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This Week's Top Articles

- **The long and the short of investing** *Roger Montgomery*
- **7 factors affecting the residential property outlook** *Jonathan Rochford*
- **Ructions in the SMSF market** *Gordon Mackenzie*
- **The golden years: the economics of increased longevity** *John Piggott*
- **SMSFs can lend to some relatives but not others** *Monica Rule*
- **Don't judge all small companies by the poor index returns** *Simon Conn*

The long and the short of investing

Roger Montgomery

The western world is living through a unique period in its history. Social, business, technological and generational disruptions are converging, including seismic shifts in the relative power of continental empires. This presents an opportunity for a strategy incorporating 'short selling' (also called a 'sold portfolio'). Currently relegated to the 'alternative' category of a portfolio, it could arguably be considered a core for many investors.

Change of course is a constant but much rarer are the multiple fronts on which it is occurring, and its pace is unique.

How does short selling work?

Imagine you discovered your local car dealership would soon be launching a 50% off sale for the same model car your neighbour owns. Is there a way you could profit from this hypothetical scenario?

If your neighbour is open to renting their car to you for a few weeks or months, with the promise of course that you'd return it, you could immediately sell it at the current market price (say, $30,000) then use the cash to purchase the same car in the local dealer's sale (for $15,000). You can then return the new car to your neighbour and pocket the difference as your profit (in this case, $15,000).

By borrowing shares and paying the lender interest and the dividends, an investor can build a portfolio of 'sold' positions, also known as 'short' positions, which aim to be re-purchased at lower prices.

I have deliberately kept the short selling analogy brief to illustrate the concept.

In 1886 when Karl Benz first drove his Benz Patent-Motorwagen horseless carriage past a blacksmith, it would have been impossible to predict which manufacturer of this world-changing technology would succeed. In the US alone there have been 1,665 car manufacturers that are now defunct. Picking a winner, even in seismic shifting technologies, is difficult. It was far more challenging to predict the winning car manufacturer than it would have been to pick the blacksmith as the loser. And therein lies an opportunity.

Now add to the disruption narrative, the 'new normal' environment of lower returns. If it is true that interest rates normalise and corporate profits grow at slower rates or margins mean revert, then it is also possible large double-digit aggregate stock market gains will give way to much more modest numbers.

The shorting opportunity

There are many reasons why an opportunity to establish a short position may be presented but practitioners cannot simply flip the process and philosophies of value investing. If value investing involves buying quality at discounts to intrinsic value, a successful short selling strategy is not simply selling expensive poor quality companies.

1. Fraudulent behaviour

Perhaps the most frequently cited strategy, but surprisingly least attractive on a risk-reward basis, is fraud within a company. Accounting and executive frauds typically produce market misperceptions. A very good fraud by definition can generate a misperception that lasts many years, and for this reason selling such discoveries in the hope of profiting from a subsequent share price decline upon the fraud's exposure inheres great risk. To mitigate this, participants using this strategy will often publicise their discovery and use the media to lubricate the dissemination of information (or misinformation, if they're incorrect). A recent example of this activist technique is Pershing Square's very public criticisms of Herbalife and their argument that it is a pyramid scheme.

2. Thematics and structural decline

The disruption idea fits into this category, which also includes structural overcapacity, deleveraging cycles and obsolescence. For example, the change in entertainment viewing habits, the crackdown on corruption in China, the changing competitive landscape in the Australian supermarket sector and the adjustment to lower coal and iron prices can all be included in this category.

3. Unexpected events

When expectations diverge from reality a third category of opportunity emerges. We have observed that sell-side analysts can sometimes be slow to downgrade their hitherto-optimistic earnings, revenue and same store sales expectations, even in the face of evidence the outlook for a company may be changing. When expectations diverge, an opportunity to take advantage of the subsequent downgrades can present opportunities for returns.

4. Financial risk

This final category can accelerate the potential of the first three. Financial risk includes balance sheet risks from excessive leverage and exposure to regulatory changes.

Of course, the best opportunities will have aspects or elements of several of the above categories and investors should ask why little of their portfolio is allocated to take advantage of the shorting opportunities presented every year.

