenty of companies claim that. A disruptor could hardly 'out-Vanguard' Vanguard (or State Street or BetaShares) and provide cheaper and better asset management through ETFs. Broad-based domestic or global equity portfolios can already have negligible costs, less than 0.1%. These ETF providers are successful, well-capitalised companies with overseas parents or partners who already have the capacity to take large shares of the Australian market. Although their growth has been impressive, they only have $15 billion, less than 10% of the money managed by CFS.

2. It will be price-led. I cannot see how anyone can convince enough people that a superior product is worth paying up for because that will depend on a promise (guarantee) of outperformance over time. Amazon can set up systems to deliver a book next day and Telstra can have the best phone coverage in Australia but nobody can promise to outperform the market consistently, whatever their resources. This 'game-changer' will be index-based or with some type of 'beta' engine, not a bunch of superb stock pickers making company visits all day. They are too expensive.

Similarly, the portfolio will not include alternatives or unlisted investments, as they have higher fees and are more expensive to manage, even if done internally. The portfolio is likely to be dominated by cash and term deposits where the 'fees' can be hidden in the product margin.

(Of course, Apple's success is far from price-led, its phones are the most expensive on the market. They have achieved this through beauty of design and creating massive desirability and arguably the best product. But in my wildest dreams I cannot see people queuing up around the corner to invest in a managed fund based on its beauty and desirability).

3. It will need to be well-capitalised and carry a great deal of market trust. This is not like buying a book with a secure credit card charging system. People will be handing over their future, their life savings, and the company must be beyond reproach. Whatever they do, they will need to buy time and spend a lot of money on marketing and disrupting and delivering results, plus ongoing R&D specifically for the Australian market.

4. It will be technology-based and self-service. Investors will input their own characteristics into an engine and it will recommend a portfolio of investments, selected according to the risk appetite and demographics of the client. This 'robo-advice' (a large part of 'fintech') is already being embraced by major players in the US, such as Charles Schwab and Fidelity's acquisition of eMoney.

5. It must break established distribution networks. An estimated 70% of financial advisers are already 'tied' to the four major banks, AMP and IOOF. At the moment, eight out of every ten people default to the super fund selected by their employer and $10 billion a year automatically flows into default super funds. Whereas everyone selects their own phone, most people do not engage with their superannuation.

A new winner would need to capture the hearts and minds of investors in the way no financial product has done before. The only alternative to making the product 'sexy' is 'fear', but how would that gain traction? As David Blanchett, Morningstar Head of Retirement Research, said:

"We all know most people aren't on track for retirement. I think surveys that talk about poor savings in the US, or the fact that people haven't saved enough for retirement, are relatively worthless. Kind of like saying, 'The sky is blue'". (Yahoo! Finance, 8 February 2015)

Severe disruption is unlikely

The growth of superannuation assets in Australia is assured by the Superannuation Guarantee regime, making it a highly desirable industry to be in. It must attract new competitors. There's no denying wealth management will change significantly over the next ten years, just like every industry driven by technology. There will be surprises, developments nobody has yet thought of, perhaps from a couple of young computer geeks in the proverbial garage. Some will do well and drag in a few billion. But that's not disruption like the executives of Kodak, Blockbuster, Nokia and Borders experienced.

Based on the short and glorious histories of Amazon, Google and Apple and their impact on established businesses, how can anyone conclude that wealth management will not face a similar massive overhaul from a new competitor? Yet that's my conclusion: I don't see how any company can make wealth management sufficiently exciting for enough people to grow a market share of 5 to 10% in the next few years. To use Google's test, what problem will the disruptor solve in such a novel way that hundreds of billions will divert from incumbents? I hope I'm wrong because it would be fun to watch.

Graham Hand has worked in banking and wealth management for 35 years and is Editor of Cuffelinks.

Is there an Uber or Amazon of wealth? Part 2

by Graham Hand on April 9, 2015

"We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next 10. Don't let yourself be lulled into inaction." Bill Gates

Part 1 was a focus on short term disruption and the potential for a new entrant to gain a significant slice of the wealth market, and concluded:

I don't see how any company can make wealth management sufficiently exciting for enough people to grow a market share of 5 to 10% in the next few years. To use Google's test, what problem will the disruptor solve in such a novel way that hundreds of billions will divert from incumbents? I hope I'm wrong because it would be fun to watch.

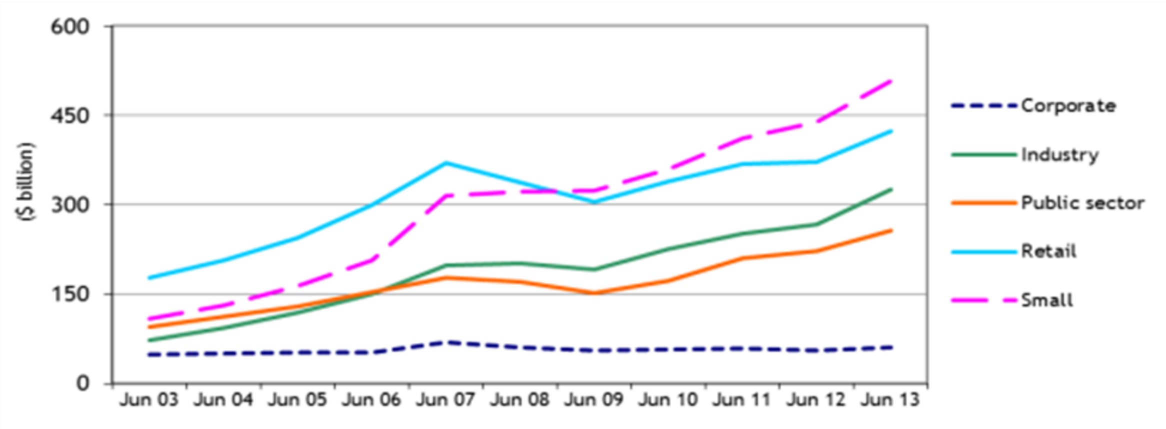
Part 2 takes a longer time frame over the next decade to 2025, and predicts the likely winners and losers, especially for superannuation.

The power of incumbents

The three main (but not only) parts of the wealth management value chain are financial planning, administration services and asset management.

While each is a distinct service, the market is dominated by businesses that perform all three roles, although clients may not realise their adviser is aligned with one of the big players. The four major banks plus AMP 'control' about 70% of financial planner business. Many clients of the Commonwealth Bank who meet a planner in their local bank branch will be set up on a Colonial First State administration platform invested in a fund managed by a group subsidiary. Such 'vertical

Chart 1: $ billion held by various superannuation industry sectors



Source: APRA Annual Superannuation Bulletin, revised February 2014 integration' is the subject of much angst from consumers, regulators and governments but it received relatively little attention from the recent Financial System Inquiry. A recommendation to review Stronger Super in 2020 is at least two Federal elections away.

However, despite their vast distribution networks, these retail fund businesses are far from winning the superannuation race they dominated until around the GFC. Between 2007 and 2008, retail super funds, heavily invested in equities, fell significantly, while SMSFs (labelled 'Small' in Chart 1) attracted new members and held a more conservative asset mix with 30% in cash and term deposits. SMSFs overtook retail funds in 2009 and now hold about one-third of the $2 trillion in super. And whereas a decade ago, the industry funds were less than half retail funds, they are now around three quarters and catching up fast.

Of course, other providers specialise in only one part of the wealth value chain. There are thousands of non-aligned financial advisers who argue they are more independent and better able to act in a client's best interests. Similarly, there are dozens of sophisticated administration platforms, especially (but not only) for assisting in the management of SMSFs, which allow investors to hold almost anything. And there are hundreds of asset managers holding billions of dollars (super and non-super), all claiming special talents which shout 'choose me'.

Industry funds in the context of market disruption

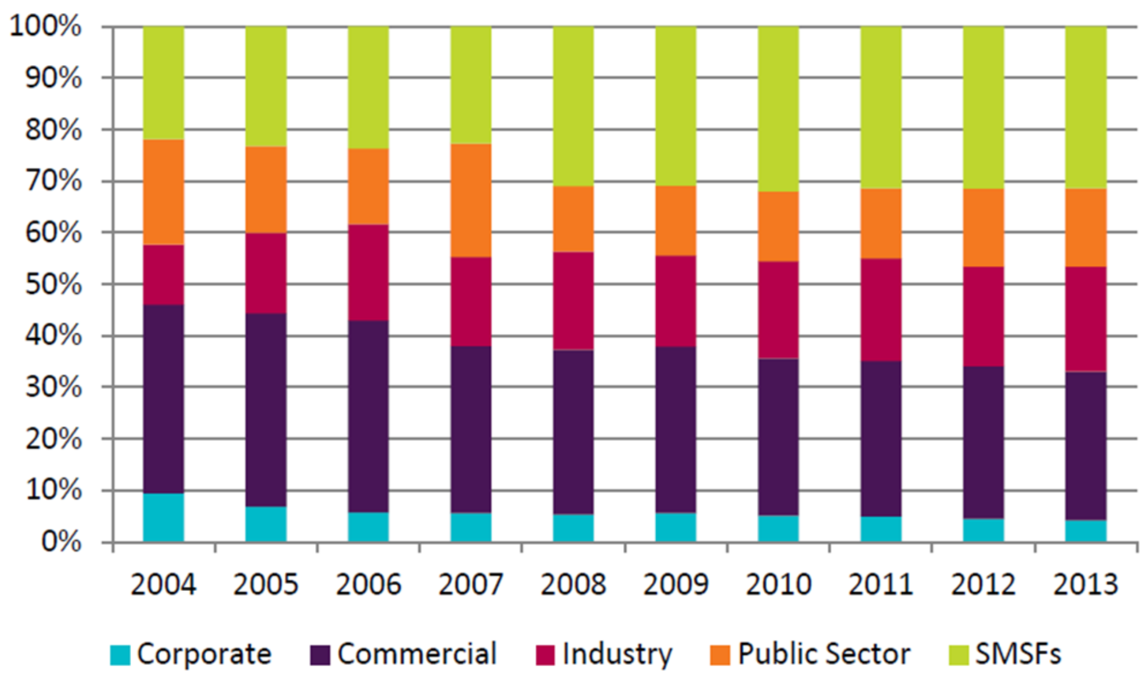
Two of the major competitive forces, SMSFs and industry funds, are almost unique in the world in their structure, making the likely future outcome for wealth management in Australia different from other countries. Chart 2 shows market shares of superannuation assets and these two segments are the big winners in the last decade. According to Rice Warner, while corporate funds, retail ('Commercial' in the chart) funds and public sector funds have all fallen significantly, industry funds have doubled their share of the large superannuation fund market (excluding SMSFs) from 15% to 30% since 2004.

What are the strengths and competitive advantages of industry funds that will enable them to thrive in the face of new sources of competition?

1. Client acquisition. Most people who start their first job on the checkout at a supermarket at the age of 15 are given a 'starter pack', and it includes an application form for the Retail Employees Superannuation Trust (REST). It's not only low income earners, as Unisuper's position in universities shows. The largest, AustralianSuper, manages almost $90 billion. While industry funds have experienced some leakage to SMSFs, the majority of clients stay for life.

2. Higher satisfaction ratings. Without entering the debate about whether it is perception or reality, industry funds are considered to deliver

Chart 2: Market share of the superannuation industry, 2004-2013.



Source: *Rice Warner submission to the Financial System Inquiry*, page 14.

Chart 3: Satisfaction with financial performance of superannuation by balance held

Source: Roy Morgan Research, six months to December 2014, sample n=15,932.

performance at least as good as retail funds at a lower price. Industry funds have led retail funds in overall satisfaction ratings for over a decade. As shown in Chart 3, what is most surprising is the satisfaction gap is much greater with larger balances, where investors are likely to be better informed and engaged. Satisfaction is similar for under $5,000 but wide for over $250,000, which accounts for only 10% of customers but a whopping 43% of balances. It's not an encouraging sign for retail funds gaining large clients from industry funds.

3. Not for profit structure. Industry funds have only one type of stakeholder, their members. This clarifies decision-making and should lead to singularity of purpose, of improving member returns and services at the least cost. Retail funds must satisfy shareholders demanding an economic return on capital, requiring a profit margin built into fees.

This final point is the most important for long term expectations. As industry funds grow, the largest bring more of their funds management in-house. The economics of paying competitive salaries for top fund managers are compelling for a fund with say $50 billion in total and $20 billion in equities, paying 0.40% to an external manager. That's $80 million in fees, which covers a lot of salaries and bonuses. Even if asset management is not brought in-house, an ever-expanding range of sector index funds plus smart beta funds are available at a fraction of the fees of active managers. With the guaranteed SG inflow from a largely disengaged client base choosing default funds, they have the potential to lower fees significantly over time.

Within 10 years, as funds grow with a largely fixed cost base spread over more assets, industry funds will commonly deliver their main default balanced fund options for 50bp or less all in. That will cover asset management, administration and even some financial advice. All the large funds will further develop their advice capability at subsidised costs with salary-based staff, removing many of the arguments about conflicts that come from commissions. While advice will not be free, it will be attractively priced, again with no profit margin driving the fees.

The main risk facing industry funds is that the government may remove the privileged position as the nominated funds under employee awards. This may be matched by increasing the number of independent directors, a change which may assist public perception. Either way, industry funds will remain a major force in the market, probably stronger than their current market share of super. Retail funds have their MySuper products around 1%, but they will not deliver better fund performance to make up for the higher fees. Even where industry funds outsource their asset management, they use the same managers as retail funds and can negotiate rates which are at least as competitive.

The rise and rise of SMSFs

The improvement in technology and developments in 'fintech' and 'roboadvice' make it easier than ever to manage an SMSF. An administrator can sign up a new SMSF, including opening a bank account, broker links, access to a term deposit aggregator, full trustee identification and comprehensive reporting, all online in less than 30 minutes. Without entering the debate about the minimum amount required for an SMSF, it is certainly cost competitive at amounts above say $500,000 (and many argue much less), where even a low 0.5% is $2,500. This will cover tax returns, audit and reporting for a simple fund, which can then choose inexpensive investment options such as ETFs or direct ASX investments to keep management costs down.

Retail funds have obviously done well in the rising stockmarket of the last few years, and they are far from struggling. Staff have still received their handsome bonuses. But there's little sign of a drop off in the establishment of SMSFs, now well over half a million.

With around 30,000 new SMSFs established each year, that's about 100 a day, with an average of two trustees. Over one million Australians have signed a 90-page Trust Deed taking legal responsibility for their own superannuation.

A recent report entitled '*The 2015 Automated Investment Advisers Global Market Review*' by FinDigital and Ignition Wealth reviewed 45 roboadvice offers, and found they were often targeting self-directed investors including SMSFs. Technology is not only for younger generations as the roboadvice offers appeal to older investors due to the better customer experience and lower fees. These developments are likely to encourage more SMSFs, as the simple advice models suggest planning decisions relating to risk assessment and asset allocation can be done without an adviser.

Where does that leave the retail funds?

Retail funds will continue to grow in absolute terms, even while they lose market share to industry funds and SMSFs. Their distribution networks and provision of most of the 'face to face' financial advice will ensure they remain strong businesses. They have billions invested in technology, and they have the marketing resources to attract corporate super, where 80% of people do not actively select their own fund but default to that selected by the employer.

On the platform side, it's an industry truism that managed funds are sold and not bought. Financial planners have their favourite platforms or funds around which they build their administration and model portfolios, and it's not easy to change. The retail providers will continue to service their networks well.

But it is increasingly easy to create the same asset allocation possibilities using the ASX and a collection of ETFs, LICs, listed bonds, alternatives and shares. There are dozens of simple

Chart 4: Membership and number of SMSFs

	Establishments	Windups	Net establishments	Total number of SMSFs	Total members of SMSFs
Jun-09	32,604	8,843	23,761	399,386	758,589
Jun-10	29,940	15,088	14,852	414,238	787,602
Jun-11	33,215	7,057	26,158	440,396	837,171
Jun-12	41,066	7,304	33,762	474,158	900,714
Jun-13	39,559	9,676	29,883	504,041	953,722
Jun-14	32,484	2,349	30,135	534,176	1,011,686

Source: Australian Taxation Office, SMSF Statistical Report, June 2014 administration platforms of varying sophistication which might cost as little as a few hundred dollars a year. A copy of the contract note for the trade on the ASX is automatically sent to the administrator for a portfolio to be updated real time. They may not have the tax sophistication of a full retail platform but the information automatically generated at the end of the year makes the financial return straightforward for a competent accountant. The ASX's mFund service delivers managed funds previously available only via a platform or long form PDS.

What about fintech, roboadvice and other new providers?

Fintech and roboadvice are starting to make an impact in wealth management services. The basic approach requires a client to answer a series of questions to assess their risk capacity, income, assets and long term goals, and an algorithm generates a suggested portfolio. There may be online or video conversations with an adviser. It is clearly no substitute for a bespoke, personal consultation with a skilled financial planner, but a minority of people have a planner. And while most people nearing retirement are no doubt missing out on good planning ideas, such as making the most of superannuation, estate planning, insurance and portfolio construction (to name a few of the things a good financial planner will cover), for many the roboadvice is a major step forward in the diversity and sophistication of their retirement planning. Chart 5 shows how much the word 'fintech' has entered our search conversations (acknowledging 'fintech' has a much broader definition than only wealth management).

While many criticise the simplicity of roboadvice, it offers better opportunities than keeping money in the familiar places of cash, term deposits, bank shares and residential property (not that such a portfolio has done poorly in recent years, but it does lack the diversity that international equities and other asset classes bring).

Such online advice and implementation is usually cheap, based on ETFs with an all-in cost of say 0.25% per annum. Although Vanguard moved into online advice based on index funds, it recently added active funds for clients who want to complement indices with active stock and bond pickers. Active management remains a massive market and roboadvisers will not necessarily ignore it.

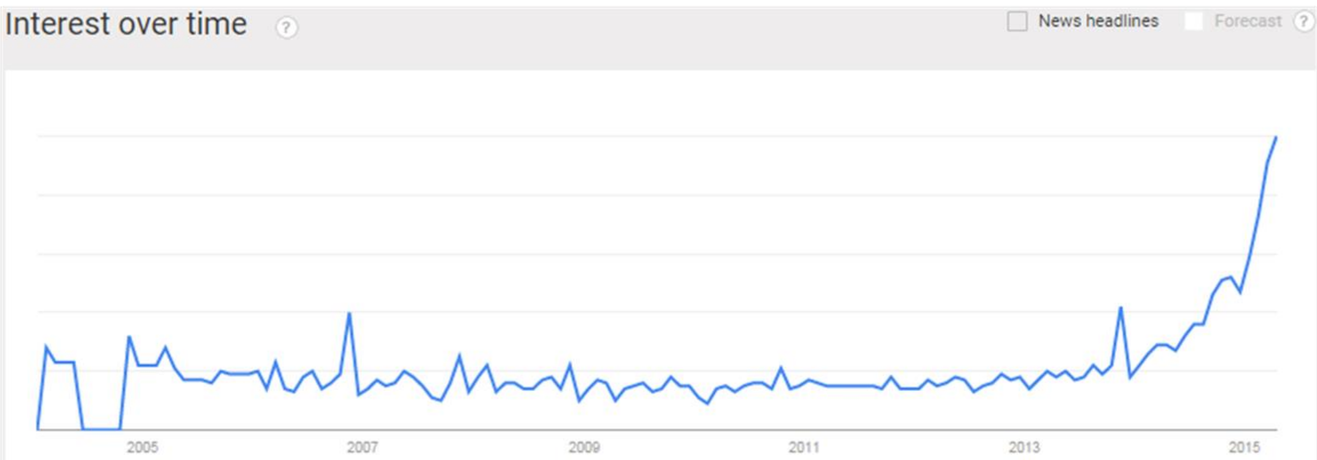
We are only at the beginning of an exciting new development: the market leader in the United States, Wealthfront, has only about USD2 billion under management, a tiny (read insignificant) share of the market despite its high profile and slick technology.

In Australia, some early movers are Decimal, Stockspot, SelfWealth, AdviceConnect and BigFuture. In the United States, more advanced are Betterment, Wealthfront and PersonalCapital, plus more established names like Charles Schwab and Vanguard.

As we discussed in Part 1, many of the new entrants in roboadvice will do well, as they have relatively low costs and capital needs, and a couple of billion under management can be an excellent business. But with $2 trillion in super, a 1% market share is $20 billion. While 1% is hardly market disruption on the scale of Amazon's effect on Borders, are there any trusted names which have the capacity to raise this much over say the next decade?

If the technology (ETFs, roboadvice, cheap administration) had been available 10 years ago, then a name like Virgin may have made a bigger splash. Its brand was moving into everything, but its impact has been largely confined to credit cards

Chart 5: Google Trends based on search term 'fintech' with April 2015 the 'base' of 100



rather than superannuation. Virgin is one of the most recognised brands in the market, yet it struggles as a wealth management name.

The best technology companies and retail brands in the world, such as Google, Apple, Facebook, Twitter, Microsoft, Ebay and Amazon, clearly have the deep pockets and distribution to design solutions that can gain a big following. It's reasonable to expect them to see the opportunities in wealth and consider it an extension of their existing businesses.

And of course there are points of intersection where incumbents use new technology to improve their own offers. Regardless of developments, face to face advisers will always have a role in coaching and guiding their clients, especially where needs are complex such as estate planning, tax, aged care and retirement. These advisers can use roboadviser tools to help with risk assessment, portfolio selection and investment reporting. This will be complementary to moving the financial advice industry into the more professional status so keenly sought by the industry.

Conclusion on the future of wealth management

Technology can change industries almost overnight, and in hundreds of 'tech hubs' around the world, some of the smartest brains of any generation are working day and night to develop an online investing and advice solution that will change the world. The former executives from Kodak, Blockbuster and Borders know that even experts in a business do not see the freight train coming until it runs over them. The new generations of investors are far less loyal to existing relationships and open to innovative forms of technology.

Recognising the warnings by Bill Gates not to underestimate long term change, my expectations are (defined for simplicity in terms of superannuation): SMSFs to continue to increase market share but with some natural cap due to most people remaining disengaged with investing; industry funds to gradually lower fees and expand more into advice and to take over retail funds as the second largest segment; retail funds to remain strong based on broad distribution but to lose market share due to higher fees without better performance; and new entrants using elegant online solutions to have some great successes and great failures but no single new party will have greater than 10% of the market by 2025.

(A six-minute video to go with this article is linked here).

Graham Hand has worked in funds management, investment banking and retail banking since 1979 and is the Editor of Cuffelinks.

What is robo-advice?

by Jeroen Buwalda on May 28, 2015

The term robo-advice is now widely used within wealth management circles, but exactly what does it mean? If that question was directed to someone on the street corner their response would be more likely to include R2-D2 or C-3PO rather than a computer telling the user how they should invest their money to achieve their financial goals.

Wikipedia defines robo-advisors as "a class of financial adviser that provides portfolio management online with minimal human intervention. While their recommendations may vary, they all employ algorithms."

The key words there are *portfolio management* and *algorithms*. Portfolio management indicates it has something to do with investing while the algorithm component refers to "a finite set of instructions that can be performed in a prescribed sequence to achieve a certain goal and has a recognisable set of end conditions." (Source: thefreedictionary.com)

Split robo-advice into three groups

The term robo-advice has quickly evolved to cover a broad range of automated advice and investment solutions. But the underlying principle is the use of a formula or set of rules to assist a customer in finding the optimal approach to their investments, savings, retirement, or protection of assets. In practical terms, robo-advice can be split into three distinct groups and each has tremendous application for wealth managers and their customers.

A. Fully automated non-discretionary investment advice

This refers to an individual subscribing to wealth guidance and advice that is implemented without the customer's explicit consent. Managed accounts fit this definition and dealer group model portfolios could probably be put here as well, particularly if the portfolio is rebalanced periodically without customer consent at each rebalance. The main distinction between these investment approaches and the new crop of robo-advice offerings is that the new kids on the block advise the customer which fund or portfolio to invest in. Traditional managed accounts, on the other hand, rely on an adviser to select the initial portfolio based on their clients' personal circumstances and appetite for risk.

The new breed of automated investment solutions still applies the principles of diversification, passive investing and regular rebalancing. Many also offer extended tools, including tax lot harvesting, to optimise capital gains tax outcomes. What really sets them apart though is an intuitive, clearly-defined and consistent investment approach which resonates with experienced and novice investors alike. As these solutions continue to innovate, they will increasingly appeal to a wider audience.

B. Self-service investment and financial advice

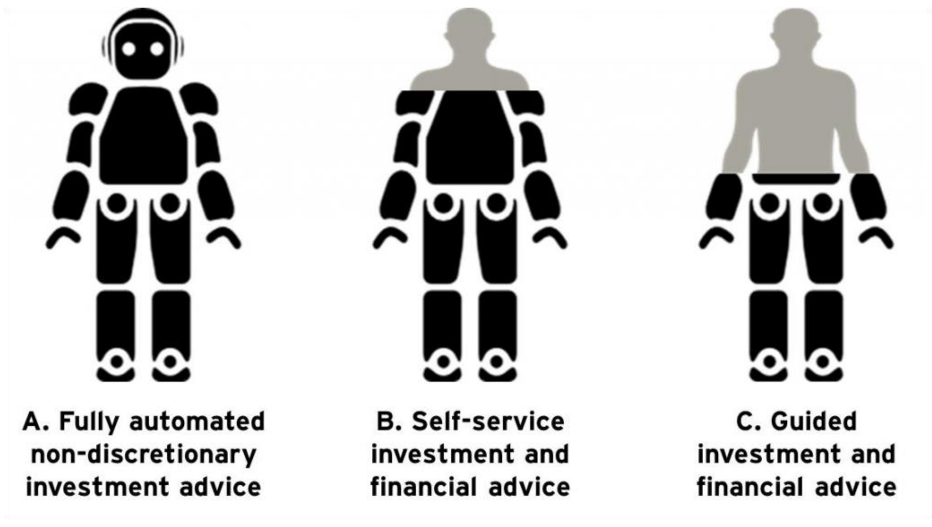
This group provides digital tools to support customers in identifying, scoping and creating wealth advice and guidance, typically in relation to a specific goal or range of goals such as an income stream in retirement or saving for education. They may use behavioural finance techniques to encourage customers to regularly monitor and contribute to their wealth journey. Some of these tools build on this even further by streamlining the goal setting process and providing default goals and timings.

The main difference between these robo-advisors and the automated investment options is that they optimise and allocate cash flow across goals. In Australia, optimising across goals is particularly difficult given the complexity of our income tax and superannuation systems. As an example, one question that sounds simple but is quite difficult for robo-advisors to answer could be whether a client should make voluntary contributions into superannuation or pay down the mortgage. If a robo-advisor can't answer this fundamental question, then chances are it optimises on investment and not on strategy.

What makes these types of robo-advisors even more compelling is the aggregation of client data. This enhances the user experience and removes unnecessary friction from the goal setting process. Where the wealth manager already has personal and investment data for the user, it can be integrated into the tool. Alternatively, the front end tool could request the user's various account details. This gives the robo-advisor a powerful advantage as it can link all the accounts together, monitor movements in the investments and track ongoing progress towards goals. At the very least, the robo-advisor could apply basic user information, such as their age and suburb, and provide an estimate of their income, expenses and assets.

C. Guided investment and financial advice

This option is typically focused on holistic strategies. It includes traditional face-to-face advice as well as remote advice delivered over the phone or by video. It also includes omni-channel advice, where a person is involved or ultimately responsible for the advice strategy.



There are a number of services available which provide online tools and access to a financial adviser for a one-off initiation fee and low monthly charge. The providers have embraced a user friendly and simplified approach to the financial advice process, with some even offering automated investment advice supported by a real financial adviser.

Robo-advisors versus real financial advisers

Will robo-advisors replace real financial advisers? The answer is, probably not. The more likely scenario is that robo-advisors will complement the work done by real financial advisers.

There is a huge gap between what regular households are willing to pay for advice and what advisers are willing to charge for advice. Robo-advisors will help to bridge that gap.

Where the two worlds are more likely to collide is in an adviser-led robo-advice tool becoming part of a dealer groups' sales process. This has real merit and could revolutionise financial advice in Australia based on the principles of customer centricity, connectivity, contemporariness and compliance.

Adviser led robo-advice tools could help to close the gap around perceived quality of advice. The ASIC report 279 – *Shadow Shopping Study of Retirement Advice* found that 39% of advice examples were poor and failed to meet the requirements of S945A. Yet, in the same study, 86% of mystery shopper participants felt they had received good quality advice. From ASIC's standpoint, adviser-led robo-advice tools could significantly improve the quality of advice. If customers continue to rate quality highly and ASIC starts seeing measurable improvements, the wealth management industry and financial advice profession will benefit in the long run.

Jeroen Buwalda is EY's Asia-Pacific wealth and asset management advisory leader.

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Scenes from a roboadvice pitch to angel investors

by Graham Hand on September 23, 2015

Somewhere in an industrial estate in Australia, three angel investors sit in lounge chairs at one end of a warehouse. It's a big, open space with large windows, deliberately not welcoming or comforting. Beside each chair is a small table with a note pad and a glass of water. Two figures appear in the distance, and walk towards the angels. It's a surprisingly long walk, and the angels watch each step. Two men stop next to a whiteboard, positioned about five metres in front of the sitting angels.

Angel 1 speaks first. "Welcome, James and John. As you know, you are here to pitch your startup business to us. You have one hour to convince us to invest. We are seeing five presentations like yours today, and I've personally heard thousands of new ideas like this, and invested in a couple of dozen. Over to you."

"Thanks," says James, his mouth dry, his fingers fidgeting with his wedding ring. "Our business provides online financial advice and investment implementation, focussed on the best outcomes for our clients, and is called 'MyOutcome'. We're looking for one million dollars for 20% of the business."

Angel 2 can't help jumping in, raising his eyebrows towards the other angels. "So you value your startup business at $5 million. This better be good. Why's it called MyOutcome?"

John responds eagerly. The name was obviously his idea. "This is 'roboadvice'. We checked Google Trends, and 'outcome' is the most rapidly rising word in financial advice. Financial planners now talk about customer 'outcomes', such as saving for a car or holiday, or retirement, or financial freedom. Not all that boring stuff like asset allocation and portfolio construction … they are a switch off for most people."

"Let me explain," James says. "Roboadvice is online, automated financial advice without the need for human intervention, and it will disrupt not only financial advisors but the entire wealth management industry. In the United States, the two market leaders, Betterment and Wealthfront, have attracted hundreds of millions of startup capital, and billions of dollars is already held in their funds. Our robo model works like this: the investor goes online and answers a series of personal questions about risk appetite, income and assets, then we run this through our algorithm analysis, which picks the most appropriate portfolio from three alternatives: aggressive, balanced, and conservative. Each of these portfolios has a different allocation to exchange-traded funds investing in bonds, domestic equities, global equities, property, plus a link to a bank account. We provide regular reports and daily valuations."

Now it's John's turn. "It's a complete package of risk analysis, advice and investment implementation. We have the team in place. One cofounder cuts the code, I am a Certified Financial Planner and I have designed the portfolios, and James here, he's the CEO, we have outsourced the web design to The Philippines. And we've just been accepted into Australia's leading fintech accelerator programme," he says. "Any questions at this stage?"

Angel 1 has been scribbling notes on his pad, and he looks up, tapping his pen on the paper. "Tell me some numbers. How much do you charge, how many customers do you expect, what are your costs?"

