Cuffelinks
Connecting investors with ideas

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Scenes from a roboadvice pitch to angel investors

Graham Hand

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 Monte Carlo simulations assume normal distributions of returns, and seriously underestimate outlier results. Do you know we have had three falls in the stockmarket of over 50% in the last 40 years, but a Monte Carlo simulation predicts one only every billion years. I've no doubt your models will be wrong on the downside, then you might receive a knock on the door from a lawyer. 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.

Assume you are an angel investor. Would you invest in this business? What else would you need to know? Who will be the winners and losers?

Please take part in our short survey and we will publish the results in a couple of weeks.

How family offices differ from institutions

Jack Gray and Steven Hall

With tongue partly planted in cheek, George Soros maintains that each day investors should ask how their portfolio would differ if they began investing today. In that spirit and starting with a blank whiteboard, a group of seasoned Chief Investment Officers (CIO) and Advisers to High Net Worths (HNW) and Family Offices (FO) were invited by Brookvine to question the constraints of convention and legacy that underlie their investment practices. It's a process we call 'Whiteboarding'.

Constraints of convention and legacy

The exercise was triggered by a suspicion that much of those practices rest on the theories, experiences and characteristics of large institutional US investors. That raises two questions:

- Is some of what we use inappropriate for relatively small Australian HNW/FOs? If so, what different theories, practices, experiences and characteristics might be more appropriate?
- What *comparative* investment advantages (opportunities, skills, governance, decision-making, risk tolerance) do Australian HNW/FOs have?

Vigorous group discussions led to rich insights and tentative conclusions. Not surprisingly we only managed to scratch the surface of the two main questions; in that sense, we started and finished from scratch. At the very least the differences between the institutional and HNW/FO 'models' of investing were highlighted and clarified, differences we intend to explore further at greater depth in future Whiteboardings.

Some of these differences and similarities follow.

Investing models compared

HNW/FO clients are significantly more engaged than their institutional counterparts, a difference with powerful bearings on decision-making and strategy. Because non-financial purposes such as lifestyle and values are important to HNW/FO clients, deep engagement is crucial. Prioritising non-financial objectives is a key decision rarely found in the

institutional world. Further complicating that decision, objectives can diverge markedly across individuals, especially across different generations.

Managing competing objectives of near-term dependable income, long-term capital appreciation and capital/inflation protection is also common in the institutional world, though income requirements tend to have higher priority for HNW/FOs. Curiously, and unlike the institutional world, while HNW/FOs spend considerable time with clients setting investment objectives, few have promulgated a set of firm, robust investment beliefs.

This difference likely has two sources. First, Advisers/CIOs to HNW/FOs have a different role; they are more like educators and influencers than just capital allocators. To succeed they need to be good advocates and listeners especially to clients' expectations, financial goals and lifestyle values. Second, they and their clients tend to have real-life investing experience gained through business building and a greater predilection for personal account investing. These result in a more hands-on and direct approach to investing that favours activity over principles.

Features of HNW/FO portfolios

HNW/FO decision-makers are more opportunistic and more prepared to invest in niche opportunities, such as alternative assets, tempered by access difficulties and the challenge of explaining risks and exposures. A common complaint regarding alternatives is a lack of quality independent manager research. HNW/FO decision-makers also pay less attention to industry preferences and norms. As a result their funds are far less diversified.

Younger generations however tend to be more concerned with diversification (including global investing) as a tool for preserving wealth, than founders who emphasise concentration as a tool for creating wealth. Founders' resistance to moving away from the sector in which they made their wealth and tax consequences create sizeable barriers to diversifying.

Naturally, tax plays a larger role in the HNW/FO world where decisions are frequently driven by tax considerations.