Whether you call it creative destruction, transition or disruption, the result is that there will always be winners and losers. If betting on the little white ball landing on red is acceptable, is betting that it doesn't land on black also acceptable?

A place for short selling

Markets serve the real economy best when they efficiently allocate capital and effectively price in all available information. In a 2009 consultation paper, the UK regulator, the Financial Service Authority, explained:

"We have consistently made it clear that we regard short selling as a legitimate investment technique in normal market conditions … Short selling can enhance the efficiency of the price formation process by allowing investors with negative information, who do not hold stock, to trade on their information. It can also enhance liquidity by increasing the number of potential sellers in the market."

Limiting the ability of rightfully sceptical investors to take the opposite side of a trade undermines efficient capital allocation and effective pricing.

Some investors believe that the risks of building a sold portfolio are unattractively skewed to the downside. The argument goes that the most you can make shorting a stock is 100% if it goes to zero, but the losses are infinite as the stock rises. The retort is that more stocks go to zero than to infinity!

More importantly and less understood however is the ability to compound returns. When selling a stock short, cash is received. If the stock does indeed fall in price, an investor can add to short positions without adding any additional capital. If one starts with a short position of $US100 with no other cash in their account, and the stock goes down to $US50, one can, without adding any more cash capital to the account, short additional shares. And if the position's direction remains favourable, returns

can be compounded.

Optimising with both long and short positions

The final point to be made is that a carefully-crafted strategy that incorporates both a purchased portfolio of high quality equities, and a portfolio of sold positions from the previously mentioned categories, can also reduce risk.

One portfolio buys shares in high quality businesses to make a profit from rising markets and prices. Another portfolio sells shares of businesses that are deteriorating so you have the opportunity to make a profit from falling markets and prices.

If these portfolios are the same size, as the market moves, one portfolio is likely increasing in value by the same amount as the other is decreasing. Your market risk has effectively been neutralised. You now have zero exposure to the vagaries of the general level of the market.

By way of example, a portfolio may have invested $100 in extraordinary businesses, while simultaneously having received $60 for the sale of another portfolio of sold positions. Cash is received for the sale of $60 worth of sold positions, which can be simply held in cash or used to add to the existing portfolio of purchased extraordinary businesses. If the $60 is held in cash, then the $60 worth of sold positions offsets the $100 of purchased extraordinary businesses and the investor's net exposure to the vicissitudes of the market is $40.

All things being equal, if the market were to subsequently fall 10% an investor with a portfolio displaying the above characteristics would expect to see the portfolio decline by only 4%.

Along with overseas exposure, participation in the effects of a heightened period of disruption and structural decline and the possible reduction in risk from a lower net exposure to the market are merely a few of the reasons why investors in volatile stock markets might consider whether such strategies could emerge from their 'alternative' allocation status and even become part of their core portfolio.

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

7 factors affecting the residential property outlook

Jonathan Rochford

In hindsight, it is easy to see that with seven key factors all having a positive impact on house prices in the last 20 years, strong price growth was inevitable. However, as the table below shows, it is not realistic to expect that this can continue, with the next five years looking like a mixed picture. The reasons for each view are detailed below.

Key Factor	Impact on last 20 years	Forecast impact on next 5 years
Tax system	Positive	Negative
Approvals to build	Positive	Neutral
Population growth	Positive	Positive
Interest rates	Positive	Neutral
Availability of credit	Positive	Negative
International demand	Positive	Negative
Momentum/sentiment	Positive	Negative

Tax system – Negative

In the next five years it is likely that Australia will implement wholesale tax reform. Twelve months ago most people thought I was crazy when I brought this up, but the national debate has advanced a long way. The Tax White Paper is due shortly, the recent Reform Summit spent most of its time focussing on tax inequity and we've got a new Prime Minister and Treasurer who have given signals that change is coming and the economy is the priority. With the politics involved it is not a done deal, but with a Prime Minister, two State Premiers, business groups and welfare groups making the case for change, the politics might be easier than many currently think.

