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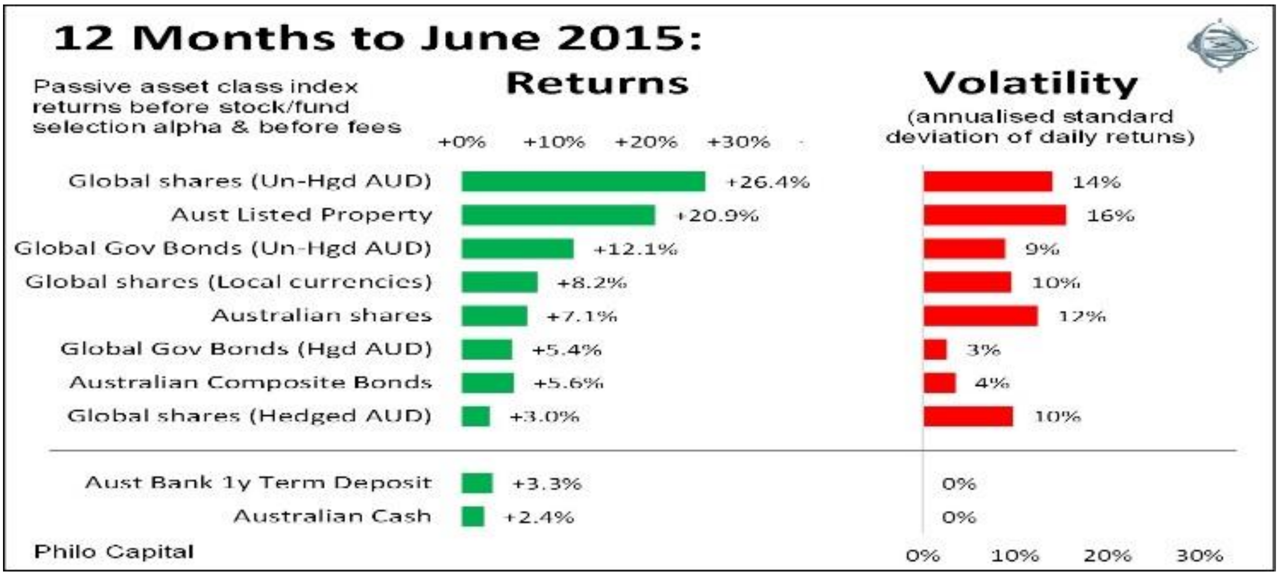
Another year of good returns and low volatility

Ashley Owen

The past 12 months have been kind to long term investors, with all asset classes generating positive returns well above inflation and cash rates, and with lower than average volatility. The chart shows passive asset class index (accumulation) returns for the 12 months to the end of June 2015 before fees.

All asset classes have done well, even 'defensive' bonds, but how long will it last? The dominant factors remain the same – the course of the European debt crisis and the pace of US interest rate hikes. The ECB and IMF appear ready to support banks and credit markets whether Greece leaves the Eurozone or stays. Also, the US Fed appears to be bending over backwards to ensure rate hikes are as slow and as well-signalled as possible, to limit the impact on business investment, consumer spending, mortgage interest rates, and markets.



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Australia

The most interesting development in macro policy in June 2015 was the public debate over Sydney house prices – whether or not they are too high, and whether or not they are preventing the RBA from cutting interest rates further. Recall that the price boom took off when RBA Governor Glenn Stevens started cutting interest rates in November 2011 with the stated intention of lifting prices in the hope that a housing construction boom might fill the hole left by the mining construction boom that has ended. Stevens now says the resultant 'crazy' house prices should not prevent him from cutting cash rates even further to try to bring down the dollar. The dollar would be lower were it not for the demand due to the flood of foreign money chasing residential and non-residential properties. Making further rate cuts more unlikely is the strong labour market, with the unemployment rate dropping unexpectedly to 6% on solid jobs growth. Another dampener was the relatively strong March quarter economic growth numbers released during the month.

Europe

Greece's dire debt situation continues to deteriorate. It has been fascinating watching the ECB and IMF come up with new creative ways to allow Greece to default (ie fail to pay interest or principal when due) without actually calling it a 'default'. Everybody, including the Greek government, knew the only way it could make payments would be with even more IMF debt that would be released if Greece agreed to a 'cash for reform' deal. The ECB and IMF finally have their heads out of the sand and are now openly planning how to remove Greece without making it too easy for others to follow. Aside from the Greek problem, the rest of Europe appears to be on the mend. Fears of deflation are receding and confidence and spending are rising, as is manufacturing production.