Two factors seem to lie behind HNW/FO's limited use of Modern Portfolio Theory including optimisers and other risk management tools. First, HNW/FOs are less concerned with risk described as volatility or tracking error and far more with risk described as (permanent) loss of capital and not meeting objectives. Second, the risks inherent in large holdings of property, founder businesses and legacy equity struggle to fit within the usual parameters of institutional investing. On the other hand, sequencing risk, a hot topic for institutions, is equally important for HNW/FOs because founders do worry about their wealth collapsing late in their life and in that of their family. Yet managing tail and other embedded risks is lower on their agenda in part because they lack the skills and experience some large institutions have in adopting and managing explicit hedges.

Cash holding and active management

Cash is an *active* component (typically *the* most active) of portfolios' tactical asset allocations and at times is held at quite high levels. HNW/FOs revert to cash when faced with potential risks and instability. By way of comparison, institutions tend to see cash as a residual (and occasionally as having option value.)

HNW/FOs have a strong preference for local managers as they are perceived as offering greater transparency and understanding through heightened bonding and trust, a likely *benefit* of domestic bias. A larger domestic bias to Australia (compared to institutional accounts) is seen as 'not unreasonable' and historically valid.

Active managers are strongly supported through a vibrant belief in the ability of Advisors/CIOs to identify and access top tier managers, though a small number remain strong advocates for passive, encouraged by the growing availability of relatively cheap specialised ETFs. Although very cost conscious, HNW/FOs are more focused on net-of-fees returns than their institutional cousins. They are more open to higher cost opportunities where justified by (necessary) complexity and/or capacity constraints.

Governance tends to be based on simple principles executed through high client engagement, which makes decision-making more timely than in the institutional world. As part of that simplicity, investment teams tend to have flat structures with

minimal specialisation by asset class or investment opportunity and a high degree of delegation to individuals.

Diversification

Participants were pragmatic about diversification. Having lived and worked through many investment cycles and crises they understand how a naïve reliance on diversification can fail at points of inflection. They also tend to focus on what they think 'works best' over time, consistent with their experience, skills and knowledge. What does 'work best' varies across HNW/FO organisations to a greater degree than it does across institutional investors.

Sufficiently many rich insights were generated for Brookvine to have already led Whiteboarding 2 that explored this topic, diversification, in greater depth.

For more insights into the ways HNW/FOs look at investing, the link is here Whiteboarding 1 Report.

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The shift to the cloud

Michael Poulsen

The enterprise technology industry is currently undergoing its most significant transition in two decades. Cloud computing has emerged as a compelling alternative to the traditional deployment of IT resources on premise, giving rise to new, multi-billion dollar cloud businesses, and disrupting incumbent IT vendors.

Major cloud applications

"It's not water vapor. It's a computer attached to a network." Larry Ellison, Oracle CEO, 2009

For most people, interaction with cloud computing is done through the consumer cloud services that they access on a regular basis. Streaming cloud services like Spotify and Netflix have revolutionised consumers' consumption of media, delivering a catalogue of music and video via the internet for a monthly subscription fee. Apple's iCloud centralises the storage of photos, documents, contacts and other information on Apple's servers, accessible from multiple connected devices. Similarly, Dropbox has transformed file storage by allowing users to store files on its servers rather than locally on their PCs or other devices.

Cloud computing is also having a dramatic impact on the way enterprises use technology. Traditionally, enterprises have purchased hardware and software licenses upfront, installing and managing equipment in on-premise data centres. However, cloud vendors have increasingly enabled IT resources to be hosted in third-party data centres, and delivered over the internet for a subscription fee. This model of IT is often referred to as 'public' cloud delivery, because enterprises typically share IT resources with many other enterprises, hosted in hyper-scale cloud data centres.