Decreasing income taxes, removing negative gearing allowances, reducing or removing capital gains tax discounts and land taxes are all in the mix. The removal of stamp duty is being proposed by some, but that is highly likely to be linked to the introduction of land taxes. The vertical fiscal imbalance dictates that state taxes such as GST and land tax must increase whilst federal income taxes must decrease. The momentum behind simpler and

fair taxes including removing loopholes leaves the many current tax benefits for property exposed.

Approvals to build – Neutral

There has been a jump in the amount of building approvals in recent years and record numbers of cranes for residential construction now dot our capital cities. However, there is still solid opposition at both state and local government levels to further easing of the approval process. Governments in Victoria and Queensland that focussed on easing restrictions in order to promote housing affordability have both been replaced this year with governments that are more concerned about amenity and community consultation. In other states where high density construction hasn't seen the same boom there's been a mild lift in approvals that should continue if demand warrants.

Population growth – Positive

Natural population growth is slowing as the Australian population ages, as well as some couples deferring having children and others having fewer. The level of migration is also trending down. However, the overall rate remains around the 20 year average and is still well above almost all other developed economies. Whilst the Australian economy is not as strong as it has been, it is still one of the more prosperous and offers among the best prospects for those with skills and the will to work hard. Even if a substantial global economic downturn occurs, Australian population growth should remain high, with a better lifestyle continuing to attract migrants from Europe, India and China particularly.

Interest rates – Neutral

The current outlook for Australian interest rates is balanced, with little change predicted by interest rate swaps over the coming five years. There has been a small increase in rates for home loans with the possibility of more margin increase for loans that have higher risk characteristics such as high LVRs or interest only periods. The higher capital levels required as part of Basel III reforms are likely to see banks increase their net interest margins to protect their return on equity ratios. Home loans are an obvious target for further rate increases, in addition to the recent 'out-of-cycle' rises which included the main owner-occupied variable rates.

Availability of credit – Negative

The recent crackdown by APRA and ASIC on bank lending standards has tightened the availability of credit for the most marginal borrowers. These potential purchasers will need to save more or borrow less. After six years of recovery since the last financial crisis, the next five years is likely to bring another global economic downturn and this would further tighten the availability of credit. Australian banks remain heavy users of overseas capital, which means that in any crisis there is a much greater demand for locally sourced deposits and a need to reduce the amount of lending.

International demand – Negative

The recent report that Sydney's largest apartment developer, Meriton, has reduced prices and increased commissions in order to meet sales targets is arguably the clearest possible sign that overseas buyers are tougher to find. China has seen a minor run on its currency, which is completely rational as its citizens fear currency devaluation, confiscation of their wealth and are looking for better risk/return opportunities elsewhere. As a result, the Chinese government has been closing down avenues for capital to exit China, with reports that some buyers are struggling to have sufficient capital available by their settlement dates.

Momentum/sentiment – Negative

The massive buzz in Sydney and Melbourne property markets just a few months ago appears to have started to die down. Auction clearance rates have fallen and agents are starting to remark that vendors need to reduce their expectations. The decline in equity markets, slowing migration and the increase in interest rates are put forward as reasons for the reduced sentiment. Beyond the two largest cities price growth has been much more subdued with the pullback of mining investment impacting Perth and Darwin.

Conclusion

The solid growth in Australian house prices in the last twenty years has made Australia's housing some of the most expensive in the world. Pushing along this price growth has been a combination of seven key factors. However, only one of these factors is likely to persist as a positive influence on prices in the next five years with two factors

expected to be neutral and four factors likely to be a negative influence on prices.

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Ructions in the SMSF market

Gordon Mackenzie

Two issues that are currently working their way through the SMSF market could have a profound impact on the way that the market operates.

The first involves the way that the largest profession servicing this market, accountants, operates. The second involves an aggressive tax play involving SMSFs.

Let's start with a reminder of how the SMSF market is regulated.

What's happening to accountants?

While becoming a member of a SMSF technically is a dealing in a 'financial product', which would normally require the adviser to be licensed under the Corporations Act, accountants are, until 1 July 2016, exempted from those rules when advising on setting up or winding up a SMSF.

Now things are changing and accountants need, from that date, either a full financial services licence or a limited financial services licence, if they want to advise a client on setting up a SMSF and deal with their existing superannuation interest.

