Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

Does the public hate us?

Graham Hand

Published in 2001, my book *Naked Among Cannibals* examined how banks had fallen from revered to reviled within a couple of decades. Over the subsequent few years, the finance industry seemed to be gradually winning back the trust of the public, with market research showing improving customer satisfaction and better ratings for 'ethics and honesty'. But events relating to Storm Financial, Westpoint, Opes Prime, Trio Capital and most recently, CBA's advice business, have been setbacks to this progress. The watering down of FOFA is a rich source of rancour for major bank critics.

A few weeks ago, I attended a meeting where two Nobel Laureates debated why the public hates the finance industry. Then this week, David Murray's Financial System Inquiry highlighted major shortcomings in Australian wealth management. The former CEO of CBA, who bought Colonial First State to create the largest fund manager in the country, was expected to be kind to the major banks, but he criticised the industry on many fronts. The Interim Report says in various sections:

"A trend in the wealth management sector is towards more vertical integration. Although this can provide some benefits to members of superannuation funds, the degree of cross-selling of services may reduce competitive pressures and contribute to higher costs in the sector."

"The quality of personal advice is an ongoing problem … ASIC shadow shopping exercises indicate that consumers often receive poor-quality advice. This poor-quality advice mainly relates to two factors, the:

- *Relatively low minimum competence requirements that apply to advisers*
- *Influence of conflicted remuneration arrangements*

The price of personal advice has often been hidden by opaque price structures and indirect payments."

"The operating costs of Australia's superannuation funds are among the highest in the Organisation for Economic Co-operation and Development (OECD), and the Super System Review concluded superannuation fees were "too high". The Grattan Institute estimates fees have consumed more than a quarter of returns since 2004."

"It is very difficult for the superannuation system as a whole to beat the market over the long run within an asset class, although it is possible for an individual fund to do so. As Nobel Laureate William Sharpe noted:

'Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs.'"

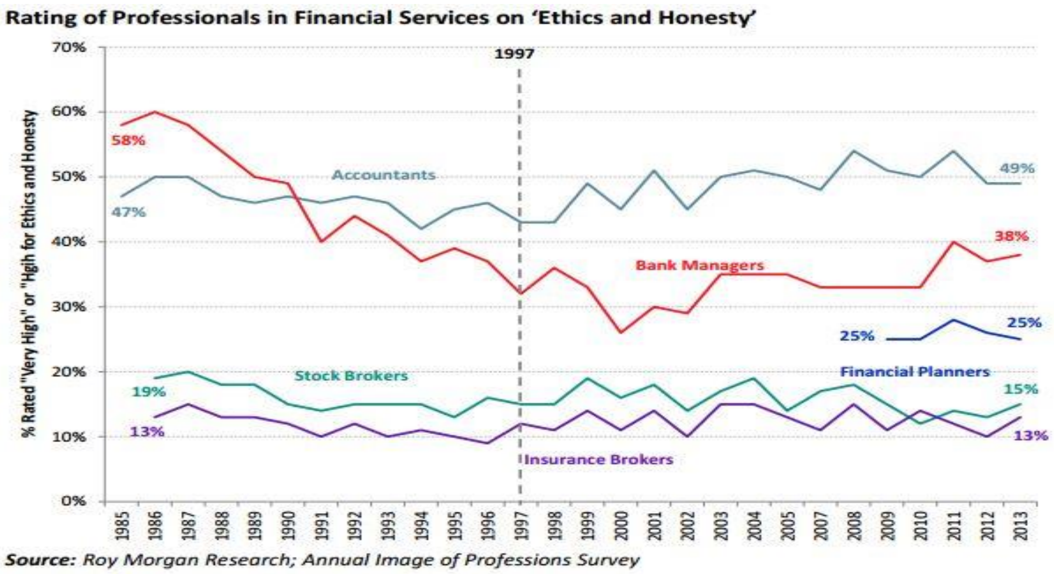
Far from easing the pressure on the major banks, David Murray has delivered more setbacks, especially to the legitimacy of the revisions to FOFA.

The image of financial services professionals in Australia

Roy Morgan Research has tracked the image of financial services professionals since 1985, and reports:

"Unfortunately, very few Australians trust professionals in the financial services industry, rating them consistently poorly for 'ethics and honesty'. Not exactly the best foundation for a successful working relationship, is it?"