John steps in front of the whiteboard, a blue pen in his hand, and starts writing. "The numbers are simple, really. The entry level, for investments of less than $2,000, is free. That's how we introduce people to MyOutcome. Above this, we will charge an administrative fee of only $5 a month. The cost of our roboadvice model, including the risk analysis and asset allocation, is only 5 basis points a month. That's only 0.05% a month on the balance of the account. It's a completely new price point that will disrupt the industry, blow wealth management apart. In superannuation alone in this country, there is over $2 trillion. Only 0.1% of that is $2 billion. This brings financial advice to the masses at a price they can afford." James and John look to each other and smile.

"Do you have any customers yet?" asks Angel 2.

"No, but we have 50 friends doing beta testing on our website, and they love it. We expect to launch within two months, and most of them will join. And the really exciting bit," says James, pausing for effect, "… is that the marginal cost is zero. Once we reach critical mass, it's all profit. Every new investor just adds to our income."

Angel 2 is not smiling. "Do you realise that in an industry where the marginal cost is zero, the price of the product trends to zero. That's why newspapers are free online, why blogs are free, why there's so much content for free. The internet killed the newspaper industry because it's possible to distribute information for free."

Angel 3 speaks for the first time. "OK, you're a startup with no revenue. Fine, but I think I'm missing something important. I understand how you can design a website with some simple questions to establish a person's risk appetite. I understand how you can buy ETFs in the market, that's all easy. But you are taking people's money. That involves identity checks, compliance, tax file numbers, reporting, tax returns, security, firewalls. It takes years to design and establish the systems and procedures for all that. Your coding mate must be a genius."

"Yes, he is a genius, but not in that way. We've outsourced all that admin work to a company called General50. It's a platform many of the financial advisers use. You're right, we would never do all that ourselves."

"And who pays for that?" said Angel 3.

"That's part of our competitive advantage. We have negotiated a great price with General50 and we pay for it from our margin. It will cost about 20 to 25 basis points, depending on volume."

Angel 2 again fiddles with his pad and pen. "So let's look at the numbers for someone with say $10,000. To start with, you charge them $60 a year, that's 0.6% per annum."

John jumps in. "But it's a flat cost, so only 0.06% on $100,000."

Angel 2 carries on calmly. "Plus you charge 5 basis points a month … a month … which is equivalent to another 60 basis points or 0.60% a year. Or did I mishear that? I've never heard of anyone quoting their management costs in per month terms. That was not 5 basis point per annum charged monthly, was it?"

"No," said John. "Per month, 5 basis points per month. Oh, and plus GST."

Angel 2 is now shaking his head. "So on $10,000 …" He waited, the numbers running through his head, somewhat puzzling him. "The fee is 0.6% plus 0.6%, which is 1.2%. Is that it, is there anything else?

"But remember, that covers the advice and the admin," said James. "Financial advisers charge at least $300 an hour, and they can take hours to give people this type of advice."

Now it was Angel 1's turn again. "But MyOutcome is simple investment advice, choosing between one of three portfolios. Financial advisers look at estate planning, insurance, super contributions … a wide range of planning issues. That's what people pay for."

"Not the 80% of people who never see a financial planner. That's who we're aiming for," says James.

"OK, so let's accept this is only investment advice. Come back to my question. 1.2%, is that the total cost for a $10,000 investor?"

John circled some numbers on the whiteboard for emphasis. "Yes, that's what we charge. Oh, plus GST plus the cost of the ETF, which will average about 30 basis points, or 0.3%. But that is paid in the price of the ETF, it's disguised in the ETF price."

Angel 3 raises his eyebrows in surprise. "It's still a cost to the investor. It is subtracted from the index return. So the return on the investment is index minus 30 basis points. Which combined with your 1.2%, takes the total cost over 1.5% for someone with $10,000. Do you realise there are retail and industry funds out there, offered by the big players, with multisector funds online for only 65 basis points all-in, for amounts above $1,000. These funds come with call centre support, comprehensive reporting and online tools, a big balance sheet should they make a mistake and need to compensate the investor, the comfort of dealing with someone who has been there for decades … versus … versus … you and your mates and a pretty website."

There is silence in the room. John is fiddling with the seam on his trousers, James is feigning a smile. James speaks first. "But no financial advice, no risk analysis."

"Your so-called risk analysis is a few basic questions to find out their risk tolerance. You don't know what the rest of their assets look like. You might as well just ask one question. Like, "How much exposure to the stock market do you want?" and go from there. I can go onto a big bank website, check what their fund does using my own assessment of risk, and off I go for less than half the price you're charging."

"But we will provide the investor with planning tools using our algorithm which shows their likely outcomes, and they can choose one with say 20% certainty, 50% certainty or 80% certainty, and we will change their portfolio accordingly," said James.

"Don't tell me, let me guess," said Angel 3. "Using a Monte Carlo simulation. You run 10,000 scenario tests to predict the range of outcomes."

"Correct," says James, proudly.

"We don't have time for this now, but you will underestimate outlier results. There have been three falls in the stockmarket of over 50% in the last 40 years, but a Monte Carlo simulation predicts one every million years. Your models will be wrong on the downside. But like I said, that's for another day."

Angel 1 steps in. "Guys, I've done some work on the leading robo in the US, Betterment. Let's compare your business to theirs." He takes a sheet of paper from his jacket pocket. "For over $10,000, they charge 0.25%, no admin fee. Over $100,000, it's 0.15%. Their average balance is $25,000, which at 0.25%, is $62.50. A lousy $62.50 per customer."

James jumped in. "With no marginal cost."

Angel 1 continues. "Do you know what CAC is, the Customer Acquisition Cost?" He does not wait for an answer. "It's the most overlooked cost in all technology businesses. You think 'we'll build it and they will come'. It's not like that. Betterment has been in the market for six years …"

James again. "And they already have $2.7 billion US dollars."

"James, you're talking about six years in the United States for the highest profile roboadvisor in the country. Vanguard manages $3 trillion, Charles Schwab well over $2 trillion. TRILLION. They have cash flows each week greater than the entire roboadvice industry. Let me tell you how Betterment gets its clients. They realised they were probably competing for the person who does it themself, or can't be bothered. So now it pays other websites a finder's fee of $40 per account. That's most of the $62.50 charged in the first year. Do you know it costs $40,000 to sponsor a major financial advice conference for a couple of days?

How many customers will you have, how much will it cost to find them and how much will be in their accounts within say three years?"

"We already have 2,000 Twitter followers, a Facebook page with over 5,000 likes, and each of us has at least 1,000 connections on LinkedIn. Part of the money we raise will go to advertising. Our budget says we will attract 2,000 people a year with an average balance of $20,000. That's $40 million a year. 2,000 lots of the flat fee of $60 is $120,000, plus 0.6% of management fee on $40 million is another $240,000. So that's about $360,000 by the end of the first year, or a million dollars after three years. Once we cover our fixed costs, our returns grow exponentially."

"How much a year will it cost to run your business?"

"Depends how quickly we hire extra staff, but we hope to keep it under $1 million in the first year. That's why we're doing the capital raising."

"Have you ever heard of the 10X rule? Common in Silicon Valley?" asked Angel 3.

John and James look at each other. "No," they say in perfect unison.

"The rule says that a new entrant in an industry must be at least 10 times better than current products to overcome the incumbent market leader. Email is more than 10X faster than mail, Amazon has more than 10X as many books as any book store, Wikipedia has more than 10X the entries of other encyclopaedias. The winners redefine the industry. Amazon destroyed Borders, Apple killed Nokia, Netflix over Blockbuster. Is anything you are doing unique or can it be quickly copied by anyone?"

John this time. "We have a great team, our website is full of amazing graphics, our outcome tools show how much money an investor will have in 20 or 30 years based on different probabilities. They can plan whether to work longer or save more, focussing on 'my outcome'. It's better than anything out there at the moment."

"But guys, there are hundreds of people like you in fintech hubs around Australia working on their own version of this. You'll have a dozen competitors in your first year, and not just startups. Do you know that Blackrock, a major supplier of ETFs, just bought the Number 3 roboadvisor in the US for $150 million, a business called FutureAdvisor. This business only had a few million in revenue, no profits, but it had the systems. Blackrock has not bought it because they can make money from roboadvice. They want to direct people to their ETFs. The roboadvice will be free. How long before Blackrock roll it out here? And in the US with a market of investible assets of maybe $30 trillion, FutureAdvisor had gathered only $600 million in three years. The entire roboadvice funds in the US is less than one tenth of one percent of the market. You expect $120 million when most of that is locked up in the big banks, industry funds and self-managed super."

"We know about all that," scoffed James. "But there's a massive backlash against banks flogging their own products. BlackRock can't just sell its own funds. And you just proved how valuable our business is – when a big player pays $150 million for the technology instead of developing it themselves."

"Nobody will worry about Blackrock selling its own ETFs when it's free and just copying an index," continued Angel 3. "It's a commodity, they're all the same. This is not pushing the product of an active manager who charges 200 basis points. If I invested in you, I'd worry there will soon be product in the market at a fraction of your price, yet you value MyOutcome at $5 million. Maybe, if one of the big guys panics and wants to buy some time, a neat website and some simple analytics, but that's mainly their failing to be imaginative."

Angel 2 had been quiet for a while. "Have you discussed this with any of the major players, the big banks for example?"

John laughs. "We don't want them to know what we're doing until we're in the market. They know we're the new kids on the block, the ones who will disrupt their industry."

Angel 3 again. "One of the roles of an angel, even if we don't invest, is to offer our guidance. I suggest you think far more B2B, that is Business to Business, and try to partner with one of the big guys. Your head is only in the B2C, or Business to Consumer, and the cost of finding consumers will chew all your capital. You will be on a continuous funding round trying to grow customers. In the most recent funding round, the Betterment CEO told his investors they would need to wait seven years for a return. Are you up for that?"

John and James looked at each other and nodded. James says, "We're in this for the long haul. Whatever it takes."

"So find a partner with existing clients. A major bank, a wealth manager, a super fund, maybe a national retailer, a newspaper, a financial newsletter with a big following … or your CAC will bury you."

Angel 3 stood up and gave both James and John a business card. A glimmer of hope crossed their faces. "I love what you guys are doing. You could be like most of the other talented graduates who work for an investment bank or consultant and within a few years, you'd be earning half a million a year and set for life. Instead, you throw it all away and beg money from your family for your startup. The Next Big Thing. It's wonderful and I hope it works for you. But sorry, guys, I'm out. Let me know when the all-in cost is less than 0.5%. That's beating the retail and industry funds, or where they will go to soon, with their own analytics."

Angel 1 jumps in. "Sorry, I'm also out. I hope you raise the capital before Blackrock and Schwab do the whole lot for free."

John and James look at each other, then at Angel 2, their last remaining hope. He takes a long sip of a glass of water before speaking. "It's an exciting journey you're on, and I love that you've thrown away everything else to live your dream. If you work with me, I can get you the customers, but it won't be direct to the market, waiting for people to visit your website. I'll introduce you to the major players who want an offer for the clients they are currently turning away. You need me more than I need you, but I like what you're doing. I'll give you half a million dollars for 50% of MyOutcome. It will keep you going while I line up your clients."

Five years later …

Graham Hand is Editor of Cuffelinks.

Risk management

Do you plan to be a 'have' or a 'have not'? – Noel Whittaker

Feeling lucky? Another stock market spike in China – Ashley Owen

Misplaced focus on high yielding stocks in retirement – David Bell

Learning when to buy and sell shares – Roger Montgomery

My 10 biggest investment management lessons – Chris Cuffe

ASIC's outlook on risk and law enforcement – Peter Kell

Do you plan to be a 'have' or a 'have not'?

by Noel Whittaker on March 12, 2015

The latest Intergenerational Report (IGR) contains some scary statistics. Within 40 years the life expectancy of the average male will be 95.5 years, and for a female 96.6 years. The population will be almost 40 million and include more than 40,000 people aged over 100.

There is nothing really new in this. For more than 35 years, there have been warnings galore about the problems that will come when the baby boomers start to leave the workforce. These people, born between 1946 and 1964, are now aged between 69 and 51 – the oldest of them are either retired or thinking about it.

Their exit from the workforce will cause labour shortages, and put pressure on wages as employers compete for a dwindling number of workers. Furthermore, their increasing need for health services will cause immense challenges for an already stretched health sector.

Adversarial politics creates inaction

Governments of all persuasions have long been aware of this ticking time bomb, but thanks to the adversarial nature of politics, there has been a lot of talk but not much action. In 1997 the Howard Government tried to fix the crisis in the nursing home industry by introducing accommodation bonds. Labor ran such a successful scare campaign the scheme was dropped.

For example, in budget after budget there have been attempts to address the rising cost of the Pharmaceutical Benefits Scheme which in 2007/2008 delivered 170 million prescriptions at a cost of $6.6 billion. In 2006 the Howard Government laid out a four-year reform package that was designed to save $3 billion over ten years, and in the 2008/2009 Budget the Rudd Government introduced new therapeutic groups aimed at driving down the cost of drugs. Still the costs escalate, and in 2013/2014 exceeded $9 billion.

The first IGR was included in the 2002/2003 budget, and a second report was released in 2007 and a third in 2010. Every time a new IGR is released we hear statements from the government of the day that we face massive problems in the future unless we make big changes to our tax and welfare system in the short to medium term. Unfortunately, there is more talk than action.

The time to act is now

The good news from the latest IGR is that average annual income is expected to rise from $66,400 to $117,300, which will boost the property and share markets. The bad news is that there will be just 2.7 people aged between 15 and 64 — potential taxpayers — for every person aged 65 and over.

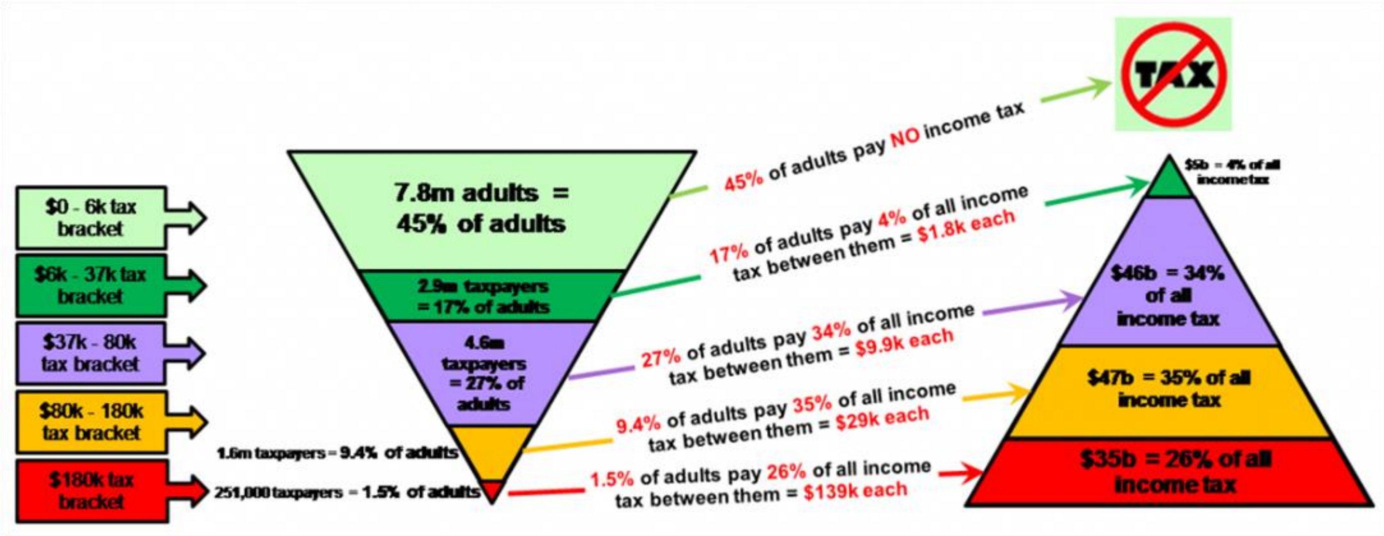
It is a wake-up call for every Australian. If you are under 40, you have time for compound interest to work its magic, which should enable you to build a decent portfolio if you start now and choose the right mix of growth assets. You will need this portfolio because you may well live to 100, at which time the age pension is certain to be severely restricted.

If you are between 40 and 65 you cannot afford to rely solely on employer-paid superannuation. The age at which you can access the age pension is being raised, and there are calls to also raise the superannuation age to 67 to match. The best strategy for you is to salary sacrifice to the maximum, and hone your skills so that you can work as long as possible. This will increase the power of compounding and make your money last longer, as it will delay the time you need to start making withdrawals.

Are you already over 65? Don't panic. Any changes to the age pension will come in gradually, and are certain to be grandfathered. However, you need to be getting good financial advice to ensure your money works as hard as realistically possible. The alternative is to face the challenge of living longer than your money.

Where will the taxes come from?

The following case study illustrates the difficulty facing any government trying to get the budget back on track. Think about a single income couple



Source: Philo Capital

with two children aged 8 and 10, where the primary breadwinner earns $75,000 a year. The income tax on this would be around $16,000, but the family's contribution to the national coffers would be just $9,000 after family payments of $7,000 a year are taken into account. If we assume the cost of the full age pension for a couple is $36,000 a year when healthcare concessions are factored in, it takes four such single income families (or eight adults of working age) to support one pensioner couple.

This imbalance will become worse as the ratio of dependants to workers grows over time. Our taxation system presents grave challenges too. Currently, 61% of personal income tax is received from a mere 11% of adults, leaving the bulk contributing very little. In addition, 87% of those aged 65 and over pay no personal income tax whatsoever.

A full review of our tax and welfare system is overdue, but the adversarial nature of politics does not make for optimism. Right now, the federal government reminds me of a dysfunctional family. Dad and Mum (the two major parties) spend all their time abusing each other and promising the world to their constituents (us, the children) while well-meaning but inexperienced relations (the minor parties) add to the turmoil by telling the kids that their parents don't know what they are talking about.

Unless you have more faith than I do that politicians of all parties will be able to solve these problems over the next 40 years, you should be making every effort to work as long as possible to accumulate as much as you possibly can for your retirement. Australia is moving inexorably to a society of haves and have nots. Despite a lot of rhetoric from our politicians, it will be the haves who will be first in line for medical care as the queues for health services grow.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. See www.noelwhittaker.com.au

Feeling lucky? Another stock market spike in China

by Ashley Owen on May 7, 2015

So far this year we have seen good returns from all asset classes (except cash), in Australia and globally. Shares are fully priced or over-priced but they are still doing better than their long term averages. Likewise, with listed and unlisted real estate. Bonds are horribly over-priced but they too have generated above average real returns.

In a world where everything is doing well for investors something is bound to go wrong. It is impossible to over-weight (or under-weight) everything in portfolios so it calls for tough decisions. How long can the great 2012-15 QE rally last?

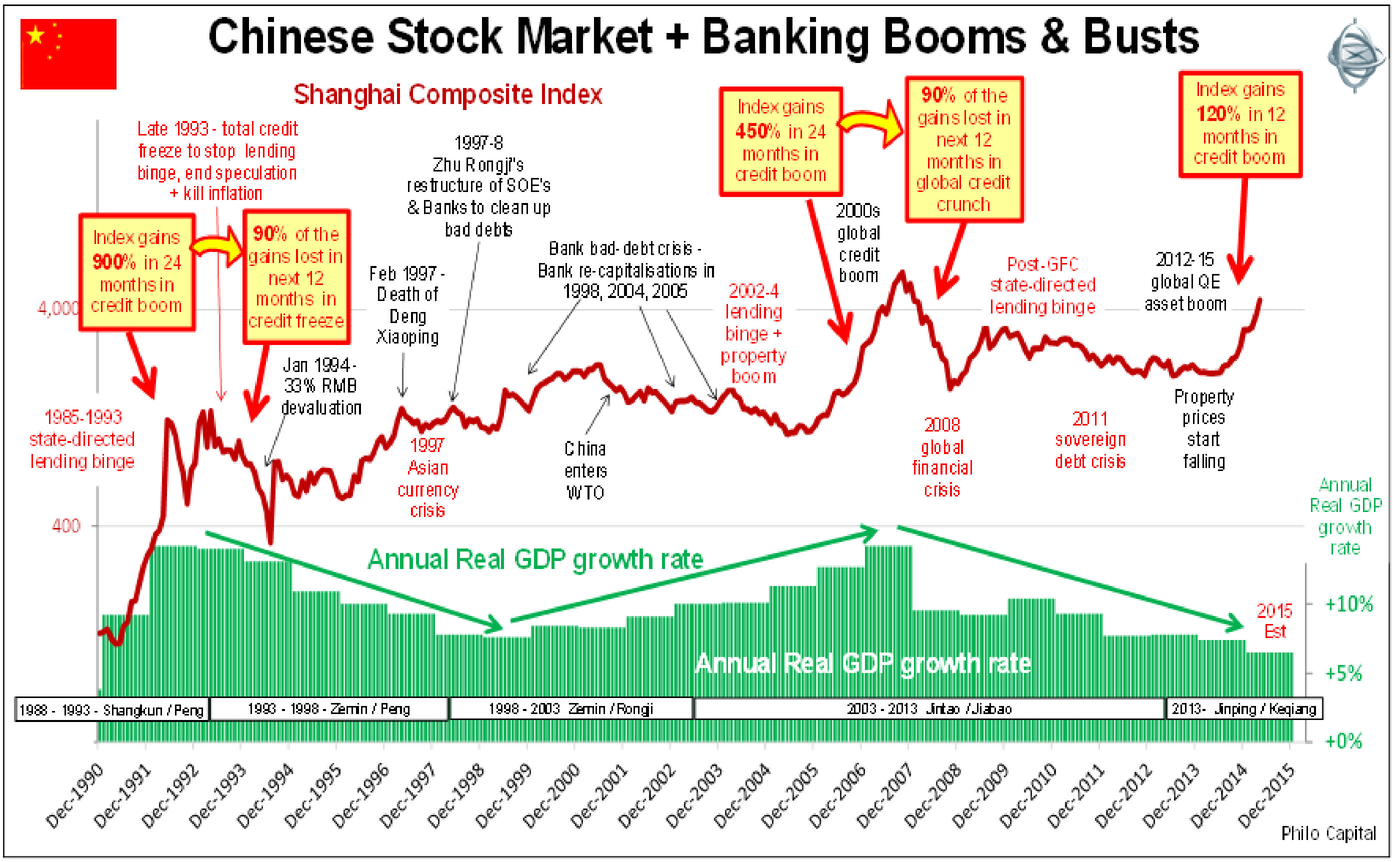
Here is a close look at the incredible spike in the prices of Chinese stocks in the last year, linked back to the perennial culprits – banks and the credit cycle.

The Shanghai index has shot up 120% in the past 12 months after five years of falls. Less well known is that this is a rather mild spike compared to past episodes.

There have been two great stock market spikes in post-1949 China. Both were fuelled by credit binges and both promptly crashed when credit dried up. In 1991-1993 the index gained 900% in 24 months but then lost 90% of the gains in the next 12 months. In 2006-2007 the index gained 450% in 24 months, but also promptly lost 90% of the gains in the next 12 months.

There was an orgy of bad lending in the 1985-1993 credit binge by the big Chinese state-owned banks. To end the party, the government had to impose a total freeze on lending in late 1993. That crunched asset prices, employment, the economy and the banking system, and it took the next 12 years to clean up the mountain of bad debts in the banks.

As soon as it did, the next great credit/property/stock market bubble took off in



2006-2007, fuelled by cheap credit and geared-up local and global investors chasing the 'China growth' story. The boom ended in a crash in 2008 when credit froze as the global banking system seized up.

In the ensuing global financial crisis, the Chinese government embarked on a massive spending and credit spree to support the economy. The bubble re-appeared firstly in housing and then moved on to shares last year when housing prices started to fall. Driving the current boom are cashed-up first-time local punters, many using margin debt, and the spike is now being chased by foreigners eager to get in on the action.

The current stock market rally is quite modest by comparison to past bubbles and pricing levels are still not stretched – for example price/earnings ratios and dividend yields are not outlandish. The market may run up a lot further from here but banks are hiding another mountain of bad debts built up in the post-GFC lending binge, and so this boom will probably end the same way as previous episodes.

Ashley Owen is Joint CEO of [Philo Capital Advisers](#) and a director and adviser to the Third Link Growth Fund. This article is educational only. It is not personal financial advice and does not consider the circumstances of any individual.

Misplaced focus on high yielding stocks in retirement

by David Bell on August 6, 2015

A lot of people seem to view high yielding stocks as the silver bullet for retirement plans. I'm less sure. In many circumstances the focus on income can be flawed, risky and difficult to implement. Return and risk are key to any investment decision.

There are two possible sources of economic return from any asset: income and capital gain. In Australia income and capital gains are taxed differently but this is a non-issue for assets in an account-based pension.

The focus on income has manifested itself lately in equities with the logic being as follows: a high yielding stock, especially one with franked dividends, may be able to meet all the necessary income requirements in the drawdown phase, leaving the capital pool untouched (but importantly variable in value) for uses such as one off discretionary spends, aged care admission, or bequests.

This may well prove the case but it doesn't mean this is the best retirement investment strategy. There are clear challenges to this line of thinking, real world realities to face up to, and risks to consider.

Challenges to the income-focused model

These days, transaction costs are very low, removing an impediment to realising capital gains to fund retirement spending. Consider the following two scenarios:

	Stock A	Stock B
Yield	6%	2%
Change in Price	2%	6%
Total Return	8%	8%

Is there any reason why, if we assume negligible transaction costs, a retiree should prefer Stock A to Stock B? To meet retirement spending requirements, we would account for our income and make a decision of what to do with our capital. From a transaction cost and tax perspective there appears little difference. One may say that it is more convenient to invest in Stock A as the income payment is received and so an active decision to sell down is not required (perhaps there is a behavioural reason why people are hesitant to sell assets in retirement). However, there is a situation where the dividend income may prove too high or the timing (dividends twice per year) doesn't match our spending plans, requiring an active reinvestment decision (which could also prove to be behaviourally difficult). Capital allocation decisions are largely unavoidable.

Risk cannot be ignored in retirement. Even if a stock generates a high yield, it can still be a volatile stock. One school of thought is that price variability is irrelevant if income levels are secure and high. I find this notion hard to accept, even if someone has very high asset levels.

Consider the case of a retiree with low assets:

- The yield may not provide sufficient income, or indeed too much income, creating the need to sell down or reinvest. Any need to sell down to meet spending requirement shortfalls breaks the foundations of the income model, which is based on the ability to hold on to the pool of dividend generating stocks

Consider the case of a retiree with high assets:

- The income from dividends may meet all of the retiree's spending needs. While there may be some cash left over the reinvestment risk does not critically impact on future retirement cash flow which is assumed to be secured through future dividend payments. However, the size of the capital pool to meet discretionary spending and bequests could be highly variable.

Volatility cannot be ignored for low balance retirees (as they will likely need to sell down to meet retirement needs) or for their high balance counterparts (as surely they have some preferences around the size of their account balance which supports one-off spends and bequests). At best, a yield focus is based on some brave assumptions, or less polite, it is a flawed strategy.

Support for income-focused model

There are some investment-based principles which could lend more support to an equity-income focused approach, including:

- The market, due to the presence of offshore participants, undervalues franking credits
- Growth strategies, funded by companies reinvesting their equity into opportunities perceived to be unattractive, may not prove successful, and so paying out earnings as dividends is a good strategy
- The market may have a behavioural bias to overvalue growth (a 'hope' bias or a potential thrill of being associated with a successful growth stock) and higher yielding stocks may be undervalued hence attractive.

The above points are views and opinions, not facts; they are highly debated in industry and academia because each one suggests that in some way markets are inefficient. One would need to have strong conviction to use these points as the basis for a retirement strategy.

Retirement drawdown patterns

Retirement strategies cannot be designed without considering real world complexities. The most relevant here is the type of retirement drawdown vehicle. Consider the difference between SMSF's and the account-based pension products provided by super funds:

- An SMSF could effectively implement a dividend-yield based retirement strategy, particularly if the SMSF had only one member so that the income level could be targeted appropriately
- A super fund solution would have multiple leakages. The account-based pension asset pool is subject to constant change (inflows from assets being transitioned from super) and payments (different levels to different members). Super fund products typically run to prescribed cash targets and so much of the dividend payments received would be reinvested

For an SMSF, a dividend yield strategy could be implemented as part of a retirement plan but for a super fund account-based pension solution, there would be much slippage as there are other significant cash flows which would break the path between dividend receipt and member payout. If a super fund account-based pension had a strong focus on equity income, it should really only be based on their market views.

(A post-script to the above paragraph is that if an SMSF implemented such a strategy through investing in a unit trust then they also need to be careful. A unit trust may focus on dividend yield but the distribution to investors can be impacted by other factors such as the flow of funds in and out of the trust.)

If the retirement strategy is built on the foundation of equity income, there needs to be great confidence in the quality and sustainability of that income. If the dividend stream stumbles, the financial plan tumbles: planned income is no longer available and a capital loss would be likely.

Not a silver bullet strategy

In summary, focusing on dividend yield as a retirement strategy can be dangerous. Risk and return are much more important than income in liquid markets with low transaction costs. Focusing on dividend yield alone is flawed as it ignores the preferences of the individual regarding their capital reserves. There are investment-based views as to why high-yielding stocks are attractive, but these are views not facts. SMSF's can implement a yield-based retirement strategy if they want to, but should be careful with how they implement (directly versus unit trust products), while for the account-based pensions offered by super funds a strategy based on equity yield should only be based on investment views.

David Bell is Chief Investment Officer at superannuation fund Mine Wealth & Wellbeing (formerly AUSCOAL Super). He is also working towards a PhD at University of NSW. This article is for general education purposes. Individuals should seek financial advice, but challenge their adviser if they recommend a strategy purely based on equity income.

Learning when to buy and sell shares

by Roger Montgomery on August 13, 2015

At a recent talk I gave at the Australian Investors Association's National Conference, I received one question more than any other: "Is it time to buy BHP?" Obstreperous commentators – paid by commissions on activity rather than returns – are incentivised to make headlines calling the bottom of the resource slump.

Price contains no information about value

Highly leveraged commodity producers with negative free cash flows, like America's largest coal producer Alpha Coal, have filed for Chapter 11 bankruptcy protection, amid a steel oversupply emanating from China, and slumping commodity prices. This is the shot-across-the-bow for Vale and Fortescue, and places a darkening cloud above the prospects and future returns for BHP and Rio because highly leveraged producers must produce even more of the commodity amid declining prices to meet their interest expenses.

But these arguments are in fact superficial. At the core of the question is a lack of understanding of the difference between price and intrinsic value. Value is not presented simply because a share price has fallen. Price information is free and the reason it is free is because it contains no information about value.

Predicting share prices, which is in essence what the resource commentators are trying to do, is impossible to do consistently well, at least in the short-term.

Intrinsic value is the vessel that helps navigate the sometimes tempestuous changes in share prices. If you have formed your view on the intrinsic value of a company, you can navigate clearly through the thunder and high seas, the gloom and the hype.

Your share portfolio may still be buffeted around by the twin tides of fashion and sentiment, but with each rise and fall you are able to strengthen it, buying more below intrinsic value and perhaps selling when share prices are well above.

Suppose you have your eye on a company and its shares fall from $15 to $12. Should you buy now? What if you buy at $12 and the shares fall to $10? Suppose you decide to buy more. What if they then decline even further to $8 or even $6? When exactly do you buy?

Only if you are confident that the business is actually worth $15 per share are you able to see a fall in the share price – from $12 to $6, for example – for what it is: a terrific opportunity. The right response is to buy more. If you're like me and you like chocolate, then surely it is rational to order more when your favourite block is on 'special' at the supermarket? It's the same with shares.

Shares are like groceries

Treat buying shares the same way you buy groceries. You actually want the share price to go down so that you can buy more. Share price declines, particularly those that are produced when everyone around you sees only doom and gloom ahead, are precisely what you want.