The most obvious client example where this would be relevant would be an individual coming up to retirement having, say, $700,000 in a retail or industry super fund, who wants to manage it themselves using a SMSF, as they will now have more time on their hands. Usually, they would seek guidance from their trusted accountant, but what will happen in future?

If the accountant goes down the licencing route, either as a licensee or an authorised representative of a licensee, their world changes significantly as the business will differ greatly from an accounting practice. At a macro conceptual level, licensees and authorised representatives work on a 'disclosure basis', in that the potential investor has to have all the risks associated with a potential investment disclosed and then they decide whether to invest or not.

At a legal relationship level, there are a whole range of rules for managing conflicts of interest by licensees and authorised reps, such as acting in the best interest of the client and not being remunerated by commission.

At a practical level there is also the paper work. Licensees and authorised reps must tell clients what they can do in terms of financial services (a Financial Services Guide) and, more importantly, they must document their recommendations and reasons for them (a Statement of Advice).

Compare this formal and stylistic way of working with that of an accountant, which is largely the reverse, where clients rely on and trust decisions and recommendations made by accountants. Ultimately, clients rely on the membership of a professional accounting body subject to its ethical and professional conduct restraints.

(Note, there are a few alternatives for accountants who do not want to go the licensing option, such as providing execution-only services or co-venturing with a licensed financial adviser who does all the activity requiring a licence).

ATO closing a contributions loophole

The other issue that will affect the SMSF market involves income tax. To limit the amount of tax benefits anyone can get out of using a SMSF, there are limits on how much they can contribute, both concessionally-taxed and after-tax. These are called the contribution caps.

It was different prior to 2007, when you could put as much into a SMSF as you wanted (not all of which would be deductible of course), but if you took out more that was considered reasonable, you paid extra tax. These were called the Reasonable Benefit Limits. From 2007, the tax system reverted to the way that it had operated before 1997, when there

were limits on the amount that could be contributed to a SMSF. Which is what we have now with the caps.

If instead of contributing to a SMSF and being limited by the contribution caps, you could lend all your wealth interest free, well, you have just driven a Mack truck through some pretty important integrity measures in the system, being those contribution caps.

As you are both the borrower, being a member of your SMSF, and the lender, why pay yourself interest? Indeed, that is what has been happening.

The ATO is now actively trying to resolve this serious integrity breach by reclassifying the income that the SMSF receives from the investment that it acquires with the funds that have been borrowed at zero interest from the member as "Non Arm's Length Income"- NALI, in the trade (an unfortunate acronym for those involved). That type of income is taxed at the **highest marginal tax rate** and not the preferential super tax rates of 15% or 0% if in pension mode.

After a couple of false starts, the ATO has now put the SMSF market on notice of the risk of tax at 47% on related party non-commercial loans.

The SMSF advising market seems to have got the message and are now saying that all loans to SMSFs, including from related parties, should be on full commercial terms. Not just with respect to the interest charged, but also in terms of LVRs and payment schedules.

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The golden years: the economics of increased longevity

John Piggott and Julian Lorkin

John Piggott is a scientia professor at UNSW Business School and director of the ARC Centre of Excellence in Population Ageing Research (CEPAR). A leading authority on retirement and pension economics and finance, he has been widely published, advised the World Bank, and actively contributed to government policy in Australia and internationally. Piggott spoke to Julian Lorkin for BusinessThink.

An edited transcript of the interview follows.

BusinessThink: I've seen various figures for how much we should be putting away for retirement – $1 million, or even $2 million, while others simply say, "As much as you can afford". What should we really be looking at?

John Piggott: Well, it depends how well you want to live in retirement. It also depends on how long you are willing to work before you start to rely on your retirement accumulations.

If your salary is not that high, you will be able to do it on the aged pension. In fact, three-quarters of the retired population currently draw on the aged pension, at least in part; half draw the full aged pension. So that gives lower income individuals a lot of income security. The aged pension in Australia is wage indexed – indexed to community standards – and so it's a very important form of longevity insurance for your old age. It goes on until you die; it's there for both you and your partner, so it's got many strengths.