For 'ethics and honesty', only 25% of Australians rate financial planners as 'very high' or 'high', and it's even worse for stockbrokers (15%) and insurance brokers (13%). The once-trusted bank manager scores only 38%, down from a healthy 58% in 1985, as shown below:



How did the Nobel Laureates explain the hatred?

At the 2014 Research Affiliates Advisory Panel at Laguna Beach in California, the first session was hosted by their Chairman, Rob Arnott, in discussion with two Nobel Laureates, Harry Markowitz and Vernon Smith. The topic was "Why Does Main Street Hate Wall Street?", or more prosaically, "Why does the public hate us?"

Harry took it gently. He thought it was mainly a lack of education, and we need to tell the public about the importance of financial intermediation for the functioning of a market economy. But digging deeper, Vernon Smith pointed out that what Adam Smith wrote in his 1776 *The Wealth of Nations* is often mistakenly quoted to justify self-interested market behaviour. Adam Smith described his system of natural liberty thus:

"Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interests in his own way."

But Vernon said this can only be understood in the context of Adam Smith's 1759 Book, *The Theory of Moral Sentiments.* While people have a right to be 'self-loving', part of their maturation is to learn rules of conduct that are 'other-regarding'. Greed is controlled through socialisation.

"He must humble the arrogance of his self-love and bring it down to something which other men can go along with … we must become the impartial spectators of our own character and conduct."

Vernon believes our industry is guilty of 'crony capitalism' based on privilege. We gamble with other people's money, offer them returns we don't know we can deliver, charge hefty fees, take the profits but pass the losses to the taxpayer. Rob echoed the views on cronyism. Consider the recent US bailouts of the most prestigious names on Wall Street. Politically-connected banks were protected, and within months, their executives were paying themselves massive bonuses, and it has continued since. As Chris Brightman, Chief Investment Officer at Research Affiliates, said in his summary:

"Much of our industry is a deadweight loss to society, and the public is justified in its disdain."

Asset consultants cannot pick outperforming managers

On the second day, we heard from Tim Jenkinson of the Said Business School at the University of Oxford. His subject was, *"Do Investment Consultants Pick Winners?"* Institutional investors (not uneducated retail) managing hundreds of billions of client money hire asset consultants like Mercer, Towers Watson, Russell and Cambridge Associates to help with fund manager selection. Jenkinson and his team quote statistics which show 94% of 'plan sponsors' employ an asset consultant. These are supposed to be 'the smartest guys in the room'. They tell our biggest investors where to allocate their money. What is the main conclusion of the paper?

"In sum, however, the analysis finds no evidence that the recommendations of the investment consultants for these U.S. equity products enabled investors to outperform their benchmarks or generate alpha." (Cuffelinks will write a comprehensive review of this study in a future edition).

Why do institutions bother with asset consultants when the managers they pick usually underperform? Well, it's a 'hand-holding service', it protects against 'headline risk', and plan sponsors probably don't even realise how inaccurate the recommendations are. Highly paid executives pay other highly paid executives to protect their backsides, without much idea whether value is being added. This process even has a name – deflection – which is the opportunity to fire someone else so that the institution or its executives are not fired. It's perhaps the most important service that asset consultants perform.

What about the theories and the academics?

If that's the real world of investing, what do theoretical models say about capital market prices? Brad Cornell, Professor of Financial Economics at California Institute of Technology (among many distinguished roles) told us that at best we can put a wide range around possible prices, and our models have basic flaws which render them of little practical use. Then Ivo Welch, Distinguished Professor of Finance and Economics at UCLA, said we should have little if any confidence in capital asset pricing models for predicting future returns. Yet these models play a major role in company valuations, M&A activity and defining flows of billions of dollars of capital. We use the models in business schools for capital budgeting and investment plans, but they have negligible predictive capacity. Chris Brightman again:

"Our clients and business partners pay us to be experts. They want to believe that we know more than we can. We are tempted to allow or even encourage this faith. Overconfidence is necessary for our business success ... Not only is there much we don't know, but also some of what we know isn't true'.

At the equivalent conference last year, I interviewed Burton Malkiel, renowned author of *A Random Walk Down Wall Street.* I asked him whether he feels any sense of disappointment at the state of the investment management industry. He replied:

"I think the reason we have not made much progress is that it is probably one of the most overpaid professions there is. It's an inefficiency, with investment professionals paid regardless of the results. The real problem with us making enough progress in our industry is the misaligned incentives."

Where does this leave us?