But how do you know the shares are cheap? Without the beacon of intrinsic value, how do you know whether to buy more or to panic? Many investors don't know the value of their shares. They frequently panic when shares fall, and also suffer from the consequences of paying too much.

I have often asked an audience of investors the following question, 'If the shares of (insert your favourite company) were trading at half price today, would you buy them?' The response is both rapid and enthusiastic, 'Yes!' And yet, sometime later, when the share price does indeed fall 50%, only a small handful of the original group ever buy the shares. Why is that? It is because share prices only fall 50% when there is bad news, either about the company being considered or about the economy or market more generally. And unfortunately, such news often perverts good ideas to bad ones. What was seen initially as a brilliant opportunity becomes a high risk 'play' that should be avoided until there is more certainty (and a higher price of course).

Your mother probably told you that first impressions are usually correct. She may not have been talking about shares on sale, but she was right again. What is good advice for choosing friends is also good for selecting shares.

The challenge is knowing when to buy

The easier part of investing is knowing what to buy. For example, is it really so difficult to see that CSL is a better business than Slater & Gordon? Is it that challenging to see that an investor should favour the fund manager Platinum Asset Management over Qantas?

The challenging part of investing isn't identifying good businesses that you would like to own. The challenging part is knowing when to buy, while the prices of all these companies are gyrating amid noise and influences that may or may not ever impact their businesses.

Nobody should miss out on buying shares in great businesses because of the fear that the shares will go down even more. And there is no need to panic and sell at depressed prices either. But such rational behaviour requires you to have something other than the price to look at. You need to know the value of the business and its shares.

Of course in order to value a company's shares, one needs to be aware of and have appraised the prospects for the business and its products or services. When the price of iron ore was $140 per tonne, we challenged the notion that the long run average would bear any resemblance to the then recent prices. Indeed, at $140, we thought $40 per tonne was more likely to eventuate. We now believe the prospects for Australia and the resource sector are likely to worsen and so we arrive at valuations for resource companies that are much lower than current prices.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is for general educational purposes and does not consider the specific needs of any investor.

My 10 biggest investment management lessons

by Chris Cuffe on October 29, 2015

Editor's introduction. There are valuable lessons to learn from Chris Cuffe's experience with the Third Link Growth Fund. The Fund's managers are selected by Chris in a 'fund of funds' structure, and all fees paid by investors go to charities. The Fund has outperformed its benchmark over seven years by 4.5% pa compound, and 5.3% pa compound in the last three years. According to research house Zenith, it ranks 3rd out of 108 comparable funds since its inception (to 31 May 2015), with a lower volatility than the median manager or the benchmark. How is such performance achieved?

Although the Third Link Growth Fund has been a success, if I'm honest with myself, after seven years and with one of the best track records in the market, you would expect it to be bigger than its $85 million. I'm proud of the pioneering structure, where the fund managers provide their services for free, enabling us currently to give more than $100,000 a month to charities. That's obviously a great story, but why has more money not flowed in?

Answering this question highlights some big lessons about investment management.

1. Financial services are sold not bought

In commerce generally, the consumer finds the best products in the market, especially with such an open system as the internet. But financial services is an industry where products are sold not bought. There are a lot of middle men and women doing the selling. People struggle to find the best products in the world of investing.

If a fund does not have active sellers and marketers, it doesn't get much support and that's how it's worked out. Listed Investment Companies (LICs) have broker networks that work their clients intensely in the offer period, while dealer groups have advisers who tell their clients where to invest.

In the pre-FOFA time when this Fund was launched, it paid no commissions, and most advisers were commission-based. We're not really long into the post-FOFA environment, but I don't think advisers scour the earth looking for the best products. They have to do the right thing by their clients, but that does not mean finding the very best. It's more what's on their radar screens.

2. Joe Average doesn't have a clue where to invest

In financial services, with most aspects of investing, Joe Average does not have a clue where to start to find the best products. To DIY in financial services is tough for the average person. I can DIY in my back yard by going to the hardware store, working out how to pave a path or tile a wall, but you can't do that easily in financial services.

3. The environment and structure must be right for the product

Third Link does not have sales support other than me telling the story (and I do this pro bono and have limited time given my other activities) and the occasional press coverage, and it lost some of its initial impetus due to the impact of the GFC. The environment must be right for the product. My Fund was more suited to a one-off big bang, a press event, a launch with a room full of people, sell it and close it quickly on the back of a heap of publicity. I don't think it suits a slow burn of continuous fund-raising over many years. Whether you like it or not, a slow burn means being on the major platforms, financial planner support and a sales force of business development managers. And stockbrokers don't support managed funds.

Third Link is rated only by the Zenith Group and it's only on one platform (the BT platform) to allow people to have a superannuation version. Platforms create administrative work and everyone helping out with Third Link is doing it pro bono, so I have not sought out other platforms.

4. Blending styles is a waste of effort

In my view, professionals blend managers in multi manager funds in exactly the way that gives a mediocre result. Typically, they will blend value managers, growth managers, large managers, small managers, etc. and then wonder why they achieve the index less their fee. The results of these blended funds have never been great.

I am not the slightest bit interested in blending styles and so some people are put off Third Link because there is no formal scientific process. My process is called experience – one of finding competent, proven managers who will swing the bat and have a go. I do watch for concentration risk but I'm mainly interested in the willingness of managers to pick stocks ignoring the index. In fact, I like to see a high tracking error which is the opposite of most professionals.

5. Past performance is the best guide to future success

Every offer document in the country says something like 'Past performance is no guide to future performance' or similar. That is exactly the opposite of how I think. It's the best guide to knowing what a manager is really like over a long period. Past performance is extremely important and a great guide to the future.

Only long-term results are relevant. The managers I use are selected for the long term. I have no interest in their short-term results. If it looks like a manager is struggling (which I would only conclude after rolling 3-year periods), I would only exit after say a poor rolling five-year result.

6. Never buy a bad stock because the price is low

I don't like 'deep value' investing where a manager is willing to buy a poor quality stock because the price is so cheap. I don't like people saying a bad stock priced cheap is low risk. I would hate to see any of the stocks held by my managers fall over.

Managers need to buy quality stocks. Adding that to a good track record and a high tracking error should mean my fund will do well in falling markets (which it does) which is a sign of a good portfolio.

7. Watch the level of funds under management

I do look at total funds under management in a manager and the types of stocks the manager buys. A small cap manager in Australia with more than $1 billion concerns me. And I am cautious about investing with a larger cap manager in Australia with more than say $6 billion under management. At that level, I need more convincing. Size can get in the way of performance. It's no coincidence that most of my managers have performance fees, which enable them to remain smaller while making it economically viable to run their business.

Most managers talk about staying below capacity and refusing to take in more money but my experience is most don't do that, especially when there's an institutional owner. It's compelling to take more money. Boutiques are best at watching capacity as they can make a lot of money from performance fees if they are good.

8. Don't be afraid of performance fees

I believe managers deserve their high fees based on their performance. In my own personal investment portfolio, I don't care about paying a 20% performance fee (as long as the right hurdle exists) if I'm getting 80%.

It's a great part of the Third Link structure that the managers kindly refund all the performance fees, as well as the management fees. It's the sizzle in the Fund. For most professionals who provide a fund-of-fund product, the underlying fee of each manager is so crucial for their own economics that they cannot pay performance fees. But I'm agnostic to fees so I just look for the best managers.

I have not selected any of the managers based on their willingness to forgo their fees. I select on merit then ask if they will waive their fees. I will restrict the Fund's size to about $150 million so no one manager has more than about $20 million.

9. Active versus passive depends on the asset class

The active versus passive debate is not a one-size-fits-all. It should be considered in the context of the asset class. In Australian equities, I'd never invest in a passive fund. You have to look at the index before you go passive. Why would you buy an index which is 30% in banks (mainly four stocks) and 15% in resources (mainly two companies)? Talk about a risky portfolio! It amazes me people would start with that. But internationally, say the MSCI World Index, index investing has merit. In Aussie small caps, you could invest in an index fund but I think there is no upside in having small resources because of their boom and bust track record. And I think the active managers of small cap industrials generally do better than the industrials index because they can find small under-researched stocks. But there's nothing wrong with indexing in parts of the fixed interest asset class.

I hope some of the roboadvice models use active management, especially in Australian equities, but I suspect they are unlikely to do so due to the cost.

10. Business risk guides a lot of investing

It's astounding in Australia the number of managers who won't risk being too different from the index. If they underperform for a short period due to departure from the index, they worry they will lose funds (and maybe their job will go as well). If resources and banks are not doing well, a fund with managers that are index unaware should do well. The best three months of relative performance of Third Link in its history was the last three months as both these sectors fell.

I listened to an active Australian equity manager tell me how proud he was of being index-unaware, yet his exposure to financials was 27%, not the 30% per the index. This is not an active position at all and he is surely being driven by the index. I would think that a position of half or double or nil is more like an active view.

This benchmark risk (that is, the lack of willingness to be different from a benchmark) has a lot to answer for in encouraging mediocre investing across the world. The dominance of these behaviours is far greater than anyone will admit. It drives many professionals to bizarre investing.

I don't have any business risk or career risk in selecting my managers. Third Link is not a business and I'm running only one fund.

The best investors I deal with are totally benchmark unaware, even as to what markets they invest into, local or overseas or cash or whatever.

Chris Cuffe is the co-founder of Cuffelinks and has a wide portfolio of interests across commercial, social and charitable sectors. More details on the Third Link Growth Fund are on www.thirdlink.com.au. How can we have a disclaimer after such firm opinions? Let's just say anyone should seek professional advice on how these lessons apply to them, as the circumstances for each investor are unique.

ASIC's outlook on risk and law enforcement

by Peter Kell on March 13, 2015

As Cuffelinks marks its 100th edition, it is an opportune time to explain to this important audience the role of ASIC as Australia's integrated corporate, markets, financial services and consumer credit regulator and law enforcer.

Making sure Australians have trust and confidence in the financial system is at the heart of everything we do. We regulate entities at every point from 'cradle to grave' – from their incorporation to their winding up – and also look after the interests of the consumers they serve in an increasingly digital world.

Our regulatory priorities are to:

- promote investor and financial consumer trust and confidence, and
- ensure fair, orderly and transparent markets.

ASIC is a law enforcement agency. We use around 70% of our regulatory resources on surveillance and enforcement. A key aspect of what we do is holding gatekeepers to account – identifying and dealing with those who break the law. Where we see non-compliance, we will act quickly and decisively through our 'detect, understand and respond' approach.

Five risk drivers

It is helpful to understand the circumstances that drive risk to investors and financial consumers. In our efforts to understand these drivers, we have identified five broad areas that are having significant impact:

First is the tension between a free market-based system and investor and financial consumer protection. This is influenced by the increasingly global economy, the compliance culture and systems of those we regulate, and the shifts in consumer sentiment and financial literacy.

Second is digital disruption. In financial services, crowdfunding and peer-to-peer lending platforms are disrupting traditional ways of accessing capital. In our markets we see digital disruption in high-frequency trading and dark liquidity. And there will be more digital disruption as we see advances in, for example, the use of mobile technology for financial transactions, increased use of 'big data' by financial services providers to customise their marketing.

Third is structural change. There has been a global shift towards market-based financing. In Australia this has been driven predominantly by growth in the superannuation sector. We also have an aging population. The government's recent Intergenerational Report covers that in detail.

The structure of the Australian funds management industry also continues to evolve with consolidation among the four major banks expected to continue. Financial markets too are seeing competition intensifying and affecting capital raising, secondary trading and post-trade infrastructure.

Fourth is financial innovation-driven complexity. Complex products are available to investors and financial consumers, but can be misunderstood or mis-sold.

Technology-driven financial innovation continues to change how markets interact, including with investors. The rapid pace of technological change has also brought challenges of cyber-resilience to the fore. At the same time Australians' use of information and communications technologies is high on a global scale.

Fifth, and finally, is globalisation. The global financial system has become more integrated, competitive and complex. Australia's financial markets are more integrated with international markets than ever before, and financial facilities, services and products are increasingly provided across borders.

Responding to key risks

Against this background, we have identified key risks that fall into the areas of conduct, innovation-driven complexity, globalisation and expectations gap.

We are undertaking proactive risk-based surveillance of high risk areas that will have the greatest impact on investors and financial consumers and the sectors and participants we regulate. In particular, we are concentrating on financial advisers and responsible entities operating managed investment schemes.

We also continue to undertake reactive surveillance to detect possible wrongdoing. Where there are issues, we take action without fear or favour.

ASIC's latest six-monthly enforcement report, detailing outcomes achieved between 1 July 2014 and 31 December 2014, recorded 348 enforcement outcomes. This included 204 criminal actions as well as civil and administrative (e.g. banning or disqualification) actions, and negotiated outcomes, including enforceable undertakings.

These outcomes were achieved across the financial services, market integrity, corporate governance and small business areas.

The report highlights ASIC's ongoing focus on tackling serious corporate fraud and loan fraud and ASIC's use of civil penalty proceedings to enforce the law.

At the same time, there are some drivers of risks that we cannot influence, and risks that we cannot address within the current regulatory settings. There may be more on this when recommendations of the recent Financial Systems Inquiry are further considered by government.

More positively, some of the risks we have identified may not crystallise.

A more detailed explanation of our work across these risk areas can be read in our Strategic Outlook on the ASIC website.

Expectations gap

Different expectations and uncertainty about outcomes in the regulatory settings can undermine confidence and behaviour.

This is magnified by uncertainty about whether the regulatory settings – established by Parliament – will be effective in more difficult economic conditions. Investors and financial consumers may also underestimate the risk they can handle when things get tougher.

We use our resources and powers to ensure that the financial system is robust and operates in the long-term best interest of Australian consumers. However, we cannot eliminate market risk, prevent all wrongdoing or ensure compensation for investors who lose money.

And finally, it is also important that the sectors and participants we regulate must look to, and act in, the long-term best interests of financial consumers to ensure that trust and confidence in the Australian financial system remains strong.

Peter Kell is Deputy Chairman of the Australian Securities & Investments Commission (ASIC).

Equities investing

Capital management techniques in LICs

by Chris Stott on January 29, 2015

In the last five years, the Australian Listed Investment Company (LIC) sector has grown at a rapid pace to reach a market capitalisation of over $26 billion. The last year alone saw 15 new LIC offerings and total capital raised touching $1.5 billion. LICs continue to be a popular investment choice for investors on the hunt for dividends in an environment where other asset classes have been struggling to provide similar levels of yield.

In October 2014, I wrote an article about why LICs trade at premiums or discounts to net tangible assets (NTA). In the last three years, the overall LIC sector discount to NTA has narrowed significantly, driven by many factors, including the increased popularity of LICs following the introduction of the FOFA (Future of Financial Advice) reforms and the proliferation of SMSFs. There still remains a small part of the sector trading at a discount to their NTAs, and as a result, we have seen the number of capital management initiatives increase compared to previous years.

Two key techniques to narrow the discount

1. Share buy backs

Share buy backs have had mixed success rates over recent decades. While the technique has worked quickly and effectively for some in narrowing the discount to NTA, it has not been the case for others who have seen their buyback programmes prolonged with no or little narrowing and leading to eventual abandonment of the initiative.

Focusing on more recent times, given the proliferation of LICs in the last few years, uncovers some examples.

Hunter Hall Global Value (ASX: HHV) announced on 27 November 2014 a share buy-back of up to 10% of issued capital. At the date of the announcement, HHV traded at a 9% discount to NTA and had been trading at a discount for the last few years, averaging 16% in the last three years. Five weeks later, the discount to NTA had narrowed to 4%, despite the fact that the company had not started implementing its buy back mechanism. In this case, announcing the buy back on its own seemed to have the desired effect.

Premium Investors (formerly listed on the ASX under the code PRV), a LIC part of the Treasury Group, traded at a discount of 15-25% for many years. It had various buy backs of up to 10% of stock under way over some years, which didn't narrow the discount to NTA to the Board's satisfaction. In August 2012, it announced a buyback of up to 75% of stock, citing the discount to NTA over a prolonged period as the main driver. This particular LIC was sub-scale with around $86 million of funds under management and had a sporadic history of paying dividends. WAM Capital Limited merged with Premium Investors on a NTA for NTA basis in December 2012.

2. Dividend policies

Newer but more established LICs trading at a discount to NTA have been providing shareholders with a formal dividend policy and more forward-looking dividend payment information.

In October 2012, two LICs which are part of Perth-based financial services group Euroz Limited, Westoz Investment Company (ASX: WIC) and Ozgrowth Limited (ASX: OZG), announced the payout of a minimum of 50% of realised profits each year and provided dividend guidance for the following two years. Before the announcement, Westoz was trading at a discount to NTA of 36% and Ozgrowth at 34%. This compares to a much narrower discount at the time of writing of 2% at Westoz and 4% at Ozgrowth.

As mentioned, one of the key drivers of the proliferation of the LIC sector is the chase for fully franked dividends and LICs are now becoming more open in providing dividend policies and guidance, which in my opinion will help narrow the discount to NTA.

Funds may liquidate if discounts persist

In the past decade in Australia, we have seen various LICs either wind up or be taken over in M&A transactions, where the discount to NTA has persisted over protracted time periods. The largest incidence of note was Ellerston GEMS Fund which listed in July 2007. It had a proven track record, a strong investment team, a flexible mandate and raised $600 million in the listing. Just over a year later, and despite a strong outperformance of the fund versus the market during the GFC, the discount to NTA widened to a hefty 24%. The company announced that redemption facilities would be put in place for shareholders to realise NTA over a three-year period and that the LIC would be delisted from the ASX. It delisted in November 2011.

Souls Private Equity Limited was a LIC focused, as the name suggests, on the private equity space. In September 2011, parent company, Soul Pattinson (ASX: SOL), made a takeover bid at NTA for the company, which was trading at a 60% discount to NTA prior to the announcement.

Strong demand for LICs but some discounts persist

Even though we are in a 'golden decade' for LICs in Australia, some LICs, particularly the smaller ones, continue to trade at a discount to NTA. More recently issued new LICs which are examples of this include NAOS Emerging Opportunities Company Limited (ASX: NCC), trading at a 12% discount to NTA and Acorn Capital Investment Fund Limited (ASX: ACQ), trading at a 15% discount to NTA at time of writing.

Other factors that we consider to be determinants of trading at a premium or discount to NTA are the liquidity of the stock, the level of marketing by the company or by the contracted investment manager and general levels of shareholder engagement such as direct presentations to shareholders, media exposure and other marketing related activities.

No single method always works

While buy backs have had mixed levels of success in narrowing the discount to NTA, there is no clear evidence that it enhances the share price relative to NTA. In more recent times, some LICs have been providing more dividend guidance and there is evidence to suggest that this has worked for those able to follow this route.

Chris Stott is Chief Investment Officer at Wilson Asset Management. His views are general in nature and readers should seek their own professional advice before making any financial decisions. Wilson Asset Management is a major manager of LICs.

Ten great quotes from Buffett's latest letter

by Graham Hand on March 5, 2015

Warren Buffett's annual letter to Berkshire Hathaway shareholders is always eagerly awaited and this week's did not disappoint. It marks 50 years since Buffett and Charlie Munger took charge, and each has summarised expectations for the next 50. Anyone short of time could read the expectations section, starting on page 34. Here are some direct quotes from the letter.

1. The best days lie ahead

Indeed, who has ever benefited during the past 238 years by betting against America? If you compare our country's present condition to that existing in 1776, you have to rub your eyes in wonder. In my lifetime alone, real per-capita U.S. output has sextupled … The dynamism embedded in our market economy will continue to work its magic. Gains won't come in a smooth or uninterrupted manner; they never have. And we will regularly grumble about our government. But, most assuredly, America's best days lie ahead.

2. Volatility is not risk

Stock prices will always be far more volatile than cash-equivalent holdings. Over the long term, however, currency-denominated instruments are riskier investments – far riskier investments – than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions. That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is far from synonymous with risk.

For the great majority of investors, however, who can – and should – invest with a multi-decade horizon, quotational declines are unimportant. Their focus should remain fixed on attaining significant gains in purchasing power over their investing lifetime. For them, a diversified equity portfolio, bought over time, will prove far less risky than dollar-based securities.

3. Forget market timing and forecasting

Investors, of course, can, by their own behavior, make stock ownership highly risky. And many do. Active trading, attempts to "time" market movements, inadequate diversification, the payment of high and unnecessary fees to managers and advisors, and the use of borrowed money can destroy the decent returns that a life-long owner of equities would otherwise enjoy. Indeed, borrowed money has no place in the investor's tool kit: Anything can happen anytime in markets. And no advisor, economist, or TV commentator – and definitely not Charlie nor I – can tell you when chaos will occur. Market forecasters will fill your ear but will never fill your wallet.

4. Difficult to find good investment managers

There are a few investment managers, of course, who are very good – though in the short run, it's difficult to determine whether a great record is due to luck or talent. Most advisors, however, are far better at generating high fees than they are at generating high returns. In truth, their core competence is salesmanship.

5. The conflict of acquisitions versus spin offs

Investment bankers, being paid as they are for action, constantly urge acquirers to pay 20% to 50% premiums over market price for publicly-held businesses. The bankers tell the buyer that the premium is justified for "control value" and for the wonderful things that are going to happen once the acquirer's CEO takes charge. (What acquisition-hungry manager will challenge that assertion?) A few years later, bankers – bearing straight faces – again appear and just as earnestly urge spinning off the earlier acquisition in order to "unlock shareholder value." Spin-offs, of course, strip the owning company of its purported "control value" without any compensating payment. The bankers explain that the spun-off company will flourish because its management will be more entrepreneurial, having been freed from the smothering bureaucracy of the parent company. (So much for that talented CEO we met earlier.)

6. Investing in Berkshire Hathaway shares

For those investors who plan to sell within a year or two after their purchase, I can offer no assurances, whatever the entry price. Movements of the general stock market during such abbreviated periods will likely be far more important in determining your results than the concomitant change in the intrinsic value of your Berkshire shares. As Ben Graham said many decades ago: "In the short-term the market is a voting machine; in the long-run it acts as a weighing machine." Occasionally, the voting decisions of investors – amateurs and professionals alike – border on lunacy. Since I know of no way to reliably predict market movements, I recommend that you purchase Berkshire shares only if you expect to hold them for at least five years. Those who seek short-term profits should look elsewhere.

7. Long-term survival

Financial staying power requires a company to maintain three strengths under all circumstances: (1) a large and reliable stream of earnings; (2) massive liquid assets and (3) no significant near-term cash requirements. Ignoring that last necessity is what usually leads companies to experience unexpected problems: Too often, CEOs of profitable companies feel they will always be able to refund maturing obligations, however large these are. In 2008-2009, many managements learned how perilous that mindset can be.

8. Investors panicking

The reason for our conservatism, which may impress some people as extreme, is that it is entirely predictable that people will occasionally panic, but not at all predictable when this will happen. Though practically all days are relatively uneventful, tomorrow is always uncertain. (I felt no special apprehension on December 6, 1941 or September 10, 2001.) And if you can't predict what tomorrow will bring, you must be prepared for whatever it does. A CEO who is 64 and plans to retire at 65 may have his own special calculus in evaluating risks that have only a tiny chance of happening in a given year. He may, in fact, be "right" 99% of the time. Those odds, however, hold no appeal for us. We will never play financial Russian roulette with the funds you've entrusted to us, even if the metaphorical gun has 100 chambers and only one bullet. In our view, it is madness to risk losing what you need in pursuing what you simply desire.

9. Charlie's simple blueprint

From my perspective, though, Charlie's most important architectural feat was the design of today's Berkshire. The blueprint he gave me was simple: Forget what you know about buying fair businesses at wonderful prices; instead, buy wonderful businesses at fair prices.

10. Cut out the bureaucracy at headquarters

At headquarters, we have never had a committee nor have we ever required our subsidiaries to submit budgets (though many use them as an important internal tool). We don't have a legal office nor departments that other companies take for granted: human relations, public relations, investor relations, strategy, acquisitions, you name it. We do, of course, have an active audit function; no sense being a damned fool. To an unusual degree, however, we trust our managers to run their operations with a keen sense of stewardship.

Is Magellan's listed fund a game changer?

by Graham Hand on March 26, 2015

The Magellan Global Equities Fund listed on the ASX on 5 March 2015 and is an unusual structure for the listed market, an actively-managed Trading Managed Fund or TMF. Magellan launched its first fund in 2007 and is now managing over $35 billion, including $10 billion of retail money. Previously, its funds were standard unlisted managed funds and a single Listed Investment Company, MFF. But its latest structure (ASX code MGE) is breaking new ground, and the question must be asked whether it is a significant milestone which will both generate a strong following and be copied by others.

[Upfront disclaimer: Magellan is a sponsor of Cuffelinks but our content is independent and we do not publish product promotions. This article is about a genuine market innovation that should interest our readers. While we discussed the structure with Magellan to clarify our understanding, they did not request nor approve this article.]

What perceived problems does it seek to address?

Over recent years, SMSF trustees and other direct investors have become increasingly comfortable using the ASX platform, especially through online brokers such as CommSec and nabtrade. Investments in the listed space compete with the unlisted funds available on platforms administered by major wealth management businesses. On the ASX, each of the alternative ways to invest in a listed portfolio of shares has its strengths and weaknesses, as described here and here in previous articles. In every case, there is a feature which detracts for some investors:

- Listed Investment Companies (LICs) – closed-ended funds which rely on buyers and sellers in the market for liquidity because there is no capacity to create or redeem units regularly according to demand. There is no market maker ensuring LICs trade at their Net Asset Value (NAV), which means they may trade at discounts to NAV at times of market stress when there are few buyers. On the other hand, they may trade at premiums (although it's difficult to understand why anyone would buy at a premium) and they are actively managed, and there are advantages in the company structure.

- Exchange Traded Funds (ETFs) – open-ended with a market-making mechanism which usually ensures they trade at close to NAV across a spread. Most are passive funds based on some type of index or smart beta. They have cost advantages but do not access the skills of an active manager.

- mFunds – ASX's service for issuing and redeeming unlisted managed funds via the ASX operating rules and settlement service, but with no real time unit pricing, and only available through brokers who have joined the mFund service, which excludes the major bank-aligned brokers. Many mainstream fund managers have also not joined. As mFund does not quote live prices, an investor must wait until after the end of trading to know the price of the units bought and sold.

Magellan's TMF seeks to address each of these weaknesses: it is open-ended, permitting the creation and redemption of new units each day via a market-making function with the intention of preserving the price close to NAV; it is actively-managed, for investors who believe a good investment manager is worth paying for; and the price quoted is live, removing the uncertainty of waiting until the end of the day.

How does the TMF solve the perceived shortcomings, and what problems of its own are created?

Why is the structure different?

The reason ETFs are able to maintain prices close to NAV is that, as index funds, their portfolios are continuously available to external market makers. This allows a third party to arbitrage between the prices of units in the fund and the underlying securities in the portfolio which pushes prices towards the NAV. For example, assume the NAV of an ETF is $5 and a buyer bids for 100,000 shares at $5.05. A market maker may go into the market and buy the underlying shares for $5 or $500,000, deliver these shares to the ETF provider and receive 100,000 shares in the ETF in exchange. These are then sold to the ETF buyer at $5.05 or $505,000 for a $5,000 profit (less transaction costs). This removes the high bidder from the market and pushes the share price closer to the NAV. The same happens in reverse there is a seller under the NAV.

The problem for active managers using this structure is that they do not want to reveal their portfolios to the market. That is the proprietary knowledge their clients pay for (Magellan's listed and unlisted global equity funds hold the same assets). Magellan has a base fee of 1.35% plus a performance fee, far higher than the cost of an ETF. Magellan could not allow a third party to replicate this portfolio each day and offer a cheaper alternative. The breakthrough achieved in the structure is that the TMF is only required to report its portfolio quarterly, and then with a lag of up to two months, denying the opportunity to replicate in a timely manner.

This creates a problem. If the portfolio is not available to a third party, who does the market-making to ensure to fund trades close to NAV? In the case of this new fund, Magellan is the market maker, and any gains or losses from the activity accrue to the fund. Magellan argues it has an incentive to perform this role well to ensure confidence is retained in the fund.

In practice, Magellan estimates the NAV based on the closing prices in global markets where the shares trade, and publishes the so-called iNAV on its website before the Australian market opens each morning. Buyers and sellers can trade live around this iNAV on the ASX. The iNAV may change but normally only due to FX movements. At the end of the day, Magellan works out the net position of buyers and sellers and creates or redeems units with the fund, and then buys or sells the underlying shares when liquid markets for those stocks open overseas. Magellan's global fund has a concentrated portfolio of major stocks in highly liquid markets and its activities have negligible impact on the market price.

What are the potential shortcomings?

We have listed at least one Achilles' heel for every competing structure, so what is TMF's?

The main issue is the ability of the fund and Magellan to accurately reflect the NAV at all times, including in stressed markets, without significantly widening the spread. What can potentially go wrong?

Magellan is acutely aware of the risks, as described in its offer PDS. MGE is a global fund which invests in stock markets which are closed during the ASX trading day. It is not possible for Magellan (as the market maker) to hedge the fund's market-making activities or always know the exact NAV. It states:

"The iNAV published by the Fund is indicative only and might not be up to date or might not accurately reflect the underlying value of the Fund."

For example, consider this (unlikely) circumstance:

- An investor sells 200,000 MGE shares at midday in Australia at $2.50 for $500,000. This price is the iNAV based on New York's close the previous day, and there has been no change in FX rates.
- A bomb explodes at the NYSE. In Asia, the S&P500 falls 10% on futures markets (Magellan believes hedging their portfolio in this time zone using futures is expensive and inefficient).
- Offshore stockmarkets open and prices are still down 10%. To match the sale done in Australia, the underlying shares are sold for an equivalent of $2.25 and the fund loses 10% or

$50,000 on this trade. This cost is borne by all investors in the fund.

This is an extreme event for illustration purposes, but risk management is about covering extreme events. Magellan says it has in place strategies based on back-testing of the same underlying fund since inception, but it is not explicit about these techniques. Magellan has the ability to widen spreads in uncertain conditions, and it's entirely possible that the fund will make money from this trading activity.

Is it a game changer?

Magellan's fund is well-suited to the structure because it holds highly liquid companies that can be bought and sold offshore without moving the price. The shares are less likely to respond significantly to announcements in the Australian trading day, as the major holdings are companies like eBay, Microsoft, Oracle, Visa and Nestle. This improves the accuracy of the NAV estimate.

In addition, Magellan has massive brand recognition among advisers, brokers and direct investors like SMSFs. As a global fund, Magellan's TMF will be supported by Australian brokers who would not promote an Australian equities fund, because the latter would be too much of a competitor to their core business in local equities. The value of broker support for a listed security should not be underestimated.

The types of funds less suited to the structure are those with less liquidity in the underlying shares, where it is difficult to estimate the NAV during the Australian day, such as a global small companies fund where the price may depend on volume traded. Some Australian funds may be open to arbitrage activity, such as the recent 60% fall in the price of Sirtex and its impact on Hunter Hall funds. Would the market react quicker than the market maker and sell at a NAV set too high?

My conclusion is that the Magellan structure will have most attraction for large cap portfolios with major managers in global equities who have the resources and capital to make markets and respond quickly to changes. The ASX is known to be fielding many enquiries from other fund managers and the Magellan structure will be replicated. It will encourage the move away from retail platforms and onto the ASX. It will take business away from mFunds, where the dependency on specific broker participation and lack of live pricing are drawbacks.