If you are in the upper half of the income range and you want to maintain that standard of living, you need a remarkably large amount of capital. In many countries this is expressed in terms of what you would be able to draw down in a form of income for the rest of your life, but in Australia we express it as wealth and so the wealth seems very large. But people are going to live a long time and they are going to need a lot of wealth to maintain a commensurate standard of living through their retirement if they have been earning well through their lifetime.

BT: At the same time, when they have been earning well they have had huge expenses: think of the mortgage, raising children, all those extra expenses. Should people be thinking they should only retire once these are paid off, and therefore they just need the money to live?

Piggott: Well, patterns are changing. Now there is family breakdown which occurs much later than what was once the case. So people are now

approaching their retirement window with debt that they once would not have had and some of their superannuation accumulation is often used to retire that debt, so they are at least secure in their own home and they have what's left to supplement their aged pension, whatever it may be.

BT: People don't seem to think about how long they are going to live. It used to be three-score years and 10; now, that is almost treated as your working age.

Piggott: People almost always underestimate how long they might expect to live. A male in Australia aged 65 could expect to live past 90.

BT: And that's with current age spans which are, of course, increasing as medical care keeps getting better.

Piggott: Generally speaking, people need to be conservative in terms of how much they might need to get them through retirement.

BT: Particularly for those who get to retirement. They have a great celebration in the office at 65, and they are presented with a huge pot of money – they think – from their superannuation fund. What should they actually be doing with it?

Piggott: I think people like to have some control over the capital they receive and I think that's reasonable. There are all sorts of uninsurable events that happen later in life, they could be medical or something to do with their children and they want to have a discretionary pool of capital to draw on.

One possible way forward to combine that discretion with some longevity insurance is to insure late in life. There are some retirement products beginning to appear in Australia now, and I think there are policy initiatives afoot that will make them more accessible and more affordable. These are called deferred annuities. So, you can hang on to most of your capital, but for a relatively small sum of money you can buy an income stream which starts at, say, 85, supposing you live that long. One reason it's a small sum of money is that some people die and that becomes part of the pool for the payout. Another reason is you're putting this money in at, say, 65 and it accumulates until you are 85. So for maybe 15% of your superannuation capital you can buy something that gives you a respectable standard of life when you're older and that means you can plan what's left.

So when people ask, "What are you going to do with your retirement income?" the first question is: "Well, how long am I going to live?" But if you buy one of these things you only have to plan for 20 years – or whatever the gap may be – and that then becomes a well-posed question that you're able to answer. I think these kinds of products are a good half-way house between giving people some discretion over their retirement resources and some insurance, when they really need it.

BT: Other countries have had annuities for many years, and they seem to be much more popular, particularly in Europe, than they are in Australia. However, many Australians have never heard of an annuity.

Piggott: Well, that is true. The UK, in particular, had a very strong annuity market that was supported by very strong tax incentives and compulsion for some period. That has now been removed and it will be interesting to see what happens to retirement incomes and the annuity market with that withdrawal – whether new retirees end up buying annuities or buying some other kind of retirement income product, like what we have, which is account-based pensions that a lot of people use in Australia.

BT: Equally, if people don't have annuities they may try to stay in the workforce longer. This would have huge advantages for people who get a bit bored in retirement, but is it good for the country to have an older working force?

Piggott: Yes. I think policies everywhere are being devised to encourage mature labour force participation, to find ways of encouraging firms to keep workers on later. There is an argument which says these people are squeezing out the young but this is fallacious. The way to think about an economy is like a balloon that goes up and down with the amount of economic activity, and so in some sense, labour supply at mature ages creates its own demand.

Now if you're used to operating in an office which has 30 employees, you are thinking about a crate [and] you have to remove someone before somebody else comes in. That's not true of the

economy as a whole. It's called the lump of labour fallacy and it's been around for 100 years.

There is nothing but upside to mature labour force participation. It's a matter of finding appropriate incentives and appropriate workplace conditions so that workers can manage continued employment into a later age, at which point many people have other responsibilities, such as to their elders or their grandchildren. It's not a matter of taking leisure when you retire, it's a matter of family becomes more important. So workplaces have to devise mechanisms for accommodating that, in much the same way as a generation or two ago they had to devise mechanisms for coping with women with young children coming back into the workforce. They had special conditions.