Notwithstanding our shortcomings, Rob Arnott said he likes to think that our industry does add value relative to what most investors would do without our 'help'. Investors would be undiversified and would typically chase every fad and bubble that comes along. Indeed, the reason that contrarian investing often does add value is that the aforementioned lemmings are common in the marketplace, and likely always will be. It is the job of advisers and educators to encourage a longer term perspective.

In the face of the CBA's apology for the behaviour of many of its advisers and the additional compensation payments it now faces, we might expect widespread industry remorse. However, what we actually have is a public argument about the merits of a Best Interests Duty, the definition of conflicted remuneration, the reason we don't need opt-in for fees, and defence of the vertical integration model.

Back at Laguna Beach in California, we drank fine wine, we appreciated the art in the galleries, we ate great food from the kitchens of the luxurious Montage Hotel, and we basked in the sunshine overlooking the Pacific Ocean. Then we jetted back to our well-paid and prestigious jobs all over the world.

William J. Bernstein, author of several classic books on investing, calls us '*talented chameleons'* that populate the financial professions. He tells his readers,

"The investment industry wants to make you poor and stupid."

That's why at least some of the public hates us.

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The perils of hybrids

Jonathan Rochford

Preference shares, more commonly known as hybrids in Australia, have become a staple in the investment diet for many retail investors and SMSFs. When economic times are good and companies are doing well, preference shares can provide steady dividends that are usually 1-3% higher than term deposits. However, as the tip of an iceberg warns of the substantial danger below the surface, the structure of hybrids and their performance in the global financial crisis both point to the risk of a shipwreck.

An age-old warning

Whilst this article mainly discusses the relatively recent experience of Australian investors with preference shares, the warnings on these securities date back to at least 1949 when Benjamin Graham wrote the first edition of his classic book *The Intelligent Investor*. Benjamin Graham is often referred to as 'the father of value investing' and the mentor of Warren Buffett, who said *The Intelligent Investor* is "by far the best book on investing ever written". In the book Graham writes about the structure of preference shares:

"Really good preferred securities can and do exist, but they are good in spite of their investment form, which is an inherently bad one … the preferred holder lacks both the legal claim of the bondholder and the profit possibilities of the common shareholder."

He goes on to note the reasons why investors buy preference shares:

"Many investors buy securities of this kind because they need income and cannot get along with the meagre returns offered by top grade (investment grade) issuers. Experience clearly shows that it is unwise to buy a bond or preferred which lacks adequate safety merely because the yield is attractive."

On when to buy preference shares, Graham argues:

"Experience teaches that the time to buy preferred stocks is when their price is unduly depressed by temporary adversity ... in other words, they should be bought on bargain basis or not at all."

To help put these arguments into context, a break-down of the key negative features of hybrid shares follows with Australian examples.

Hybrids don't have equity control rights

In Australia, if investors holding more than 5% of ordinary shares object to the current management or Board of a company they have a right to call for an extraordinary general meeting. The dissenting shareholder group can then propose to change the current directors with a view to new directors changing the overall direction of the company. Hybrid holders have no such rights even when their dividends stop, providing that dividends to ordinary equity have also ceased.

Hybrids don't have covenant protections like loans or bonds

When a company fails to pay interest on its bonds or loans without prior permission from the lenders, it has contractually defaulted. This effectively hands control of the future of the company over to its lenders, which may ultimately result in insolvency with the Board formally handing its powers over to external administrators. Hybrid holders have no such contractual rights when their dividends are not paid. Their payments are at the full discretion of the Board and are also non-cumulative, meaning that a missed payment is forever lost. Whilst having no dividends might be an acceptable outcome for holders of ordinary equity who can also participate in capital growth, hybrid holders typically invest for regular income and get little or no benefit from the increasing equity value of a company. Holders of hybrids ELDPA (issued by Elders) and PXUPA (issued by Paperlinx) would be well aware of their lack of equity or debt control mechanisms, even though they haven't received any dividends for many years.

Hybrids have no protections to stop the issuer from becoming excessively leveraged if earnings decline or if the company chooses to issue large amounts of senior ranking debt. Excessive gearing increases the risk that a company will switch off dividends to ordinary and hybrid holders for many years in order to reduce a substantial debt load.