It's not likely to be a major competitor to ETFs, which will continue to have cost advantages and appeal to those who do not believe in paying for active management. It's likely to complement ETFs by allowing a total ASX-based solution, where an investor may have a 'core' ETF and a 'satellite' TMF with fees for a different type of exposure. LICs will continue to have a following, aided by their company structures and use by several high profile managers such as Wilson Investment Management. Boutique LICs, such as the recent Future Generations and Global Value Fund offers, would not have the resources to manage a TMF.

As new active funds are listed in this format, the ASX's suite permits a diverse portfolio without paying higher fees for the traditional choice and administration strengths of retail platforms. The ASX itself becomes more of a competing platform.

In the short time between launch on 5 March 2015 and 24 March 2015, about 26 million units in MGE traded at around $2.50 with narrow spreads, usually only 1 cent. Net amount issued to 1,500 investors was about $60 million, equivalent to the launch of a new mid-sized LIC. It's not quite game changer territory, but that sort of success will invite many competitors.

Footnote: Since this article was published, we have been advised by Aurora Funds Management that the Aurora Sandringham Dividend Income Trust (ASX code AOD), listed in November 2005, was the first (open ended) exchange traded managed fund (ETMF) in Australia. In 2006, they commenced self-market making for this fund. In addition, ETF provider BetaShares has a range of listed funds with some variance on normal indexing which the ASX labels MF, or Managed Fund.

Graham Hand has worked in wealth management and banking for 38 years and is the Editor of Cuffelinks.

Don’t treat bank shares as defensive assets

by Philipp Hofflin on May 7, 2015

Residential property constitutes by far the largest asset class in Australia, and on average, property accounts for over two-thirds of Australian households’ net worth. If you include investment in the shares of banks, which are themselves heavily exposed to property, the average Australian household has about 70% of its net worth ‘at risk’ exposure to residential property.

What does this mean for the share market?

Various commentators have recently warned that the market valuations of the four major domestic banks are high. But instead of analysing P/E multiples, low credit losses or high payout ratios, in this article we apply a ‘big picture’ outside view of the banks.

Australian banks have been outstanding performers from both a revenue and share price perspective. Currently all four major Australian banks (ANZ, Commonwealth, National Australia Bank, Westpac) are among the largest 14 banks in the world by market capitalisation, which is extraordinary given that no German, French, Italian, or domestic British bank is in that top 14. There is one Japanese bank in the top 14, whereas 25 years ago, when the Japanese property bubble was at its peak, nine out of the top ten banks were Japanese. This is not just a question of market concentration — the entire Japanese banking sector value is 20% less than the big four Australian banks together.

Another useful comparison across countries and history is the size of the banking sector relative to the value of all the other listed companies in (Figure 1).

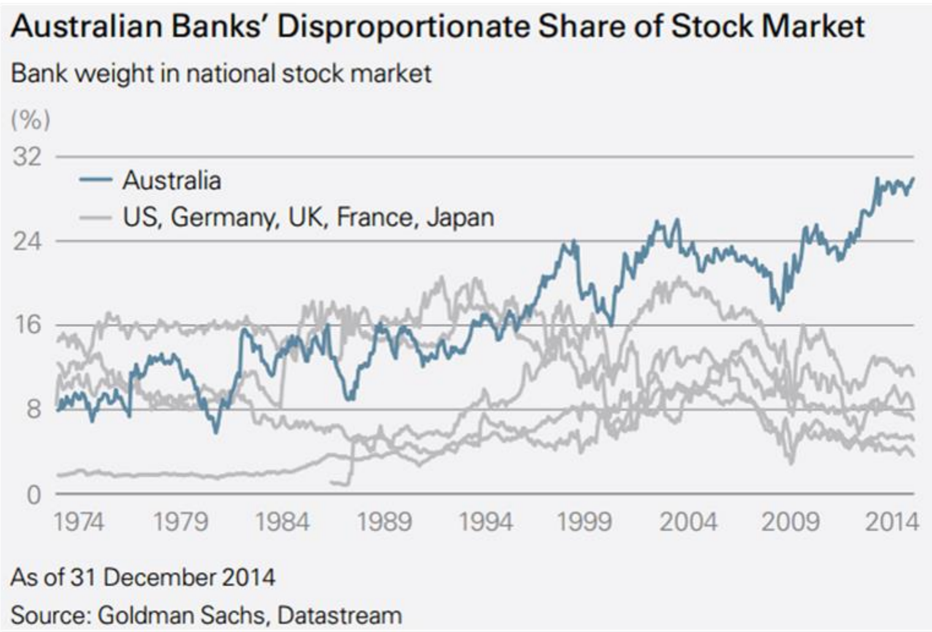
The Japanese banking sector accounted for just above 20% of the market at the 1990 peak of the Japanese debt and property bubble. A similar level of 20% was reached by the UK banking sector at the peak of the pre-global financial crisis boom in the 2000s (though this was enhanced by non-domestic banks, such as HSBC and Standard Chartered, being listed in London). The index weight of Australian domestic banks is over 30%, a level not even reached during lending and property bubbles in markets overseas. It seems reasonable that the value of a nation’s (listed) bank sector should bear some relation-ship to the value of its (listed) national economy. Across the world this ratio is about 1:10; in Australia it is 1:2.

Australian banks do well because there is a lot of debt

Why are Australian banks so highly valued? Put simply, Australian banks earn very high profits. However, this is not because, in our view, they are better run, enjoy better margins, or use more advanced technology, but because there is a lot of debt in Australia. This debt is effectively the top line of a bank’s P&L — the more debt, the more net interest and fee income.

This relationship is illustrated by Figure 2, which shows financial sector profits (which are dominated by banks) relative to GDP and

Figure 1:



outstanding credit to GDP. As both quantities are expressed as a percentage of GDP, one might expect a steady ratio. Instead we find that since the late 1950s credit has grown about five-fold relative to GDP and so have financial sector profits. In this sense the high valuations of Australian banks have been driven by the same drivers as in the United Kingdom before the global financial crisis, and in Japan before the bust.

Figure 2:

A Growing Share of GDP

As of 31 December 2014

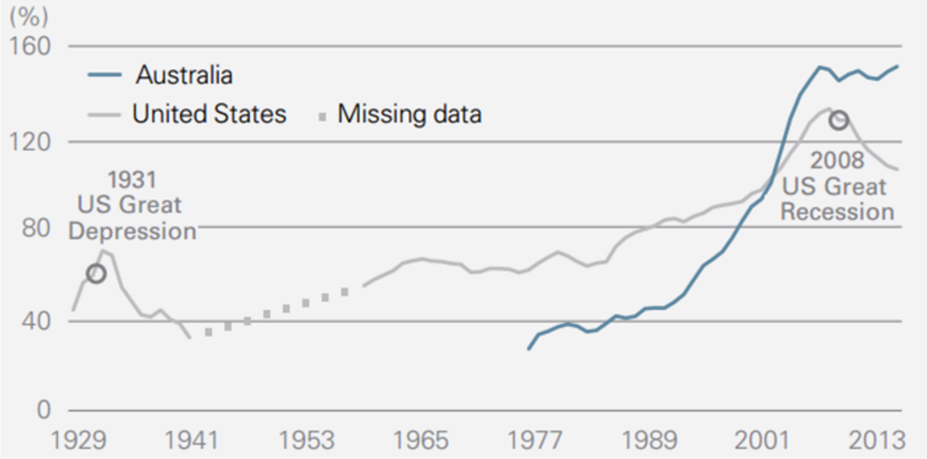
Source: UBS

The household sector has primarily been responsible for this growth in debt, as individuals have increased borrowing to purchase residential property. Figure 3 shows the household debt to income ratio over time for the United States and Australia. We note three features of these developments. Australian household gearing, previously much more conservative than that in the United States, rose very rapidly between 1990 and 2008 and exceeded US debt levels. US households have de-geared since 2008 while Australian households have not, and indeed the latest data show new record highs in Australia. The gap to the United States has thus widened further.

Figure 3:

Rising Household Debt

Household debt-income ratios



As of 31 December 2013

Source: Merrill Lynch, Minack Advisors

This data is not encouraging, but we note that there have been some positive lessons learned from the US crisis. 'Low-doc' lending, which the banks were just ramping up in the lead-up to 2008, seems to have mostly disappeared, liquidity levels at the banks have improved dramatically, and regulators have insisted on them holding significantly more capital. This does help but to what extent, if the lending and speculative investing continue unchecked? One is inevitably reminded of George Santayana's well-known aphorism that 'those who do not learn from history are condemned to repeat it.'

What to do?

These risks are real, in our view, but we do not know when and how these distortions will be remedied. We are more confident that, in a decade hence, this distortion will be obvious, like so many others before it. In the meantime, however, we face difficult choices. Given the uncertainties, and in particular our lack of information about the timing of any adjustment, how can investors sensibly and prudently proceed?

We describe two actions that can be taken within the context of the Australian stock market:

1. Investors around the world have sought out stocks with sound yields and defensive earnings, focusing on the utility, infrastructure, health care, and telecommunications sectors. However, in Australia (and only in Australia, it seems), this focus has included banks. Given their gearing and exposure to the domestic

economy, we do not subscribe to this local view of banks as defensives.

In our view, however, there are genuine defensives within the Australian market, in the sense that a sharp economic downturn would affect such companies less. These companies may have their own idiosyncratic problems at times, but they can mitigate macro-economic sensitivity within a portfolio. In our view, not all yields are created equal and some are safer than others.

2. There are, furthermore, successful Australian companies that have expanded globally and now run competitive businesses offshore or export to other nations. These companies can act as hedges to the Australian residential/bank exposure because a decline in the Australian dollar, lower wage growth, and spare capacity in Australia would raise the value of these companies. We believe the value of these companies would be enhanced in local currency in the event of a recession finally ending Australia's remarkable run of 24 years without a downturn and its associated 24-year run of increasing household leverage.

In closing, we would like to stress that we are not predicting an imminent crash in Australian property prices. However, investors should be aware of the enormous exposure Australians have to this risk and that property and banks are likely to be highly correlated in any downturn. And while we can't predict when these market distortions will start to unwind, we suggest that investors consider treating banks less like defensive holdings and consider domestic companies with global exposure in their portfolios.

Dr Philipp Hofflin is a Portfolio Manager at Lazard Asset Management. This article is general information and does not address the personal needs of any individual. This article is an extract from the longer version and is reproduced with permission.

Platinum's Kerr Neilson: it's all about the price

by Graham Hand on May 21, 2015

Kerr Neilson, Managing Director of Platinum Asset Management, was interviewed by Vincent O'Neill, Director of Private Wealth at Stanford Brown, on 24 April 2015 at the Stanford Brown Quarterly Investor Insight luncheon.

VO: What makes a good investment manager?

KN: You need to have some idea about what you bring to the game. You wouldn't enter the Olympics without some 'edge', and it's the same in the investing business. You have to define your 'edge' to yourself. One 'edge' you could bring is that which others find difficult, such as thinking in a contrarian manner. There's a big problem with investments. Believe it or not, there's no specific price for any asset. Some good companies are now worth 10 times the amount they got down to in the GFC. They haven't become 10 times better companies. When you buy and sell in the stock market, you need to have a reference point against what other people think. Value can shift around massively. You need to be a contrarian to start looking for gaps. You need a way to distil out the confusion and noise.

VO: And what have you changed or learned over the years?

KN: Like all investors, you initially start looking for a bargain. But now we have the internet, it's completely transformational. It's as important as the railways and the automobile. On the one hand, you know what you'd pay for traditional companies, but then you've got this ginormous event which opens up the world to everyone. A company can be so much more valuable even though it started in a garage in Sydney. The value proposition is difficult to understand. With these changes, you need to change your own approach, at least at the margin.

VO: And you need a recognition that some are speculative.

KN: You need a high upside to justify the uncertainty and you need peripheral vision. A problem analysts have is that they spend a lot of time on a company, and they feel they need to be rewarded for that time. They still want to buy it, but you can't do that if you're running money.

VO: In what conditions does Platinum underperform?

KN: The times we are least effective are the times like the last six years, where there is little dispersion of valuations, and huge trending. The herd is going in one direction. The one market you had to be in was the US, and we have been progressively moving out of it.

VO: Does that make it difficult for you, as people question your stance?

KN: You need to build a team slowly over a long period of time because you have to think differently. To keep people of that nature is not easy, it's a certain type of mentality.

VO: You're a keen student of history. Can you share some of the key lessons from the past, including any insights for the current conditions of extreme monetary policy.

KN: You don't need to be an historian, just start with the human condition. We are all slaves to our frailties, and we have little ability to suppress those animal instincts: fear, greed, jealousy, all these weaknesses we have. When you read the literature of the 1930's, we had all this discussion about when to tighten monetary policy, and then you had some very volatile markets. So you can find precedents in history, but you must always look for the differences. We have a big change which is globalisation, and it is more powerful now. We have a transfer of capital and technology, and a massive pool of labour in China and India that is priced at $100 a week rather than $100 an hour. You need to be careful because we'll have a lot of labour substitution which implies that growth in the West will be lower. The gap is so huge and the biggest problem we face is this arbitrage of labour costs. Through technology, you can quickly teach people how to do things, you can automate so much of this.

VO: Older people spend less on goods and services, they don't have babies or buy houses, while they have higher health costs. What do you think about the drag on global growth from changing demographics over coming decades?

KN: In my view, technology is more disruptive than the ageing of the population. And India and Indonesia have the opposite problem of millions of young people entering the labour force, what do they do? The challenge is expectations. We've had 24 years of growth in this country. We're not prepared to make these adjustments and it will come through the exchange rate. I don't think the exchange rate will drop right now, but our labour costs are making us uncompetitive, so there must be more reduction in the currency. Our expectations have to be reined in.

VO: Can you talk us through your views on China.

KN: China will grow slower and in our view, India will outpace it by a factor of two. China might go down to 4½% to 5%. It was spending $4 out of $10 on building for the future, capital works like bridges and roads. In China, the locals are switching from property to shares, at the same time superannuation and insurance is growing, so there is more of a market economy going into financial assets. We can still buy companies at reasonable prices but they've moved very quickly.

Here's a point I can never repeat often enough. This business is not about creativity and great dreaming. It's all about price. When the price of something has collapsed by two-thirds, as the Chinese stock market did until a year ago, that's not when you get worried. It's when it's gone up three-fold you should be worried. When it goes down you should be delighting in the prospect. Let me labour this point. If I offered you the car of your dreams, you'd be hounding me to tell you the price. I used to be in stockbroking, and as prices went up, our clients really lusted after shares as they became more expensive. But that's not what they'd do with their Mercedes Benz S- Class.

VO: You've had a lot of exposure to Japan, can we expect Japanese companies to be managed to deliver shareholder value better?

KN: This is a remarkably introverted country, but we are seeing clear evidence of the leading companies changing in the way they select directors and the focus on profit. They don't have bad returns on sales but they always over invest. They have such social cohesion that they'll all fall into line. The market's around 20,000 and it's likely to get to 25,000 and then get into trouble at 30,000 – I think it's got 50% to go over the next couple of years. When you have a currency that falls from 75 to 120, your cost competitiveness is spectacular.

VO: What are your views on the economic outlook for Europe?

KN: The central problem is the productivity gap between the north and the south. The south can't close the gap. There's no central exchequer, there's no backing of a central bank. I suspect somewhere down the line we will get into trouble again.

VO: Are you still happy to be overweight in shares and not too much in cash at the moment?

KN: It depends on your time frame. In 1939 if you owned shares in Deutschland and your cities were flattened and industrial base destroyed, it took until 1954 to get your money back. The same is true in Japan. The only places that you did not retrieve your wealth was in China and Russia because there was a regime change. So you're talking to a junkie here, we always see the benefit of shares because of the rewards over the long history. The trouble is, most of us go to water because we do not fully comprehend that it's the very essence of our living, our whole structure, to own these companies. To lose faith in equities, you have to believe there's a change in the entire structure. A fundamental change in the economic management of the system. So that's why we say it is volatile but it is the underpinnings of our living standards. Even in the worst of times, capital will migrate to the best business opportunities. It's a constant in our system, and to lose that, you must think we're going back to some form of central control and ownership.

Please take away from this one critical message. Price is critical. What does the price say? It's not about the headlines, it's what is in the price.

Graham Hand was a guest of Stanford Brown Financial Advisers.

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2015 asset class review and 2016 outlook

by Ashley Owen on December 17, 2015

This review is about asset classes, not individual funds or stocks. Getting asset class views right (or wrong) can gain (or cost) portfolios 20-30% or more in any given year. In contrast, managed funds tend to outperform or underperform their asset class benchmarks by only a few percent each year (most underperform in most years). The vast bulk of managed fund returns each year is due to the return from the asset class in which they operate (often called 'beta') and not from the skill of the manager in beating its asset class benchmark ('alpha'). Good asset allocation is usually much more critical for overall portfolio performance than picking funds or stocks.

(The data used here is current as at 11 December 2015. Click on any of the charts to enlarge, as there is an enormous amount of detail in many of them).

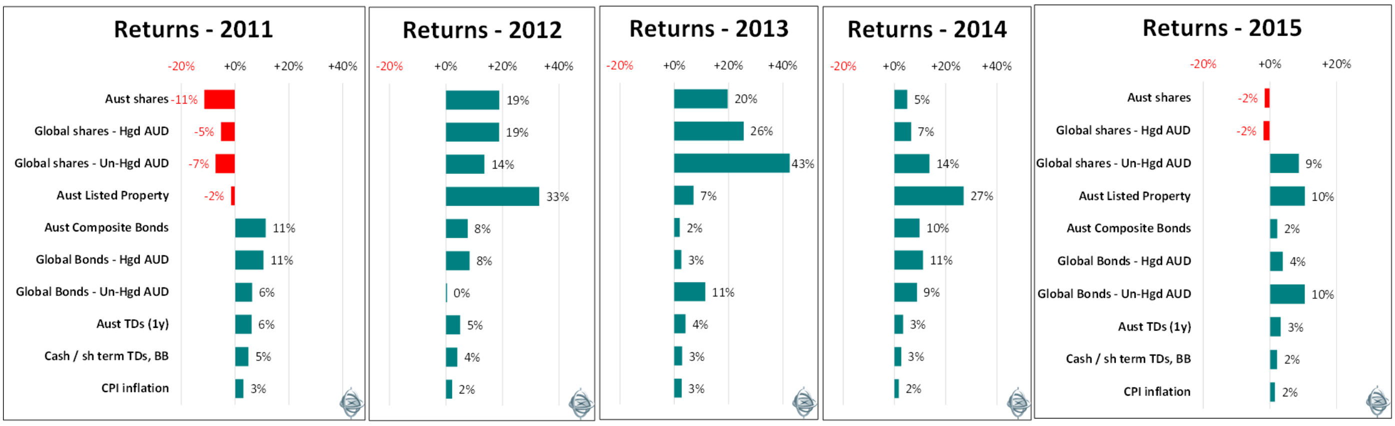
Winners and losers

2015 was a year when all asset classes did relatively poorly relative to their long term expected averages.

We went into 2015 favouring Australian shares, Australian listed property and unhedged global shares (favouring developed over emerging markets) in portfolios. We were underweight Australian fixed income (but favouring short duration), global bonds, TDs and cash.

Our favoured asset classes performed well overall – Australian shares were down a little (-2% including dividends) but unhedged global shares (+9%) and property trusts (+10%) did quite well. Conversely the asset classes we were underweight returned less than their expected averages – Australian bonds (+2%), global bonds (hedged) (+4%), TDs (+3%) and cash (+2%).

Asset class returns for the past five years



Australian shares

Returns diverged greatly across different sectors of the local market.

2015

- Miners were hit by falling commodities prices plus high debt loads. The only exception was gold mining stocks, with the gold price holding up relatively well due to lingering QE hyper-inflation fears.
- Banks were hit by high capital requirements plus fears of bad debt blow-outs from miners and property lending, and doubts over the sustainability of dividends.
- Revenue and earnings were weak overall but dividends were increased on higher payout ratios.

2016

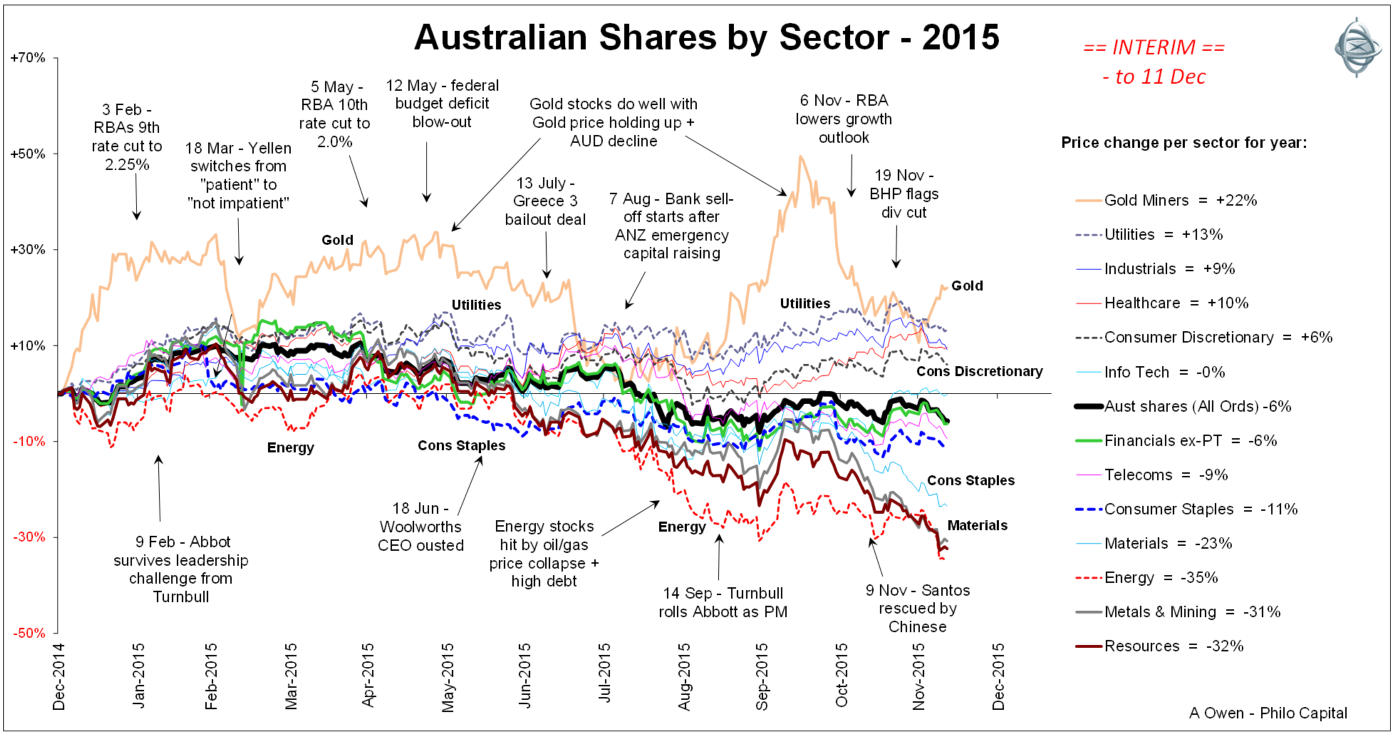
- Miners are likely to cut dividends, with bank dividends under pressure too. But dividend yields are still attractive, assuming they are not cut significantly in aggregate.
- The overall market is around fair value on long term fundamental valuation measures, but we are relatively bullish in the short term as well.

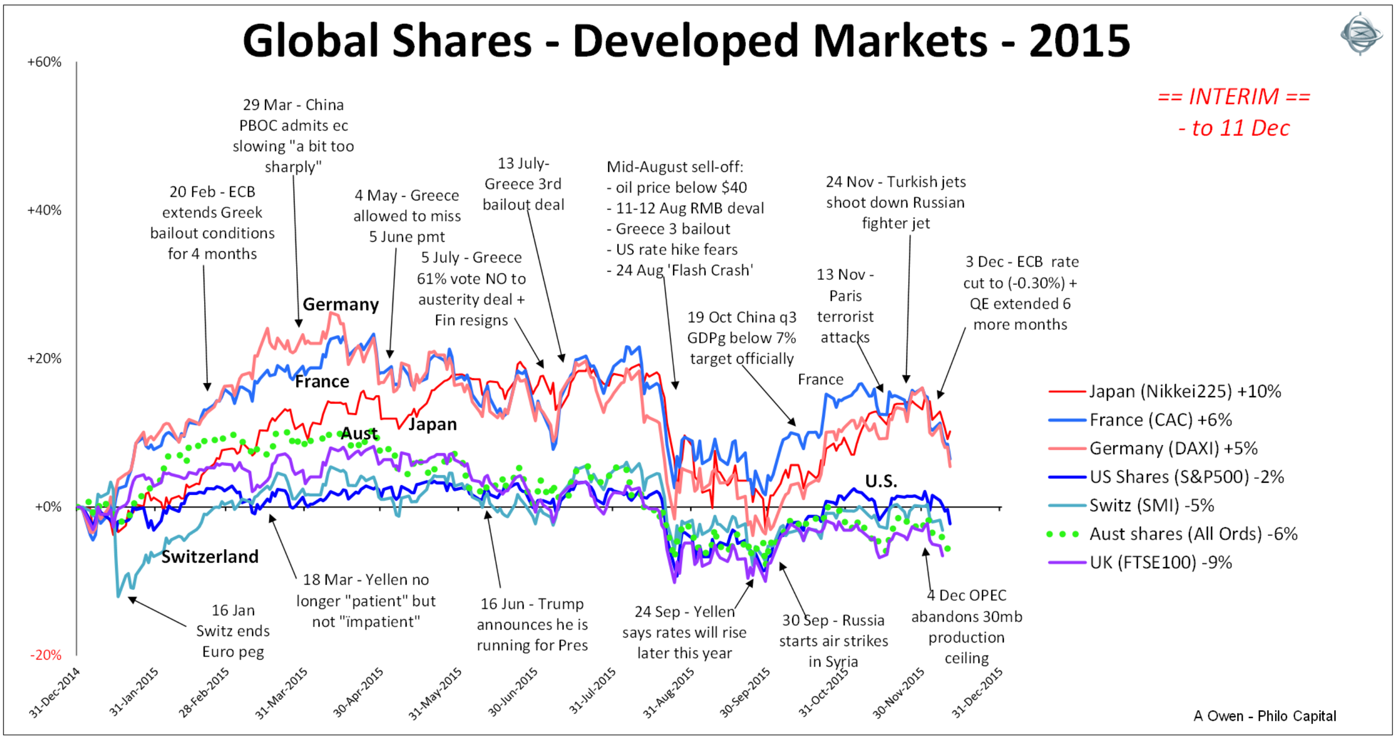
Global Shares – 'developed' markets

Many developed country stock markets delivered better performances than Australia in 2015.

2015

- Markets were flat overall, but being unhedged on the currency for Australian investors added 9% to returns for the year.

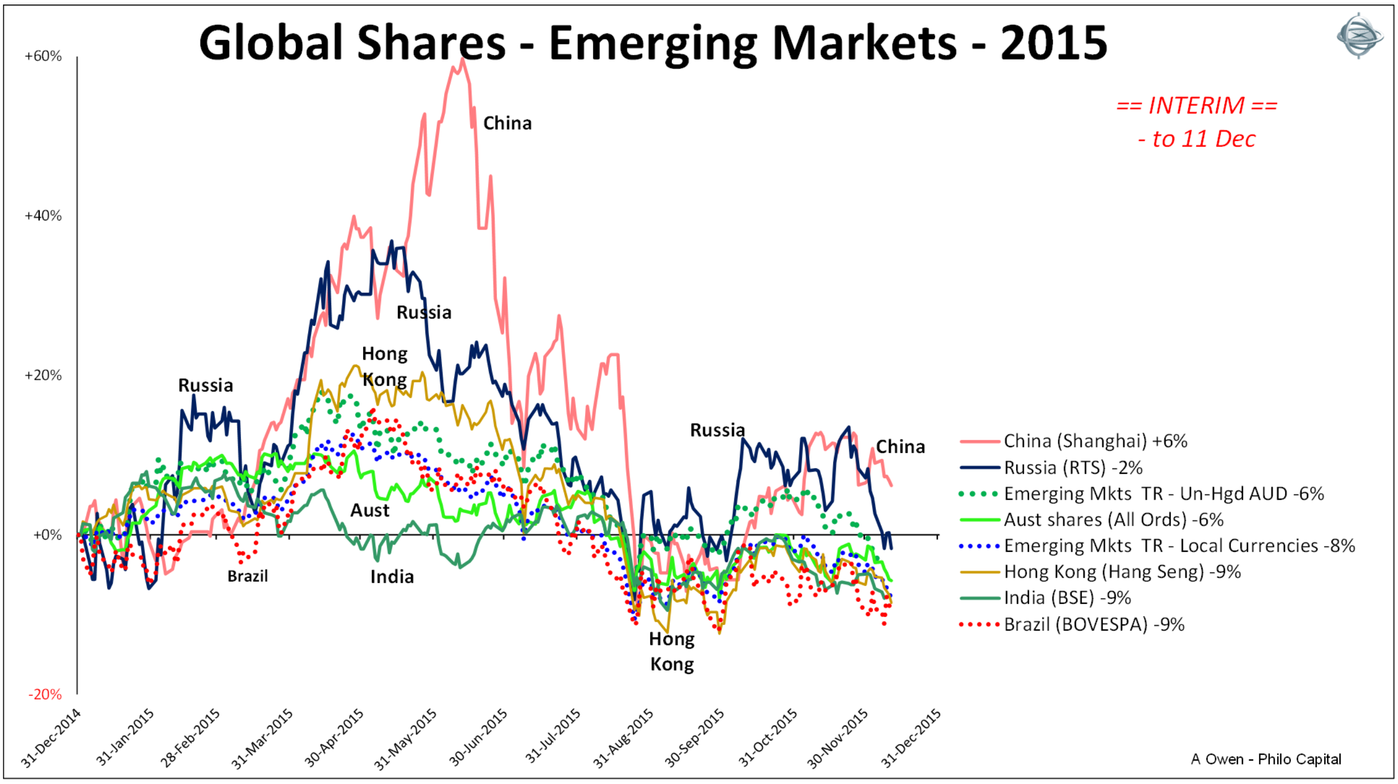




- US markets were flat. The rising US dollar plus the oil/gas collapse hurt not only oil/gas stocks but related manufacturing as well. Most tech stocks were up strongly except Apple which was flat. US revenues and earnings were weak but dividends and buybacks were strong.
- European and Japanese markets held up reasonably well despite stagnation & deflation in their local markets, but were assisted by weakening Euro and Yen.

2016

- US recovery and sentiment has a good chance of remaining strong enough to withstand slow rate hikes. The Fed has made it clear that rate hikes will be gradual and well-signalled.
- European markets are likely to be benign. Greek failure to stick to its repayment plan will be absorbed.
- The US market (which is half the overall global market) is overvalued on several long term fundamental measures.



Emerging Markets shares

In contrast to the sombre performance of developed markets, emerging markets went on a wild ride during the year but still finished relatively flat overall.

2015

- Commodities price collapses affected many emerging markets.
- The Chinese stock bubble raged on until mid-June but then burst despite stop-start policy action to prop it up.
- Russia was up and down with oil price gyrations, India was the best BRIC economy but had poor returns and Brazil was in deep recession and plagued by widening corruption crises.

2016

- Corporate defaults likely to increase with rising US dollar and rising US interest rates.
- Emerging markets deficit / debt / currency crisis looming in Latin America, Middle East & South-East Asia.
- US rate hikes and credit market shocks likely to suck hot money out of emerging markets stock and bond markets.