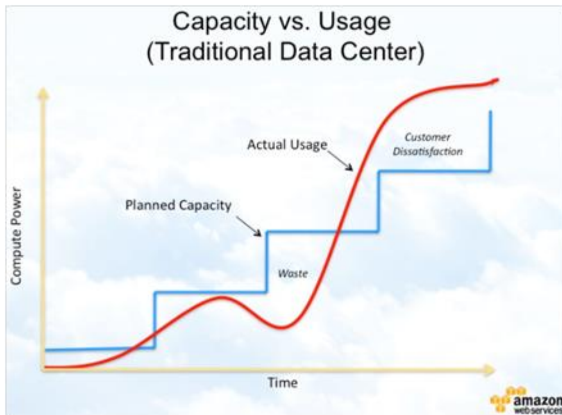
Sales automation software company Salesforce.com was among the first and most successful enterprise cloud computing companies, having grown rapidly since its creation in 1999. It was followed by Amazon, which launched Amazon Web Services (AWS) in 2006. AWS provides cloud computing and storage services, and is one of the largest and most dominant cloud vendors today, with $4.6 billion of cloud revenue in 2014. In aggregate, market research firm Gartner estimates that the public cloud computing market was worth over $150 billion in 2014, and expects it to double by 2019.

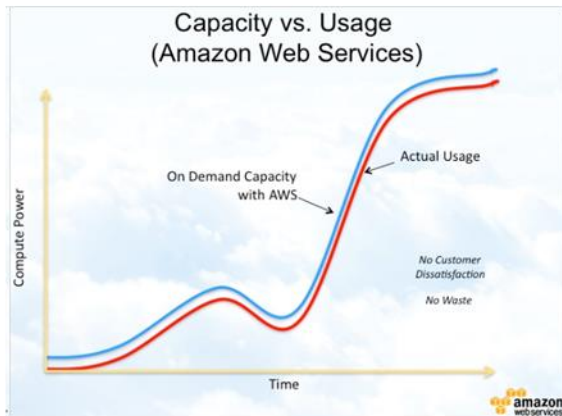
Benefits and adoption

Cloud computing confers a number of benefits:

- It enables enterprises to benefit from the economies of scale achieved by their cloud vendors, often reducing the total cost of ownership of enterprise technology, and improving the quality of their IT.
- Subscriptions for cloud services are typically billed on an ongoing basis, reducing significant upfront costs.
- While on-premise hardware and software resources can be difficult and time-consuming to provision, enterprises are now able to provision cloud hardware and software with the click of a button.

- As shown below, the cloud allows enterprises to adjust their cloud hardware and software capacity according to their needs, increasing the efficiency of their technology expenditure. This flexibility enables smaller firms to scale up and down quickly as required. For example, a promotional web article or video might prompt a spike in traffic to their website.





Source: Amazon.

Cloud computing has so far been most readily adopted by smaller enterprises, which are likely to derive the most significant benefit from the scale and resource utilisation achieved by cloud vendors. In 2013, approximately 50% of Salesforce.com's revenue was sourced from small and medium-sized businesses with fewer than 1,000 employees. Likewise, WorkDay, which sells payroll software in the cloud, has been focusing on mid-market customers in the United States. AWS has been extremely successful in attracting and supporting the growth of (former) start-ups, including Uber, Airbnb, Netflix, Spotify, Yelp, and Shazam.

Among large enterprises, cloud adoption has focused on discrete business processes and development and testing workloads. Large enterprises have typically few incentives to migrate mature, mission-critical processes to the cloud. This is the case for commonly-used custom airline reservation systems running on IBM mainframes, integrated Oracle financials applications, or SAP supply chain management products used by multinational companies. Large-scale migrations may be multi-billion dollar undertakings, and can involve material transition risk. Large enterprises can also be affected by regulatory considerations, data sovereignty or security concerns.

Example: implications for Microsoft

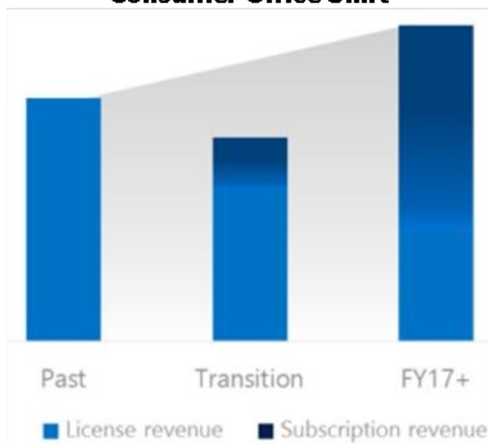
New cloud entrants threaten to disrupt the businesses of incumbent IT vendors. After achieving consumer success with its Gmail service, Google released 'Apps for Work', which delivers email, word processing, and spreadsheet functionality via the internet, in competition with Microsoft's lucrative Office business. Concurrently, Amazon offered its customers the ability to initiate and migrate server workloads to the public cloud, and improved the ease with which they could implement alternatives to Microsoft's software.