Hybrids are extended in the bad times and redeemed in the good times

Whilst the Australian experience with preference shares is much shorter than the US that Graham wrote about, investors here have experienced the same negative outcomes stemming from not having a maturity date. Many investors discovered in the last decade that step-ups don't guarantee redemption at their expected call date, with 12 widely-held securities (AAZPB, BENHB, ELDPA, MBLHB, MXUPA, NABHA, NFNG, PXUPA, RHCPA, SBKHB, SVWPA and TPAPA) still outstanding today that have gone past their expected call dates. Loans and bonds at these companies matured during the financial crisis, with new debt issued at significantly higher margins. Preference shareholders are still stuck with the pre-crisis margin and step-up levels.

The opposite side of giving the issuer control over the timing of redemption is now starting to become evident. AAZPB and TPAPA are likely to be redeemed in the second half of 2014. Another potential candidate for redemption is GMPPA, as Goodman is likely to be able to replace the preference shares with cheaper senior debt. GMPPA currently trades above $100 reflecting the relatively attractive returns in the eyes of the market. Current holders are at risk of seeing that premium disappear if the company chooses to redeem, as happened with the price drop of HLNG and HLNGA.

The key issue linking AAZPB, TPAPA and GMPPA is that investors who bought in pre-crisis would have much rather been redeemed during the GFC as replacement securities offered better value then.

Hybrids can convert to equity at the worst times

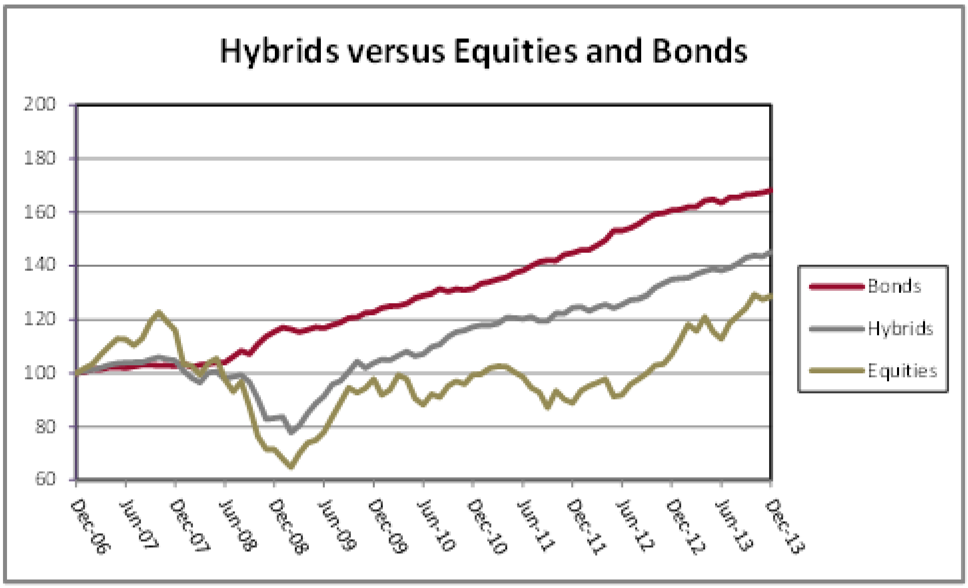
Most ASX-listed hybrids contain the right for the issuer to convert the securities to ordinary equity at specific times, most likely when the company is in financial difficulty and when ordinary equity is least desirable. For example, holders of Willmott's WFLPA in 2009 were offered the opportunity to exchange into ordinary equity worth 22.9% less than the issue price of the hybrids. In 2010, Willmott defaulted on its debts with the ordinary equity and hybrids both wiped out.

Bank hybrids are now issued with a standard clause that they will automatically convert to equity if the Common Equity Tier One capital ratio falls below 5.125%. If this point is reached, the bank will have recorded substantial losses on its loans and shareholders are likely to question whether the bank will continue to survive. The prospect of a large scale dilution of ordinary equity will put additional downward pressure on the equity price. It may fall further still if hybrids are compulsorily converted and many respond by selling their newly-acquired equity as quickly as possible.

Recent vintage bank hybrids also contain a maximum conversion ratio limiting the number of ordinary shares that can be received in a conversion process. This means a hybrid shareholder can receive shares worth substantially less than the $100 issue price.