US

During June the March quarter economic growth numbers were revised downward to a contraction, caused largely by a huge trade deficit, in turn caused by the high US dollar driven up by investors preparing for upcoming US interest rate hikes. But data for the June quarter has been stronger. Retail sales are looking up and new building approvals are strong. Household incomes, spending and confidence are also improving solidly. The unemployment rate at 5.5% is continuing its slow decline since peaking at 10% in October 2009, and CPI inflation still running at zero, well below its post-GFC high of 3.9% in August 2011. Fed chair Janet Yellen appears to be signalling a start to rate hikes in the fourth quarter this year.

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Do franking credits matter?

Geoff Warren

Dividend imputation has been under scrutiny. The Tax Discussion Paper raises the notion that imputation does little to encourage investment in a small, open economy like Australia, where share prices and hence the cost of capital are set in international capital markets. Imputation is thus seen as a costly tax break for domestic shareholders with minimal associated benefits for the overall economy. The idea is that the removal of imputation could fund a reduction in the corporate tax rate, perhaps to as low as 20%, leading to a surge in foreign investment.

This line of argument has some merit: lowering the corporate tax rate should indeed attract additional foreign investment at the margin. However, this stance is somewhat narrow. To be fair, the Tax Discussion Paper is only airing a view for discussion, not making a policy recommendation. Nevertheless, it is worth asking what may be overlooked in adopting this line.

Mixed evidence on whether imputation is priced

The relationship between imputation and the return on investment required to satisfy the market (which might be called 'cost of capital') has been extensively examined in the finance literature. Unfortunately, there is no agreement.

One problem is that investors benefit from imputation to varying degrees. There are two theoretical approaches to solving this. The first involves identifying the 'marginal investor' – the last investor enticed to hold a stock, so that demand equals supply. The idea that share prices are determined in international capital markets implicitly assumes a marginal overseas investor who places no value on imputation credits. The second approach views share prices as reflecting some weighted average of investor demands. Here imputation credits would be partially priced, perhaps in accord with the 60-80% held by domestic investors.

Empirical analysis is no more enlightening. Four methods have been used to estimate the market value of imputation credits: analysing ex-dividend price drop-offs; comparing securities that differ in their dividend/imputation entitlements; examining if imputation credits are associated with lower market returns; and establishing whether stocks offering imputation credits trade on higher prices relative to fundamentals like earnings. Results are mixed. The majority of drop-off and comparative pricing studies find imputation to be partially priced, with a wide range of estimates. Meanwhile, footprints from imputation are hard to detect in returns and price levels. In any event, all empirical studies suffer from significant methodological issues.

Another issue is that the pricing of imputation might vary across stocks or time, perhaps due to differing marginal investors. For the smaller, domestic company segment where investors are substantially local, it is reasonable to expect that imputation might be priced.

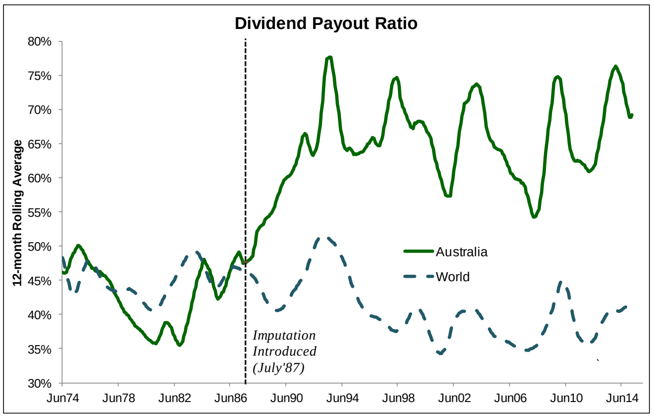
With the finance literature failing to arrive at a consensus, the assumption that imputation does not lower the cost of capital amounts to an extreme position along the spectrum. The possibility remains that imputation credits might be priced either partially, or in certain situations.

Imputation and behaviour

Of prime importance is how imputation influences behaviour, and whether these behaviours are beneficial or otherwise. This matters more than how imputation impacts 'numbers' like cost of capital estimates. Many decisions are not based on formal quantitative analysis; and imputation tends to be a second-order influence in any event. Analysis may be used to support decisions, but rarely drives them.

Recognition of the value of imputation credits has influence over behaviour in three notable areas, the first being the clearest and most important:

- **Payout policy** – Imputation has encouraged higher company payouts: the divergence in the payout ratio for Australia versus the world post imputation is stark (see chart). Actions taken by companies to distribute imputation credits clearly indicate they recognise their value to certain shareholders, e.g. off-market buy-backs.