Microsoft has aggressively responded to these challenges, releasing the cloud-delivered Office 365 productivity suite and its Azure cloud platform. Cloud customer benefits include: mobile access to Microsoft software products, latest updates, and enhanced functionality, all with lower implementation and management costs. It is not surprising that Microsoft's commercial cloud business grew by 88% in the fourth quarter of 2014, after posting seven consecutive quarters of triple-digit growth. It now has an annualised revenue run-rate in excess of $8 billion, making it the largest enterprise cloud vendor globally.

However, the shift from the sale of on-premise licenses to cloud subscriptions has materially affected Microsoft's revenue and earnings in the short term. While it has traditionally recognised one-time on-premise sales upfront, cloud contracts are typically characterised by smaller, ongoing payments. It will take time for cumulative subscription revenue to exceed the value of cannibalised on-premise sales. Meanwhile, the cost of delivering cloud software is structurally higher than on-premise. Microsoft's cloud earnings margins should, however, expand as its cloud business grows and it improves the utilisation of its data centres.

It is Magellan's view that in the longer-term, Microsoft is likely to benefit significantly from growth in its cloud business. Cloud delivery increases the addressable market for Microsoft's products by allowing enterprises to access, deploy, and manage its software products more easily and cost effectively. Microsoft considers that the lifetime value of transactional Office customers increases 1.2-1.8x when they migrate to the use of Office 365. Cloud delivery may also allow Microsoft to launch new, innovative products that were previously not feasible on-premise, such as machine-learning software leveraging Microsoft's hyper-scale data centre network. Cloud delivery of Office could also reduce piracy over time.

While the upfront price of Microsoft's cloud products is lower than its on-premise products, the cumulative total price of its cloud products over time is likely higher. This dynamic is particularly apparent with respect to consumer Office 365. Office 365 has a subscription price of $100 per annum, a large discount to the circa $180 upfront price on-premise. However, customers have historically only upgraded their on-premise Office licenses every five to seven years, implying an equivalent price of $26-36 per annum on-premise. As shown below, the short-term headwind of lower upfront revenue is dwarfed by an indicative longer-term benefit from the shift to cloud subscriptions.



Source: Microsoft, 2013.

Shift to the cloud affects many businesses

The shift to the cloud has had a significant impact on the enterprise IT industry, and presents challenges and opportunities for incumbent vendors. As they transition, many inherently stable software companies may experience short-term earnings and stock price volatility well in excess of any change in their underlying value. Such volatility may potentially present attractive investment opportunities for long-term investors.

Michael Poulsen is an Investment Analyst covering the Information Technology sector at Magellan Asset Management Limited. This article is for general information only and does not take individual investment objectives into account.

SMSFs investing in overseas real estate

Monica Rule

A question I am often asked is whether SMSFs can invest in overseas real estate?

Under the superannuation law, whether SMSFs invest in properties situated in Australia or overseas, the legal requirements are the same. For example:

Sole Purpose Test: The property investment must be made solely to provide retirement benefits for members and cannot be for private use or for use while holidaying in the foreign country.

Trust Deed and investment strategy: The property acquisition must be allowed by the SMSF's Trust Deed and be consistent with the SMSF's investment strategy.

Arm's-length transactions: The purchase price for the property and rental income from the property must be at the market rate.

Related-party acquisitions: The property should not be acquired from members or related parties of the members unless it meets the legal definition of a 'business real property'.

In-house asset rules: The purchase of the property and leasing of the property must comply with the in-house asset rules under the law.

Borrowing: If borrowing is required, it must be a legally complying Limited Recourse Borrowing Arrangement (LRBA).