Hybrids have much higher drawdowns than bonds

The experience of many Australian investors during the financial crisis aligns with the patterns of preference share trading identified by Benjamin Graham. The graph below compares the ASX accumulation index, the Elstree Hybrid Index (an index that tracks a broad mix of ASX listed hybrids) and the S&P/ASX Corporate Bond Index using the data covering the seven year period from 2007 to 2013. This is an 'apples with apples' comparison as each index includes both capital and income return components. It shows a peak to trough fall of 47.2% for the equity index and 26.6% for the hybrid index, whilst the bond index fell by only 0.8%. The hybrid index did recover its losses much faster than the equity index taking 29 months compared to 71 months to return to the pre-crisis peaks, but bonds again proved to be far lower risk taking only 8 months.



The hybrid index may substantially understate the volatility many Australian investors actually experienced over the seven years, as some hybrid funds suffered peak to trough falls of approximately 40%. Ten securities defaulted and suffered a complete loss of capital whilst both Elders and Paperlinx still trade below 50% of the issue price and have not paid dividends for several years.

Conclusion

In the current times of low interest rates and low economic growth, many Australian investors are building their exposure to hybrids unaware of the risks they are taking.

Benjamin Graham warned of many of the above problems as far back as 1949. Investors then and still today chase yield in bull markets, sacrificing protection measures like covenants in the process. Value investors following Graham's advice will take advantage of the current low yields on Australian hybrids to sell down their positions and realise substantial capital gains. If Graham's comments on the cyclicality of hybrids again prove to be true, then they may once again be available at bargain basement prices.

Jonathan Rochford is a Portfolio Manager at Narrow Road Capital. Narrow Road Capital advises on and invests in various credit securities. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.

Why would you invest in junk?

Warren Bird

The Australian bond market made history this year. For the first time a company whose credit rating is below 'investment grade' – often colloquially called 'junk' - successfully raised funds by selling Australian dollar bonds publicly in the institutional market. The company issued $300 million of 7 year bonds in May 2014, then returned to raise another $400 million in June through an 8 year issue.

Many readers might be wondering why anyone would invest in 'junk'. In this case there are some unique reasons, but the issuing success of this company provides an opportunity to explore the investment case for high yield bonds.

The issuer and the yield

One of the reasons for the success of these deals is the familiarity of the company to investors. After all, Qantas is a household name! Not only is Qantas the 'national carrier', but it's listed on the ASX and held in many share portfolios. Further, Qantas has been an issuer in the bond market before, so its credit fundamentals are well known to fund managers.

In fact, credit analysts looked at the airline relatively recently. In April and May of 2013, Qantas raised $250 million through a bond maturing in 2020. At that time the company was rated BBB, which is investment grade, but after well-publicised problems late in the year, Standard & Poor's cut the rating to BB+ in December 2013. Moody's followed suit in January 2014.

A sub-investment grade rated company that was not so familiar would almost certainly not have been as successful in raising funds. However, local investors seem to have formed a view that Qantas' cash reserves, plus the fact that it has strategic options for dealing with its financial problems, make it a relatively 'safe' play outside the usual AAA to BBB credit range.

Of course, investors have only done this because Qantas paid a high yield. The 8 year deal done in May 2014 paid investors 7.96%, at a premium over the Government bond rate of just over 4.0%. The range of yields on other similar maturity bonds in the market at the time was more like 4.25 – 5.25%.

Risk and return

High yields are precisely the point to investing in the sub-investment grade space. High yields compensate investors for higher risk.

Mostly, this is a higher risk of default. Based on historical outcomes, bonds rated in the BB range are about ten times more likely to default at some point over the next ten years than the average investment grade securities (A to BBB ratings). See here for a more detailed discussion of credit risk and the meaning of high yield risk. There is also a liquidity premium to high yield securities compared with investment grade bonds.

However, the high yield market usually overpays for these risks and thus delivers very competitive return outcomes, against both shares and bonds (this analysis uses the Bank of America Merrill Lynch BB/B index hedged to A$ to June 2014. That is, the comparison is not based on a handful of domestic bonds, but the well-established US market). Over the long run of 25 years, high yield has returned 11% per annum, compared with 9.5% for Australian shares and 8.8% for Australian bonds. It has done this with 8% pa volatility, which is more than bonds (4%), but much lower risk than shares (17%).

Over the medium term of five years, high yield also compares very favourably. The return from June 2009 to 2014 was 15.9% pa. Volatility was 14%, which is higher than over the long run. Bonds have delivered 6.9% pa, but at lower than long run volatility (3%), while shares have returned 11.2% pa at about the same as their long run volatility.