BT: One thing that certainly was looking at policy was the Henry Tax Review, published in 2010, of which you were on the panel. I know it looked at the budget both state and nationwide. It seems to be implying we are heading for a larger structural deficit, which would of course make affording an older population more difficult. Is that really the case?

Piggott: Oh yes. I think a lot of it is driven by the ageing demographic. There's no question that per capita government expenditures will be going up, and those outlays will have to be financed. And, sooner or later, they are going to have to be financed by taxes. You can run deficits for a little while – our national debt is not a disaster by any means, yet – but there's only one direction with our tax reform.

So what should those reforms be? That's something that I think the tax white paper will address. On the table is an increase in consumption taxation – increasing the rate of the GST – [and] maybe increasing the progressivity of the personal income tax. People have talked about the top rate of personal income tax going to 51%. It's currently 49%, it was 47%, but then there was a levy. A deficit emergency levy. It could go up further. Personally I would not be opposed to that but I think that is an issue for the community and community consensus.

BT: But in all of this, we are missing that one piece of good news, which is that we are living longer.

Piggott: It's a victory for humankind and it's all happened in the past 200 years. We are in a lucky time to be alive.

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SMSFs can lend to some relatives but not others

Monica Rule

I have always found it odd that SMSF members can have their SMSF trustee provide financial assistance to the members' cousins and former spouses, just not to other relatives. How is this possible?

Who is a relative?

It's not clear if it was intended but there is a loophole in the superannuation law. The law prohibits SMSF members from providing financial assistance to members and relatives of the members of an SMSF. However, the definition of a 'relative' of a member of an SMSF is a parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the individual or of his or her spouse; or, a spouse of the individual or of any other individual referred previously.

As examples, cousins and former spouses are not mentioned. Therefore, SMSF trustees can provide financial assistance to their cousins and former spouses as long as the terms of financial assistance are at arm's length and in accordance with their SMSF's investment strategy. This means the loan should be documented so that it is enforceable by the SMSF trustees should there be a problem and interest at the market rate must be charged on the loan.

You may think that cousins and former spouses are included in the definition of a related party somewhere under the superannuation law. In fact, they are. Cousins and former spouses are included in the section which outlines who an individual can establish an SMSF with. This area of the law states that you can establish an SMSF with a relative.

Here, the definition of a 'relative' of an SMSF member is a parent, child, grandparent, grandchild, sibling, aunt, uncle, great-aunt, great-uncle, niece, nephew, **first cousin or second cousin** of the individual or of his or her spouse or **former spouse**; or, a spouse or **former spouse** of the individual, or of an individual referred to previously.

As long as none of the members of an SMSF is a child of a cousin or of a former spouse; and, none of the other members of the SMSF is directly related to the cousins such as being the spouse of the cousin or being a parent of the cousins, the SMSF would not be prohibited from providing financial assistance to these people. Otherwise they will fall within the parameters of being a 'relative' due to the parent relationship or spousal relationship existing between the two parties.

Always check the related party rules

I love working with the superannuation law, but when an important defining term can include one relationship under one area of the law and exclude it in another, I can understand why many people find it frustrating. These inconsistencies seem odd, and it does make understanding tricky for the average SMSF investor. The important thing to remember here is that it's always best to talk to an SMSF specialist before proceeding with any related party transactions.

Monica Rule is an SMSF specialist and author, see www.monicarule.com.au.