- **Where taxes are paid** – Imputation encourages paying Australian company tax at the margin (referred to as 'integrity benefits' in the Tax Discussion Paper). If the tax rate is roughly the same in Australia and overseas, why not pay locally and generate imputation credits?

- **Portfolios** – Australian investors may prefer domestic companies paying high, fully-franked yields, all other things being equal. This preference is more likely to manifest as a 'tilt', rather than a dominating factor. There are multiple reasons for home bias, or the historical favour for bank stocks, for instance.

Would removing imputation matter?

Whether and how removing imputation would make a difference depends on what else happens, especially any concurrent corporate tax rate reduction. For instance, this could dictate the tenor of share price reactions, as effects from loss of imputation are pitted against higher earnings. Rather than delve into a multitude of possibilities, I offer two substantial comments.

First, removing imputation would do away with a major driving force for higher payouts. Higher payouts have contributed to more disciplined use of capital, through reducing the 'cash burning a hole in company's pockets', and creating more situations where justification is required to secure funding. This is a *MAJOR* benefit of the imputation system: a view also expressed by many fund managers. Hence dismantling imputation could be detrimental to both shareholders and the Australian economy through less efficient deployment of capital.

Second, imputation probably matters most for small, domestic companies, many of which are unlisted. In this sector, it is more likely that local investors who value imputation credits are the ones setting prices and providing the funding. Any adverse impacts from removing imputation may be concentrated in this (economically important) segment.

Imputation removes the double-taxation of corporate earnings, but only for resident shareholders. Reintroducing double-taxation for domestic investors in order to fund a revenue-neutral switch that provides a net benefit to overseas investors doesn't seem quite right. The notion that the outcome will be greater foreign investment with limited losses elsewhere appears questionable, especially once the implications for domestically-focused companies and potential behavioural responses are taken into account.

Geoff Warren is Research Director at the Centre for International Finance and Regulation (CIFR). This article draws on a paper titled "Do Franking Credits Matter? Exploring the Financial Implications of Dividend Imputation", written with Andrew Ainsworth and Graham Partington from the University of Sydney. The paper can be found at: *http://www.cifr.edu.au/project/F004.aspx*

House affordability, where are the institutions?

Adrian Harrington

Housing affordability has become a topical issue with everyone from politicians to the man in the street having an opinion. Top of the discussion list is negative gearing. Those in favour of its abolition argue the favourable tax treatment has created a surge of investment from mum and dad investors and SMSFs into residential property which has pushed up prices.

What is missing is the acknowledgement that without these investors we would not have a deep stock of rental accommodation. Despite having one of the world's largest pools of capital through the superannuation system, Australia's super funds and institutional investors have, for a variety of reasons (low yield, tax, inability to get scale), not invested in the provision of private rental accommodation.

Experience with overseas institutions

IP Real Estate, one of the leading magazines for global institutional real estate, has just published a major feature on institutional investment into residential real estate in Europe, the US and Canada. Here's a small selection of insights:

- Bill Hughes, Head of Real Assets at Legal and General Investment Management in the UK pointed out that they have invested more than £2.5 billion (A$5.0 billion) in the past three years across social housing, student accommodation and care homes, and have a pipeline of 29,000 units and 17,600 student accommodation units. He noted that "the proportion of residential real estate in portfolios can vary between zero and 30% at the moment, but proportions are expected to increase as the sector becomes more mainstream."

- Syntrus Achmea Real Estate and Finance, a Dutch real estate investment manager, has invested approximately €4.5 billion ($7.0 billion) in the Dutch residential market with 30,000 units in the portfolio.

- Ivanhoe Cambridge, the real estate arm of the Canadian pension fund Caisse de Depot et Placement du Quebec, plans to increase its residential exposure to 12%, up from 3% in 2011.

In the US, pension funds (the equivalent of our superannuation funds) and listed real estate investment trusts (REITs) are major investors into residential real estate.

According to the Pension Real Estate Association, which represents all the major US pension funds who invest in real estate, in 2013, 22.9% of their overall real estate allocation was invested in multi-family apartments and single family homes, a staggering $US49 billion (A$62 billion). In Australia, not one major super fund owns a portfolio of rental accommodation. Again, some do developments such as CBUS but just like Mirvac and Stockland, the developments are sold off upon completion.

Multi-family (the US version of apartments) represents around 13% of the total market capitalisation of all REITs listed on the NYSE. By way of comparison, we do not have one listed A-REIT on the ASX that provides residential rental accommodation (apartments or houses). We have a few listed developers like Stockland and Mirvac but they only develop and sell residential apartments and houses. We also have a few A-REITs focusing on seniors accommodation – AVEO for retirement villages, Ingenia, Lifestyle Communities and Gateway for manufacturing housing estates.