The medium term comparison is fascinating. The five years to June 2014 commences just after the bottom of the GFC-induced blow-out in credit spreads and fall in share prices. Of course, the sharemarket has rebounded nicely since the GFC, but few would investors would realise that high yield bonds over the same period have provided almost 5% per year better return than shares.

So why is it called 'junk'?

Given risk and return outcomes, it is unfair to call the asset class 'junk'. That term came into being nearly 100 years ago when the high yield market was comprised entirely of companies who had previously been rated more highly, but which had encountered financial difficulties and become more risky as a result. These 'fallen angels' did not deliberately run their businesses to be BB or B credit rated, and issuing bonds with such ratings was problematic. They became, in the eyes of investors who had previously bought their debt, 'junk'. Some would say that Qantas is a perfect example of such a fallen angel.

However, the modern high yield market is different. Since the 1980's it has become a means by which particular kinds of businesses have been able to tap the capital markets for funding that might not have otherwise been available. Some people argue that the high yield market democratised capital markets, because banks, insurance companies and pension funds had previously spurned such issuers unfairly.

Therefore, nowadays the high yield market is mainly populated by companies who deliberately run their businesses as BB or B rated. They either have reasonably stable earnings but operate with high leverage ratios, or they have more conservative leverage in a highly volatile industry. They operate in industries not typically found in the investment grade space, and thus offer a more diverse universe of credits. The US market comprises around 1,500 sub-investment grade issuers and is valued at US$1.3 trillion.

Manage the risk properly

That said, each individual high yield bond does carry a relatively high risk of default. The only effective way to manage a credit risk portfolio is through continuous credit research and an appropriate level of diversification. The higher the credit risk of individual investments, the smaller the exposures to each company should be and the larger the number of individual holdings required. In high yield, we're talking at least 50-100 holdings, if not more. Further, these should be spread across as many industries as possible in order to make sure you don't have a concentration of risks.

Investors need to be cautioned against simply buying some Qantas bonds, along with a handful of the other high yield bonds that are available to retail investors in Australia, and believing that they have a healthy portfolio. The concentration of holdings makes that approach highly risky.

This is a space where managed funds or ETF's really come into their own as an efficient way of getting the diversity that is needed.

Many investors are unnecessarily put off by the colloquialism 'junk' and don't appreciate the case that exists for high yield bonds to be included in their portfolio. A well-managed portfolio of 'junk bonds' is not a junk portfolio. It can be a high-returning, moderate risk asset class.

Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management. His roles now include consulting, serving as an External Member of the GESB Board Investment Committee and writing on fixed interest. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.

Australia's default: shares versus bonds through the crisis

Ashley Owen

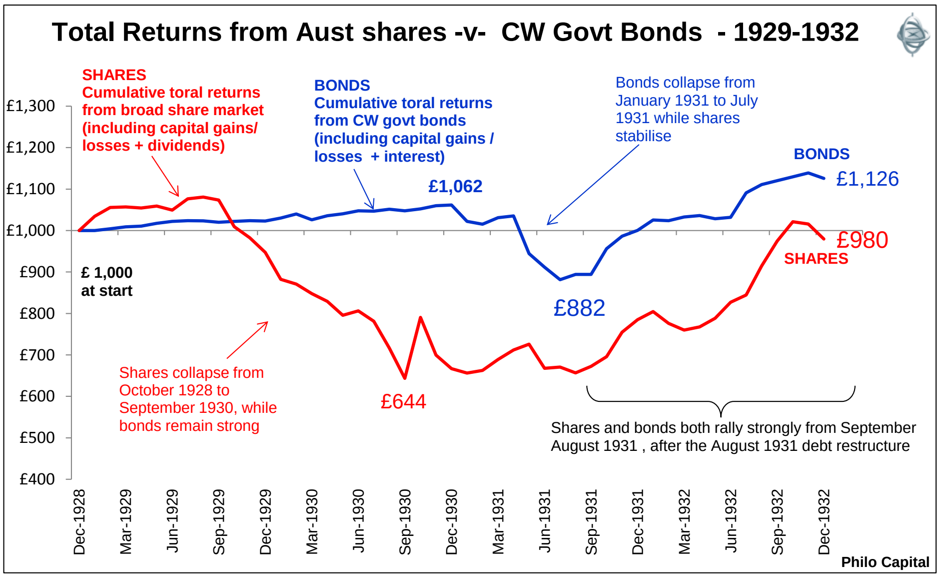
In the first three parts of this series over the last month, we have explored the ways governments can avoid repaying their debts in full; how Australia's big default and debt restructure occurred in the 1930s; and the returns achieved by bond investors before, during and after the debt restructure.