Commodities

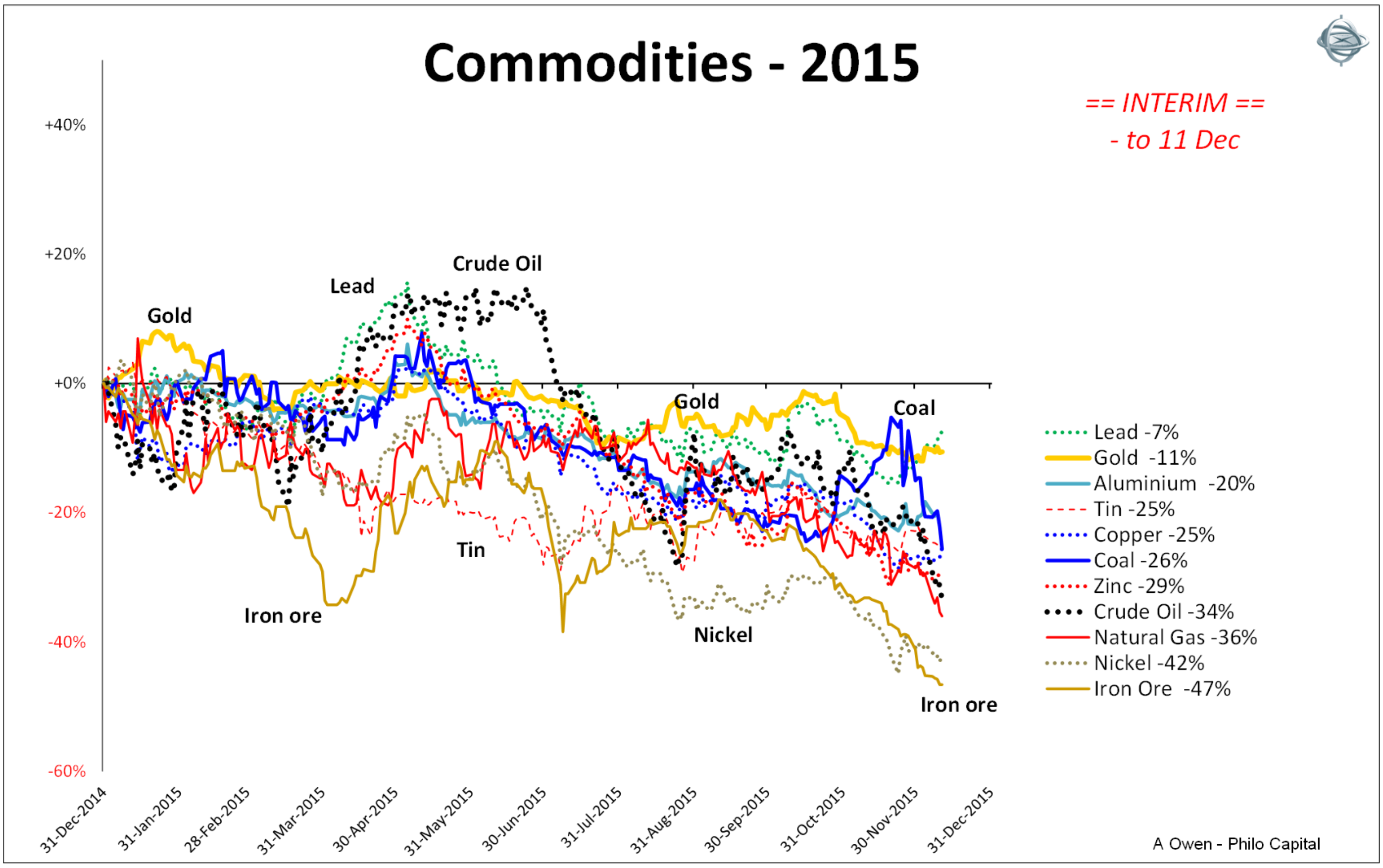
Commodities prices continued their long slide since the cycle peaked in 2011 with major impacts on developed and emerging stock markets.

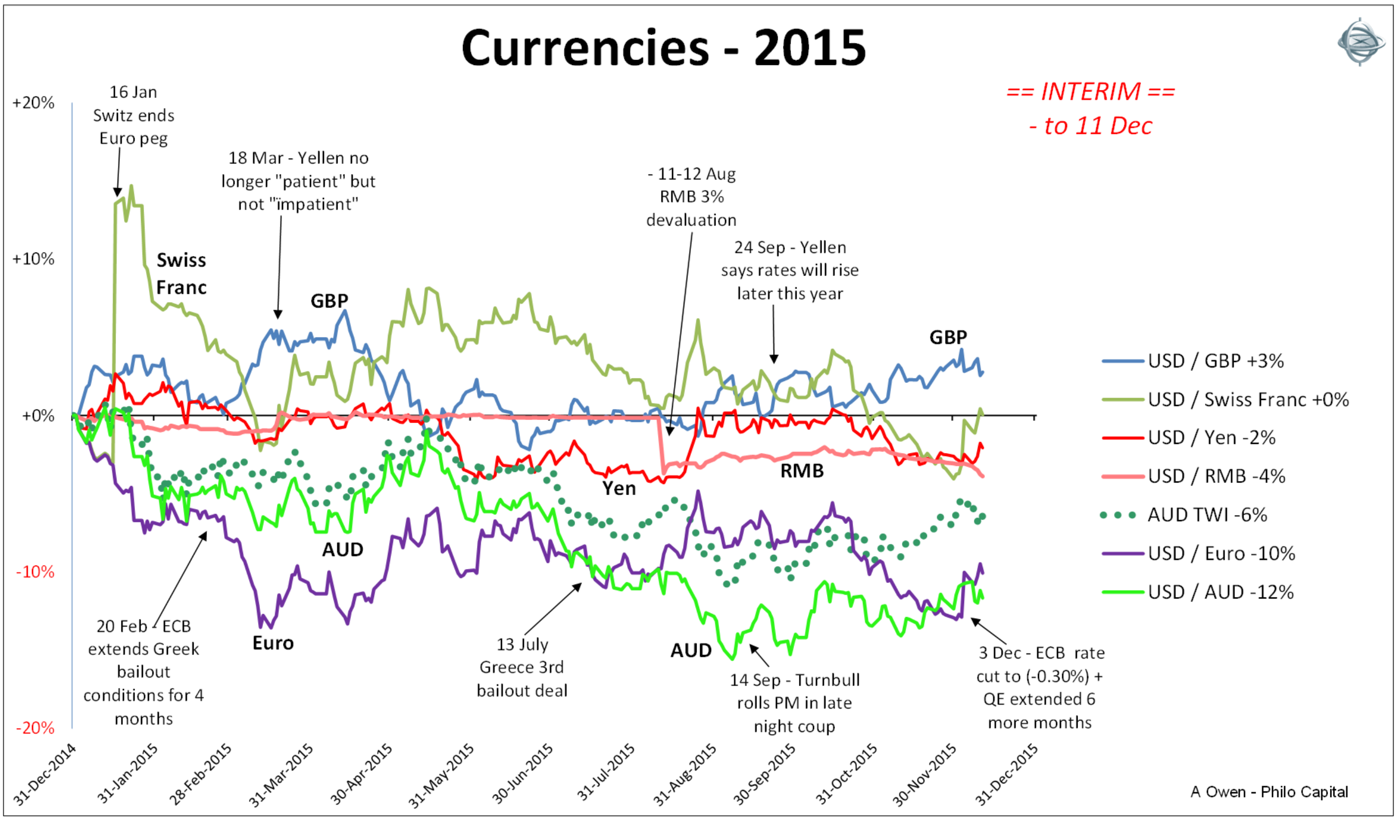
2015

- All commodities were down heavily again.
- Global demand and growth outlooks were lowered progressively during the year.
- Over-supply worsened, with new production still coming on stream, swamping weak demand.

2016

- Demand remaining weak, with stagnant Japan and Europe, slowing China.
- Prices may stabilise if over-supply curtailed as mine closures accelerate.
- LNG over-supply to hit Australian LNG. Buyers may renege or renegotiate.
- Escalating Middle-East conflicts should support oil prices – good for markets.





Currencies

Currency hedging decisions are critical and make a big different to portfolio returns.

2015

- The US dollar and UK pound rose on expectations of rate hikes by the Fed and Bank of England.
- The Aussie dollar was weakest despite having the best economic growth.
- Chinese RMB mini-devaluation in August.

2016

- Further RMB devaluation is likely, but expect retaliation from US, especially with US election rhetoric.
- Emerging market currency crises (like 1997) may be triggered by commodity revenue collapse.
- Aussie dollar sell-off likely if budget blow-out continues to worsen, without credible plan to return to surplus.
- The AUD is still over-valued on fundamentals, and likely to be sold off in EM debt / currency crisis, so still more potential gains to be had from being un-hedged.

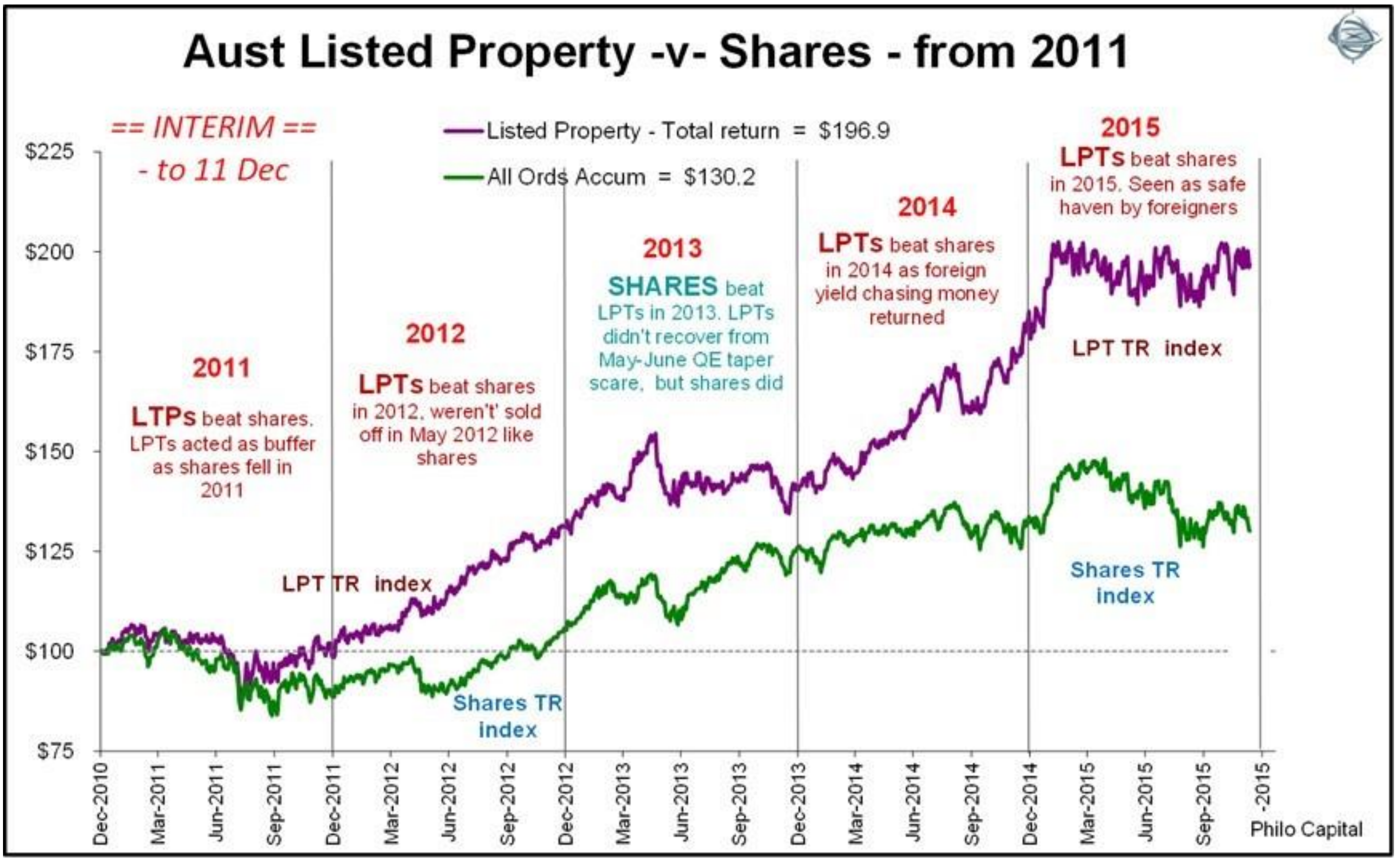
Australian real estate

2015

- Good returns from listed property which beat shares again.
- Listed returns have been better than direct property over the past four years but the gap is now gone, and both are overpriced.
- Returns have come from yield/cap rate compression plus gearing rising at ultra-low interest rates (neither is sustainable) rather than from rent rises.
- Listed trusts returned as ‘safe haven’ after 2013 QE taper sell-off.
- Mergers and acquisitions activity boosted prices.

2016

- Continued strong foreign demand for direct and listed property, M&A activity to continue.
- Likely to suffer along with shares in EM debt scare (like in QE taper scare).
- Although we have favoured listed over unlisted property, unlisted is less prone to flight of hot foreign money in panic sell-offs which may hit markets in the coming year.

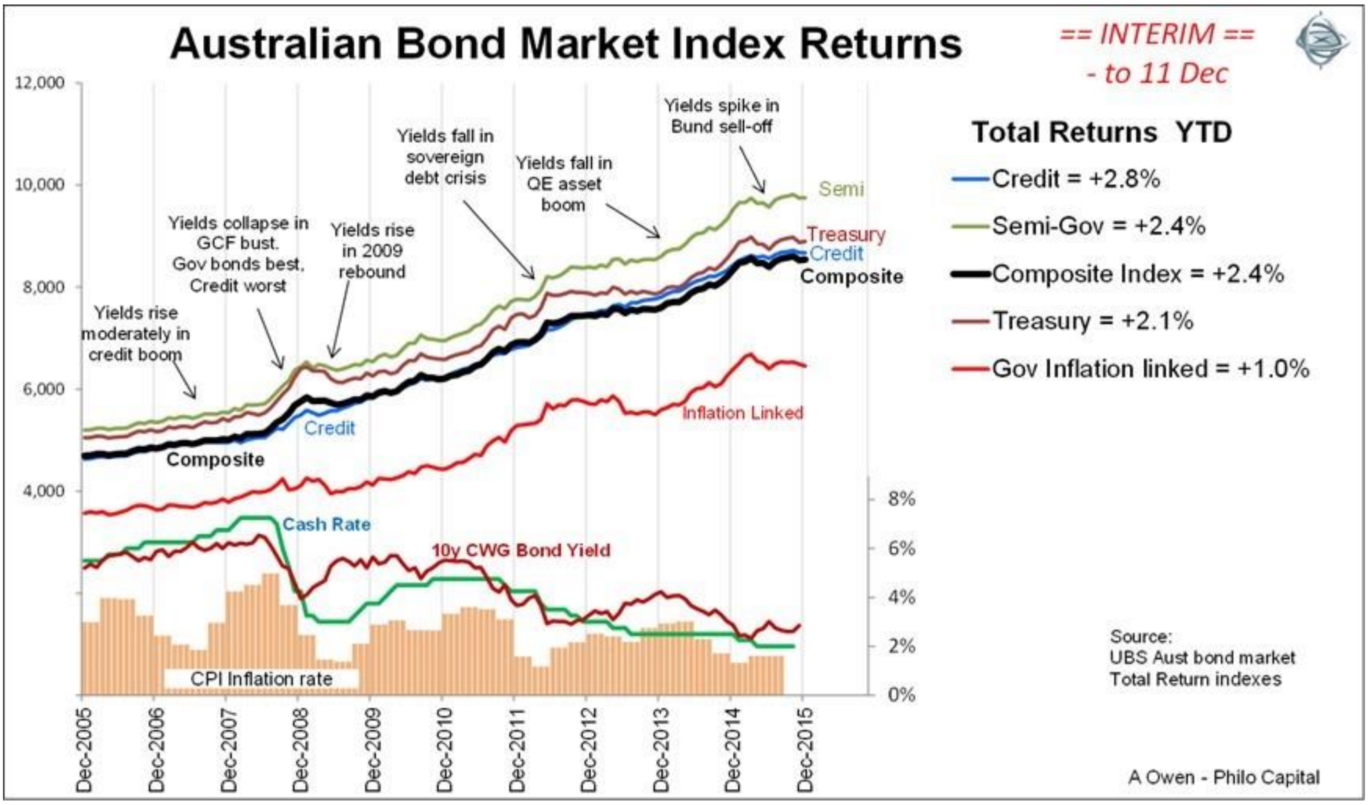


Australian fixed income

The next chart shows returns from the main sectors of the domestic bond market over the past 10 years.

2015

- Below average returns from all sectors this year.
- Yields spiked in the April-May German Bund crisis.
- Short yields finished lower with the declining cash rates but long yields ended flat or a little up.
- Credit did best, but spreads are still vulnerable to sharp sell-offs in credit market scares.
- Strong foreign demand supported prices.



2016

- Long term returns likely to be below average.
- Short term returns likely to be benign, with yields staying relatively low.
- Australian bonds likely to be sold off by foreigners in emerging markets debt scare. There is also an increasing risk of Australia losing its AAA credit rating with the budget blowout continuing. This would scare some foreign investors and cause yields to spike.
- Short duration likely to perform better than long.

Global bonds

After the yield declines across the board in 2014, bond yields in most markets edged a little higher in 2015, leading to below average returns.

2015

- Negative yields across much of Europe. Almost all of Europe is below US yields.
- Broad global bond sell-off in April-May triggered by snap back in German Bunds which had been pushed down to ultra-ultra-low levels by mid-April.
- Japanese yields remained virtually flat all year supported by QE, with deflation and stagnation persisting.
- US and UK yields rose with their economic recoveries and expectations of very slow rate hikes.
- The global government bond benchmark returned 4% in hedged AUD, but 10% unhedged due to the falling Aussie dollar (but few investors use unhedged global bonds, preferring the 'safety' and much lower volatility of hedged bonds).

2016

- We expect benign returns for global government bonds with yields staying low, especially in the big markets of Japan and Europe. No sign of serious inflation for years.
- US rate hike programme should keep US yields relatively low. The quicker the rate hikes, the lower the yields will remain.

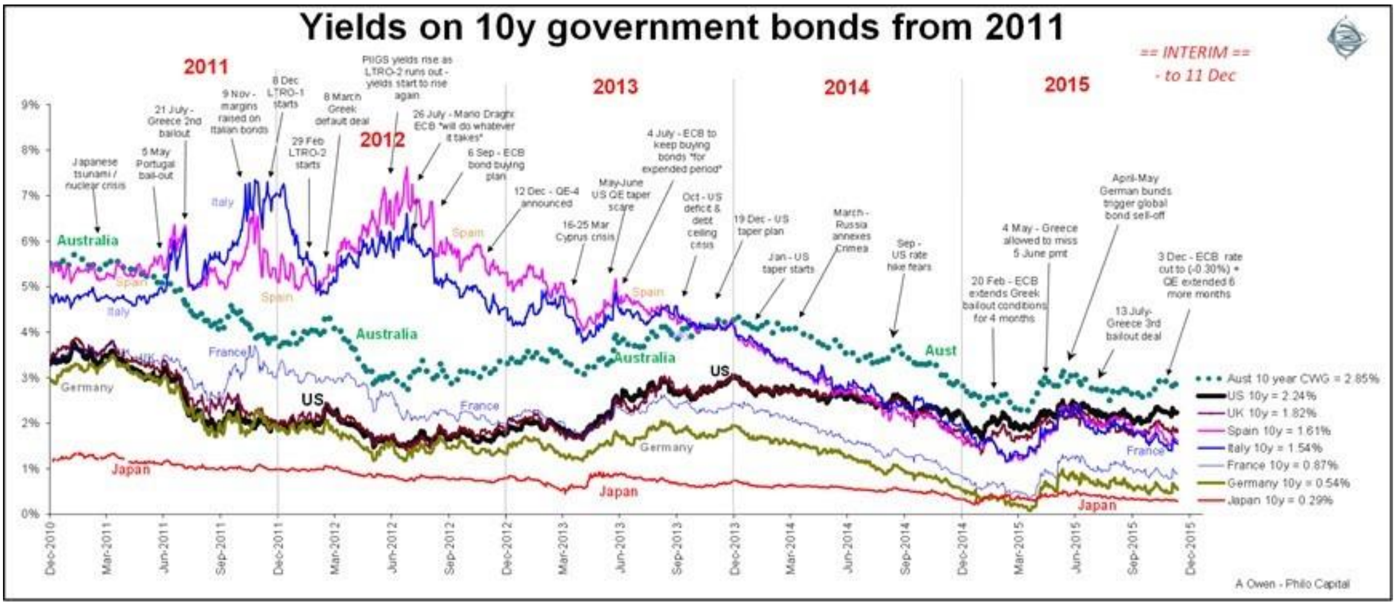
Likely shocks

Every year there are usually one or more general sell-offs in global markets, but most are not serious and markets recover quickly.

The most likely source of a general market shock in the coming year would appear to be from the combined effects of collapsing commodities prices, high debt levels (particularly US dollar debt), unsustainably low credit spreads, and rising US dollar and US interest rates. The most likely candidates would be high indebted emerging market corporates and governments, especially those with budget deficits and weak reserves.

Chinese corporate defaults will probably continue to escalate but should be manageable due to China's huge reserves and government ownership of the banking system.

The problem is likely to be more serious in smaller emerging markets with wide deficits and dwindling reserves. There are likely to be sharp currency collapses as capital is withdrawn rapidly from some markets. Another Russian default (like 1998) is not out of the question. The Australian dollar, shares and bonds are usually sold off quickly in such circumstances.



In the developed markets there will probably be some losses and collapses in credit funds and commodities hedge funds, including perhaps even some commodities or credit ETFs.

Wishing all readers a safe and prosperous 2016.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is for general education only and is not personal financial advice. It does not consider the financial circumstances of any individual.

Property investing

Sydney residential market – bust in the making?

by Adrian Harrington on April 23, 2015

This article was prompted by questions on the Sydney market from one of our readers, Bruce:

I would be most grateful if one of your experts could shed some light on the current housing market in Sydney. As a SMSF investor in the pension phase, I am struggling to understand what is happening. Auction clearance rates over 85%, properties regularly selling before auction or 10-15% over their reserve, the industry arguing that there is an under supply of accommodation and the State Government forcing Councils to approve more dwellings to increase Sydney's population by another 25%. Is it similar to the Dutch Tulips or the South Sea Bubble? Or can we draw on the experience of nation-wide housing bubbles in Japan, Ireland and the US to understand the localised phenomenon of Sydney?

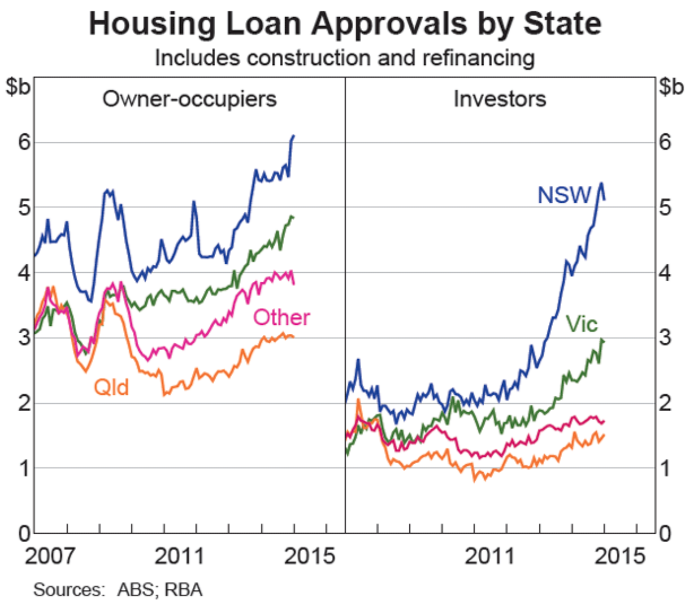
In our IT connected world, why do people want to pay a huge premium to live in Sydney? Has there been a fundamental shift in the inherent value of Sydney to make it as valuable as London, New York or Tokyo? As the family home is the most tax-effective investment you will ever make, does this encourage taxpayers to invest in larger and more expensive properties? What is the outlook for property if wages remain stagnant and the number of people in employment remains the same? How will people be able to service these huge loans without the benefit of rising incomes?

Not a day seems to go by without at least one new headline pointing to a Sydney housing boom. We are often asked why the Sydney market is so strong, how much longer the growth can persist and will it ultimately end in tears. Unfortunately, there are no simple answers.

Most people are quick to point to record low interest rates as the root cause of the Sydney housing boom. With cash and term deposit rates not much higher than the inflation rate, investors are being forced to look elsewhere for yield, and housing (not to mention the blue chips stocks such as the banks and Telstra) appears to be a key beneficiary.

The RBA has pointed out in its [March 2015 Financial Stability Review]() that "… *the composition of new mortgage finance remains skewed to investors … and investor housing loans in NSW have increased by 150% over the past three years and now account for almost half of the value of all housing loan approvals in that State"* (see Figure 1).

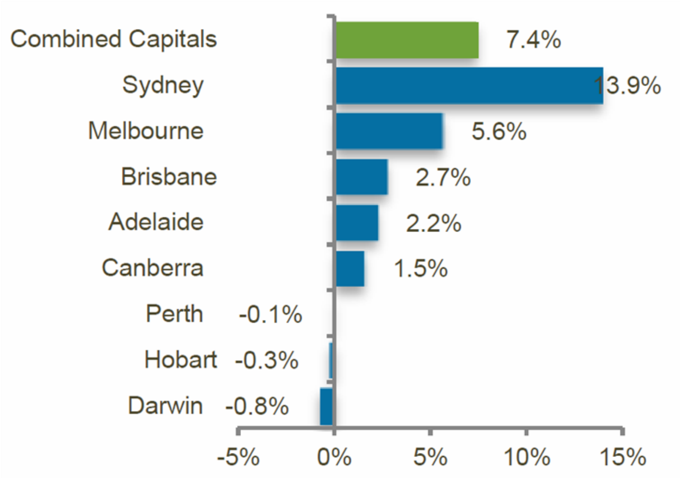
Figure 1: Housing loans by state: 2007 – 2015



However, low interest rates and heightened investor activity are not the sole drivers of the Sydney housing boom, otherwise we would be in the midst of a housing boom across Australia which, as the latest house price figures from CoreLogic RP Data ([Home Value Index]()) confirm, we are not.

Sydney's home values were up 13.9% in the year to March 2015 – the only market to record double digit growth. Melbourne was the next best performing market with an annual increase of 5.6% (Figure 2). Surprisingly, Perth, Hobart and Darwin all recorded declines in value of 0.1%, 0.3% and 0.8% respectively.

Figure 2: Annual change in dwelling values: March 2015

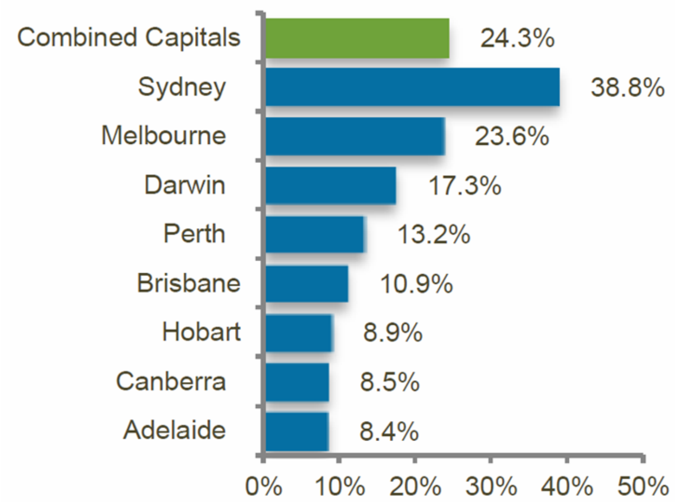


Source: CoreLogic RPData

Looking at home value changes since the last market trough, again price growth has not been uniform across the country (Figure 3). Sydney home values have increased by 38.8%, Melbourne's are up 23.6%, Perth's are up 13.2% and Brisbane at 10.9%. Hobart, Canberra and Adelaide have all recorded single digit growth of 8.9%, 8.5% and 8.4% respectively.

Therefore, there must be other factors at play that are coming together driving the strength in Sydney house prices. No wonder the RBA has a dilemma. The RBA needs a stronger housing market to offset a downturn in the resource sector yet only Sydney and Melbourne seem to be responding.

Figure 3: Change in dwelling values since the trough to March 2015



Source: CoreLogic RPData. Note that the 'trough' is at different times in different cities.

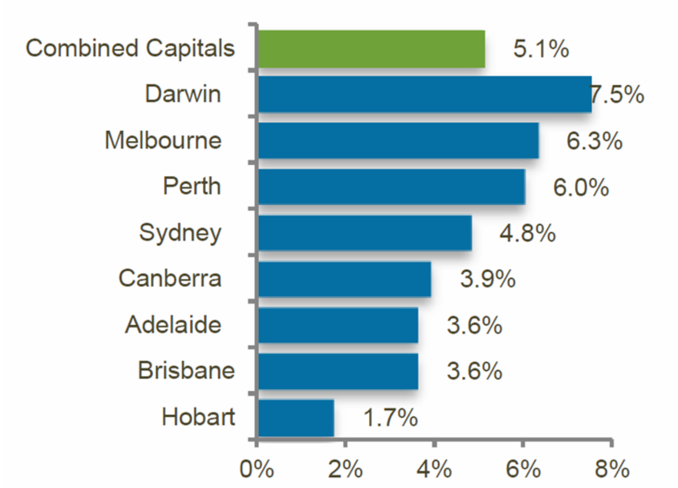
Why is Sydney out of step with the rest of the county?

There are seven other factors worth considering:

1. Price catch-up

We need to go back and review the price performance of Sydney over the past ten years to put the recent price movements into a longer term perspective. According to CoreLogic RP Data, Sydney's annual price growth over the past decade has been relatively subdued at just 4.8% putting Sydney well behind Darwin at 7.5%, Melbourne at 6.3%, and Perth at 6.0% (Figure 4).

Figure 4: Average annual change in dwelling values: 2005 – 2015



Source: CoreLogic RPData

Sydney housing market did not perform that well in the mid 2000's and there has been a degree of catch-up between 2012 and 2014. However, the strong market has continued into 2015 and it appears that certain parts of the Sydney market are now overshooting.

2. Fear of Missing Out (FOMO) syndrome

When investment markets (whether property or equities) are running hot there is the natural human physic to jump on the bandwagon commonly known as the 'fear of missing out' syndrome. This is certainly alive and well in Sydney and is partly responsible for fuelling the current price exuberance.

3. Demand and population growth

Sydney is experiencing a population explosion. Annual population growth averaged 1.3% between the early 80's and mid 2000's but in recent years has been running at higher levels. According to ABS Regional Population Growth statistics, in the year to June 2014, Sydney's population increased by 84,200 to 4.84 million – an increase of 1.8%, and above the national average of 1.6%.

Population growth is a combination of international migration, interstate migration and natural growth (births less deaths). Australia's is running very high international migration levels. Net international migration (arrivals less departures) in the year to June 2014 was around 213,000 – of which 73,300 located in NSW (most whom would have located in Sydney).

When it comes to interstate migration, the level of outflow of residents from NSW to other states has slowed considerably in recent years. In the year to June 2014, there was a net loss of just 6,857 residents. Back in 2004-2005, NSW recorded a net loss of 26,321 people. This means a higher proportion of Sydney residents are now staying, putting further pressure on the demand for housing.