Who will provide the rental accommodation?

Before we go and change the rules around negative gearing, let's stop and think who will step in to provide the much needed rental accommodation in Australia? Based on the evidence to date, it won't be our institutions.

Adrian Harrington is Head of Funds Management at Folkestone Limited (ASX:FLK). This article is for general information only and does not take individual objectives into account.

SMSF technology isn't standing still

Andrew Bloore

Despite the rhetoric from institutional superannuation funds, the ongoing technology development of SMSFs as a simple, cost effective and self-directed superannuation vehicle continues to attract new members. The advent of user-focused tools enabling members to direct their investments, to receive information, to make decisions and to intuitively help members reach their own goals is moving ahead in leaps and bounds.

Technology improving for SMSFs

Technology is an enabler. SMSFs are more adaptable than other superannuation vehicles to the specific needs of a single individual. The day is coming where the majority of SMSFs can be administered and audited without paper or the intervention of people. The delivery of information can be tailored to provide an individual with what they need most. For example, a member can be provided with information from the fund's records as they walk in to see a broker or an adviser and display the assets held with that adviser or broker on their tablet or other personal device, just because their phone knows where they are. This personalises the experience and adds to the feeling of control that is the feature of SMSFs most desired by members.

Other ways SMSF technology is moving beyond administration is to add financial modelling or portfolio management tools, or comparisons with other SMSF funds on performance and risk metrics, or direct links to services such as share broking and company valuations. Better search engines can alert members to information on companies they have invested in, and link that with research tools.

Good use of data means the SMSF can do things that are specific to each member, tailored by them. Work that used to take time can be made simple. If the SMSF knows when a term deposit was opened and when it matures, it can remind the member and search for the best rates in the market, with an online mechanism to place the next investment. Link this with financial modelling tools and the SMSF becomes a vehicle focussed on the needs and outcomes of the individual.

Businesses that don't automate will lose clients

The vast majority of assets can already be tracked every day electronically and paperlessly. And as an administrator, I can assure you that the monitoring of assets is becoming easier. It will take some time for all institutions to catch up but eventually they will either be forced to provide information electronically or lose business to people who do (of course, there are many examples of individual asset prices such as for collectibles and real estate which are not tracked each day, but these are an exception).

UBank is the online bank subsidiary of National Australia Bank, and many clients use this bank for their competitive cash rates. However, they don't provide automated data feeds each day and as a result clients are forced to receive a statement and process their transactions manually from the statement. Clients with us have closed accounts and opened others because the marginal improvement in interest rates is not enough to offset the paper-based and time-lagged administration created by the lack of timely and useful information.

I hear you say that is just one account and it can't be that hard. What if you are working out exactly what pension has been paid and whether the minimums for the year have been met. Or what contributions have been made when the statements for June do not arrive until July. We can monitor this every day with a bank account that includes a data feed. Otherwise, we all have to get on the phone and expend time working it out manually. Making life easy is what technology can do the best for everyone.

SMSFs adapt to client needs

The basic premise of the Superannuation Industry (Supervision) Act (SIS Act) is the sole purpose test, which at its core is designed to provide a member with a result tailored to meet specific retirement needs. As superannuation balances grow, the importance of ensuring a fund is invested in a way that specifically benefits the needs of the individual becomes more important.

SMSF functionality has an innate ability to progress at the speed any individual wishes. I look at our clients and I am fascinated by the rate of change of their knowledge and needs. After all, no one cares about the financial position of an individual more than the individual themselves. Technology is not about providing choice as that exists regardless of technology. It is more about simple administration and ease of timely information. We are already in that world and the next generation of technology is being developed. It is fascinating to see the progress.

Andrew Bloore is Chief Executive of SuperIQ, a leading administrator and provider of integrated services for SMSFs. This article is general information and does not address the personal circumstances of any individual.

Let's debunk this myth about SMSFs and global shares

Graham Hand

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 recently 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 below.

In fact, Multiport believes the 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.

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 savings of over one million Australians, and the design of superannuation policy, the knowledge about what they invest in needs significant improvement.

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

Graham Hand is Editor of Cuffelinks.

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

Are Chinese investors still on training wheels?