In part 4, we look at the returns from the broad stock market versus the government bond market during the 1930s crisis. We see how the impact of the Greece-like default and restructure of government bonds affected bond returns, compared with the impact of the 1929 crash on share returns.

Bonds versus shares during the crisis

Despite the default and restructure for all domestic Australian bonds, bond investors who held on during the crisis (and refinanced their old defaulted bonds with new 'haircut' bonds), did better than share investors.

The chart below shows total returns (including capital gains/losses plus income) from the start of 1929 to the end of 1932. Share market returns are measured by the Sydney Commercial Index (the main index of large stocks across all of the main industries), including dividends paid. Bond returns are based on Commonwealth bonds maturing in five years or longer, including interest coupons.



For a snapshot of the key events during the period, refer to the [chart in Part 2 of this series.]

Income return was the same for shares and bonds but capital losses different

Share and bond investors received the same investment *income* over the four years: dividends from the broad share market gave investors 19% in total over the period, the same as the 19% interest paid on bonds.

The big difference was in the market prices of shares versus bonds. Share prices fell twice as far as bond prices, dropping 46% from the peak in 1929 to the bottom in August 1931. Share prices started to recover in September after the August 1931 debt restructure deal. The broad share index was still 20% lower by the end of 1932, whereas bond prices had recovered to par. However the 20% capital losses on shares were almost made up for by dividend income, leaving investors almost square after four years, and ahead 15% in real purchasing power terms after the general price deflation of 17% over the period.

These are very good investment returns for the four years during the worst of the 'Great Depression': 29% real total returns from government bonds, including the default and restructure, and 15% real total returns from shares, including the 1929 stock market crash!

Three phases of the crisis

There were essentially three phases of the crisis, and shares and bonds did different things in these three phases. The first phase was late 1929 to September 1930. During this phase share prices collapsed while bond prices remained strong. Investors dumped shares in the panic and bought government bonds as a 'safe haven'. Some safe haven, as the government defaulted.

Share prices nearly halved over the period, which included the October 1929 'crash', which was much milder in Australia than in the US because Australia did not have a wild speculative bubble in the late 1920s, and so there was no bubble to burst. Australia was already in recession, in 1928-1929, commodities prices had already collapsed, and credit markets had already dried up for Australia (thanks primarily to the profligate NSW government).

The second phase was between September 1930 and the August 1931 debt restructure. Share prices stabilised after the August 1930 'Mobilisation Agreement' under which the commercial banks agreed to lend the Commonwealth government £3 million per month to pay interest on debt and to keep the government running. Shares stopped falling but bonds (the so-called 'safe haven') collapsed, all the way to the August 1931 default and restructure.

The third phase was after the August 1931 debt restructure, when prices of shares and bonds recovered strongly together.

Not only did Australian shares suffer less than US shares, they started to recover a year earlier than US shares. The main reasons were that Australia abandoned the gold standard and depreciated its currency more than a year earlier (from January 1930), and also because Australia did not go on a Keynsian debt-funded spending spree – because it was simply unable to borrow from domestic or international debt markets.

Investors' worst fears were realised

As usual, the best returns were received from buying in the depths of despair, when there is 'blood in the streets'. Investors' worst fears were realised: the government failed to pay interest and principle on its entire stock of domestic bonds and notes. Interest payments were slashed 22.5% across the board and bond holders had to wait up to 30 years to get their money back. The 'worst case scenario' turned into fact, but returns were still very good for bond investors, even through the default and restructure.

The same was the case for the defaulted Greek bonds in 2012. The 'worst case scenario' came true – the government failed to pay and the debt was restructured in a 'haircut' deal, but there was still plenty of money to be made. Several hedge funds made a mountain of money buying off panicking investors at the depths of the crisis. The losers were the investors (mostly European banks and pension funds) that sold into the fear.

Australian investors, bonds and listed bonds

By the way, recently there has been much chatter in the ill-informed national media about Australians not being accustomed to bond investing, and also not being accustomed to bonds being listed on the stock exchange. This is complete nonsense.