The recent growth in Sydney's population is set to continue. The NSW State Government is forecasting positive growth for metropolitan Sydney of 1.6% on an annual basis out to 2031 – this equates to population growth of 1.575 million over the 20-year period to 2031, or growth of 78,775 per annum. Therefore, at the current (2011 Census) rate of 2.7 people per household across Sydney, an additional 29,177 new dwellings are required per year to match demand based on past household formation rates.

4. Supply

We simply haven't been building enough houses in Sydney to meet this demand and this is putting upward pressure on prices.

In the past five years, there have been 195,920 dwelling commencements in NSW compared to 272,243 in Victoria – that's a staggering 28% less dwellings built in NSW (*ABS – 8752.0 Building Activity*). In 2011, commencements totalled just 33,433 in NSW compared to 54,606 in Victoria. In 2014, commencement levels were up 47% on 2011 levels, however at 49,313 commencements NSW was still lagging Victoria with 58,330 commencements.

Despite recent efforts by the Baird Government to speed up the release of land, Sydney's land release program has generally lagged. Sydney also has a convoluted planning process that leads to significant delays and risks in the development process, which adds to the cost of development (higher financing costs and statutory costs such as rates and land tax) which ultimately gets passed on to the price of land and housing. Victoria has a much more transparent planning system and this is one of the key reasons Melbourne has been better able to respond to demand and kept the price of land well below that of Sydney.

Decisive action by both State Government and the 43 councils in Sydney (that is way too many but I'll leave a discussion of council rationalisation for another day) is required to remove roadblocks and reform the planning system to bring onto the market much-needed new housing supply.

5. Cost of land provision

The cost of providing the basic raw material – land – in Sydney is higher than any other Australian city due to planning delays as noted above and infrastructure charges. According to the HIA – Core Logic RPData Land Report for September 2014, the median residential lot value in Sydney was $320,000 compared to $220,000 in Melbourne.

Historically, the NSW government covered the cost of providing infrastructure for new housing from general tax revenue. Over recent decades, state policies have shifted toward user-funding of infrastructure, which has meant a significant increase in the private cost of development.

Urbis (*National Dwelling Cost Study for the National Housing Supply Council – 2011*) estimates that in 2010 total government charges (excluding GST) levied on Sydney developers was approximately $60,000 per greenfield dwelling, and between $20,000 and $30,000 per greenfield dwelling in other cities. For infill developments, total government charges levied on developers for greenfield developments are approximately $20,000 to $25,000 per apartment in Sydney and Brisbane and around $10,000 per apartment in Melbourne and Perth.

6. Fragmented land ownership and geographic constraints

The ownership of land on the urban fringe of Sydney is highly fragmented. As Sydney grows, having multiple owners on the fringe makes it more difficult and costly to amalgamate and bring large parcels of land to market.

Unlike Melbourne, Sydney is geographically constrained on all four boundaries by nature which is limiting the release of cheap land on the urban fringe. Some could argue that is a good thing as it prevents even further urban sprawl. But the simple fact is less land availability means higher land prices.

7. Foreign investors

Foreign investor activity in the Sydney market has been rising, reflecting a global search for yield, a lower Australian dollar and the increased interest in Sydney from Asia, particularly China.

It is true that in certain parts of Sydney foreign capital is driving prices higher. Some inner city apartment markets and the higher price point suburbs such as Point Piper in the east and Mosman in the north have witnessed strong price gains off the back of foreign buyer demand.

Despite the hype surrounding foreign investment, the November 2014 House of Representatives' Standing Committee on Economics Report on [foreign investment in residential real estate] concluded:

"… that foreign investment is not causing the market distortions that have been advocated in some quarters, particularly for first home buyers. This is because foreign investment levels are not large enough to do so overall and because overseas buyers mainly operate at a different price bracket from first home buyers and buy different types of properties."

We should not forget that a significant component of this international investment is going into new development which is contributing to the increase in supply. The Report also concluded:

"The housing supply issues that have been on-going in Australia would worsen if foreign investment was curtailed. One of the likely outcomes of any restriction on foreign buyers could therefore be further price increases – the opposite to what some in the community believe would occur if foreign investment was further restricted".

The RBA, which has also downplayed the role of foreign investment in driving house prices, concludes that foreign purchases:

"… are for new, high-density, inner-city properties, as well as properties close to universities. Furthermore, the properties they purchase tend to be valued well above the average national sales price. In contrast, most purchases by first home buyers have been for established homes that are priced well below the national average … and it is, in many ways, not surprising that house prices have gone up, because interest rates are very low, and, as I said, population growth, now at 1.7 per cent a year, is reasonably robust. Those two things help to explain why house prices have gone up."

Foreign comparisons

Finally, we are increasingly bombarded with overseas commentators pointing out Australian, and in particular Sydney, housing is amongst the most expensive in the world. Whilst on most raw measures it is, one thing these commentators often forget to take into account is our geographic location.

Australia is one of the most urbanised nations in the world, with 80-85% of the population living within 50 kilometres of the coast and 67% living within our capital cities. If we compare the prices of Australia's capital cities to other global coastal cities, Australia is not that different to other countries. However, when compared on a country-by-country basis Australia, looks expensive because the analysis does not allow for the price differential between coastal and inland locations. Of the top 10 least affordable cities in the world, of which Sydney is one, only London is not a coastal city (Table 1, below).

Table 1: 10 Least affordable major metropolitan markets: 2015

Rank: Least Affordable	Affordability Rank (Out of 86)	Nation	Metropolitan Market	Median Multiple
1	86	China	Hong Kong	17.0
2	85	Canada	Vancouver, BC	10.6
3	84	Australia	Sydney, NSW	9.8
4	82	U.S.	San Francisco, CA	9.2
4	82	U.S.	San Jose, CA	9.2
6	81	Australia	Melbourne, VIC	8.7
7	80	U.K.	London (GLA)	8.5
8	79	U.S.	San Diego, CA	8.3
9	78	N.Z.	Auckland	8.2
10	77	U.S.	Los Angeles, CA	8.0

Source: Demographia – 11th Annual Demographia International Housing Affordability Survey: 2015

Conclusion

There is no question that rising prices, auction clearance rates consistently above 80% and falling yields, are pointing to a Sydney housing boom. It is not sustainable but we don't expect a major price correction for the reasons we have outlined above. Rather we would expect the rate of price growth to slow during the remainder of 2015.

When the Sydney housing market starts to lose momentum, some investors will be left holding a very expensive but low yielding asset with a lower-than-expected rate of capital gain.

Prospective investors would be wise to use some caution when considering an investment in the Sydney market. Just as we pointed out earlier, the national housing market is not homogenous, nor is it within the Sydney market. Sydney is a diverse market accommodating many different buyer preferences and price points. There are certainly pockets now where prices have run too hard and are above fair value and that is where the risk concentrations are being built up. Investors should focus on housing that is well located around good public transport hubs, educational facilities and retail centres.

One caveat on our outlook. With the ratio of household debt to income at record highs, the Sydney market will respond swiftly to any perception of interest rate rises, any contraction in global banking liquidity or government intervention. We welcome the recent moves by APRA and ASIC to increase their surveillance of home lending by banks, especially to investors. Prudent lending is critical to ensuring the strong Sydney market does not end in tears.

Adrian Harrington is Head of Funds Management at Folkestone Limited (ASX code FLK). This article is general information and does not consider the personal circumstances of any investor.

What real estate agents don't tell you

by Graham Hand on July 9, 2015

Explore the rear entrance of an apartment hotel or resort that is more than five years old and take a look at the contents of the skips in the lane outside. They are often full of sofas, dining chairs, mattresses and televisions. Seven years earlier, when the proposal for a shiny new building was just a model in a display apartment for off-the-plan sales, hundreds of dreamers signed up to buy apartments. They also agreed to a furniture package for $40,000 to allow the building to operate as a hotel or resort. After years of people on holidays staying in the rooms, jumping on the sofas and leaning back on the chairs, the furniture needs replacing. Over the five years, that's another $8,000 a year of costs to write off for each owner. It's not such a dream now.

A few years later, the apartment will probably need a new bathroom and kitchen. How many years of income will that cost?

If you don't believe a sofa lasts only five years, you've probably never owned one of these short-let apartments. Hundreds of kids and honeymooners and party animals have enjoyed themselves on the furniture while on holiday. Have you ever watched coverage of schoolies week?

The most misleading number in investing

Real estate agents quoting gross yields on residential property are using the most misleading number in investing. The costs associated with residential property consume most of the income, leaving uninformed investors blind to the actual returns until the expenses start to come in. In an era where the professionalism of financial advisers is slammed daily in the media, many property agents get away with poor disclosure without comment.

Obviously, this is not a marginal asset class few people care about. Residential real estate in Australia is worth $5.8 trillion, and it dwarfs listed equities of $1.6 trillion and superannuation of $2 trillion. It accounts for over half of Australia's wealth (see [CoreLogic Housing and Economic Market Update, April 2015]).

Why are gross versus net yields so important for real estate?

Invest in a term deposit at 3% and you will earn 3%. There are no other costs involved. In equities, the effective yield earned can be better than the quoted dividend rate when imputation credits are added back. But residential property is the opposite. Net yields should be the main focus because expenses are high and unavoidable, even if the property is left empty.

A typical commentary on a real estate 'entertainment' programme goes like this:

"Is this a buy or a sell? It's a one-bedder only 10 kilometres from the centre of Sydney, close to buses, 65 square metres, asking $750,000, would rent for $650 a week."

"Well, the starting point is you don't want to be out of this market," replies the agent confidently. "This place will be worth $50,000 more in a year – that's $1,000 every week. And look, $650 a week is about $35,000 a year, that's a yield of 4.5%. Where can you get that today?"

Can you imagine what ASIC would do to a licensed adviser who spoke like that, or included it in an offer document? Prices do not always rise, and that yield is not available by buying that apartment.

CoreLogic quotes rental rates of 3.7% for 'combined capitals' across Australia, but this number is gross rental yields (for example, see page 7 of above-linked report). It's the number the industry loves to talk about. But even if we put aside stamp duty, legal costs, borrowing costs and vacancies, what about the regular costs of owning a property? These are the ongoing drains on income that are often overlooked. According to a Reserve Bank of Australia Research Paper, 'Is Housing Overvalued' (June 2014), the running costs of long term rental properties are 1.5% per annum, and transaction costs of 7.3% averaged over ten years are 0.7%, giving costs of 2.2% per annum.

That takes the net yield to 1.5% before allowing for repairs and maintenance. Reality is completely different than the real estate brochures and entertainment programmes convey.

How do management rights work?

When a large apartment building is constructed, the lots or units are purchased either by people who want to live in them (owner occupiers) or let them (investors). The 'management rights' to the building are sold by the developer, which gives the manager the right to charge a fee to look after the building and in some circumstances, run a letting scheme. The manager estimates how much income the building can generate when deciding how much to pay for the rights.

Of course, there are hundreds of thousands of different schemes in Australia, ranging from small premises run by mum and dad to professional managers (including listed companies) who may pay up to $15 million to manage a large, prestigious building by the beach with great views. The management rights might include running a restaurant, a reception centre, housekeeping, a real estate business as well as the letting and maintenance. Income includes payments from the body corporate, plus owners who enter a letting agreement pay a percentage of the letting charges, say 8% for long term letting and 12% for short term. The vast majority of apartment buyers in a hotel or resort sign up with the manager because there are efficiencies in one person managing the whole building. But what the buyer does not realise is that every change of a light bulb, every adjustment of the remote control, and every time the room is cleaned is a money-making opportunity to recover that $15 million.

Higher income, higher expenses

An apartment costing say $500,000 might rent permanently for $500 a week, but as part of a hotel, $250 night in high season. How can this not

Table 1: Extracts from tax returns for typical short term letting apartments

Type	Estimated Value	Financial Year	Income	Expense	Net income
1 bedroom NSW	$500,000	2013/2014	$62,475	$46,881	$15,594
		2012/2013	$56,248	$40,083	$16,165
2 bedroom QLD	$500,000*	2009/2010	$20,944	$29,684	-$8,739
		2008/2009	$24,740	$31,388	-$6,648
		2007/2008	$26,631	$31,473	-$4,842
3 bedroom QLD	$350,000	2013/2014	$27,946	$28,018	-$72

*Bought in 2004 for $500,000, sold in 2011 for $505,000 (gross before costs).

Table 2: Detailed income and expense returns

Income or Expense	3 bedroom QLD	2 bedroom QLD	1 bedroom NSW
Rents received	$27,946	$20,944	$62,475
Expenses			
Advertising for tenants	$922	$264	$3,124
Body corporate fees	$6,246	$7,309	$8,247
Cleaning	$3,693	$4,099	$15,568
Council rates	$1,458	$3,521	$936
Depreciation on plant	$1,422		$2,123
Insurance	$931		
Property agent fees	$3,689	$8,683	$8,205
Repairs and maintenance	$671	$4,793	
Special building write off	$1,772		
Water charges	$1,666		$694
Linen	$2,419		
Electricity	$1,121	$834	
Total expenses	**$28,018**	**$29,684**	**$46,881**
Net rent	**-$72**	**-$8,739**	**$15,594**

(Tax returns do not use the same categories in every case).

be a better deal? Consider the examples in Table 1 of well-established apartments in hotel or resort schemes targeted at short-term letting.

The expenses from short term letting are far more than permanent, especially costs such as cleaning and replacing equipment. Owning an apartment for short term letting can be an annoying experience of monthly expenses to maintain the apartment to the standard required by the hotel or resort manager. Table 2 (above) contains more detail from the tax returns of these apartments.

It's hard to believe a small apartment can incur $47,000 in costs a year. People who put their apartments into these letting pools are probably prepared for some of the same costs as long term rentals, such as strata fees and council rates, but who expects regular costs such as those shown in Table 3 (next page)?

It's a monthly crap shoot. The owner pays $360 a year for the phone system, and could buy the television for a year of hiring fees. The dry cleaning can be $100 a month. The cost of cleaning a one-bedroom apartment after one night is an unbelievable $73. How long does it take to clean a small apartment in a building with 200 such apartments? If you think the management fee should cover the quick visits to the apartment and complaints by guests, read the fine print. There is no way of knowing how often a light bulb is replaced or a bed cover dry cleaned. Who dry cleans a shower curtain every month? That $1 light bulb costs $23 to replace. This is a big money earner for the manager. A guest might stay for one night and after expenses such as booking agent fees, advertising levy, housekeeping and repairs, little is left for the owner. It's not worth the wear and tear on the apartment.

Who cares, capital gains and tax deductions are more important than income

Many investors may consider the income to be a minor part of the expected return, especially if they realise it's only likely to be 1.5%. Residential property prices in Sydney were up 14% in the year to March 2015, so a few dollars in expenses is tolerable (although it was less than 5% per annum for the decade before 2015).

There's a problem here as well with short term letting. Most owner occupiers do not want to live in a building where the majority of other tenants are holiday-makers. These visitors are out to have a good time. They party late at night, crash their suitcases into the lifts and walls, drag their wheels across the floorboards or carpets, return from the beach in their towels and drip on the furniture. The kitchen benches get scratched, the carpet must be cleaned regularly and equipment is stolen.

Table 3: Examples of specific expenses in short term letting

Typical Expenses	Amount
Cost of cleaning one-bedder after a one night stay	$73.32 per night
Assist guest to use air conditioner	$13.68
Fixed bath tap and repaired toilet roll holder	$27.35
Fixed oven	$13.68
Dry clean doona	$64.90 regularly
Dry clean blanket	$43.78 per month
Fixed loose dining table	$13.68
New knife	$20.00
Cable TV	$47.85 per month
PABX	$30.53 per month
Replace blown light bulb	$23.36
Fixed DVD player	$13.68
Pest control	$16.50 per quarter
Repaired bed wheel	$13.68
Fixed fridge and reset	$13.68
Dry clean shower curtain	$26.40 per month
Rehooked curtain	$13.68
Fixed leaking toilet	$27.35
Reset microwave oven	$13.68
Television hire	$37.00 per month
Refit towel rail	$54.00

People who assume guests look after the room in the same way they look after their own home don't know how some people live. A permanent resident living in a building does not want to battle a lift full of suitcases every time they leave their apartment.

So the secondary market sales of these apartments are usually not to owner occupiers, and the building gradually becomes dominated by short term lets. The major buying force that pushes up the price of real estate, the person buying their dream home, is not in the market. The premises are also subject to intense wear and tear, and the foyers are full of holiday brochures and bags and screaming children and people waiting to check in or out. So these apartments are worth less than in owner occupied buildings. Investors ask to see the net return after five years, the tired furniture and dirty carpet, and the income yield is not enough to create demand unless the price is relatively low. In many locations, these apartments in hotel schemes are the cheapest in town. It's no surprise the two-bedder listed above made a large capital loss after expenses (stamp duty, agent's fees, legal fees) despite seven years of ownership.

At least the loss is a tax deduction, able to be offset against other income. But buying an asset to create a loss and a tax deduction is a strange way to build wealth. Many investors talk about the 'tax deduction benefits' as if that is a good aim in itself. The only reason it's a tax deduction is because it's a loss.

OK, but at least I can holiday there

How about justifying the purchase by using the apartment once a year for a holiday? Forget it. The time of the year when the rent is the best is also when the owner wants to use it. Don't confuse an investment with a lifestyle decision such as a holiday. Anyone who wants a week in a resort should pay for a week in a resort, not a year of problems owning the place.

Graham Hand is Editor of Cuffelinks and is now onto his third sofa in an investment property. He will soon write another article on some of the merits of residential real estate. This article is for general educational purposes about a specific market segment, and individuals should obtain their own professional advice.

Where to from here for house prices?

by Roger Montgomery on October 22, 2015

No rational valuation measure produces a number for local house prices that even remotely approximates what houses and real estate sell for in Australia. But does it follow that a bursting is the only route from here?

For decades residential housing has sold on gross yields of 2% to 5%. Inverting the yield – and remember we are talking 'gross' yield here, which does not count the cost of maintenance, taxes, interest payments or management fees – houses have frequently traded on multiples of 25 to 50 times the gross earnings. Let's agree houses aren't cheap.

What drives house prices?

In the very long run, it isn't demographics or interest rates or immigration or construction costs or any of those things that makes investing in your home a sensible decision. What makes residential real estate investment essentially a sensible decision is that you are effectively short the Australian dollar. Not against other currencies but against itself, its purchasing power.

Housing becomes worth more over long periods of time because the purchasing power of the dollar declines due to inflation. The house that was bought decades ago is worth more in dollar terms, especially based on the land value (so the argument is not as strong for densely-built apartments).

In Australia, home ownership is hailed as a worthy aspiration. Tax structures such as zero capital gains tax on the primary place of residence and the deductibility of interest costs against residential property income as well as legislated incentives such as the first home buyers grant, have contributed to the pursuit of real estate as a worthy investment. That feeds its popularity and Australians' predisposition to it.

Then add to the mix the accessibility of credit. With a deposit of 10% or less and low interest rates, and many properties become relatively attainable and even affordable.

What has happened to long term house prices?

If one believes that housing is a way to short the dollar, then it should be that house prices will generally follow inflation. The Herengracht Index is the longest study ever of house price changes – following house prices along the Herengracht canal in Amsterdam. Created by real estate finance professor Piet Eichholz of Maastricht University, the index goes back to the construction of the Herengracht in the 1620s and was first published from 1628 up to 1973, later extended to 2008.

The strip of homes in the index has always been some of Amsterdam's most favoured and attractive real estate. This stability renders the index a useful tool for understanding how inflation-adjusted real estate prices change over time.

It shows that between 1628 and 2008 – 380 years – house prices rose and fell but on average the real price merely doubled. This corresponds to an average annual real price increase of about 0.1%.

In Australia long term studies have also shown prices followed inflation but only until the 1970's when prices in Australia detached from their correlation with inflation and started to follow incomes, in particular the rising incomes of the baby boomers.

Demographics and immigration are supportive, on a net basis, for house prices in Australia. While individuals are studying longer and starting families and careers later, all cohorts from their early thirties onwards provide support to house prices.

Finally, in the shorter term, interest rates, employment, foreign investment and lender behaviour will have an impact on house prices as will changes to zoning and other government interferences.

When crowd psychology takes over

From time to time, these short-term influences combined with the mystery of crowd psychology corrupt an otherwise sound premise and an appropriate valuation.

In all bubbles the sound premise that once catalysed the favourable change in prices is forgotten and all that matters is that prices are expected to rise materially in the future as they have in the past. At some stage, if prices keep rising they become self-reinforcing. The mere fact that prices are rising confirms to the onlookers that the original premise remains sound. And those commentators who might warn of impending doom are discredited by the rising prices.

The price one pays always determines one's return, so the higher the price, the lower the return. There is also a difference that exists between investing and speculating. Investing is where funds are committed today in the expectation that more funds will be produced later from the operations of an asset. Investing therefore doesn't care whether the stock market or property market is open or not. A sufficient return can be made from long-term operation or development of the business or the property. Speculation, on the other hand, cares less about the asset and more about the change in price.

Combining the concepts together produces some insight into the development of a bubble from otherwise more normal changes in price. When activity switches from being investment-like to speculative the risks of a bubble forming are heightened. And when speculation is justified by apparently rational arguments – such as the weight of money argument that Chinese investment in Australian property will keep house prices supported – the risks that the seeds of an even bigger bubble will germinate start to increase.

The role of banks

Those risks are also fuelled by profit-motivated financial institutions holding the keys to the cash register amid cheap credit. In the pursuit of growth and maintaining their competitive position, lenders can fuel the already speculative flames by loosening otherwise sound lending practices.

And this happened in Australia. Earlier this year, ASIC found 'troubling' flaws in credit standards in the interest-only mortgage market, which represents 37% of home loans held by banks, building societies and credit unions. Interest-only loans have grown by about 80% since 2012 and we now have low and no deposit loans, which leave the borrower with little or no margin of safety if their circumstances change. A pin awaits every bubble and how toxic the aftermath becomes is directly proportional to the level of gearing that fuelled the rise.

ASIC's review of 140 customer files held by banks and credit unions revealed that lenders incorrectly calculated how much time the borrower had to repay the principal when the interest-only period ended in 40% of cases. In about one-third of cases, ASIC found no evidence the institution had assessed the appropriateness of the product for the borrower and in more than 20% of cases, the lenders had not appropriately assessed the borrowers' living expenses.

When house prices compared to incomes are stretched and those incomes have been estimated incorrectly, the seeds for an ugly reckoning are planted. The question is whether they will germinate and mature, resulting in a bursting.

If in the US, a decade ago, Freddie Mac and Fannie Mae had been required by regulators to lend only based on 30% deposits, and to verify incomes and expenses, and to ensure loans were limited so that payments only amounted to one-third of incomes, the bubble in property prices that preceded the GFC might have been prevented.

The average house price in Sydney consumes more than 65% of the average income of a borrower geared to 80%. The reversal of the resource boom and the end of automotive manufacturing in Australia will leave holes in job prospects. We also know that throughout history prices for assets have risen spectacularly when interest rates are low.

The signs are changing

Unlike the US a decade ago, we have already seen regulatory changes to investment lending growth, lending practices and foreign investor permissions that may just be enough to prevent any bubble from inflating too fast or too far. The increase in bank capital charges for residential mortgages has already forced banks to increase their rates on investment loans, and last week, Westpac took the highly unusual step of increasing rates on owner-occupied variable rates out-of-cycle with a change in the cash rate. Other banks will follow.

Plus, the banks are imposing quantitative limits on investment lending, and publishing postcode lists where they believe valuations are stretched and warrant extra deposit margins. Anyone who has tried to borrow to finance an apartment in the last few months has experienced a different attitude to a year ago. Auction clearance rates are now at their lowest level for three years.

All of this suggests some of the steam will come out of the housing market now. Of course asset prices never move in steady straight lines so a smooth transition to lower prices might not be possible. The oversupply in apartments currently under construction and the replacement of local bank lenders (who are baulking at oversupply and poorer developer standards) by Malay, Japanese and Chinese banks suggests the road could still be bumpy for investors who have overstretched.

Many investors buy and then worry about a crash. Perhaps the solution is to wait for a crash, or at least a long pause, before buying and have a lot less to worry about.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is for general educational purposes and does not consider the specific needs of any individual.

Real estate social infrastructure coming of age

by Adrian Harrington on November 19, 2015

Investors are increasingly turning their attention to real estate social infrastructure sectors such as childcare, seniors housing (manufactured housing, retirement villages and aged care), student accommodation, government premises (police stations, courthouses, etc.), medical and health facilities as legitimate investment options.

Positive drivers

The growth in real estate social infrastructure opportunities is primarily being driven by:

- demographic and social changes – our aging population is increasing the demand for seniors housing and health services, higher participation of females in the workforce and the growing number of 0-5 year olds is increasing the demand for childcare whilst the rise of international students is one reason the student accommodation market is booming
- the demand for better quality facilities – operators (tenants) and their customers are requiring higher quality facilities. For example, the childcare sector is moving from 'child minding' to early learning which is changing the design and layout of centres away from converted houses, the health care sector is being driven by advances in medical technology and procedures and the aged care sector, supported by government regulation on quality standards, is increasing the demand for higher quality aged care facilities
- government financing and budget constraints – the public sector's ability to fund the level of infrastructure required to meet the needs of the community is under pressure and governments are increasingly seeking private sector participation
- relative high population growth rates and greater density and urbanisation of our major cities – increases the need for investment on social infrastructure assets that support communities both in the inner city and on the urban fringes and
- the growing realisation that operators should focus on their core business – managing and delivering services to the community rather than the provision, ownership and management of the underlying real estate assets.

Drivers add to the investment quality

Real estate social infrastructure is an attractive real estate investment given:

- relatively high yields – social infrastructure assets typically have yields of between 100 and 150 basis points higher than major office, retail and industrial assets
- attractive lease structure – a combination of a long duration initial lease term of circa 10 years plus, inflation protection given rental increases are typically linked to CPI changes and a triple-net structure which means that all capital

expenditure and refurbishments related to the asset are paid by the tenant

- stickiness of tenants – tenants are inherently linked to their premises due, in many cases, to the specialised nature of the assets, particularly the internal fit-outs
- strong demand – the favourable demand drivers (noted above) for early learning, health and medical, student accommodation and seniors living
- government support – many of the social infrastructure sectors receive some form of government subsidies or payments and
- the attractive investment characteristics – social infrastructure assets typically exhibit low volatility and generate consistent cash flows as a result of the less cyclical demand drivers, and therefore, offer a low correlation with other asset classes, resulting in attractive diversification benefits for investors.

Risk of investing in social infrastructure

The benefits of social infrastructure assets need to be considered in light of the risks.

The key risk to investors is the specialised nature and often the critical importance of the operator leasing the asset. Owning a private hospital is a highly-specialised asset and having a well-capitalised and competent hospital operator such as Ramsay Health Care is critical. Successful investing in this sector requires a sound relationship between the operator (sometimes a government agency) and the real estate owner and an understanding of the underlying businesses operating within the facility.

Also, social infrastructure sectors to varying degrees have high levels of government regulation and intervention which are susceptible to change. However, this can also be a positive, especially if the government is partially or fully underwriting the cash flows of the sector.

While the increased operating leverage and other industry risks clearly warrant a risk premium, the sectors risk-reward profile has improved greatly as many of these social infrastructure sectors have grown and matured. For many of them, they are no longer a cottage industry. Consolidation of operators in the early learning, health and aged care sectors is well underway. Many of the operators are publicly-listed companies such as G8 in the early learning sector, Ramsay Health Care and Primary Health Care in the healthcare sector and Japarra, Regis and Estia in the aged care space.

Listed and unlisted investment options

There are now five sector specialist A-REITs and four sector specialist real estate developers and managers listed on the ASX providing exposure to early learning, manufactured housing, retirement,

Table 1: ASX Listed Real Estate Social Infrastructure – November 2015

A-REIT	Sub-sector	S&P Sub-sector Classification	Market Capitalisation $m
Folkestone Education Trust	Early Learning	A-REIT	535
Ingenia Group	Manufactured Housing/ Retirement Villages	A-REIT	410
Arena REIT	Early Learning & Medical/Healthcare	A-REIT	403
Generation Healthcare REIT	Medical/Healthcare & Aged Care	A-REIT	393
Aspen Group	Manufacturing Housing/ Caravan Parks	A-REIT	164
Aveo	Retirement Villages	Real Estate Manager/Developer	1,509
Gateway Lifestyle	Manufactured Housing	Real Estate Manager/Developer	663
Lifestyle Communities	Manufactured Housing	Real Estate Manager/Developer	254
Eureka Group	Manufactured Housing	Real Estate Manager/Developer	124

Source: IRESS

aged care and health/medical (Table 1). It is early days, as these entities represent less than 0.5% of the entire listed A-REIT and real estate manager or developer sectors. By way of comparison, social infrastructure real estate represents more than 20% of the market capitalisation of the US REIT Index.

The performance of the social real estate focused A-REITs has generally been positive. The two best performing A-REITs in the S&P/ASX300 Index over the three years to 31 October 2015 were both real estate-related social infrastructure A-REITs – the Folkestone Education Trust (early learning) and Ingenia (seniors living) with total returns of 30.8% p.a. and 24.7% p.a. respectively, outperforming the S&P/ASX300 A-REIT Index's 16.0% p.a.

The unlisted market is also embracing the real estate social infrastructure sector. Three notable unlisted social infrastructure funds are the Australian Unity Healthcare Fund which owns more than $760 million of hospitals, medical clinics, nursing homes, day surgeries, consulting rooms, rehabilitation units, radiology and pathology centres; the Folkestone-managed CIB Fund which owns a portfolio of police stations and courthouses leased back to the Victorian government; and the Transfield-managed Campus Living Villages Fund which owns a portfolio of student accommodation facilities in Australia, New Zealand, the US and UK.

Real estate is not only the big end of town

Much of the real estate media focus is on large office buildings, major shopping centres and infrastructure assets like toll roads and ports. Social infrastructure features solid demand drivers, the evolution of tenants from cottage industry operators and attractive investment characteristics. We expect real estate social infrastructure (both listed and unlisted) to attract more longer-term investment capital and become a viable component of many more real estate investment portfolios.

Adrian Harrington is Head of Funds Management at Folkestone Limited (ASX:FLK). This article is for general education purposes and does not address the needs of any individual.

Fixed interest investing

A journey through the life of a fixed rate bond

by Warren Bird on March 5, 2015

"You never really know a man until you stand in his shoes and walk around in them." Atticus Finch, *To Kill a Mockingbird.*

Fixed income securities – or bonds – have the most predictable returns of any asset class, yet they are often maligned and misunderstood by market commentators who want to call them risky.

Rather than launching into a conceptual response to these scurrilous accusations, this article takes a leaf from Atticus Finch's book. It walks in the shoes of an actual fixed income security, one whose days on earth are just about over, but which has led a long and fulfilling life. It looks back on this bond since 2002, reflects on the fluctuations in its price and reviews how it performed for investors who owned it. Hopefully readers will feel that they then know the asset class much better.

The security in question is the Commonwealth Government Bond that will mature on 15 April 2015 at the ripe old age of 13 years.

Issued in May 2002, it promised to make two interest payments every year until April 2015, when it will return its face value to its owners. Its annual coupon rate was 6.25%, so the payments would be 3.125% of face value each in April and October. The rate of 6.25% was in line with market yields at the time, so investors who bought into the issue outlaid $100 for $100 face value (it was priced at par) and sat back to enjoy the steady income over the next 13 years.

The first year

The bond's price didn't stay at par for long. A fixed income security with over a decade until maturity is a frisky sort of animal and moves quickly if you prod it. Nowhere near as jumpy as shares, but still twitchy.