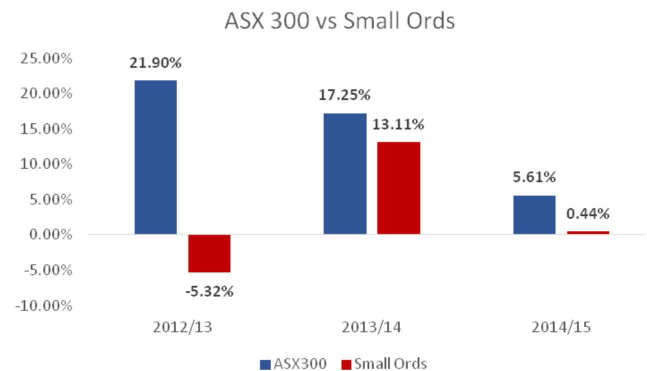
Don't judge all small companies by the poor index returns

Simon Conn

When I reflect on the Australian equities industry over a number of cycles, I believe that the small cap sector is still fundamentally misunderstood in terms of investor outcomes. Small caps are normally seen as either an opportunity for phenomenal growth outcomes – a way to add 'spice' to more conservative portfolios – or, as prone to absolute carnage and wealth destruction. It is uncommon for investors to see smalls as part of a sustainable long term strategy, for apparent good reasons.

Small cap index returns disappointing

The small cap index has been basically flat over the last three years, during which time the broader ASX300 has gained over 9% per annum. Looking back further, over the last 10 years (as at 30 September 2015) the Small Ords Accumulation Index has delivered investors close to a zero return. It is no surprise then that investors push back when advisors recommend an allocation to small caps.



What explains this underperformance of the small cap index? This index, by its very nature, is more susceptible to market fluctuations due to the fact it includes less tested and more trends-based stocks, such as newly-listed Initial Public Offers. It is also an index that can change rapidly in composition over time. As the mining boom took hold, for instance, investors saw the small cap miners grow from a small percentage of the index to over 40% at the peak of the boom. Most stocks associated with mining recorded strong capital gains as they were bid up to extreme valuations with demand exceeding supply. Investors were chasing the dream of ongoing capital appreciation. Then, as commodity prices fell, the anticipated profits of these companies largely evaporated, destroying investor wealth.

Similarly, the tech wreck of the early 2000s was driven by hope and an indiscriminate belief that every company would experience ongoing capital appreciation.

How is it possible then that over the same period of time some well-credentialed fund managers have delivered solid investment returns?

Not all small caps are created equally

The first lesson is investors should not tar all small caps with the same brush. The sector should be

approached with a disciplined investment philosophy, in line with their large-cap objectives. Smaller does not have to mean lower quality. A bottom-up research process can reveal a number of small companies with attributes that can generate sustainable long term returns – competitive advantage, predictable earnings and sound management – trading at a reasonable price.

Sustainable long term returns are a function of both capital growth and growing dividends over time. Consistent and growing dividends are not typically associated with small cap investing. However, from our perspective, this income is an attractive feature of many higher quality smaller companies and is not something investors should forsake for being active in this space.

Steadfast and Pact Group are excellent examples of companies with these quality long term investment characteristics.

Steadfast is an industry leader in Small to Medium Enterprise insurance broking and underwriting with 750 offices across Australia, New Zealand and Singapore. Its broker business has strong bargaining power with insurers, providing them with a distribution channel which cannot be easily replicated. The broking relationship is sticky with client renewal rates over 90%, underpinning a resilient earnings stream. Its underwriting agencies are complementary to the broker business. Going forward, investors can expect earnings growth to come through further acquisitions of brokers in its network, as well as acquisitions of underwriting agencies.

Pact Group is the largest manufacturer of rigid plastics in Australia and New Zealand, with a small presence in the fast-growing Asian region. The majority of Pact's customers are manufacturers of well-known household and dairy products, including Unilever and Fonterra. Pact also benefits from a dominant market position in a game where scale has significant benefits in the procurement of raw materials, reducing overheads and maintaining a national network of infrastructure and expertise. The real opportunity for Pact is to continue their successful track record of growing through sensible bolt-on acquisitions. The company has grown this way for many years with 43 completed since 2002.

There are many other quality stocks in this sector of the market, which together in a well-constructed portfolio present investors with the ability to generate sustainable earnings growth in the current low growth environment.

Investors should not be put off by the anaemic returns recorded by the small cap index over the last few years, but focus on what active management can achieve with a disciplined process.

Simon Conn is Senior Portfolio Manager at Investors Mutual Ltd. This article contains general financial information only and does not consider an individual's personal circumstances.

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