Understand the ownership laws in the foreign country

If the laws and customs of the foreign country allow a foreign investor (ie the SMSF) to invest directly in real properties (without a local entity intermediary), then the SMSF will not have a problem as long as it satisfies all the requirements of the superannuation law. The SMSF trustee will need to maintain documentary evidence as proof that the SMSF owns the overseas property and that the ownership is recognised in the foreign country.

In many countries, however, a foreign entity cannot hold a property directly. Therefore, an SMSF may need to establish a local entity which buys the property for the SMSF, with the SMSF owning all the interest in the local entity. The local entity may also need to be a taxpayer in that foreign country. As a result, indirect investment in overseas real estate can be a problem for SMSFs.

I have encountered transactions where the SMSF trustees needed to establish a Limited Liability Company (LLC) in the foreign country with its own bank account. The SMSF then invested in the shares of the LLC which then used the capital to finance the acquisition of the overseas property. The LLC is used as a flow-through vehicle for tax purposes. Any tax paid by the LLC may be eligible to be claimed back as a credit in Australia under the double tax agreement.

Watch the 'in-house asset' test

The problem with this requirement is that the investment by the SMSF in the LLC is treated as an 'in-house asset' under the superannuation law. The law only allows an SMSF to invest in a related entity and for the related entity not to be treated as an in-house asset, if the related entity is a non-geared entity. One of the requirements of a non-geared entity is that it does not have a loan with another entity unless the loan is a deposit with an authorised deposit taking institution which falls within the auspices of the *Banking Act 1999*. Unfortunately, overseas bank accounts do not comply with our banking legislation and therefore the SMSF investment in the LLC would be considered an in-house asset. This means the SMSF is restricted to an investment in the LLC of 5% of the total value of its assets.

An SMSF trustee would also need to consider the risks associated with fluctuations in foreign currency and exchange rates. All superannuation assets need to be converted into Australian dollars for financial statements. The dollar variations could affect other calculations in SMSFs such as member balances and minimum pension payment requirements.

If an SMSF needs to enter into a LRBA to acquire an overseas property, it may have difficulties finding a lender, as the lender would be lending money to the SMSF to acquire shares in the LLC. Most banks will not lend if the security on the LRBA is overseas shares. If a foreign bank provides the loan to an SMSF, the documentation on the loan may not be consistent with the LRBA requirements under the superannuation law and the nature of the loan may, therefore, not be limited recourse.

Overseas investments can be complex and also come with higher risk due to the laws and customs of the foreign country. SMSF trustees need to consider overseas investments very carefully.

Monica Rule is an SMSF specialist and author, see www.monicarule.com.au. This article is general education only and readers should seek specialist advice before taking action.

Mortgage funds: if only we had a trendier name, like P2P

Lachlan Perks

When was the last time you saw a *positive* story about a mortgage fund in the financial press?

The only time a mortgage fund or its operator is mentioned in the press these days is to chronicle what went wrong in the wake of the GFC, detail the mismanagement that took place and update the public on the progress of the multitude of court cases being brought about by ASIC and others.

There is no denying that, post-GFC, some operators of mortgage funds have been shown to be foolish or greedy at best and, at worst, criminal. However, the GFC brought into focus a lack of corporate governance, excessively risky management decision-making and misleading marketing practices across a whole range of industries and asset classes.

Post-GFC, almost every other asset class has been allowed to reform itself and prove to the investing public that it has changed and is worthy of a second chance. Mortgage funds do not appear to have been afforded this same opportunity. Instead they seem to have been consigned to a purgatory of mistrust.

Contrast this situation with the burgeoning crowdfunding and P2P (peer-to-peer) lending industries. In the many newspaper columns dedicated to these industries, the coverage is almost universally positive. There are few questions being asked about whether these platforms are actually offering an acceptable risk-adjusted return to the investor. Interest in digital methods of raising capital seems to have reached the point where the mode of capital raising is of more interest than whether or not the investment would satisfy basic investment fundamentals.