As it happened, over the remainder of 2002 bond yields fell, so our April 2015 security sharply appreciated in value. By its first anniversary in May 2003, it was priced to yield just under 5%, with a market value of nearly $111.90 (see *Term deposit investors did not understand the risk* for a refresher on the link between bond prices and market yields). Two interest payments had been made, totalling 6.25% of the initial outlay, which when added to the mark-to-market gain of 12% made for quite a handsome return of 18% over 12 months.

Some investors bailed out at that point, locking in their gain. Those who bought the bond from them would now expect to earn 5% per annum over the next 12 years, with the 6.25% coupon payments being offset by the amortisation of the bond from $111.90 to $100 over that period.

That first year pretty much set the trading range for the first half of our bond's life. In yield terms, the market traded the April 2015 bond between 5 and 6% for several years.

Towards middle age

As the years went by, our bond became less frisky. To use the jargon of fixed income, it had a shorter duration. The next time the yield on the April 2015 bond got down to 5% was August 2005, when it had just less than ten years until maturity. Its price this time rose only to $109.

It's as if during its life a bond looks more longingly at its destiny – par value at maturity – and starts to resist the pressure on its price that is exerted by fluctuations in market yields.

By the later months of 2007 and into 2008, investors wanted higher yields to compensate for higher inflation. The April 2015 was traded in the market at a yield above its coupon rate and its price fell below par. Around its sixth birthday in May 2008 the yield peaked at 6.5%, meaning that it hit the low price point in its life. The market at that time valued it at $98.30.

Popularity explodes

Things changed quickly in the second half of 2008. As the global financial crisis unfolded the demand for government bonds exploded. Our April 2015, along with his longer term cousins, had never been more popular. As the world financial system risked collapse, and the global economy faced deflation risk, the yields investors were willing to accept from bonds plummeted.

During October 2008, we were once again back at 5%. This time, as our bond was older and thus getting shorter in duration, its price reached only $106.

However, it didn't stop there. As support for financial corporation debt fell in the opinion polls to all-time lows, the 'yes' vote for government bonds kept climbing. The April 2015 yield fell further – to 4.5%, then to 4.0% and eventually to a new low of just 3.5% by January 2009. Even though our bond now had only six years and a bit to maturity, it still had enough vigour to respond to this fall in yields with a price appreciation to $115. Heady days!

Popularity fades

However, after a while the smart money decided to move back into risk assets. Shares or corporate bonds – anything but government bonds yielding less than 4%. Just as quickly as our bond's popularity had risen, it dropped. By the middle of 2009 it was again yielding above 5% and its price had fallen below $105. It would trade there for a couple more years, until the financial crisis mark II arrived.

Popularity returns

Our bond carried a AAA rating throughout its life which became highly valued by global investors from late 2011 when sovereign wealth funds and central banks were attracted like moths to a flame to the Australian government bond market.

Most of this demand was for securities longer than the April 2015, but our bond was carried in their slipstream back to lower yields. They reached 3.5% again around September 2011, though its vigour was beginning to fade and our bond could only rally to a price of about $109 this time. It managed to appreciate a bit further over the next few months, hitting $111 for its tenth birthday in May 2012. But it took an incredibly low yield of 2.1% to get it there.

Amortising to maturity

Since then, our bond has been enjoying a relatively lazy life. Its yield has traded around 2.5% for most of this time and its price action has been dominated by a steady trend towards par, where it will be valued when it retires in a couple of months. Its owners for these past three years have been receiving $3.125 each half year in coupon payments per $100 face value, but for that to yield them 2.5% pa there has also been a gradual decline in capital value of just under $2 each half year.

The chart (next page) shows the price and yield history of the April 2015 bond in full.

A life well-lived

What have we learned from walking in the shoes of the April 2015 government bond?

First, that the life of a bond can sometimes be a wild ride. Its price fluctuated, sometimes rapidly, reflecting changes in market yields. Therefore, its short-term return also fluctuated. Rarely, if ever, was the annual return equal to the original yield of 6.25%.

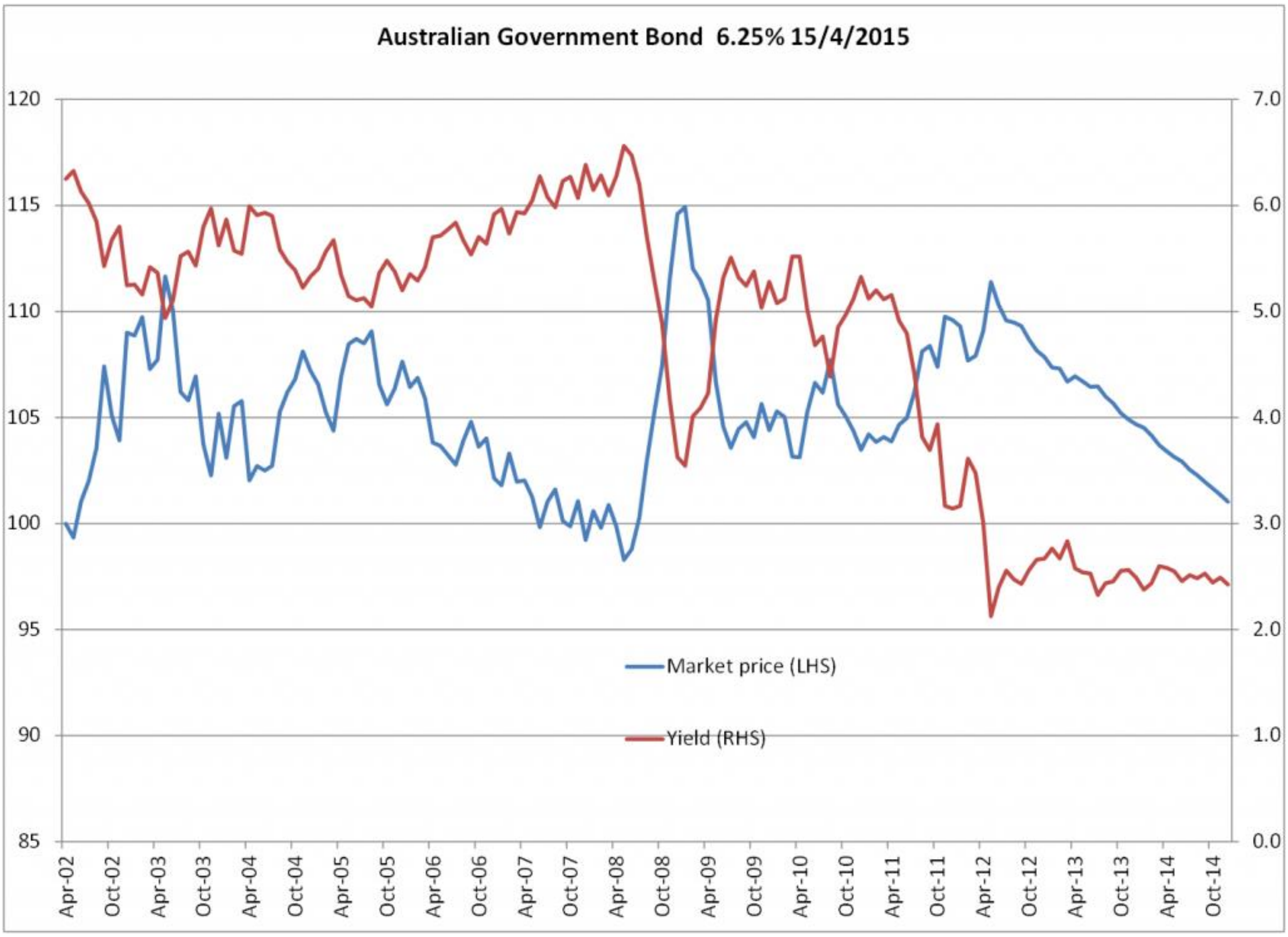
Second, every time the yield got back to 6.25% it was valued at par, but as it happens this bond spent most of its life trading at a yield below that level and thus at a price above par.

Third, the fluctuations became smaller as maturity approached and the inexorable pull of par value became stronger. A yield that early in its life resulted in the price being well away from par produced smaller and smaller premia over time.

Fourth, the bond never missed a beat in paying the regular interest promised when it was first issued. Over the whole of its life, the April 2015 bond delivered. And from any point in its life, its new owners continued to receive the promised coupons plus a predictable rate of capital price amortisation. They could, therefore, easily predict the long term return they would make on their investment.

As its name implied, it provided its owners a regular fixed income. It's been a bond's life well-lived.

Warren Bird is Executive Director of Uniting Financial Services, a division of the Uniting Church (NSW & ACT). He has 30 years' experience in fixed income investing, including 16 years as Head of Fixed Interest at Colonial First State. He also serves as an Independent Member of the GESB Investment Committee. This article is general education and does not consider any investor's personal circumstances.



A beginner's guide to peer to peer lending

by Jonathan Rochford on February 5, 2015

What is peer to peer lending?

Peer to peer lending (P2P) is an alternative to traditional bank intermediated lending. Potential borrowers and lenders are brought together on a website, in much the same way that Amazon brings together buyers and sellers of general merchandise. What is unique about P2P lending is that borrowers and lenders are often both individuals, instead of a traditional business to consumer loan.

P2P lending has gained prominence in recent months following the billion dollar IPO of Lending Club in the US. In Australia, Society One has attracted the country's second largest bank Westpac, as well as business moguls James Packer and Lachlan Murdoch as equity investors. Lending Club and Society One both specialise in personal loans, but the Australian website Balmain Private specialises in commercial property lending on a P2P basis. Ratesetter from the UK also set up in Australia a few months ago, while Lend2Fund is preparing to launch soon.

How does it work?

Potential borrowers submit an application form to the website platform, much the same as any other loan application. The platform's systems and staff then verify the critical information (borrower identity, credit history and employment), assess the risk of the loan, set the interest rate and put the application up on the website. Potential lenders review the available applications and select the borrowers they want to fund, in part or full. Once the loan amount is fully funded the website then passes the money from the lender/s to the borrower, minus an upfront fee.

Once the loan is made, the platform is responsible for the servicing of the loan, which encompasses processing repayments and chasing up missed payments. If the borrower defaults the platform handles the debt collection aspects but the lender bears any loss.

Why does it exist?

P2P lending is growing rapidly as it fills a number of gaps in credit markets. Firstly, P2P lending is primarily unsecured personal loans, which banks struggle to make at a competitive interest rate. These loans are typically for smaller amounts with a relatively high work load to establish and maintain. Banks generally prefer to offer potential borrowers credit cards as these deliver banks higher interest rates, a perpetual loan period and ongoing transaction revenue. As with many online orientated businesses, P2P lending has a lower cost of operation than bricks and mortar retail and thus it can offer lower interest rates than banks, which attracts potential borrowers.

Secondly, P2P lending currently offers high prospective returns to investors. In a world of ultra-low interest rates, gross returns of 6-25% are very attractive relative to bank deposit rates. For reasons explained later, these rates are likely to fall in the future but whilst competition is minimal and funding is somewhat restricted the higher expected rates of return will draw in potential lenders.

How new is P2P lending?

P2P lending in its current form dates back to 2005, but its roots can be seen right across capital markets. Non-bank lenders have brought together borrowers and capital providers for thousands of years. Stock exchanges have been fragmenting the ownership of companies into marketable parcels for hundreds of years. Corporate bonds have fragmented the debt of corporations for decades. Amazon has used the internet to bring together buyers and sellers of goods, with Amazon providing the platform for the products and the support necessary to facilitate the sales. In a sense P2P lending isn't new at all, it just uses modern technology to change the way some loans are made.

Is P2P lending risky?

Like all lending activities, P2P has the potential to range from very good to very bad. Subprime lending in the US showed that if done badly, supposedly 'safe as houses' residential lending can have default rates that exceed 50%. In contrast, many lenders to prime quality borrowers averaged default rates less than 1% per annum.

The first key test for P2P lending will come during the next economic downturn. Many P2P borrowers are living paycheque to paycheque (if they had savings it is unlikely they would need a loan) and don't have material assets to sell. As unemployment rises, it is likely that default rates on P2P loans will also increase. There is limited data available predating the financial crisis but what is available for Lending Club shows that negative returns were recorded in 2007 and 2008.

How will P2P lending evolve?

P2P lending suits particular niches within the credit markets, but it doesn't offer the prospect of completely removing banks from the picture. Loans that are relatively small, that don't involve overdraft or revolving facilities, or that are considered higher risk are most suited to a P2P platform. Shorter term (three years or less) unsecured loans to individuals and businesses are therefore the ideal targets. Secured business lending that goes just beyond the credit criteria that banks will allow is also fertile ground. Debtor finance, which uses unpaid invoices as security, is another attractive area for P2P lending.

As P2P platforms grow it is likely that individuals will be largely replaced by institutions as the lenders, as P2P platforms turn to cheaper institutional capital for their funding. This development would mirror the way that non-bank lenders in residential mortgages, commercial mortgages and auto loans obtain their funding through bank warehouses and securitisation markets. Moody's has recently rated a pool of P2P loans, with the lack of credit ratings previously a key hurdle to attracting more institutional capital. Banks and finance companies will ultimately set up competitor brands or buy out P2P platforms completely, with Goldman Sachs currently in discussions with the Aztec Money platform. What banks currently lack is the technology and entrepreneurship to start competing websites, but as the platforms are proven to be profitable they will attract funding and takeover offers from banks.

How should potential lenders analyse the risk?

In analysing the risk of any credit investment, the 5 C's of credit are a good starting point. These are:

Character: assessing willingness to pay
Cashflow: assessing ability to repay

Capital: assessing the equity contribution of the borrower
Collateral: minimising the loss if the borrower defaults
Covenants: restrictions to stop the risk level increasing

Where the typically unsecured personal loans of P2P lending differ from most other forms of lending is that capital, collateral and covenants are largely non-existent. Borrowers haven't saved much (no capital) and own few or no material assets that could be sold if they fail to repay their loan (no collateral). Being personal loans there aren't going to be any material covenants. This leaves character and cashflow as the main items to assess.

Character will be best shown by the borrower's credit history. Potential borrowers with a history of repaying their loans, credit cards and utilities on time and in full are the lowest risk. Borrowers with no history, or with a history of missing their obligations are higher risk. Cashflow assessment is a comparison of the borrower's income relative to their expenses. If the borrower has a good employment history and an income that easily covers their rent and other general expenses as well as debt repayments, then the risk will be low. If the borrower has irregular income or a scattered work history, then the probability of default will be much higher. If the borrower doesn't have a meaningful excess of expected income after meeting expected expenses, then the probability of default will also be elevated.

Conclusion

P2P lending is an interesting and potentially profitable addition to the credit investment universe. The use of new technology allows credit to be made available to more potential borrowers at lower interest rates. The place of individuals as the main lenders is likely to fade over time, with their replacements being banks and securitisation markets who can offer a lower cost of capital. As with all new markets, new entrants are springing up, with banks and finance companies likely to start competitor brands or buy existing platforms. When analysing potential loans, lenders should focus on the character and cashflow of the potential borrowers and remember that the higher interest rates paid by higher risk borrowers doesn't automatically translate to higher net returns.

Jonathan Rochford is Portfolio Manager at Narrow Road Capital. This article has been prepared for educational purposes and is not meant as a substitute for professional and tailored financial advice. Narrow Road Capital advises on and invests in a wide range of securities.

Australia's government debt and its 'lazy balance sheet'

by Ashley Owen on February 26, 2015

The Federal Budget and the level of government debt are hot topics in the media once again, so an update on the facts will provide some context for the debate.

Government debt levels and interest burden

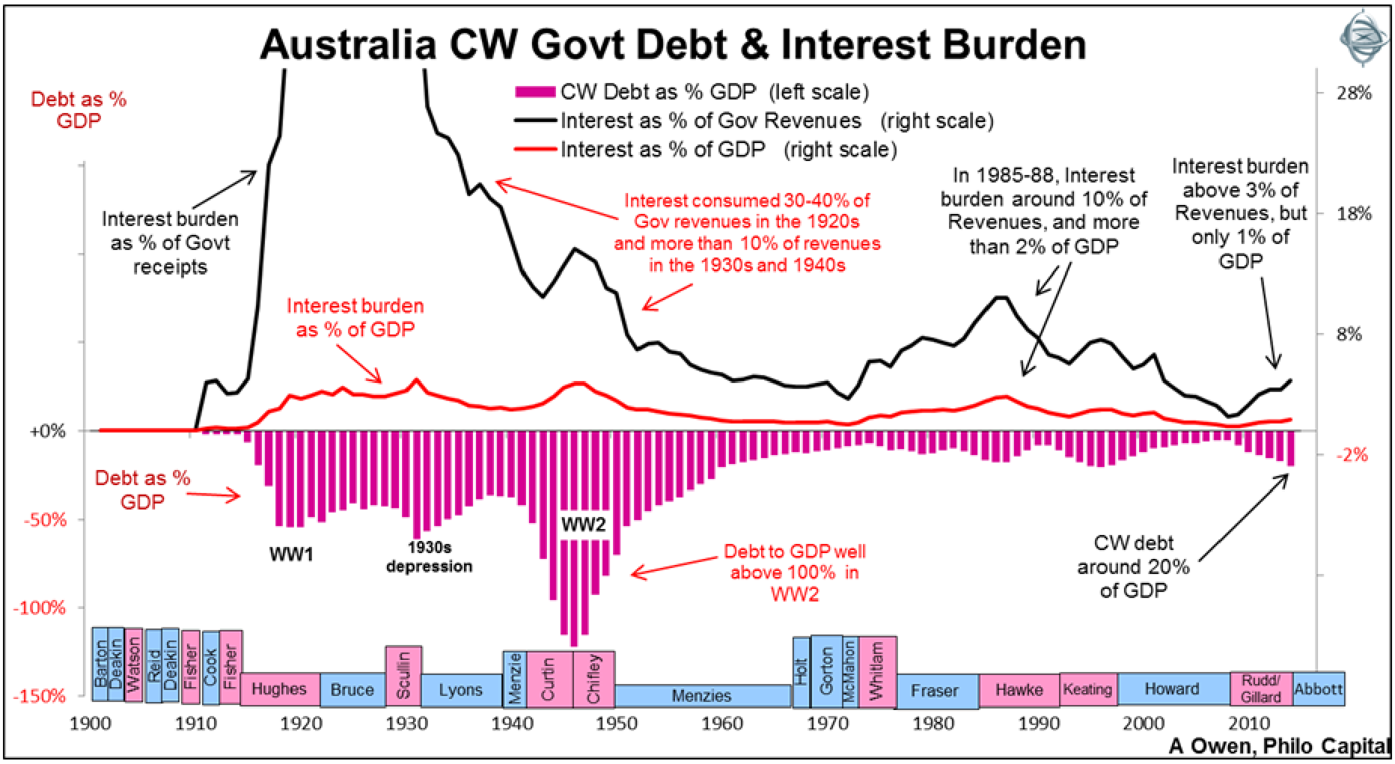
This first chart (next page) shows the level of Commonwealth (CW) Government debt measured in three ways:

- debt relative to national income (GDP) – pink bars on the lower section of the chart
- government interest burden relative to national income – black line
- government interest burden relative to government income (mainly tax receipts) – red line

Where we are now?

The current position (mid-February 2015) is that Commonwealth Government debt securities outstanding total $356 billion, or around 22% of national income (GDP). (Source: Australian Office of Financial Management)

But this excludes many other types of debts, including unfunded 'defined benefit' pension liabilities, other financial liabilities and



commitments and derivative exposures. It also excludes assets held to fund those other liabilities, for example, the Future Fund's assets to fund future government pension liabilities.

Interest being paid on debt securities is $16 billion per year or $44 million per day. This equates to 4.5% of Commonwealth Government revenues and about 1.1% of national income.

The above chart shows that on these measures the level of debt and the level of interest paid on that debt are very low, and on a par with the low levels of the 1950s to the 1970s.

Australia's debt-to-GDP ratio first increased dramatically to fund the war-time spending during WW1 and then rose again in the 1930s depression. The main reason for the increase in the ratio in the 1930s was the dramatic collapse in national income, not an increase in debt. In fact, between 1929 and 1932 the level of debt actually reduced by 15% but nominal GDP contracted by 31%.

Australia did not go on a Keynesian deficit spending spree in the 1930s depression like the US because we simply were not able to borrow. The Commonwealth and state governments had run out of credit availability in foreign debt markets by 1929, and the Commonwealth's then wholly-owned Commonwealth Bank refused to lend it more money. So the only option was to stick to the savage and deflationary austerity of the 1931 'Premier's Plan' and force all holders of domestic government debt into a haircut restructure deal not unlike the recent Greek debt restructure.

The chart shows that after WW2 the debt to GDP ratio reduced in the 1950s but it was not because the government paid off debt. The level of debt kept growing steadily, but the national income grew even faster, so the debt to GDP ratio declined although the level of debt rose. The rising level of debt was mostly put to good use being invested in productive purposes, mainly infrastructure to support the rapidly growing population, driven by the post-war 'baby boom' and the aggressive 'populate or perish' immigration program.

Interest burden

The black line on the above chart shows that interest payments on government debt consumed 30-40% of all government revenues in the 1920s (on a par with the PIIGS and Japan today) and it was still consuming more than 10% of revenues in the 1930s and 1940s (on a par with the US today). The interest burden was then brought down in the post-war boom in the 1950s and 1960s, as national income rose at a much quicker rate than the rise in interest rates.

In recent years the interest burden of government debt was at its lowest level ever in 2007-2008 when the level of debt was also at its lowest level.

However, the current interest burden (at around 1% of GDP and around 4% of tax receipts) is no higher now than it was in the 1950s to the 1970s. This is due to the relatively low level of debt and the relatively low interest rates today.

'Lazy balance sheet'

If Australia was a company its national debt would be labelled a very 'lazy balance sheet' and the CEO and Chairman would be thrown out by shareholders for not borrowing enough to invest for future growth!

Australia has always been a country in which the opportunities for growth and investment have far exceeded the local savings pool available to fund its development, and so it has always had to import people and capital, in the form of equity and debt.

Many people liken a country to a household, where it is prudent to have no debt, or at least to pay off debts as quickly as possible. However, a country is more like a company than a household. In a household, the breadwinner(s) stop generating income and have to draw down their accumulated savings during decades of retirement. Companies and countries can exist forever (in theory anyway) and they can (and probably should) carry debt as long as the cost of debt (interest) is lower than the additional income generated from the investments funded by that debt.

In truth, the reality for most countries is probably somewhere between these two views. Australia has an aging population and rising welfare and health costs, but it is still the best placed among its 'developed' country peers (in the OECD for example) thanks to its relatively favourable demographics. It is far better placed than Japan and northern European countries that have declining populations, declining workforces and declining tax-payer bases. Those countries are indeed more like households, where the breadwinners in aggregate are reducing their income-generating ability and are literally dying off.

Government deficits

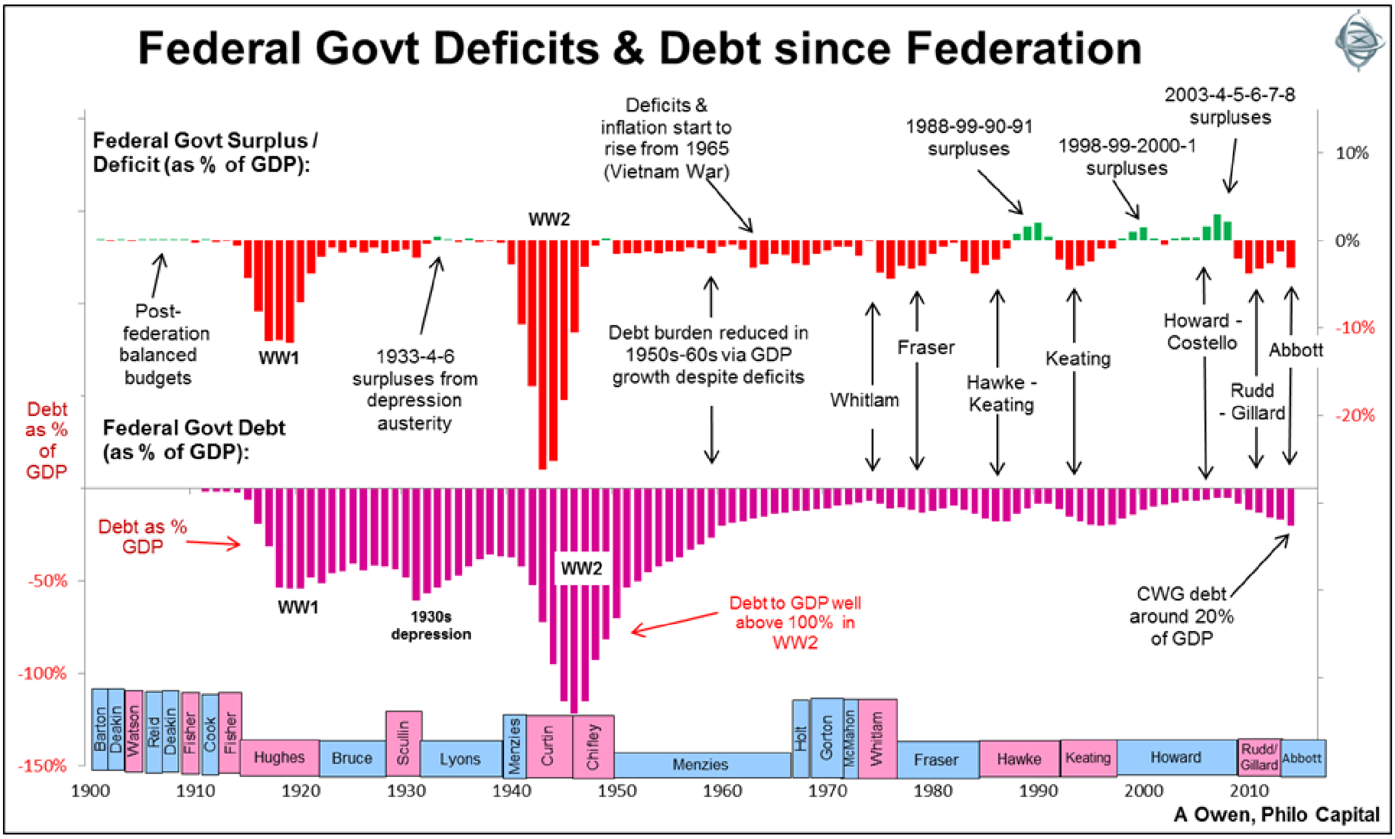
Governments borrow money when they run a budget deficit – where their outlays exceed their revenues. The second chart shows government surpluses or deficits for Australia (upper section of the chart) together with the Debt to GDP ratio (lower section) for reference.

The above chart shows that the Abbott government deficit performance (relative to national income) is similar to those under Rudd/Gillard, Keating, Hawke, Fraser and Menzies, but far lower than the deficits in both World Wars and in the 1930s depression.

'Good' or 'bad' debt?

When a household, company or country borrows money, the debt ideally should be used to generate future revenues that will repay the interest on the debt and also repay the principal due at maturity.

In the case of a household there is said to be 'good debt' (debt that is used to buy an asset or activity that generates enough income or capital



growth to more than cover the principal and interest on the debt), and 'bad debt' (debt that is used to fund lifestyle expenses). The argument goes that it is the same with a country, and debt used to pay pensions, welfare and healthcare costs fall into the category of 'bad debt' that must be avoided because it doesn't generate revenue to cover the interest on the debt. Whether it is good or bad debt, rising pensions, welfare and healthcare costs in a country with an aging population must either be kept in check or met with rising tax revenues. If not, it will require larger deficits and debts in the future.

Focus on income instead of debt

This brief story has shown that most of the big changes in Australia's Debt to GDP ratios over time were due to changes in the national income (i.e. the output from the economy) more than changes in the level of debt. While most of the shrill media debate is focused on the absolute level of debt, what is more important is a debate about what the debt is spent on, and whether it will maximise the productive capacity of the economy in the future.

Australia still has a relatively 'lazy balance sheet' (i.e. a relatively low level of debt) and is still a country with far more opportunities and development potential than the savings pool available locally to fund it, together with a growing and relatively young population relative to our 'developed' country peers.

With record low interest rates and global investors clamouring to lend us money, this is the time to borrow at ultra-low rates locked in for long periods and use the money wisely to fund long term projects to maximise Australia's long term economic growth. But that requires long term vision and that is sadly lacking in our leaders from all sides of politics in Australia.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.

Impact of house price falls on other assets

by Craig Swanger on April 23, 2015

For many years, The Economist and other commentators have claimed there is a 'housing bubble' in Australia. The property sector and Australia's banks say there's not. Given the implications for property and for investors in the banks that are themselves heavily exposed to property, it is an important debate. We briefly lay out both sides of the argument, and then show the impact on other asset classes should there be a correction.

Case against the bubble: supply not keeping up with demand

Several compounding factors can be blamed for the housing price increases (see Chart 1, next page):

1. Net migration has been more than double the long-term average since 2005
2. Foreign investment has also doubled
3. Annual increase in population due to births less deaths shifted to new records from 2005
4. Supply inflexibility as dwelling commencements have not increased since the 1980s.

Case for the bubble: fundamentals out of whack

The case against relies more on the idea that Australian housing should comply with some global benchmarks such as those shown in Chart 2 (next page). Regardless of which of these fundamental ratios are used, Australia comes across as one of the most expensive housing markets in the world:

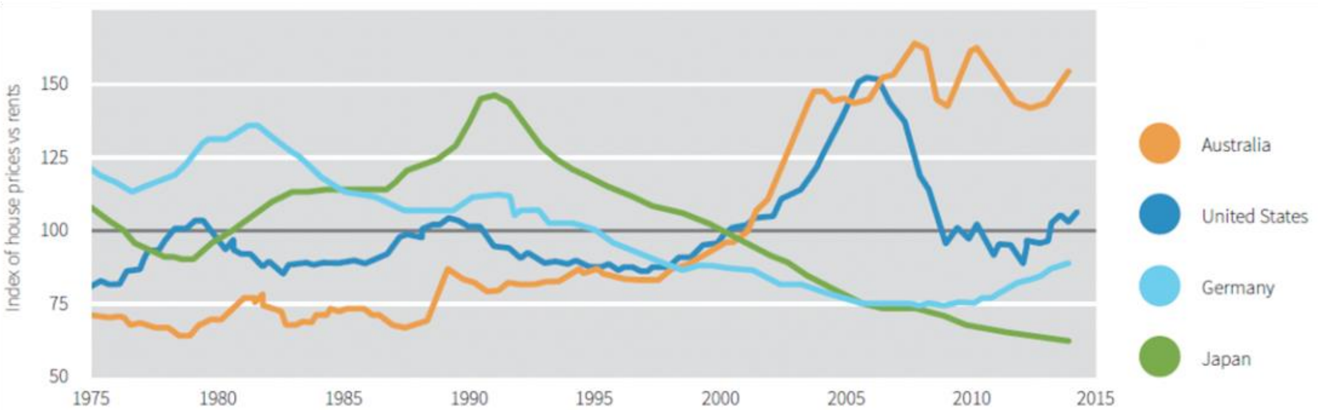
- Rental yield vs long-term averages – Only Britain and Canada are further from long-term averages than Australia. China is far below Australia on this measure.
- Inflation-adjusted price increases – 'Real' prices in Australia are up 2.8 times since 1975, compared to the US at 1.3 times.

Of course no-one knows whether residential property is due for a strong correction. All you can

Chart 1: House prices, Australia 1987-2014, compared to changes in supply and demand

Source: ABS, FIRB, RBA

Chart 2: Price/ rent index, various countries, 1975-2014 (higher the ratio, the more expensive the *capital values compared to rental income)*



Source: The Economist

do is be prepared and not over-exposed to the risk of a bubble, while not over-reacting, putting all your cash in the bank and potentially reducing your income. The key is to ensure you have the means to ride out any downturns without being forced to sell.