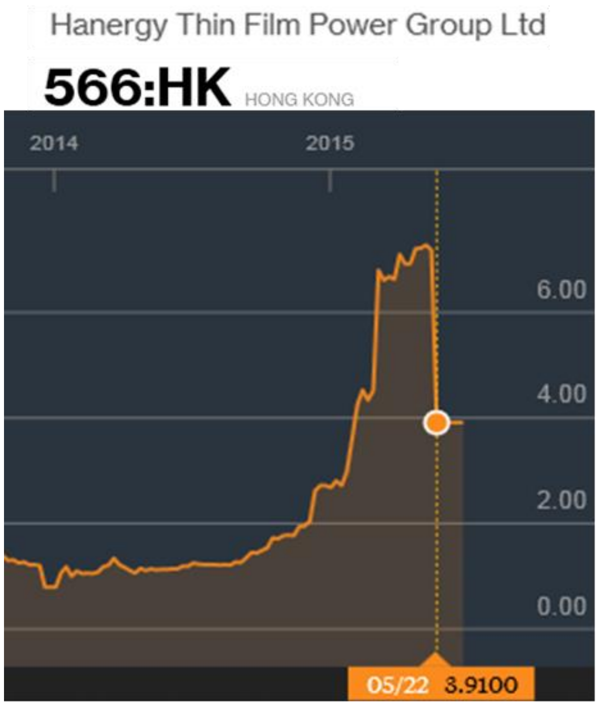
Jonathan Rochford

Watching the Chinese investment markets from a distance is a little like watching a young child learning to ride a bike. Rapid progress is being made but at any time it can all come crashing down. Whilst urbanisation briskly increased from 1982 it is only in the last few years that capital restrictions have begun to ease. Restrictions on lending and deposit rates are being loosened, property ownership restrictions are being dropped and access to the share markets has been freed up for retail investors. As a result, non-bank lending has grown exponentially, property has boomed and stock prices have gone up like a skyrocket. There's a real sense that in the last few years the training wheels have been removed and investors are being left to discover how capital markets work on their own. Whilst markets are going up everyone is happy but are investors even considering it is possible they can go down? Below are two case studies which might provide some insight on how much due diligence Chinese investors are undertaking.

Hanergy Thin Film Power Group

From the perspective of Chinese investors, Hanergy Thin Film was a one way trip to wealth with its Chairman, on paper, briefly reaching the top spot on China's rich list. The problem is that there is apparently little or no actual business and its 'revolutionary' technology is far from proven or profitable. The Bloomberg graph below shows that a year ago shares could be bought for little over one Hong Kong dollar, they peaked at 7.88, then crashed by 47% in a day and have since been suspended from trading.

Most shocking is that this is not a two dollar company. It grew to a market capitalisation of over US$40 billion with few questions asked. Barron's and Bronte Capital did some digging in the months before the share price collapse and concluded something was badly wrong. A simple wander around one site showed few employees and little activity, certainly nothing like what would have been expected by such a supposedly booming company. Information pointing to shorting by the Chairman and margin loans has emerged in the aftermath of the share price collapse, but the opaque related-party transactions and concerns about manipulation of the share price were well known before the collapse. One article asks whether Hanergy is China's equivalent to Enron. The Hong Kong securities regulator is undertaking an investigation and the shares remain suspended.



Zhuhai Zhongfu Enterprise Co.

Zhuhai Zhongfu has a real business selling plastic bottles to the likes of Coca-Cola and Pepsi in China. Business has been tough in recent years as some of its customers seek to bring their bottle manufacturing in-house. Revenues have been falling, there were big losses in 2012 and 2013 and only a small profit in 2014. Cash levels were declining and were far too small to meet a large portion of debt classified as a current liability. One line of its debt had last traded at a 19.3% yield in June 2014 before the bonds were delisted. A Chinese broker had named it as one of the four riskiest borrowers in China in April 2015. All of this is familiar territory for a company close to default and so there should have been no surprise when on 29 May 2015, Zhuhai Zhongfu couldn't repay all of the principal due that day.

What is unusual is that the share price rose by 211% in the year before the default on a fairly consistent upward trajectory with a market capitalisation of US$1.4 billion on the day of the default. The credit rating was at A+ until seven days before the default when it was cut to BB. Investors and the Chinese credit rating agency appear to have paid no attention whatsoever to the company financials which pointed to imminent issues.

Conclusion

As an outsider it is very difficult to know whether these companies are representative of listed equities in China. With a median P/E ratio of 75, an explosion in margin loans and a rapid increase in retail investors, suspicions are high that there is a bubble. What can be said with confidence is that in these two cases, Chinese investors didn't do basic due diligence such as visiting the company and reading the financials. If these two examples are representative of the Chinese share markets then a collapse that rivals the dot com bust or Japan in the 1990's could be on the cards.

Jonathan Rochford is Portfolio Manager at Narrow Road Capital. This article was prepared for educational purposes and is not a substitute for professional and tailored financial advice. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.