Sometimes I joke that if I operated my fund through a fancy online presence and called myself a P2P lender, I would be hailed as one of the 'entrepreneurs', the 'innovators' seeking to 'disrupt' the banking industry, a modern day Robin Hood hell bent on 'democratising' property-related financing and bringing it to the masses. Instead, as my business only has a modest online presence, our fund is called a 'mortgage fund' and is largely disregarded. Am I the only one that sees this contradiction?

This article seeks to dispel the idea that all mortgage funds are bad news. Choosing to disregard all debt-based investments because of the historical bad behaviour of a few is throwing the baby out with the bathwater.

A common misconception about debt

People seem to find it difficult to differentiate between the risks of taking on too much debt as a borrower and making an investment that is backed by a debt.

Many people would have little hesitation in investing in either a commercial property syndication leveraged at 60% or buying a residential investment property leveraged at 70%. These investments would probably be considered relatively conservative. However, if the opportunity is presented to invest in a loan that is secured by a first registered mortgage over that same commercial property leveraged at 60% (or the residential property at 70%), many of those investors would consider it a very risky proposition. This attitude fails to appreciate that the debt position secured by a first registered mortgage within the capital stack is the lowest risk – it is actually the equity component that provides the debt investors with their first loss buffer.

For example, consider a residential investment property purchased for $800,000 using 70% leverage:

Initial Purchase of Investment Property	
Asset value	$800,000
Debt (70% LVR)	$560,000
Equity (exc. costs of settlement)	$240,000
Total	$800,000

Now consider the position if the value of the investment property falls by 15%:

15% Reduction in Asset Value	
Asset value	$680,000
Debt (82.35% LVR)	$560,000
Equity (exc. costs of settlement)	$120,000
Total	$680,000

As you can see from this simple scenario, if you are an investor in the equity component of the capital stack you have lost 50% of your equity. However, if you are an investor in the debt component then 100% of your investment is preserved and there is further buffer to protect your investment from any further deterioration in the underlying asset value.

Not all mortgage funds are created equally

Although they are often thrown in the same bucket, there are actually three quite distinct structures that fall within the 'mortgage fund' moniker: debenture issuers, pooled mortgage funds and contributory mortgage funds. For example, a contributory mortgage fund gives the investor absolute control over which mortgage funding opportunities they invest their money in. These different structures may bring about very different investment experiences and outcomes.

The GFC highlighted the frailty of some debenture structures as well as the misleading claims used to promote pooled funds. Neither of these structures were able to deliver on the promises of their pre-GFC marketing flyers. In contrast, contributory mortgage funds emerged from the GFC relatively unscathed.

Moving forward, I believe contributory mortgage funds will become the preeminent structure within the mortgage fund industry, pooled mortgage funds will continue to have their place but will be accompanied by more modest claims as to their liquidity whilst debenture structures are unlikely to remain viable.

Changes in the banking landscape has created opportunities

The Australian banking landscape has undergone enormous change since the onset of the GFC. Consolidations have occurred within Australian banks, global banks have withdrawn or moved toward niche markets, and new macro prudential controls continue to be introduced.

These factors in combination have led to a situation where banks are highly selective in terms of the type of lending that they do, and have tended to favour residential home loans at the expense of commercial loans. Accordingly, well credentialed borrowers who would previously have been able to access bank finance are now turning to private finance or are unable to have their funding needs met at all.

This shift in the banking landscape has created a fertile environment for the mortgage fund industry and the providers of private finance.

Conclusion

Whilst P2P lenders may promise returns of 8 to 10% per annum, which sounds attractive as a headline, these loans are typically unsecured. By contrast, many mortgage funds also offer returns of 8 to 10% per annum but secured against a first registered mortgage over real property thereby offering a superior risk-adjusted return.

Lachlan Perks is the Co-Founder and Director of Keystone Capital, manager of a contributory mortgage fund designed for wholesale clients. Lachlan is also the Managing Director of property funds management business, PPI Funds Management.

This article does not constitute formal advice and contains general information only. It does not consider the individual needs of any investor.

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