What impact would such a correction have on other asset prices?

Australians are heavily invested in residential property and so the impact of a property crash is obvious for those assets. But the impact on other investments is just as important to understand. Australia's banks have around 61% of their loan books exposed to residential property, and banks now represent 32% of the ASX 300 and are the top four holdings in the average SMSF portfolio.

Table 1 (next page) describes the potential impacts on other asset values from a material (e.g. 20%) fall in home prices.

Views on the direction of Australia's property market are mixed. Fundamentals should point to a fall in prices in the medium term, but Australia's unique geography and high immigration constantly defy economic fundamentals. In the face of such uncertainty, it is prudent to stay the course but ensure that you are prepared for the unlikely scenario of, say, a 20% fall in real house prices and that this won't have a material impact on your lifestyle.

Craig Swanger is Head of Markets at FIIG Securities Limited. This article is for general education purposes and does not address the specific circumstances of any individual.

Asset Class	Impact	Capital Value	Income
Cash/ Term Deposits	All TDs would be safe	No impact	No immediate change but rates would be lower on rollovers for several years.
Foreign currency eg USD	AUD will slump heavily. In previous downturns of the Australian economy, the AUD has fallen by up to 40%, meaning holding investments in foreign currency will see increases in capital value and income.	Increase with fall in AUD.	Income earned in USD will be worth more in AUD as the exchange rate changes.
Banks – Equities	Bank earnings would be severely impacted, as would their capital ratios resulting in lower dividends, more capital raisings	Expect falls of 40-60%, like 2008, but rebound would be slower	Dividends would have to be cut. In 1991-1993, the banks cut dividends by up to 75%.
Banks – Hybrids	Non-viability clauses don't get triggered until 30-40% falls, but the market will sell them off heavily as the risk of trigger rises	Falls could be as large as 50-80%. During 2008, hybrids sold off 30% and that was prior to non-viability clauses	Mostly unimpacted, some distributions could be deferred/ cancelled
Banks – Bonds	APRA's tests showed that no bank would fail even in their 35-40% fall in house prices.	Falls of 5-15% could be expected due to the credit deterioration of the banks' balance sheets.	Fixed rate bonds: no change. Floating rate would fall with RBA cuts
Equities – Other industrials	Profits from Australian sources would fall heavily.	Falls would not be as extreme as bank stocks, but expect at least 2008 falls, ie 30-50%	Some declines in dividends paid, but far less than banking sector
Equities – Resources	Will be dragged down by the overall ASX, but profits will be far less impacted due to the export earnings and the rising USD.	Smaller than industrials, but still significant falls.	Likely to be flat, but could even rise due to higher USD.
Other industrials and resources – bonds	Highly leveraged companies dependent upon domestic earnings will be stressed. Other industrials can be expected to meet obligations.	The lower RBA cash rate will push up bond values. High yield bonds likely to fall in value where credit quality is stressed.	Income can be expected to be unimpacted for most bonds. Floating rate notes will see lower income, but there are very few of these.
Equities - Global *(hedged, impact of currency considered above)*	If caused by a slowdown in China, global equities are likely to fall too, albeit by far less.	0-20% fall (as the most likely cause of an Australian recession is a problem in China)	no impact
Global corporate bonds	Unlikely to be impacted unless linked to the same cause.	No impact, unless held in foreign currency, in which case gains would be likely	No impact, unless held in foreign currency, in which case increased income (in AUD) would be likely
Hedge funds	Genuine hedge funds will be either unimpacted or will profit from the higher volatility	Small positive impact likely (0-10%)	no impact
Property – listed or unlisted	A residential property market fall of this magnitude will result in lower retail spending and lower rental growth for commercial and industrial properties.	A 20% fall in residential values will cause 15-30% in other property sectors. Falls in property investment values then depend upon the leverage	Rental income will fall with the fall in the economy. Leveraged property trusts will put distributions on hold as they have to pay interest on loans before paying any distributions
Property debt securities, eg RMBS	Even "B" rated RMBS notes will withstand a 20% fall in home prices.	Little to no impact. Credit risk will rise, so lower rated notes will lose some capital value, but will be offset by	Little to no impact

Other good stuff

The economic reality of breeding and owning racehorses

by Garry Mackrell on July 16, 2015

Australia is unique in the thoroughbred racing world in that ownership of horses is spread across a broad spectrum of Australians and is not just the province of royalty, the rich and famous. Indeed, there are some 100,000 owners or part-owners in Australia. Australia holds the second largest number of races per annum in the world after the U.S. and allocates the third most prize money (in excess of $500 million per annum) after the U.S. and Japan.

There are about 360 race tracks in this country. Each year there are around 36,000 racehorses (excluding steeplechasers and hurdlers) of which 30,000 are race starters racing on average six times a year at over 2,700 race meetings. So there is plenty of opportunity to be a participant and, you would think, be a profitable player somewhere in the value chain.

Before you jump in and decide a portion of your hard-earned could be invested in a Group 1 winner, maybe the Melbourne Cup, or even more profitably to breed and race a colt who wins the Golden Slipper and goes on to fantastic success as a stallion, let me provide a few insights which provide a reality check on your dreams of fame and fortune.

To attempt this in a short discourse I will necessarily restrict comment to some key statistics that drive the economics of the business, and some aspects of how to view risk and return in the main elements of the racehorse value chain.

(For the uninitiated, a male horse is born as a colt, and at four years old, becomes a so-called 'entire', or a stallion if he goes to stud. A female horse is born as a filly, and becomes a mare at four years old).

Industry and participant drivers

Prize money is rising steadily over time and although some major races are being allocated ever-more generous amounts, it is also being spread across regional and country race meetings.

Of the $500 million in prize money, $140 million goes to the 580 so-called 'black type' races, of which 72 are Group 1 races attracting nearly $70 million. Prize money for Saturday races in the major Eastern State cities ranges from around $40,000 to $85,000, mid-week city around $20,000 to $40,000, down to $10,000 to $30,000 for regional and country meetings. Prizes are skewed strongly to winners, falling to modest amounts if the horse runs 5th.

However, the numbers of horses being bred and raced is, somewhat surprisingly, falling steadily over time. Horses bred have fallen by a third over the past two decades; the breeding mare population is now around 23,000 of which 21,000 are mated. Although foal success rates have improved somewhat, the number of foals born is 14,000 a year. The number who go on to race have to be registered and in 2013/14, this was over 12,000, of which 9,000 were registered by age two, around 2,500 by age three and the balance (900) older. The number of foals sold at auction was around 4,000, with the surprisingly larger balance retained by breeders and owners for racing or breeding.

Even more starkly, the number of registered stallions has fallen over the past two decades from 2,090 to 670. Only about 100 might be regarded as significant players, of which 40 shuttle between Australia and northern hemisphere countries.

In 2013/14, of the 30,000 race starters:

- 4,200 did not earn any prize money
- 15,000 earned $1,000 to $10,000
- 10,200 earned $10,000 to $100,000
- 700 earned $100,000 to $500,000
- 50 earned greater than $500,000.

The bulk in each category, especially the larger amounts, were at the lower end of the distribution range. In earning these amounts:

- 18,000+ did not win a race in the year
- 7,000+ won one race
- 3,000+ won two races
- less than 2,000 won 3 or more races.

The ages of these horses ranged from nearly 3,000 running before age three, just under 8,000 each for under four and five, 5,500 under six and around 6,000 above six.

The above clearly demonstrates winners, and especially winners of valuable races, are very much in the minority and their time in the racing headlines, unless a tough, durable stayer, is around three or four years. Being the highly-refined athletes they are, they need a good deal of time to first learn the whole process of what racing is about, then achieving and retaining race fitness.

There will also be times they are injured. If healthy, they generally have two or three race campaigns a year where the aim is to run four to seven times and more as the horse matures with each campaign. Many never race for a wide variety of reasons.

The economics of racehorses

To appreciate why racehorse numbers are falling necessitates an examination of the micro economics of racing. While the purchase price of a yearling (the most common entry point for buyers) varies enormously from a few thousand dollars to occasionally in multiples of millions, studies around the world suggest the most profitable racehorses tend to cost between $70,000 and $250,000. The average sale price of yearlings sold in 2013/14 was $70,000, with the median at $35,000.

The intending buyer has the obvious choice of buying a filly or a colt. There is a positive bias in the price of colts, especially those with athleticism, pedigrees, conformations (correctness of bone structure), sound X-rays and dispositions which, if successful runners, may ultimately lead to them being stallion candidates. However, as seen above, the realisation of this dream applies to well under 1% of the racing population.

Conversely, a sound gelding can have a materially longer career. Fillies with similar attributes are also in demand, but generally their racing careers stop at ages of four to five years.

Our analysis, therefore, needs to distinguish between time in racing and the potential residual value a horse retains when it ceases racing. While there are material differences in purchase prices and later, nomination fees for horses running in the big prize money races, the actual costs of racing a horse are reasonably standard.

Assuming a horse costs $100,000, the aim is to progress from regional tracks to mid-week and then Saturday metropolitan class races and above. Budget to spend around $40,000 to $50,000 from purchase date to the time it first runs. In addition, there will be around $25,000 to $45,000 per annum in training fees, spelling charges, vets, farrier and chiropractic services, transport etc., depending on whether the trainer is city or country based. If you own a percentage of a horse, the above costs break down in the same proportion.

As a rough rule of thumb, if a horse can generate prize money of an average of $5,000 per race, implying sound regional and possibly mid-week city class, it is a horse which covers both its costs and has a good chance of paying back the purchase price. Earning an average of $10,000 per race is a Saturday city class horse and, if it stays sound, may double the initial investment. At $20,000 average per race, the horse is a probable ‘black type’, and $50,000 per race is exceptional and fortunate.

The probabilities of having a horse that fits each particular earning category is something I guesstimate as around 15-20%, 8-10%, 4% and 1% respectively of the population. Profitable investment is highly skewed to outliers.

When investing in most other asset classes (property, shares etc.), the most you can lose is your principal. Unless you are disciplined and are prepared to cut your losses early, if you persist in racing your horse without success, you will ultimately lose a lot more than your principal. Even if you make an early call, and especially if you have a slow gelding or an average-looking mare whose family is not progressing, the selling price might well be less than $10,000, often for country trainers to try their luck in weaker company.

With these considerations in mind, the market is becoming more highly bifurcated – horses with the athletic carriage, looks, pedigree etc are being increasingly sought after, whereas the greater population of more unimposing and average pedigree are increasingly lacking appeal.

It doesn’t mean the latter can’t be highly successful runners. It is a game of probabilities but buying prices are fundamentally driven by buyers’ imaginations of future glories of their glamorous purchase, including the horse’s potential residual value after racing. Regrettably, buying a piece of a $1 million colt is also no guarantee of success. Conversely, but equally frustrating, if you happen to have a champion racehorse mare, history shows such mares don’t always prove to be as successful as broodmares.

The obvious insight here is that returns from investing in racehorses are not normally distributed like most other asset classes. Buying a portfolio of 'average' horses will most likely result in significant losses. The search is for the few valuable outliers to pay for the rest (even here there will be significant volatility of returns from year to year).

Types of racehorse buyers

How racehorse buyers approach this lop-sided skew is significantly influenced by which group they derive from, including:

- wealthy individuals who are prepared to outlay large sums of money essentially in the pursuit of glory
- large horse studs which are focussed on breeding and acquiring their future champion stallion and broodmare lines which sustain their businesses
- family and other more boutique studs aiming for reliable broodmare lists
- famous trainers, ranging from those who have up to 180 horses in their stables, down to the country trainer with a handful of horses, all of whom have loyal clients with widely-ranging amounts of funds to outlay and who are repeat buyers of shares in the trainer's selections
- race syndication groups, where in order to avoid the impracticality of having to offer a prospectus, ASIC provides exemptions for racehorses purchased by 10 or fewer legal entities and 40 or fewer owners of a stallion. The target price range for the syndication groups tends to be $50,000 to $150,000.

The spread of ownership tends to be more widely distributed where the primary motivation is buying to race. Where the ownership is spread, after their race careers are finished, race mares are then sold privately or via public auction to the various breeding groups to dissolve the partnerships.

Residual value considerations

When investing in racehorses, due consideration needs to be given to whether the horse will have residual value after it ceases running. A stunning colt with an outstanding pedigree and key Group 1 wins can attract bids from the big stallion studs of $10 million to $30 million. Likewise, an outstanding mare with the right family and strong 'black type' race record can also attract $500,000-$1 million plus on sale.

A colt has a 99% chance it will ultimately be gelded to improve tractability (manageability) and behaviour, keep its weight under control and generally extend its potential race career. After racing, geldings are virtually giveaways to people who want hacks.

For stallions, first year stud fees are pitched at what the stud manager judges the market will bear. Recently, fees have ranged up to $60,000 per 'service' but generally around half this or lower. Once the stallion's progeny start racing, fees will quickly skew materially as results start to flow, to upwards of $100,000 or drift back to $10,000 to $20,000 as experience and new sexier entrants emerge. With 150 to 220 matings possible in a domestic season and a possible northern hemisphere season as well, a successful stallion's career can extend until they are over 20 years old, and be highly profitable to the owners.

A filly's potential value for breeding after racing will be driven by her general looks and conformation (musculature, body proportions, bone structure, etc.), her race record and that of her immediate family. However, this potential value will only be known after probably her third or fourth foal has been racing for a year or two, or five to six years later!

In the interim, if you select the right stallions and the filly produces attractive foals, the market will be prepared to pay a premium for her progeny, until race results come through and her then remaining residual value will move strongly up or down.

The productive life of a mare can extend until their early 20s, and if fertile and has few misses, can produce as many as 15 foals. The average is probably eight to 10. Pregnancies run for 11 months and 10 days, so you get one foal a year, with a likelihood of the mare not being mated for various reasons every four to six years. The most successful progeny tends to be the first four foals, but keen buying interest will be sustained if one or more of these early foals win 'black type' races.

Assuming you buy a mare for $100,000, and pay $30,000 for the stud fee, you can expect to pay an additional $30,000 to $40,000 for the foal by the time the foal is sold as a yearling. So, to recover the investment in your mare you need to average $100,000 for the first three foals ie payback takes five years plus.

Again, experience shows that in addition to a number of mares in your portfolio not falling pregnant, occasionally the mare will lose the unborn foal, or it will be stillborn. More frequently, the foal can be lacking in stature, or has conformation or X-ray issues with their legs. A mature horse weighs around 500 kilograms. Horses with deficiencies in their bones or the way they move will be much more likely to break down when racing and some features can be genetically transmitted, so as a consequence, will be severely marked down by buyers.

The probability of a stream of yearlings from the same mare which attract keen buying interest every year is low. The prices fetched for a portfolio of mares have a similar skew to racehorse performance: a few stars overcompensate for the rest.

The large studs with their greater numbers and ready access to their own stallions can spread their overheads and steadily build the depth and consistency of their broodmare lines via their portfolio strategies. The smaller broodmare studs have greater year to year variability of returns.

The need for investors to recover the cost of their outlays as soon as practicable has driven the Australian thoroughbred industry relentlessly towards breeding sprinters, primarily because these types mature earlier and hence race earlier.

Ironically, some races which attract the biggest prize money are staying races such as the Classic Oaks/Derbies, Cox Plate and Caulfield and Melbourne Cups. Stayer-type stallions are not in vogue. Indeed, the stocks of local stayers is so threadbare that investors have been trundling off to Europe in droves to find staying-types who might do well under Australian conditions and tactics. Buying a partly-tried stayer has much faster payback potential than having to wait for your yearling to be four or even five before it runs.

Limit outlays while learning the game

Investing in racehorses is not for the faint-hearted, especially if you really cannot afford the losses and the associated ongoing costs of racing or breeding. If your primary interest is the general thrill of being a participant, budget for the potential losses and regard this as your entertainment spending.

If you see the industry as a potential high risk but also high return possibility, then you have to be clear as to how you propose to approach the risk and high failure rates. I have made comment about the outlier nature of the profit skew. Investors endeavour to address this by investing in smallish shares of a portfolio of horses. Small shares in more expensive horses are more likely to give a more balanced risk/reward outcome than owning outright one or two cheaper punts.

While luck does play a critical role, the luckier ones seem to be those who have been in the game for long periods and have learned the hard way what is more likely to be a good horse. Black Caviar raced and won 25 times – she won most by several lengths, but in reality she often won by less than a second or two. So the difference between a champion and an also ran is very small.

To have the best you must associate yourself with the best. Before plunging in, find out who (trainers, bloodstock agents, syndicators) have earned the market's respect for their judgments, what their modus operandi are, and limit your outlays until you better understand the game.

Garry Mackrell is a former member of the Executive Committee of the Commonwealth Bank, now 'retired' and an optimistic mare stud owner as the proprietor of Bell View Park Stud. Most of the broad statistics quoted in this article are derived from The 2013/14 Australian Racing Fact Book.

Why empty nesters won't downsize

by Adele Horin on February 12, 2015

Downsizing seems the rational and ethical thing to do if you're an empty nester rattling around in a big house. But Australians have an aversion to downsizing. When it comes to our homes, most of us aren't governed by reason and sense. We're governed by emotion.

A new report from the think tank Per Capita makes it clear older people are generally loath to 'free up' houses for the younger generation. They're staying put in homes that in some cases may be unsafe for them. Removing the financial barriers to downsizing doesn't seem to hold the answer.

And that's because most people stay put for psychological reasons. They don't respond to Treasury's cold language of 'under-occupation' and 'efficiency'. They love their homes and garden; they've invested time and energy in them. The home is a repository of memories and precious possessions. For some, it's the last bulwark of independence. At this very moment some elderly Australian is protesting, "I'll leave here in a box."

"Public policy needs to grasp these complexities," says the report author, Emily Millane, "rather than focusing solely on … whether older people are seen to be … making an 'efficient use of housing stock.'"

Because so many older people want to stay put, it may be time for the government to bite the bullet, and provide more help to make their homes safer. Ms Millane wants the government to set up a scheme to help older Australians retrofit their houses. It's one of many interesting recommendations in her report, The Head, The Heart & The House. 'Ageing in place' is what governments want us to do because it's cheaper than subsidising a move to a nursing home; and it's what most older Australians prefer. But stairs, unmanageable gardens, narrow doorways, and tricky bathrooms can imperil people's safety. Alternatively, some older people are stuck in denial, pretending they can manage these impediments when it's clear to their children they're one day away from a fall.

A government scheme to reimburse older Australians for home modifications would have to be carefully implemented. Given a lot of older Australians have valuable homes destined for their children's inheritance, such a scheme could easily become a home improvement rort.

"It wouldn't be a case of here's $50,000 because you're over 70," Ms Millane said. "There would need to be regulations about what constitutes appropriate grants and for what purpose; and Government could not be directing funds to people who were able to fund their own renovations."

Small modifications could make a big difference: ramps, handrails, chairlifts; and repairs to make a house safer, drier, and healthier. Bigger changes, like creating a space for a live-in carer, might also be possible. But grants would not necessarily be confined to physical improvements. Technology has advanced in ways that make it safer for older people to live independently. Sensors that monitor people's movements in the home might suit some; or technologies that remind people to take their medication might qualify for a grant.

As well as making homes physically safer, there's the human element. A burgeoning older population living at home will require a big home care workforce to help them. How to pay for quality care, and ensure it's no longer rationed? Ms Millane says the government should facilitate a home equity release scheme. Asset-rich Australians should be obliged to borrow against their home to pay for home care. They would get a loan payable back to the government once their house was sold. What do you think?

A lot of my friends have been talking about downsizing but hardly anyone's taken the plunge. Instead these empty nesters have consciously decided to stay put. What they've done is smarten up or renovate houses they've lived in for 20 years to make them fit for another 20. In their 80s perhaps they'll revisit the downsizing question, or perhaps not.

Despite the perception that downsizing is commonplace – what with sea-changers, tree-changers, and the inner city apartment boom – the percentage actually making the move is surprisingly small, as I've written before; only 9% of Australians aged 50 and over moved into a smaller place over the five-year period from 2006 to 2011.

Will baby boomers adopt a different attitude to downsizing as they get older? The idea of being asset-rich and cash-poor like many in their parents' generation may not appeal. I know 60-somethings who plan to sell the home 'when they're old', find an apartment, free up some cash, and enjoy life. Not for them a frugal existence in the family home on the pension and some measly super. It remains to be seen whether, when the crunch comes, they'll feel any less attached to the family home than did their parents.

In the meantime, there's research for the government to do. The Housing Help for Seniors pilot was introduced by the Labor government but axed in Tony Abbott's first budget. It protected the age pension for people who sold their homes to downsize. The scheme had low uptake but it ran for barely six months. Worth another look?

We need a national housing policy responsive to the ageing population, including a growing number of renters. Initiatives to encourage downsizing will succeed only if they address the psychological barriers to moving. But for the majority of elderly who'll probably stay put, we also need policies to make their houses safe.

Adele Horin was the social issues journalist with the Sydney Morning Herald for 18 years prior to her 'retirement'. This article was first published on Adele's Coming of Age blog (adelehorin.com.au), and is reproduced with her permission.

How I lost my files to ransomware

by Graham Hand on July 23, 2015

This is a cautionary tale, at the risk of embarrassing myself. I did not even know what 'ransomware' was until it infected my computer. This article is not a definitive piece on how to protect yourself from a virus. The main message is **don't do as I did.**

Ransomware is a type of malware that prevents access to computer files until the victim pays a ransom to regain access or retrieve the data.

How was I tricked?

Let's start at the beginning to at least give me some excuses. I had been exchanging emails and phone calls with Telstra, as part of a significant upgrade to faster broadband speed, higher data allowance and upgraded mobile phone plan. In my defence, my head was in a 'Telstra numbers' mode, full of megabytes and download speeds.

Then a few days after my upgrade, I received an email, supposedly from Telstra Customer Care, telling me I was over 50% of my monthly data allocation, with a link to my usage level. How could that be? I had only just changed to the new package. Immediately preparing myself to call Telstra and tell them to get their act together, that they had me on the wrong plan, I clicked on the link to check the numbers. Bad mistake, a strike at my soft underbelly.

The email was not from Telstra. This message jumped up on my screen.

It was a ransomware virus called CryptoLocker. Google it if you want to know more. It works by encrypting all the files on your computer, and to unlock or decrypt them, you pay a 'ransom' to receive a decryption key. I immediately removed the virus but it was too late. All my files – Word, Excel, Powerpoint presentations, photographs, videos – were encrypted and could not be opened. The ransom requested was GBP700, payable in Bitcoins. They said if I tried to remove the virus, it would not decrypt the files and the cost of the key would increase to GBP1,400.

Searching online for a solution, some people suggested there is a publicly available key to decrypt the files, but this is a public key used by other malware scams. My understanding is CryptoLocker uses two keys: one to encrypt and another to decrypt the data. The decryption key is a private key, which is not available other than by paying the ransom.

What about my backup?

I immediately contacted my technical support, who said this was a particularly nasty virus, and industry advice is not to pay the ransom as most people do not receive the decryption code after payment. An online search confirmed this, while others said they did not want to encourage criminals by paying the ransom. It was better to rebuild from backups.

Where were my backups? This is the embarrassing bit.

First, we tried 'System Restore', which if enabled on the computer, should hold shadow copies of files. But when we clicked on 'Previous Versions', nothing was there.

Second, what about back-ups to external hard drives? I had been told some months earlier that there are only two types of external hard drives: those that have stopped working, and those that are about to stop working. A company called Backblaze, which runs 25,000 external hard drives continuously in its backup business, reports a 5% fail in the first 18 months, and 22% in four years. No doubt this is unfair, but I used it as an excuse not to back up to external hard drives more regularly.

Third, my computer had been set up to copy files regularly to Dropbox. When I went into my Dropbox account, the files there were also encrypted. So I wrote to Dropbox asking if they had saved previous versions. There ensued an exchange of emails with Dropbox, such as:

"I'd be happy to help you roll back your entire account to a certain point in time. Could you go tohttps://www.dropbox.com/events and send me the link indicating the first event you would like to undo? Your account will be reverted to before this event took place."

But over many exchanges of email, we could not open my old files. I don't blame Dropbox for this, we just ran out of time and patience.

So where did I eventually find some of the lost files? I had older files on an external hard drive from my last (too long ago) back up. Otherwise, I retrieved wanted files that had been attached to emails: photographs, documents, spreadsheets. I recovered a decent amount stored by Google on Gmail (and it would be the same with any reputable email service) and all Cuffelinks files are 'in the cloud'.

But I did lose a lot of personal material. I had copied photographs to my computer from my iPhone to free space on the phone. Other personal records, documents and spreadsheets, were lost.

What are the lessons?

All it takes is one email from a trusted friend or a familiar company, complete with logo and well-designed customer letter, plus a moment's lack of the usual caution and this could happen to you. The lessons are:

1. Always pause before opening a link, regardless of who it is from, and make sure it is legitimate. Hackers have ways of accessing your contacts and companies you deal with.
2. Back up to an external hard drive regularly, but make frequent checks and hardware upgrades.
3. Store additional copies in the 'cloud'.
4. Activate the programme which stores shadow copies.
5. Email important documents to yourself. From my experience, this is a robust solution, and if anyone thinks it is not, let me know.

Repeating, I am not a technical expert on this subject, and I welcome comments from people who know a lot more than I do. Including the best ways to back up (no product flogs, please).

Comment by Tony Cuffe who works in technical support

This type of invasive software is, unfortunately, becoming more and more common. It opens up a lot of discussion as to how to avoid it in the future. Backing up properly is a form of risk management.

For Mac users I suggest that an Apple Time Machine is installed as well as using a programme such as Carbon Copy to do remote backups of valuable files such as photos and documents on a regular basis to remote drives. These can be setup to run automatically in the background.

For Windows users this is not so simple. There are a range of different solutions from different suppliers. One that seems pretty good is from Acronis. They do both automatic updates to local remote drives and also the cloud.

Speaking of cloud, we are now primarily using Google Drive along with the full suite of Google apps for work applications. This means that all files are being kept in the cloud and are not touchable with programmes like CryptoLocker. We are currently retiring our laptops and replacing with them with Chromebooks. The only thing needed is an internet connection via Wi-Fi and you have everything available.

Finally, as for email, using a hosted cloud service such as Apple iCloud or Google Gmail is the only way to go as you can easily re-download your email to any device whether it be Windows, Apple or Linux. I use both for different email addresses but my first choice is now Gmail and particularly Gmail for business so you can set up your own domain name for your email address.

Graham Hand is Editor of Cuffelinks. This article is a general warning and does not consider the personal circumstances of any readers, nor is it intended as a definitive solution to protecting data and files.

Stop worrying about how much you matter

by Peter Bregman on August 6, 2015

For many years – almost as long as he could remember – Ian* owned and ran a successful pub in his small town in Ireland. Ian was well-known around town. He had lots of friends, many of whom he saw when they came to eat and drink, and he was happy.

Eventually, Ian decided to sell his establishment. Between his savings and the sale, he made enough money to continue to live comfortably. He was ready to relax and enjoy all his hard work.

Except that almost immediately, he became depressed. That was 15 years ago and not much has changed.

I've seen a version of Ian's story many times. The CEO of an investment bank. A famous French singer. The founder and president of a grocery store chain. A high-level government official. And these are not just stories – they're people I know (or knew) well.

They have several things in common: They were busy and highly successful. They had enough money to live more than comfortably for as long as they lived. And they all became seriously depressed as they got older.

What's going on?

The typical answer is that people need purpose in life and when we stop working we lose purpose. But many of the people I see in this situation continue to work. The French singer continued to sing. The investment banker ran a fund.

Perhaps getting older is simply depressing. But we all know people who continue to be happy well into their nineties. And some of the people who fall into this predicament are not particularly old.

I think the problem is much simpler, and the solution is more reasonable than working, or staying young, forever.

People who achieve financial and positional success are masters at doing things that make and keep them relevant. Their decisions affect many others. Their advice lands on eager ears.

In many cases, if not most, they derive their self-concept and a strong dose of self-worth from the fact that what they do and what they say – in many cases even what they think and feel – matters to others.

Think about Ian. If he changed his menu or his hours of operation, or hired someone new, it directly affected the lives of the people in his town. Even his friendships were built, in large part, on who he was as a pub owner. What he did made him relevant in the community.

Relevancy, as long as we maintain it, is rewarding on almost every level. But when we lose it? Withdrawal can be painful.

As we get older, we need to master the exact opposite of what we've spent a lifetime pursuing. We need to master irrelevancy.

This is not only a retirement issue. Many of us are unhealthily – and ultimately unhappily – tied to mattering. It's leaving us overwhelmed and over-busy, responding to every request, ring and ping with the urgency of a fireman responding to a six-alarm fire. Are we really that necessary?

How we adjust – both within our careers and after them – to not being that important may matter more than mattering.

If we lose our jobs, adjusting to irrelevancy without falling into depression is a critical survival skill until we land another job. If managers and leaders want to grow their teams and businesses, they need to allow themselves to matter less so others can matter more and become leaders themselves. At a certain point in our lives, and at certain times, we matter less. The question is: Can you be OK with that?

How does it feel to just sit with others? Can you listen to someone's problem without trying to solve it? Can you happily connect with others when there is no particular purpose to that connection?

Many of us (though not all) can happily spend a few days by ourselves, knowing that what we're doing doesn't matter to the world. But a year? A decade?

Still, there is a silver lining to this kind of irrelevancy: freedom.

When your purpose shifts like this, you can do what you want. You can take risks. You can be courageous. You can share ideas that may be unpopular. You can live in a way that feels true and authentic. In other words, when you stop worrying about the impact of what you do, you can be a fuller version of who you are.

That silver lining may be our anti-depressant. Enjoying the freedom that comes with being irrelevant can help us avoid depression and enjoy life after retirement, even for people who have spent their careers being defined by their jobs.

So what does being comfortable with the feeling of irrelevancy – even the kind of deep irrelevancy involved in ending a career – really look like? It may be as simple as doing things simply for the experience of doing them. Taking pleasure in the activity versus the outcome, your existence versus your impact.

Here are some small ways you might start practicing irrelevancy right away:

- Check your email only at your desk and only a few times a day. Resist the temptation to check your email first thing in the morning or at every brief pause.
- When you meet new people, avoid telling them what you do. During the conversation, notice how frequently you are driven to make yourself sound relevant (sharing what you did the other day, where you're going, how busy you are). Notice the difference between speaking to connect and speaking to make yourself look and feel important.
- When someone shares a problem, listen without offering a solution (if you do this with employees, an added advantage is that they'll become more competent and self-sufficient).
- Try sitting on a park bench without doing anything, even for just a minute (then try it for five or 10 minutes).
- Talk to a stranger (I did this with my cab driver this morning) with no goal or purpose in mind. Enjoy the interaction – and the person – for the pleasure of it.
- Create something beautiful and enjoy it without showing it to anyone. Take note of beauty that you have done nothing to create.

Notice what happens when you pay attention to the present without needing to fix or prove anything. Notice how, even when you're irrelevant to the decisions, actions, and outcomes of the world around you, you can feel the pleasure of simple moments and purposeless interactions.

Notice how, even when you feel irrelevant, you can matter to yourself.

*Not his real name.

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[Peter Bregman] is CEO of Bregman Partners, a company that strengthens leadership in people and organisations through programmes (including the Bregman Leadership Intensive), coaching, and as a consultant to CEOs and leadership teams. Best-selling author of '18 Minutes', *his latest book is* 'Four Seconds'. *To receive an email when he posts, [click here].*

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