The recent listing of bonds on the ASX is nothing new. Bonds were listed on Australian stock exchanges for more than a century. Bond-holding has exceeded share-holding for Australian investors for most of our history. In addition, bond trading has exceeded share trading on the main public exchanges in volume and depth for most of the history of stock exchanges in Australia.

Shares only overtook bonds as the preferred investment for Australians in the late 1960s, thanks to two main factors. The first was the speculative mining boom of the late 1960s, in which almost all of mining stocks that appeared in the boom promptly disappeared worthless in the crash that followed. The second factor was tax: specifically the removal of tax rebates on bond interest in 1969, followed by the granting of franking credits to shareholders in 1987. Australia is like almost all other 'developed' countries in the world, where bond investing has been more popular and more widespread than share investing for most of its history.

This concludes our 4-part story of Australia's big government debt default.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.

Which countries should be classified as emerging market?

Jack McGinn

Many retail investors are drawn to invest in emerging market funds, but think little about which countries they are investing in? Emerging market indices are poor representations of the investment opportunities available in that asset class. This arises in part because the index includes countries which are no longer emerging and omits some which manifestly are.

Readers would have no problem naming countries considered 'core' emerging markets: China, India, Brazil, Mexico. Others would utilise the 'BRICs' misnomer. But how about Vietnam? Or Israel? Or Taiwan?

It's difficult to compile a definitive list of which countries qualify as 'emerging markets' and which do not. The methodology for including countries in the index is far from academic. Investors in emerging markets, and particularly retail investors purchasing exchange traded funds which mirror the index, have a particular conception of what they're buying: access to markets where, in theory, there is scope for higher returns if investors are willing to tolerate the potential for higher risk.

Investors in the asset class typically seek to benefit from the tailwinds around hundreds of millions of people being lifted out of poverty via globalisation, through the allocation of capital to companies which are contributing to and benefiting from sustainable development.

Yet this is hardly a truthful representation of the constituents of the index. Most prominently, South Korea and Taiwan are not countries characterised by youthful populations, rapid urbanisation, a shift from agriculture to industry and an emerging consumption-driven middle class. They went through those transitions years or even decades ago.

Rather, these are societies where the median age is higher than the US, GDP per capita is higher than Italy and life expectancies match those of Denmark. On the UN's Human Development Index (HDI) from March 2013, both are very firmly 'very high human development' societies. Indeed, both have levels of human development higher than that of the UK.

Yet emerging market indices typically allocate a quarter of their assets to Taiwan and South Korea, countries not yet reclassified as developed markets based purely on the basis of technicalities around market access.

Country	MSCI Designation	HDI	HDI rank	HDI peer
South Korea	Emerging	0.91	12th	Canada (0.91)
Taiwan	Emerging	0.88	25th	Italy (0.88)
United Kingdom	Developed	0.88	26th	Czech Rep (0.87)
Vietnam	Frontier	0.62	127th	South Africa (0.63)
India	Emerging	0.55	136th	Ghana (0.58)

Meanwhile emerging markets investors struggle to access large developing country markets like Vietnam, Nigeria and Bangladesh, which are quickly integrating themselves into the global economy and 'emerging' as viable, long-term investment destinations. These 'frontier' countries are firmly emerging markets in socioeconomic terms.

This situation results in investors missing out on long-term investment opportunities. Equally, those countries excluded by emerging market indices are overlooked for portfolio flows which can help contribute to long-term socioeconomic development.

This is only one, albeit pertinent, example of the absurdity of investing according to an index, for the simple reason that they are necessarily backwards looking. Both in terms of companies and countries, they are composed of yesterday's winners, not tomorrow's. Investing through indices is akin to driving along a road by looking in the rear view mirror.

The concept of exchanges falling into categories such as developed or emerging is a diminishing cogent notion. It is becoming increasingly easy for companies to choose the location in which to list, such as Chinese entities in New York or Russian companies in Hong Kong. More and more businesses are now truly global, and are either listed in developed markets but derive a significant to large portion of earnings from emerging markets, or vice versa.

The index thus bears little resemblance to the opportunities available to investors in emerging markets. This is especially so when the indices include countries which no longer benefit from the strong sustainable development tailwinds that are expected to be the driver of potentially higher returns in emerging markets whilst excluding some which do.

Bottom-up stock-pickers should not be hamstrung in searching for returns for their clients by arbitrary indexes. The fact is businesses do not run themselves in line with indexes so therefore asset managers should not feel the need to allocate capital or define risk on such a basis.

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